

SILICON GRAPHICS INC  
Form 10-Q  
February 06, 2008  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, D.C. 20549**

**FORM 10-Q**

(Mark One)

**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
For the quarterly period ended December 28, 2007.

Or

**Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_ .

Commission File Number 001-10441

**SILICON GRAPHICS, INC.**

(Exact name of registrant as specified in its charter)

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**DELAWARE** **94-2789662**  
(State or other jurisdiction of **(I.R.S. Employer**  
incorporation or organization) **Identification No.)**  
**1140 East Arques Avenue, Sunnyvale, California 94085-4602**  
**(Address of principal executive offices) (Zip Code)**  
**(650) 960-1980**  
**(Registrant's telephone number, including area code)**

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

Indicate by check mark whether the registrant is 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 filer

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

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Sections 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court. Yes  No

As of January 25, 2008, the registrant had 11,180,334 shares of common stock, par value \$0.01 per share, outstanding.

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**QUARTERLY REPORT ON FORM 10-Q**  
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Silicon Graphics, SGI, the SGI logo, Silicon Graphics Onyx, SGI Origin, Silicon Graphics Tezro, Silicon Graphics Fuel, InfiniteStorage, IRIX, SGI Altix, Altix ICE and Altix XE are our trademarks in the U.S. and/or other countries. All other brand names, service marks, trademarks and trade names appearing in this form 10-Q or the accompanying prospectus are the property of their respective owners.

As used in this report, Predecessor Company refers to Silicon Graphics, Inc. prior to September 29, 2006, the end of the last fiscal quarter prior to our emergence from federal bankruptcy protection. References to Successor Company refer to Silicon Graphics, Inc. on and after September 29, 2006. Unless the context requires otherwise, the words SGI, we, company, us and our refer to Silicon Graphics, Inc. and its subsidiaries.

**Table of Contents****PART I FINANCIAL INFORMATION****Item 1. Financial Statements****SILICON GRAPHICS, INC.****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS****(In thousands, except per share amounts, unaudited)**

	Successor Company			Predecessor Company
	Three Months Ended		Six Months Ended	Three Months Ended
	Dec. 28, 2007	Dec. 29, 2006	Dec. 28, 2007	Sept. 29, 2006
Product and other revenue	\$ 40,460	\$ 58,680	\$ 80,602	\$ 45,229
Product revenue from related party	2,953	5,002	8,407	15,377
Global services revenue	46,698	44,041	92,187	61,199
<b>Total revenue</b>	<b>90,111</b>	<b>107,723</b>	<b>181,196</b>	<b>121,805</b>
<b>Costs and expenses:</b>				
Cost of product and other revenue	34,938	59,918	72,630	42,710
Cost of service revenue	27,310	29,387	53,199	32,265
Research and development	14,464	14,984	27,760	16,007
Selling, general and administrative	44,163	41,606	85,387	42,359
Other operating expenses, net	20	2,885	195	3,926
<b>Total costs and expenses</b>	<b>120,895</b>	<b>148,780</b>	<b>239,171</b>	<b>137,267</b>
Operating loss	(30,784)	(41,057)	(57,975)	(15,462)
Interest expense (contractual interest of \$7,841 for the three-month period ended September 29, 2006)	(2,990)	(3,158)	(5,942)	(7,688)
Interest and other income (expense), net (1)	(6,970)	1,199	(7,353)	11,286
Income from equity investment				105
Loss before reorganization items and income taxes	(40,744)	(43,016)	(71,270)	(11,759)
Reorganization items, net				340,397
Income (loss) before income taxes	(40,744)	(43,016)	(71,270)	328,638
Income tax provision	1,432	678	7,099	2,382
Net income (loss)	\$ (42,176)	\$ (43,694)	\$ (78,369)	\$ 326,256
<b>Net income (loss) per share:</b>				
Basic	\$ (3.78)	\$ (3.93)	\$ (7.04)	\$ 1.20
Diluted	\$ (3.78)	\$ (3.93)	\$ (7.04)	\$ 0.77
<b>Weighted-average shares used to compute net income (loss) per share:</b>				
Basic	11,147	11,125	11,136	271,563

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Diluted	11,147	11,125	11,136	423,875
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- (1) The three-month period ended December 28, 2007, includes a write-down of \$6 million of our equity investment in SGI Japan to the estimated fair value of the investment, which was approximately \$15 million at December 28, 2007. The three-month period ended September 29, 2006, includes a pre-tax gain of approximately \$10 million on the sale of a portion of the Predecessor Company's investment in SGI Japan. See Note 11, *Investment in SGI Japan*.

See accompanying notes to these condensed consolidated financial statements.

**Table of Contents****SILICON GRAPHICS, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS****(In thousands, except share and per share amounts, unaudited)**

	Dec. 28, 2007	June 29, 2007
<b>Assets:</b>		
<b>Current assets:</b>		
Cash and cash equivalents	\$ 33,135	\$ 69,887
Short-term marketable investments	41	223
Short-term restricted investments	9,399	6,763
Accounts receivable, net of allowance for doubtful accounts of \$1,879 at December 28, 2007 and \$2,012 at June 29, 2007	41,750	47,643
Inventories	58,848	54,354
Prepaid expenses	7,448	6,153
Other current assets	44,387	49,576
<b>Total current assets</b>	<b>195,008</b>	<b>234,599</b>
Restricted investments	611	302
Property and equipment, net	42,842	43,392
Other intangibles, net	59,422	71,264
Other non-current assets, net	71,207	59,501
<b>Total assets</b>	<b>\$ 369,090</b>	<b>\$ 409,058</b>
<b>Liabilities and stockholders' equity:</b>		
<b>Current liabilities:</b>		
Accounts payable	\$ 19,668	\$ 14,387
Accrued compensation	31,806	35,382
Income taxes payable	3,578	2,209
Other current liabilities	45,524	44,420
Current portion of long-term debt (\$2,250 from related parties at December 28, 2007 and none at June 29, 2007)	4,283	261
Current portion of deferred revenue	89,647	84,798
Current portion of restructuring liability	1,067	1,410
<b>Total current liabilities</b>	<b>195,573</b>	<b>182,867</b>
Long-term debt (\$42,750 from related parties at December 28, 2007 and \$45,000 at June 29, 2007)	80,750	85,000
Non-current portion of deferred revenue	59,582	32,362
Other non-current liabilities	25,708	24,370
<b>Total liabilities</b>	<b>361,613</b>	<b>324,599</b>
<b>Stockholders' equity:</b>		
Preferred stock, \$0.01 par value; 5,000,000 shares authorized		
Common stock, \$0.01 par value, and additional paid-in capital; 25,000,000 shares authorized; 11,535,661 and 11,125,000 shares issued and outstanding at December 28, 2007 and June 29, 2007, respectively	189,491	188,101
Accumulated deficit	(182,014)	(103,642)
<b>Total stockholders' equity</b>	<b>7,477</b>	<b>84,459</b>

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Total liabilities and stockholders' equity	\$ 369,090	\$ 409,058
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See accompanying notes to these condensed consolidated financial statements.

**Table of Contents****SILICON GRAPHICS, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(In thousands, unaudited)**

	Successor Company		Predecessor Company
	Six Months Ended	Three Months Ended	Three Months Ended
	Dec. 28, 2007	Dec. 29, 2006	Sept. 29, 2006
<b>Cash flows from operating activities:</b>			
Net income (loss)	\$ (78,369)	\$ (43,694)	\$ 326,256
<b>Adjustments to reconcile net income (loss) to net cash used in operating activities:</b>			
Effect of plan of reorganization and revaluation of assets and liabilities			(342,996)
Depreciation and amortization	19,221	11,021	10,202
Write-off of in-process R&D		500	
Impairment of equity investment	6,149		
Amortization of inventory fair value adjustment to cost of sales	4,230	12,576	
Utilization of pre-petition foreign tax loss carryforwards	4,889		
Gain on sale of equity investment			(9,848)
Stock-based compensation expense	1,888	124	122
Other	(258)	(790)	(1,474)
<b>Changes in operating assets and liabilities:</b>			
Accounts receivable	6,098	(16,569)	8,187
Inventories	(11,169)	(2,533)	(13,639)
Accounts payable	5,006	(31,222)	6,361
Accrued compensation	(3,575)	(36)	2,616
Deferred revenue	32,069	49,265	(18,189)
Other assets and liabilities	(10,496)	(3,904)	5,844
Total adjustments	54,052	18,432	(352,814)
Net cash used in operating activities	(24,317)	(25,262)	(26,558)
<b>Cash flows from investing activities:</b>			
<b>Marketable investments:</b>			
Purchases	10	61	(168)
Maturities			107
<b>Restricted investments:</b>			
Purchases	(6,193)	(13,133)	(6,686)
Maturities	3,772	31,155	5,580
Proceeds from sale of equity investment			18,690
Purchases of property and equipment	(5,671)	(2,969)	(1,064)
Decrease (increase) in other assets	(2,864)	2,729	(2,327)
Net cash provided by (used in) investing activities	(10,946)	17,843	14,132
<b>Cash flows from financing activities:</b>			
Payments of debt principal	(15,197)	(8,185)	(130,007)
Proceeds from financing	15,000	8,000	114,825
Payments of debt issuance and debt modification costs	(772)		(896)
Net proceeds from financing arrangements	(20)		
Repurchases of common stock for restricted stock unit withholding tax	(500)		



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Proceeds from issuance of stock			56,529
Net cash provided by (used in) financing activities	(1,489)	(185)	40,451
Net increase (decrease) in cash and cash equivalents	(36,752)	(7,604)	28,025
Cash and cash equivalents at beginning of period	69,887	82,698	54,673
Cash and cash equivalents at end of period	\$ 33,135	\$ 75,094	\$ 82,698

See accompanying notes to these condensed consolidated financial statements.

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**SILICON GRAPHICS, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**1. Description of Business**

We are a leader in high-performance computing ( HPC ) and data management. We sell a broad line of mid-range to high-end computing servers, data storage and visualization systems. In addition, we provide customer support and professional services related to our products. We are a leading developer of enterprise-class, high performance features for the Linux operating system. We provide our customers with a standard Linux operating environment combined with our differentiated Linux extensions that improve performance, simplify system management and provide a more robust development environment. Our shared memory and cluster computing systems predominately incorporate Intel Itanium 2 and Xeon processors.

Our products and services are used by the scientific, technical and business communities to solve challenging data-intensive computing and data management problems. These problems typically require large amounts of computing power and fast and efficient data movement both within the computing system and to and from large-scale data storage installations. Our end users employ our systems to access, analyze, transform, manage, visualize and store very large amounts of data in real time or near real time. The vertical markets we serve include defense and strategic systems, weather and climate, physical sciences, life sciences, energy (including oil and gas), aerospace and automotive, media and entertainment, and business intelligence and data analytics. Applications for our systems within these vertical markets include simulating global climate changes, accelerating engineering of new automotive designs, supporting homeland security initiatives and gaining business intelligence through data-mining. Our services facilitate rapid installation and implementation of our products, optimizing their use, maintaining their availability and educating customers to increase productivity.

We manufacture our products in Chippewa Falls, Wisconsin. We distribute our products through our direct sales force and through indirect channels including resellers, distributors and systems integrators.

**2. Proceedings Under Chapter 11 of the Bankruptcy Code**

*Chapter 11 Reorganization and Emergence from Bankruptcy*

On May 8, 2006 (the Petition Date ), the Predecessor Company and certain of its subsidiaries (collectively, the Debtors ), filed voluntary petitions for reorganization under Chapter 11 of the Bankruptcy Code in the United States Bankruptcy Court for the Southern District of New York (the Court ). The Debtors remained in possession of their assets and properties as debtors-in-possession under the jurisdiction of the Court and in accordance with the provisions of the Bankruptcy Code. At a hearing held on September 19, 2006, the Court confirmed the Predecessor Company's First Amended Joint Plan of Reorganization, dated July 27, 2006 (as modified, the Plan ). This order became final on September 29, 2006 and we emerged from Chapter 11 on October 17, 2006 (the Effective Date ). Pursuant to the Plan, we issued 11,125,000 shares of new common stock to certain of the Predecessor Company's creditors in satisfaction of claims and upon exercise of stock purchase rights and overallotment options. Of the 11,125,000 shares of outstanding new common stock, we issued 10,000,000 shares to holders of certain allowed debt claims and we issued 1,125,000 additional shares to certain backstop purchasers pursuant to a Backstop Purchase Agreement that guaranteed the claims of certain note holders. In addition, we reserved 1,250,000 shares of the new common stock for issuance pursuant to the terms of our Management Incentive Plan, which share reserve has since been increased. See Note 5, *Stock-Based Compensation*.

Our new common stock trades on the Nasdaq Capital Market under the symbol SGIC.

**Table of Contents***Reorganization items*

Reorganization items, net represents expense or income amounts incurred as a direct result of the Predecessor Company's Chapter 11 filing and are presented separately in our condensed consolidated statements of operations for the Predecessor Company. Such items consisted of the following (in thousands):

	<b>Predecessor Company Three Months Ended Sept. 29, 2006</b>
Professional fees	\$ 8,942
Gains on settlements with creditors	(6,343)
Effects of the plan of reorganization	(142,033)
Fresh-start valuation of assets and liabilities	(200,963)
	<b>\$ (340,397)</b>

Included in the effects of the Plan is a charge of \$4 million for the acceleration of stock-based compensation resulting from the cancellation of Predecessor Company stock options and restricted stock awards.

**3. Basis of Presentation**

The accompanying condensed consolidated financial statements include the accounts of Silicon Graphics, Inc. and our wholly- and majority-owned subsidiaries. The unaudited results of operations for the interim periods shown herein are not necessarily indicative of operating results for the entire fiscal year. In the opinion of management, all adjustments, consisting only of normal recurring adjustments necessary to present fairly the financial position, results of operations and cash flows for all periods presented have been made. These condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the fiscal year ended June 29, 2007 filed with the Securities and Exchange Commission.

The preparation of interim condensed consolidated financial statements in conformity with accounting principles generally accepted in the United States requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses and related disclosure of contingent liabilities in the financial statements and the accompanying notes. On an ongoing basis, we evaluate these estimates, including those related to customer programs and incentives, bad debts, inventory, lease residual values, warranty obligations, restructuring, income taxes and contingencies. We base our estimates on historical experience and on various other assumptions that we believe are reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities. Actual results may differ materially from these estimates.

For the period subsequent to the Petition Date and prior to emergence, the accompanying condensed consolidated financial statements were prepared in accordance with Statement of Position 90-7, *Financial Reporting by Entities in Reorganization Under the Bankruptcy Code* (SOP 90-7). Accordingly, interest was not accrued on debt subject to compromise subsequent to the Petition Date. Reorganization items, which included the expenses, realized gains and losses, and provisions for losses resulting from the reorganization under the Bankruptcy Code, were reported separately as reorganization items in the Predecessor Company's consolidated statements of operations.

We emerged from federal bankruptcy protection on the Effective Date and adopted fresh-start accounting as of September 29, 2006 in accordance with SOP 90-7. We were required to use fresh-start accounting because holders of existing voting shares immediately before filing and confirmation of the Plan received less than 50% of the voting shares of the emerging entity and reorganization value was less than post-petition liabilities and allowed claims. Under fresh-start accounting, we are required to allocate reorganization value to assets and liabilities in a manner similar to that which is required under Statement of Financial Accounting Standards (SFAS) No. 141, *Business Combinations* (SFAS 141). In addition, under the provisions of fresh-start accounting, a new entity was deemed created for financial reporting purposes. Accordingly, our financial information disclosed under the heading *Successor Company* is presented on a basis different from, and is therefore not comparable to, our financial information disclosed under the heading *Predecessor Company*. For further information on fresh-start

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accounting, see Note 4, *Fresh-Start Accounting*.

The condensed consolidated balance sheet as of December 28, 2007 includes the remaining effect of adjustments to the carrying value of assets or amounts and classifications of liabilities that were necessary when adopting fresh-start accounting.

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The statements of operations and cash flows for the three-month period ended September 29, 2006 reflect the operations of the Predecessor Company, which includes the gain from the discharge of debt and the application of fresh-start accounting. The adoption of fresh-start accounting had a material effect on the condensed consolidated financial statements as of December 28, 2007 and September 29, 2006 and will have a material impact on condensed consolidated statements of operations for periods subsequent to December 28, 2007.

### **4. Fresh-Start Accounting**

On September 19, 2006, the Court confirmed the Plan. Our emergence from Chapter 11 proceedings on the Effective Date resulted in a new reporting entity and adoption of fresh-start accounting in accordance with SOP 90-7 as of September 29, 2006. Reorganization adjustments were made to reflect the discharge of certain pre-petition liabilities and the adoption of fresh-start accounting.

