

SILICON GRAPHICS INC
Form 10-K
October 16, 2006
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

Annual Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.
For the fiscal year ended June 30, 2006.

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

Commission File Number 1-10441

SILICON GRAPHICS, INC.

(Exact name of registrant as specified in its charter)

Delaware
(State or Other Jurisdiction of

94-2789662
(I.R.S. Employer

Incorporation or Organization)

Identification No.)

1200 Crittenden Lane, Mountain View, California 94043-1351

(Address of principal executive offices, including zip code)

Registrant's telephone number, including area code: **(650) 960-1980**

Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to Section 12(g) of the Act:

Title of each class
Common Stock, \$0.001 par value
6.50% Senior Secured Convertible Notes

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act of 1933. Yes No

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Securities Exchange Act of 1934 (the Exchange Act). Yes No

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

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

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

Large accelerated filer Accelerated filer Non-accelerated filer

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

The aggregate market value of the registrant's voting stock held by non-affiliates of the registrant, based upon the closing sale price of the Common Stock on December 30, 2005 on the Over-the-Counter Bulletin Board, was approximately \$74 million. Shares of voting stock held by each executive officer and director and by each person who owns 5% or more of any class of registrant's voting stock have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

As of September 15, 2006, the registrant had 274,247,196 shares of Common Stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Part III of this Form 10-K will be filed with the Securities and Exchange Commission as an amendment to this Form 10-K in accordance with General Instruction G(3).

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The Business section and other parts of this Annual Report on Form 10-K contain forward-looking statements about our business, objectives, financial condition, and future performance that involve risks and uncertainties. These forward-looking statements include, among others, statements relating to the following: expected emergence from Chapter 11, expected levels of revenue, gross margin, operating expense, future profitability, our expectations for new product introductions and market conditions, our assessment of the adequacy of our liquidity and capital resources, our belief regarding capital levels required for fiscal 2007, headcount reductions, and the expected impact on our business of restructuring actions, legal proceedings, and government actions. We have based these forward-looking statements on our current expectations about future events. In some cases, you can identify forward-looking statements by terminology such as may, will, should, expects, plans, anticipates, believes, estimates, predicts, potential, or continue or the negative of such terms and similar terms. These forward-looking statements are only predictions and are subject to risks and uncertainties that could cause our actual results to differ materially from those expressed or implied in such statements. Factors that might cause such a difference in results include, but are not limited to: the effects of our Chapter 11 filing; our ability to maintain adequate liquidity; our ability to obtain and maintain normal terms with customers, suppliers and service providers; our ability to continue as a going concern; our ability to operate pursuant to the terms of our credit agreement; our ability to consummate our plan of reorganization with respect to our Chapter 11 Cases; our ability to maintain contracts that are critical to our operations; risks associated with the volatility of our stock price; risks associated with the timely development, production and acceptance of new products and services; increased competition; dependence on third party partners and suppliers; the failure to achieve expected product mix and revenue levels; failure to manage costs and generate improved operating results and cash flows; failure to maintain compliance with debt covenants; and failure to maintain adequate cash resources for the operation of our business. Additional risks and uncertainties include the following: risks related to liquidity and the adequacy of our capital resources; risks related to our ability to achieve profitable operations or limit losses; risks related to the impact on our business of the restructuring effected in fiscal 2005 and the significant restructuring effected in fiscal 2006 and to be effected in fiscal 2007; risks related to our compliance with debt covenants; changes in customer order patterns; the impact of employee attrition and our ability to hire certain key professionals in areas such as sales, marketing, finance, engineering and product management in order to execute our business strategies; adverse changes in general economic or business conditions; adverse changes in the markets for our products, including expected rates of growth and decline in our current markets; heightened competition, reflecting rapid technological advances and constantly improving price/performance, which may result in significant discounting and lower gross profit margins; continued success in technological advancements and the acceptance of new product introductions; risks related to dependence on our partners and suppliers; risks related to foreign operations (including weak or disrupted economies, unfavorable currency movements, and export compliance issues); risks associated with intellectual property disputes and other claims and litigation; and other factors, including, but not limited to, those discussed below under the heading Risk Factors in Item IA of this Form 10-K. We undertake no obligation to publicly update or revise any forward-looking statements, whether changes occur as a result of new information, future events, changed assumptions, or otherwise.

ITEM 1. BUSINESS**General**

SGI is a leading provider of products, services, and solutions for use in high-performance computing and storage. We sell highly scalable servers, storage solutions, and associated software products that enable our customers in the scientific, technical and business communities to solve their most challenging problems and provide them with strategic and competitive advantages. Whether analyzing images to aid in brain surgery, studying global climate changes, accelerating the engineering of new automotive designs, providing technologies for homeland security, or gaining business intelligence from mining a company's databases, SGI's systems are designed to compute vast amounts of data, translate data into high-resolution images in a realistic timeframe and scale, and provide high-speed storage. We also offer a range of services and solutions, including professional services, customer support, and education. These products and services are used in a range of application segments including defense and intelligence, sciences, engineering analysis, and enterprise data management.

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Chapter 11 Reorganization

On May 8, 2006 (the *Petition Date*), Silicon Graphics, Inc. (the *Company* or *SGI*) and certain of its subsidiaries (collectively, the *Debtors*), filed voluntary petitions for reorganization under chapter 11 of Title 11 (*Chapter 11*) of the United States Code (the *Bankruptcy Code*) in the United States Bankruptcy Court for the Southern District of New York (the *Court*) (Case Nos. 06-10977BRL through 06-10990BRL) (the *Chapter 11 Cases*). Certain subsidiaries of SGI, consisting principally of international subsidiaries, are not debtors (collectively, the *Non-Debtors*) in this bankruptcy proceeding. The Debtors remain in possession of their assets and properties as debtors-in-possession (*DIP*) under the jurisdiction of the Court and in accordance with the provisions of the Bankruptcy Code. In general, as debtors-in-possession, each of the Debtors is authorized to continue to operate as an ongoing business, but may not engage in transactions outside the ordinary course of business without the prior approval of the Court. For further information regarding these petitions, see Note 1 to the consolidated financial statements in Part II, Item 8 of this Form 10-K.

On May 10, 2006, SGI, Silicon Graphics Federal, Inc. and Silicon Graphics World Trade Corporation (collectively, the *Borrowers*) entered into a Post-Petition Loan and Security Agreement (the *Interim DIP Agreement*) dated as of May 8, 2006 with Quadrangle Master Funding Ltd., Watershed Technology Holdings, LLC and Encore Fund, L.P. (collectively, the *Interim DIP Lenders*). The Interim DIP Agreement provided \$70 million of DIP financing (the *\$70 million DIP Financing*) to the Borrowers secured by certain of the Borrowers' assets.

In June 2006, the Debtors entered into a replacement Post-Petition Loan and Security Agreement (the *DIP Agreement*) with Morgan Stanley Senior Funding, Inc. (the *Administrative Agent*), Wells Fargo Foothill, Inc., the Interim DIP Lenders and certain other lenders party thereto (collectively, the *DIP Lenders*), providing up to \$130 million of debtor-in-possession financing (the *\$130 million DIP Financing*). This \$130 million DIP Financing was approved by the Court on June 26, 2006 and we borrowed \$100 million against this facility, of which a portion of the funds were used to repay our outstanding borrowings against the \$70 million Interim DIP Financing and our pre-petition asset-backed credit facility.

