3PAR Inc.
Form 10-Q
August 10, 2009
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

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

For the quarterly period ended June 30, 2009

OR

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

For the transition period from to

Commission file number: 001-33823

3PAR Inc.

(Exact name of registrant as specified in its charter)

DELAWARE	**77-0510671**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
4209 Technology Drive Fremont, CA	**94538**
(Address of principal executive offices)	**(Zip Code)**

Registrant s telephone number, including area code: (510) 413-5999

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 x 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	x
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 x

The number of shares of the registrant s Common Stock, $.001 par value, outstanding at July 31, 2009 was: 61,613,264

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QUARTERLY REPORT ON FORM 10-Q

FOR THE THREE MONTHS ENDED JUNE 30, 2009

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

3PAR Inc.

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands, except share data)

(unaudited)

	June 30, 2009	March 31, 2009
ASSETS		
Current assets:		
Cash and cash equivalents	$ 52,404	$ 47,621
Short-term investments	44,337	56,186
Accounts receivable, net	39,513	34,706
Inventory	25,778	26,650
Deferred cost	2,882	2,887
Prepaid and other current assets	2,978	2,500
Total current assets	167,892	170,550
Property and equipment, net	21,346	22,079
Other non-current assets	190	190
Total assets	$ 189,428	$ 192,819
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 7,392	$ 9,303
Accrued compensation and benefits	9,338	14,643
Other accrued liabilities	3,744	4,080
Deferred revenue	28,407	25,707
Accrued warranty	4,251	3,999
Total current liabilities	53,132	57,732
Accrued warranty, non-current	2,722	3,031
Deferred revenue, non-current	6,980	6,303
Other long-term liabilities	1,175	1,224
Total liabilities	64,009	68,290
Commitments and contingencies (Note 13)		
Stockholders equity:		
Common stock, $0.001 par value; 300,000,000 shares authorized at June 30, 2009 and March 31, 2009; 61,554,283 and 61,044,243 shares issued and outstanding at June 30, 2009 and March 31, 2009, respectively	61	61
Additional paid-in capital	302,020	299,445
Deferred stock-based compensation	(5)	(15)
Accumulated other comprehensive income (loss)	83	(21)
Accumulated deficit	(176,740)	(174,941)

Total stockholders equity	125,419	124,529
Total liabilities and stockholders equity	$ 189,428	$ 192,819

The accompanying notes are integral part of these condensed consolidated financial statements.

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3PAR Inc.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share amounts)

(unaudited)

	Three Months Ended June 30, 2009	2008
Revenue:		
Product	$ 38,802	$ 39,924
Support	5,667	3,029
Total revenue	44,469	42,953
Cost of revenue:		
Product	13,714	14,021
Support	1,730	1,006
Total cost of revenue (1)	15,444	15,027
Gross profit	29,025	27,926
Operating expenses:		
Research and development (1)	11,632	10,157
Sales and marketing (1)	15,580	14,301
General and administrative (1)	3,901	3,373
Total operating expenses	31,113	27,831
Income (loss) from operations	(2,088)	95
Other income (expense), net:		
Interest income	173	778
Interest expense		(17)
Other, net	203	(8)
Total other income, net	376	753
Income (loss) before income tax provision	(1,712)	848
Income tax provision	(87)	(170)
Net income (loss)	$ (1,799)	$ 678
Net income (loss) per common share, basic	$ (0.03)	$ 0.01
Net income (loss) per common share, diluted	$ (0.03)	$ 0.01
Shares used to compute net income (loss) per common share:		
Basic	61,262	60,233
Diluted	61,262	63,088

(1) Includes stock-based compensation as follows:

Cost of revenue	$	81	$	48
Research and development		641		453
Sales and marketing		677		555
General and administrative		441		231

The accompanying notes are integral part of these condensed consolidated financial statements.

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3PAR Inc.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(unaudited)

	Three Months Ended June 30, 2009	Three Months Ended June 30, 2008
Cash flows from operating activities:		
Net income (loss)	$ (1,799)	$ 678
Adjustments to reconcile net income (loss) to net cash used in operating activities:		
Depreciation and amortization	2,033	1,439
Stock-based compensation expense	1,840	1,287
Amortization of premium (accretion of purchase discounts) on short-term investments, net	159	(230)
Provision for doubtful accounts	163	95
Writedown for excess and obsolete inventory	400	220
Changes in assets and liabilities:		
Accounts receivable	(4,970)	590
Inventory	667	(5,379)
Deferred cost	5	(508)
Prepaid expenses and other current assets	(478)	(149)
Other non-current assets		(1)
Accounts payable	(1,914)	706
Accrued liabilities	(5,825)	(2,178)
Deferred revenue	3,377	2,402
Accrued warranty	(57)	(98)
Other long-term liabilities	(49)	(44)
Net cash used in operating activities	(6,448)	(1,170)
Cash flows from investing activities:		
Proceeds from maturities of short-term investments	17,714	4,600
Proceeds from sales of short-term investments	10,000	
Purchases of short-term investments	(15,920)	(31,669)
Purchase of property and equipment	(1,296)	(2,313)
Net cash provided by (used in) investing activities	10,498	(29,382)
Cash flows from financing activities:		
Proceeds from issuance of common stock	733	140
Repurchase of shares of common stock		(95)
Repayments on line of credit		(4,000)
Repayment of notes payable		(436)
Net cash provided by (used in) financing activities	733	(4,391)
Net change in cash and cash equivalents	4,783	(34,943)
Cash and cash equivalents, beginning of period	47,621	97,585
Cash and cash equivalents, end of period	$ 52,404	$ 62,642

The accompanying notes are integral part of these condensed consolidated financial statements

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3PAR Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

1. The Company and its Significant Accounting Policies

The Company

3PAR Inc. (the Company) began operations in May 1999 and is a provider of utility storage solutions for mid-sized to large enterprises, financial services firms, cloud computing service providers, consumer-oriented Internet/Web 2.0 companies and government entities. Its utility storage products offer simple, efficient and scalable tiered storage arrays designed to enhance the economics and performance of storage. The Company s utility storage solution is designed to provision storage services rapidly and simply, reduce administrative cost, improve server and storage utilization, lower power requirements and scale efficiently to support the continuous growth of data.

Fiscal Year

The fiscal year ends on March 31. References to fiscal 2010, for example, refer to the fiscal year ending March 31, 2010.

Significant Accounting Policies

Basis of Presentation

The unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) and with the instructions to Securities and Exchange Commission (SEC) Form 10-Q and Article 10 of SEC Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. For further information, these financial statements should be read in conjunction with the audited consolidated financial statements and related notes contained in the Company s Annual Report on Form 10-K (File No. 001-33823) for the year ended March 31, 2009 (Form 10-K).

The unaudited condensed consolidated financial statements contain all normal recurring accruals and adjustments that, in the opinion of management, are necessary to state fairly the Company s consolidated financial position at June 30, 2009, and the consolidated results of its operations for the three months ended June 30, 2009 and 2008, and the consolidated cash flows for the three months ended June 30, 2009 and 2008. The results of operations for the three months ended June 30, 2009 are not necessarily indicative of the results to be expected for the full year.

The condensed consolidated balance sheet at March 31, 2009 has been derived from the audited consolidated financial statements at that date but does not include all of the information and footnotes required by GAAP.

The Company s significant accounting policies are disclosed in the Company s Form 10-K.

The Company has evaluated subsequent events through August 10, 2009, the date the Company filed its Quarterly Report on Form 10-Q for the quarter ended June 30, 2009.

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3PAR Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

Recent Accounting Pronouncements

In May 2009, the FASB issued SFAS No. 165, *Subsequent Events* (SFAS 165). SFAS 165 establishes general standards for accounting for and disclosure of events that occur after the balance sheet date but before financial statements are available to be issued. More specifically, SFAS 165 sets forth the period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition in the financial statements, identifies the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements and the disclosures that should be made about events or transactions that occur after the balance sheet date. The adoption of SFAS 165 did not have a material impact on our consolidated financial statements.

In April 2009, the Financial Accounting Standards Board (FASB) issued FSP No. FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*, which provides additional guidance for estimating fair value in accordance with SFAS No. 157, *Fair Value Measurements* (SFAS 157). FSP No. 157-4 states that a significant decrease in the volume and level of activity for the asset or liability when compared with normal market activity is an indication that transactions or quoted prices may not be determinative of fair value because there may be increased instances of transactions that are not orderly in such market conditions. Accordingly, further analysis of transactions or quoted prices is needed, and a significant adjustment to the transactions or quoted prices may be necessary to estimate fair value. The Company adopted FSP No. 157-4 effective April 1, 2009. The adoption of FSP No, 157-4 did not have a material impact on the Company s consolidated results of operations and financial condition.

In April 2009, the FASB issued FSP No. FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments*, which requires disclosures about the fair value of the Company s financial instruments for which it is practicable to estimate that value, whether recognized or not recognized in the balance sheets, in interim reporting periods as well as in annual reporting periods. In addition, this FSP requires disclosures of the methods and significant assumptions used to estimate the fair value of those financial instruments. FSP No. 107-1 and APB 28-1 are effective for interim and annual periods ending after June 15, 2009. The Company adopted this FSP effective April 1, 2009 and the adoption did not have a material impact on its consolidated results of operations and financial condition.

In April 2009, the FASB issued FSP No. FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments,* which establishes a new method of recognizing and reporting other-than-temporary impairments of debt securities and requires additional disclosures related to debt and equity securities. FSP No. 115-2 and 124-2 does not change existing recognition and measurement guidance related to other-than-temporary impairments of equity securities. The Company adopted FSP No. 115-2 and 124-2 effective April 1, 2009. The adoption of FSP No. 115-2 and 124-2 did not have a material impact on the Company s consolidated results of operations and financial condition.

In April 2009, FASB issued FASB Staff Position (FSP) No. FAS 141(R)-1, *Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies*, which amends and clarifies the initial recognition and measurement, subsequent measurement and accounting, and related disclosures of assets and liabilities arising from contingencies in a business combination under Statement of Financial Accounting Standards (SFAS) No. 141 (revised 2007), Business Combinations (SFAS 141R). This FSP is effective for assets and liabilities arising from contingencies in business combinations for which the acquisition date is on or after December 15, 2008. The Company adopted FSP No. FAS 141(R)-1 effective April 1, 2009. The adoption of FSP No. FAS 141(R)-1 did not have a material effect on the Company s consolidated results of operations and financial condition.

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3PAR Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

In June 2008, the FASB issued FSP No. EITF Issue 03-6, *Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities* (FSP EITF 03-6-1) to clarify whether instruments granted in share-based payment transactions are participating securities prior to vesting and, therefore, need to be included in the earnings allocation in computing earnings per share (EPS) under the two-class method described in paragraphs 60 and 61 of FASB Statement No. 128, *Earnings per Share*. The Company adopted this FSP effective April 1, 2009 and the adoption did not have a material impact on the Company s consolidated results of operations and financial condition.

In February 2008, the FASB issued Financial Staff Position (FSP) SFAS 157-2, *Effective Date of FASB Statement No. 157 (FSP 157-2), which delays the effective date of SFAS No. 157, Fair Value Measurement* (SFAS 157), for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). SFAS 157 establishes a framework for measuring fair value and expands disclosures about fair value measurements. The Company adopted FSP SFAS No 157-2 effective April 1, 2009. The adoption of FSP SFAS No. 157-2 did not have a material effect on the Company s consolidated results of operations and financial condition.

In December 2007, FASB issued SFAS No. 141 (R), *Business Combinations* (SFAS No.141(R)), which becomes effective for fiscal periods beginning after December 15, 2008. SFAS No. 141 (R) requires all business combinations completed after the effective date to be accounted for by applying the acquisition method (previously referred to as the purchase method). Companies applying this method will have to identify the acquirer, determine the acquisition date and purchase price and recognize at the acquisition-date the fair values of the identifiable assets acquired, liabilities assumed, and any noncontrolling interests in the acquiree. In the case of a bargain purchase, the acquirer is required to reevaluate the measurements of the recognized assets and liabilities at the acquisition date and recognize a gain on that date if an excess remains. The Company adopted SFAS No. 141(R) effective April 1, 2009. The adoption of SFAS No 141(R) did not have a material effect on the Company s consolidated results of operations and financial condition future acquisition occurs.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements, an Amendment of ARB 51* (SFAS 160), which becomes effective for fiscal periods beginning after December 15, 2008. This statement amends Accounting Research Bulletin No. 51 to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. The statement requires consolidated net income to be reported at amounts that include the amounts attributable to both the parent and the noncontrolling interest. It also requires disclosure on the face of the consolidated statement of income, of the amounts of consolidated net income attributable to the parent and to the noncontrolling interest. In addition this statement establishes a single method of accounting for changes in a parent s ownership interest in a subsidiary that do not result in deconsolidation and requires that a parent recognize a gain or loss in net income when a subsidiary is deconsolidated. The Company adopted SFAS No 160 effective April 1, 2009. The adoption of SFAS No. 160 did not have a material effect on the Company s consolidated results of operations and financial condition.