Reorganization adjustments resulted primarily from:

- i. changes in the carrying values of assets and liabilities to reflect fair values, including the establishment of certain intangible assets;
- ii. discharge of the Predecessor Company's pre-petition liabilities in accordance with the Plan;
- iii. addition of new financing;
- iv. cash distributions paid or payable to pre-petition creditors; and
- v. issuance of Successor Company common stock and cancellation of Predecessor Company common stock.

The fair value allocated to the assets and liabilities of the Successor Company is in conformity with SFAS No. 141, *Business Combinations*. These adjustments are based upon the work of management to determine the relative fair values of our assets and liabilities. The estimates and assumptions utilized are inherently subject to significant uncertainties and contingencies beyond our control. Accordingly, there can be no assurance that the estimates, assumptions and values reflected in the valuations will be realized, and actual results could vary materially. Moreover, the market value of our common stock may differ materially from the equity valuation.

As a result of the adoption of fresh-start accounting, our post-emergence financial statements are not comparable with our pre-emergence financial statements, because they are, in effect, those of a new entity.

### **5. Stock-Based Compensation**

On November 19, 2007, our stockholders approved the amended and restated Silicon Graphics, Inc. Management Incentive Plan ( MIP ). The amendment and restatement of the MIP increased the number of shares issuable thereunder from 1,250,000 to 2,473,750. The MIP permits us to issue a variety of equity incentives, including options to purchase our common stock and restricted stock units ( RSUs ). RSUs represent the right to receive a number of shares of our common stock upon the lapsing of vesting or other restrictions. Of the total number of shares reserved, a maximum of 924,375 shares may be issued for full value benefits. Full value benefits are stock awards designed to provide equity compensation based on the full value of a share of stock, such as RSUs. The MIP also imposes per-participant award limits. Stock options and RSUs granted under the MIP are generally expected to have a vesting period of up to 48 months. As of December 28, 2007, 1,680,202 equity grants had been issued since October 17, 2006, of which 320,792 were RSUs and 1,359,410 were stock options.

#### *Determining Fair Value of Stock Options*

The fair value of each option is estimated on the date of grant using the Black-Scholes-Merton closed-form option valuation model that uses the assumptions noted in the following table. Expected volatility is primarily a weighted average of peer companies' historical and implied volatility.

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The expected life has been calculated for all outstanding grants using the simplified approach as described in SEC Staff Accounting Bulletin No. 107. For purposes of performing our valuation, we combine the employees and directors into one group. The amounts listed below represent the weighted averages. The risk-free rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of grant.

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	Successor Company		Six Months Ended	Predecessor Company
	Three Months Ended		Dec. 28, 2007	Three Months Ended
	Dec. 28, 2007	Dec. 29, 2006	Dec. 28, 2007	Sept. 29, 2006
Expected volatility	37.19%	43.00%	37.10%	130.00%
Expected term (in years)	4.50	4.47	4.51	2.08 2.55
Risk-free rate (%)	3.30	4.42	3.42	4.77-4.80
Expected dividends				
<i>Stock-based Compensation Expense</i>				

The compensation costs that have been included in our results of operations and the total income tax benefit, if any, that we recognized in our condensed consolidated statement of operations for these stock-based compensation arrangements were as follows (in thousands):

	Successor Company		Six Months Ended	Predecessor Company
	Three Months Ended		Dec. 28, 2007	Three Months Ended
	Dec. 28, 2007 *	Dec. 29, 2006	Dec. 28, 2007	Sept. 29, 2006
Stock-based compensation cost included in:				
Cost of product and other revenue	\$ 34	\$ 6	\$ 62	\$
Cost of service revenue	(42)	6	17	
Research and development	253	58	561	
Selling, general, and administrative	530	54	1,248	122
Reorganization items				3,981
Total stock-based compensation expense before income taxes	775	124	1,888	4,103
Income tax benefit recognized				
Total stock-based compensation expense after income taxes	\$ 775	\$ 124	\$ 1,888	\$ 4,103

As of December 28, 2007, there was \$8.1 million of total unrecognized compensation expense related to unvested stock options that we expect to vest over a weighted-average period of 3.3 years. Additionally, as of December 28, 2007, there was \$5.7 million of unrecognized stock-based compensation expense related to unvested RSUs that we expect to vest over a weighted-average period of 2.9 years.

*Summary of Stock Options*

A summary of options under all of our share-based compensation plans as of December 28, 2007 and changes during the three months ended December 28, 2007, were as follows (in thousands, except exercise price and contractual term):

	Shares	Weighted-Average Exercise Price per Share	Weighted-Average Remaining Contractual Term (in Years)	Aggregate Intrinsic Value
Options outstanding at June 29, 2007	1,035	\$ 22.04	6.40	\$ 5,959
Options granted	416	\$ 18.66	6.80	
Options exercised		\$		
Options forfeited or expired	(92)	\$ 19.84	6.31	

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Options outstanding at December 28, 2007	1,359	\$	21.15	6.16	\$	952
Options vested and exercisable at December 28, 2007	237	\$	20.10	5.43	\$	196
Options expected to vest after December 28, 2007	1,194	\$	21.16	6.13	\$	836



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The aggregate intrinsic value represents the difference between \$19.03, our average stock price on the last trading day of the fiscal period, December 28, 2007, and the exercise price per share, multiplied by the number of in the money options that would have been received by the option holders had all option holders exercised their options on December 28, 2007. The weighted-average intrinsic value of options granted during the six months ended December 28, 2007 was \$6.73.

*Summary of Restricted Stock Units*

RSUs are generally subject to forfeiture if employment terminates prior to the release of vesting restrictions. We expense the cost of the RSUs, which is determined to be the fair market value of the shares underlying the RSU at the date of grant, ratably over the period during which the vesting restrictions lapse.

Unvested RSUs outstanding as of December 28, 2007 and changes during the three months ended December 28, 2007 were as follows (in thousands, except weighted average grant date fair value):

	Number of Shares	Weighted- Average Grant Date Fair Value
RSUs outstanding at June 29, 2007	289	\$ 21.48
RSUs granted	141	\$ 18.72
RSUs released pursuant to vesting	(79)	\$ 21.23
RSUs forfeited	(30)	\$ 19.90
RSUs outstanding at December 28, 2007	321	\$ 20.48

Of the RSUs released during the three months ended December 28, 2007, 28,000 units were withheld to satisfy the tax withholding requirement (valued at \$0.5 million) for the total number of units that vested. The aggregate intrinsic value of RSUs outstanding was \$6.1 million and \$7.8 million as of December 28, 2007 and June 29, 2007, respectively.

*Other Disclosures Pertaining to All Share-Based Compensation Plans*

There was no cash received from option exercises under share-based payment arrangements during the three or six months ended December 28, 2007. Because of our net operating losses, we did not realize any tax benefits for the tax deductions from share-based payment arrangements during the six months ended December 28, 2007.

**6. Inventories**

Inventories were as follows (in thousands):

	Dec. 28, 2007	June 29, 2007
Components and subassemblies	\$ 22,678	\$ 19,310
Work-in-process	15,059	21,270
Finished goods	17,048	9,268
Demonstration systems	4,063	4,506
Total inventories	\$ 58,848	\$ 54,354

Pursuant to fresh-start accounting, in the Successor Company's opening September 29, 2006 balance sheet, inventory amounts were stated at fair market value. Components and subassemblies were not adjusted as the carrying value reflected fair value. Work-in-process and finished goods inventories were recorded at selling price less cost to sell, cost to complete and a reasonable apportionment of the profit margin associated with

the selling and the post emergence completion effort.

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The resulting impact of fresh-start accounting to inventories as of September 29, 2006 was an increase of approximately \$28.3 million. At December 28, 2007, \$1 million of this valuation adjustment was remaining, which we expect to be utilized by the end of fiscal 2008. As a result, the amount of cost of goods sold recognized by the Successor Company has been higher than the amount historically recognized by the Predecessor Company.

**7. Other Current Assets**

Other current assets were as follows (in thousands):

	Dec. 28, 2007	June 29, 2007
Deferred cost of goods sold	\$ 24,195	\$ 24,150
Value-added tax receivable	3,179	7,846
Other receivable	10,047	11,631
Other	6,966	5,949
<b>Total other current assets</b>	<b>\$ 44,387</b>	<b>\$ 49,576</b>

**8. Other Intangibles, Net**

Other Intangibles, net of accumulated amortization, were approximately \$59 million as of December 28, 2007. Other Intangible Assets were established in connection with our adoption of fresh-start accounting (see Note 4, *Fresh-Start Accounting*). Subsequent to June 29, 2007, additional adjustments of \$1.1 million and \$5.5 million for the three and six months ended December 28, 2007, respectively, were made to the fresh-start valuation previously disclosed in our Annual Report on Form 10-K for fiscal 2007 and are reflected in the table below. The adjustments were principally due to utilization of the Predecessor Company's foreign tax net operating loss carryforwards. Other Intangible Assets consist of the following (in thousands, except years):

	Weighted Average Remaining Amortization Period (Years)	Gross Carrying Amount		Accumulated Amortization		Net Carrying Amount		
		June 29, 2007	Adjustments	Dec. 28, 2007	June 29, 2007	Dec. 28, 2007	Dec. 28, 2007	
Developed product technology	5	\$ 27,700	\$ (2,840)	\$ 24,860	\$ (3,463)	\$ (2,135)	\$ (5,598)	\$ 19,262
Customer backlog	4	2,700	(277)	2,423	(1,652)	(173)	(1,825)	598
Royalty license agreements	4	1,900	(195)	1,705	(285)	(175)	(460)	1,245
Trademark/trade name portfolio	16	6,400	(656)	5,744	(282)	(176)	(458)	5,286
Customer relationships	5	44,184	(1,553)	42,631	(5,938)	(3,662)	(9,600)	33,031
		\$ 82,884	\$ (5,521)	\$ 77,363	\$ (11,620)	\$ (6,321)	\$ (17,941)	\$ 59,422

Total amortization expense for other intangible assets for the three months ended December 28, 2007 and December 29, 2006 was approximately \$3 and \$4 million, respectively. Total amortization expense for the six months ended December 28, 2007 was approximately \$6 million. Future annual amortization expense for other intangible assets is estimated to be as follows (in thousands):

Fiscal 2008 (for fiscal quarters remaining at December 28, 2007)	\$ 5,935
Fiscal 2009	11,852
Fiscal 2010	11,831
Fiscal 2011	11,796

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Fiscal 2012	11,480
Thereafter	6,528
	<u>\$ 59,422</u>

**Table of Contents****9. Other Non-Current Assets**

Other non-current assets were as follows (in thousands):

	Dec. 28, 2007	June 29, 2007
Spare parts, net of accumulated depreciation of \$6,512 at December 28, 2007 and \$3,913 at June 29, 2007	\$ 16,930	\$ 17,563
Investment in SGI Japan (see Notes 11 and 16)	14,720	20,869
Non-current deferred cost of goods sold	28,156	10,824
Other, net of accumulated amortization of \$1,274 at December 28, 2007 and \$1,649 at June 29, 2007	11,401	10,245
<b>Total other non-current assets</b>	<b>\$ 71,207</b>	<b>\$ 59,501</b>

Deferred cost of goods sold will be recognized over the contract terms ranging up to five years.

**10. Debt and Other Financing Arrangements**

Debt consisted of the following at December 28, 2007 and June 29, 2007 (in thousands):

	Dec. 28, 2007	June 29, 2007
Term Loan due October 17, 2011	\$ 85,000	\$ 85,000
Other	33	261
<b>Total</b>	<b>85,033</b>	<b>85,261</b>
Less: amounts due within one year	(4,283)	(261)
<b>Amounts due after one year</b>	<b>\$ 80,750</b>	<b>\$ 85,000</b>

In October 2006, we entered into a Senior Secured Credit Agreement (the Agreement), providing us with an \$85 million term loan from Morgan Stanley Senior Funding, Inc. and a \$30 million line of credit from General Electric Capital Corporation (GE).

In September 2007, the lenders under the \$85 million term loan, including Quadrangle Master Funding Ltd. (Quadrangle) and Watershed Technology Holdings, LLC (Watershed), or their affiliates, which are significant stockholders of SGI, purchased and assumed the position of GE under the Agreement and substituted themselves as the lenders under the \$30 million line of credit. Interest on the \$85 million term loan is based on the three-month LIBOR plus 7%, and it is secured by the assets of the Company. On the same day, we entered into a Second Amendment to the Agreement (the Second Amendment) with Morgan Stanley Senior Funding, Inc., as agent for the lenders. The Second Amendment eliminated our obligations to comply with the maximum leverage ratio and minimum consolidated EBITDA covenants originally set forth in the Agreement through December 2008. After December 2008, we must comply with maximum leverage ratio and minimum consolidated EBITDA requirements, which have been adjusted as set forth in the Second Amendment. The Second Amendment eliminated our obligation to comply with the minimum liquidity requirement set forth in the Agreement and also set the total line of credit at \$20 million. Under the Second Amendment, the interest rates on line of credit advances were increased to the LIBOR rate plus 4.75% or the Alternative Base Rate plus 3.50%, at our option. The financing facility matures in October 2011. Annual principal payments over the next five years are as follows (in millions): fiscal 2008 \$0; fiscal 2009 \$13; fiscal 2010 \$17; fiscal 2011 \$17 and fiscal 2012 \$38.

During the second quarter of fiscal 2008, the maximum amount drawn on the line of credit and subsequently paid within thirty days of being drawn was \$12 million.

On January 2, 2008, Quadrangle Debt Recovery Advisors LP (QDRA), an investor in the Company, announced the completion of its spin-off from Quadrangle Group LLC. As part of the separation, QDRA changed its name to Monarch Alternative Capital LP (Monarch). Monarch holds the investment in the Company's stock previously held by QDRA. Also, on January 2, 2008, Quadrangle's position in the term loan was assumed

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by Monarch.

On February 4, 2008, we entered into a third amendment that increased the amount under the term loan to \$127.5 million. See Note 22, *Subsequent Events*. Annual principal payments for the additional amount borrowed under the term loan are as follows (in millions): fiscal 2008 \$0; fiscal 2009 \$0; fiscal 2010 \$3; fiscal 2011 \$7 and fiscal 2012 \$33.

**Table of Contents****11. Investment in SGI Japan***Sale of Interest*

In August 2006, the Predecessor Company completed the sale of a portion of its equity investment in SGI Japan to SGI Japan, Ltd. The Predecessor Company received cash proceeds of approximately \$17 million, net of withholding taxes, and recorded a net gain of approximately \$8 million in the first quarter of fiscal 2007. As a result of the sale, our ownership interest was reduced to approximately 10%. The Company accounts for this investment under the cost method.

*Impairment of Investment*

During the three months ended December 28, 2007, we determined that there had been an other-than-temporary impairment of our remaining investment in SGI Japan. As a result, we wrote down the investment by \$6 million, which represented the difference between the investment's carrying value and the estimated fair value of the investment as of December 28, 2007. We included the impairment loss in interest and other income (expense), net in the three and six months ended December 28, 2007. The value of the investment after the write down was approximately \$15 million, which represented the estimated fair value of the investment at December 28, 2007.

See Note 16, *Related Party Transactions*, for further information on our related party relationship with SGI Japan.

**12. Guarantees***Financial Guarantees*

Currently, we have issued financial guarantees to cover rent on leased facilities and equipment, in favor of government authorities and certain other parties to cover liabilities associated with the importation of goods and to support payments in advance of future delivery on our goods and services. The majority of our financial guarantees have terms of one year or less. Our maximum potential obligation under financial guarantees at December 28, 2007 was \$10.6 million for which we had \$10 million of assets held as collateral. The full amount of the assets held as collateral was included in restricted investments.

The cost of the assets held as collateral closely approximates fair value. At December 28, 2007, we did not have any obligations associated with our guarantees that met the criteria to be recorded as liabilities on our statement of financial position.

*Product Warranties*

At the time of sale of our products, we provide for an estimated cost to warrant these products against defects in materials and workmanship for a period of up to three years. This accrual was reflected under other current liabilities in the condensed consolidated balance sheets of this Quarterly Report on Form 10-Q.