At a hearing held on July 27, 2006, the Court approved the Company's Disclosure Statement, ruling that it contained adequate information for soliciting creditor approval of the Company's Plan of Reorganization. At a hearing held on September 19, 2006, the Court confirmed the Company's Plan of Reorganization as amended (the *Plan*). This Confirmation Order became a Final Order on October 2, 2006. We expect to emerge in October 2006 subject to the remaining conditions precedent to emergence:

The conditions precedent to the effectiveness of the Exit Facility and the Backstop Commitment Agreement are satisfied or waived by the parties thereto and the Reorganized Debtors have access to funding under the Exit Facility;

Allowed General Unsecured SGI Federal Claims and Allowed General Unsecured SGI World Trade Claims shall not aggregate more than \$1 million;

All actions, agreements, instruments or other documents necessary to implement the terms and provisions of the Plan are effected or executed and delivered, as applicable; and

All authorizations, consents and regulatory approvals, if any, required by the Debtors in connection with the consummation of the Plan are obtained and not revoked.

Under Chapter 11, we are continuing to operate our business without interruption as a debtor-in-possession under the jurisdiction of the Court and in accordance with the applicable provisions of the Bankruptcy Code, the Federal Rules of Bankruptcy Procedure, applicable court orders, as well as other applicable laws and rules. In general, a debtor-in-possession is authorized under Chapter 11 to continue to operate as an ongoing business, but may not engage in transactions outside the ordinary course of business without the prior approval of the Court.

Although we cannot currently estimate the impact of the Chapter 11 filings on our future financial statements, we have determined that we will be required to review certain assumptions used in determining the fair values of our long-lived assets and other intangibles, deferred revenue and the realizability of our accounts receivable among other items. These charges will have a significant non-cash impact on our future results of operations, but will have no impact on the underlying cash, working capital assumptions or the underlying operation of the business.

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Proposed Business Plan

In connection with our Chapter 11 proceeding, we prepared a proposed business plan that was presented to our Court appointed Creditors Committee on June 30, 2006 and is described in our Disclosure Statement. Certain highlights of the business plan are provided below. The projections underlying the business plan were not prepared to conform to the guidelines established by the American Institute of Certified Public Accountants regarding financial forecasts, and were not audited, reviewed, or compiled by our independent registered public accounting firm. It should also be noted that the following highlights are forward looking and based on certain forecasts, market assumptions and many other factors and, as such, are inherently inaccurate and should not be relied upon. Further, our proposed business plan described in the Disclosure Statement and the assumptions utilized therein were determined prior to the finalization of our consolidated financial statements for fiscal 2006. A change in these assumptions or factors could significantly affect the projections contained in the business plan. Additionally, you should carefully read the Cautionary Statement Regarding Forward-Looking Information section of this Form 10-K for a list of some of the items that could affect our business and actual financial results.

The business plan projects pro forma year-over-year consolidated revenue growth of between approximately 2.5% to 5.0% given our strategies regarding new product development, penetration of new markets and the stabilization of our current core of revenue sources. Accordingly, the business plan projects consolidated revenue of \$532 million in fiscal 2006 to increase to approximately \$671 million in fiscal 2011. The business plan projects gross profit of between 38% and 40% with slight changes as the mix of products changes and as revenue increases while fixed costs of goods sold remains static. The business plan projects that we will continue to implement further restructuring actions to reduce costs in fiscal 2008 and as such, operating expenses, excluding restructuring, will continue to decline through fiscal 2008. For fiscal 2009 and beyond, the projections assume that operating expenses will increase for modest annual increases in employee compensation. The business plan projects an operating loss of approximately \$22 million in fiscal 2007 as we continue to implement restructuring actions to achieve profitability in fiscal 2008 and beyond.

The business plan projects that, at emergence, we will obtain a term loan for approximately \$70 million and will repay the outstanding debtor-in-possession (DIP) facility with part of the \$50 million proceeds from the rights offering and the \$70 million exit facility. Post-emergence projected interest expense represents interest expense associated with the \$70 million exit facility.

Upon emergence, the business plan projects that our new common stock will consist of 25,000,000 authorized shares of the reorganized company with distributions including approximately 10,000,000 shares issued and distributed to holders of Allowed Secured Note Claims and Allowed Cray Unsecured Debenture Claims, 1,125,000 shares distributed as Overallotment Shares pursuant to the Backstop Purchasers pursuant to the Backstop Purchase Agreement, and a certain number of shares not to exceed 10% of the new common stock to be distributed pursuant to the terms of the New Management Incentive Plan.

In preparing the business plan, we made many assumptions, which, if changed, could significantly affect the results of operations against the business plan. Some of the major assumptions include: current and projected market conditions in each of our respective markets; successful implementation of our top-line growth strategies; successful execution of operational improvements including cost savings opportunities in our manufacturing operations and in administrative departments; and the ability to maintain sufficient working capital to self-fund our operations or gain access to financing sources to fund any deficiencies. We undertake no obligation to publicly update or revise any of the projections or information discussed in the business plan, whether changes occur as a result of new information, future events, changed assumptions, or otherwise.

Business Strategy

For more than 20 years, SGI systems have enabled discovery, innovation and information transformation for scientists, engineers and creative professionals who benefit from systems engineered to meet their specific needs. We are taking the knowledge that we have gained in our traditional markets, coupled with the services our customers rely on and are making that more broadly available across our customers organization or enterprise. The unique shared-memory architecture of our server product line enables enterprise customers dealing with bigger data sets to access, analyze and transform their data to improve their decision-making and their overall competitive advantage. Furthermore, we have expanded our product line to include servers with Intel Xeon processors and clusters. SGI's strategy, to incorporate

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leading-edge technology in point-solutions that target specific workflow requirements and package the technology in a unified solution, enables all customers to efficiently deploy a blended server solution to support multi-workflow requirements.

This strategy requires that we maintain industry leadership with our products and services and provide highly differentiated solutions to our customers. Accordingly, the core elements of our strategy are as follows:

Leading-Edge Innovation. Being at the forefront of high-performance computing, data management and services is core to our strategy, and accordingly we invest significantly in product development. SGI has introduced many important innovations to the world, including the first scalable NUMA (Non-Uniform Memory Access) system and work that led to the first storage area networks. Recent innovations in interoperability have brought to SGI a range of product lines that operate well together in customer environments, enabling SGI to solve a broader range of customer problems.

Support of Industry Standards. SGI is committed to the support of open standards for core elements of its new generation products, while focusing its proprietary component technology development to areas that deliver differentiated features and performance. Commitment to an open system platform is important for several reasons. First, it enables our customers to benefit from the superior price performance of today's best-of-breed components, such as commodity DRAMs and the Intel Itanium and Xeon families of processors. Second, it enables SGI to leverage the research and development of Intel and the Linux community and therefore to focus our resources on systems architecture, storage management and solution delivery, all of which we believe is differentiated in important respects in the marketplace. Third, our support of industry standards, such as the Linux operating system, enables SGI to assimilate easily into standards-based IT environments.

