

CRAY INC
Form 10-Q
May 05, 2015

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

FORM 10-Q

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

For the quarterly period ended: March 31, 2015

Or

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

For the transition period from: to

Commission File Number: 0-26820

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

Washington
(State or Other Jurisdiction of
Incorporation or Organization)

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

901 Fifth Avenue, Suite 1000
Seattle, Washington
(Address of Principal Executive Office)
(206) 701-2000
(Registrant's telephone number, including area code)

98164
(Zip 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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ☒ No ☐

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

Large accelerated filer ☒

Accelerated filer ☐

Non-accelerated filer ☐ (Do not check if a smaller reporting company)

Smaller reporting company ☐

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

As of April 30, 2015, there were 40,820,807 shares of Common Stock issued and outstanding.

CRAY INC.
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Available Information

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

PART I. FINANCIAL INFORMATION

Item 1. Unaudited Condensed Consolidated Financial Statements

CRAY INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited and in thousands, except share data)

	March 31, 2015	December 31, 2014
ASSETS		
Current assets:		
Cash and cash equivalents	\$118,631	\$112,633
Restricted cash	16,849	16,874
Short-term investments	9,562	16,289
Accounts and other receivables, net	80,958	165,113
Inventory	210,159	143,632
Deferred tax asset	39,075	36,073
Prepaid expenses and other current assets	25,399	17,948
Total current assets	500,633	508,562
Long-term investments	2,897	—
Long-term investment in sales-type lease, net	27,155	31,089
Property and equipment, net	34,383	34,793
Service spares, net	1,953	1,868
Goodwill	14,182	14,182
Intangible assets other than goodwill, net	3,334	3,895
Deferred tax assets	42,274	41,414
Other non-current assets	17,067	15,631
TOTAL ASSETS	\$643,878	\$651,434
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$61,191	\$48,699
Accrued payroll and related expenses	9,837	16,054
Other accrued liabilities	5,183	16,285
Deferred revenue	71,751	65,910
Total current liabilities	147,962	146,948
Long-term deferred revenue	41,087	47,588
Other non-current liabilities	2,082	3,044
TOTAL LIABILITIES	191,131	197,580
Shareholders' equity:		
Preferred stock — Authorized and undesignated, 5,000,000 shares; no shares issued or outstanding	—	—
Common stock and additional paid-in capital, par value \$.01 per share — Authorized, 75,000,000 shares; issued and outstanding 40,880,628 and 40,822,377 shares, respectively	602,025	598,390
Accumulated other comprehensive income	11,222	6,503
Accumulated deficit	(160,500)	(151,039)
TOTAL SHAREHOLDERS' EQUITY	452,747	453,854

TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$643,878	\$651,434
See accompanying notes		

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

	Three Months Ended March 31,	
	2015	2014
Revenue:		
Product	\$52,741	\$30,015
Service	26,903	25,095
Total revenue	79,644	55,110
Cost of revenue:		
Cost of product revenue	40,756	23,972
Cost of service revenue	14,852	13,201
Total cost of revenue	55,608	37,173
Gross profit	24,036	17,937
Operating expenses:		
Research and development, net	22,187	22,621
Sales and marketing	12,552	11,776
General and administrative	6,140	5,413
Total operating expenses	40,879	39,810
Loss from operations	(16,843	) (21,873
Other income (expense), net	744	(646
Interest income, net	364	61
Loss before income taxes	(15,735	) (22,458
Income tax benefit	6,341	9,520
Net loss	\$(9,394	) \$(12,938
Basic net loss per common share	\$(0.24	) \$(0.34
Diluted net loss per common share	\$(0.24	) \$(0.34
Basic weighted average shares outstanding	39,003	38,317
Diluted weighted average shares outstanding	39,003	38,317
See accompanying notes		

CRAY INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS

(Unaudited and in thousands)

	Three Months Ended March 31,	
	2015	2014
Net loss	\$ (9,394	) \$(12,938)
Other comprehensive income (loss), net of tax:		
Unrealized gain (loss) on available-for-sale investments	(14	) 4
Foreign currency translation adjustments	483	23
Unrealized gain (loss) on cash flow hedges	4,320	(328)
Reclassification adjustments on cash flow hedges included in net loss	(70	) 20
Other comprehensive income (loss)	4,719	(281)
Comprehensive loss	\$ (4,675	) \$(13,219)
See accompanying notes		

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

	Three Months Ended March 31,	
	2015	2014
Operating activities:		
Net loss	\$(9,394	) \$(12,938)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	3,971	3,910
Share-based compensation expense	3,173	2,522
Deferred income taxes	(3,902	) (9,797)
Other	(969	) 639
Cash provided (used) due to changes in operating assets and liabilities:		
Accounts and other receivables	81,341	124,120
Long-term investment in sales-type lease, net	2,529	—
Inventory	(68,617	) (24,127)
Prepaid expenses and other assets	(4,801	) (5,588)
Accounts payable	13,371	1,612
Accrued payroll and related expenses and other accrued liabilities	(15,049	) (21,102)
Deferred revenue	1,176	1,760
Net cash provided by operating activities	2,829	61,011
Investing activities:		
Sales/maturities of available-for-sale investments	8,479	9,000
Purchases of available-for-sale investments	(4,697	) (52,732)
Increase in restricted cash	—	(19,432)
Purchases of property and equipment	(1,849	) (3,501)
Net cash provided by (used in) investing activities	1,933	(66,665)
Financing activities:		
Proceeds from issuance of common stock through employee stock purchase plan	169	169
Purchase of employee restricted shares to fund related statutory tax withholding	(134	) (453)
Proceeds from exercises of stock options	362	986
Net cash provided by financing activities	397	702
Effect of foreign exchange rate changes on cash and cash equivalents	839	10
Net increase (decrease) in cash and cash equivalents	5,998	(4,942)
Cash and cash equivalents:		
Beginning of period	112,633	192,633
End of period	\$118,631	\$187,691
Supplemental disclosure of cash flow information:		
Cash paid for interest	\$—	\$5
Cash paid for income taxes	\$661	\$1,232
Non-cash investing and financing activities:		
Inventory transfers to fixed assets and service inventory	\$2,083	\$680
See accompanying notes		

CRAY INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1— Basis of Presentation

In these notes, Cray Inc. and its wholly-owned subsidiaries are collectively referred to as the “Company.” In the opinion of management, the accompanying Condensed Consolidated Balance Sheets, Statements of Operations, Statements of Comprehensive Loss, and Statements of Cash Flows have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and notes required by GAAP for complete financial statements. Management believes that all adjustments (consisting of normal recurring adjustments) considered necessary for fair presentation have been included. Interim results are not necessarily indicative of results for a full year. The information included in this Form 10-Q should be read in conjunction with “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and the financial statements and notes thereto included in the Company’s Annual Report on Form 10-K for the fiscal year ended December 31, 2014.

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

Principles of Consolidation

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

Use of Estimates

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

Revenue Recognition

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

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

following criteria are met:

• The delivered item(s) has value to the customer on a standalone basis; and

- If the arrangement includes a general right of return relative to the delivered item(s), delivery or performance of the undelivered item(s) is considered probable and substantially in the control of the Company.

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

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

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

When the Company is unable to establish selling price using VSOE or TPE, the Company uses estimated selling price, or ESP, in its allocation of arrangement consideration. The objective of ESP is to determine the price at which the Company would transact a sale if the product or service were sold on a standalone basis. In determining ESP, the Company uses the cost to provide the product or service plus a margin, or considers other factors. When using cost plus a margin, the Company considers the total cost of the product or service, including customer-specific and geographic factors. The Company also considers the historical margins of the product or service on previous contracts and several factors including any changes to pricing methodologies, competitiveness of products and services and cost drivers that would cause future margins to differ from historical margins.

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

Services. Maintenance services are provided under separate maintenance contracts with customers. These contracts generally provide for maintenance services for one year, although some are for multi-year periods, often with prepayments for the term of the contract. The Company considers the maintenance period to commence upon acceptance of the product or installation in situations where a formal acceptance is not required, which may include a warranty period. When service is part of a multiple element arrangement, the Company allocates a portion of the arrangement consideration to maintenance service revenue based on estimates of selling price. Maintenance contracts that are billed in advance of revenue recognition are recorded as deferred revenue. Maintenance revenue is recognized ratably over the term of the maintenance contract.

Revenue from engineering services is recognized as services are performed.

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

The Company records revenue from certain research and development contracts which include milestones using the milestone method if the milestones are determined to be substantive. A milestone is considered to be substantive if

management believes there is substantive uncertainty that it will be achieved and the milestone consideration meets all of the following criteria:

- It is commensurate with either of the following:
 - The Company's performance to achieve the milestone; or
 - The enhancement of value of the delivered item or items as a result of a specific outcome resulting from the Company's performance to achieve the milestone.

It relates solely to past performance.

It is reasonable relative to all of the deliverables and payment terms (including other potential milestone consideration) within the arrangement.

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

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

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

Note 2— New Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board, or FASB, issued Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers: Topic 606 (ASU 2014-09), to supersede nearly all existing revenue recognition guidance under GAAP. The core principle of ASU 2014-09 is to recognize revenues when promised goods or services are transferred to customers in an amount that reflects the consideration that is expected to be received for those goods or services. ASU 2014-09 defines a five step process to achieve this core principle and, in doing so, it is possible more judgment and estimates may be required within the revenue recognition process than required under existing GAAP including identifying performance obligations in the contract, estimating the amount of variable consideration to include in the transaction price and allocating the transaction price to each separate performance obligation. ASU 2014-09 is effective for the fiscal and interim reporting periods beginning after December 15, 2016 using either of two methods: (i) retrospective to each prior reporting period presented with the option to elect certain practical expedients as defined within ASU 2014-09; or (ii) retrospective with the cumulative effect of initially applying ASU 2014-09 recognized at the date of initial application and providing certain additional disclosures as defined per ASU 2014-09. The Company is currently evaluating the potential impact of the pending adoption of ASU 2014-09 on its consolidated financial statements.