Product warranty activity was as follows (in thousands):

	Successor Company		Six Months Ended	Predecessor Company
	Three Months Ended Dec. 28, 2007	Three Months Ended Dec. 29, 2006	Dec. 28, 2007	Three Months Ended Sept. 29, 2006
Product warranty beginning balance	\$ 5,650	\$ 4,942	\$ 5,646	\$ 5,481
New warranties issued	1,427	2,940	3,055	1,195
Warranties paid	(1,468)	(2,025)	(3,208)	(1,735)
Changes in warranty rate estimates	(313)	(85)	(197)	1
Product warranty ending balance	\$ 5,296	\$ 5,772	\$ 5,296	\$ 4,942





**Table of Contents****13. Earnings (Loss) Per Share**

Set forth below is a reconciliation of basic and diluted earnings (loss) per share (in thousands, except per share amounts):

	Successor Company		Six Months Ended	Predecessor Company
	Three Months Ended Dec. 28, 2007	Three Months Ended Dec. 29, 2006	Dec. 28, 2007	Three Months Ended Sept. 29, 2006
Net income (loss)	\$ (42,176)	\$ (43,694)	\$ (78,369)	\$ 326,256
Weighted average shares outstanding-basic	11,147	11,125	11,136	271,563
6.50% Senior Secured Convertible Notes				150,862
6.125% Convertible Subordinated Debentures				1,450
Weighted average shares outstanding-diluted	11,147	11,125	11,136	423,875
Net income (loss) per share:				
Basic	\$ (3.78)	\$ (3.93)	\$ (7.04)	\$ 1.20
Diluted	\$ (3.78)	\$ (3.93)	\$ (7.04)	\$ 0.77
Potentially dilutive weighted securities excluded from computations because they are anti-dilutive	1,362	70	1,318	26,344

Potentially dilutive weighted securities include the assumed exercise of stock options and the assumed vesting of RSUs as well as the assumed conversion of debt using the if-converted method. There was no convertible debt for the quarter ended December 28, 2007.

Earnings per share information reported by the Predecessor Company is not comparable to earnings per share information reported by the Successor Company because all existing equity interests of the Predecessor Company were eliminated (without a distribution) upon the consummation of the Plan.

**14. Comprehensive Income (Loss)**

The difference between reported net income (loss) and comprehensive income (loss) was not considered material for the periods presented.

**15. Segment Information**

We have two reportable segments, products and global services. Our reportable segments are determined after assessment of factors such as quantitative thresholds of business components to be included into reportable segments, customer base, economic characteristics, homogeneity of products, technology, delivery channels and other factors, and are aligned with the process by which the chief operating decision maker (Chief Executive Officer) makes operating decisions and evaluates performance.

**Products**

Our products segment consists of our core systems and our legacy systems. Our products are distributed through our direct sales force and through indirect channels, including resellers, distributors and systems integrators.

Our core systems consist of HPC systems and storage systems based on either the Intel Itanium 2 or Intel Xeon microprocessors and the Linux or Microsoft Windows operating systems. Our core systems include our server products sold under the Altix brand name. The other component of our core systems is our storage systems sold under the InfiniteStorage brand name. Our storage systems line is targeted at data growth which

is a significant factor present in most computing environments.

Our legacy systems consist of our high-performance servers and visualization systems based on MIPS RISC microprocessors and IRIX operating system. Our legacy systems include the SGI Origin family of high-performance servers. Legacy systems also include the Silicon Graphics Tezro and Silicon Graphics Fuel workstations and the Silicon Graphics Onyx family of graphics systems. Our legacy systems also include the remarketed versions of the MIPS and IRIX based workstations, graphics systems and high-performance servers as well as remarketed versions of our storage solutions.

***Global Services***

Our global services organization supports our computer hardware and software products and provides professional services to help customers realize the full value of their information technology investments. Our customer support organization provides ongoing maintenance and technical support, including contracted maintenance services, hardware deployment services (install and de-install), time and materials-based services and spare parts. Our professional services organization provides technology consulting, customer education, managed services and third-party products.

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Revenue from external customers for similar classes of products and services was as follows (in thousands):

	Successor Company			Predecessor Company
	Three Months Ended		Six Months Ended	Three Months Ended
	Dec. 28, 2007	Dec. 29, 2006	Dec. 28, 2007	Sept. 29, 2006
<b>Core Systems:</b>				
Server products	\$ 23,282	\$ 40,954	\$ 54,910	\$ 34,914
Storage products	13,505	10,920	21,737	12,750
Total Core Systems	36,787	51,874	76,647	47,664
<b>Legacy Systems:</b>				
Server products	6,216	10,966	11,103	12,324
Storage products	410	842	1,259	618
Total Legacy Systems	6,626	11,808	12,362	12,942
Total Products revenue	\$ 43,413	\$ 63,682	\$ 89,009	\$ 60,606
<b>Global Services:</b>				
Customer support	\$ 40,193	\$ 35,080	\$ 78,423	\$ 48,396
Professional services	6,505	8,961	13,764	12,803
Total Global Services revenue	\$ 46,698	\$ 44,041	\$ 92,187	\$ 61,199
Total consolidated revenue	\$ 90,111	\$ 107,723	\$ 181,196	\$ 121,805

In the second quarter of fiscal 2008 and fiscal 2007 as well as the six months ended December 28, 2007, no single customer represented 10% or more of our total revenue. No single customer represented 10% or more of our total revenue in the first quarter of fiscal 2007.

**Segment Results**

We evaluate our segments based on the direct revenue, costs of sales and expenses that we can directly attribute to those segments. On a quarterly basis, we utilize a set of assumptions to allocate indirect costs, which contribute to overall company profit and loss, to our segments. Operating segments do not sell products to each other, and accordingly, there is no inter-segment revenue to be reported.

Operating results for our reportable segments were as follows (in thousands):

	Successor Company			Predecessor Company
	Three Months Ended		Six Months Ended	Three Months Ended
	Dec. 28, 2007	Dec. 29, 2006	Dec. 28, 2007	Sept. 29, 2006
<b>Revenue from external customers:</b>				
Products	\$ 43,413	\$ 63,682	\$ 89,009	\$ 60,606
Global services	46,698	44,041	92,187	61,199
Total consolidated revenue	\$ 90,111	\$ 107,723	\$ 181,196	\$ 121,805

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Operating Income (loss):				
Products	\$ (32,488)	\$ (36,437)	\$ (62,613)	\$ (23,448)
Global services	1,724	(1,735)	4,833	11,912
Total reportable segments	(30,764)	(38,172)	(57,480)	(11,536)
Other operating expense	(20)	(2,885)	(195)	(3,926)
Total consolidated operating loss	\$ (30,784)	\$ (41,057)	\$ (57,975)	\$ (15,462)

**Table of Contents****16. Related Party Transactions**

We record revenue for products sold to SGI Japan when evidence of an arrangement exists, delivery has occurred, the price is fixed or determinable and collectibility is reasonably assured as prescribed by SEC Staff Accounting Bulletin ( SAB ) No. 104, *Revenue Recognition*. Revenue and cost of revenue associated with sales to SGI Japan were as follows (in thousands):

	Successor Company			Predecessor Company
	Three Months Ended		Six Months Ended	Three Months Ended
	Dec. 28, 2007	Dec. 29, 2006	Dec. 28, 2007	Sept. 29, 2006
Product revenue	\$ 2,953	\$ 5,002	\$ 8,407	\$ 15,377
Cost of product revenue	\$ 1,879	\$ 3,238	\$ 5,884	\$ 9,233

Aggregate amounts receivable from and amounts payable to SGI Japan were immaterial at December 28, 2007 and June 29, 2007.

**17. Income Taxes**

We file income tax returns with the U.S. government, various states and foreign jurisdictions. Our U.S. income tax returns for fiscal 2004 to 2006 are open, and to date, we have not been notified of any pending audits or of any proposed adjustments to those returns. SGI has however established tax contingencies associated with a liability that arose from an IRS refund payment to Cray Research in prior years. We are also negotiating the settlement of tax issues relating to our investment in Cray Research. We have reached a negotiated settlement of certain tax issues related to deductions under section 172(f) of the Internal Revenue Code that affect the years 1984 through 1988. This settlement, which has been approved by the Joint Committee of Tax at the end of fiscal 2007, will result in approximately \$7.5 million of tax refund/credit, including applicable interest. The actual amount of the interest on the refund receipt may be different from our estimate. We have recognized the estimated benefit related to this potential credit in fiscal 2007 as an adjustment to goodwill and/or other intangibles. Management reasonably expects proceeds from the settlement within fiscal 2008.

In the quarter ended September 28, 2007, we recorded an additional adjustment to increase income tax expense by \$2.4 million with a corresponding reduction of intangible assets relating to the results of operations for the Successor Company's nine-months ended June 29, 2007 for utilization of certain foreign subsidiaries' Predecessor net operating loss carryforwards. This adjustment was not material to the Company's consolidated financial position or results of operations for any previous periods.

In addition, we have open income tax audits for fiscal years 1995 through 2005 in various foreign jurisdictions. The most significant of these tax audits has resulted in a tax adjustment of approximately \$12 million payable to the Canadian government. We believe there would potentially be offsetting refunds against this tax adjustment from the Canadian government because we have requested refunds of overpaid taxes from the Canadian Government (made in April 2005 through a voluntary disclosure) for fiscal years 1996 through 2002. The discussions with the Canadian tax authorities regarding refund for over-paid taxes is still in progress; therefore, it is uncertain as to whether our application for refund and the amount requested will be accepted. If accepted however, it will result in a net cash benefit to us. We have not recognized any benefit related to this potential credit as of December 28, 2007, and any benefit, if recognized, will be an adjustment to other intangibles.

We are also currently under income tax audit in Germany and India on issues related to transfer pricing for the fiscal 2003 through 2005. We believe our transfer pricing practice in these two jurisdictions is adequately documented and supported by an independent study of practices by comparable companies (a transfer pricing report). We are under examination by the Hong Kong tax authorities on issues unrelated to

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transfer pricing for the years 2002 through 2005. However, we do not expect any adjustments as a result of this examination. We have net operating loss carryforward in all three jurisdictions that may be utilized to reduce any adjustment to our income taxes that may be proposed as a result of the audits or examinations.

Prior to our bankruptcy reorganization, SGI had over \$1 billion in U.S. net operating loss carryforwards due to prior period losses. Ordinarily, net operating losses incurred prior to a bankruptcy are subject to limitation under Section 382 of the Internal Revenue Code. However, SGI received a private letter ruling from the Internal Revenue Service on January 29, 2008 indicating the limitations of Section 382 do not apply to the ownership change that occurred upon our emergence from bankruptcy. Accordingly, the pre-bankruptcy net operating losses of SGI can be used without limitation.

*Unrecognized Tax Benefits*

The Successor Company adopted FASB Interpretation No. 48 ( FIN 48 ), *Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109*, as of September 29, 2006. There was no material impact on the Successor Company's consolidated results of operations resulting from the implementation of FIN 48. A reconciliation of the beginning and ending amount of unrecognized tax benefits for the Successor Company is as follows (in thousands):

	<b>Six Months Ended Dec. 28, 2007</b>
Unrecognized tax benefits beginning balance at June 29, 2007	\$ 19,580
Additions based on tax positions taken during a prior period	1,327
Additions for tax positions taken during the current period	925
Reductions due to settlements with taxing authorities	
Reductions due to a lapse of the applicable statute of limitations	(631)
Unrecognized tax benefits at December 28, 2007	\$ 21,201

Substantially all unrecognized tax benefits are recorded in other non-current liabilities.

To the extent the unrecognized tax benefits existed prior to September 29, 2006, the date we adopted fresh-start accounting, future settlement and adjustments to these unrecognized tax benefits will be adjustments to goodwill and/or other intangibles or to additional paid-in-capital, rather than adjustments to our statement of operations. As of December 28, 2007, \$2.2 million of unrecognized tax benefits, if recognized, would favorably affect our effective tax rate.

*Interest and Penalties*

Interest and penalties related to income taxes are recognized in the income tax provision. Penalties were not recorded in the six months ended December 28, 2007 or the six months ended December 29, 2006.

During the three and six month periods ended December 28, 2007, we recognized \$0.4 million and \$0.7 million, respectively, in interest expense. During the three month period ended September 29, 2006 (Predecessor Company) and the three month period ended December 29, 2006 (Successor Company), we recognized \$0.4 million and \$0.4 million, respectively, in interest. The Successor Company had approximately \$10.5 million for the payment of interest and penalties accrued at December 28, 2007.

**18. Research and Development Arrangements**

During the first quarter of fiscal 2007, we entered into research and development arrangements with certain third parties for a period of three years. Currently, the value of these arrangements totals \$28.0 million and covers periods through fiscal 2009. The objective of these arrangements is to help fund the development of technologies or products that meet specific operational needs for our business partners and lead towards the commercialization of new products that can be sold for incremental revenue. During the three months and six months ended December 28, 2007, we earned approximately \$2.5 million and \$5.0 million, respectively, in compensation compared with approximately \$2

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million for the three months ended December 29, 2006 and approximately \$1 million for the three months ended September 29, 2006. The amounts earned are recognized as an offset to research and development expense.

### **19. Recent Accounting Pronouncements**

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* ( SFAS 159 ). SFAS 159 gives us the irrevocable option to carry many financial assets and liabilities at fair value, with changes in fair value recognized in earnings. SFAS 159 is effective for us in the fiscal year beginning June 28, 2008, although early adoption is permitted. We are currently assessing the potential impact that the adoption of SFAS 159 will have on our consolidated financial statements.

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In June 2007, the Emerging Issues Task Force ( EITF ) issued a consensus on EITF No. 07-3, *Accounting for Nonrefundable Advance Payments for Goods or Services to Be Used in Future Research and Development Activities* ( EITF 07-3 ). The EITF reached a consensus that nonrefundable advance payments for goods or services that will be used or rendered for future research and development activities pursuant to an executory contract arrangement should be deferred and capitalized. Such amounts should be recognized as an expense as the related goods are delivered or the related services are performed. Entities should continue to evaluate whether they expect the goods to be delivered or services to be rendered. If an entity does not expect the goods to be delivered or services to be rendered, the capitalized advance payment should be charged to expense in the period in which it is determined that the goods will not be delivered or services will not be rendered. Entities should report the effects of applying this issue as a change in accounting principle through a cumulative-effect adjustment to retained earnings or to other components of equity or net assets in the statement of financial position as of the beginning of the year of adoption. The consensus in EITF 07-3 is effective for us in the fiscal year beginning June 28, 2008. We are currently evaluating the impact, if any, of the adoption of EITF 07-3 on our consolidated financial position, results of operations and cash flows.

In November 2007, the EITF issued a consensus on EITF 07-1, *Accounting for Collaboration Arrangements Related to the Development and Commercialization of Intellectual Property* ( EITF 07-1 ). The EITF reached a consensus that a participant in a collaborative arrangement that is deemed to be the principal participant for a transaction should record the transaction on a gross basis in its financial statements. Entities should evaluate the income statement classification of payments between participants pursuant to a collaborative arrangement based on the nature of the arrangement, the nature of the entity's business operations, the contractual terms of the arrangement, and whether those payments are within the scope of other authoritative accounting literature on income statement classification. If the payments are within the scope of other authoritative accounting literature, the entity should apply the relevant provisions of that literature. To the extent that the payments are not within the scope of other authoritative accounting literature, the income statement classification for the payments should be based on an analogy to authoritative accounting literature, or if there is no appropriate analogy, a reasonable, rational and consistently applied accounting policy election. EITF 07-1 should be applied retrospectively to all prior periods presented for all collaborative arrangements existing as of the effective date. The consensus in EITF 07-1 is effective for us in the fiscal year beginning June 27, 2009. We are currently evaluating the impact, if any, of the adoption of EITF 07-1 on our consolidated financial position, results of operations and cash flows.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), *Business Combinations* ( SFAS 141R ), which establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree in a business combination. SFAS No. 141R also establishes principles around how goodwill acquired in a business combination or a gain from a bargain purchase should be recognized and measured, as well as provides guidelines on the disclosure requirements on the nature and financial impact of the business combination. SFAS 141R will be applicable to any business combinations we close after June 29, 2009.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements, and an Amendment of ARB No. 51* ( SFAS 160 ). This statement amends ARB 51 to establish accounting and reporting standards for the noncontrolling interest (minority interest) in a subsidiary and for the deconsolidation of a subsidiary. Upon its adoption, effective for us in the fiscal year beginning June 27, 2009, noncontrolling interests will be classified as equity in the Company's balance sheet and income and comprehensive income attributed to the noncontrolling interest will be included in the Company's income and comprehensive income. The provisions of this standard must be applied prospectively upon adoption except for the presentation and disclosure requirements. We do not expect the adoption of SFAS 160 to have a significant impact on our consolidated financial statements.

## **20. Contingencies**

We may, from time to time, be involved in lawsuits, claims, investigations and proceedings that arise in the ordinary course of business. In accordance with SFAS No. 5, *Accounting for Contingencies*, we record a provision for a liability when management believes that it is both probable that a liability has been incurred and we can reasonably estimate the amount of the loss. We believe we have adequate provisions for any such matters. We review these provisions at least quarterly and adjust these provisions to reflect the impact of negotiations, settlements, rulings, advice of legal counsel and other information and events pertaining to a particular case.

We are currently being audited for state sales and use tax matters for the years 2003 through 2006 in California. In addition, we have open income tax, VAT, and sales and use tax audits for years 1996 through 2005 in various foreign jurisdictions. The most significant of these tax audits has resulted in a tax adjustment of approximately \$12 million payable to the Canadian government. We have requested refunds of overpaid taxes from the Canadian Government (made in April 2005 through a voluntary disclosure) for fiscal years 1996 through 2002. The discussions with the Canadian tax authorities regarding refund for over-paid taxes is still in progress; therefore, it is uncertain as to whether our application for refund and the amount requested will be accepted. We are also currently under income tax audit in Germany and India on issues related to transfer pricing for the fiscal 2003 through 2005. We are under examination by the Hong Kong tax authorities on issues unrelated to transfer pricing for the years 2002 through 2005.