Direct Engagement with Our Customers. SGI benefits greatly from its close association with its customers, who are often among the leading experts in their fields. We maintain a program of regular contact and technical discourse with our customers. In addition to sponsoring many industry conferences and forums around the world, SGI engineers and executives meet regularly with the SGI User Group, an independent entity whose membership includes elite users of SGI solutions. This direct interaction between the leading edge of the computing world and SGI has influenced our architectural approach, and we consider this close association to be a core part of our ongoing strategy.

Market Focus. Leveraging our strengths in scalable high-performance computing, data management and deep domain expertise, we are developing solutions that map to customers' enterprise and workflow environments. We have also aligned our marketing resources to address specific market needs and drive innovation to benefit our target markets.

Investing in ISV and Reseller Relationships. SGI depends on a strong ecosystem of software, hardware and partners. We are investing in a worldwide global developer program for independent software vendors, including porting and benchmarking support, direct interaction with our engineering staff, and sales and marketing resources. We understand that our success depends on theirs. We also engage in a variety of programs with OEM and reselling partners, who bring our technologies to a variety of customers not serviced directly by SGI. Investment in developing reseller channels and in software application partners joint marketing continues to be a key strategy for us, as it supports our ability to deliver a complete market-driven solution.

Products

SGI systems are developed to enable our customers to overcome the challenges of complex data-intensive workflows, and accelerate breakthrough discoveries, innovation, and information transformation. SGI systems are primarily based on the Linux operating system and Intel Itanium 2 and Xeon microprocessors; although we continue to offer systems based on the IRIX® operating system and MIPS® RISC microprocessors. The SGI server platform addresses specific workflow requirements with its Linux-based comprehensive family of SGI® Altix® products in a unified infrastructure that is based on industry-standard Linux operating system, a comprehensive storage offering, and common development and administrative toolsets across the platform.

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Scalable Servers. SGI offers a full range of scalable servers from our entry level SGI® Altix® 400 series of servers and clusters through the SGI® Altix® 4000 series of servers and supercomputers. These Altix product families feature Intel Itanium 2 processors, the Linux operating system, and SGI® NUMAflex , which enables customers to configure systems to meet their exact requirements, while maintaining optimum flexibility in meeting their changing needs over time. Altix 400 series systems combine SGI's NUMAflex architecture with entry-level pricing to deliver exceptional value as a scalable solution for departmental, database and cluster applications. The Altix 4000 systems are the most scalable systems in the industry and achieve this performance through the combination of the proven NUMAflex approach and the power of up to 1024 Itanium 2 processors running a single operating system. Altix systems can further be brought together in clusters to create supercomputers of 10,240 processors or more that are among the most powerful in the world today.

Altix XE. SGI Altix® XE is a value-priced entry-level server and integrated cluster solution that complements the Altix scalable server product lines. It offers superior performance and energy efficiency at a lower price point. The combination of the advanced Intel® Dual-Core Xeon® processor architecture delivered in a fully factory integrated cluster solution, backed by SGI's industry-leading service and support provides customers with exceptional value in the SGI Altix XE platform.

Storage Solutions. Customers across high-performance computing and enterprise markets desire ever increasing performance from their servers, creating a parallel need to manage the massive amounts of data generated by these servers. SGI InfiniteStorage is a line of scalable, high-performance storage solutions built specifically for data-intensive workflow management, faster cycle times, and higher levels of access, availability and security.

Within the InfiniteStorage line, SGI offers a broad range of disks and disk subsystems, ranging from entry-level disk arrays to complex enterprise-class storage systems, in either direct- or fabric-attached configurations. SGI offers industry-leading scalable network-attached storage (NAS) through a range of file-serving solutions bundles. SGI also offers storage area network (SAN) solutions based on tightly integrating our CXFS shared file system, along with SGI's FailSafe high-availability software and Data Migration Facility (DMF) for hierarchical storage management. InfiniteStorage systems can be attached to SGI systems and a variety of platforms from other vendors. This approach is intended to allow these solutions to scale across storage architectures and operating systems in addition to scaling from megabytes to exabytes and from hundreds to millions of files in a single system.

Global Services

The quality and reliability of our products and our understanding of SGI customers' technical and business challenges is critical to our success. SGI's Technology Solutions service portfolio offers system solution engineering services, professional and managed services, and traditional customer support and education. Through our Technology Solutions, we offer our customers service solutions tailored to meet their business objectives and maximize the return on their technology investment. We provide customer support services online, through SGI global support centers, and through authorized local service providers in countries where SGI does not have a local office. SGI's support offerings include both hardware and software support, and range from on-site and mission critical support to same-day and next-day support with response times based on the needs of the customer.

Support Services. SGI Support Services consist of a core set of offerings that are available worldwide. Our proven support offerings include hardware and software support and range from on-site and mission critical support to same day and next day support with response times based on the needs of the customer. In addition, SGI support customers receive excellent benefits from SGI Electronic Support tools such as Embedded Support Partner (ESP), SGI Knowledgebase, and Supportfolio.

Managed Services. SGI Managed Services include a broad range of product-focused services to maximize system performance and accelerate productivity. Services include hardware installation, system deployment, implementation, and on-site and remote system management. Specific implementation services include system administration, installation and configuration of SGI systems, SAN and CXFS Implementation, File Server Implementation and High-Availability Software Implementation.

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Professional Services. SGI Professional Services is a total solution provider operating worldwide. We design solutions to help our customers achieve their technology and business goals and overcome their greatest challenges. Our teams of solution architects, project managers, and technical engineers deliver comprehensive solutions as well as specific services that address the solution's life cycle from initial problem assessment to solution architecture, deployment, and integration through follow-on support and service. SGI delivers solutions focused around High Performance Computing (HPC), Storage and Media Solutions. Our Professional Services group maps solutions to the customer's workflow utilizing our extremely rich technology portfolio with a complete spectrum of industry best-in-class technology including servers, storage, interconnect, software and consulting. SGI has expertise in a broad range of industries for complete solution stacks including development, deployment and management.

Marketing, Sales, and Distribution

SGI sells system products and solutions through both a direct sales force and indirect channel partners. In fiscal 2006, SGI initiated a program to recruit and develop a stronger reseller channel in order to reach a greater number of customers and introduce our products to new markets. The SGI direct sales and support organization operates throughout the United States and in most significant international markets. We have channel partners in almost all the countries in which we have a presence; in other countries, we work through SGI authorized distributors.

Our indirect channel partners include service providers, systems integrators, value-added resellers, master resellers, and OEMs.

We maintain active programs to encourage independent software development for our systems. Through our Global Developer Program, we provide hardware, software, service, and marketing support benefits to attract and retain software developers and enable these developers to deliver the highest quality software on both our Linux and IRIX platforms.

Our Solutions Finance organization works with customers to arrange third party financing for sales-type lease transactions and assists in the remarketing of off-lease systems.

Information with respect to international operations and export sales is presented in Note 10 to the consolidated financial statements included in Part II, Item 8 of this Form 10-K. See also Risk Factors included in Item IA of this Form 10-K.