Note 3— Fair Value Measurement

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

In general, fair values determined by Level 1 inputs utilize quoted prices (unadjusted) in active markets for identical assets or liabilities. Fair values determined by Level 2 inputs utilize observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the related assets or liabilities. Fair values determined by Level 3 inputs are unobservable data points for the asset or liability, and include situations where there is little, if any, market activity for the asset or liability. The following table presents information about the Company's financial assets and liabilities that have been measured at fair value as of March 31, 2015, and indicates the fair value hierarchy of the valuation inputs utilized to determine such fair value (in thousands):

Description	Fair Value as of March 31, 2015	Quoted Prices in Active Markets (Level 1)	Significant Other Observable Inputs (Level 2)
Assets:			
Cash and cash equivalents and restricted cash	\$ 135,480	\$ 135,480	\$—
Available-for-sale investments (1)	12,459	12,459	—
Foreign exchange forward contracts (2)	16,778	—	16,778
Assets measured at fair value at March 31, 2015	\$ 164,717	\$ 147,939	\$ 16,778

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

Foreign Currency Derivatives

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

As of March 31, 2015 and December 31, 2014, the Company had outstanding forward contracts that were designated and accounted for as cash flow hedges of anticipated future cash receipts on sales contracts payable in foreign currencies. The outstanding notional amounts were approximately (in millions):

	March 31, 2015	December 31, 2014
British Pounds (GBP)	59.3	77.9
Euros (EUR)	16.8	40.7
Swiss Francs (CHF)	1.6	0.9
Singapore Dollars (SGD)	—	0.1
Swedish Krona (SEK)	—	84.8

The Company had hedged foreign currency exposure related to these designated cash flow hedges of approximately \$121.2 million and \$192.5 million as of March 31, 2015 and December 31, 2014, respectively.

As of March 31, 2015, the Company had outstanding forward contracts that had been dedesignated for the purposes of hedge accounting treatment with notional amounts of 9.5 million Euros and 26.3 million British Pounds, respectively.

As of December 31, 2014, the Company had outstanding forward contracts that had been dedesignated for the purposes of hedge accounting treatment with notional amounts of 28.3 million British Pounds. The foreign currency exposure related to these contracts was approximately \$53.3 million as of March 31, 2015 and \$43.4 million as of December 31, 2014. Unrealized gains or losses recorded in the Condensed Consolidated Statement of Operations related to these contracts are generally offset by foreign currency adjustments on related receivables. These forward contracts are considered to be economic hedges.

Cash receipts associated with the hedged contracts are expected to be received from 2015 through 2018, during which time the revenue on the associated sales contracts is expected to be recognized, or in the case of receivables denominated in a foreign currency, the receivables balances will be collected. Any gain or loss on hedged foreign currency will be recognized at the time of customer acceptance, or in the case of receivables denominated in a foreign currency, over the period during which hedged receivables denominated in a foreign currency are outstanding.

Fair values of derivative instruments designated as cash flow hedges (in thousands):

Hedge Classification	Balance Sheet Location	Fair Value as of March 31, 2015	Fair Value as of December 31, 2014
Foreign currency contracts	Prepaid expenses and other current assets	\$8,379	\$5,360
Foreign currency contracts	Other non-current assets	4,855	5,717
Foreign currency contracts	Other accrued liabilities	—	(1,219)
Foreign currency contracts	Other non-current liabilities	—	(152)
Total fair value of derivative instruments designated as cash flow hedges		\$13,234	\$9,706

Fair values of derivative instruments not designated as cash flow hedges (in thousands):

Hedge Classification	Balance Sheet Location	Fair Value as of March 31, 2015	Fair Value as of December 31, 2014
Foreign currency contracts	Prepaid expenses and other current assets	\$2,092	\$2
Foreign currency contracts	Other non-current assets	1,452	—
Foreign currency contracts	Other accrued liabilities	—	(235)
Foreign currency contracts	Other non-current liabilities	—	(533)

Total fair value of derivative instruments not designated as cash flow hedges	\$3,544	\$(766)
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Note 4— Accumulated Other Comprehensive Income

The following table shows the impact on product revenue of gross and net of tax reclassification adjustments from accumulated other comprehensive income resulting from hedged foreign currency transactions recorded by the Company for the three months ended March 31, 2015 and 2014 (in thousands). The gross reclassification adjustments increased product revenue for the three months ended March 31, 2015 and decreased product revenue for the three months ended March 31, 2014.

	Three Months Ended March 31,	
	2015	2014
Gross of tax reclassifications	\$117	\$(33)
Net of tax reclassifications	\$70	\$(20)

The following tables show the changes in Accumulated Other Comprehensive Income by component for the three months ended March 31, 2015 and 2014 (in thousands):

Three Months Ended March 31, 2015

	Unrealized Gain (Loss) on Investments	Foreign Currency Translation Adjustments	Unrealized Gain on Cash Flow Hedges	Accumulated Other Comprehensive Income
Beginning balance	\$12	\$2,069	\$4,422	\$6,503
Current-period change, net of tax	(14)	) 483	4,250	4,719
Ending balance	\$(2)	) \$2,552	\$8,672	\$11,222

Income tax expense (benefit) associated with current-period change	\$(10)) \$(328)) \$2,824	\$2,486
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Three Months Ended March 31, 2014

	Unrealized Gain on Investments	Foreign Currency Translation Adjustments	Unrealized Loss on Cash Flow Hedges	Accumulated Other Comprehensive Income
Beginning balance	\$—	\$3,257	\$(2,404)	) \$853
Current-period change, net of tax	4	23	(308)	) (281)
Ending balance	\$4	\$3,280	\$(2,712)	) \$572

Income tax expense (benefit) associated with current-period change	\$2	\$(167)) \$(205)) \$(370)
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Note 5— Loss Per Share ("EPS")

Basic EPS is computed by dividing net loss available to common shareholders by the weighted average number of common shares, excluding unvested restricted stock, outstanding during the period. Diluted EPS is computed by dividing net loss available to common shareholders by the weighted average number of common and potential common shares outstanding during the period, which includes the additional dilution related to conversion of stock options, unvested restricted stock and unvested restricted stock units as computed under the treasury stock method. For the three months ended March 31, 2015 and 2014, outstanding stock options, unvested restricted stock and unvested restricted stock units were antidilutive because of the net losses and, as such, their effect has not been included in the calculation of basic or diluted net loss per share. For the three months ended March 31, 2015 and 2014, potential gross common shares of 2.9 million and 3.2 million, respectively, were antidilutive and not included in computing diluted EPS. An additional 1.5 million and 1.1 million performance vesting restricted stock and performance vesting restricted stock units were excluded from the computation of diluted EPS for the three months

ended March 31, 2015 and 2014, respectively, because the conditions for vesting had not been met as of the balance sheet date.

Note 6— Investments

The Company's investments in debt securities with maturities at purchase greater than three months are classified as "available-for-sale." Changes in fair value are reflected in other comprehensive income (loss). The carrying amount of the Company's investments in available-for-sale securities as of March 31, 2015 are shown in the table below (in thousands):

	Cost	Unrealized Losses	Fair Value
Short-term available-for-sale securities	\$9,565	\$(3	) \$9,562
Long-term available-for-sale securities	2,898	(1	) 2,897
Total	\$12,463	\$(4	) \$12,459

The carrying amount of the Company's investments in available-for-sale securities as of December 31, 2014 are shown in the table below (in thousands):

	Cost	Unrealized Gains	Fair Value
Short-term available-for-sale securities	\$16,269	\$20	\$16,289

Note 7— Accounts and Other Receivables, Net

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

	March 31, 2015	December 31, 2014
Trade accounts receivable	\$41,749	\$126,874
Unbilled receivables	15,206	20,788
Advance billings	10,001	4,960
Short-term investment in sales-type lease	9,793	10,187
Other receivables	4,306	2,401
	81,055	165,210
Allowance for doubtful accounts	(97	) (97
Accounts and other receivables, net	\$80,958	\$165,113

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

As of March 31, 2015 and December 31, 2014, accounts receivable included \$49.6 million and \$87.0 million, respectively, that resulted from sales to the U.S. government and system acquisitions primarily funded by the U.S. government (U.S. Government). Of these amounts, \$3.2 million and \$2.1 million were unbilled as of March 31, 2015 and December 31, 2014, respectively, based upon contractual billing arrangements with these customers. As of March 31, 2015, one non-U.S. Government customer accounted for 12% of total accounts and other receivables. As of December 31, 2014, no non-U.S. Government customers accounted for more than 10% of total accounts and other receivables.

Note 8— Sales-type Lease

As of March 31, 2015 and December 31, 2014, the Company had a sales-type lease with one of its customers. Under the terms of the arrangement, the Company has agreed to provide a high performance computing solution to the customer for a term of four years, beginning at the customer's acceptance of the system.

The following table shows the components of the net investment in the sales-type lease as of March 31, 2015 and December 31, 2014 (in thousands):

	March 31, 2015	December 31, 2014
Total minimum lease payments to be received	\$47,267	\$ 53,134
Less: executory costs	(9,533)	(10,717)
Net minimum lease payments receivable	37,734	42,417
Estimated residual value of leased property (unguaranteed)	1,195	1,253
Less: unearned income	(1,981)	(2,394)
Net investment in sales-type lease	36,948	41,276
Less: long-term investment in sales-type lease	(27,155)	(31,089)
Investment in sales-type lease included in accounts and other receivables	\$9,793	\$ 10,187

As of March 31, 2015, minimum lease payments for each of the succeeding four fiscal years are as follows (in thousands):

2015 (Less than 1 Year)	\$10,129
2016	13,505
2017	13,505
2018	10,128
Total minimum lease payments to be received	\$47,267

Note 9— Inventory

Inventory consisted of the following (in thousands):

	March 31, 2015	December 31, 2014
Components and subassemblies	\$73,376	\$60,851
Work in process	54,963	46,954
Finished goods	81,820	35,827
Total	\$210,159	\$143,632

Finished goods inventory of \$78.5 million and \$35.3 million was located at customer sites pending acceptance as of March 31, 2015 and December 31, 2014, respectively. At March 31, 2015, three customers accounted for \$73.2 million, and at December 31, 2014, two customers accounted for \$31.2 million of finished goods inventory.