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The outcome of any tax audits cannot be predicted with certainty, but we believe that any resulting audit adjustments to any of our open tax returns will not, with the exception of Canada, result in a material impact on our financial condition, results of operations or cash flows.

As described in Note 2, *Proceedings under Chapter 11 of the Bankruptcy Code*, on the Petition Date, May 8, 2006, the Debtors filed voluntary petitions for relief under Chapter 11. As of the Petition Date, most pending litigation (including some of the actions described below) was stayed, and absent further order of the Court, no party, subject to certain exceptions, was permitted to take any action, again subject to certain exceptions, to recover on pre-petition claims against us. On the Effective Date, we emerged from Chapter 11.

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On August 10, 2005, our German subsidiary, which was not a party to the Chapter 11 cases, filed a lawsuit with the LG Munich, a Higher Regional Court in Germany, against T-Systems International GmbH ( TSI ), a systems integrator, relating to a dispute regarding whether acceptance criteria were met with regard to an SGI system delivered in the spring of 2003. We are seeking full payment for the system in an amount equal to 4.6 million (\$6.7 million based on the conversion rate as of December 28, 2007). On September 21, 2005, TSI filed a counterclaim contesting our claim and alleging damages of 9 million plus interest since April 2004 (\$13.1 million based on the conversion rate as of December 28, 2007), which exceeds our contractual limit of liability of 2 million (\$2.9 million based on the conversion rate as of December 28, 2007). On December 7, 2005, we responded to TSI's counterclaim and filed a motion seeking an additional 3.8 million (\$5.5 million based on the conversion rate as of December 28, 2007) for lost profit relating to maintenance services. We cannot currently predict the outcome of this dispute.

On October 23, 2006, we filed a patent infringement lawsuit against ATI Technologies Inc. ( ATI ) in U.S. District Court, Western District of Wisconsin. In our complaint, we assert that products in ATI's line of Radeon graphics processors infringe our U.S. Patent No. 6,650,327. The Complaint seeks unspecified damages and a court ordered injunction against future infringement by ATI.

In late 2006, AMD announced the completion of its acquisition of ATI. We filed an amended complaint adding two additional patents to its claims on November 30, 2006. ATI filed an answer to the complaint on December 1, 2006. ATI filed its answer to the amended complaint on December 14, 2006. The trial has been set for February 4, 2008.

As a result of anonymous allegations and allegations by an ex-employee, we conducted an internal investigation into whether certain systems were delivered to an entity in China in possible violation of U.S. export laws. We have voluntarily shared information with respect to the investigation with the U.S. Department of Commerce. We cannot be assured that the Department or other agencies of the U.S. government will not institute any proceedings against us in the future. In addition, from time to time, we receive inquiries from regulatory agencies informally requesting information or documentation. There can be no assurance in any given case that such informal review will not lead to further proceedings involving us in the future.

Third parties in the past have asserted, and will in the future assert, intellectual property infringement claims against us, and such future claims, if proved, could require us to pay substantial damages or to redesign our existing products or pay fees to obtain cross-license agreements. Litigation may be necessary in the future to enforce or defend our intellectual property rights, to protect our trade secrets or to determine the validity and scope of our proprietary rights or the proprietary rights of others. Any such litigation could result in substantial costs and diversion of management resources, either of which could harm our business, operating results and financial condition. Further, many of our current and potential competitors have the ability to dedicate substantially greater resources to enforcing and defending their intellectual property rights than we have.

On May 1, 2007, we received a letter from counsel for Bharat Heavy Electricals Ltd. ( BHEL ), located in India, alleging delay in and failure to deliver products and technical problems with our hardware and software. BHEL has asserted a claim for damages, reimbursement and interest of \$1.9 million and has demanded arbitration. We are currently investigating the claim and are in the early stages of the arbitration process under the Arbitration and Conciliation Act of 1996 before Justice M. Jagannadha Rao (Retd). We cannot currently predict the outcome of this dispute.

We are not aware of any pending disputes, including those disputes and settlements described above, that would be likely to have a material adverse effect on our consolidated financial condition, results of operations or liquidity. However, litigation is subject to inherent uncertainties and costs and unfavorable outcomes could occur. An unfavorable outcome could include the payment of monetary damages, cash or other settlement, or an injunction prohibiting us from selling one or more products. If an unfavorable resolution were to occur, there exists the possibility of a material adverse impact on our consolidated financial condition, results of operations or cash flows of the period in which the resolution occurs or on future periods.

### **21. Shelf Registration Statement**

On November 1, 2007, we filed a shelf registration statement on Form S-3 with the SEC to register the sale of an aggregate of up to \$100 million of our common stock for sale in one or more primary offerings that we may choose to effect in the future. The registration statement has not yet been declared effective. The terms of a future offering, if any, would be described in an amendment to the registration statement, prospectus supplement or free-writing prospectus to be filed with the SEC.

### **22. Subsequent Events**

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On February 4, 2008, we entered into a Third Amendment to the Agreement (the Third Amendment ) with Morgan Stanley Senior Funding, Inc., as agent for the lenders, to amend the Senior Secured Credit Agreement entered into in October 2006. The Third Amendment increases the principal amount of the term loan from \$85 million to \$127.5 million. Term loan repayment obligations remain at \$4,250,000 from December 26, 2008 through September 25, 2009, and increase to provide quarterly payments of \$5,250,000 starting on December 25, 2009 and payable through September 24, 2010, and quarterly payments of \$6,250,000 starting on December 24, 2010 and payable through June 24, 2011, with a maturity date payment of \$70,750,000. The call premiums for the term loan and revolving credit commitments were increased to two percent. The interest rates on both the term loan and the line of credit remained the same, with floors added for the LIBOR rate of 3.5% and the Alternative Base Rate of 6.25%. The Amendment also allows us to establish securities, deposit or other accounts of up to \$3 million to secure performance bonds and guarantees, surety bonds, letters of credit and other similar obligations. A three percent fee was incurred on the \$42.5 million added to the term loan.

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As of December 28, 2007, we owned 3 million shares of Series Y Preferred Stock of MicroUnity Systems Engineering, Inc. ( MUSE ). The shares were acquired through a Cray investment in MUSE in 1991 and were written off in 2001. On January 17, 2008, we entered into a stock repurchase agreement with MUSE. Under the stock repurchase agreement, MUSE repurchased all the preferred stock currently owned by us for an aggregate price of approximately \$4 million and agreed to share future contingent revenue share payments through the end of 2008. The Company will record a \$4 million gain on the sale of this investment in the third quarter of fiscal 2008 related to the non-contingent payment.

### **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

This quarterly report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, or the Securities Act, and Section 21E of the Securities Exchange Act of 1934, or the Exchange Act. These statements involve known and unknown risks, uncertainties and other important factors that may cause our actual results, performance or achievements to be materially different from any future results, performances or achievements expressed or implied by the forward-looking statements. These forward-looking statements include, but are not limited to, those concerning the following:

our estimates regarding the sufficiency of our cash resources and our ability to raise additional capital;

our expectations regarding acceptance of our recently-introduced SGI Altix and storage products;

our expectations regarding future operating results or financial performance, including maintenance of gross margins and profitability;

our intentions and expectations regarding the introduction of new products by us and our competition; and

our ability to maintain compliance with our debt covenants.

In some cases, you can identify forward-looking statements by terms such as anticipates, believes, could, estimates, expects, intends, may, potential, predicts, projects, should, will and would, as well as similar expressions. Forward-looking statements reflect our current views and assumptions with respect to future events, are based on assumptions and are subject to risks, uncertainties and other important factors. We discuss many of these risks, uncertainties and other important factors in greater detail under the heading Risk Factors and elsewhere in this report and in our most recent annual report on Form 10-K. Given these risks, uncertainties and other important factors, you should not place undue reliance on these forward-looking statements. Also, these forward-looking statements represent our estimates and assumptions only as of the date these forward-looking statements are made. We undertake no obligation to publicly update or revise any forward-looking statements, whether changes occur as a result of new information, future events, changed assumptions, or otherwise.

### **Overview**

We are a leader in HPC and data management. We sell a broad line of mid-range to high-end computing servers, data storage and visualization systems. In addition, we provide customer support and professional services related to our products. We are a leading developer of enterprise-class, high performance features for the Linux operating system. We provide our customers with a standard Linux operating environment combined with our differentiated Linux extensions that improve performance, simplify system management and provide a more robust development environment. Our shared memory and cluster computing systems predominately incorporate Intel Itanium 2 and Xeon processors.

Our products and services are used by the scientific, technical and business communities to solve challenging data-intensive computing and data management problems. These problems typically require large amounts of computing power and fast and efficient data movement both within the computing system and to and from large-scale data storage installations.



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Our end users employ our systems to access, analyze, transform, manage, visualize and store very large amounts of data in real time or near real time. The vertical markets we serve include defense and strategic systems, weather and climate, physical sciences, life sciences, energy (including oil and gas), aerospace and automotive, media and entertainment, and business intelligence and data analytics. Applications for our systems within these vertical markets include simulating global climate changes, accelerating engineering of new automotive designs, supporting homeland security initiatives and gaining business intelligence through data-mining. Our services facilitate rapid installation and implementation of our products, optimizing their use, maintaining their availability and educating customers to increase productivity.

Over the past 18 months, we have appointed a new Chief Executive Officer and other key members of management, introduced our first cluster computing systems, reorganized our sales and marketing organizations, developed important sales and marketing relationships to broaden our market reach and implemented new services initiatives.

We are extending our sales and marketing activities into broader market segments with new products and services that we developed using our experience and leadership in our traditional markets. Using our technology and market knowledge, we deliver systems that have performance and ease-of-use features that are designed to enable our customers to solve their computing needs cost-effectively. Based on our expertise in the Linux computing environment, we have also expanded our server product lines to include servers that target rapidly-growing segments of the HPC market.

We manufacture our products in Chippewa Falls, Wisconsin. We distribute our products through our direct sales force and through indirect channels including resellers, distributors and systems integrators.

### **Critical Accounting Estimates**

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent liabilities. On an ongoing basis, we evaluate these estimates, including: those related to customer programs and incentives; bad debts; inventory; lease residual values; warranty obligations; restructuring; incomes taxes and contingencies. We base our estimates on historical experience and on various other assumptions that we believe are reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ materially from these estimates. There were no material changes to our critical accounting policies and estimates since June 29, 2007. Refer to Management's Discussion and Analysis in our most recent Annual Report on Form 10-K.

During the three months ended December 28, 2007, we determined that there had been an other-than-temporary impairment of our remaining investment in SGI Japan. As a result, we wrote down the investment by \$6 million, which represented the difference between the investment's carrying value and the estimated fair value of the investment as of December 28, 2007. We included the impairment loss in interest and other income (expense), net in the three and six months ended December 28, 2007. The value of the investment after the write down was approximately \$15 million, which represented the estimated fair value of the investment at December 28, 2007. It is difficult to determine the estimated fair value of our investment in SGI Japan, primarily because SGI Japan is a privately owned company. We considered a number of factors in making our determination of the estimated fair value of our investment, including the historical operating results and forecasted operating results of SGI Japan. Actual results could differ from the forecasted results and if the actual results are unfavorable relative to the future forecast, we may record an additional impairment in a future period.

### **Results of Operations**

We adopted fresh-start accounting on September 29, 2006, and emerged from Chapter 11 on October 17, 2006. As a result of the application of fresh-start accounting, the Successor Company's financial statements are not comparable with the Predecessor Company's financial statements. However, for purposes of discussion of the results of operations, the six months ended December 28, 2007 have been compared to the combined three months ended September 29, 2006 and the three months ended December 29, 2006 as included in our condensed consolidated statements of operations. In this discussion, we disclose the fresh-start and other impacts on our results of operations that vary from historical Predecessor Company periods to aid in the understanding of our financial performance. Fresh-start accounting and deferral of revenue recognition required by U.S. generally accepted accounting principles have had and will continue to have a significant non-cash impact on our future consolidated results of operations, but will have no impact on the underlying cash, working capital assumptions or the underlying operation of our business.

The financial information and the discussion below should be read in conjunction with the accompanying condensed consolidated financial statements and notes thereto. The operating results for any quarter are not necessarily indicative of results to be expected for any future periods.



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(In thousands, except per share amounts)	Successor Company			Predecessor Company
	Three Months Ended		Six Months Ended	Three Months Ended
	Dec. 28, 2007	Dec. 29, 2006	Dec. 28, 2007	Sept. 29, 2006
Total revenue	\$ 90,111	\$ 107,723	\$ 181,196	\$ 121,805
Cost of revenue	62,248	89,305	125,829	74,975
Gross profit	27,863	18,418	55,367	46,830
Gross profit margin	30.9%	17.1%	30.6%	38.4%
Total operating expenses	58,647	59,475	113,342	62,292
Operating loss	(30,784)	(41,057)	(57,975)	(15,462)
Interest and other income (expense), net	(9,960)	(1,959)	(13,295)	3,703
Loss before reorganization items and income taxes	(40,744)	(43,016)	(71,270)	(11,759)
Reorganization items, net				340,397
Income (loss) before income taxes	(40,744)	(43,016)	(71,270)	328,638
Net income (loss)	\$ (42,176)	\$ (43,694)	\$ (78,369)	\$ 326,256
Net income (loss) per share:				
Basic	\$ (3.78)	\$ (3.93)	\$ (7.04)	\$ 1.20
Diluted	\$ (3.78)	\$ (3.93)	\$ (7.04)	\$ 0.77

**Revenue**

The following discussion of revenue is based on the results of our reportable segments as described in Note 15, *Segment Information*, to our notes to the condensed consolidated financial statements in Part I, Item 1 of this report. Total revenue is principally derived from two reportable segments, products and global services. Our products segment includes our core systems, which include our high-performance computing systems, storage systems, and other products based on Intel Itanium 2 and Intel Xeon microprocessors and the Linux operating system, and our legacy systems, which include our high-performance servers and visualization systems based on our MIPS RISC microprocessors and IRIX operating system.

Revenue for the second quarter of fiscal 2008 decreased by \$18 million, or 16%, compared with the corresponding period of fiscal 2007, reflecting a decrease in our product revenue that was partially offset by a moderate increase in our global services revenue. Revenue for the first six months of fiscal 2008 declined \$48 million, or 21%, compared with the corresponding period of fiscal 2007, due to declines in sales in both of our reportable segments. Revenue for the second quarter and first six months of fiscal 2008 included the unfavorable impact of fresh-start accounting adjustments, primarily related to customer service revenue, of \$2 million and \$6 million, respectively, compared with an unfavorable impact of \$16 million in each of the corresponding periods of fiscal 2007.

The following table presents total revenue by reportable segment (in thousands):

Products and other:	Successor Company			Predecessor Company
	Three Months Ended		Six Months Ended	Three Months Ended
	Dec. 28, 2007	Dec. 29, 2006	Dec. 28, 2007	Sept. 29, 2006
Core systems	\$ 36,787	\$ 51,874	\$ 76,647	\$ 47,664



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Legacy systems	6,626	11,808	12,362	12,942
Total products and other	\$ 43,413	\$ 63,682	\$ 89,009	\$ 60,606
% of total revenue	48%	59%	49%	50%
Global services	\$ 46,698	\$ 44,041	\$ 92,187	\$ 61,199
% of total revenue	52%	41%	51%	50%
Total revenue	\$ 90,111	\$ 107,723	\$ 181,196	\$ 121,805

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*Products.* Revenue from our products segment for the second quarter and the first six months of fiscal 2008 decreased by \$20 million, or 32%, and \$35 million, or 28%, respectively, compared with the corresponding periods in fiscal 2007. The overall decline in product revenue for the second quarter and the first six months of fiscal 2008 was primarily due to a decrease in large transactions compared with the corresponding periods in fiscal 2007. Our product business was also impacted by lower than expected bookings in the second half of fiscal 2007, some of which would normally ship in the first six months of fiscal 2008. This decline in product revenue was partially offset by an increase in revenue from our established storage products. Revenue recognized from our products business was impacted by a significant increase in net deferrals for transactions accounted for under SOP 97-2, which were \$16 million and \$41 million in the second quarter and first six months of fiscal 2008, respectively, compared with \$9 million and \$12 million in the corresponding periods in fiscal 2007. This impact was reflected in the overall increase in deferred revenue on our balance sheet.

Revenue from core systems for the second quarter of fiscal 2008 decreased by \$15 million, or 29%, compared with the corresponding period in fiscal 2007. Increases in our storage business were offset by lower sales of our SGI Altix servers, which declined \$17 million from the corresponding period of fiscal 2007. The storage increase was driven by the success of the special purpose storage products. Revenue from core systems for the first six months of fiscal 2008 decreased \$23 million, or 23%, compared with the corresponding period of fiscal 2007. Revenue from our SGI Altix server products and our discontinued Prism product family decreased while revenue from our storage business declined slightly. Revenue from our SGI Altix Xeon based servers increased as X86 clusters continue to gain market share.