No single end-user customer accounted for 10% or more of our revenues in any of the last three fiscal years. While our sales in the U.S. government sector represent substantially more than that level, these sales are made to and through numerous government agencies and to integrators and resellers who work with those agencies. Information regarding revenue and operating profit by reportable segments and revenue from external customers by geographic region is presented in Note 18 to the consolidated financial statements included in Part II, Item 8 of this Form 10-K and in the Management's Discussion and Analysis of Financial Condition and Results of Operations in Part II, Item 7 of this Form 10-K.

Research and Development

SGI is concentrating its research and development efforts on products and technologies that it believes hold the highest potential, including global shared memory system architectures and storage. Our strategy is to derive maximum leverage from these efforts by using a foundation of industry-standard components, such as the Intel Itanium family of microprocessors and the Linux operating system. As a result, we have sharply reduced our investment in visualization technology and graphics as well as MIPS microprocessors and the IRIX operating system. There can be no assurance that we will maintain or create sufficient differentiation to achieve and sustain a competitive advantage.

During fiscal 2006, fiscal 2005 and fiscal 2004, SGI spent approximately \$84 million, \$93 million, and \$109 million, respectively, on research and development, representing approximately 16% of total revenue in fiscal 2006 and 13% of total revenue in each of fiscal 2005 and fiscal 2004. We are committed to continuing innovation and differentiation, and as a result will most likely continue to make research and development investments consistent with historical levels. However, declines in total revenue over the last several fiscal years have led us to reduce the absolute dollar level of our investment in research and development.

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Manufacturing

SGI's single point of manufacture and fulfillment is located in Chippewa Falls, Wisconsin. Our manufacturing operations primarily involve the assembly and test of high level subassemblies and subsystems, configured specifically to customer requirements. All finished products are subject to appropriate environmental and functional testing prior to shipment. We continually evaluate the allocation of manufacturing activities among our own operations and those of suppliers and subcontractors.

Most of our products incorporate components that are available from only one or limited sources. Key components that are sole-sourced include application specific integrated circuits (ASICs), microprocessors and certain cable, power and memory products. We have chosen to deal with sole sources in these cases because of unique technologies, economic advantages, or other factors. But reliance on single or limited source vendors involves several risks, including the possibility of shortages of key components. Continued availability of these components could be affected if producers were to discontinue supplying, or to change the payment terms for, components customized to meet our requirements. Risks also include limited bargaining flexibility, long lead times, reduced control over delivery schedules, and the possibility of charges for excess and obsolete inventory. We attempt to mitigate these potential risks by working closely with these and other key suppliers on product introduction plans, strategic inventories, and internal and external manufacturing schedules and levels. Consistent with industry practice, we acquire components through a combination of formal purchase orders, supplier contracts, and open orders based on projected demand information. These purchase commitments typically cover our requirements for periods ranging from 30 to 180 days.

We also have single sources for less critical components, such as peripherals, communications controllers, monitors, and chassis, but we believe that in most cases we could develop alternative sources for these components if necessary. However, unexpected reductions, interruptions or price increases would, at least in the short term, adversely affect our operating results.

Several of our suppliers are located outside the United States. Pricing from these suppliers can be strongly affected by such factors as trade protection measures and changes in currency exchange rates. In addition, the markets for memory modules, which are a significant component of our overall systems cost, can be volatile both in terms of pricing and availability.

Competition

The computer industry is highly competitive and is known for rapid technological advances. These advances result in frequent product introductions, short product life cycles and steadily improving price/performance. Customers make buying decisions based on many factors, including solution completeness, product features, price/performance, total cost of ownership, product quality and reliability, ease of use, capabilities of the system software, availability of third party applications, software, customer support, product availability, and corporate reputation. Significant discounting from list prices is prevalent in the industry.

Our focus on addressing a large portion of the workflow with high performance offerings in our key application segments provides advantages in being able to develop solutions specifically for these users. However, our competitors such as IBM, Hewlett-Packard, Sun Microsystems and Dell are generally far larger companies with much greater resources. We also compete with systems manufacturers and resellers of systems based on X86 class microprocessors. Because a computer system is a substantial investment requiring multi-year support, concerns as to our continued viability can have a significant competitive impact. In some instances, the diversified business of our competitors can support very deep discounting to gain market share in the high-performance computing business. We believe growth in the Linux-based systems market may also attract increased competition. An important competitive development in our market has been the emergence of networked clusters and commodity computers from suppliers like Dell Computer as an alternative to our midrange products. These clusters have grown at a faster than anticipated rate and are taking an increasing share of the high-performance computing market.

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Proprietary Rights and Licenses

We currently own and have applied for more than 700 U.S. patents, and we intend to continue to protect our inventions with patents in the United States and abroad. We also hold various U.S. and foreign trademarks. Although we believe the ownership of patents, copyrights, trademarks, and service marks is an important factor in our business and that our success does depend in part on the ownership thereof, we rely primarily on the innovative skills, technical competence, and marketing abilities of our personnel to differentiate our products and services within the marketplace.

As is customary in our industry, we license from third parties a wide range of software, including the LINUX and UNIX operating systems, for internal use and use by our customers.

Our business will be affected by our success in protecting proprietary information and obtaining necessary licenses. We are in discussions with several parties regarding the potential use of our patents, which may result in licensing fees, royalties or a one-time settlement. If negotiations are not successful, we may need to litigate. If we were to litigate, we could incur significant costs and we might not prevail in our case. Litigation or changes in the interpretation of intellectual property laws could expand or reduce the extent to which we or our competitors are able to protect intellectual property or could require significant changes in product design. Because of technological changes in the computer industry, current extensive patent coverage, and the rapid rate of issuance of new patents, it is possible certain components of our products and business methods may unknowingly infringe existing patents of others. The computer industry has seen a substantial increase in litigation with respect to intellectual property matters, and we have been engaged in several intellectual property disputes both as plaintiff and defendant. We are in discussions with several parties that have asserted intellectual property infringement claims, and we expect that litigation of this sort will reoccur from time to time. See Risk Factors .

Seasonality and Backlog

We do not consider our business to be highly seasonal, although in two of the past three years revenues in the second fiscal quarter ending in December have been higher than other quarters in our fiscal year, reflecting in part buying patterns of calendar year-end customers. Past performance should not be considered a reliable indicator of our future revenues or financial performance.

Our consolidated backlog at June 30, 2006 was \$127 million, up from \$120 million at June 24, 2005. Backlog is comprised of committed purchase orders for products and services deliverable within nine months. We generally do not maintain sufficient backlog to meet our quarterly objectives for product revenue without obtaining significant new orders that are booked and shipped within the quarter. In addition, we have not yet reflected in our backlog portions of longer delivery-cycle contracts we have been awarded, but which will not be delivered in the next nine months. The deliveries associated with these contracts are currently scheduled to ship outside the time frame provided in our bookings policy and will not be recognized as revenue in fiscal 2007. These types of orders generally also require us and our partners to develop and deliver future products, and are subject to performance guarantees collateralized by letters of credit and additional penalties for delays in delivery or non-performance. Although the backlog reflects only orders for which a firm purchase order has been issued or a contract has been made, many orders in backlog are subject to customer cancellation or rescheduling in certain circumstances, and government customers typically have rights of cancellation for convenience. As a result, backlog should not be considered a reliable indicator of our ability to achieve any particular level of revenue or financial performance.