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3PAR Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

2. Balance Sheet Components

The following tables provide details of selected balance sheet accounts:

	June 30, 2009	March 31, 2009
	(in thousands)	
Accounts Receivable, Net		
Trade accounts receivable	$ 40,802	$ 35,832
Less: Allowance for doubtful accounts	(1,289)	(1,126)
Total	$ 39,513	$ 34,706

	June 30, 2009	March 31, 2009
	(in thousands)	
Inventory		
Raw materials	$ 22,135	$ 21,914
Work in process	1,886	2,985
Finished goods	1,757	1,751
Total	$ 25,778	$ 26,650

3. Short-term Investments

The following tables summarize the available-for-sale securities presented as short-term investments:

	June 30, 2009			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
	(in thousands)			
Short-term Investments				
United States Government and agency securities	$ 24,276	$ 46	$	$ 24,322
Corporate debt securities	7,991	39	(2)	8,028
Commercial paper	11,987			11,987
Total short-term investments	$ 44,254	$ 85	$ (2)	$ 44,337

	March 31, 2009			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value

	(in thousands)			
Short-term Investments				
United States Government and agency securities	$ 42,110	$ 24	$ (12)	$ 42,122
Corporate debt securities	9,546	8	(44)	9,510
Municipal bonds	2,553	3		2,556
Commercial paper	1,998			1,998
Total short-term investments	$ 56,207	$ 35	$ (56)	$ 56,186

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3PAR Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

As of June 30, 2009, all of the Company s short-term investments were classified as available-for-sale. The cost basis and fair value of available-for-sale securities, by contractual maturity, are as follows:

	June 30, 2009	
Due in	**Amortized Cost**	**Fair Value**
	(in thousands)	
Less than 1 year	$ 44,254	$ 44,337
1 to 2 years		
2 to 5 years		
Total short-term investments	$ 44,254	$ 44,337

The Company invests in securities that are rated investment grade or better. Unrealized gains and losses are recorded as a component of accumulated other comprehensive income (loss) in stockholders equity. If these investments are sold at a loss or are considered to have other than temporarily declined in value, a charge to operations is recorded based on the likelihood of selling the security prior to recovering it cost basis. The specific identification method is used to determine the cost of securities disposed of, with realized gains and losses reflected in other income (expense), net.

4. Fair Value Measurements

SFAS No. 157 defines fair value as the price that would be received from selling an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. When determining the fair value measurements for assets and liabilities required to be recorded at fair value, the Company considers the principal or most advantageous market in which it would transact and it considers assumptions that market participants would use when pricing the asset or liability, such as inherent risk, transfer restrictions, and risk of nonperformance.

Fair Value Hierarchy

SFAS No. 157 establishes a fair value hierarchy that requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. A financial instrument s categorization within the fair value hierarchy is based upon the lowest level of input that is significant to the fair value measurement. SFAS No. 157 establishes three levels of inputs that may be used to measure fair value:

Level 1 - Quoted prices in active markets for identical assets or liabilities. The Company s Level 1 assets consist of money market fund deposits and United States government and agency securities that are traded in active markets with sufficient volume and frequency of transactions.

Level 2 - Observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets with insufficient volume or infrequent transactions (less active markets); or model-derived valuations in which all significant inputs are observable or can be derived principally from or corroborated by observable market data for substantially the full term of the assets or liabilities. As of June 30, 2009, the Company had commercial paper and corporate debt securities for which fair value was determined using Level 2 inputs.

Level 3 - Unobservable inputs to the valuation methodology that are significant to the measurement of fair value of assets or liabilities. As of June 30, 2009, the Company had no financial assets or liabilities for which fair value was determined using Level 3 inputs.

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3PAR Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

The following table summarizes our financial assets measured at fair value on a recurring basis as of June 30, 2009 (in thousands):

	Fair Value Measurements at Reporting Date Using		
Description	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Total Balance**
Cash equivalents:			
Money market funds	$ 48,435	$	$ 48,435
Short-term investments:			
United States Government and agency securities	24,322		24,322
Corporate debt securities		8,028	8,028
Commercial paper		11,987	11,987
	$ 72,757	$ 20,015	$ 92,772

5. Derivative Instruments and Hedging Activities

The functional currency of the Company s foreign subsidiaries is the United States (U.S.) Dollar. However, in countries outside the U.S., the Company transacts business in various currencies besides the U.S. Dollar. In addition, the Company has certain cash accounts, receivables and payables balances denominated in currencies other than the U.S. Dollar. The Company hedges certain British Pound and Euro denominated receivables held by the Company using foreign exchange contracts to reduce the risk that its earnings would be adversely affected by changes in the British Pound and Euro exchange rates. These derivatives are not designated as hedging instruments under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

The Company accounts for the derivative instruments in accordance with SFAS No. 52, *Foreign Currency Translation*, as either assets or liabilities on the balance sheet and measures them at fair value. Gains and losses on these foreign exchange contracts as well as the related costs are included in other income (expense), net along with the foreign currency gains and losses of the related hedged items. At June 30, 2009, the notional principal of the foreign exchange contract to sell British Pounds and Euro for U.S Dollars was £1.9 million (or approximately $3.1 million) and 600,000 (or approximately $839,000), respectively, with an original maturity of 30 days. As of June 30, 2009, the Company had no material gains or losses in change of fair value of the open contract impact to the financial condition

For the quarter ended, June 30, 2009, the losses on the foreign exchange contracts recorded in other income (expense) were $491,923.

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3PAR Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

6. Property and Equipment, Net

Property and equipment, net consists of the following:

	Estimated Useful Life	June 30, 2009	March 31, 2009
		(in thousands)	
Property and Equipment, Net			
Computer equipment	3 years	$ 31,723	$ 30,378
Computer software	5 years	3,393	3,107
Machinery and equipment	3-5 years	3,595	3,823
Furniture and fixtures	7 years	2,199	2,323
Leasehold improvements	Shorter of lease term or 5 years	8,531	8,517
		49,441	48,148
Less: accumulated amortization and depreciation		(28,095)	(26,069)
Total		$ 21,346	$ 22,079

7. Deferred Revenue

Deferred revenue consists of the following:

	June 30, 2009	March 31, 2009
	(in thousands)	
Deferred Revenue		
Product	$ 12,325	$ 12,010
Support	16,082	13,697
Total deferred revenue, current	28,407	25,707
Support, non-current	6,980	6,303
Total deferred revenue	$ 35,387	$ 32,010

The Company recognizes revenue when persuasive evidence of an arrangement exists, the product has been delivered, the fee is fixed or determinable, collection of the resulting receivable is reasonably assured and, if applicable, upon completion of installation and/or satisfaction of evaluation criteria or expiration of the evaluation period, as the case may be. Deferred product revenue relates to arrangements where any of the above revenue recognition criteria have not been met.

Deferred support revenue primarily represents customer billings in excess of revenue recognized for post contract customer support contracts, which the Company is legally entitled to invoice and collect. Revenue is recognized ratably over the support period, which typically ranges from

one to three years.

3PAR Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

8. Line of Credit

On May 30, 2008, the Company entered into an amended and restated loan and security agreement, which provides for borrowings up to $15.0 million. This agreement was amended and extended through May 28, 2010 on May 29, 2009. The revolving line of credit agreement contains a financial covenant that requires the Company to maintain a minimum tangible net worth of $85.0 million, which is increased by 50% of any new net equity proceeds and/or 50% of quarterly profits since March 31, 2009. Tangible net worth is defined as the consolidated total assets minus any amounts attributable to goodwill and intangible assets, reserves not already deducted from assets and total liabilities including all subordinated debt. In addition, the Company is required to maintain a quick ratio of at least 1.25 to 1.0. The revolving line of credit provides the Company two options for interest rate: (i) the lender s variable prime rate of at least 4.00% or (ii) LIBOR plus 200 basis points for the applicable period, subject to a LIBOR rate floor of 1.50%, in effect at the time of the borrowing. To date there have been no borrowings under the revolving line of credit. As of June 30, 2009, the Company is in compliance with the debt covenant required to maintain the line of credit. There have been no borrowings under the current revolving line of credit.

The Notes Payable and the revolving line of credit are collateralized by an interest in all of the Company s assets, excluding intellectual property. The Company is not permitted to sell its intellectual property other than to issue a nonexclusive license in the ordinary course of business.

9. Income Taxes

The Company has incurred annual operating losses since inception. As a result of those continuing losses, management has determined that it is more likely than not that the Company will not realize the benefits of the deferred tax assets and therefore has recorded a valuation allowance to reduce the carrying value of the deferred tax assets in the U.S. to zero. The Company s tax provision relates primarily to state income taxes and provisions for income tax related to the Company s international subsidiaries.

The Company s only material uncertain tax position is its research and development credits, none of which would affect its income tax expense if recognized to the extent that the Company continues to maintain a full valuation allowance against its deferred tax assets. The Company estimates that there will be no material changes in its uncertain tax positions in the next 12 months. The Company recognizes interest and penalties related to income tax matters as part of the provision for income taxes. To date, the Company has incurred no such charges.

The Company files annual income tax returns in the U.S. federal jurisdiction, various U.S. state and local jurisdictions, and in various foreign jurisdictions. The Company remains subject to tax authority review for all jurisdictions for all years.

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3PAR Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

10. Share Based Payments

Stock Option Activity:

Activity with respect to outstanding stock options for the first three months of fiscal 2010 is as follows:

	Number of Shares	Weighted Average Exercise Price per Share
Balance at March 31, 2009	8,169,962	$ 6.54
Options granted	1,250,566	9.00
Options exercised	(460,383)	1.98
Options cancelled	(221,443)	9.24
Balance at June 30, 2009	8,738,702	$ 7.06

Restricted Stock Unit Awards

Restricted stock unit awards may be granted under the 2007 Plan on terms approved by the Board of Directors. Stock awards generally provide for the issuance of restricted stock which vests over a fixed period. Activity with respect to outstanding restricted stock units for the first three months of fiscal 2010 is as follows:

	Number of Shares	Weighted Average Grant Date Fair Value
Balance at March 31, 2009	355,000	$ 7.48
Granted	274,000	9.33
Cancelled	(20,000)	7.50
Balance at June 30, 2009	609,000	$ 8.31

During the three months ended June 30, 2009, the Company awarded non-vested restricted stock units to its executive officers under the 2007 Plan. 25% of the restricted stock unit will vest and will be released to the recipients on June 1, 2010. The restricted stock unit will continue to vest as to 25% of the restricted stock unit annually thereafter, and shares will be distributed to the recipients on each vest date. If a participant terminates employment prior to the vesting date, the unvested restricted stock will be canceled and returned to the 2007 Plan.

Fair Value Disclosures

The fair value of each option was estimated on the date of grant using the Black-Scholes model with the following weighted average assumptions:

	Three Months Ended June 30,	
	2009	2008
Employee Stock Options		
Risk-free interest rate	1.64%	2.53%
Expected life (years)	4.18	4.13
Dividend yield	0.00%	0.00%
Expected volatility	55.7%	52.0%

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The Employee Stock Purchase Plan was adopted during the third quarter of fiscal 2008. Subsequent to the adoption, rights to purchase shares are only granted during the second and fourth quarters of each fiscal year.

The risk-free interest rate for the expected term of the option is based on the yield available on United States Treasury Zero Coupon issues with an equivalent expected term. The expected term represents the period of time that share-based awards are expected to be outstanding, giving consideration to the contractual terms of the awards, vesting schedules and expectations of future employee behavior. Given the Company s limited operating history, comparable companies from a representative peer group selected on industry data were used to determine the expected term. The computation of expected volatility was based on the historical volatility of the Company and comparable companies from a representative peer group selected based on industry data. As required by SFAS No. 123 (revised 2004), *Share-Based Payment*, management made an estimate of expected forfeitures and is recognizing stock-based compensation costs only for those equity awards that the Company expects to vest.

Shares Subject to Repurchase

Certain stock options granted by the Company are exercisable at the date of grant, with unvested shares subject to repurchase by the Company in the event of voluntary or involuntary termination of employment of the stockholder. Such exercises are recorded as a liability on the balance sheet and reclassified into equity as the options vest. As of June 30, 2009 and March 31, 2009, a total of 12,069 shares and 18,482 shares of common stock, respectively, were subject to repurchase by the Company at the original exercise price of the related stock option. The corresponding exercise value of $39,000 and $51,000 as of June 30, 2009 and March 31, 2009, respectively, was recorded in accrued liabilities.

Activity with respect to non-vested shares subject to repurchase for the first three months of fiscal 2010 is as follows:

Non-vested as of March 31, 2009	18,482
Vested	(6,413)
Repurchased	
Non-vested as of June 30, 2009	12,069

11. Net Income (Loss) per Common Share

The following table sets forth the computation of net loss per common share:

	Three Month Ended June 30,	
	2009	2008
	(in thousands, except per share amounts)	
Numerator:		
Net income (loss)	$ (1,799)	$ 678
Denominator:		
Weighted average number of shares outstanding - basic	61,262	60,233
Incremental shares using the treasury stock method:		
Employee share based awards		2,509
Common stock subject to repurchase		266
Warrants to purchase common stock		80

Weighted average number of shares outstanding - diluted		61,262		63,088
Net income (loss) per share - basic	$	(0.03)	$	0.01
Net income (loss) per share - diluted	$	(0.03)	$	0.01

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The following potential shares of common stock (prior to application of treasury method) outstanding at June 30, 2009 and 2008 were excluded from the computation of diluted net income (loss) per common share for the periods presented because including them would have had an antidilutive effect:

	June 30,	
	2009	2008
	(in thousands)	
Employee share based awards	8,739	6,956
Restricted Stock Unit	609	
Employee Stock Purchase Plan		31
Common stock subject to repurchase	12	266
	9,360	7,253

12. Comprehensive Income (Loss)

Comprehensive income (loss) consists of net income and changes in accumulated other comprehensive income (loss). Comprehensive income (loss) for the three months ended June 30, 2009 and 2008 was as follows:

	Three Month Ended June 30,	
	2009	2008
	(in thousands)	
Net income (loss)	$ (1,799)	$ 678
Change in unrealized gain/ (loss) on short-term investments	104	(254)
Comprehensive income (loss)	$ (1,695)	$ 424

13. Commitments and Contingencies

Legal Matters

From time to time, third parties assert claims against the Company arising from the normal course of business activities. As of June 30, 2009, there are no claims that in the opinion of management, might have a material adverse effect on the Company s financial position, results of operations or cash flows.