Revenue from legacy systems for the second quarter and first six months of fiscal 2008 decreased by \$5 million, or 44%, and \$12 million, or 50%, respectively, compared with the corresponding periods in fiscal 2007. The decrease in legacy systems revenue was due to declines in sales of both our MIPS- and IRIX-based servers and graphics systems as customers continued to transition away from legacy system technology and into Linux-based systems. The long-term decline of the IRIX-based business has accelerated following end-of-life purchase requirements. Legacy system revenue was largely limited to program sales linked to product line extension agreements with existing customers.

*Global Services.* Revenue from our global services segment consists of customer support and professional services. Professional services revenue includes revenue generated from the sale of third-party products and our consulting and managed services.

Revenue from global services for the second quarter of fiscal 2008 increased \$3 million, or 6%, compared with the corresponding period in 2007. The customer service business accounted for \$5 million of the increase. Revenue generated from professional services contracts decreased \$2 million compared with the corresponding period of 2007, primarily due to decreases in our third party professional services business. Global services revenue declined \$13 million, or 12%, for the first six months of fiscal 2008 compared with the corresponding period in 2007. Global services revenue for the second quarter and first six months of fiscal 2008 included the unfavorable impact of fresh-start accounting adjustments of \$2 million and \$6 million, respectively, compared with an unfavorable impact of \$12 million in each of the corresponding periods of fiscal 2007. After consideration of the unfavorable impacts of fresh-start, global services revenue declined in the second quarter and first six months of fiscal 2008 compared with the corresponding periods in fiscal 2007. The decline was primarily due to a reduction in our traditional support revenue as a result of lower pricing for new contracts, coupled with a decline in the overall installed base that resulted in fewer contract renewals. In addition, third party professional services revenue also declined, primarily due to a large sale in the first six months of fiscal 2007 that did not recur in fiscal 2008.

Our backlog is calculated in accordance with our internal performance measurements or non-GAAP financial measures, and at December 28, 2007 our consolidated backlog was \$96 million, up from \$65 million at September 28, 2007 and \$66 million at June 29, 2007. Backlog is comprised of committed purchase orders for products and professional services deliverable within nine months.

We generally do not maintain sufficient backlog to meet our quarterly objectives for product revenue without obtaining significant new orders that are booked and shipped within the quarter. Our backlog reflects only orders for which a firm purchase order has been issued or a contract has been made, although orders in backlog are subject to customer cancellation or rescheduling in certain circumstances, and government customers typically have rights of cancellation for convenience. SGI systems have also been selected for a number of multi-year U.S. government programs, with expected purchases that are not reflected in our current backlog. In addition, we may enter into longer delivery-cycle contracts for which a portion of the value is not reflected in our current backlog, since a portion of such orders may be scheduled to ship outside the time provided in our bookings policy. These types of orders generally also require us and our partners to develop and deliver future products, and are subject to performance guarantees collateralized by letters of credit and additional penalties for delays in delivery or non-performance.

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*Geographic Revenue.* Total revenue by geographic area was as follows (in thousands):

Area	Successor Company				Predecessor Company			
	Three Months Ended		Six Months Ended		Three Months Ended			
	Dec. 28, 2007	Dec. 29, 2006	Dec. 28, 2007	Sept. 28, 2006	Sept. 28, 2006	Sept. 28, 2006		
Americas	\$ 56,079	62%	\$ 70,756	66%	\$ 121,081	67%	\$ 76,170	63%
Europe	23,190	26%	25,459	23%	37,532	21%	20,608	17%
Rest of World	10,842	12%	11,508	11%	22,583	12%	25,027	20%
Total revenue	\$ 90,111		\$ 107,723		\$ 181,196		\$ 121,085	

Revenue for the second quarter of fiscal 2008 decreased in all geographic areas compared with the corresponding period in fiscal 2007, with the largest percentage decline occurring in the Americas. The decrease in the Americas was primarily due to a decrease in large deals compared with the same period in fiscal 2007. Revenue for the first six months of fiscal 2008 declined in all geographies compared with the corresponding period in fiscal 2007, with the largest percentage decline occurring in Rest of World. The decline in Rest of World was primarily driven by two large sales in Japan in the first six months of fiscal 2007 that totaled \$12 million and that did not recur in fiscal 2008.

**Gross Profit Margin**

Cost of product and other revenue includes costs related to product shipments, including materials, labor, overhead, and other direct or allocated costs involved in their manufacture or delivery. Costs associated with engineering service revenue are included in cost of service revenue, unless the engineering service effort meets the criteria for government-funded research. If the contract meets the criteria for a government funded research arrangement, the costs to deliver the contract and the related proceeds earned from the contract are included in research and development expense. Cost of service revenue includes all costs incurred in the support and maintenance of our products, as well as costs to deliver professional services, including the costs associated with third-party products purchased in support of professional services.

Overall gross profit margin in the second quarter and first six months of fiscal 2008 was 31% in each period, compared with 17% and 28%, in the corresponding periods of fiscal 2007. The increase in overall gross profit margin in both periods of fiscal 2008 was primarily due to the impacts of fresh-start accounting adjustments. Gross profit margin in the second quarter and first six months of fiscal 2008 included unfavorable impacts of fresh-start accounting adjustments of \$6 million and \$13 million, respectively, compared with \$28 million in each of the corresponding periods of fiscal 2007.

Product and other gross profit margin in the second quarter and first six months of fiscal 2008 were 20% and 18%, respectively, compared with 6% and 17% in the corresponding periods of fiscal 2007. The increase in product and other gross profit margin in the second quarter and first six months of fiscal 2008 were due to the impacts of fresh-start accounting adjustments. The unfavorable impacts of these adjustments were \$4 million and \$7 million in the second quarter and first six months of fiscal 2008, compared with \$16 million in each of the corresponding periods of fiscal 2007. The net favorable impact of fresh-start adjustments in fiscal 2008 compared with fiscal 2007 were partially offset by lower product revenue volumes, primarily in our legacy systems which typically have approximately double the gross margins, as a percent of revenue, of our core systems.

Global services gross profit margin in the second quarter and first six months of fiscal 2008 was 42% in each period, compared with 33% and 41% in the corresponding periods of fiscal 2007. The increase in global services gross profit margin in both periods of fiscal 2008 was primarily due to the impacts of fresh-start accounting adjustments. The unfavorable impacts of these adjustments were \$2 million and \$6 million in the second quarter and first six months of fiscal 2008, compared with \$12 million in each of the corresponding periods of fiscal 2007. The net favorable impact of fresh-start adjustments in fiscal 2008 compared with fiscal 2007 were partially offset by lower customer support revenue and related margins.

**Table of Contents****Operating Expenses**

Operating expenses were as follows (in thousands):

	Successor Company		Six Months Ended Dec. 28, 2007	Predecessor Company Three Months Ended Sept. 29, 2006
	Three Months Ended			
	Dec. 28, 2007	Dec. 29, 2006		
Research and development	\$ 14,464	\$ 14,984	\$ 27,760	\$ 16,007
% of total revenue	16%	14%	15%	13%
Selling, general and administrative	\$ 44,163	\$ 41,606	\$ 85,387	\$ 42,359
% of total revenue	49%	39%	47%	35%
Other operating expenses, net	\$ 20	\$ 2,885	\$ 195	\$ 3,926
% of total revenue	%	3%	%	3%

*Operating Expenses (excluding Other Operating Expenses).* Operating expenses, excluding other operating expenses, for the second quarter of fiscal 2008 increased by \$2 million, or 4%, from the corresponding period of fiscal 2007 and increased as a percentage of total revenue from 53% to 65%. Operating expenses, excluding other operating expenses, for the first six months of fiscal 2008 decreased by \$2 million, or 2%, from the corresponding period of fiscal 2007. The increase in operating expenses for the second quarter of fiscal 2008 was primarily attributable to increased compensation associated with salary increases, severance costs, stock-based compensation, and from a slight increase in headcount and to legal expenses primarily associated with ATI patent litigation. These increases were partially offset by reductions in audit fees, facilities costs, and non-recurring engineering expense.

*Research and Development Expense.* Research and development expense for the second quarter and first six months of fiscal 2008 decreased \$1 million, or 3%, and \$3 million, or 10%, respectively, compared with the corresponding periods of fiscal 2007. The decreases reflected an increase in credits to expense received from research and development funding arrangements of \$0.3 million and \$1.6 million in the second quarter and first six months of fiscal 2008, respectively, lower non-recurring engineering expense, and lower facilities costs. These reductions were partially offset by increased material costs and increased compensation associated primarily with salary increases and stock-based compensation.

*Selling, General and Administrative Expenses.* Selling, general, and administrative expenses for the second quarter and first six months of fiscal 2008 increased by \$3 million, or 6%, and \$1 million, or 2%, respectively, compared with the corresponding periods of fiscal 2007. The increases reflected increased compensation associated primarily with salary increases, severance costs, stock-based compensation, and from a slight increase in headcount. In addition, increases were attributable to legal expenses primarily due to ATI patent litigation and marketing spending related to marketing efforts to increase revenues. These increases were partially offset by reduced audit fees and lower facilities costs. Included in the second quarter of fiscal 2008 was \$0.6 million of severance expense for employee terminations that were part of our organizational realignment efforts. Included in the first six months of fiscal 2008 was \$4 million associated with the amortization of intangibles compared with \$2 million in the corresponding period of fiscal 2007.

*Other Operating Expenses.* Other operating expense of less than \$0.1 million and \$1.2 million for the second quarters of fiscal 2008 and fiscal 2007, respectively, represents the costs of our restructuring plans. Other operating expense for the second quarter of fiscal 2008 included \$0.1 million for accretion and other costs related to our vacated leased facilities partially offset by adjustments to our estimates of severance-related costs. Other operating expense of \$0.2 million and \$5.1 million for the first six months of fiscal 2008 and fiscal 2007, respectively, represents the costs of our restructuring plans. Other operating expense for the first six months of fiscal 2008 included \$0.2 million for accretion and other costs related to our vacated leased facilities partially offset by adjustments to our estimates of severance-related costs.

In addition, other operating expense in the second quarter of fiscal 2007 included \$1.7 million in bankruptcy-related charges representing post-emergence charges, primarily professional fees, incurred subsequent to our emergence from bankruptcy, as a direct result of our Chapter 11 filing.

**Table of Contents****Interest and Other**

Interest and other income (expense) were as follows (in thousands):

	Successor Company			Predecessor Company
	Three Months Ended		Six Months Ended	Three Months Ended
	Dec. 28, 2007	Dec. 29, 2006	Dec. 28, 2007	Sept. 29, 2006
Interest expense	\$ (2,990)	\$ (3,158)	\$ (5,942)	\$ (7,688)
Investment gain (loss)	\$ (6,149)	\$	\$ (6,149)	\$ 10,100
Foreign exchange gain (loss)	(538)	234	(1,107)	23
Miscellaneous income (expense)	(599)	56	(827)	526
Interest income	316	909	730	637
Interest and other income (expense), net	\$ (6,970)	\$ 1,199	\$ (7,353)	\$ 11,286
Income from equity investment	\$	\$	\$	\$ 105

*Interest Expense.* Interest expense in the second quarter of fiscal 2008 was relatively constant compared to interest expense in the second quarter of fiscal 2007. Our average borrowings were \$90 million during the second quarters of both fiscal years. The debtor-in-possession ( DIP ) financing arrangements, which we paid off in the second quarter of fiscal 2007, carried a higher interest rate than our 2008 financing credit facility, which we obtained during the second quarter of fiscal 2007 upon our emergence from bankruptcy. The reduction in interest expense due to the lower interest rate on outstanding borrowings in the second quarter of fiscal 2008 was partially offset by higher loan cost amortization expense in the second quarter of fiscal 2008 compared to the second quarter in fiscal 2007.

Interest expense in the first half of fiscal 2008 decreased by \$5 million compared to interest expense in the first six months of fiscal 2007. The decrease was primarily due to higher loan cost amortization expense on our DIP financing arrangements in the first half of fiscal 2007 compared to loan cost amortization expense in the comparable period in 2008. Our average borrowings were \$88 million in the first half of fiscal 2008 compared to \$97 million in the comparable period in 2007, resulting in lower interest expense in fiscal 2008 compared to fiscal 2007. In addition, our DIP financing arrangements in place during the first half of fiscal 2007 carried a higher interest rate than our 2008 credit facility.

*Interest and Other Income (Expense), Net.* Interest and other income (expense), net includes interest income on our cash investments, foreign exchange gains and losses, gains and losses on other investments, and other non-operating items. Interest income and other income (expense), net, was a net expense of \$7 million in both the second quarter and first six months of fiscal 2008, primarily due to a \$6 million impairment loss on our investment in SGI Japan, foreign exchange losses attributable to the weakening US dollar, bank charges and annual fees on our credit facilities partially offset by interest income on our cash investments. Interest and other income (expense), net in the second quarter and first six months of fiscal 2007 was net income of \$1 million and \$12 million, respectively. The net income of \$1 million in the second quarter of fiscal 2007 was primarily due to higher interest income on higher levels of cash investments and foreign exchange gains. The net income of \$12 million in the first six months of fiscal 2007 was primarily due to a pre-tax investment gain of \$10 million resulting from the sale of a portion of our equity interest in SGI Japan.

*Income from Equity Investment.* Income from equity investment represents our share of the results of operations of SGI Japan. In August 2006, the Predecessor Company completed the sale of a portion of its equity investment in SGI Japan to SGI Japan, Ltd. As a result of the sale, our ownership interest was reduced to approximately 10%. Due to the decline in our ownership percentage, we began to account for this investment under the cost method of accounting in accordance with APB 18, *The Equity Method of Accounting for Investments in Common Stock*, in the second quarter of fiscal 2007.

**Table of Contents****Reorganization Items, Net**

Reorganization items, net represent expense or income amounts incurred as a direct result of the Predecessor Company's Chapter 11 filing and are presented separately in our condensed consolidated statements of operations. Such items consisted of the following (in thousands):

	<b>Predecessor Company Three Months Ended Sept. 29, 2006</b>
Professional fees	\$ 8,942
Gains on settlements with creditors	(6,343)
Effects of the plan of reorganization and fresh-start accounting	(142,033)
Increase to fresh-start basis of assets and liabilities	(200,963)
	<b>\$ (340,397)</b>

**Provision for Income Taxes**

The Successor Company's net provision for income taxes of \$7.1 million for the six months ended December 28, 2007 arose principally from net income taxes payable in foreign jurisdictions. Of the \$7.1 million of the Successor Company's net provision for income taxes, \$4.9 million will be offset in the tax returns of those foreign jurisdictions through the utilization of certain foreign subsidiaries' Predecessor Company net operating loss carryforwards. As required by fresh-start accounting, the recognition of tax benefits through the reduction in the valuation allowance established by the Predecessor Company has been recognized as a reduction of intangible assets. Included in the \$7.1 million is a \$2.4 million additional adjustment to increase tax expense with a corresponding additional reduction of intangible assets relating to the results of operations for the nine months ended June 29, 2007. The Successor Company's net provision for income taxes of \$0.7 million for the three months ended December 29, 2006 arose principally from net income taxes payable in foreign jurisdictions. The Predecessor Company's net provision for income taxes of \$2.4 million for the three months ended September 29, 2006 arose principally from net income taxes payable in foreign jurisdictions and withholding taxes paid on the gain from the sale of a portion of equity interest in SGI Japan.

**Financial Condition**

As discussed in Results of Operations above, the Successor Company's financial statements are not comparable with the Predecessor Company's financial statements. However, for purposes of discussion of financial condition, the six months ended December 28, 2007 have been compared to the combined three months ended September 29, 2006 and the three months ended December 29, 2006 as included in our condensed consolidated statements of cash flows.

**Cash Balances.** At December 28, 2007, our unrestricted cash and cash equivalents and marketable investments totaled \$33 million, compared with \$70 million at June 29, 2007. At December 28, 2007 and June 29, 2007, we also held \$10 million and \$7 million, respectively, of restricted investments. Restricted investments consist of short- and long-term investments held under a security agreement or pledged as collateral against letters of credit and other bank facilities. The decrease in cash and cash equivalents compared with June 29, 2007 is primarily the result of cash used in operations and investing during the first six months of fiscal 2008.