Environmental Laws

Certain of our products and operations are regulated under various laws in the U.S., Europe and other parts of the world relating to the environment, including laws and regulations that can limit the use of certain substances in our products or require us to recycle our products when they become waste. While it is our policy to ensure that our operations and products comply with environmental laws at all times any failure to so comply with environmental laws or customer requirements relating to such laws could require us to stop producing or selling certain products, recall noncompliant products, or otherwise incur substantial costs in order to acquire costly material or to make other operational changes in order to achieve compliance. Although environmental costs and liabilities have not materially

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affected us to date, due to the nature of our operations and legal developments affecting our products and operations, environmental costs and liabilities could have a material adverse affect on our business and financial position in the future.

From time to time new regulations are enacted, and it is difficult to anticipate how such regulations will be implemented and enforced. We cannot estimate the possible loss exposure; therefore, no accrual for the costs to comply with these regulations has been recorded. We track regulatory developments that may impact our business and devote resources toward developing strategies for compliance with new requirements as they are enacted.

For example, we face increasing complexity in our product design and procurement operations as we adjust to new and anticipated requirements relating to the materials composition of our products, including the European Union Directive on the Restriction on the Use of Certain Hazardous Substances in Electrical and Electronic Equipment (RoHS), which regulates the use of lead and other hazardous substances in electrical and electronic equipment put on the market in the European Union on or after July 1, 2006. Due to these restrictions, we have decided not to ship our remarketed products to Europe after July 1, 2006, and we are completing our work with our suppliers to assure RoHS compliance with respect to our other products. If a regulatory authority determines that one of our products is not RoHS-compliant, we may have to redesign and re-qualify certain components to meet RoHS requirements, which could subject us to increased engineering expenses in this process, and could face shipment delays, penalties and possible product detentions or seizures.

We may face significant costs and liabilities in connection with product take-back legislation, such as the European Union Directive on Waste Electrical and Electronic Equipment (WEEE), which makes producers of electrical and electronic equipment, including computers, responsible for the collection, recycling, treatment and disposal of past and future covered products. Legislation similar to RoHS and WEEE has been or may be enacted in other jurisdictions, including in the United States, Japan and China. These and other environmental laws may become stricter over time and require us to incur substantial compliance costs. RoHS and WEEE are being implemented by individual countries in the European Union and it is likely that each jurisdiction will implement, interpret or enforce RoHS and WEEE somewhat differently. In addition, final guidance from individual jurisdictions may impose different or additional responsibilities on us. Our failure to comply with WEEE and ROHS, contractual obligations relating to WEEE and RoHS or other environmental laws could result in our being directly or indirectly liable for costs, fines or penalties and third-party claims, and could jeopardize our ability to conduct business in countries in the European Union.

Employees

As of June 30, 2006, we had 1,738 regular employees compared with 2,423 at June 24, 2005. Our future success will require that we continue to retain and motivate highly qualified technical, sales, marketing and management personnel. We have never had a work stoppage, and no employees are represented by a labor union. We have workers' councils where required by European Union or other applicable laws.

Corporate Data

SIG was originally incorporated as a California corporation in November 1981, and reincorporated as a Delaware corporation in January 1990. SIG's website address is www.sgi.com. Our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports are available, without charge, on the investor relations page of our website, www.sgi.com, as soon as reasonably practicable after they are electronically filed with or furnished to the SEC. Our Corporate Governance Guidelines, Code of Business Conduct and Ethics and the charters of the Audit Committee, Compensation and Human Resources Committee and Corporate Governance and Nominating Committee of our Board of Directors are also posted on our website at www.sgi.com/company_info/. Copies are also available, without charge, from the Corporate Secretary, Silicon Graphics, Inc., 1200 Crittenden Lane, Mountain View, CA 94043.

Trademarks Used in the Form 10-K

Silicon Graphics, SGI, Octane, Onyx, Origin, Tezro, Fuel, FailSafe, IRIX, and Altix are registered trademarks, and CXFS, NUMAflex and Prism are trademarks of Silicon Graphics, Inc. in the U.S. and/or other countries worldwide.

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EXECUTIVE OFFICERS OF THE REGISTRANT

The executive officers of SGI and their ages as of September 15, 2006 are as follows:

Name	Age	Position and Principal Occupation	Executive Officer Since
Dennis McKenna	57	Chairman of the Board, Chief Executive Officer and President	2006
Kathy Lanterman	46	Senior Vice President, Chief Financial Officer and Corporate Controller	2002
Eng Lim Goh, PhD	46	Senior Vice President and Chief Technology Officer	2000
Barry Weinert	52	Vice President, General Counsel and Corporate Secretary	2006

Executive officers of SGI are elected annually by the Board of Directors and serve at the Board's discretion. There are no family relationships among any directors, nominees for director, or executive officers of SGI.

Mr. McKenna was appointed as the President and Chief Executive Officer of the Company in January 2006. On February 1, 2006, the Board of Directors appointed Mr. McKenna as a director and Chairman of the Board. Prior to joining the Company, Mr. McKenna served as the President and Chief Executive Officer of SCP Global Technologies, a private company that is a supplier of semiconductor capital equipment, from March to August 2005. From October 1997 to August 2004, Mr. McKenna served initially as President and Chief Executive Officer, and subsequently as President and Chief Executive Officer and Chairman, of ChipPAC, Inc., a public global semiconductor manufacturing and services company.

Ms. Lanterman became Senior Vice President, Chief Financial Officer and Corporate Controller in February 2006. She served as Vice President, Corporate Controller from April 2002 through February 2006 after joining SGI in July 2001 as Assistant Controller. She was a consultant to SGI from April 1999 until she was hired in 2001, working on projects including the implementation of our global Enterprise Resource Planning system.

Dr. Goh became Senior Vice President and Chief Technology Officer in May 2001. He was appointed Vice President and Chief Technology Officer in October 2000, Vice President of Global Systems Engineering in October 1999, and Chief Scientist in December 1998. He joined SGI in September 1989 and has held a variety of systems engineering positions since that time.

Mr. Weinert became Vice President and General Counsel in January 2006. He joined SGI in May 1995 as Commercial Counsel and served as the Associate General Counsel from March 2001 until January 2006.

ITEM 1A. RISK FACTORS

SGI operates in a rapidly changing environment that involves a number of risks, some of which are beyond our control.

We have been incurring losses and consuming cash in our operations and must reverse these trends. We have incurred net losses and negative cash flows from operations resulting from year over year declines in revenue during

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each of the past several fiscal years. At June 30, 2006, our principal source of liquidity was unrestricted cash and marketable investments of \$55 million, down from \$64 million at June 24, 2005. Currently, we expect to continue consuming cash from operations through at least the first half of fiscal 2007. We also experience significant intra-quarter fluctuations in our cash levels, with the result that our cash balances are generally at their highest point at the end of each quarter and significantly lower at other times. These intra-quarter fluctuations reflect our business cycle, with significant requirements for inventory purchases in the early part of the quarter and most sales closing in the last few weeks of the quarter. To maintain adequate levels of unrestricted cash within each quarter, we offer certain customers discounted terms for early payment and hold certain vendor payments to the beginning of the following quarter. We also continue to focus on expense controls, margin improvement initiatives and working capital efficiencies. However, it is essential to our operating plans for fiscal 2007 that our restructuring plan yields its anticipated savings and we meet the goals of our financing arrangements for both fiscal years. See Financial Condition .