Lease Obligations

The Company leases equipment and office space under non-cancelable operating leases with various expiration dates through May 2014. In April 2005, the Company s primary facilities lease was renegotiated with a new lease expiration date in May 2014, an option to cancel in May 2010 and two consecutive options to extend the lease, each for an additional five-year period. To the extent the Company elects to terminate the lease in 2010, it will be required to pay an early termination fee of approximately $1.0 million. The Company currently has no plans to exercise the early termination option.

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Future minimum lease payments under non-cancelable operating leases, assuming no early termination, are as follows (in thousands):

For the years ending March 31,	Rent Commitment
2010 (remaining nine months)	1,840
2011	2,378
2012	2,198
2013	2,013
2014	1,406
Thereafter	197
Total minimum lease payments	$ 10,032

Warranties

The Company provides for future warranty costs upon product delivery. The specific terms and conditions of those warranties vary depending upon the product sold and country in which the Company does business. The warranties are generally for three years from the date of installation of equipment.

Factors that affect the Company s warranty liability include the number of installed units, historical experience and management s judgment regarding anticipated rates of warranty claims and cost per claim. The Company assesses the adequacy of its recorded warranty liabilities each period and makes adjustments to the liability as necessary.

Changes in the warranty liability are as follows:

	Three Months Ended June 30,	
	2009	2008
	(in thousands)	
Beginning balance	$ 7,030	$ 6,184
Provision	1,061	870
Settlements made	(1,118)	(968)
Ending balance	$ 6,973	$ 6,086

Warranty liabilities are classified based on the assumption that the claims will be made ratably over the three-year term, which to date has been consistent with the Company s actual warranty experience, as follows:

	June 30, 2009	March 31, 2009
	(in thousands)	
Current	$ 4,251	$ 3,999
Non-current	2,722	3,031

Total	$ 6,973	$ 7,030

Non-cancelable Purchase Commitments

The Company outsources the production of its hardware to third-party contract manufacturers. In addition, the Company enters into various inventory related purchase commitments with these contract manufacturers and suppliers. The Company had $9.7 million and $6.2 million in non-cancelable purchase commitments with these providers as of June 30, 2009 and March 31, 2009, respectively. As of June 30, 2009 and March 31, 2009, the liability for these purchase commitments was $195,000 and $243,000, respectively.

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Guarantees and Indemnifications

The Company indemnifies its officers and directors for certain events or occurrences, subject to certain limits, while the officer or director is or was serving at the Company s request in such capacity. The maximum amount of potential future indemnification is unlimited; however, the Company has a director and officer insurance policy that limits its exposure and enables it to recover a portion of any future amounts paid. The Company is unable to reasonably estimate the maximum amount that could be payable under these arrangements since these obligations are not capped but are conditional to the unique facts and circumstances involved. Accordingly, the Company has no liabilities recorded for these agreements as of June 30, 2009 and March 31, 2009.

In its sales agreements, the Company may agree to indemnify its indirect sales channels and end-user customers for any expenses or liability resulting from claimed infringements of patents, trademarks or copyrights of third parties. The terms of these indemnification agreements are generally perpetual any time after execution of the agreement. The maximum amount of potential future indemnification is unlimited. To date the Company has not paid any amounts to settle claims or defend lawsuits. The Company is unable to reasonably estimate the maximum amount that could be payable under these arrangements since these obligations are not capped but are conditional to the unique facts and circumstances involved. Accordingly, the Company has no liabilities recorded for these agreements as of June 30, 2009 and March 31, 2009.

14. Segment Information and Significant Customers

FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information*, defines operating segments as components of an enterprise about which separate financial information is available and which is regularly evaluated by management, namely the chief operating decision maker of an organization, in order to make operating and resource allocation decisions. The Company has concluded that it operates in one business segment, the development, marketing and sale of information storage solutions. The Company s headquarters and most of its operations are located in the U.S.; however, it conducts limited sales, marketing and customer service activities through small offices in Europe and Asia. Revenue is attributed by geographic location based on the ship-to location of the Company s reseller or customer, as applicable. The Company s assets are primarily located in the U.S. and not allocated to any specific region. Therefore, geographic information is presented for total revenue only.

The following presents total revenues by geographic region:

	Three Months Ended June 30,	
	2009	2008
	(in thousands)	
United States	$ 35,519	$ 39,381
International	8,950	3,572
Total	$ 44,469	$ 42,953

One customer represented 10% and another customer represented 20% of total revenue in the three months ended June 30, 2009 and 2008, respectively. One customer accounted for 11% of accounts receivable, net at June 30, 2009 and another customer accounted for 12% of accounts receivable, net at March 31, 2009.

15. Stock Repurchase Program

On July 29, 2008 the Company s board of directors authorized a stock repurchase program for up to $10.0 million worth of the Company s common stock. The Company is authorized to make purchases in the open market and any such purchases will be funded from available working capital. The number of shares to be

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purchased and the timing of purchases will be based on the price of the Company s common stock, general business and market conditions, and other investment considerations. Shares are retired upon repurchase. During fiscal year 2009, the Company purchased 227,200 shares under this program for an aggregate purchase price of $1.5 million. There were no purchases of shares under this program during the first fiscal quarter of 2010. The Company is authorized to purchase up to an additional $8.5 million worth of shares under this program as of June 30, 2009. The Company s policy related to repurchases of its common stock is to charge any excess of cost over par value entirely to additional paid-in capital in absence of retained earnings.

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

In addition to historical information, this report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, which are subject to the safe harbor created by those sections. These statements include, among other things, statements concerning our expectations regarding:

the growth and growth rate of our operations, business, revenues, operating margins, costs and expenses;

fluctuations in our gross margins;

the effect of recent accounting pronouncements on our financial position, results of operations, and cash flows;

our future stock-based compensation charges;

our foreign exchange risk and our practices related to hedging those risks;

our future uncertain tax positions;

the potential impact of our storage solution on the total lifetime cost of storage for our customers;

the increase of research and development, sales and marketing and general and administrative expenses in the future;

our future capital expenditures, including investments in our infrastructure and in test and development equipment to support our research and development efforts;

the availability of individuals with the specific skills required for key positions, as well as our ability to attract, hire and retain sales employees and key personnel;

our hiring of sales and other key personnel and the impact such hiring may have on our business, growth and competitive position;

the future yield on our investment portfolio;

the sufficiency of our existing cash balances to meet our future capital requirements;

the materiality of our exposure related to contractual guarantees and indemnities;

- *the materiality of the exposure of our cash equivalents to changes in value and the projected value of our investment portfolio;*

- *future changes in competitive practices and landscape in our industry;*

- *our future reliance on establishing relationships with resellers and authorized service providers to sell, service and support our products in select markets;*

- *our continued investments in international markets and our expansion strategies in those markets;*

- *the contribution of international sales as a percentage of our total revenue on an annual basis;*

as well as other important statements regarding our future operations, financial condition and prospects and business strategies. Forward-looking statements are based on our management s beliefs and assumptions, and on information currently available to our management, as of the date of this filing. These forward-looking statements are subject to certain risks and uncertainties that could cause our actual results to differ materially from those reflected in the forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed in this report, and in particular, the risks discussed under the heading Risk Factors in Part II, Item 1A of this report and those discussed in other documents we file with the Securities and Exchange Commission. We undertake no obligation to revise or publicly release the results of any revision to these forward-looking statements. Given these risks and uncertainties, readers are cautioned not to place undue reliance on such forward-looking statements.

The following discussion should be read in conjunction with our financial statements and the related notes contained elsewhere in this Quarterly Report on Form 10-Q and in our other Securities and Exchange Commission, or SEC, filings, including our Annual Report on Form 10-K for the year ended March 31, 2009.

Overview

We are the leading global provider of utility storage solutions for mid-sized to large enterprises, financial services firms, cloud computing service providers, consumer-oriented Internet/Web 2.0 companies, and government entities. Utility storage provides a foundation upon which organizations are able to build highly virtualized, consolidated IT infrastructures for managing their data. We help organizations build storage infrastructures to meet the performance and high availability demands of the virtual datacenter. Our storage systems are designed to be self-managing (*smart*), capacity efficient (*thin*), and resiliently adaptable (*ready*). We believe our storage systems provide substantial benefits for our customers, including reducing administrative costs and provisioning complexity, improving server and storage utilization, easing power and cooling requirements, scaling efficiently to support continuous growth, and adapting rapidly to meet changing business needs.

Established by engineers with substantial experience in the high-end server and storage markets, we began operations in 1999. From our inception, our corporate and product development objectives have focused on finding ways to use physical storage resources more efficiently and effectively by reducing unused storage and power consumption. Our utility storage solutions are comprised of the 3PAR InServ Storage Servers and the 3PAR InForm Suite, which includes the 3PAR InForm Operating System and other software applications.

We have sales offices in the United States, Canada, Germany, Japan, United Kingdom and Singapore and research and development facilities in California and Northern Ireland.

We have experienced a history of net losses in each fiscal year since our inception as we have invested significantly in our product development, customer services and sales and marketing organizations to support the growth of our business. While we plan to continue focusing on constraining discretionary operating expenses in light of the current general economic downturn, we plan to continue to invest heavily into our sales, customer service, and engineering organizations, which could limit our ability to generate profitability. We believe this strategy will better position us in the market to achieve substantial, long-term growth and market share in our business.

During the first quarter of fiscal 2010 ended June 30, 2009, we experienced a generally weaker demand environment as reflected in customer order activity. Our revenues declined sequentially from the quarter ended March 31, 2009 and increased only modestly on a year-over-year basis. Continued or increased weakness in general economic conditions, a reduction in storage infrastructure spending even if general economic conditions improve, or deterioration in the financial condition of our customers and customer prospects will adversely impact our business, revenues, rates of revenue growth (if any), operating results and financial condition, including as a result of potential inventory writedowns, longer sales cycles, potential increases in price competition, reduced unit sales, increased number of days of sales outstanding and customer payment defaults.

The last day of our fiscal year is March 31. Our fiscal quarters end on June 30, September 30, December 31 and March 31. Our current fiscal year, which we refer to as fiscal 2010, will end on March 31, 2010.

Revenue, Cost of Revenue and Operating Expense

Revenue

We derive our revenue from sales of our InServ Storage Servers, licenses of our InForm Suite and other software applications and related support. Prior to March 2007, we typically sold our products with a three-year basic hardware warranty and software warranty, which was limited to bug fixes for any non-conforming software products. Commencing in March 2007, in anticipation of evolving customer requirements for software support, we changed from a software warranty model to a software support model. Under the software support model, the customer receives, in addition to bug fixes, unspecified software upgrades and enhancements, on a when-and-if available basis, over the term of the support period. Support revenue also includes our extended and premium hardware warranties. Our premium hardware warranty offers faster service response time than our basic hardware warranty.

As a result of the implementation of our software support model in March 2007, we expect our support revenue to increase in future periods.

Cost of Revenue

Cost of product revenue consists primarily of raw materials, manufacturing cost for our products, shipping and logistics cost, expenses for inventory obsolescence and warranty obligations. Cost of premium and extended warranty obligations are included in cost of support revenue. We utilize third parties to manufacture subcomponents of our products, which are then shipped to our Fremont, California operations facility for final assembly and testing prior to customer shipment. We outsource onsite support to third-party support vendors.

Cost of support revenue consists of personnel cost and outside vendor cost to support premium and extended warranty services for all periods presented. Beginning March 2007, cost of support revenue also includes costs associated with providing software support. As a result of the implementation of our software support model in March 2007, we expect cost of support revenue to increase in future periods.

Gross Margin

Gross profit is the difference between revenue and cost of revenue, and gross margin is gross profit expressed as a percentage of revenue. Product mix and system configurations affect our gross margin because our software and support margins are higher than our hardware margins. Larger systems tend to have greater software and support components and thereby result in a higher margin. Our gross margin tends to be higher for direct sales than for indirect sales because we generally sell our products to resellers at a discount. Our gross margin has fluctuated significantly in the past, and we expect it will continue to fluctuate in the future primarily as a result of product mix and order size.

Operating Expense

Operating expense consists of research and development, sales and marketing, and general and administrative expense. The largest component of our operating expense in each case is personnel cost. Personnel cost consists of salaries, benefits and incentive compensation for our employees. We grew from 451 employees at March 31, 2008 to 591 employees at March 31, 2009 and to 614 at June 30, 2009. While our personnel costs generally have increased from period to period, in light of the general economic downturn, we implemented tighter cost control measures over other discretionary expenses during fiscal 2009, which we continued to impose during the first quarter of fiscal 2010.

Research and Development Expense

Research and development expense consists primarily of personnel cost, prototype expense, consulting services and facilities cost associated with personnel. Consulting services generally consist of contracted engineering consulting for specific projects. We expense research and development expense as incurred. We expect to continue to devote substantial resources to the development of our products. We believe that these investments are necessary to maintain and improve our competitive position.

Sales and Marketing Expense

Sales and marketing expense consists primarily of personnel cost, sales commission, marketing programs and facilities cost associated with sales and marketing and certain customer service and support activities not associated with cost of revenue. We plan to continue to increase the number of direct sales personnel we employ. Our sales personnel are not immediately productive and therefore the increase in sales and marketing expense we incur when we add new sales representatives is not immediately offset by increased revenue and may never result in increased revenue. The timing of our hiring of new sales personnel and the rate at which they generate incremental revenue could therefore affect our future period-to-period financial performance.

General and Administrative Expense

General and administrative expense consists primarily of personnel and facilities costs related to our executive, finance, human resources, information technology and legal organizations, as well as fees for professional services. Professional services consist of fees for outside legal, audit, compliance with the Sarbanes-Oxley Act of 2002, or Sarbanes-Oxley, and information technology consulting. We expect to continue to incur significant accounting and legal costs related to compliance with rules and regulations implemented by the SEC, as well as insurance, investor relations and other costs associated with being a public company.