**Cash Consumption Trends.** Primarily as a result of net losses, operating activities used \$24 million during the first six months of fiscal 2008, compared with \$52 million during the same period of fiscal 2007. During the first six months of fiscal 2008, accounts receivable decreased \$6 million compared to the \$8 million increase that was generated during the same period of fiscal 2007. Inventory increased \$11 million during the first six months of fiscal 2008, primarily due to an increase in manufacturing inventory to support the current production schedule which includes large installations planned in the second half of the fiscal year, compared to the \$16 million increase in inventory reported in the same period of fiscal 2007. Accounts payable increased \$5 million in the first six months of fiscal 2008, primarily due to the timing of inventory receipts and invoices, compared with a decrease of \$25 million in the same period of fiscal 2007. We continue to pay all vendor obligations according to contractual terms. During the first six months of fiscal 2008, accrued compensation decreased \$4 million, primarily due to the timing of the payment of payroll, compared with the \$3 million increase in accrued compensation in the same period of fiscal 2007. Deferred revenue increased \$32 million in the first six months of fiscal 2008, primarily due to the timing of revenue recognition on sales transactions, compared with an increase of \$31 million in the same period of fiscal 2007. Other assets and liabilities increased \$10 million net in the first six

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months of fiscal 2008, primarily due to cost of goods sold deferrals, compared to the \$2 million decrease in the same period of fiscal 2007. Included in the cash used in operating activities from continuing operations are cash payments related to past restructuring actions. Cash payments for severance and contractual and facilities obligations related to these actions totaled approximately \$0.7 million and \$8 million in the first six months of fiscal 2008 and fiscal 2007, respectively.

Investing activities used \$11 million in cash during the first six months of fiscal 2008, compared with providing \$32 million during the same period of fiscal 2007. The negative cash flows in the first six months of fiscal 2008 were primarily due to purchases of property and equipment and, to a lesser degree, net purchases of restricted investments. The

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positive cash flows in the first six months of fiscal 2007 were primarily due to the sale of a portion of our equity investment in SGI Japan to SGI Japan, Ltd. and net proceeds from maturities of restricted investments. Principal investing activities in the first six months of both fiscal 2008 and fiscal 2007 primarily consisted of purchases of property and equipment of \$6 million and \$4 million, respectively.

Financing activities used \$1 million in cash during the first six months of fiscal 2008, compared with providing \$40 million during the same period of fiscal 2007. During the first six months of fiscal 2008, we borrowed and subsequently repaid \$15 million on our line of credit. During the first six months of fiscal 2007, we received proceeds of \$30 million from DIP funding issued while under Chapter 11, \$93 million from our new exit financing, and \$57 million from the Rights Offering and sale of Overallotment shares, and repaid debt principal of \$138 million.

At December 28, 2007, our principal sources of liquidity included unrestricted cash and marketable investments of \$33 million and \$20 million of availability under our revolving line of credit. While we are continuing to implement initiatives aimed at improving revenue and margins for our core systems products and reducing our costs of operations, we expect to consume cash from operations in fiscal 2008. We expect that the combination of our cash balance and existing credit facility, including the February 2008 amendment to the facility that increased the amount of the facility by a total of \$42.5 million, provides adequate liquidity to meet our operating needs for the next twelve months. However, we still may choose to raise additional capital for sales and marketing initiatives, research and development, general corporate purposes and to repay indebtedness. We experience significant intra-quarter fluctuations in our cash levels, with the result that our cash balances are generally at their highest point at the end of each quarter and significantly lower at other times. These intra-quarter fluctuations reflect our business cycle, with significant requirements for inventory purchases in the early part of the quarter and most sales closing in the last few weeks of the quarter. In addition, in certain circumstances in support of large deals, we are required to purchase inventories several quarters in advance of when we receive the cash. To maintain adequate levels of unrestricted cash within each quarter, we work to establish milestone payment arrangements whenever possible, offer certain customers discounted terms for early payment, and hold certain vendor payments until the beginning of the following quarter.

*Asset Based Credit Facility.* In October 2006, we entered into the Agreement providing us with an \$85 million term loan from Morgan Stanley Senior Funding, Inc., as agent for the lenders, and a \$30 million line of credit from GE.

On September 11, 2007, the lenders under the \$85 million term loan, including Quadrangle and Watershed, or their affiliates, which are significant stockholders of SGI, purchased and assumed the position of GE under the Agreement and substituted themselves as the lenders under the \$30 million line of credit. Interest on the \$85 million term loan is based on the three-month LIBOR plus 7%, and it is secured by the assets of the Company. On the same day, we entered into the Second Amendment with Morgan Stanley Senior Funding, Inc., as agent for the lenders. The Second Amendment eliminated our obligations to comply with the maximum leverage ratio and minimum consolidated EBITDA covenants originally set forth in the Agreement through December 2008. After December 2008, we must comply with maximum leverage ratio and minimum consolidated EBITDA requirements, which have been adjusted as set forth in the Second Amendment. The Second Amendment eliminated our obligation to comply with the minimum liquidity requirement set forth in the Agreement and also set the total line of credit at \$20 million. Under the Second Amendment, the interest rates on line of credit advances were increased to the LIBOR rate plus 4.75% or the Alternative Base Rate plus 3.50%, at our option. The financing facility matures in October 2011. Annual principal payments over the next five years are as follows (in millions): fiscal 2008 \$0; fiscal 2009 \$13; fiscal 2010 \$17; fiscal 2011 \$17 and fiscal 2012 \$38.

On January 2, 2008, QDRA an investor in the Company, announced the completion of its spin-off from Quadrangle Group LLC. As part of the separation, QDRA changed its name to Monarch. Monarch holds the investment in the Company's stock previously held by QDRA. Also, on January 2, 2008, Quadrangle's position in the term loan was assumed by Monarch.

On February 4, 2008, we entered into a Third Amendment to the Agreement with Morgan Stanley Senior Funding, Inc., as agent for the lenders. The Third Amendment increases the principal amount of the term loan from \$85 million to \$127.5 million. Term loan repayment obligations remain at \$4,250,000 from December 26, 2008 through September 25, 2009, and increase to provide quarterly payments of \$5,250,000 starting on December 25, 2009 and payable through September 24, 2010, and quarterly payments of \$6,250,000 starting on December 24, 2010 and payable through June 24, 2011, with a maturity date payment of \$70,750,000. See Note 22, *Subsequent Events*, for additional information. Annual principal payments for the additional amount borrowed under the term loan are expected to be as follows (in millions): fiscal 2008 \$0; fiscal 2009 \$0; fiscal 2010 \$3; fiscal 2011 \$7 and fiscal 2012 \$33.

*Shelf Registration Statement.* On November 1, 2007, we filed a shelf registration statement on Form S-3 with the SEC to register the sale of an aggregate of up to \$100 million of our common stock for sale in one or more primary offerings that we may choose to effect in the future. The registration statement has not yet been declared effective. The terms of a future offering, if any, would be described in an amendment to the registration statement, prospectus supplement or free-writing prospectus to be filed with the SEC.





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### **Off-Balance Sheet Arrangements**

In the ordinary course of business, we enter into off-balance sheet arrangements as defined by the SEC Final Rule 67 ( FR-67 ), *Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations*, including certain guarantees. None of these off-balance sheet arrangements either has, or is reasonably likely to have, a material current or future effect on our financial condition, results of operations, liquidity, or capital resources. See Note 12, *Guarantees*, in notes to condensed consolidated financial statements in Part I, Item 1 of this Quarterly Report on Form 10-Q for further information regarding these guarantees.

### **Contractual Obligations**

During the first six months of fiscal 2008 there was no material change to our contractual obligations, inclusive of rent obligations.

### **Chapter 11 Reorganization**

On May 8, 2006, the Predecessor Company and certain of its subsidiaries filed voluntary petitions for relief under Chapter 11 of the Bankruptcy Code. We emerged from bankruptcy protection on October 17, 2006. Our emergence from bankruptcy protection resulted in a new reporting entity on the emergence date and new shares of common stock in the Successor Company were issued to the bondholders of the Predecessor Company. These shares began trading on the Nasdaq Capital Market under the symbol SGIC on October 23, 2006. We adopted fresh-start accounting in accordance with SOP 90-7 as of September 29, 2006. As required by fresh-start accounting, our assets and liabilities were adjusted to fair value at that date, and certain assets and liabilities not previously recognized in the Predecessor Company's financial statements were recognized at that date. The adoption of fresh-start accounting has had and will have a significant non-cash impact on our future results of operations, but has not had and will not have any impact on the underlying cash, working capital assumptions or the underlying operation of the business.

As a result of our emergence from bankruptcy, the assets and liabilities of the Successor Company were adjusted to their relative fair values in conformity with SFAS 141, *Business Combinations*, as of September 29, 2006. The fresh-start accounting adjustments that had the most significant impact on our financial results for the fiscal year ended June 29, 2007 and will continue to affect our financial results going forward are as follows:

***Deferred revenue valuation.*** In connection with our adoption of fresh-start accounting, approximately \$37 million of deferred revenue and \$17 million of deferred cost of sales related to our accounting under SOP 97-2 that had previously been deferred were reduced to zero. In addition, the remaining deferred revenue was revalued resulting in an additional \$41 million impairment of deferred revenue, resulting in \$40 million in deferred revenue being on the Successor Company's opening balance sheet. Customer support deferred revenue and product and professional services deferred revenue were the two primary components of deferred revenue of the Predecessor Company that were significantly reduced by fresh-start accounting.

***Inventory valuation.*** We have raw materials, work-in-progress, finished goods, delivered systems and demonstration inventory. At September 29, 2006, a write-up of \$28.3 million was required to record these inventories at fair value. The result of the valuation adjustment on our results of operations is that costs of goods sold will increase by the magnitude of the valuation adjustment as the revalued inventory is sold and recorded as cost of goods sold. We expect the impact of the inventory valuation write-up to unfavorably impact cost of sales through the fourth quarter of fiscal 2008. At December 28, 2007, approximately \$1 million of the write-up remains to be recognized to cost of sales, all of which will be recognized by the end of fiscal 2008.

***Intangibles.*** New intangible assets resulted from the adoption of fresh-start accounting. Other intangible assets, net of accumulated amortization, were approximately \$59.4 million as of December 28, 2007, and approximately \$86.7 million as of September 29, 2006. Subsequent to September 29, 2006, additional adjustments were made to the fresh-start valuation previously disclosed in our Annual Report on Form 10-K for fiscal 2007. The adjustments were principally due to utilization of the Predecessor Company's foreign tax net operating loss carryforwards. We are required to amortize the value of these intangible assets over varying periods ranging from 3 to 17 years, impacting both cost of sales and selling, general and administrative expense.

### **Recent Accounting Pronouncements**

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See Note 19, *Recent Accounting Pronouncements*, to our Consolidated Financial Statements in Part I, Item 1 of this Report for a description of recent accounting pronouncements, including our expected adoption dates and estimated effects on our results of operations, financial condition, and cash flows.

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### **Item 3. Quantitative and Qualitative Disclosures about Market Risk**

The information required under this Item 3 is included in Part II, Item 1A below entitled *Risk Factors* and should be read in connection with the information on market risk related to changes in interest rates and non-U.S. currency exchange rates in Part II, Item 7A, *Quantitative and Qualitative Disclosures About Market Risk*, in our Annual Report on Form 10-K for the year ended June 29, 2007. There have been no material changes in our exposure to market risk from that described in such report.

### **Item 4. Controls and Procedures**

#### *Evaluation of Disclosure Controls and Procedures*

As of the end of the period covered by this report, or the *Evaluation Date*, we carried out an evaluation under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended, or the Exchange Act). There are inherent limitations to the effectiveness of any system of disclosure controls and procedures. Accordingly, even effective disclosure controls and procedures can only provide reasonable, not absolute, assurance of achieving their control. Subject to these limitations, and based on the evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that, as of the *Evaluation Date*, the disclosure controls are not effective as a result of the material weakness discussed in Item 9A, *Controls and Procedures*, of our Annual Report on Form 10-K for the year ended June 29, 2007.

We are in the process of implementing changes to respond to the aforementioned material weakness on an immediate and longer term basis. The immediate responsive action being taken includes the implementation of process improvements related to foreign tax subsidiary reporting, enhancing the training of our tax accounting personnel, and implementing additional procedures appropriate for the internal financial close process as it relates to the tax department. We have begun remediation and expect to continue to implement further improvements throughout the next six months.

#### *Changes in Internal Control over Financial Reporting*

Additionally, we are investing in ongoing efforts to continuously improve our internal control over financial reporting and have committed considerable resources to the improvement of the design, implementation, documentation, testing and monitoring of our internal controls.

As of the date of this filing, we believe that we have made progress in the implementation of the corrective actions noted above and toward remediation of the material weakness disclosed in Item 9A, *Controls and Procedures*, of our Annual Report of Form 10-K for the fiscal year ended June 29, 2007.

There was no change in our internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the six months ended December 28, 2007 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Because of its inherent limitations, our internal control over financial reporting may not prevent material errors or fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. The continued effectiveness of our internal control over financial reporting is subject to risks, including that the controls may become inadequate because of changes in conditions or that the degree of compliance with our policies or procedures may deteriorate.

## **PART II OTHER INFORMATION**

### **Item 1. Legal Proceedings**

Information regarding legal proceedings is set forth in Note 20, *Contingencies*, to our notes to the condensed consolidated financial statements in Part I, Item 1 of this report, which information is hereby incorporated by reference.

**Item 1A. Risk Factors**

In evaluating our business, you should carefully consider the following risks in addition to the other information in this Quarterly Report on Form 10-Q. Any of the following risks could materially and adversely affect our business, results of operations and financial condition. It is not possible to predict or identify all such factors and, therefore, you should not consider any of the below risks to be a complete statement of all the potential risks or uncertainties that we face.

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*Our success depends on continued growth in sales of our recently-introduced clustered computing and storage products.*

We have changed the focus of our business from the sale of our legacy high-performance servers and visualization systems, which were based on our MIPS RISC microprocessors and IRIX operating systems and associated services, to our core products, which include high-performance clustered computing systems based on the Intel Xeon processors and the Linux operating system, high-performance shared memory computing systems based on the Intel Itanium2 processor and the Linux operating system, storage solutions, and associated services. We expect revenue from our legacy products and the customer support services for these products to continue to decline. Since the beginning of fiscal 2007, we have introduced Altix ICE, our first clustered computing product designed for the HPC market, expanded our Altix XE family of clustered computing products, and introduced new storage products. Our ability to achieve our overall revenue, gross margin and profitability objectives will depend significantly on the success of our core products, including these newly-introduced products, and associated professional and customer support services. Our limited operating history with these products and in the storage market makes it difficult for us to predict the level of market acceptance and sales of our clustered computing systems and storage products. Our ability to sustain and increase the rate of acceptance and revenue growth of these products depends on numerous factors, including:

competition from storage system vendors and suppliers of low-end and mid-range server clusters;

the performance of our core products in the field;

our ability to attract new customers that value our differentiated product features;

the quality and competitiveness of our support and consulting services;

the continued availability of dependable, low-cost microprocessors, including Intel's microprocessor families;

our ability to integrate our products into customers' existing Linux and other operating environments; and

continued growth in the demand for the Linux operating system for demanding computing environments.

*We expect demands on our working capital due to our increased bookings volume, in particular for large deals.*

Over the past several quarters we have seen significant incremental increases in quarter-over-quarter bookings. In addition, we have recently received orders for and have been awarded a number of significant deals. Our working capital requirements for these deals are such that we often must buy materials in support of the delivery requirements well before receiving cash or recognizing revenue. We may also incur expenses purchasing components we use in our products or the expense of manufacturing products during a period in which we have not received a firm order or payment for those products. We would incur these expenses in anticipation of receiving future orders for these products. In addition, the orders or contracts for which we incur expenses before receiving revenue may be reduced or changed, and we will not be able to recoup the expenses we have incurred. Because these cash outflows may occur in a period during which we will not receive payment for the orders, our cash balance may be significantly reduced in that period and our operating results for that period may suffer.

*We expect our operating results to continue to fluctuate significantly. These fluctuations will make our operating results difficult to predict and could cause them to fall below expectations, resulting in declines in our stock price.*

Our historical operating results have fluctuated significantly from period to period due to a variety of factors, and our future operating results are likely to fluctuate as well. As a result, comparing our operating results on a period-to-period basis may not be meaningful. You should not rely on our past results or the nature or timing of fluctuations in those results as an indication of our future performance. Also, a significant portion of our quarterly sales typically occurs near the end of the quarter. Thus, delays in the completion of sales can make our operating results difficult to predict. If our revenue or operating results fall below the expectations of investors or any securities analysts who may follow our stock, the price

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of our common stock would likely decline. Further, if our revenue increases or our operating results improve during a particular period but that increase or improvement is a one-time event or is not representative of a trend, the price of our common stock may fluctuate.