During the three months ended March 31, 2014, the Company wrote off \$0.4 million of inventory, primarily related to its CS300 product line. The Company had no inventory write-offs during the three months ended March 31, 2015.

Note 10— Deferred Revenue

Deferred revenue consisted of the following (in thousands):

	March 31, 2015	December 31, 2014
Deferred product revenue	\$27,613	\$ 21,152
Deferred service revenue	85,225	92,346
Total deferred revenue	112,838	113,498
Less: long-term deferred revenue	(41,087)	(47,588)
Deferred revenue in current liabilities	\$71,751	\$ 65,910

As of March 31, 2015 and December 31, 2014, the U.S. Government accounted for \$69.6 million and \$63.8 million, respectively, of total deferred revenue. As of March 31, 2015 and December 31, 2014, no non-U.S. Government customers accounted for more than 10% of total deferred revenue.

Note 11— Share-Based Compensation

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

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

In determining the fair value of stock options, the Company uses the Black-Scholes option pricing model. The following key weighted average assumptions were employed in the calculation for the three month periods ended March 31, 2015 and March 31, 2014:

	Three Months Ended March 31, 2015	Three Months Ended March 31, 2014
Risk-free interest rate	1.36%	1.24%
Expected dividend yield	—%	—%
Volatility	50.71%	50.40%
Expected life	4.0 years	4.0 years
Weighted average Black-Scholes value of options granted	\$12.04	\$11.01

The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant. The Company does not anticipate declaring dividends in the foreseeable future. Volatility is based on historical data. The expected life of an option is based on the assumption that options will be exercised, on average, about two years after vesting occurs. The Company recognizes compensation expense for only the portion of options or stock units that are expected to vest. Therefore, management applies an estimated forfeiture rate that is derived from historical employee termination data and adjusted for expected future employee turnover rates. The estimated forfeiture rate applied to the Company's stock option grants during the three months ended March 31, 2015 and 2014 was 8.0% and 10.0%, respectively. If the actual number of forfeitures differs from those estimated by management, additional adjustments to compensation expense may be required in future periods. The Company's stock price volatility, option lives and expected forfeiture rates involve management's best estimates at the time of such determination, which impact the fair value of the option calculated under the Black-Scholes methodology and, ultimately, the expense that will be recognized over the vesting period or requisite service period of the option. The Company typically issues stock options with a four year vesting period (the requisite service period) and amortizes the fair value of stock options (stock compensation cost) ratably over the requisite service period.

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

The following table sets forth the gross share-based compensation cost resulting from stock options and unvested restricted stock that were recorded in the Company's Condensed Consolidated Statements of Operations for the three months ended March 31, 2015 and 2014 (in thousands):

	Three Months Ended March 31, 2015	2014
Cost of product revenue	\$70	\$52
Cost of service revenue	66	69
Research and development, net	873	761
Sales and marketing	938	751
General and administrative	1,226	889
Total	\$3,173	\$2,522

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

	Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term
Outstanding at December 31, 2014	1,930,990	\$12.34	
Grants	35,000	\$29.78	
Exercises	(59,007)	\$6.14	
Canceled and forfeited	(5,560)	\$11.04	
Outstanding at March 31, 2015	1,901,423	\$12.86	6.5
Exercisable at March 31, 2015	1,277,910	\$8.85	5.6
Available for grant at March 31, 2015	1,991,533		

As of March 31, 2015, there was \$28.9 million of aggregate intrinsic value of outstanding stock options, including \$24.6 million of aggregate intrinsic value of exercisable stock options. Intrinsic value represents the total pretax intrinsic value for all "in-the-money" options (i.e., the difference between the Company's closing stock price on the last trading day of its first quarter of 2015 and the exercise price, multiplied by the number of shares of common stock underlying the stock options) that would have been received by the option holders had all option holders exercised their options on March 31, 2015. During the three months ended March 31, 2015, stock options covering 59,007 shares of common stock with a total intrinsic value of \$1.6 million were exercised. During the three months ended March 31, 2014, stock options covering 143,258 shares of common stock with a total intrinsic value of \$4.3 million were exercised.

A summary of the Company's unvested restricted stock grants and changes during the three months ended March 31, 2015 is as follows:

	Service Vesting Restricted Shares		Performance Vesting Restricted Shares		Total Restricted Shares	
	Shares	Weighted Average Grant Date Fair Value	Shares	Weighted Average Grant Date Fair Value	Shares	Weighted Average Grant Date Fair Value
Outstanding at December 31, 2014	1,033,602	\$19.48	817,000	\$15.41	1,850,602	\$17.68
Granted	8,000	\$29.14	—	\$—	8,000	\$29.14
Forfeited	—	\$—	(10,000)	\$12.88	(10,000)	\$12.88
Vested	(17,162)	\$11.24	—	\$—	(17,162)	\$11.24
Outstanding at March 31, 2015	1,024,440	\$19.69	807,000	\$15.45	1,831,440	\$17.82

The estimated forfeiture rate applied to the Company's restricted stock grants during the three months ended March 31, 2015 was 8.0%. The aggregate fair value of restricted stock vested during the three months ended March 31, 2015 and 2014 was \$0.5 million and \$1.1 million, respectively.

During the three months ended March 31, 2015, the Company granted a total of 699,300 performance vesting restricted stock units with a grant date fair value of \$30.04 per unit to senior level executives. Restricted stock units are not outstanding shares and do not have any voting or dividend rights. These restricted stock units are subject to performance measures that are currently not considered "probable" of attainment and as such, no compensation cost has been recorded. If the performance criteria is met in a future period, the restricted stock units will vest and a share of common stock representing each restricted stock unit will be issued by the Company. The performance vesting restricted stock units are eligible to vest between 2017 and 2020.

Including performance-based equity awards, the Company had \$47.7 million of total unrecognized compensation cost related to unvested stock options, unvested restricted stock and unvested restricted stock units as of March 31, 2015.

Excluding the \$33.3 million of unrecognized compensation cost related to unvested restricted stock and restricted stock units that are subject to performance measures that are currently not considered "probable" of attainment, unrecognized compensation cost would have been \$14.4 million. No compensation expense is recognized for unvested restricted stock or restricted stock units subject to performance measures that are not considered probable of attainment. Unrecognized compensation cost related to unvested stock options and unvested non-performance-based restricted stock is expected to be recognized over a weighted average period of 2.8 years.

Note 12— Taxes

The Company's effective tax rates for the three months ended March 31, 2015 and 2014 were as follows:

	Three Months Ended March 31,	
	2015	2014
Effective Tax Rates	40%	42%

The primary reason for the difference between the expected statutory tax rate of 35% and the actual tax rate of 40% for the three months ended March 31, 2015 was the result of state and foreign taxes. The primary reason for the difference between the expected statutory tax rate of 35% and the actual tax rate of 42% for the three months ended March 31, 2014 was the result of state taxes.

The Company reduced substantially all of the remaining valuation allowance held against its U.S. deferred tax assets during the year ended December 31, 2014. The Company continues to provide a valuation allowance against specific U.S. deferred tax assets and a full valuation allowance against deferred tax assets arising in a limited number of foreign jurisdictions as the realization of such assets is not considered to be more likely than not at this time. In a future period the Company's assessment of the realizability of its deferred tax assets and therefore the appropriateness of the valuation allowance could change based on an assessment of all available evidence, both positive and negative in that future period. If the Company's conclusion about the realizability of its deferred tax assets and therefore the appropriateness of the valuation allowance changes in a future period it could record a substantial tax provision or benefit in the Condensed Consolidated Statement of Operations when that occurs.

Note 13— Segment Information

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

Supercomputing

Supercomputing includes a suite of highly advanced supercomputers and cluster systems which are used by single users all the way up through large research and engineering centers in universities, government laboratories, and commercial institutions. Supercomputing also includes the ongoing maintenance of these systems as well as system analysts.

Storage and Data Management

Storage and Data Management offers the Cray Sonexion and Tiered Adaptive Storage solution as well as other third-party storage products and their ongoing maintenance as well as system analysts.

Maintenance and Support

Maintenance and Support provides ongoing maintenance of Cray supercomputers, big data storage and analytics systems, as well as system analysts.

Engineering Services and Other

Included within Engineering Services and Other is the Company's analytics business and Custom Engineering.

The following table presents revenues and gross margin for the Company's operating segments for the three months ended March 31 (in thousands):

	Three Months Ended March 31,	
	2015	2014
Revenue:		
Supercomputing	\$59,830	\$43,626
Storage and Data Management	15,194	8,065
Maintenance and Support	22,953	21,965
Engineering Services and Other	4,620	3,419
Elimination of inter-segment revenue	(22,953)	(21,965)
Total revenue	\$79,644	\$55,110
Gross Profit:		
Supercomputing	\$19,424	\$13,223
Storage and Data Management	3,721	2,907
Maintenance and Support	11,324	10,214
Engineering Services and Other	891	1,807
Elimination of inter-segment gross profit	(11,324)	(10,214)
Total gross profit	\$24,036	\$17,937

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

The Company's geographic operations outside the United States include sales and service offices in Europe and the Middle East, South America, Asia Pacific and Canada. The following data represents the Company's revenue for the United States and all other countries, which is determined based upon a customer's geographic location (in thousands):

	United States		Other Countries		Total	
	2015	2014	2015	2014	2015	2014
Three months ended March 31,						
Product revenue	\$31,564	\$10,463	\$21,177	\$19,552	\$52,741	\$30,015
Service revenue	18,919	17,744	7,984	7,351	26,903	25,095
Total revenue	\$50,483	\$28,207	\$29,161	\$26,903	\$79,644	\$55,110

Sales to the U.S. Government totaled approximately \$47.8 million for the three months ended March 31, 2015, compared to approximately \$22.0 million for the three months ended March 31, 2014. For the three months ended March 31, 2015, one non-U.S. Government customer accounted for 14% of total revenue and revenue in India accounted for 19% of total revenue. For the three months ended March 31, 2014, one non-U.S. Government customer accounted for 13% of total revenue and revenue in Japan accounted for 25% of total revenue.