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Other Income, Net

Other income, net includes interest income on cash balances and short-term investments, interest expense on our outstanding debt and borrowings under our revolving line of credit, and losses or gains on our hedging activities and remeasurement of non-United States dollar transactions into United States dollars. If we are successful in growing our international sales we may be subject to increased currency conversion risks because a larger portion of our sales could be denominated in foreign currencies. We have historically invested our available cash balances in money market funds, short-term United States Government and agency obligations, municipal bonds, corporate debt securities and commercial paper.

Income Tax Provision

The Company s tax provision relates primarily to state income taxes and provisions for income tax related to the Company s international subsidiaries.

Critical Accounting Policies and Estimates

Our consolidated financial statements are prepared in accordance with generally accepted accounting principles in the United States, or GAAP. These accounting principles require us to make estimates and judgments that can affect the reported amounts of assets and liabilities as of the date of the consolidated financial statements as well as the reported amounts of revenue and expense during the periods presented. We believe that the estimates and judgments upon which we rely are reasonable based upon information available to us at the time that we make these estimates and judgments. To the extent there are material differences between these estimates and actual results, our consolidated financial statements will be affected. The accounting policies that reflect our more significant estimates and judgments and which we believe are the most critical to aid in fully understanding and evaluating our reported financial results are revenue recognition, stock-based compensation, inventory valuation, warranty provision, allowances for doubtful accounts and income taxes.

The description of our critical accounting policies that involve significant management judgment appears in our 2009 Annual Report on Form 10-K under Management s Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies and Estimates.

Results of Operations for the Three Months Ended June 30, 2009 and 2008

Revenue

The following tables present period over period comparisons of our revenue by revenue source for the three months ended June 30, 2009 and 2008 (dollars in thousands):

	Three Months Ended June 30,		Change in	
Types of Revenue:	**2009**	**2008**	**$**	**%**
Product	$ 38,802	$ 39,924	$ (1,122)	-3%
As % of total revenue	*87.3%*	*92.9%*		
Support	5,667	3,029	2,638	87%
As % of total revenue	*12.7%*	*7.1%*		
Total revenue	$ 44,469	$ 42,953	$ 1,516	4%

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Revenue by geography:	Three Months Ended June 30, 2009	2008	Change in $	%
United States	$ 35,519	$ 39,381	$ (3,862)	-10%
As % of total revenue	*79.9%*	*91.7%*		
International	8,950	3,572	5,378	151%
As % of total revenue	*20.1%*	*8.3%*		
Total revenue	$ 44,469	$ 42,953	$ 1,516	4%

Revenue by Sales Channel:	Three Months Ended June 30, 2009	2008	Change in $	%
Direct	$ 27,175	$ 36,350	$ (9,175)	-25%
As % of total revenue	*61.1%*	*84.6%*		
Indirect	17,294	6,603	10,691	162%
As % of total revenue	*38.9%*	*15.4%*		
Total revenue	$ 44,469	$ 42,953	$ 1,516	4%

Our total revenue increased by $1.5 million, or 4%, to $44.5 million in the three months ended June 30, 2009 from $43.0 million in the three months ended June 30, 2008. Product revenue decreased by $1.1 million, or 3%, to $38.8 million in the three months ended June 30, 2009 from $39.9 million in the three months ended June 30, 2008. The decrease in product revenue during the three months ended June 30, 2009 was principally due to the fact that the quarter ended June 30, 2008 was benefited from the recognition of $2.8 million of deferred revenue associated with certain March 2007 transactions that we were previously recognizing on a ratable basis. This was partially offset by increased revenues of $1.2 million from an end of life disk drive purchase in the quarter ended June 30, 2009. Product revenue from our existing customers accounted for 73% of total revenue in the three months ended June 30, 2009 compared to 81% in the three months ended June 30, 2008. We increased the number of our sales and marketing personnel to 216 at June 30, 2009, from 167 at June 30, 2008, which contributed to our ability to expand our customer base.

Support revenue increased by $2.6 million, or 87%, to $5.7 million in the three months ended June 30, 2009 from $3.0 million in the three months ended June 30, 2008. The increase in support revenue in the three months ended June 30, 2009 compared to the same period in the prior year is primarily attributable to the growth in the installed base of our storage solutions, which resulted in a higher number of initial PCS, extended and premium warranty contracts and support renewals from existing customers.

In the three months ended June 30, 2009, International total revenue represented $9.0 million or 20% from to $3.6 million or 8% compared to the same period in the prior year. The increase in International revenue as a percent of total revenue is driven by the higher number of sales and services personnel which grew at a faster rate than in the US.

In the three months ended June 30, 2009, we derived 61% of our total revenue from direct sales to customers compared to 85% in the three months ended June 30, 2008, while the indirect sales represented 39% and 15% during the same periods, respectively. The increase in indirect sales as a percentage of revenue in the three months ended June 30, 2009 compared to the same period in the prior year is mainly related to increased sales to the United States government agencies as well as in non-English speaking markets where the sale of our products is conducted primarily through our resellers and channel partners.

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Cost of Revenue and Gross Margin

The following table presents period over period comparisons of our cost of revenue by cost source for the three months ended June 30, 2009 and 2008 (dollars in thousands):

	Three Months Ended June 30,		Change in	
	2009	2008	$	%
Cost of product revenue	$ 13,714	$ 14,021	$ (307)	-2%
As % of product revenue	*35.3%*	*35.1%*		
Cost of support revenue	1,730	1,006	724	72%
As % of support revenue	*30.5%*	*33.2%*		
Total cost of revenue	15,444	15,027	417	3%
Gross profit	$ 29,025	$ 27,926	$ 1,099	4%
Gross margin	65.3%	65.0%		

Cost of revenue increased by $417,000, or 3%, to $15.4 million in the three months ended June 30, 2009 from $15.0 million in the three months ended June 30, 2008 primarily due to increased cost to provide customer support due to an increase in our installed base.

Cost of product revenue decreased by $307,000, or 2%, to $13.7 million in the three months ended June 30, 2009 from $14.0 million in the three months ended June 30, 2008 compared to 3% decrease in our product revenue during the same period. The increase in our product margin in the three months ended June 30, 2009 is due primarily to product cost and expense reductions partially offset by inventory write-downs for excess and obsolescence related to certain components of our E-Class platform inventory in anticipation of increased customer demand for our new F-Class InServ storage server.

Cost of support revenue increased by $724,000, or 72%, to $1.7 million in the three months ended June 30, 2009 from $1.0 million in the three months ended June 30, 2008 primarily due to increased personnel cost and infrastructure costs required to support the growth in our installed base partially offset by our efforts to contain overall costs, which enabled us to improve our support revenue margin in the three months ended June 30, 2009 compared to the same period in the prior year.

Research and Development

The following table presents period over period comparisons of our research and development expense for the three months ended June 30, 2009 and 2008 (dollars in thousands):

	Three Months Ended June 30,		Change in	
	2009	2008	$	%
Research and development	$ 11,632	$ 10,157	$ 1,475	15%
As % of total revenue	*26%*	*24%*		

Our research and development expense increased by $1.5 million, or 15%, to $11.6 million in the three months ended June 30, 2009 from $10.2 million in the three months ended June 30, 2008. The increase in fiscal 2010 was primarily due to increase in research and development personnel to 211 employees at June 30, 2009 from 176 employees at June 30, 2008 resulting in an increase in employee compensation and related cost.

As a percentage of our total revenue, research and development expense increased to 26% in the three months ended June 30, 2009 from 24% in the three months ended June 30, 2008, respectively. The percentage increase is attributable principally to the increase in our research and development expense, which grew at a higher rate than our revenue in the three months ended June 30, 2009.

Of the $1.5 million increase in research and development expense in the three months ended June 30, 2009, employee compensation and related benefits and depreciation accounted for $730,000 and $565,000 respectively. The remainder of the increase in the three months ended June 30, 2009 related to higher stock-based compensation and allocated facilities/IT expense.

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Sales and Marketing

The following table presents period over period comparisons of our sales and marketing expense for the three months ended June 30, 2009 and 2008 (dollars in thousands):

	Three Months Ended June 30, 2009	Three Months Ended June 30, 2008	Change in $	Change in %
Sales and marketing	$ 15,580	$ 14,301	$ 1,279	9%
As % of total revenue	*35%*	*33%*		

Our sales and marketing expense increased by $1.3 million, or 9%, to $15.6 million in the three months ended June 30, 2009 from $14.3 million in the three months ended June 30, 2008. This increase reflects in part the increase in sales and marketing personnel to 216 employees at June 30, 2009 from 167 employees at June 30, 2008. The increased salary, sales commission and related benefits expenses were offset by lower travel and recruiting expenses.

As a percentage of our total revenue, sales and marketing expense increased to 35% in the three months ended June 30, 2009 from 33% in the three months ended June 30, 2008 principally due to the increase in our sales and marketing expense, which grew at a higher rate than our revenue in the three months ended June 30, 2009 principally as a result of an increase in sales personnel.

General and Administrative

The following table presents period over period comparisons of general and administrative expense for the three months ended June 30, 2009 and 2008 (dollars in thousands):

	Three Months Ended June 30, 2009	Three Months Ended June 30, 2008	Change in $	Change in %
General and administrative	$ 3,901	$ 3,373	$ 528	16%
As % of total revenue	*9%*	*8%*		

Our general and administrative expense increased by $528,000, or 16%, to $3.9 million in the three months ended June 30, 2009 from $3.4 million in the three months ended June 30, 2008. This increase reflects in part the increase in general and administrative personnel to 70 employees at June 30, 2009 from 57 employees at June 30, 2008. The remainder of the increase relates primarily to higher professional fees and stock-based compensation.

As a percentage of our total revenue, general and administrative expenses increased to 9% of total revenue in the three months ended June 30, 2009 compared to 8% of total revenue in the three months ended June 30, 2008.

Other Income, Net

The following table presents period over period comparisons of our other income, net for the periods presented (dollars in thousands):

	Three Months Ended June 30, 2009	Three Months Ended June 30, 2008	Change in $	Change in %
Other income (expense), net:				
Interest income	$ 173	$ 778	$ (605)	(78)%
Interest expense		(17)	17	(100)%
Other, net	203	(8)	211	(2,638)%
Total other income, net:	$ 376	$ 753	$ (377)	(50)%

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Other income, net decreased by $377,000, or 50%, to $376,000 in the three months ended June 30, 2009 from $753,000 in the three months ended June 30, 2008. The decrease in other income, net in the three months ended June 30, 2009 compared to the same period in the prior year is primarily due to lower yield on our investment portfolio partially offset by foreign currency gains primarily related to British Pound denominated accounts receivable.

In light of the current turmoil in the financial markets, we moved the majority of our corporate cash assets into very short-term and liquid investments during the second quarter of fiscal 2009. As a result, we expect the yield on our investment portfolio to remain at a very low level for the near future. The hedging activity we implemented during fiscal 2009 is intended to reduce, but not eliminate, the risk that our other income, net will be adversely affected by the fluctuations in the foreign currency exchange rates. However, we believe that the foreign currency gains or losses may continue to impact other income, net for the future.

Income Tax Provision

During the three months ended June 30, 2009, we recorded an income tax provision of $87,000 compared to $170,000 in the three months ended June 30, 2008. The income tax provision for the three months ended June 30, 2009 is composed of foreign and state income taxes.

On September 30, 2008, California enacted Assembly Bill 1452 which among other provisions, suspends net operating loss deductions for 2008 and 2009 and extends the carryforward period of any net operating losses not utilized due to such suspension; adopts the federal 20-year net operating loss carryforward period; phases-in the federal two-year net operating loss carryback periods beginning in 2011 and limits the utilization of tax credits to 50% of a taxpayer s taxable income. We have incorporated the impact of this new law to the income tax provision. As a result, only 50% of California tax liability was offset by the available state research & development tax credit carryover yielding $0 of tax liability for the three months ended June 30, 2009. This new law is expected to result in state income tax expense in future quarters.

On October 3, 2008, the United States enacted a law, Emergency Economic Stabilization Act of 2008, which contains the Tax Extenders and Alternative Minimum Tax Relief Act of 2008. Under this act, the research credit was retroactively extended for amounts paid or incurred after December 31, 2007 and before January 1, 2010. There was no impact to our effective tax rate or tax provision in the first quarter of fiscal 2010 and we anticipate that there will be no impact on our fourth quarter of fiscal 2010 as the result of this law change due to our valuation allowance.

The Company s only material uncertain tax position is its research and development credits, none of which would affect its income tax expense if recognized to the extent that the Company continues to maintain a full valuation allowance against its deferred tax assets. The Company estimates that there will be no material changes in its uncertain tax positions in the next 12 months. The Company recognizes interest and penalties related to income tax matters as part of the provision for income taxes. To date, the Company has incurred no such charges.

We file annual income tax returns in the U.S. federal jurisdiction, various U.S. state and local jurisdictions, and in various foreign jurisdictions. We remain subject to tax authority review for all jurisdictions for all years.

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Liquidity and Capital Resources

The following table summarizes our cash, cash equivalents and short-term investments at June 30, 2009 and March 31, 2009 (dollars in thousands):

	June 30, 2009	March 31, 2009	Increase/ (Decrease)
Cash and cash equivalents	$ 52,404	$ 47,621	$ 4,783
Short-term investments	44,337	56,186	(11,849)
Total	$ 96,741	$ 103,807	$ (7,066)

Our cash equivalents and short-term investments are invested primarily in money market funds, short-term United States Government treasury and agency obligations, corporate debt securities and commercial paper.

Since our inception in 1999 through our IPO in November 2007, we funded our operations primarily with proceeds from the issuance of convertible preferred stock, customer payments for our products and services, proceeds from the issuance of notes payable and borrowings under our revolving line of credit facility. In November 2007, we completed our IPO which provided us with approximately $97.4 million in net proceeds after deducting underwriting discounts and commissions of approximately $7.5 million and other offering costs of $2.9 million.