Additional factors that may cause fluctuations in our operating results include:

the timing and magnitude of shipments and the timing of installations and acceptance of our products, particularly those relating to large transactions;

changes in demand, sales cycles and prices for our products and services;

our ability in a timely manner to develop, introduce and ship new products and product enhancements that meet end-user requirements;

the timing of product releases, enhancements or announcements by us or our competitors;

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changes in the competitive dynamics of our markets, including new entrants or competitors discounting of product prices;

government budget and appropriations processes and spending cycles;

the revenue mix between our services and products and among our products;

our ability to attract new customers and retain existing customers;

changes in the gross margin for any of our products;

the availability, costs and timeliness of delivery of components obtained from third parties that are used in our products, the loss of one or more of our suppliers or a reduction in the capacity of one or more of our suppliers;

our inability to control operating expenses; and

variability in our ability to recognize revenue from sales resulting from application of AICPA Statement of Position 97-2, *Software Revenue Recognition*, or SOP 97-2, which requires the deferral of revenue under certain circumstances.

***Sales to or funded by the United States government, which account for the majority of our revenue, are subject to disruptions and delays.***

We derive a substantial portion of our revenue directly from U.S. government entities. In addition, many of our scientific and research customers depend on U.S. government funding for their information technology budgets. As a result, a majority of our revenue depends on sales to or funded by the U.S. government. Sales to or funded by the government present risks in addition to those involved in sales to commercial customers, including potential disruptions and delays due to changes in appropriation and spending patterns. Our government business is also highly sensitive to changes in the U.S. government's national and international priorities and budgeting. Changes in the continuing war on terrorism may affect funding for our programs or result in changes in government programs or spending priorities that may harm our business. In addition, the U.S. government can typically terminate or modify its contracts with us at any time for its convenience. Our U.S. government business is also subject to specific procurement regulations and a variety of other requirements. Failure to comply with these or other applicable regulations and requirements could lead to suspension or debarment from government contracting or subcontracting for a period of time. Any disruption or limitation in our ability to do business with the U.S. government or entities funded by the U.S. government would materially and adversely affect our revenue, operating results and the price of our stock.

***We have a history of losses, and we may not become profitable on a quarterly or annual basis. The failure to attain profitability on a sustained basis would harm our business and the value of our common stock.***

For many years, we have incurred substantial net operating losses and have failed to achieve positive cash flows from operations. For the first six months of fiscal 2008, ended December 28, 2007, we recognized an operating loss of \$58.0 million. We expect to incur losses and negative operating cash flows for the foreseeable future. If our revenue does not increase or if we fail to maintain our expenses at an amount less than our revenue, we will not be able to achieve or sustain profitability. A number of factors could preclude us from successfully bringing costs and expenses in line with our revenue, including unplanned uses of cash, the inability to forecast business activities accurately, further decline in our revenue and slower than expected acceptance of our newer products. In addition, a substantial portion of our service revenue comes from service of legacy systems, which is the most profitable segment of our service business. If this should decline faster than we anticipate, our profits would decrease. Our failure to operate profitably or to achieve positive cash flows on a quarterly or annual basis would harm our business and the value of our common stock.

***We may be unable to maintain our overall gross margin. A failure to maintain our overall gross margin would negatively affect our financial performance and stock price.***



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Our overall gross margin for our business has been and will continue to be affected by a variety of factors, including:

demand for our products and services;

the revenue mix among our products and between products and services;

discount levels and price competition;

our average system order size and end-user mix;

our ability to maintain sufficient levels of supplier credits in support of strategic deals;

the cost of components and service personnel; and

new product introductions and enhancements by us and our competitors.

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Due to these and other factors, we may be unable to maintain our overall gross margin. As we enter into new markets and introduce new products and services, our ability to forecast our overall gross margin and anticipate the effect of these and other factors diminishes. Reductions in our overall gross margin would negatively affect our financial performance and could lead to a decline in the price of our stock.

*We may not be able to raise additional capital in the future on commercially attractive terms or at all, which would restrict our growth and impair our ability to operate.*

We may need to obtain additional financing to fund our business, make acquisitions that are important to our strategy, or repay amounts outstanding under our financing facility. Financing may be unavailable in amounts or on terms acceptable to us. The failure to obtain any necessary financing, or our inability to obtain such financing on commercially attractive terms, could materially harm our business and the price of our stock. Our continued compliance with the terms of our financing facility limits our ability to obtain additional financing and our flexibility in planning for or reacting to changes in our business and the industry. In the event that our cash flows, together with available borrowings, are insufficient to meet our cash requirements, we may be required to reduce planned capital expenditures, sell additional assets or seek other sources of capital. If we raise funds by incurring further debt, our operations and finances would likely become subject to further restrictions. If we fail to comply with these further restrictions, our creditors may be able to exercise remedies that substantially impair our ability to operate. If we obtain additional funds by selling equity securities or if we issue equity derivative securities in connection with obtaining financing, our existing stockholders may suffer dilution and equity securities we issue may have rights, preferences or privileges senior to our common stock.

*Our business would be adversely affected by any production delay, discontinuance or decreased competitiveness of the microprocessors we use.*

Our core products incorporate system architectures designed for specific microprocessors that we obtain from third parties, including Intel. We require the assistance of microprocessor suppliers in connection with our technical development activities, and we rely on the continued development of their products so that they remain competitive in terms of performance and cost. As a result, our business depends on the continued availability, reliability and competitiveness of the microprocessors that we use and would be severely harmed by production delays or discontinuance of these microprocessor families. It is also important to our competitive position that our chosen microprocessors be competitive in quality and performance as well as price. Any increase in the cost of the microprocessors that we use in our products could make our products less competitive or lower our margins. Microprocessor technology changes rapidly, and in order to be competitive we must keep pace with those changes. Shortages in microprocessor supply and delays in new product introductions or product improvements could result in significant, widespread delays in the shipment of our systems, which would severely harm our operating results and stock price. Although we have taken steps with the introduction of new products to mitigate our dependence on a single microprocessor, the transition will take some time, and the mitigation will be expensive and time-consuming.

*We rely on a limited number of suppliers, and in some cases single-source suppliers, and any disruption or termination of these supply arrangements could delay shipments of our products and could materially and adversely affect our revenue and relationships with current and prospective end-users.*

We purchase the hardware for our storage products primarily from two suppliers, and purchase several of the components of our server products, from a small number of suppliers or a single supplier. This reliance on a limited number of suppliers involves several risks, including:

supplier capacity constraints;

price increases and limited bargaining flexibility;

establishing collaborative relationship with suppliers;

timely production and delivery; and

component quality.

We may be unable to obtain enough of these components in the future, and the prices of these components may increase. In addition, problems with respect to component quality and timeliness of deliveries may occur, which may delay customer acceptance and our ability to recognize revenue, may cause us to incur additional costs, or cause us to incur penalties under customer contracts that require timely delivery. In addition, our suppliers could enter into exclusive agreements with, or acquire or be acquired by, one of our competitors, increase their prices, refuse to sell their products to us, discontinue products or go out of business. Disruption or termination of the supply of our product components could require us to alter the design of our products to accommodate replacement components, and would require our personnel to spend significant amounts of time working with customers and new suppliers to minimize customer inconvenience and the down time of our products. Any disruption or termination of supply could seriously harm our relationships with current and prospective customers.

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***We face intense competition and expect competition to increase in the future, which could hinder the growth of or reduce our revenue or customer base.***

The server and storage markets are highly competitive, with rapid technological advances and constantly improving price/performance ratios. Our primary competitors include IBM and Hewlett Packard and with respect to our storage business, Network Appliance and EMC. We depend in part on maintaining sufficient levels of supplier credits in order to compete for strategic deals. If the magnitude of these credits were to become restricted either due to a strategy or regulatory change, it could impact both our gross margins and our ability to compete. Most of our competitors have substantially greater technical, marketing and financial resources and brand recognition. Some of our competitors also have a larger installed base of customers than we do. Particularly in the storage market, there are many new entrants that are competing with us and rapidly introducing new products and technologies. In addition, clustered computing systems comprise a significant percentage of the HPC market, and an increasing number of vendors are competing for this share of the market. Also, as the market for Linux-based systems grows, the number of competitors in that market is likely to increase. Intensifying competition in these markets and other markets in which we compete or that we may decide to enter may result in lower prices and thus lower gross margins, and our financial performance may suffer as a result.

***We maintain relatively low inventory and acquire components only as needed; as a result, if shortages of these components arise, we may not be able to secure enough components to build new products to meet customer demand.***

We maintain relatively low inventory and acquire components only as forecasted, and do not always enter into long-term supply contracts for these components. As a result, our ability to respond to customer orders efficiently may be constrained by the then-current availability or terms and pricing of these components. Our industry has experienced component shortages and delivery delays in the past, and we may experience shortages or delays of critical components in the future as a result of strong demand in the industry or other factors. Many of the other components required to build our systems are occasionally in short supply and subject to industry allocations. If shortages or delays arise, the prices of these components may increase or the components may not be available at all. We may not be able to secure enough components at reasonable prices or acceptable quality to build new products to meet customer demand, which could harm our business, operating results and financial condition.

***If we are unable to develop new hardware and software products upgrades and enhancements and to respond to technological changes, we may fail to increase, or we may lose, market share.***

Our future growth depends on our successful development and introduction of new products and enhancements to existing products in order to meet customer needs and to address the rapidly-changing competitive landscapes in the markets in which we compete. We have recently introduced new products in the clustered computing and storage markets, including our recently introduced visualization products and our Industrial Strength Linux<sup>®</sup> Environment initiative and we continue to spend significant resources on research and development in an effort to develop and introduce new hardware and software products, software enhancements and upgrades. The introduction of new clustered computing and storage products requires close collaboration among, and continued development of new technology by, multiple hardware and software design teams, internal manufacturing teams, outside suppliers of key components such as semiconductors, and contract manufacturers. The failure to collaborate and develop new technology effectively could cause our products under development to fail to meet specifications or to miss the timetables that we establish.

Our products must interoperate in our customers' computing environments, which often have unique specifications, use multiple protocol standards, incorporate products from multiple vendors and contain legacy components. We must be able to modify our products quickly to meet an end-user's unique environment, and as network, hardware and software technologies change we must be able to adapt rapidly. If we find errors in the software or defects in the hardware used in our customers' computing environments or problematic network configurations or settings, we may have to modify our products so that they will interoperate with our customers' computing environments. Failure to quickly modify our products and adapt to technological change could cause longer installation times for our products, delays of future purchases of our products or cancellations of orders, any of which would seriously harm our operating results.

***If we fail to manage the introduction of new products or enhancements effectively, we may fail to increase, or may lose, market share.***

Short product life cycles in our markets place a premium on our ability to enhance our products and manage transition to our new products. As we introduce new or enhanced products, we must successfully manage the transition from older products in order to minimize disruption in customers' ordering patterns, avoid excessive levels of older product inventories

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and ensure that sufficient supplies of new products can be delivered to meet customer demand. In addition, we must train and manage our sales force effectively in order to ensure that our sales force is aware of, and prepared to communicate to customers effectively about, the scheduled availability of and the improvements and features offered by the new products or enhancements. Development delays, excess costs, supplier quality or yield problems, variations in product and component costs and excess inventories of older products and components could adversely affect our business and operating results.

***If we fail to manage future expansion in current and new markets effectively, our business would be harmed.***

We intend to focus additional resources in the high-performance data management sectors in our vertical markets in order to increase our penetration and strengthen our end-user and other relationships in these sectors. This focus will require substantial management attention with respect to managing increasingly complex operations, allocating resources, managing expenditures, developing product roadmaps and recruiting, hiring, training, integrating and retaining highly skilled and motivated individuals. In addition, as we expand into new markets, we may face longer sales and implementation cycles, increased competition and increased pressure on our gross margins. Our operating results and financial condition would be harmed if we are not successful in managing this expansion effectively.

***A number of our executive officers have only recently been hired and they have limited experience with our business and with working with each other.***

Robert Bo Ewald joined us as our Chief Executive Officer in April 2007. Various other key employees and executive officers have joined us in the last year, including Douglas Britt, Senior Vice President of Worldwide Sales, Shahin Khan, Vice President of Strategy and Development, Irene Qualters, Senior Vice President of Software Engineering, and Raj Das, Vice President of Storage Marketing. These key personnel have limited experience with us and with each other, and they may be unable to work together to manage our business effectively or to generate positive operating results.

***If we lose key personnel or if we are unable to attract and retain highly-qualified personnel on a cost-effective basis, it would be more difficult for us to manage and grow our business.***

Our future performance depends on the continued service of our key technical, sales, services and management personnel. It is also critical that we are able to attract and retain technical, sales, service and management personnel with appropriate security clearances in order to enable us to maintain and increase our classified government business. Competition for these and the other personnel we require is intense, and we may fail to attract and retain key executives and employees in the future. To manage our operations, we rely on our key employees and executives, many of whom have many years of experience with our products and customers and the security clearances that are required to work with a number of our product installations. The loss of members of senior management or key employees could result in significant disruptions to our business, and the integration of replacement personnel could be time-consuming and disruptive and might be unsuccessful. The process of hiring, training and successfully integrating qualified personnel into our operations is lengthy and expensive. If we are not able to recruit and retain key personnel effectively, the quality and speed with which our products are developed, marketed and sold, and our ability to respond to technological developments in our industry, would likely be seriously compromised, and our reputation and business would suffer as a result.

***We may fail to comply with our debt covenants, and this noncompliance could place us in default and lead to termination of our facility and acceleration of our indebtedness.***

Our current financing facility, as amended, provides up to \$147.5 million of financing, consisting of an \$127.5 million term loan that matures in October 2011 and a \$20 million revolving line of credit. Monarch and Watershed, the two largest holders of our common stock, are the two largest lenders under the facility. Under the terms of this facility, we are required to comply with certain covenants, including maximum levels of capital expenditures and, beginning in calendar 2009, maximum leverage ratio, minimum levels of EBITDA and minimum levels of cash and cash availability. We may be unable to remain in compliance with these covenants, and noncompliance could lead to a default under the terms of the facility. In the event that we default, the facility could be terminated and our obligation to repay the indebtedness could be accelerated, which would seriously harm our financial condition and operating results and could adversely impact our ability to obtain replacement financing.

***Our international sales may require export licenses and expose us to additional risks.***

Our sales to customers outside the United States are subject to U.S. export regulations. Under these regulations, sales of many of our high-end products require clearance and export licenses from the U.S. Department of Commerce. Our international sales would be adversely affected if these regulations were tightened, or if they are not modified over time to reflect the increasing performance of our products. Delay or denial in the granting of any required licenses could make it more difficult to make sales to non-U.S. customers. In addition, we could be subject to regulations, fines and penalties for



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violations of import and export regulations if we were found in violation of these regulations. End-users could circumvent end-user documentation requirements that are intended to aid in our compliance with export regulations, potentially causing us to violate these regulations. These violations could result in penalties, including prohibitions on us from exporting our products to one or more countries, and could materially harm our business, including our sales to the U.S. government.

### ***We are subject to the risks of international operations.***

We generate a significant portion of our revenue from sales shipped to customer locations outside the United States, with international revenue representing 41.3%, 44.9% and 45.5% of our total revenue in fiscal 2005, 2006 and 2007, respectively. As a result, our business is subject to the risks associated with doing business internationally. International transactions frequently involve increased financial and legal risks arising from stringent contractual terms and conditions and the widely differing legal systems and customs in foreign countries. War, terrorism or public health issues in the regions of the world in which we do business may cause damage or disruption to commerce by creating economic and political uncertainties. These events could adversely affect our business in any number of ways, such as decreasing demand for our products, increasing our operating expenses, making it difficult to deliver products to customers, and causing delays and other problems in our supply chain. Our future revenue, gross margin, expenses and financial condition could also suffer due to other international factors, including but not limited to:

changes in a country's economic and labor conditions;

currency fluctuations;

compliance with a variety of foreign laws, as well as U.S. laws affecting the activities of U.S. companies abroad;

changes in tax laws;

changes in employment law;

changes in the regulatory or legal environment;

fluctuations in transportation costs;

natural and medical disasters; and

trade sanctions and protection measures.

***If we do not maintain strong financial controls, investor confidence in us may decline and our stock price may decline as a result.***

Maintaining our financial controls has become increasingly complex due to the constant evolution in accounting principles and changes to disclosure laws. Our business has also become more complex with the implementation of fresh-start accounting, and implementing and monitoring the appropriate controls are more complicated. Managing these factors in a cost-effective manner can be challenging, and we may be found to have significant deficiencies or material weaknesses in our internal control over financial reporting. For example, in connection with the audit of our fiscal 2007 financial statements, we identified a material weakness related to accounting for income taxes. The material weakness was comprised of the following deficiencies: We did not have adequate resources with sufficient technical expertise to properly account for income taxes in accordance with generally accepted accounting principles, specifically under fresh start accounting. We did not have adequate policies and procedures in place to ensure that the schedules supporting the income tax provision were properly prepared and reviewed.

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These deficiencies resulted in a material error in our income tax provision. Any such deficiency or weakness could undermine investor confidence and our stock price could decline as a result.