To seek to improve our liquidity, we are continuing to implement restructuring actions aimed at substantial expense reductions and a revenue generation initiative aimed at reversing the decline in our revenues. In addition, our operating goals require us to maintain stable year-over-year revenue levels while realizing our targeted expense savings and margin improvements. If we fail to achieve these targets, we will likely consume further cash in our operations, which would further impair our liquidity. See Financial Condition .

Our future financial results will be affected by the adoption of fresh start accounting and may not reflect historical trends. The Company's emergence from Chapter 11 proceedings will result in a new reporting entity and adoption of fresh-start reporting in accordance with SOP 90-7. As required by fresh-start accounting, our assets and liabilities will be adjusted to fair value, and certain assets and liabilities not previously recognized in the Company's financial statements will be recognized under fresh-start accounting. Because we have not yet completed our reorganization and adopted fresh start accounting, the condensed consolidated financial statements as of June 30, 2006 do not give effect to any adjustments in the carrying values of assets or liabilities that will be recorded upon implementation of the Company's Plan. Accordingly, our financial condition and results of operations from and after the effective date will not be comparable to the financial condition and results of operations reflected in our historical consolidated financial statements. For further information about fresh start accounting, see Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations, Fresh Start Reporting .

We face significant challenges in connection with our bankruptcy reorganization. On May 8, 2006, we and certain of our subsidiaries filed voluntary petitions for relief under chapter 11 of the Bankruptcy Code. See Note 1 to the consolidated financial statements in Part II, Item 8 of this Form 10-K for further information. Our ability, both during and after the Chapter 11 Cases, to continue as a going-concern is dependent upon, among other things, (i) our ability to successfully achieve required cost savings to complete our restructuring; (ii) our ability to maintain adequate cash on hand; (iii) our ability to generate cash from operations; (iv) the consummation of a plan of reorganization under the Bankruptcy Code; and (v) our ability to achieve profitability. There can be no assurance that we will be able to successfully achieve these objectives in order to continue as a going-concern. The accompanying consolidated financial statements do not include any adjustments that might result should we be unable to continue as a going-concern.

There is a risk of non-occurrence of the effective date. At a hearing held on September 19, 2006, the Court confirmed our Plan (the Confirmation Date). While the Plan has been confirmed by the Court, it has not yet been consummated. Although we believe that the effective date of the Plan (the Effective Date) will occur soon after the Confirmation Date, there can be no assurance as to such timing. Under the Plan, the Effective Date must occur within 30 days of the date of the Court's order confirming the Plan. Moreover, if each of the conditions to consummation and the occurrence of the Effective Date has not been satisfied or duly waived on or before October 20, 2006, or such later date as may be consented to by the parties, the Court may vacate the Confirmation Order, in which event the Plan would be deemed null and void. The failure of the Effective Date to occur on or before October 20, 2006, would (unless duly waived) constitute a termination event under the Restructuring Agreement that could allow parties to terminate their obligations to support the Plan. This, in turn, could cause an event of default under the Company's post-petition financing agreement and the post-petition financing order that could give rise to termination of the post-petition credit facility and the Debtors' ability to use cash collateral as well as the exercise of remedies by the agent thereunder with respect to some or all of the Debtors' assets.

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We may not achieve our operating goals and may not be in compliance with debt covenants. In June 2006, the Debtors entered into a replacement Post-Petition Loan and Security Agreement with Morgan Stanley Senior Funding, Inc., Wells Fargo Foothill, Inc., and certain other lenders party thereto, providing up to \$130 million of debtor-in-possession financing. See Note 13 to the consolidated financial statements in Part II, Item 8 of this Form 10-K. Under the terms of the \$130 million DIP Financing, we are required to comply with various terms and conditions. Although to date we have been in compliance, there can be no assurance that we will be able to comply with such terms and conditions in the future. In the event that we default under the DIP Agreement and the DIP Agreement is terminated, there can be no assurance that sufficient alternative financing arrangements will be available. Furthermore, in the event that cash flows, together with available borrowings under the \$130 million DIP Financing or alternative financing arrangements, are not sufficient to meet the Company's cash requirements, we may be required to reduce planned capital expenditures, sell additional assets and seek other sources of capital. We can provide no assurance that such actions will be sufficient to cover any cash shortfalls. The need to comply with the terms of our debt obligations may also limit our ability to obtain additional financing and our flexibility in planning for or reacting to changes in our business and the industry. In addition, if we are unable to achieve the goals of our going-forward business plan and operational restructuring strategy, we may be forced to sell all or parts of our business, develop and implement further restructuring plans or become subject to further insolvency proceedings.

We may not be successful in closing our exit financing. We have received a commitment and paid a commitment fee to Morgan Stanley Senior Funding, Inc. and General Electric Capital Corporation to provide the Company with a credit facility adequate to meet our forecasted cash requirements. The commitment for financing is dependent on completing a definitive loan agreement, and other closing conditions. While we believe that we will be able to successfully meet these requirements, we cannot guarantee that the funds will be made available to us until all such conditions are met.

Our bankruptcy reorganization may negatively impact our future operations and the operations of our subsidiaries. As part of the first day relief requested in the Chapter 11 Cases, the Court entered orders allowing us to pay certain pre-petition key vendor trade claims in the ordinary course of business. However, we were not permitted to pay all of our vendors in full. As a result, while we have not yet experienced any significant disruption in our relationships with our suppliers or vendors, we may have difficulty maintaining existing relationships, or creating new relationships with suppliers or vendors. Our suppliers and vendors could stop providing supplies or services to us or provide such supplies or services only on terms such as cash on delivery, cash on order, or other terms that could have an adverse impact on our short-term cash flows. In addition, the filing of the Chapter 11 Cases may adversely affect our ability to retain existing customers, attract new customers and maintain contracts that are critical to our operations.

The filing of the Chapter 11 Cases and the publicity surrounding the filing might also adversely affect the businesses of our non-debtor subsidiaries. Because our business is closely related to the businesses of all of our subsidiaries, any downturn in the business of our subsidiaries could also affect our prospects. It remains uncertain whether the commencement of the Chapter 11 Cases and the associated risks will adversely affect the businesses of any of our subsidiaries. In addition, our non-debtor subsidiaries do not have the benefit of the automatic stay and other protections afforded by the Bankruptcy Code.

Upon consummation of the Plan, our existing common stock will be cancelled and have no value. Under the Plan, all of our existing common stock will be cancelled upon consummation of the Plan and the holders of such securities will receive no recovery. This has caused a significant negative reaction from our stockholders and may adversely affect our ability to attract new stockholders in the future.