On July 29, 2008, our board of directors approved the investment of up to $10 million for the purchase of shares of our common stock in the open market under a stock repurchase program. Subject to applicable securities laws, rules and regulations, the shares may be repurchased at our discretion from time to time in the open market. Such purchases will be made at times and in amounts as we deem appropriate, based on factors such as market conditions, legal requirements, and other corporate considerations. As of June 30, 2009, we have purchased 227,200 shares under this program at an average purchase price of $6.77 per share. There were no purchases of shares under this program during the first fiscal quarter of 2010.

We have a loan and security agreement with a commercial bank with a revolving line of credit, under which the aggregate amount available for borrowing is $15.0 million. The borrowings are collateralized by all of our assets with the exception of intellectual property. Our amended revolving line of credit agreement expires on May 28, 2010 and it contains a financial covenant that requires us to maintain a quick ratio of no less than 1.25 to 1.00. In addition, we are required to maintain a quarterly tangible net worth of not less than $85.0 million, which is increased by 50% of any new net equity proceeds and/or 50% of quarterly profits since March 31, 2009. The interest rate on the line of credit equals, at the election of the borrower, either the lender s variable prime rate or LIBOR plus 200 basis points for the applicable period, subject to a LIBOR rate floor of 1.50%, in effect at the time of the borrowing. We were in compliance with these financial covenants at June 30, 2009. There have been no borrowings under the current revolving line of credit.

The following table summarizes our cash flows from operating, investing and financing activities for the periods presented (dollars in thousands):

	Three Months Ended June 30, 2009	2008
Net cash used in operating activities	$ (6,448)	$ (1,170)
Net cash provided by (used in) investing activities	10,498	(29,382)
Net cash provided by (used in) financing activities	733	(4,391)

Cash Flows from Operating Activities

Our cash flows from operating activities are significantly influenced by our cash investments to support the growth of our business in areas such as research and development, sales and marketing and corporate administration. Our operating cash flows are also influenced by our working capital needs to support growth, in particular fluctuations in inventory, accounts receivable, accounts payable and other current assets and liabilities. Certain metrics such as inventory and accounts receivable turns historically have been impacted by our product mix and the timing of orders from our customer base. Our largest source of operating cash flows is cash collections from our customers. Our primary uses of cash from operating activities are personnel related expenditures and purchases of inventory.

During the first three months of fiscal 2010, operating activities used $6.4 million of cash compared to $1.2 million during the first three months of fiscal 2009. The increase in cash usage was caused by the higher net loss, adjusted for non-cash expense primarily for depreciation and stock-based compensation and $1.0 million increase in deferred revenue, and an increase in accounts receivable due to slower cash collections driven by higher volume of shipments late in the quarter, decrease in accrued liabilities primarily due to a higher payout of employee incentive compensation and lower accounts payable due to timing of invoice processing and payments. The usage of cash during the period partially offset by lower inventory purchases.

Cash Flows from Investing Activities

Cash flows from investing activities primarily relate to investments of our available cash and cash equivalent balances and capital expenditures to support our growth. Net cash provided by investing activities was $10.5 million in the first three months of fiscal 2010 compared to cash used in investing activities of $29.4 million in the first three months of fiscal 2009.

The increase in net cash provided by investing activities in the first three months of fiscal 2010 is attributable to an increase in sales and maturities of short-term investments of $23.1 million and a $15.7 million decrease in purchase of short-term investments and a $1.0 million decrease in capital expenditures.

Cash Flows from Financing Activities

Net cash provided by financing activities in the first three months of fiscal 2010 was $733,000 as compared to net cash used in financing activities of $4.4 million in the first three months of fiscal 2009. The increase in net cash provided by financing activities was related primarily to higher proceeds from stock option exercises during the first three months of fiscal 2010 when compared to the same period in the prior year and a $4.0 million and $436,000 repayment of the line of credit and notes payable, respectively, during the first three months of fiscal 2009.

We believe that our existing cash balances will be sufficient to meet our anticipated capital requirements for the next 12 months. However, we may need to raise additional capital or incur additional indebtedness to continue to fund our operations in the future. Our future capital requirements will depend on many factors, including our rate of revenue growth, if any, the expansion of our sales and marketing and research and development activities, the timing and extent of our expansion into new geographic territories, the timing of introductions of new products and enhancements to existing products and the continuing market acceptance of our products. Although we currently are not a party to any agreement or letter of intent with respect to potential material investments in, or acquisitions of, complementary businesses, services or technologies, we may enter into these types of arrangements in the future, which could also require us to seek additional equity or debt financing. Additional funds may not be available on terms favorable to us or at all.

Contractual Obligations

The following table summarizes our contractual obligations as of June 30, 2009 (in thousands):

		Payments due by period			
	Total	**Less than 1 Year**	**1 to 3 Years**	**3 to 5 Years**	**More than 5 Years**
Operating lease obligations	$ 10,032	$ 1,840	$ 4,576	$ 3,419	$ 197
Non-cancellable inventory purchase commitments	9,746	9,746			
Total	$ 19,778	$ 11,586	$ 4,576	$ 3,419	$ 197

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Guarantees

In the ordinary course of business, we have entered into agreements with, among others, customers, resellers, system integrators and distributors that include guarantees or indemnity provisions. Based on our historical experience and information known to us as of June 30, 2009, we believe that our exposure related to these guarantees and indemnities as of June 30, 2009 was not material. In the ordinary course of business, we also enter into indemnification agreements with our officers and directors and our certificate of incorporation and bylaws include similar indemnification obligations to our officers and directors. It is not possible to determine the amount of our liability related to these indemnification agreements and obligations to our officers and directors due to the lack of prior indemnification claims and the unique facts and circumstances involved in each particular potential case.

Off-Balance Sheet Arrangements

During the periods presented, we did not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purpose.

Recent Accounting Pronouncements

See Note 1 of Notes to Condensed Consolidated Financial Statements for recent accounting pronouncements that could have an effect on us.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Foreign Currency Risk

Most of our sales contracts are denominated in the United States Dollar. As we expand our international sales, we expect that an increasing portion of our revenue could be denominated in foreign currencies. As a result, our cash and cash equivalents and operating results could be increasingly affected by changes in foreign currency exchange rates. Additionally, our international sales and marketing operations incur expenses that are denominated in foreign currencies. These expenses could be materially affected by foreign currency fluctuations. Our exposures are to fluctuations in exchange rates in the United States Dollar versus the British Pound and the Euro and, to a lesser extent, the Swiss Franc, the Japanese Yen, the Korean Won and the Chinese Yuan.

In order to decrease the inherent risk associated with translation of foreign currency cash balances into our reporting currency, we have not maintained excess cash balances in foreign currencies. Additionally, we are hedging British Pound and Euro denominated receivables held by us to reduce the risk that our earnings would be adversely affected by the fluctuations in the exchange rate of the British Pound and the Euro against the United States Dollar. We account for these derivative instruments as either assets or liabilities on the balance sheet and measure them at fair value. Gains and losses from foreign exchange forward contracts are recorded each period as a component of other income (expense), net in the consolidated statements of operations.

We do not enter into foreign exchange forward contracts for speculative or trading purposes. Foreign currency transaction gain, including the impact of hedging, was $203,000 in the three months ended June 30, 2009.

Interest Rate Sensitivity

We had cash equivalents totaling $52.4 million at June 30, 2009. These amounts were invested primarily in money market funds. We believe that our cash equivalents do not have a material exposure to changes in the fair value as a result of changes in interest rates due to the short term nature of our cash equivalents. Declines in interest rates, however, would reduce future interest income. Based on our cash equivalents at June 30, 2009, a hypothetical 100 basis points decline in interest rates would reduce our interest income by approximately $524,000 over a one year period.

Short-term investments consist of United States Government treasury and agency obligations, corporate debt securities and commercial paper. We do not enter into investments for trading or speculative purposes. If we sell our investments prior to their maturity, we may incur a charge to operations in the period the sale takes place.

The following tables present the hypothetical changes in fair values in the securities, excluding cash equivalents, held at June 30, 2009 that are sensitive to changes in interest rates. The modeling technique used measures the change in fair values arising from hypothetical parallel shifts in the yield curve of plus or minus 50 basis points (BPS) and 100 BPS over six and twelve-month time horizons.

The following table estimates the fair value of the portfolio at a twelve-month time horizon (in thousands):

	Valuation of Securities Given an Interest Rate Decrease of X Basis Points		Current Fair Market Value	Valuation of Securities Given an Interest Rate Increase of X Basis Points	
12-Month Period	**100 BPS**	**50 BPS**		**50 BPS**	**100 BPS**
United States Government and agency securities	$ 24,417	$ 24,370	$ 24,322	$ 24,274	$ 24,226
Commercial paper	12,013	12,000	11,987	11,974	11,961
Corporate debt securities	8,073	8,051	8,028	8,005	7,983
Total short-term investments	$ 44,503	$ 44,421	$ 44,337	$ 44,253	$ 44,170

The following table estimates the fair value of the portfolio at a six-month time horizon (in thousands):

	Valuation of Securities Given an Interest Rate Decrease of X Basis Points		Current Fair Market Value	Valuation of Securities Given an Interest Rate Increase of X Basis Points	
6-Month Period	**100 BPS**	**50 BPS**		**50 BPS**	**100 BPS**
United States Government and agency securities	$ 24,513	$ 24,417	$ 24,322	$ 24,226	$ 24,131
Commercial paper	12,039	12,013	11,987	11,961	11,935
Corporate debt securities	8,119	8,073	8,028	7,983	7,937
Total short-term investments	$ 44,671	$ 44,503	$ 44,337	$ 44,170	$ 44,003

At June 30, 2009, we had no interest rate exposure to our existing obligations since we had no outstanding principal under our subordinated term loan agreement and have not made any borrowings under our revolving line of credit. However, we could be exposed to interest rate risk if we make borrowings under our revolving line of credit.

Item 4T. Controls and Procedures

(a) Disclosure Controls and Procedures

Our management evaluated, with the participation of our Chief Executive Officer and our Chief Financial Officer, the effectiveness of our disclosure controls and procedures as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on this evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that as of the end of the period covered by this Quarterly Report on Form 10-Q, our disclosure controls and procedures were effective to provide reasonable assurance that information we are

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required to disclose in reports that we file or submit under the Securities Exchange Act of 1934 (i) is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms, and (ii) is accumulated and communicated to our management, including our Chief Executive Officer and our Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

(b) Changes in Internal Control over Financial Reporting.

There were no changes in our internal control over financial reporting that occurred during the period covered by this Quarterly Report on Form 10-Q that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings

We are not currently a party to any material litigation, and we are not aware of any pending or threatened litigation against us that we believe would adversely affect our business, operating results, financial condition or cash flows. The software and storage infrastructure industries are characterized by frequent claims and litigation, including claims regarding patent and other intellectual property rights as well as improper hiring practices. As a result, in the future, we may be involved in various legal proceedings from time to time.

Item 1A. Risk Factors

Set forth below and elsewhere in this report and in other documents we file with the SEC are descriptions of the risks and uncertainties that could cause our actual results to differ materially from the results contemplated by the forward-looking statements contained in this report. The descriptions below include any material changes to and supersede the description of the risk factors affecting our business previously disclosed in Part I, Item 1A. Risk Factors of our Annual Report on Form 10-K for the fiscal year ended March 31, 2009.

Risks Related to Our Business and Industry

We have a history of annual losses.

Since our formation, we have recorded a net loss in all of our annual fiscal periods. In fiscal 2009, 2008 and 2007, our net losses were $959,000, $10.1 million, and $15.5 million, respectively, and in the first three months of fiscal 2010, our net loss was $1.8 million. While we reported net income in both the first quarter and third quarter of fiscal 2009, we were not profitable in the year ended March 31, 2009. As of June 30, 2009, our accumulated deficit was $176.7 million. During fiscal 2010, we do not expect our expense levels to decline significantly. In addition, we anticipate that we will continue to incur significant legal, auditing, accounting and other expenses resulting from public company regulatory requirements. As a result, we will be required to increase our revenue substantially in order to achieve profitability on an annual basis, and our ability to increase revenues is subject to the numerous risks and uncertainties described below.

The general economic downturn and reduced information technology spending could have an adverse impact on our revenues, revenue growth rates, and operating results.

Our business depends on the overall demand for information technology, and in particular for storage infrastructure, and on the capital spending budgets and financial health of our current and prospective customers. The purchase of our products is often discretionary and may require our customers to make significant initial commitments of capital. The general economic downturn has dramatically reduced business spending on technology infrastructure. In response to the global recession, deterioration in their own financial condition, or an inability to obtain financing for capital investments, our customers and customer prospects could reduce or defer their spending on storage infrastructure, which could result in lost opportunities, declines in bookings and revenues, order cancellations or indefinite shipping delays.

During the first quarter of fiscal 2010 ended June 30, 2009, we experienced a generally weaker demand environment as reflected in customer order activity. Our revenues declined sequentially from the quarter ended March 31, 2009 and increased only modestly on a year-over-year basis. Continued or increased weakness in general economic conditions, a reduction in storage infrastructure spending even if general economic conditions improve, or deterioration in the financial condition of our customers and customer prospects will adversely impact our business, revenues, rates of revenue growth (if any), operating results and financial condition, including as a result of potential inventory writedowns, longer sales cycles, potential increases in price competition, reduced unit sales, increased number of days of sales outstanding and customer payment defaults.

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Our operating results may fluctuate significantly, which makes our future operating results difficult to predict. If our operating results fall below expectations, the price of our common stock could decline.