***Our products may contain component, manufacturing or design defects or may not meet our customers' performance criteria, which could cause us to incur significant installation or repair expenses, harm our customer relationships and industry reputation, reduce our revenue and make achieving profitability more difficult.***

We may experience design, manufacturing or component quality problems with our products that require us to replace components or entire products, in order to meet customers' performance criteria, or to meet continuing performance obligations through customer support services or warranty programs. Our product warranties last up to three years for certain products. As a result of component, manufacturing or design defects, we may be required to incur significant expenses to repair or replace a substantial number of products under our product warranties. Further, our customers may discover latent defects in our products that were not apparent when our products were installed. These defects may cause us to incur significant repair or replacement expenses beyond the normal installation period. Most of our customers use our systems for applications that are critical to their organization; as a result system reliability is critical to the success of our products. Any component, manufacturing or design defect or other reliability issues could cause us to lose customers or revenue or could damage our customer relationships and industry reputation.



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### ***If we fail to offer high-quality customer support, our business would suffer.***

After our products are deployed within the environments of our end-users, our end-users depend on our customer support organization to resolve issues relating to our products. The ability to offer high-quality customer support service is critical to the successful marketing and sale of our products. If we or any resellers of our products do not effectively assist our customers in deploying our products, succeed in helping our customers to resolve post-deployment issues quickly, and provide ongoing support, it would adversely affect our ability to sell our products to existing end-users and would harm our prospects with potential customers. Further, as we continue to expand our operations internationally, our customer support organization will face additional challenges, including those associated with providing on-site support. Our failure to maintain high-quality customer support services would harm our business, operating results and financial condition.

### ***We may become involved in intellectual property disputes, which could be expensive, distract our management team and result in reduced ability to use technologies that are important to our business.***

Monitoring and protecting against the unauthorized use of our patented technologies, products, trademarks and other proprietary rights are expensive, time-consuming and difficult. It is possible that third parties have used or in the future will use our intellectual property without our permission or knowledge. Periodically, we review publicly available information regarding intellectual property being developed by others in order to identify potential violations of our proprietary rights. The steps we have taken may not prevent unauthorized use of our intellectual property. Third parties in the past have asserted, and will in the future assert, intellectual property infringement claims against us. Future claims, if proved, could require us to pay substantial damages, redesign our existing products or pay fees to obtain cross-license agreements.

We expect that, as the number of hardware and software patents issued continues to increase, and as competition in the markets we address intensifies, the volume of intellectual property claims will also increase. Litigation may be necessary in the future to enforce or defend our intellectual property rights, to protect our trade secrets or to determine the validity and scope of our proprietary rights or the proprietary rights of others. Even if we are successful in obtaining licenses or entering into settlement arrangements, litigation could result in substantial costs and diversion of management resources, either of which could harm our business, operating results and financial condition. Further, many of our current and potential competitors have the ability to dedicate substantially greater resources to enforcing and defending their intellectual property rights than we have.

### ***Our use of open source and third-party software could impose unanticipated conditions or restrictions on our ability to commercialize our products.***

We incorporate open source software into our products. Open source software is made available to us and to the public by its authors or other third parties under licenses that impose certain obligations on licensees in the event those licensees re-distribute or make derivative works of the open source software. The terms of many open source licenses have not been interpreted by United States or other courts, and these licenses could be construed in a manner that imposes unanticipated conditions or restrictions on our ability to commercialize our products. In this event, we could be required to seek licenses from third parties in order to continue offering our products, to make generally available, in source code form, proprietary code that links to certain open source modules, to re-engineer our products, or to discontinue the sale of our products if re-engineering could not be accomplished on a timely basis, any of which might harm our business, operating results and financial condition.

### ***Our bankruptcy reorganization may negatively impact our future operations and the operations of our subsidiaries.***

In October 2006, we emerged from a Chapter 11 bankruptcy that has harmed, and may continue to harm, our ability to retain existing customers and suppliers, attract new customers and suppliers, and maintain contracts that are critical to our operations. The publicity surrounding our bankruptcy reorganization had a negative effect on our reputation and operating results.

### ***We may incur substantial costs in order to comply with laws and regulations governing the environment, which could harm our operating results.***

We are subject to various state, federal and international laws and regulations governing the environment, including those restricting the presence of certain substances in electronic products and making producers of those products financially responsible for their collection, treatment, recycling and disposal. These laws and regulations have been enacted in a number of jurisdictions in which we sell our products, including various European Union, or EU, member countries. For example, the EU has enacted the Restriction of the Use of Certain Hazardous Substances in Electrical and Electronic Equipment, or RoHS, and the Waste Electrical and Electronic Equipment, or WEEE, directives. RoHS prohibits the use of certain substances,



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including lead, in certain products, including hard drives, sold after July 1, 2006. The WEEE directive obligates parties that sell electrical and electronic equipment in the EU to put a clearly identifiable mark on the equipment, register with and report to EU member countries regarding distribution of the equipment and provide a mechanism to take back and properly dispose of the equipment. Similar legislation may be enacted in other locations where we sell our products. We will need to ensure that we comply with these laws and regulations as they are enacted, and that our suppliers also comply with these laws and regulations. If we or our suppliers fail to comply with the legislation, our customers may refuse or be unable to purchase our products, which could harm our business, operating results and financial condition.

In connection with our compliance with these environmental laws and regulations, we could incur substantial costs above our current estimates and be subject to disruptions to our operations and logistics. In addition, if we were found to be in violation of these laws, we could be subject to governmental fines and liability to our customers. If we have to make significant capital expenditures to comply with environmental laws, or if we are subject to significant expenses in connection with a violation of these laws, our business, operating results and financial condition could suffer.

***If our stock continues to have extremely low trading volume or our stock price continues to be volatile, stockholders may only be able to resell our shares at a loss or at a price below the most recently-quoted share price.***

Our common stock began trading on the Nasdaq Capital Market on October 23, 2006. From October 23, 2006 through January 25, 2008, the price of our common stock has fluctuated between \$14.62 and \$30.66 per share, with an average daily trading volume of approximately 28,357 shares. Because of our extremely low trading volume, any sale of common stock may have a depressive effect on our stock price. Also, volatility in our stock price may impact your ability to sell your shares at a profit. In addition to general market volatility and our low trading volume, many factors, a number of which are beyond our control, may have a significant adverse effect on the market price of our stock, including:

new products or services offered by us or our competitors;

failure to meet any publicly announced revenue or other financial projections;

actual or unanticipated variations in quarterly operating results;

changes in financial estimates by any securities analysts who follow our stock or the stock of our competitors;

announcements of significant acquisitions, strategic partnerships, joint ventures or capital commitments by us or our competitors;  
and

issuances of debt or equity securities.

In addition, the stock market in general, the Nasdaq Capital Market and companies in our industry have experienced extreme stock price and volume fluctuations that have often been unrelated or disproportionate to the operating performance of particular companies. Broad market and industry factors may negatively affect the market price of our common stock, regardless of our actual operating performance. In the past, following periods of volatility in the market price of a company's securities, securities class action litigation has often been instituted against that company. This type of litigation, if instituted, could result in substantial costs and a diversion of management's attention and resources, which would harm our business.

***Insiders have substantial control over us, which limits other stockholders' ability to influence corporate matters and could delay or prevent a third party from acquiring control over us.***

Monarch and Watershed, and their affiliates, beneficially own, in the aggregate, approximately 41% of our outstanding common stock. As a result, these stockholders are able to exercise influence over all matters requiring stockholder approval, including the election of directors and the approval of corporate transactions, such as a merger or other sale of our company or its assets. Monarch and Watershed are represented on

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our board of directors, and their affiliates also hold a majority of our indebtedness under our financing facility. In these capacities, these entities have the ability to exert significant control over us and our operations and may have a risk tolerance that differs from that of stockholders generally.

***Shares eligible for sale in the future could negatively affect our stock price.***

The market price of our common stock could decline as a result of sales of a large number of shares of our common stock or the perception that these sales may occur. This may make it more difficult for us to raise additional funds through the issuance of debt or the sale of equity securities. As of January 25, 2008, we had 11,180,334 outstanding shares of common stock, all of which are eligible for resale on the Nasdaq Capital Market. Shares held by Monarch, Watershed and Symphony Asset Management LLC and their affiliated entities, which totaled 5,632,191, currently may be sold publicly only in compliance with the volume, manner of sale and other restrictions of Rule 144 under the Securities Act, unless they are sold pursuant to a registration statement. We are obligated to file a shelf registration statement covering the resale of these shares of our common stock. When declared effective, all such shares will be freely tradable pursuant to the registration statement.

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As of December 28, 2007, there were an aggregate of 1,680,202 shares of common stock issuable upon exercise of outstanding stock options and settlement of RSUs, and we plan to issue additional stock options or RSUs in the future. The first vesting date for most of these stock options and RSUs was December 1, 2007. We expect increased sales of our common stock as those options and units vest.

***Because our operating results continue to be impacted by accounting adjustments that make it difficult to compare recent results to historical results and understand the true cash-flow dynamics, investors may be deterred from investing in our common stock.***

As required by fresh-start accounting policies that we were required to adopt upon our emergence from federal bankruptcy protection, we adjusted all of our assets and liabilities to fair value, and recognized certain deferred assets and liabilities, as of September 29, 2006. As a result of these adjustments, our financial condition and operating results from and after September 29, 2006 are not comparable to the financial condition and operating results reflected in the historical consolidated financial statements of the Predecessor Company. In addition, our adoption of SOP 97-2 for our transactions, including many of our large transactions, has required us to defer recognition of significant amounts of revenue. This revenue deferral has also caused our operating results to differ significantly from our operating results prior to such adoption. Because of these and other accounting adjustments a reader may not understand the actual trends in our business and may decide not to invest in our common stock as a result. As a result we may continue to experience volatility and extremely low trading volume in our common stock and stockholders may not be able to sell their shares at a profit.

***We do not intend to pay cash dividends on our common stock. Stockholders will realize a return on their investment only if our stock price appreciates and they sell.***

Our policy is to retain earnings to provide funds for the operation and expansion of our business. We have not paid cash dividends on our common stock and do not anticipate that we will do so in the foreseeable future. Our current financing facility prohibits the payment of cash dividends without the consent of our lenders. Any future payment of dividends will depend on our growth, profitability, financial condition, contractual restrictions and other factors that our board of directors may deem relevant.

***Delaware law and our amended and restated certificate of incorporation and bylaws contain provisions that could delay or discourage takeover attempts that stockholders may consider favorable and result in a lower market price for our common stock.***

Provisions in our certificate of incorporation and bylaws may have the effect of delaying or preventing a change of control or changes in our board of directors. These provisions include the following:

the division of our board into three classes;

the right of the board of directors to elect a director to fill a vacancy created by the expansion of the board of directors or due to the resignation or departure of an existing board member;

the prohibition of cumulative voting in the election of directors, which would otherwise allow less than a majority of stockholders to elect director candidates;

the requirement for the advance notice of nominations for election to the board of directors or for proposing matters that can be acted upon at a stockholders meeting;

the ability of our board of directors to alter our bylaws without obtaining stockholder approval;

the ability of the board of directors to issue, without stockholder approval, up to 5,000,000 shares of preferred stock with terms set by the board of directors, which rights could be senior to those of our common stock;

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the elimination of the rights of stockholders to call a special meeting of stockholders and to take action by written consent in lieu of a meeting; and

the required approval of at least 75% of the shares entitled to vote at an election of directors to adopt, amend or repeal our bylaws or repeal the provisions of our amended and restated certificate of incorporation regarding the election and removal of directors and the inability of stockholders to take action by written consent in lieu of a meeting.

In addition, because we are incorporated in Delaware, we are governed by the provisions of Section 203 of the Delaware General Corporation Law. These provisions may prohibit large stockholders, particularly those owning 15% or more of our outstanding voting stock, from merging or combining with us. These provisions in our amended and restated certificate of incorporation and amended and restated bylaws and under Delaware law could discourage potential takeover attempts, could reduce the price that investors are willing to pay for shares of our common stock in the future and could potentially result in the market price being lower than they would without these provisions.

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

(a) We held our 2007 Annual Meeting of Stockholders on November 19, 2007.

(b) The matters described below were voted on at the Annual Meeting of Stockholders, and the number of votes cast with respect to each matter and with respect to the election of directors, were as indicated.

1. To elect two Class I Directors, each for a three-year term.

**Class I Directors**

Robert H. Ewald:	For: 9,048,042	Withheld: 40,211
James A. McDivitt:	For: 9,001,310	Withheld: 86,943

2. To approve our amended and restated Management Incentive Plan.

For: 6,639,976	Against: 634,802	Abstain: 97,643	Non Votes: 1,715,832
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3. To approve our Employee Stock Purchase Plan.

For: 7,227,579	Against: 47,895	Abstain: 96,947	Non Votes: 1,715,832
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**Item 6. Exhibits**

The following Exhibits are filed as part of, or incorporated by reference into, this Quarterly Report on Form 10-Q:

- 2.1 Debtors First Amended Joint Plan of Reorganization Under Chapter 11 of the Bankruptcy Code, as modified, dated September 15, 2006 (incorporated by reference to Exhibit 2.1 to the Registrant's Current Report on Form 8-K, filed with the SEC on September 19, 2006)
- 2.2 Disclosure Statement for Debtors First Amended Joint Plan of Reorganization under Chapter 11 of the Bankruptcy Code dated July 27, 2006 (incorporated by reference to Exhibit 2.2 to the Registrant's Current Report on Form 8-K, filed with the SEC on September 19, 2006)
- 3.1 Amended and Restated Certificate of Incorporation of the Registrant (incorporated by reference to Exhibit 3.2 to the Registrant's Current Report on Form 8-K, filed with the SEC on October 20, 2006)
- 3.2 Bylaws of the Registrant (incorporated by reference to Exhibit 3.2 to the Registrant's Current Report on Form 8-K, filed with the SEC on October 20, 2006)
- 3.3 Amendment to the Bylaws of the Registrant (incorporated by reference to Exhibit 3.2 of the Current Report on Form 8-K, filed on December 21, 2007)
- 4.1 Amended and Restated Certificate of Incorporation of the Registrant (reference is made to Exhibit 3.1)
- 4.2 Bylaws and Amendment to the Bylaws of the Registrant (reference is made to Exhibits 3.2 and 3.3)

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- 4.3 Specimen Common Stock Certificate of the Registrant (incorporated by reference to Exhibit 4.3 of the registrant's Form S-3 filed on November 1, 2007)



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- 4.4 Registration Rights Agreement, dated October 17, 2006, by and among Silicon Graphics, Inc. and certain stockholders of Silicon Graphics, Inc. , including Watershed Capital Partners, L.P., Watershed Capital Institutional Partners, L.P., Watershed Capital Partners (Offshore), Ltd., QDRF Master Ltd., Quadrangle Debt Recovery Income Fund Master Ltd., Quadrangle Debt Opportunities Fund Master Ltd., and Encore Fund, L.P. (incorporated by reference to Exhibit 10.1 to the Registrant's Current Report on Form 8-K, filed with the SEC on October 20, 2006)
- 4.5 First Supplemental Indenture, dated September 18, 2006, between Silicon Graphics, Inc. and U.S. Bank National Association, as Trustee (incorporated by reference to Exhibit 4.10 to the Registrant's Annual Report on Form 10-K, filed with the SEC on October 16, 2006)
- 4.6 Second Supplemental Indenture, dated September 18, 2006, between Silicon Graphics, Inc. and U.S. Bank National Association, as Trustee (incorporated by reference to Exhibit 4.11 to the Registrant's Annual Report on Form 10-K, filed with the SEC on October 16, 2006)
- 10.31 Form of Employment Continuation Agreement
- 10.32 Summary of Amendment to the Employment Agreement by and between the Registrant and Robert H. Ewald
- 10.33 Silicon Graphics, Inc. 2007 Management Incentive Plan (incorporated by reference to Annex B to the Registrant's Schedule 14A filed on October 10, 2007)
- 10.34 Forms of Notice of Restricted Stock Unit Award and Restricted Stock Unit Award Agreement for Employees
- 10.35 Forms of Notice of Stock Option Award and Stock Option Agreement for Employees
- 10.36 Forms of Notice of Restricted Stock Unit Award and Restricted Stock Unit Agreement for Non-Employee Directors
- 10.37 Forms of Notice of Stock Option Award and Stock Option Agreement for Non-Employee Directors
- 10.38 Silicon Graphics, Inc. 2007 Employee Stock Purchase Plan (incorporated by reference to Annex C to the Registrant's Schedule 14A filed on October 10, 2007)
- 10.39 Third Amendment to the Senior Secured Credit Agreement dated February 4, 2008
- 10.40 Form of Separation Agreement and General Release
- 31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32.1 Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 for Robert H. Ewald and Kathy Lanterman

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**SIGNATURE**

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

Dated: February 6, 2008

SILICON GRAPHICS, INC.

a Delaware corporation

By: /s/ Kathy Lanterman  
Kathy Lanterman  
Chief Financial Officer  
(Principal Financial Officer and Principal Accounting Officer)