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

Preliminary Note Regarding Forward-Looking Statements

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

Overview

We design, develop, manufacture, market and service the high-end of the high-performance computing, or HPC, market, primarily categories of systems commonly known as supercomputers and provide storage and analytics solutions. We also provide software, system maintenance and support services and engineering services related to supercomputer systems and our storage and data analytics solutions. Our customers include domestic and foreign government and government-funded entities, academic institutions and commercial entities. Our key target markets are the supercomputing portion of the HPC market and the expanding storage and analytics market. We provide customer-focused solutions based on three models: (1) highly integrated supercomputing and storage solutions, complete with highly tuned software, that stress capability, scalability, sustained performance and reliability at scale; (2) flexible commodity-based "cluster" supercomputing and storage solutions based upon utilizing best-of-breed components and working with our customers to define solutions that meet specific needs; and (3) turn-key analytic solutions featuring industry standards and innovative graph technologies. All of our solutions also emphasize total cost of ownership, scalable price-performance and data center flexibility as key features. Our continuing strategy is to gain market share in the supercomputer market segment, extend our technology leadership, maintain our focus on execution and profitability and grow by continuing to expand our addressable market in areas where we can leverage our experience and technology, such as in high performance storage systems and powerful analytic tools for large volumes of data, popularly referred to as "big data". We also meet diverse customer requirements by combining supercomputing, cluster, storage and analytics technologies described above, into unique solutions offerings that work in a workflow-driven datacenter environment.

Summary of First Three Months of 2015 Results

Total revenue increased \$24.5 million for the first three months of 2015 compared to the first three months of 2014, from \$55.1 million to \$79.6 million, due mainly to higher product revenue. The increase in product revenue of \$22.7 million was primarily attributable to a higher volume of Supercomputing and Storage and Data Management acceptances in the three months ended March 31, 2015 as compared to the first three months of 2014. Product revenue was positively impacted by customer acceptances of two large systems in the first quarter of 2015 for which we had previously anticipated acceptance to occur in the fourth quarter of 2014. Our product revenue is subject to significant quarter-to-quarter fluctuations and can be concentrated in particular quarters, often the fourth quarter. It is dependent

on factors such as the timing of new product releases, planned customer acceptances, and the availability of certain key components, among other factors.

Net loss for the first three months of 2015 was \$9.4 million compared to net loss of \$12.9 million for the same period in 2014. The decrease in net loss was primarily attributable to an increase in gross profit of \$6.1 million due to higher revenue, partially offset by a decrease in income tax benefit of \$3.2 million.

Net cash provided by operating activities was \$2.8 million for the first three months of 2015 compared to net cash provided by operating activities of \$61.0 million for the first three months of 2014. Net cash provided by operating activities in the first three months of 2015 was primarily driven by collections from customers that resulted in a decrease of \$81.3 million in

our accounts receivable balance, offset by an increase of \$68.6 million in inventory as a result of systems builds for future deliveries and the net loss of \$9.4 million.

Market Overview and Challenges

Significant trends in the HPC industry include:

- Supercomputing with many-core commodity processors driving increasing scalability requirements;
- Increased micro-architectural diversity, including increased usage of many-core processors and accelerators, as the rate of per-core performance increases slows;
- Data needs growing much faster than computational needs;
- Technology innovations in memory and storage allowing for faster data access such as NVRAM, SSDs and flash devices;
- The commoditization of HPC hardware, particularly processors and system interconnects;
- The growing commoditization of software, including plentiful building blocks and more capable open source software;
- Electrical power requirements becoming a design constraint and driver in total cost of ownership determinations;
- Increasing use of analytics technologies (Hadoop, Spark, NoSQL and Graph) in both the HPC and big data markets; and
- Cloud computing for cost-effective computing on loosely-coupled HPC applications.

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

In the market for the largest, and most scalable systems, those often costing in excess of \$3 million, the use of generally available network components can result in increasing data transfer bottlenecks as these components do not balance processor power with network communication capability. With the arrival of increasing processor core counts due to new many-core processors, these unbalanced systems will typically have even lower productivity, especially in larger systems running more complex applications. We augment standard microprocessors with other processor types, such as graphics processing units and many-core attached processors, in order to increase computational power, further complicating programming models. In addition, with increasing scale, bandwidth and processor core counts, large computer systems use progressively higher amounts of power to operate and require special cooling capabilities. To position ourselves to meet the market’s demanding needs, we concentrate our research and development efforts on technologies that enable our supercomputers to perform at scale - that is, to continue to increase actual performance as systems grow ever larger in size - and in areas where we can leverage our core expertise in other markets whose applications demand these tightly-coupled architectures. We also have demonstrated expertise in several processor technologies. We expect to be in a comparatively advantageous position as larger many-core processors become available and as multiple processing technologies become integrated into single systems in heterogeneous environments. In addition, we have continued to expand our addressable market by leveraging our technologies, customer base, the Cray brand and industry trends by introducing complementary products and services to new and existing customers, as demonstrated by our emphasis on strategic initiatives, such as storage and data management and “big data” analytics.

In storage, we are developing and delivering high value products for the high performance storage and data archiving markets. Cray storage products are primarily positioned to enable tight integration of storage to computing solutions and/or utilize parallel file processing technologies and facilitate storage across multiple data tiers. We support open source parallel file systems and protocol such as Lustre and are a founding member of the OpenSFS (Open Scalable File System) consortia for Lustre.

In analytics, we are developing and delivering high performance data discovery and advanced analytics solutions. These solutions compete with open source software, running on commodity cluster systems. Although these competitive systems have low acquisition costs, the total cost of ownership, or TCO, is driven up by management,

power and efficiency challenges. We concentrate our efforts on developing solutions that minimize the TCO, delivering faster time-to-solution and advanced capabilities that are key drivers for many of our data analytics customers.

We have also expanded our addressable market by providing cluster systems and solutions to the supercomputing market that allow us to offer flexible platforms to incorporate best of breed components to allow customers to optimize the system to fit their unique requirements.

Key Performance Indicators

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

Revenue. Product revenue generally constitutes the major portion of our revenue in any reporting period and, for the reasons discussed in this Form 10-Q or in our annual report on Form 10-K, is subject to significant variability from period to period. In the short term, we closely review the status of product shipments, installations and acceptances in order to forecast revenue and cash receipts; longer-term, we monitor the status of the pipeline of product sales opportunities and product development cycles. We believe product revenue growth measured over several quarters is a better indicator of whether we are achieving our objective of increased market share in the supercomputing market. The introduction of Cray XC and Cray CS products, along with our longer-term product roadmap are efforts to increase product revenue. We are also increasing our business and product development efforts in storage and data management along with big data analytics. Service revenue related to our maintenance offerings is more constant in the short term and assists, in part, to offset the impact that the variability in product revenue has on total revenue.

Gross profit margin. Our product gross profit margin increased from 20% for the three months ended March 31, 2014 to 23% during the same period in 2015. The product gross profit margin increased in part due to a lower percentage of our revenue being derived from cluster products, which typically carry a lower margin. Service gross profit margin decreased from 47% for the three months ended March 31, 2014 to 45% for the same period in 2015 primarily due to lower margins on engineering services contracts.

Operating expenses. Our operating expenses are driven primarily by headcount, contracted third-party research and development services, and incentive compensation expense. As part of our ongoing expense management efforts, we continue to monitor headcount levels in specific geographic and operational areas. Operating costs have increased as we made significant additional investments in sales and marketing and support staff to support our recent growth and position ourselves for growth in the future.

Liquidity and cash flows. Due to the variability in product revenue, new contracts, and payment terms, our cash position also varies significantly from quarter-to-quarter and within a quarter. We monitor our expected cash levels, particularly in light of increased inventory purchases for large system installations and the risk of delays in product shipments and acceptances and, longer-term, in product development.

Results of Operations

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

Revenue and Gross Profit Margins

Our revenue, cost of revenue and gross profit margin for the three months ended March 31, 2015 and 2014, respectively, were (in thousands, except for percentages):

	Three Months Ended March 31,		
	2015	2014	
Product revenue	\$52,741	\$30,015	
Less: Cost of product revenue	40,756	23,972	
Product gross profit	\$11,985	\$6,043	
Product gross profit margin	23	% 20	%
Service revenue	\$26,903	\$25,095	
Less: Cost of service revenue	14,852	13,201	
Service gross profit	\$12,051	\$11,894	
Service gross profit margin	45	% 47	%
Total revenue	\$79,644	\$55,110	
Less: Total cost of revenue	55,608	37,173	
Total gross profit	\$24,036	\$17,937	
Total gross profit margin	30	% 33	%

Product Revenue

Product revenue of \$52.7 million and \$30.0 million for the three months ended March 31, 2015 and 2014, respectively, was primarily from sales of our Cray XC, Cray CS and Sonexion storage systems. Product revenue for the three months ended March 31, 2015 increased from the prior year period primarily due to a higher volume of Supercomputing and Storage and Data Management acceptances in the three months ended March 31, 2015 as compared to the first three months of 2014. Product revenue was positively impacted by customer acceptances of two large systems in the first quarter of 2015 for which we had previously anticipated acceptance to occur in the fourth quarter of 2014.

Service Revenue

Service revenue for the three months ended March 31, 2015 was \$26.9 million compared to \$25.1 million for the same period in 2014. The increase in service revenue was due to higher maintenance revenue from our larger installed system base and higher engineering services revenue.