Our annual and quarterly operating results have fluctuated in the past and may fluctuate significantly in the future due to a variety of factors, many of which are outside of our control. Numerous factors may limit our visibility with respect to future business activity, revenues, and operating results, and any forecasts that we may provide, or that securities analysts may publish, of future financial performance will be subject to substantial risks and uncertainties. For example, the general economic downturn has recently had an adverse effect on our visibility as customers reevaluate capital spending budgets in light of the continuing recession and their own financial circumstances. The timing of orders and our ability to recognize revenue under generally accepted accounting principles can also influence our visibility with respect to operating results. We typically receive a substantial portion of our orders in the last two weeks of each fiscal quarter, and, many of the orders we receive may include conditions or may not ship or be installed during the quarter in which they are received, in which case we cannot recognize revenue for those orders. For example, in the quarter ended June 30, 2009, our revenues were less than the expectations of securities analysts due in part to customer installation delays related to a number of large equipment purchases. These delays precluded us from recognizing revenues with respect to these transactions in the quarter ended June 30, 2009. Finally, some of our orders are conditional upon customer acceptance criteria or successful testing of our products, and orders placed with our resellers by governmental entities may generally be terminated unilaterally or may be subject to additional conditions. As a result, predicting when orders will translate to revenue, and consequently predicting our future operating results, is extremely difficult. In addition, our quarterly and annual expenses as a percentage of our revenue may be significantly different from our historical or projected rates, and our operating results in future quarters may fall below expectations.

In any quarter, a substantial portion of our revenue may be largely attributable to orders from a limited number of customers, which can result in our recognizing a substantial amount of revenue without a corresponding increase in operating expenses. Although in fiscal 2009, no customer represented 10% or more of our total revenue, in the first quarter fiscal 2010, 10% of our revenue, was attributable to sales to a single customer. For these reasons, comparing our operating results, particularly our gross profit results, on a period-to-period basis may not be meaningful. You should not rely on our past results as an indication of our future performance.

In addition to other risk factors listed in this Risk Factors section, factors that may affect or result in period-to-period variability in our operating results include:

- reductions in customers budgets for storage infrastructure purchases and indefinite delays in their budgeting and purchasing cycles, especially given the general economic downturn, could have an adverse effect on our business and operating results because the purchase of our products requires our customers to make strategic and capital investment decisions about their storage infrastructures;

- aggressive pricing tactics by our competitors could adversely affect our operating results because we may offer our products at a discount to win business and maintain existing customers, which could decrease our gross margins;

- the length of time between our receipt of orders and the recognition of revenue from those orders, which can be several quarters because orders may contain terms that do not permit us to recognize revenue until certain conditions have been satisfied;

- reductions in the size of individual transactions involving initial system sales, because smaller systems tend to have a smaller software component and, therefore, could decrease our gross margins;

any delays in installation or our ability to satisfy other revenue recognition criteria that affect even a small number of large transactions, as occurred in our quarter ended June 30, 2009, could have an adverse impact on our revenues, revenue growth (if any), and operating results.

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

the timing of product releases or upgrades by us or by our competitors, which could have an adverse effect on our revenue if customers delay orders pending the new release or upgrade.

We face significant competition from a number of established companies, which have offered and may continue to offer substantial pricing discounts and pursue other aggressive competitive tactics in order to attract and maintain customers.

We face intense competition from a number of established companies that seek to provide storage solutions similar to our utility storage solution. Currently, these competitors include EMC, Hitachi, IBM, NetApp, HP, Sun, and Dell. All of these competitors, as well as other potential competitors, have longer operating histories, significantly greater resources, more employees, better name recognition, a larger base of customers and more established customer relations than we have. Consequently, some of these companies have substantial control and influence regarding the acceptance of a particular industry standard or competing technology.

In addition, these competitors may also be able to devote greater resources to the development, promotion and sale of products and may be able to deliver competitive products or technologies at a significantly lower initial cost than our products. For example, some of our competitors have offered bundled products and services in order to reduce the initial cost of their storage solution to a customer. Our competitors also may choose to adopt more aggressive pricing policies than we may choose to adopt. For example, some of our competitors have offered their products either at significant discounts or even for free in response to our efforts to market the technological merits and overall cost benefits of our products.

Some of our competitors may also have the ability to manufacture competitive products at lower costs. Our current or potential competitors may also offer bundled arrangements that include IT solutions, such as document management or security that we do not currently offer and that are unrelated to storage, but that may be desirable and beneficial features for our current and prospective customers. We also face competition from current and prospective customers that continually evaluate our capabilities against the merits of manufacturing storage products internally. Competition may also arise due to the development of cooperative relationships among our current and potential competitors or third parties, some of which already exist, to increase the ability of their products to address the needs of our prospective customers. Accordingly, it is possible that new competitors or alliances among competitors may emerge and rapidly acquire significant market share.

We also have many competitors that have developed competing technologies. For example, some of our competitors have recently released or announced plans to release a storage technology that will directly compete with our utility storage solution, including our 3PAR Thin Provisioning software application. We expect our competitors to continue to improve the performance of their current products, reduce their prices and introduce new services and technologies that may offer greater performance and improved pricing compared to our products, any of which could harm our business. In addition, our competitors may develop enhancements to, or future generations of, competitive products that may render our services or technologies obsolete or uncompetitive. These and other competitive pressures may prevent us from competing successfully against current or future competitors.

Many of our established competitors have long-standing relationships with key decision makers at many of our current and prospective customers. As a result, we may not be able to compete effectively and maintain or increase our market share.

Many of our competitors benefit from established brand awareness and long-standing relationships with key decision makers at many of our current and prospective customers. We expect that our competitors will seek to leverage these existing relationships to discourage customers from purchasing our products. In particular, when competing against us, we expect our competitors to emphasize the importance of data storage retention, the high cost of data storage failure and the perceived risks of relying on products from a company with a shorter operating history and less predictable operating results. These factors may cause our current or prospective customers to be unwilling to purchase our products and instead to purchase the products of our better-known and more established competitors. In the event that we are unable to successfully sell our products to new customers, persuade customers of our competitors to purchase our products instead, or prevent our competitors from persuading our customers to purchase our competitors products, we may not be able to maintain or increase our market share. This would have a negative impact on our future operating results.

Our ability to increase our revenue will depend substantially on our ability to attract and retain sales, management and other key personnel, and any failure to attract and retain these employees could harm our future revenues, business, operating results and financial condition.

Our ability to increase our revenue will depend substantially on our ability to attract and retain qualified sales personnel as well as replace sales personnel we promote to managerial positions within the sales organization. In particular, we anticipate hiring direct sales personnel in fiscal 2010 and our operating plan assumes that we will be able to attract and retain our sales and other key employees. These positions require candidates with specific backgrounds in the storage industry, and competition for employees with this expertise can be intense. In addition, we believe that there are only a limited number of individuals with the specific skills required for many of our sales and other key positions. We have experienced substantial competition in our hiring efforts and also in our retention efforts as our personnel have been frequently recruited by other companies, including our competitors. As a result, we may be unable to identify, hire, or retain qualified individuals, which could have a material adverse effect on our future revenues, business, operating results, and financial condition.

To the extent that we are successful in hiring new employees to fill these positions, we need a significant amount of time to train the new employees before they can become effective and efficient in performing their jobs. As a result of the difficulty in finding and training qualified candidates, it is critical for us to retain the individuals who currently fill these positions. In particular, because competition for highly skilled sales and engineering employees can be intense in our industry, recruitment practices can be aggressive. Substantial groups of our employees in key functional areas such as sales and systems engineers have been targets of aggressive recruiting efforts, which could reoccur and result in a loss of key employees. Many of the employers with whom we compete for talent, or who may target our employee base, are larger with substantially greater resources than we have and may be able to offer compensation packages or other benefits that we do not provide or that are substantially more lucrative than our operating budgets permit. Any loss of our existing or future sales or other key personnel could harm our business, operating results and financial condition.

Our future success depends on our ability to attract and retain key management personnel or to quickly fill any management vacancies that may arise. Our management personnel and other key employees can terminate their employment at any time, and our business could suffer if we are unable to replace any departing management personnel or other key employees. For example, we are currently in a period of transitioning our office of the Vice President of Worldwide Sales with the recent departure of our former vice president of worldwide sales. If we are unable to effectively accomplish the transition in a timely manner, disruption in our sales organization may occur and our future revenues could be harmed. Our future success is also dependent upon our ability to attract additional personnel for all other areas of our organization, including our customer services and finance department. Competition for qualified personnel is intense, and we may not be successful in attracting and retaining such personnel on a timely basis, on competitive terms, or at all. If we are unable to attract and retain the necessary technical, sales and other personnel on a cost-effective basis, we may be unable to grow our business and increase our revenue.

Our sales cycle can be long and unpredictable, and our sales efforts require considerable time and expense. As a result, our sales are difficult to predict and may vary substantially from quarter to quarter, which may cause our operating results to fluctuate.

Our sales efforts involve substantial education of our current and prospective customers about the use and benefits of our products, including their technical merits and capabilities and potential cost savings to the organization as compared to the incumbent storage solutions or other storage solutions that our customers or prospective customers may be considering. This education process can be extremely time consuming and typically involves a significant product evaluation process. Historically, our sales cycle averages three to four months, but has, in some cases, exceeded 12 months. Despite the substantial time and money that we invest in our sales efforts, we cannot assure you that these efforts will produce any sales. In addition, product purchases by our current and prospective customers are frequently subject to their budget constraints, lengthy approval processes, and a variety of unpredictable administrative, processing and other delays, which have become increasingly prevalent during the current economic downturn. A substantial number of our purchase orders do not include a shipment date, and shipments to customers may be delayed for substantial periods based on the customer s specific needs. Our sales cycle may prevent us from recognizing revenue in a particular quarter, is relatively long and costly and may not produce any sales, which may cause our operating results to fluctuate and harm our business.

We purchase our disk drives, power supplies and certain components for our controller nodes from a limited number of qualified suppliers. If these or any of our other suppliers are not able to meet our requirements, as a result of parts shortages, deterioration in their financial condition in light of the global recession, or otherwise, it could harm our business.

We purchase sophisticated components from a limited number of qualified suppliers. We purchase our disk drives from Xyratex or Seagate, our power supplies from Power-One Inc., and ASICs for our controller nodes from Renesas. Initially, suppliers of our disk drives, power supplies and ASICs require up to several months to qualify through a lengthy testing process and a substantial amount of work to enable interoperability with our products. In the event that it became necessary for us to find another supplier of these or any of the other components of our products, for any reason, including financial difficulties of suppliers arising from the global recession, the time required to transition to the new supplier could take up to 12 months, due to the lengthy qualification and technology development process.

We have in the past and may in the future experience quality control issues and delivery delays with our suppliers due to factors such as high industry demand or the inability of some vendors to consistently meet our quality or delivery requirements. We do not have a long-term contract with any of our current suppliers, and we purchase all components from our suppliers on a purchase order basis. In addition, the current global economic downturn could adversely impact our suppliers ability to provide essential services to us on a timely basis, if at all. If any of our suppliers were to cancel or materially change their commitments with us or fail to meet the quality or delivery requirements needed to satisfy customer orders for our products, we could lose time-sensitive customer orders, be unable to develop or sell certain products cost-effectively or on a timely basis, if at all, and have significantly decreased revenue, which would harm our business, operating results and financial condition.

Additionally, we periodically transition our product line to incorporate new technologies developed by us or our suppliers. For example, from time to time our suppliers may discontinue production of existing components and products due to new technologies that are replacing such components and products. Often times we are not given substantial advanced notice of such discontinuances and our suppliers may require a significant amount of time to qualify the new technologies to ensure that they are compatible with our products. If such new technologies are not qualified in a timely manner, we could experience inventory shortages, which could adversely affect our ability to fulfill customer orders which could harm our business.

We rely principally on two contract manufacturers to assemble portions of our products, and our failure to accurately forecast demand for our products or successfully manage our relationships with our contract manufacturers could negatively impact our ability to sell our products.

We rely principally on two contract manufacturers to assemble the disk chassis and controller nodes for each of our InServ Storage Server products, manage our supply chain and, alone or together with us, negotiate component costs. Specifically, we rely on AsteelFlash, to assemble our controller nodes and on Flash and Xyratex Technology Limited to assemble our disk chassis. Our reliance on our contract manufacturers for these disk chassis and controller nodes reduces our control over the assembly process, quality assurance, production costs and product supply. If we fail to manage our relationship with our contract manufacturers or if either of our contract manufacturers experiences delays, disruptions, capacity constraints or quality control problems in its operations, our ability to ship products to our customers could be impaired and our competitive position and reputation could be harmed. If we or our contract manufacturers are unable to negotiate with suppliers for reduced component costs, our operating results could be harmed.

The general economic downturn may adversely impact the financial condition and manufacturing capacity of our contract manufacturers, which could impair their ability to perform under our agreements. In addition, our contract manufacturers may terminate our agreements with them upon prior notice to us or for reasons such as if we become insolvent, or if we fail to perform a material obligation under our agreements with them. If we are required to change contract manufacturers or assume internal manufacturing operations for any reason, (including financial problems of our contract manufacturers, reduction of manufacturing output made available to us, or the termination of one of our contracts), we may lose revenue, incur increased costs and damage our customer relationships. Qualifying a new contract manufacturer and commencing volume production are expensive and time-consuming. We are required to provide forecasts to our contract manufacturers regarding product demand and production levels. We maintain with our contract manufacturers a rolling 90-day firm order for products they manufacture for us, and these orders may only be rescheduled or cancelled under certain limited conditions. If we inaccurately forecast demand for our products, we may have excess or inadequate inventory or incur cancellation charges or penalties, which could adversely impact our operating results.

We intend to introduce new products and product enhancements, which could require us to achieve volume production rapidly by coordinating with our contract manufacturers and component suppliers. We may need to increase our component purchases, contract manufacturing capacity and internal test and quality functions if we experience increased demand. If our contract manufacturers are unable to provide us with adequate supplies of high-quality products, or if we or either of our contract manufacturers are unable to obtain adequate quantities of components, it could cause a delay in our order fulfillment, in which case our business, operating results and financial condition could be adversely affected.

Our ability to sell our products is highly dependent on the quality of our customer support and services, and any failure to offer high-quality support and services would harm our business, operating results and financial condition.