The conduct of our business may be restricted under the Bankruptcy Code. The Debtors are operating their businesses as debtors-in-possession pursuant to the Bankruptcy Code. Under applicable bankruptcy law, during the pendency of the Chapter 11 Cases, the Debtors are required to obtain the approval of the Court prior to engaging in any transaction outside the ordinary course of business for the debtor entities. In connection with any such approval, creditors and other parties in interest may raise objections to such approval and may appear and be heard at any hearing with respect to any such approval. Accordingly, although the Debtors may seek the approval of the Court to sell assets and settle liabilities (including for amounts other than those reflected on the Company's consolidated financial statements), there can be no assurance that the Court will grant such approvals. The Court also has the authority to oversee and exert control over the Debtors' ordinary course operations.

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As a result of the restrictions described above, prior to the Effective Date, our ability to respond timely to changing business and economic conditions may be significantly restricted, and we may be prevented from engaging in transactions that might otherwise be considered beneficial.

Our on-going restructuring activities may not reduce our losses and cash consumption. We have implemented several expense-related restructurings in recent years. In addition, in September 2005, March 2006, and June 2006 we began to implement restructuring plans aimed at further substantial expense reductions and continue to execute on these plans. See Overview Further Restructurings to Reduce Expenses . Although we will seek to implement these actions in a manner that does not materially reduce revenue or impair our ability to compete successfully, we cannot be certain that these outcomes will not occur or that these actions will accomplish their intended objective of reducing our losses and cash consumption. Substantially all of the restructuring charges have required or will require the outlay of cash.

We are operating under new leadership that will cause strategic and operational changes in our business. On January 27, 2006, the Board of Directors appointed Mr. Dennis McKenna as our new President and Chief Executive Officer in order to effectuate the turnaround of our business. In addition, our Board of Directors appointed Mr. McKenna as a director and Chairman of the Board on February 1, 2006. Also on February 27, 2006 Mr. Jeffery Zellmer, the Company's Senior Vice President and Chief Financial Officer and Mr. Warren Pratt, the Company's Executive Vice President and Chief Operating Officer, resigned. Ms. Kathy Lanterman, the Company's Vice President and Controller, was appointed the new Senior Vice President and Chief Financial Officer of the Company.

We are currently in a transition period as a result of these leadership changes. We may continue to have strategic, operational or leadership changes to our business in the future and we cannot assure you that such strategic, operational or leadership changes, if any, will lead to an improvement of our business and financial condition. There can also be no assurance that any such strategic, operational or leadership changes will not lead to a further deterioration of our business or financial condition.

We may not be able to raise additional capital in the future. In the future, we may need to obtain additional financing to fund our business or repay our debt, and we cannot assure you that financing will be available in amounts or on terms acceptable to us. In addition, if funds are raised by incurring further debt, our operations and finances may become subject to further restrictions and we may be required to limit our service or product development activities or other operations, or otherwise modify our business strategy. If we fail to comply with financial or other covenants required in connection with such a financing, our creditors may be able to exercise remedies that could substantially impair our ability to operate. In addition, if we obtain additional funds by selling any of our equity securities or if we issue equity derivative securities in connection with obtaining debt financing, the percentage ownership of our stockholders will be reduced, stockholders may experience additional dilution, or the equity securities may have rights, preferences or privileges senior to the common stock.

Our success is dependent on continued revenue growth from newer product families. The SGI Altix family of servers and superclusters based on the Intel Itanium 2 processor and the Linux operating system was introduced in January 2003 and additional products in this line were added during fiscal 2004. In addition, our SGI Altix XE family of cluster products was introduced in June 2006. Our Linux-based systems sales declined by 40% in fiscal 2006 compared with fiscal 2005. Risks associated with these newer product families include dependence on Intel in terms of price, supply, dependability, performance, product roadmaps and timely access to design specifications, and continued support for and development of the Itanium 2 and Xeon processor families; the availability of Linux applications optimized for the 64-bit Itanium platform or our scalable systems architecture; acceptance of the Linux operating system in demanding environments; and competition from other suppliers of Intel-based servers, including clusters of low-end servers. These clusters are rapidly increasing as an important competitive factor in the high performance server market and have had a negative effect on our revenues and our gross margins.

Future revenue growth from our newer product families is especially important because revenues from our

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traditional MIPS and IRIX products and maintenance business are expected to continue to decline. Our ability to achieve future revenue growth will depend significantly on the market success of these newer product families in servers and storage as well as our ability to generate sales to match or replace revenues generated from large sales transactions in prior periods. If one or more of the product lines were to fail in the market, it could have an adverse effect on our business and liquidity.

Our product strategy and business would be adversely affected by any delay, discontinuance or decreased competitiveness of the microprocessors we use. Our core products are based on system architectures that have been developed by working closely with partners for optimization on our products. Our product strategy and business depend on the continued availability and competitiveness of the microprocessors that we use and would be adversely affected by any further delays and/or discontinuance of these processor families. In addition, we may incur penalties under long-term contracts that require the delivery of future products. It is also important to our competitive position that our chosen microprocessors be competitive as to performance as well as price. Microprocessor technology changes rapidly, and in order to be competitive we must keep pace with those changes. Although we have taken steps with the introduction of new products to mitigate our dependence on a single microprocessor, the transition will take some time, and the migration may be expensive and time consuming.

Our results of operations would be adversely affected if the carrying value of our long-lived assets became impaired. We evaluate our long-lived assets, including property and equipment and goodwill, whenever events or circumstances occur that indicate that the carrying amount of a long-lived asset may not be recoverable. Such events or circumstances may include the discontinuation of a product or product line, a sudden or consistent decline in the forecast for a product, changes in technology or in the way an asset is being used, a history of operating or cash flow losses or an adverse change in legal factors or in the business climate. Our long-lived asset impairment review would be based on a cash flow analysis and would require judgment with respect to many factors, including future cash flows, changes in technology, the continued success of product lines and future volume and revenue and expense growth rates. It is possible that our estimates of cash flows may change within the next twelve months resulting in the need to reassess the carrying value of our long-lived assets for impairment. The process of evaluating the potential impairment of goodwill is subjective and requires significant estimates and assumptions at many points during the analysis. Our estimated future cash flows are based on assumptions that are consistent with our annual planning process and include estimates for revenue and operating margins and future economic and market conditions. We base our fair value estimates on assumptions we believe to be reasonable at the time, but that are unpredictable and inherently uncertain. Actual future results may differ from those estimates. As a result, we may incur substantial non-cash impairment charges, which could adversely affect our results of operations. For example, in the third quarter of fiscal 2006 our operating results were adversely impacted by an \$8 million charge for the impairment of goodwill associated with our Products reporting unit. See Note 11 to the consolidated financial statements in Part II, Item 8 of this Form 10-K for further information on our goodwill impairment assessment.

Our financial reporting controls and procedures may be impaired by our restructuring activities and attrition. The uncertainties surrounding our business prospects, the Chapter 11 filing, and our continuing restructuring actions have increased the challenges of attracting and retaining qualified employees. Our annualized attrition rates have increased significantly in fiscal 2006 compared with fiscal 2005. There is no guarantee that we can retain highly qualified employees, or that we will be able to hire highly qualified candidates, as new skills are needed. In addition, while we will strive to ensure that material weaknesses do not develop in our internal controls due to headcount reductions or other factors, there is no guarantee that our internal controls will be unaffected by the restructuring actions or increasing attrition. If material weaknesses develop and we are unable to efficiently and effectively address these matters, investors could lose confidence in the reliability of our internal controls over financial reporting.