Cost of Product Revenue and Product Gross Profit

Cost of product revenue increased by \$16.8 million for the three months ended March 31, 2015, compared to the same period in 2014 driven primarily by higher product revenue. For the three months ended March 31, 2015, product gross profit margin increased 3% points to 23% from 20% in the same period in 2014. The product gross profit margin increased in part due to a lower percentage of our revenue being derived from cluster products, which typically carry a lower margin. Product gross profit margins in any one period may not be indicative of future results as product gross profit margins can vary significantly between contracts for many reasons.

Cost of Service Revenue and Service Gross Profit

For the three months ended March 31, 2015, cost of service revenue increased by \$1.7 million compared to the same period in 2014 driven primarily by higher service revenue. Service gross profit margin for the three months ended March 31, 2015 decreased by 2% points to 45% compared to 47% in the same period in 2014. The decrease was primarily due to lower margins on engineering services contracts.

Research and Development Expenses

Research and development expenses for the three months ended March 31, 2015 and 2014, respectively, were (in thousands, except for percentages):

	Three Months Ended March 31,	
	2015	2014
Gross research and development expenses	\$25,646	\$25,078
Less: Amounts included in cost of revenue	(3,213)	(1,457)
Less: Reimbursed research and development (excludes amounts in cost of revenue)	(246)	(1,000)
Net research and development expenses	\$22,187	\$22,621
Percentage of total revenue	28	% 41 %

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

For the three months ended March 31, 2015, gross research and development expenses increased by \$0.6 million compared to the same period in 2014 primarily due to increased investments in the development of new products. We increased our average headcount which resulted in higher compensation expense of \$1.3 million, including \$0.1 million in increased share based compensation. This was offset by a \$0.7 million decrease in outside services. Net research and development expenses decreased by \$0.4 million for the three months ended March 31, 2015, compared to the same period in 2014. The decrease was due to an increase in amounts included in cost of revenue, offset in part by higher gross research and development expenses and a decrease in reimbursed research and development expenses.

Sales and Marketing and General and Administrative Expenses

Our sales and marketing and general and administrative expenses for the three months ended March 31, 2015 and 2014, respectively, were (in thousands, except for percentages):

	Three Months Ended March 31,	
	2015	2014
Sales and marketing	\$12,552	\$11,776
Percentage of total revenue	16	% 21 %
General and administrative	\$6,140	\$5,413
Percentage of total revenue	8	% 10 %

Sales and Marketing. Sales and marketing expense for the three months ended March 31, 2015 increased by \$0.8 million, from the same period in 2014 primarily due to increased salaries and employee-related expenses incurred in connection with the expansion of our sales force. Compensation expense increased by \$0.8, including a \$0.2 million increase in share based compensation.

General and Administrative. General and administrative expense for the three months ended March 31, 2015 increased by \$0.7 million from the same period in 2014 primarily due to a year over year increase in headcount to support the growth in the business. Compensation expense increased by \$0.7 million, including a \$0.3 million increase in share based compensation.

Other Income (Expense), net

For the three months ended March 31, 2015, we recognized net other income of \$0.7 million compared to net other expense of \$0.6 million for the same period in 2014. Net other income and expense for the three months ended March 31, 2015 and 2014 included gains and losses from foreign currency transactions, investments and disposals of assets.

Interest Income, net

Our interest income and interest expense for the three months ended March 31, 2015 and 2014, respectively, were (in thousands):

	Three Months Ended March 31,	
	2015	2014
Interest income	\$369	\$71
Interest expense	(5	) (10
Interest income, net	\$364	\$61

Interest income, net for the three months ended March 31, 2015 increased as compared to the same period in 2014 due to amortization of unearned income on the sales-type lease that we entered into with a customer.

Taxes

Our effective tax rates were approximately 40% and 42% for the three months ended March 31, 2015 and 2014, respectively. The primary reason for the difference between the expected statutory tax rate of 35% and the actual tax rate of 40% for the three months ended March 31, 2015 was the result of state and foreign taxes. The primary reason for the difference between the expected statutory tax rate of 35% and the actual tax rate of 42% for the three months ended March 31, 2014 was the result of state taxes.

New Accounting Pronouncements

In May 2014, FASB, issued ASU 2014-09, to supersede nearly all existing revenue recognition guidance under GAAP. The core principle of ASU 2014-09 is to recognize revenues when promised goods or services are transferred to customers in an amount that reflects the consideration that is expected to be received for those goods or services. ASU 2014-09 defines a five step process to achieve this core principle and, in doing so, it is possible more judgment and estimates may be required within the revenue recognition process than required under existing GAAP including identifying performance obligations in the contract, estimating the amount of variable consideration to include in the transaction price and allocating the transaction price to each separate performance obligation. ASU 2014-09 is effective for the fiscal and interim reporting periods beginning after December 15, 2016 using either of two methods: (i) retrospective to each prior reporting period presented with the option to elect certain practical expedients as defined within ASU 2014-09; or (ii) retrospective with the cumulative effect of initially applying ASU 2014-09 recognized at the date of initial application and providing certain additional disclosures as defined per ASU 2014-09. We are currently evaluating the impact of our pending adoption of ASU 2014-09 on our consolidated financial statements.

Liquidity and Capital Resources

We generate cash from operations predominantly from the sale of supercomputing systems and related services. We typically have a small number of significant contracts that make up the majority of total revenue. We also recently entered into a sales-type lease agreement with a customer, under which we will receive quarterly payments over the next four years. The material changes in certain of our balance sheet accounts were due to the timing of product deliveries, customer acceptances, contractually determined billings and cash collections. Working capital requirements, including inventory purchases and normal capital expenditures, are generally funded with cash from operations.

Cash and cash equivalents increased by \$6.0 million from December 31, 2014 to March 31, 2015. The increase was primarily attributable to collections from customers that resulted in a decrease of \$81.3 million in our accounts receivable balance and sales and maturities of debt securities of \$8.5 million, offset by an increase of \$68.6 million in inventory as a result of systems builds for future deliveries, purchases of debt securities of \$4.7 million and the net loss of \$9.4 million.

As of March 31, 2015, we had working capital of \$352.7 million compared to \$361.6 million as of December 31, 2014. During the three months ended March 31, 2015, we invested \$4.7 million in debt securities and had a total of \$12.5 million in debt security investments as of March 31, 2015.

Cash flow information included the following (in thousands):

	Three Months Ended March 31,	
	2015	2014
Cash provided by (used in):		
Operating Activities	\$2,829	\$61,011
Investing Activities	\$1,933	\$(66,665)
Financing Activities	\$397	\$702

Operating Activities. Net cash provided by operating activities was \$2.8 million for the first three months of 2015 compared to net cash provided by operating activities of \$61.0 million for the first three months of 2014. Net cash provided by operating activities in the first three months of 2015 was primarily driven by collections from customers that resulted in a decrease of \$81.3 million in our accounts receivable balance, offset by an increase of \$68.6 million in inventory as a result of systems builds for future deliveries and the net loss of \$9.4 million. For the three months ended March 31, 2014, net cash provided by operating activities was primarily driven by a decrease of \$124.1 million in accounts receivable, offset by an increase of \$24.1 million in inventory and payment of the 2013 accrued incentive compensation expense, which resulted in a decrease of \$21.1 million in accrued payroll and related expenses.

Investing Activities. Net cash provided by investing activities was \$1.9 million for the three months ended March 31, 2015, compared to \$66.7 million net cash used in investing activities for the same 2014 period. Net cash provided by investing activities for the three months ended March 31, 2015 was due principally to sales and maturities of debt securities of \$8.5 million, partially offset by purchases of debt securities and property and equipment of \$4.7 million and \$1.8 million respectively. For the three months ended March 31, 2014, net cash used in investing activities was due principally to purchases of debt securities of \$52.7 million and an increase in restricted cash of \$19.4 million, partially offset by sales and maturities of debt securities of \$9.0 million.

Financing Activities. Net cash provided by financing activities for the three months ended March 31, 2015 was \$0.4 million compared to \$0.7 million net cash provided by financing activities for the same period in 2014. Net cash flows from financing activities for both periods resulted primarily from cash received from the issuance of common stock from the exercise of options and from the issuance of stock through our employee stock purchase plan, offset by statutory tax withholding amounts made in exchange for the forfeiture of common stock by holders of vesting restricted stock awards.

In addition, we lease certain equipment and facilities used in our operations under operating leases in the normal course of business and have contractual commitments under certain development arrangements. The following table summarizes our contractual obligations as of March 31, 2015 (in thousands):

	Amounts Committed by Year				
	Total	2015 (Less than 1 Year)	2016-2017	2018-2019	Thereafter
Contractual Obligations					
Development agreements	\$14,250	\$9,717	\$4,483	\$50	\$—
Operating leases	36,260	3,739	9,301	8,657	14,563
Total contractual cash obligations	\$50,510	\$13,456	\$13,784	\$8,707	\$14,563

As of March 31, 2015, we had a \$10.0 million unsecured line of credit with Wells Fargo Bank, National Association and an \$11.0 million letter of credit facility with Silicon Valley Bank. Both facilities are designed to support the issuance of letters of credit and foreign exchange hedging transactions. The Wells Fargo Bank, National Association credit facility matures in October 2015 and the Silicon Valley Bank credit facility matures in December 2015. We made no draws and had no outstanding cash borrowings on any lines of credit as of March 31, 2015.

As of March 31, 2015, we had \$12.6 million in outstanding letters of credit and \$16.8 million in restricted cash associated with certain letters of credit to secure customer prepayments and other customer related obligations.

In our normal course of operations, we have development arrangements under which we engage outside engineering resources to work on our research and development projects. For the three months ended March 31, 2015, we incurred \$2.8 million for such arrangements.