Once our products are deployed, our customers depend on our support organization to resolve any issues relating to our products. Our products provide mission-critical services to our customers and a high level of customer support is necessary to maintain our customer relationships. We rely on authorized service providers in certain locations in the United States to install our products and deliver initial levels of on-site customer support and services. While we carefully identify, train, and certify our authorized service providers, it may be more difficult for us to ensure the proper delivery and installation of our products or the quality or responsiveness of the support and services being provided. As we grow our business, our ability to provide effective customer support and services will continue to be largely dependent on our ability to attract, train and retain qualified direct customer service personnel and our ability to maintain and grow our network of authorized service providers. Additionally, as we expand our operations internationally, our support organization will face additional challenges, including those associated with delivering support, training and documentation in languages other than English, as well as identifying, training, and certifying international authorized service providers to support products we may deploy in geographical areas in which we may not currently have authorized service providers.

In addition, our sales process is highly dependent on strong word-of-mouth recommendations from our customers. We believe that communication among our customers is both rapid and frequent. Any failure to maintain high-quality customer support and services, or a market perception that we do not maintain high-quality customer support and services, could harm our reputation, adversely affect our ability to sell our products to existing and prospective customers, and could harm our business, operating results and financial condition.

We rely on channel partners and resellers to sell our products in markets where we do not have a direct sales force, and on channel partners and authorized service providers to service and support our products in markets where we do not have direct customer service personnel. Any disruptions to, or failure to develop and manage, our relationships with channel partners, resellers and authorized service providers could have an adverse effect on our customer relationships and on our ability to increase revenue.

Our future success is highly dependent upon our ability to establish and maintain successful relationships with a variety of channel partners, resellers and authorized service providers in markets where we do not have a direct sales force or direct customer service personnel. We currently have a direct sales force in the United States, the United Kingdom, Germany and Japan, although we rely heavily on our channel partners in Japan. In other markets, we rely and expect to continue to rely on establishing relationships with channel partners, resellers and authorized service providers. Our ability to maintain or grow our international revenue will depend, in part, on our ability to manage and expand our network of channel partners, resellers and authorized service providers internationally. Whereas, channel partners and resellers engage in the sale of products, in addition to their sales activities, our channel partners also provide installation, post-sale service and support on our behalf in their local markets. We also have agreements with authorized service providers that, although they do not sell our products, deliver and install our products, as well as provide post-sale customer service and support, on our behalf in their local markets. In markets where we rely on channel partners, resellers and authorized service providers, we have less contact with our customers and less control over the sales process and the quality and responsiveness of our channel partners, resellers and authorized service partners. As a result, it may be more difficult for us to ensure the proper delivery and installation of our products or the quality or

responsiveness of the support and services being offered. Any failure on our part to effectively identify and train our channel partners, resellers and authorized service providers and to monitor their sales activity as well as the customer support and services being provided to our customers in their local markets could harm our business, operating results and financial condition.

Identifying, training, and retaining qualified channel partners, resellers and authorized service providers requires significant time and resources. In order to maintain and expand our network of channel partners, resellers and authorized service providers, we must continue to scale and improve the systems, processes, and procedures that support our resellers and authorized service providers, which will require continuing investment in our information technology infrastructure and dedication of significant training resources. As we grow our business and support organization, these systems, processes, and procedures may become increasingly complex, difficult and expensive to manage, particularly as the geographic scope of our customer base expands globally.

We typically enter into non-exclusive, written agreements with our channel partners, resellers and authorized service providers. These agreements generally have a one-year, self-renewing term, have no minimum sales commitment, and do not prohibit our channel partners, resellers and authorized service providers from offering products and services that compete with ours. Accordingly, our channel partners, resellers and authorized service providers may choose to discontinue offering our products and services or may not devote sufficient attention and resources toward selling our products and services. Additionally, our competitors may provide incentives to our existing and potential channel partners, resellers and authorized service providers to use, purchase or offer their products and services or to prevent or reduce sales of our products and services. The occurrence of any of these events could harm our business, operating results and financial condition.

If we fail to manage growth effectively, our business would be harmed.

In recent years, we have experienced substantial growth in the size and scope of our business, and if that growth continues, it will place significant demands on our management, infrastructure and other resources. In fiscal 2009, our number of employees increased from 451 to 591 and in the first quarter of fiscal 2010, we increased our number of employees to 614. We have also expanded the geographic scope of our business, including the establishment of a research and development operations in Northern Ireland in fiscal 2008 and a sales office in Singapore in fiscal 2009. We expect to continue to expand internationally through direct sales efforts and by establishing indirect sales and support relationships with channel partners, resellers and authorized service providers in select international markets. Continued growth in the size and scope of our business operations will require substantial management attention. For example, our management will have to increasingly dedicate its time and attention to oversee our efforts to recruit, integrate and retain highly-skilled personnel to join our growing internal departments; to manage a growing and dispersed geography to support the expansion of our research and development, sales and customer support organizations; and to expand and improve our information technology infrastructure and network of facilities to support a growing employee and customer base. In addition, our management will have to enhance and improve company-wide processes and procedures to address human resource, financial reporting and financial management matters that are consistent across our organization and comply with applicable U.S. and international regulatory and legal requirements. If we are not successful in effectively managing our growth, it could harm our business, operating results and financial condition.

Our international sales and operations introduce risks that can harm our business, operating results and financial condition.

In fiscal 2009 and in the three months ended June 30, 2009 we derived 16% and 20% of our revenue from end customers outside the United States, respectively. We expect that our international sales will continue to contribute a similar percentage of our total revenue on an annual basis. We have direct sales personnel in the United States, the United Kingdom, Germany, Canada and Japan and agreements with third-party resellers or channel partners in Belgium, France, China, Czech Republic, Hong Kong, India, Italy, Japan, Korea, Luxembourg, Malaysia, The Netherlands, Poland, Spain, the United Kingdom, Singapore, South Africa and Taiwan. In addition, we currently have international subsidiaries in the United Kingdom, Germany, Singapore and Japan. We expect to continue to hire additional sales personnel and expand our network of channel partners and resellers internationally and as a result may need to establish additional international subsidiaries and offices. Our international operations subject us to a variety of risks, including:

- our inability to employ qualified management and other personnel;

- the increased travel, infrastructure and legal compliance costs associated with multiple international locations;
- difficulties in enforcing contracts, collecting accounts receivable and longer payment cycles, especially in emerging markets;
- the need to localize our products and licensing programs for international customers;
- tariffs and trade barriers and other regulatory or contractual limitations on our ability to sell or develop our products in certain foreign markets;
- increased exposure to foreign currency exchange rate risk; and
- reduced protection for intellectual property rights in some countries.

In addition, although the functional currency of our foreign subsidiaries is the U.S. Dollar, in countries outside the U.S. we transact business in various currencies besides the U.S. Dollar and we have certain cash accounts, receivables and payables balances denominated in currencies other than the U.S. Dollar. We are currently hedging certain Euro and British Pound denominated receivables held by us to reduce the risk that our earnings would be adversely affected by changes in the British Pound exchange rate. Our hedging activities reduce, but do not entirely eliminate, the impact of currency exchange rate movements, and therefore fluctuations in exchange rates could negatively impact our results from operations.

As we continue to expand our business globally, our success will depend, in large part, on our ability to anticipate and effectively manage these and other risks associated with our international operations. Our failure to manage any of these risks successfully could harm our international operations and reduce our international sales, which in turn could adversely affect our business, operating results and financial condition.

We are subject to governmental export and import controls that could subject us to liability or impair our ability to compete in foreign markets.

Because we incorporate encryption technology into our products, our products are subject to United States export controls and may be exported outside the United States only with the required level of export license or through an export license exception. In addition, various countries regulate the import of certain encryption technology and have enacted laws that could limit our ability to introduce products or could limit our customers ability to implement our products in those countries. Changes in our products or changes in export and import regulations may create delays in the introduction of our products in international markets, prevent our customers with international operations from deploying our products throughout their global systems or, in some cases, prevent the export or import of our products to certain countries altogether. Any change in export or import regulations or related legislation, shift in approach to the enforcement or scope of existing regulations, or change in the countries, persons or technologies targeted by such regulations, could result in decreased use of our products by, or an inability to export or sell our products to, existing or prospective customers with international operations and harm our business.

We are subject to laws and regulations governing the environment and may incur substantial environmental regulation costs, which could harm our operating results.

We are subject to various state, federal and international laws and regulations governing the environment, including those restricting the presence of certain substances in electronic products and making producers of those products financially responsible for the collection, treatment, recycling and disposal of certain products. These laws and regulations have been enacted in several jurisdictions in which we sell our products, including various European Union, or EU, member countries. For example, the EU has enacted RoHS and WEEE directives. RoHS prohibits the use of certain substances, including lead, in certain products, including hard drives, sold after July 1, 2006. The WEEE directive obligates parties that sell electrical and electronic equipment in the EU to put a clearly identifiable mark on the equipment, register with and report to EU member countries regarding distribution of the equipment and provide a mechanism to take back and properly dispose of the equipment. There is still some uncertainty in certain EU countries as to which party involved in the manufacture, distribution and sale of electronic equipment will be ultimately responsible for registration, reporting and disposal. Similar legislation may be enacted in other locations where we sell our products. We will need to ensure that we comply with these laws and regulations as they are enacted, and that our component suppliers also comply with these laws and regulations. If we or our component suppliers fail to comply with the legislation, our customers may

refuse or be unable to purchase our products, which could harm our business, operating results and financial condition.

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

As we seek to increase our sales to the public sector, we may face difficulties and risks unique to government contracts that may have a detrimental impact on our business, operating results and financial condition.

Historically, we have sold products to United States government agencies through third-party resellers. We established a wholly owned subsidiary through which we have sold and intend to continue to sell directly to more entities and agencies within the United States government and state and local governments. Developing new business in the public sector often requires the development of relationships with different agencies or entities, as well as with other government contractors. If we are unable to develop or sustain such relationships, we may be unable to procure new contracts within the timeframes we expect, and our business, operating results and financial condition may be adversely affected. Contracting with the United States government often requires businesses to participate in a highly competitive bidding process to obtain new contracts. We may be unable to bid competitively if our products or services are improperly priced, or if we are incapable of providing our products and services at a competitive price. The bidding process is an expensive and time-consuming endeavor that may result in a financial loss for us if we fail to win a contract on which we submitted a bid. Further, some agencies within the United States government may also require some or all of our personnel to obtain a security clearance or may require us to add features or functionality to our products that could require a significant amount of time and prevent our employees from working on other critical projects. If our key personnel are unable to obtain or retain this clearance or if we cannot or do not provide required features or functionality, we may be unsuccessful in our bid for some government contracts.

Contracts with governmental entities also frequently include provisions not found in private sector contracts and are often governed by laws and regulations that do not affect private sector contracts. These unique provisions may permit public sector customers to take actions not available to customers in the private sector. These actions may include termination of contracts for convenience or due to a default. The United States government can also suspend operations if Congress does not allocate sufficient funds to a particular agency or organization, and the United States government may allow our competitors to protest our successful bids. The occurrence of any of these events may negatively affect our business, operating results and financial condition.

In order to maintain contracts we may obtain with government entities, we must also comply with many rules and regulations that may affect our relationships with other customers. For example, the United States government could terminate its contracts with us if we come under foreign government control or influence, may require that we disclose our pricing data during the course of negotiations, and may require us to prevent access to classified data. If the United States government requires us to meet any of these demands, it could increase our costs or prevent us from taking advantage of certain opportunities that may present themselves in the future. United States government agencies routinely investigate and audit government contractors administrative processes. They may audit our performance and our pricing, and review our compliance with rules and regulations. If they find that we have improperly allocated costs, they may require us to refund those costs or may refuse to pay us for outstanding balances related to the improper allocation. An unfavorable audit could reduce our revenue, and may result in civil or criminal liability if the audit uncovers improper or illegal activities. This could harm our business, operating results and financial condition.

If we are unable to protect our intellectual property rights, our competitive position could be harmed and we could be required to incur significant expenses to enforce our rights.

We depend on our ability to protect our proprietary technology. We rely on trade secret, patent, copyright and trademark laws and confidentiality agreements with employees and third parties, all of which offer only limited protection. Despite our efforts, the steps we have taken to protect our proprietary rights may not be adequate to preclude misappropriation of our proprietary information or infringement of our intellectual

property rights, particularly outside of the United States. Further, with respect to patent rights, we do not know whether any of our pending patent applications will result in the issuance of patents or whether the examination process will require us to narrow our claims, and even if patents are issued, they may be contested, circumvented or invalidated over the course of our business. Moreover, the rights granted under any of our issued patents or patents that may be issued in the future may not provide us with proprietary protection or competitive advantages, and, as with any technology, competitors may be able to develop similar or superior technologies to our own now or in the future. Protecting against the unauthorized use of our products, trademarks and other proprietary rights is expensive, difficult and, in some cases, impossible. Litigation may be necessary in the future to enforce or defend our intellectual property rights, to protect our trade secrets or to determine the validity and scope of the proprietary rights of others. This litigation could result in substantial costs and diversion of management resources, either of which could harm our business. Furthermore, many of our current and potential competitors have the ability to dedicate substantially greater resources to enforce their intellectual property rights than we do. Accordingly, despite our efforts, we may not be able to prevent third parties from infringing upon or misappropriating our intellectual property.

Claims by others that we infringe their proprietary rights could harm our business.