We are increasingly dependent on our key suppliers. Our strategy of developing system products based on industry-standard technologies has increased our technical dependence on Intel and other key suppliers. It is therefore important that we receive appropriate development cooperation from our suppliers, and that the products from these suppliers continue to evolve in ways that support the differentiation that we seek to bring to our products. In particular, our Altix family depends on continued component availability, dependability, quality, performance and price/performance. Our financial performance and business prospects would be adversely affected if our suppliers were to reduce their support, including to supply components on terms that enable us to compete effectively for sales with substantial price sensitivity.

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The competitiveness of our system products, particularly our servers, is also significantly affected by the availability on our platform of third-party software applications that are important to customers in our target markets. The success of our Linux-based products and services depends on, among other things, the growth of the Linux market, the acceptance of Linux solutions by customers in demanding environments, the availability of Linux applications optimized for the 64-bit Itanium 2 platform or our scalable systems architecture and our dependence on acceptance of SGI-developed code by the open source community and by Linux distributors with whom we partner.

Our dependence on key suppliers, including sole source suppliers, may prevent us from delivering an acceptable product on a timely basis.

We rely on both single source and sole source suppliers for many of the components we use in our products. For example, we currently utilize microprocessors from a sole source supplier in our Altix family of servers and superclusters and have designed our system architecture to optimize performance using their processors. If we were to utilize an alternative microprocessor, the transition would require an alternative design, which would be costly and cause significant delays in the development of future products, adversely affecting our business and operating results.

Our business is dependent on our ability to anticipate our needs for components and products and our suppliers' ability to deliver such components and products in time to meet critical manufacturing and distribution schedules. In addition, we have benefited from favorable discounts on certain components from key suppliers for selected transactions. Our business could be adversely affected, for example, if suppliers fail to meet product release schedules, if we experience supply constraints, if we fail to negotiate favorable pricing or if we experience any other interruption or delay in the supply chain that interferes with our ability to manufacture our products or manage our inventory levels. Risks also include limited bargaining flexibility, the possibility of charges for excess and obsolete inventory and risks involved with end of life buys from single source and sole source suppliers. We are currently focused on maximizing our working capital by working closely with our suppliers and tightly managing our overall supply chain.

In addition, we are in the process of transitioning to an alternate supplier to act as our foundry for certain key integrated circuits for new products planned for 2008 and later. There can be no assurance that we will be able to complete the transition without significant incremental cash impact.

We may not be able to retain and attract qualified employees. Our success depends on our ability to continue to attract, retain and motivate highly qualified technical, sales and marketing and management personnel. The uncertainties surrounding our business prospects, the Chapter 11 Cases and our continuing restructuring actions have increased the challenges of retaining world-class talent. Our annualized attrition rates have increased significantly in fiscal 2006 compared with fiscal 2005. Although we have put programs in place to encourage employee retention, there is no guarantee that we can retain highly qualified employees or that we will be able to hire highly qualified candidates as new skills are needed.

We are dependent on sales to the U.S. government. A significant portion of our revenue is derived from sales to the U.S. government, either directly by us or through system integrators and other resellers. Sales to the government present risks in addition to those involved in sales to commercial customers, including potential disruptions due to changes in appropriation and spending patterns. Our U.S. government business is also highly sensitive to changes in the U.S. government's national and international priorities and budgeting. Events like Operation Iraqi Freedom and the continuing war on terrorism may affect funding for our programs or result in changes in government programs or spending priorities that may adversely affect our business. In addition, the U.S. government can typically terminate or modify its contracts with us at any time for its convenience. Our government business is also subject to specific procurement regulations and a variety of other requirements. Failure to comply with these or other applicable regulations and requirements could lead to suspension or debarment from government contracting or subcontracting for a period of time. Any disruption or limitation in our ability to do business with the U.S. government could have an adverse impact on us.

A portion of our business requires security clearances from the U.S. government. These arrangements are subject to periodic review by customer agencies and the Defense Security Service of the Department of Defense.

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We expect our operating results to fluctuate for a variety of reasons. Our revenue and operating results may fluctuate for a number of reasons from period to period, and we have consistently fallen short of our forecasts in recent years. Decreases in revenue can arise from any number of factors, including decreased demand, supply constraints, delays in the availability of new products, transit interruptions, overall economic conditions, competitive factors, military or terrorist actions, or natural disasters. Demand can also be adversely affected by concerns specifically associated with our financial health and by product and technology transition announcements by us or our competitors. The timing of customer acceptance of certain large-scale server products may also have a significant effect on periodic operating results. Margins are heavily influenced by revenue levels, mix considerations, including geographic concentrations, the mix of product and service revenue, industry price trends, competitive pricing pressures (particularly for high visibility accounts) and the mix of server and desktop product revenue as well as the mix of configurations within these product categories. As a result of the concentration of sales in the third month of each quarter, developments late in a quarter can have a significant impact on that period's results.

We operate in a highly competitive industry. The computer industry is highly competitive, with rapid technological advances and constantly improving price/performance. Most of our competitors have substantially greater technical, marketing and financial resources. They also generally have a larger installed base of customers and a wider range of available applications software. Competition may result in significant discounting and lower gross margins. In addition, as our Linux-based systems business grows, the number of our competitors may grow commensurate with the increased market opportunity. An important competitive development in our market has been the emergence of networked clusters of commodity computers from suppliers like Dell Computer as an alternative to our midrange products. These clusters have grown at a faster than anticipated rate and are taking an increasing share of the high-performance computing market. These clustered systems may not be subject to U.S. export regulations, which may make them more attractive to certain international customers. See *Many of our international sales require export licenses*. Although we have introduced a cluster product, we face significant competition in this market.

Our typical concentration of sales at the end of our fiscal quarters makes period-to-period financial results less predictable. Over half of each quarter's product revenue results from orders booked and shipped during the third month, and disproportionately in the latter half of that month. This makes the forecasting of revenue inherently uncertain and can produce pressure on our internal infrastructure during the third month of a quarter. Because we plan our operating expenses, many of which are relatively fixed in the short term, on expected revenue, even a relatively small revenue shortfall may cause a period's results to be substantially below expectations.

We are subject to the risks of international operations. We generate a large portion of our revenue outside the United States, and as a result, our business is subject to the risks associated with doing business internationally. International transactions frequently involve increased financial and legal risks arising from stringent contractual terms and conditions and the widely differing legal systems and customs in foreign countries. War, terrorism or public health issues in the regions of the world in which we do business have caused and may continue to cause damage or disruption to commerce by creating economic and political uncertainties. Such events could adversely affect our business in any number of ways, such as decreasing demand for our products, increasing our costs of operations, making it difficult to deliver products to customers, and causing delays and other problems in our supply chain. Our future revenue, gross margin, expenses and financial condition could also suffer due to other international factors, including but not limited to: changes in a country's economic and labor conditions; currency fluctuations; compliance with a variety of foreign laws, as well as U.S. laws affecting the activities of U.S. companies abroad; changes in tax laws; changes in the regulatory or legal environment; difficulties associated with repatriating cash generated abroad; fluctuations in transportation costs; natural and medical disasters; and trade protection measures.