At any particular time, our cash position is affected by the timing of cash receipts for product sales, maintenance contracts, government co-funding for research and development activities and our payments for inventory, resulting in significant fluctuations in our cash balance from quarter-to-quarter and within a quarter. Our principal sources of liquidity are our cash and cash equivalents, short-term investments and cash from operations. We expect our cash resources to be adequate for at least the next twelve months.

Critical Accounting Policies and Estimates

This discussion, as well as disclosures included elsewhere in this quarterly report on Form 10-Q, are based upon our Condensed Consolidated Financial Statements, which have been prepared in accordance with GAAP. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses, and related disclosure of contingencies. In preparing our financial statements in accordance with GAAP, there are certain accounting policies that are particularly important. These include revenue recognition, inventory valuation, accounting for income taxes, research and development expenses and share-based compensation. Our significant accounting policies are set forth in Note 2 to the Consolidated Financial Statements included in our 2014 Annual Report on Form 10-K and should be reviewed in conjunction with the accompanying Condensed Consolidated Financial Statements and notes thereto as of March 31, 2015 in this quarterly report on Form 10-Q, as they are integral to understanding our results of operations and financial condition in this interim period. In some cases, these policies represent required accounting. In other cases, they may represent a choice between acceptable accounting methods or may require substantial judgment or estimation.

Additionally, we consider certain judgments and estimates to be significant, including those relating to the estimated selling price determination used in revenue recognition, percentage of completion accounting, estimates of proportional performance on co-funded engineering contracts, collectibility of receivables and prepaid engineering services, determination of inventory at the lower of cost or market, useful lives for depreciation and amortization, determination of future cash flows associated with impairment testing of long-lived assets, including goodwill and other intangibles, determination of the implicit interest rate used in the sales-type lease calculation, estimated warranty liability, determination of the fair value of stock options and other assessments of fair value, calculation of deferred income tax assets, including estimates of future financial performance in the determination of the likely recovery of deferred income tax assets, our ability to utilize such assets, potential income tax assessments and other contingencies. We base our estimates on historical experience, current conditions and on other assumptions that we believe to be reasonable under the circumstances. Actual results may differ materially from these estimates and assumptions. Our management has discussed the selection of significant accounting policies and the effect of judgments and estimates with the Audit Committee of our Board of Directors.

Revenue Recognition

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

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

services such as training and engineering services can be delivered as a discrete delivery or over the term of the contract. A multiple-element arrangement is separated into more than one unit of accounting if the following criteria are met:

- The delivered item(s) has value to the customer on a standalone basis; and

- If the arrangement includes a general right of return relative to the delivered item(s), delivery or performance of the undelivered item(s) is considered probable and substantially in our control.

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

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

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

When we are unable to establish selling price using VSOE or TPE, we use estimated selling price, or ESP, in our allocation of arrangement consideration. The objective of ESP is to determine the price at which we would transact a sale if the product or service were sold on a standalone basis. In determining ESP, we use the cost to provide the product or service plus a margin, or consider other factors. When using cost plus a margin, we consider the total cost of the product or service, including customer-specific and geographic factors. We also consider the historical margins of the product or service on previous contracts and several factors including any changes to pricing methodologies, competitiveness of products and services and cost drivers that would cause future margins to differ from historical margins.

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

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

Revenue from engineering services is recognized as services are performed.

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

We record revenue from certain research and development contracts which include milestones using the milestone method if the milestones are determined to be substantive. A milestone is considered to be substantive if management

believes there is substantive uncertainty that it will be achieved and the milestone consideration meets all of the following criteria:

- It is commensurate with either of the following:
 - Our performance to achieve the milestone; or
 - The enhancement of value of the delivered item or items as a result of a specific outcome resulting from our performance to achieve the milestone.
- It relates solely to past performance.

It is reasonable relative to all of the deliverables and payment terms (including other potential milestone consideration) within the arrangement.

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

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

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

Inventory Valuation

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

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

Accounting for Income Taxes

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

We recognize the income tax benefit from a tax position only if it is more likely than not that the tax position will be sustained on examination by the applicable taxing authorities, based on the technical merits of our position. The tax benefit recognized in the financial statements from such a position is measured based on the largest benefit that has a greater than fifty percent likelihood of being realized upon ultimate settlement.

Estimated interest and penalties are recorded as a component of interest expense and other expense, respectively. As of March 31, 2015, we had approximately \$91.0 million of net deferred tax assets, against which we provided a \$9.7 million valuation allowance, resulting in a net deferred tax asset of \$81.3 million. During the year ended December 31, 2014 we reduced substantially all of the remaining valuation allowance held against our U.S. deferred tax assets. The assessment of our ability to utilize our deferred tax assets included an assessment of all known business risks and industry trends as well as forecasted domestic and international earnings over a number of years. Our ability to forecast results significantly into the future is severely limited due to the rapid rate of technological and competitive change in the industry in which we operate.

We continue to provide a valuation allowance against specific U.S. deferred tax assets and a full valuation allowance against deferred tax assets arising in a limited number of foreign jurisdictions as the realization of such assets is not considered to be more likely than not at this time. In a future period our assessment of the realizability of our deferred tax assets and therefore the appropriateness of the valuation allowance could change based on an assessment of all available evidence, both positive and negative in that future period. If our conclusion about the realizability of our deferred tax assets and therefore the

appropriateness of the valuation allowance changes in a future period we could record a substantial tax provision or benefit in our Condensed Consolidated Statement of Operations when that occurs.

Research and Development Expenses

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

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

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

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

Share-based Compensation

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

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

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

We grant performance vesting restricted stock and performance vesting restricted stock units to executives as one of the ways to align compensation with shareholder interests. Vesting of these awards is contingent upon achievement of certain performance conditions. Compensation expense for these awards is only recognized when vesting is deemed to be probable.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

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

Interest Rate Risk: We invest our available cash in money market mutual funds whose underlying investments include investment-grade debt instruments of corporate issuers and in debt instruments of the U.S. government and its agencies. We do not have any derivative instruments or auction rate securities in our investment portfolio. We protect and preserve invested funds by limiting default, market and reinvestment risk. Investments in both fixed-rate and floating-rate interest earning instruments carry a degree of interest rate risk. Fixed-rate securities may have their fair market value adversely affected due to a rise in interest rates, while floating-rate securities may produce less income

than expected if interest rates fall. Due in part to these factors, our future investment income may fall short of expectations due to changes in interest rates or we may suffer losses in principal if

forced to sell securities which have declined in market value due to changes in interest rates. Although we have the above noted risks, a 0.5% change in interest rates would not be material.

Foreign Currency Risk: We sell our products primarily in North America, Asia and Europe. As a result, our financial results could be affected by factors such as changes in foreign currency exchange rates or weak economic conditions in foreign markets. Our products are generally priced based on U.S. dollars, and a strengthening of the dollar could make our products less competitive in foreign markets. While we often sell products with payments in U.S. dollars, our product sales contracts may call for payment in foreign currencies and to the extent we do so, or engage with our foreign subsidiaries in transactions deemed to be either short-term or long-term in nature, we are subject to foreign currency exchange risks.

As of March 31, 2015, we had entered into forward exchange contracts that were designated as cash flow hedges that hedge approximately \$121.2 million of anticipated cash receipts on specific foreign currency denominated sales contracts. These forward contracts hedge the risk of foreign exchange rate changes between the time that the related contracts were signed and when the cash receipts are expected to be received. As of March 31, 2015, we had entered into forward exchange contracts that had been dedesignated for the purposes of hedge accounting treatment totaling \$53.3 million. Unrealized gains or losses recorded in the Condensed Consolidated Statement of Operations related to these contracts are generally offset by foreign currency adjustments on related receivables. These forward contracts are considered to be economic hedges.

Our foreign maintenance contracts are typically paid in local currencies and provide a partial natural hedge against foreign exchange exposure. To the extent that we wish to repatriate any of these funds to the United States, however, we are subject to foreign exchange risks. We do not hold or purchase any currency forward exchange contracts for trading purposes. As of March 31, 2015, a hypothetical 10% unfavorable change in foreign currency exchange rates would impact our annual operating results and cash flows by approximately \$1.1 million.

Item 4. Controls and Procedures

Evaluation of disclosure controls and procedures. Under the supervision and with the participation of our senior management, including our chief executive officer and chief financial officer, we conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as of the end of the period covered by this quarterly report. Based on this evaluation, our chief executive officer and chief financial officer concluded as of March 31, 2015 that our disclosure controls and procedures were effective such that the information required to be disclosed in our SEC reports (i) is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and (ii) is accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate to allow timely decisions regarding required disclosure.

Changes in internal control over financial reporting. There have been no changes in our internal control over financial reporting that occurred during the quarter ended March 31, 2015 that have materially affected or are reasonably likely to materially affect our internal control over financial reporting.

Limitations on effectiveness of control. Our management, including our chief executive officer and chief financial officer, does not expect that our disclosure controls and procedures or our internal controls will prevent all errors and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within our Company have been detected.

Part II. OTHER INFORMATION

Item 1A. Risk Factors

You should carefully consider the risks described below together with all of the other information in this quarterly report on Form 10-Q and in our 2014 annual report on Form 10-K. If any of these risks actually occur, our business, financial condition or operating results could be materially adversely affected and the trading price of our common stock could decline.

Our operating results fluctuate significantly and we may not achieve profitability in any given period. Our operating results are subject to significant fluctuations which make predicting revenue and operating results for any specific period very difficult, particularly because a material portion of product revenue recognized in any given quarter or year typically depends on a very limited number of system sales expected for that quarter or year and the product revenue generally depends on the timing of product acceptances by customers and contractual provisions affecting revenue recognition. Delays in achieving customer acceptances of installed systems and recognizing revenue from a product transaction or transactions due to development or product delivery delays, not receiving needed components timely or with anticipated quality and performance, inability of a system to meet performance requirements or targets or other contractual obligations, or for other reasons, could have a material adverse effect on our operating results in any specific quarter or year, and could shift associated revenue, gross profit and cash receipts from one quarter to another, or even from one year to another in the case of revenue expected to be realized in the fourth quarter of any year as occurred in the fourth quarter of 2014. In addition, because our revenue can be concentrated in particular quarters, often the fourth quarter, rather than evenly spread throughout a year, we generally do not expect to sustain profitability over successive quarters even if we are profitable for the year.