Third parties could claim that our products or technology infringe their proprietary rights. In addition, we have in the past and may in the future be contacted by third parties suggesting that we seek a license to certain of their intellectual property rights that they may believe we are infringing. We expect that infringement claims against us may increase as the number of products and competitors in our market increases and overlaps occur. In addition, to the extent that we gain greater visibility, we believe that we will face a higher risk of being the subject of intellectual property infringement claims. Any claim of infringement by a third party, even those without merit, could cause us to incur substantial costs defending against the claim, and could distract our management from our business. Furthermore, a party making such a claim, if successful, could secure a judgment that requires us to pay substantial damages. A judgment against us could also include an injunction or other court order that could prevent us from offering our products. In addition, we might be required to seek a license for the use of such intellectual property, which may not be available on commercially reasonable terms, or at all. Alternatively, we may be required to develop non-infringing technology, which could require significant effort and expense and may ultimately not be successful. Any of these events could seriously harm our business. Third parties may also assert infringement claims against our customers, resellers and authorized service providers. Because we generally indemnify our customers, resellers and authorized service providers if our products infringe the proprietary rights of third parties, any such claims would require us to initiate or defend protracted and costly litigation on their behalf, regardless of the merits of these claims. If any of these claims succeed, we may be forced to pay damages on behalf of our customers, resellers and authorized service providers.

We may not generate positive returns on our research and development investments.

Developing our products is expensive. In fiscal 2009 and in the three months ended June 30, 2009, our research and development expenses were $46.3 million, or 25% of our total revenue, $11.6 million, or 26% of our total revenue, respectively. Our future plans include significant investments in research and development and related product opportunities. We believe that we must continue to dedicate a significant amount of resources to our research and development efforts to maintain our competitive position. However, our ability to generate positive returns on these investments may take several years, if we are able to do so at all.

If we do not successfully anticipate market needs and develop products and product enhancements that meet those needs, or if those products do not gain market acceptance, our business, operating results and financial condition could be adversely affected.

We compete in a market characterized by rapid technological change, frequent new product introductions, evolving industry standards and changing customer needs. We cannot assure you that we will be able to anticipate future market needs or be able to develop new products or product enhancements to meet those needs in a timely manner, or at all. For example, our failure to develop additional features that our competitors are able to provide could adversely affect our business. In addition, although we invest a considerable amount of money into our research and development efforts, any new products or product enhancements that we develop may not achieve widespread market acceptance. As competition increases in the storage industry and the information technology industry in general, it may become even more difficult for us to stay abreast of technological changes or develop new technologies or introduce new products as quickly as our competitors,

many of which have substantially greater financial and engineering resources than we do. Additionally, risks associated with the introduction of new products or product enhancements include difficulty in predicting customer needs or preferences, transitioning existing products to incorporate new technologies, the capability of our suppliers to deliver high-quality components required by such new products or product enhancements in a timely fashion, and unknown defects in such new products or product enhancements. If we are unable to keep pace with rapid industry, technological or market changes or effectively manage the transitions to new products or new technologies, it could harm our business, operating results and financial condition.

Our products are highly technical and may contain undetected software or hardware errors or failures, which could cause harm to our financial condition and our reputation and adversely affect our business.

Our products are highly technical and complex and are critical to the operation of storage networks. We test our products prior to commercial release and during such testing have discovered and may in the future discover errors and defects that need to be resolved prior to release. Resolving these errors and defects can take a significant amount of time and prevent our technical personnel from working on other important tasks. In addition, our products have contained and may in the future contain one or more errors, defects or security vulnerabilities that were not detected prior to commercial release to our customers. Some errors in our products may only be discovered after a product has been installed and used by customers. Any errors, defects or security vulnerabilities discovered in our products after commercial release, as well as any computer virus or human error on the part of our customer support personnel or authorized service providers that result in a customer s data unavailability, loss or corruption, could result in loss of revenue or delay in revenue recognition, loss of customers and increased service and warranty costs, any of which could adversely affect our business, operating results and financial condition. In addition, we could face claims for product liability, tort or breach of warranty, including in relation to changes to our products made by our resellers or authorized service providers. Our contracts with our customers contain provisions relating to warranty disclaimers and liability limitations, which may not be upheld. Defending a lawsuit, regardless of its merit, is costly and may divert management s attention and adversely affect the market s perception of us and our products. In addition, if our business liability insurance coverage proves inadequate or future coverage is unavailable on acceptable terms or at all, our business, operating results and financial condition could be harmed.

If flaws in the design, production, assembly or testing of our products or our suppliers components were to occur, we could experience a rate of failure in our products that would result in substantial repair, replacement or service costs and potential damage to our reputation. Continued improvement in manufacturing capabilities, control of material and manufacturing quality and costs and product testing are critical factors in our future growth. We cannot assure you that our efforts to monitor, develop, modify and implement appropriate test and manufacturing processes for our products will be sufficient to permit us to avoid a rate of failure in our products that results in substantial delays in shipment, significant repair or replacement costs or potential damage to our reputation, any of which could harm our business, operating results and financial condition.

Changes in financial accounting standards or business practices may cause adverse, unexpected financial reporting fluctuations and affect our reported operating results.

A change in accounting standards or business practices can have a significant impact on our operating results and may affect our reporting of transactions completed before the change is effective. New accounting pronouncements and varying interpretations of existing pronouncements have occurred and may occur in the future. Changes to existing accounting rules or our business or accounting practices, such as our change to a software support model in March 2007, may adversely affect our reported financial results.

We may seek to engage in the acquisition of other companies or assets, all or many of which could be viewed negatively, lead to integration problems, disrupt our business, increase our expenses, reduce our cash, cause dilution to our stockholders and harm our financial condition and operating results.

In the future, we may seek to acquire companies or assets that we believe may enhance our market position. We may not be able to find suitable acquisition candidates and we may not be able to complete acquisitions on favorable terms, if at all. If we do complete acquisitions, we cannot assure you that they will not be viewed negatively by customers, financial markets or investors. In addition, any acquisitions that we make could lead to difficulties in integrating personnel and operations from the acquired businesses and in retaining and motivating key personnel from these businesses. Acquisitions may disrupt our ongoing operations, divert

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management from day-to-day responsibilities and increase our expenses. Any acquisitions may reduce our cash available for operations and other uses and could result in an increase in amortization expense related to identifiable assets acquired, potentially dilutive issuances of equity securities or the incurrence of debt, any of which could harm our business, operating results and financial condition.

We are incurring significant costs as a result of operating as a public company, and our management is required to devote substantial time to new compliance initiatives.

As a public company, we are incurring significant legal, accounting and other expenses that we did not incur as a private company. In addition, the Sarbanes-Oxley Act of 2002, or Sarbanes-Oxley, as well as rules subsequently implemented by the Securities and Exchange Commission, or the SEC, and NYSE have imposed various new requirements on public companies, including requiring changes in corporate governance practices, and may continue to impose new or modified requirements on public companies. Our management and other personnel are required to devote a substantial amount of time to these compliance initiatives. Moreover, these rules and regulations have increased our legal and financial compliance costs and made some activities more time-consuming and costly.

In addition, Sarbanes-Oxley requires, among other things, that we maintain effective internal control over financial reporting and disclosure controls and procedures. In particular, we must perform annual system and process evaluation and testing of our internal control over financial reporting to allow management and our independent registered public accounting firm to report on the effectiveness of our internal control over financial reporting, as required by Section 404 of Sarbanes-Oxley. Our testing, or the subsequent testing by our independent registered public accounting firm, may reveal deficiencies in our internal control over financial reporting that are deemed to be material weaknesses. Our compliance with Section 404 requires that we incur substantial expenses and expend significant management time on compliance-related issues.

If we are not able to comply with the requirements of Section 404, or if deficiencies in our internal control over financial reporting are identified and deemed to be material weaknesses, the market price of our stock could decline and we could be subject to sanctions or investigations by the SEC, NYSE or other regulatory authorities, which would require additional financial and management resources.

If we need additional capital in the future, it may not be available on favorable terms, or at all.

We may require, or elect to access, additional capital from equity or debt financing in the future to fund our operations, or respond to competitive pressures or strategic opportunities. We may not be able to secure additional financing on favorable terms, or at all. The terms of additional financing may place limits on our financial and operating flexibility. If we raise additional funds through further issuances of equity, convertible debt securities or other securities convertible into equity, our existing stockholders could suffer significant dilution in their percentage ownership of our company, and any new securities we issue could have rights, preferences or privileges senior to those of existing or future holders of our common stock. If we are unable to obtain necessary financing on terms satisfactory to us, if and when we require it, our ability to grow or support our business and to respond to business challenges could be significantly limited.

Interruption or failure of our information technology and communications systems or services provided by our suppliers and manufacturers could impair our ability to effectively provide our products and services, which could damage our reputation and harm our operating results.

The availability of our products and services depends on the continuing operation of our information technology and communications systems. Our servers are vulnerable to computer viruses, break-ins and similar disruptions from unauthorized tampering with our computer systems. Any damage to or failure of our systems could result in interruptions in our service, which could reduce our revenue. Our systems are vulnerable to damage or interruption from earthquakes, terrorist attacks, floods, fires, power losses, telecommunications failures, computer viruses, computer denial of service attacks or other attempts to harm our systems. In addition, our corporate headquarters, inventory storage facilities and product assembly centers, as well as the facilities of many of our suppliers and manufacturers, are located in areas with a high risk of major earthquakes. Some of our manufacturers also have facilities located in Asia, which could be adversely impacted by political or economic stability, inadequacy of local infrastructure to support our needs and difficulty in maintaining sufficient quality control over manufactured components and products. The occurrence of a natural disaster or other unanticipated problems at one or more of these locations could result in delays or cancellations of customer orders or the deployment of our products, and lengthy interruptions in our service, any of which could adversely affect our business, operating results and financial condition.

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Risks Related to Ownership of Our Common Stock

The trading price of our common stock is likely to be volatile.

The trading prices of the securities of technology companies have been highly volatile, and our common stock has a limited trading history. Factors that could affect the trading price of our common stock include:

- market conditions in our industry, the industries of our customers and the economy as a whole;
- variations in our operating results;
- announcements of technological innovations, new or enhanced services, strategic alliances or significant agreements by us or by our competitors;
- gain or loss of significant customers;
- recruitment or departure of our key personnel;
- the volume of shares of our common stock available for public sale, including for sale by affiliates and other stockholders that own substantial amounts of our common stock;
- changes in the estimates of our operating results or changes in recommendations by any securities analysts that elect to follow our common stock; and
- adoption or modification of regulations, policies, procedures or programs applicable to our business.

In addition, if the market for technology stocks or the stock market in general experiences loss of investor confidence, the trading price of our common stock could decline for reasons unrelated to our business. The trading price of our common stock might also decline as a result of events that affect other companies in our industry even if these events do not directly affect us. Some companies that have had volatile market prices for their securities have had securities class actions filed against them. If a suit were filed against us, regardless of its merits or outcome, it could result in substantial costs and divert management s attention and resources. This could harm our business, operating results and financial condition.

Reports published by securities or industry analysts, including projections in those reports that exceed our actual results, could adversely affect our stock price and trading volume.

Securities research analysts establish and publish their own quarterly projections regarding us and our business. These projections may vary widely from one another and may not accurately predict the results we actually achieve. Our stock price may decline if we fail to meet securities research analysts projections. Similarly, if one or more of the analysts who covers us downgrades our stock or publishes inaccurate or unfavorable research about our business, our stock price could decline. If one or more of these analysts ceases coverage of our company or fails to publish reports on us regularly our stock price or trading volume could decline.

In addition, if securities or industry analysts cease coverage of our company, the trading price for our stock and the trading volume could decline.

Insiders have substantial control over us and are able to influence corporate matters.

At March 31, 2009, our directors and executive officers and their affiliates beneficially own, in the aggregate, approximately 39% of our outstanding common stock. In addition, a former affiliate of one of our directors beneficially owns approximately 17% of our outstanding common stock. As a result, these stockholders are able to exercise significant influence over all matters requiring stockholder approval, including the election of directors and approval of significant corporate transactions, such as a merger or other sale of our company or its assets. This concentration of ownership limits our stockholders ability to influence corporate matters and may have the effect of delaying or preventing a third party from acquiring control over us.

Anti-takeover provisions in our charter documents and under Delaware law could discourage, delay or prevent a change in control of our company and may affect the trading price of our common stock.

Provisions in our certificate of incorporation and bylaws may have the effect of delaying or preventing a change of control or changes in our management. Our amended and restated certificate of incorporation and amended and restated bylaws include provisions that:

- authorize our board of directors to issue, without further action by the stockholders, up to 20,000,000 shares of undesignated preferred stock;

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- require that any action to be taken by our stockholders be effected at a duly called annual or special meeting and not by written consent;
- specify that special meetings of our stockholders can be called only by our board of directors, the chairman of the board, the chief executive officer or the president;
- establish an advance notice procedure for stockholder approvals to be brought before an annual meeting of our stockholders, including proposed nominations of persons for election to our board of directors;
- establish that our board of directors is divided into three classes, Class I, Class II and Class III, with each class serving staggered terms;
- provide that our directors may be removed only for cause;
- provide that vacancies on our board of directors may be filled only by a majority of directors then in office, even though less than a quorum;
- specify that no stockholder is permitted to cumulate votes at any election of directors; and
- require a super-majority of votes to amend certain of the above-mentioned provisions.

In addition, we are subject to the provisions of Section 203 of the Delaware General Corporation Law regulating corporate takeovers. Section 203 generally prohibits us from engaging in a business combination with an interested stockholder subject to certain exceptions

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None

Item 3. Defaults Upon Senior Securities

None

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

None

Item 5. Other Information

None

Item 6. Exhibits

Exhibit No.	Description
31.1	Certification of Principal Executive Officer Pursuant to Exchange Act Rule 13a-14(a) or 15d-14(a), as Adopted Pursuant to Section 302 of The Sarbanes Oxley Act of 2002.

31.2	Certification of Principal Financial Officer Pursuant to Exchange Act Rule 13a-14(a) or 15d-14(a), as Adopted Pursuant to Section 302 of The Sarbanes Oxley Act of 2002.
32.1	Certifications of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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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

Dated: August 10, 2009

3PAR Inc.

By: /s/ ADRIEL G. LARES
Adriel G. Lares
Vice President of Finance, Chief Financial Officer

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