Although we have recorded positive annual net income since 2010, we experienced net losses in earlier periods. Net income may fluctuate significantly as a result of many factors, including as a result of significant investments we may make to grow our business even though the benefits of those investments often require many years to come to fruition and may not be realized when expected or at all.

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

- our ability to secure sufficient orders for our Cray XC and Cray CS systems as well as upgrades and successor systems such as our next generation "Shasta" system;
- successfully delivering and obtaining sufficient customer acceptances of our Cray XC and Cray CS systems, including attached Sonexion storage systems;
- our ability to successfully generate revenue and profitability from sales of our analytics and storage and data management products, as well as upgrades and successor systems;
- revenue delays or losses due to customers postponing purchases to wait for future upgraded or new systems, including those containing new processors, delays in delivery of upgraded or new systems, longer than expected customer acceptance cycles or penalties resulting from system acceptance issues;
- our ability to efficiently scale our internal processes effectively to enable growth;
- the level of revenue recognized in any given period, which is affected by the very high average sales prices and limited number of significant system sales and resulting potential acceptances in any quarter, the timing of product acceptances by customers and contractual provisions affecting the timing and amount of revenue recognition;
- our ability to continue to broaden our customer base beyond our traditional customers;
- our expense levels, including research and development expense net of government funding;
- our ability to successfully and timely design, integrate and secure competitive processors for our Cray XC and Cray CS systems and upgrades and successors systems;
- the level of product gross profit contribution in any given period due to volume, competition or product mix, particularly with the introduction of flexible commodity-based supercomputers, competitive factors, strategic transactions, product life cycle, currency fluctuations, acceptance penalties and component costs;
- the competitiveness of our products and prices;
- our ability to secure additional government funding for future development projects;

maintaining and successfully completing our product development projects on schedule and within budgetary limitations;

the level and timing of maintenance contract renewals with existing customers; and

the terms and conditions of sale or lease for our products and services.

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

- the timely availability of acceptable components, including, but not limited to, processors, in sufficient quantities to meet customer delivery schedules and other customer commitments at a competitive cost;
- the timing and level of government funding and resources available for product acquisitions and research and development contracts, which has been, and may continue to be, adversely affected by the current economic and fiscal uncertainties, increased governmental budgetary limitations and disruptions in the operations of the U.S. government;
- the introduction or announcement of competitive or key industry supplier products;
- competitor pricing strategies;
- price fluctuations in the processors and other commodity electronics and memory markets;
- the availability of adequate customer facilities to install and operate new Cray systems;
- currency fluctuations, international conflicts or economic crises, including the ongoing economic challenges in the United States, Japan and Europe and fluctuations in oil prices that can affect the resources available to potential customers to purchase products;
- general economic trends, including changes in levels of customer capital spending; and
- our customers' ability to make future payments in accordance with contractual terms of their purchase or sales-type lease agreements.

Because of the numerous factors affecting our revenue and results of operations, we may not achieve profitability on a quarterly or annual basis in the future. We anticipate that our quarterly results will fluctuate significantly, and include losses, even in years where we expect or achieve positive annual net income. Delays in third-party component availability, product development, receipt of orders, or product acceptances, the level and timing of approved government fiscal budgets, issues with third-party component performance, reductions in outside funding for our research and development efforts and achieving contractual development milestones have had a substantial adverse effect on our past results and could continue to have such an effect on our results in 2015 and in future years.

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

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

- the level of product differentiation in our Cray XC systems and successor systems such as our next generation Shasta system. We need to compete successfully against HPC systems from both large, established companies and smaller companies and demonstrate the value of our balanced high bandwidth systems;
- whether potential customers delay purchases of our products because they decide to wait for successor systems or upgrades that we have announced or they believe will be available in the future;
-

our ability to meet all customer requirements for acceptance. Even once a system has been delivered, we sometimes do not meet all of the contract requirements for customer acceptance and ongoing reliability of our systems within the provided-for acceptance period, which has resulted in contract penalties and delays in our ability to recognize revenue from system deliveries. Most often these penalties have adversely affected gross profit at the time of revenue recognition through the provision of additional equipment and services and/or service credits to satisfy delivery delays and performance shortfalls. The risk of contract penalties is increased when we bid for new business prior to completing development of new products when we must estimate future system performance, such as has been required with our Cray XC systems and will be frequently required for subsequent systems such as our next generation Shasta system; and

our ability to source competitive, key components in appropriate quantities (to have enough to sell without ending up with excess inventory that can lead to obsolescence charges), in a timely fashion and on acceptable terms and conditions and that meet the performance criteria required.

Failure to successfully develop and sell our Cray XC systems and successor systems such as our next generation Shasta system into the supercomputing market and recognize revenue for such systems will adversely affect our operating results.

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

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

If the U.S. government and other governments purchase, or fund the purchase of, fewer supercomputers or delay such purchases, our revenue would be reduced and our operating results would be adversely affected. Historically, sales to the U.S. Government have represented the largest single market segment for supercomputer sales worldwide, including our products and services. In 2012, 2013, 2014 and the first three months of 2015, approximately 68%, 51%, 48% and 60%, respectively, of our revenue was derived from such sales. Our plans for the foreseeable future contemplate significant sales to the U.S. Government. Sales to the U.S. Government, including further sales pursuant to existing contracts, have been, and may continue to be, adversely affected by factors outside our control, such as by: Congressional decisions in addressing budget concerns and current economic uncertainty;

disruptions in the operations of the U.S. government;

“sequestration”;

the downgrading of U.S. government debt or the possibility of such action;

the political climate in the U.S. focusing on cutting or limiting budgets and their effect on government budgets;

the limits on federal borrowing capacity;

changes in procurement policies;

budgetary considerations, including Congressional delays in completing appropriation bills as occurred in 2011, 2012, 2013 and 2014;

domestic crises;

political efforts to limit the activities of U.S. intelligence community agencies; including proposed state legislation that would limit or even criminalize doing business with the NSA for certain companies doing business with state governments; and

international political developments, such as the downgrading of European debt.

If agencies and departments of the United States or other governments were to stop, reduce or delay their use and purchases of supercomputers, our revenue and operating results would be adversely affected.

Our reliance on third-party suppliers poses significant risks to our operating results, business and prospects. We rely upon third-party vendors to supply processors, including accelerators, for most of the products we sell and use service providers to co-develop key technologies. We subcontract the manufacture of a majority of the hardware components for our high-end products, including integrated circuits, printed circuit boards, memory parts, connectors, cables and power supplies, on a sole or limited source basis to third-party suppliers. We use contract manufacturers to assemble certain important components for all of our systems. We also rely on third parties to supply key software and hardware capabilities, such as file

systems, solution-specific servers and storage subsystems, and in the case of our Sonexion products, we rely on third-party original equipment manufacturers to supply complete storage systems. Because specific components must be designed into our systems well in advance of initial deliveries of those systems, we are particularly reliant on our processor vendors to deliver on the capabilities and pricing expected at the time we design key elements of the system and make binding bids to customers. We are subject to substantial risks because of our reliance on these and other limited or sole source suppliers, including the following risks:

if a supplier does not provide components or systems that meet our specifications in sufficient quantities and with acceptable quality on time or deliver when required, or delays future components or systems beyond anticipated delivery dates, then sales, production, delivery, acceptance and revenue from our systems could be delayed and/or reduced and we could be subject to costly penalties even once delivered and accepted, which has happened multiple times in the past and has at times significantly lowered our revenue for a particular quarter or year;

if a supplier cannot provide a competitive key component (for example, due to inadequate performance or a prohibitive price) or eliminates key features from components, such as with the processors we design into our systems, our systems may be less competitive than systems using components with greater capabilities;

if an interruption of supply of our components, services or capabilities occurs because a supplier changes its technology roadmap, decides to no longer provide those products or services, increases the price of those products or services significantly or imposes reduced delivery allocations on its customers, it could take us a considerable period of time to identify and qualify alternative suppliers, to redesign our products as necessary and to begin to manufacture the redesigned components or otherwise obtain those services or capabilities. In some cases, such as with key integrated circuits and memory parts or processors, we may not be able to redesign such components or find alternate sources that we could use in any realistic timeframe;

if a supplier plans future processors that are made available in a way that encourages customers to delay purchases of our products because they decide to wait for successor systems or upgrades they believe will be available in the future or to purchase products with the future processors from our competitors who are willing to take greater risk on delivery;

if a supplier of a component is subject to a claim that the component infringes a third-party's intellectual property rights, as has happened with multiple suppliers, our ability to obtain necessary components could be adversely affected or our cost to obtain such components could increase significantly;

if a supplier providing us with key research and development and design services or core technology components with respect to integrated circuit design, network communication capabilities or software is late, fails to provide us with effective functionality or loses key internal talent, our development programs may be delayed or prove to be impossible to complete;

if a supplier provides us with hardware or software that contains bugs or other errors or is different from what we expected, our development projects and production systems may be adversely affected through reduced performance or capabilities, additional design testing and verification efforts, re-spins of integrated circuits and/or development of replacement components, and the production and sales of our systems could be delayed and systems installed at customer sites could require significant, expensive field component replacements or result in penalties;

some of our key component and service suppliers are small companies with limited financial and other resources, and consequently may be more likely to experience financial and operational difficulties than larger, well-established companies, which increases the risk that they will be unable to deliver products as needed; and

if a key supplier is acquired or has a significant business change, such as occurred with the acquisition of the third-party original equipment manufacturers that supplies complete storage systems for our Sonexion product, the production and sales of our systems and services may be delayed or adversely affected, or our development programs may be delayed or may be impossible to complete.

Certain delays in the availability of acceptable components, including processors and memory parts, and increases in order lead times for certain components, adversely affected our revenue and operating results in multiple prior periods, in some cases significantly, and could adversely affect future results.

If our cluster systems are not successful, our operating results will be adversely affected. Our cluster products were first introduced late in 2012. We have had relatively limited experience selling cluster-based solutions, including into

the same markets we sell our core supercomputers, and if we cannot successfully and at acceptable margins sell these solutions, our operating results will be adversely affected.

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

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

Acquisitions may also cause us to:

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

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

If we are unable to compete successfully in the highly competitive HPC market, our business will not be successful. The market for HPC systems is very competitive. An increase in competitive pressures in our market or our failure to compete effectively may result in pricing reductions, reduced gross margins and loss of market share and revenue. Many of our competitors are established companies well known in the HPC market, including IBM, Hewlett-Packard, Lenovo, Dell, NEC, Hitachi, Fujitsu, Silicon Graphics International and Atos SE. Most of these competitors have substantially greater research, engineering, manufacturing, marketing and financial resources than we do.

We also compete with systems builders and resellers of systems that are constructed from commodity components using processors manufactured and/or designed by Intel, ARM, AMD, NVIDIA and others. These competitors include the companies named above and Dell, with IBM using both third-party processors and its own proprietary processors, as well as smaller companies that benefit from the low research and development costs needed to assemble systems from commercially available commodity products. Such companies, because they can offer high peak performance per dollar, can put pricing pressure on us in certain competitive procurements. In addition, to the extent that Intel, IBM and other processor suppliers develop processors with greater capabilities or at a lower cost than the processors we currently use, our Cray XC systems may be at a competitive disadvantage to systems utilizing such other processors until we can design in, integrate and secure competitive processors, if at all.

Our growth initiatives in the big data analytics and storage and data management markets must also compete successfully with many established companies and new entrants, many of whom have significantly greater resources and brand recognition in these markets than we do.

Periodic announcements by our competitors of new HPC, storage or data analytics systems or plans for future systems and price adjustments may reduce customer demand for our products. Many of our potential customers already own or lease high performance computer, storage or data analytics systems. Some of our competitors may offer substantial discounts to potential customers. We have in the past and may again be required to provide substantial discounts to make strategic sales, which may reduce or eliminate any gross profit on such transactions, or require us to provide

lease financing for our products, which could result in a multi-year deferral of our receipt of cash and revenue for these systems. These developments limit our revenue and financial resources and reduce our ability to be profitable and grow.

If we cannot retain, attract and motivate key personnel, we may be unable to effectively implement our business plan. Our success depends in large part upon our ability to retain, attract and motivate highly skilled management, development, marketing, sales and service personnel. The loss of and failure to replace key engineering management and personnel could adversely affect multiple development efforts. Recruitment and retention of senior management and skilled

technical, sales and other personnel is very competitive, and we may not be successful in either attracting or retaining such personnel. From time to time, including recently, we have lost key personnel to other high technology companies, and many larger companies with significantly greater resources than we do have aggressively recruited, and continue to aggressively recruit, key personnel. As part of our strategy to attract and retain key personnel, we may offer equity compensation through stock options and restricted stock grants. Potential employees, however, may not perceive our equity incentives as attractive enough. In addition, due to the intense competition for qualified employees, we may be required to and have had to increase the level of compensation paid to existing and new employees, which could materially increase our operating expenses.

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

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

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

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

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

Customers and other third parties may make statements speculating about or announcing an intention to complete purchases or acceptances of our products before such purchases or acceptances are substantially certain, and these proposed purchases or acceptances may not be completed when or as expected, if at all. From time to time, customers and other third parties may make statements speculating about or announcing a potential purchase of our products before we have obtained an order for such purchases or completed negotiations and signed a contract for the purchase

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

We are subject to increasing government regulations and other requirements due to the nature of our business, which may adversely affect our business operations. In 2012, 2013, 2014 and the first three months of 2015, approximately 68%, 51%, 48% and 60% respectively, of our revenue was derived from the U.S. Government. In addition to normal business risks, our contracts with the U.S. government are subject to unique risks, some of which are beyond our control. Our contracts with the U.S. government are subject to particular risks, including:

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

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

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

Our business is subject to potential U.S. government inquiries and investigations. We may be subject to U.S. government inquiries and investigations of our business practices due to our participation in government contracts. Any such inquiry or investigation could potentially result in a material adverse effect on our results of operations and financial condition.

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

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

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

We incorporate software licensed from third parties into the operating systems for our products as well as in our tools to design products and any significant interruption in the availability of these third party software products or defects in these products could reduce the demand for our products or cause delay in development. The operating system as well as other software we develop for our supercomputers contains components that are licensed to us under open source software licenses. Our business could be disrupted if this software, or functional equivalents of this software,

were either no longer available to us or no longer offered to us on commercially reasonable terms. In either case we would be required to redesign our operating system software to function with alternative third-party software, or develop these components ourselves, which would result in increased costs and could result in delays in product shipments. Our supercomputer systems utilize software system variants that incorporate Linux technology. The open source licenses under which we have obtained certain components of our operating system software may not be enforceable. Any ruling by a court that these licenses are not enforceable, or that Linux-based operating systems, or significant portions of them, may not be copied, modified or distributed

as provided in those licenses, would adversely affect our ability to sell our systems. In addition, as a result of concerns about the risks of litigation and open source software generally, we may be forced to protect our customers from potential claims of infringement. In any such event, our financial condition and results of operations may be adversely affected.

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

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

- harm to our ability to compete in relevant markets or in customer perception of our products;
- unanticipated costs or adverse tax consequences;
- exposure to potential liabilities to third parties or Intel, or claims for indemnification by Intel, including with respect to third-party litigation matters;
- delays and difficulties in receiving key components for our products from suppliers, including Intel;
- loss of customers, vendors or alliances; and
- failure to create long-term shareholder value with the additional cash resources.

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

The “conflict minerals” rule of the Securities and Exchange Commission, or SEC, has caused us to incur additional expenses, could limit the supply and increase the cost of certain metals used in manufacturing our products, and could make us less competitive in our target markets. On August 22, 2012, the SEC adopted a rule requiring disclosure by public companies of the origin, source and chain of custody of specified minerals, known as conflict minerals, that are necessary to the functionality or production of products manufactured or contracted to be manufactured by us. The rule requires companies to obtain sourcing data from suppliers, engage in supply chain due diligence, and file annually with the SEC a specialized disclosure report on Form SD covering the prior calendar year. Implementation of our conflict minerals policy could limit our ability to source at competitive prices and to secure sufficient quantities of certain minerals used in the manufacture of our products, specifically tantalum, tin, gold and tungsten, as the number of suppliers that provide conflict-free minerals may be limited. In addition, we have incurred, and may continue to incur, material costs associated with complying with the conflict minerals rule, such as costs related to the determination of the origin, source and chain of custody of the minerals used in our products, the adoption of conflict minerals-related governance policies, processes and controls, and possible changes to products or sources of supply as a result of such activities. Within our supply chain, we may not be able to sufficiently verify the origins of the relevant minerals used in our products through the data collection and due diligence procedures that we implement, which may harm our reputation. Furthermore, we may encounter challenges in satisfying those customers that require that all of the components of our products be certified as conflict free, and if we cannot satisfy these customers, they may choose a competitor’s products. We continue to investigate the presence of conflict materials within our supply chain.

We are required to evaluate our internal control over financial reporting under Section 404 of the Sarbanes-Oxley Act of 2002 at the end of each fiscal year, and any adverse results from such future evaluations could result in a loss of investor confidence in our financial reports and have an adverse effect on our stock price. Pursuant to Section 404 of the Sarbanes-Oxley Act of 2002, we are required to furnish a report by our management and a report by our

independent registered public accounting firm on our internal control over financial reporting in our annual reports on Form 10-K as to whether we have any material weaknesses in our internal controls over financial reporting. Depending on their nature and severity, any future material weaknesses could result in our having to restate financial statements, could make it difficult or impossible for us to obtain an audit of our annual financial statements or could result in a qualification of any such audit. In such events, we could experience a number of adverse consequences, including our inability to comply with applicable reporting and listing requirements, a loss of market confidence in our publicly available information, delisting from the NASDAQ Global Market, an inability to complete a financing, loss of other financing sources such as our line of credit, and litigation based on the events themselves or their consequences.

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

For example, our Restated Articles of Incorporation and Amended and Restated Bylaws provide for:

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

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

Item 6. Exhibits

Exhibit	Exhibit Description	Incorporated by Reference			Exhibit/Annex	Filed Herewith
		Form	File No.	Filing Date		
10.1	Offer Letter between the Company and Ryan W. J. Waite, dated October 27, 2014					X
10.2	Offer Letter between the Company and Margaret Ann Williams, dated April 14, 2005	8-K	000-26820	5/9/2005	10.1	
10.3	2015 Executive Bonus Plan					X
31.1	Certification of Chief Executive Officer Pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002					X
31.2	Certification of Chief Financial Officer Pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002					X
32.1	Certificate pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002					X
101.INS XBRL Instance Document*						
101.SCH XBRL Taxonomy Extension Schema Document*						
101.CAL XBRL Taxonomy Extension Calculation Linkbase Document*						
101.DEF XBRL Taxonomy Extension Definition Linkbase Document*						
101.LAB XBRL Taxonomy Extension Label Linkbase Document*						
101.PRE XBRL Taxonomy Extension Presentation Linkbase Document*						

Pursuant to Rule 406T of Regulation S-T, the Interactive Data Files on Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities and Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

SIGNATURES

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

CRAY INC.

Date: May 5, 2015

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

Date: May 5, 2015

/S/ BRIAN C. HENRY
Brian C. Henry
Executive Vice President and Chief Financial Officer

Date: May 5, 2015

/S/ CHARLES D. FAIRCHILD
Charles D. Fairchild
Vice President, Corporate Controller and Chief Accounting Officer