

3PAR Inc.  
Form 10-K  
June 12, 2008  
Table of Contents

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D. C. 20549

**Form 10-K**

(Mark One)

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

For the fiscal year ended March 31, 2008

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**  
(State or other jurisdiction  
of incorporation or organization)

**4209 Technology Drive**  
**Fremont, CA**  
(Address of principal executive offices)

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

**77-0510671**  
(I.R.S. Employer Identification No.)

**94538**  
(Zip Code)

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

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<b>Title of Each Class:</b> Common Stock, par value \$0.001 per share	<b>Name of Each Exchange on which Registered</b> NYSE Arca
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**Securities registered pursuant to Section 12(g) of the Act: None**

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

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

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. 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 definition of accelerated filer large accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer   
Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting Company

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

As of September 30, 2007, the last business day of the Registrant's most recently completed second fiscal quarter, the Registrant's common stock was not listed on any exchange or over-the-counter market. The Registrant's common stock began trading on NYSE Arca on November 16, 2007. At March 31, 2008, the aggregate market value of the Registrant's common stock held by non-affiliates of the Registrant based upon the closing sale price of such shares on NYSE Arca on March 31, 2008 was approximately \$188,451,167. Shares of the Registrant's common stock held by each executive officer and director and by each entity or person that, to the Registrant's knowledge, owned 5% or more of the Registrant's outstanding common stock as of March 31, 2008 have been excluded in that such persons may be deemed to be affiliates of the Registrant. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

The number of shares of the Registrant's Common Stock, \$.001 par value, outstanding at May 31, 2008 was: 60,576,681

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the Registrant's Proxy Statement relating to the Registrant's 2008 Annual Meeting of Shareholders, to be held on September 10, 2008, are incorporated by reference into Part III of this Annual Report on Form 10-K where indicated.

**Table of Contents****TABLE OF CONTENTS**

	<b>Page No.</b>
<b>PART I</b>	
Item 1. <u>Business</u>	3
Item 1A. <u>Risk Factors</u>	18
Item 1B. <u>Unresolved Staff Comments</u>	31
Item 2. <u>Properties</u>	32
Item 3. <u>Legal Proceedings</u>	32
Item 4. <u>Submission of Matters to a Vote of Security Holders</u>	32
<b>PART II</b>	
Item 5. <u>Market for Registrant's Common Equity, Related Stockholder Matters, and Issuer Purchases of Equity Securities</u>	33
Item 6. <u>Selected Consolidated Financial Data</u>	36
Item 7. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	38
Item 7A. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	56
Item 8. <u>Financial Statements and Supplementary Data</u>	58
Item 9. <u>Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u>	88
Item 9A. <u>Controls and Procedures</u>	88
Item 9B. <u>Other Information</u>	88
<b>PART III</b>	
Item 10. <u>Directors, Executive Officers and Corporate Governance</u>	89
Item 11. <u>Executive Compensation</u>	89
Item 12. <u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	89
Item 13. <u>Certain Relationships and Related Transactions, and Director Independence</u>	89
Item 14. <u>Principal Accountant Fees and Services</u>	89
<b>PART IV</b>	
Item 15. <u>Exhibits and Financial Statement Schedules</u>	90
<u>Signatures</u>	91

---

**Table of Contents**

*This Annual Report on Form 10-K, including the Management's Discussion and Analysis of Financial Condition and Results of Operations, contains forward-looking statements regarding future events and our future results that are subject to the safe harbors created under the Securities Act of 1933 (the Securities Act) and the Securities Exchange Act of 1934 (the Exchange Act). All statements other than statements of historical facts are statements that could be deemed forward-looking statements. These statements are based on current expectations, estimates, forecasts, and projections about the industries in which we operate and the beliefs and assumptions of our management. Words such as expects, anticipates, targets, goals, projects, intends, plans, believes, seeks, estimates, continues, may, variations of such words, and similar expressions are intended to identify such forward-looking statements. In addition, any statements that refer to projections of our future financial performance, our anticipated growth and trends in our business, and other characterizations of future events or circumstances are forward-looking statements. Readers are cautioned that these forward-looking statements are only predictions and are subject to risks, uncertainties, and assumptions that are difficult to predict, including those identified below, under Item 1A. Risk Factors, and elsewhere herein. Therefore, actual results may differ materially and adversely from those expressed in any forward-looking statements. We undertake no obligation to revise or update any forward-looking statements for any reason.*

**PART I**

**ITEM 1. BUSINESS**

**Overview**

We are the leading global provider of utility storage solutions for large to medium enterprises, business-oriented service providers, consumer-oriented Internet/Web 2.0 companies and government entities. Utility storage is a segment of the larger, global market for Fibre Channel and iSCSI open storage area networks, or SANs, a market in which we compete with larger, more established companies. Our utility storage products offer simple, efficient and massively scalable tiered storage arrays designed to be key building blocks for utility computing. Utility computing is an emerging IT architecture that virtualizes key IT infrastructure elements, primarily application servers and storage arrays, to create shared infrastructures for workload consolidation that can enable services to be delivered more rapidly, flexibly, reliably and economically. Virtualization presents a logical view of resources that is independent of the actual underlying physical assets. Utility computing aims to capture key advantages of both mainframe computing and client/server, or distributed computing, which utility storage helps enable by reducing complexity and inefficiency in the storage infrastructure.

We believe that our utility storage solution dramatically enhances the economics and performance of storage. Our utility storage solution is designed to provision storage services more rapidly than alternative approaches, reduce administrative costs, improve server and storage utilization, lower power and cooling requirements and scale efficiently to support the continuous growth of data.

We deliver our utility storage solution through our InServ Storage Server arrays, all of which are powered by our InForm Suite of software. IDC, a third-party market research firm, estimates in its December 2007 report *Worldwide Disk Storage Systems 2007-2011 Forecast Update: Mature, But Still Growing and Changing* that the global market for Fibre Channel and SANs will be approximately \$12.7 billion in 2008. We compete in segments of this market that IDC estimates will be approximately \$8.5 billion in 2008.

We began operations in May 1999 and are headquartered in Fremont, California. We began commercial shipments of our products in March 2002 and have shipped over 600 systems to more than 300 end customers, including Credit Suisse Group, Department of Justice (FBI), Dow Jones & Company, Inc., MySpace.com, Omniture, Inc., Priceline.com, SAVVIS, Inc., TransUnion LLC, United States Census Bureau, USinternetworking, Inc. (an AT&T company), Verizon Business and the Virginia Information Technologies Agency.

## **Table of Contents**

### **Industry Background**

Organizations that generate and retain large amounts of data use enterprise level storage systems for storing, protecting and recovering electronic information in the form of digital data. Efficient and accurate access to data can be critical to the success of an organization and can be a key competitive differentiator.

### ***Data Growth and Increasing Regulatory Compliance***

The increasing reliance on business-critical enterprise applications such as e-mail, relational databases, enterprise resource planning, customer relationship management and workgroup collaboration tools, as well as digital content for Internet services, online video and digital imaging, is resulting in the rapid growth of data across all enterprises and geographies. We believe the management and protection of this data throughout its lifecycle, from creation to archiving, is becoming a significant component of organizations' IT budgets. In addition, global compliance initiatives and government regulations, such as those issued under the Sarbanes-Oxley Act of 2002, or Sarbanes-Oxley, and the Health Insurance Portability and Accountability Act, as well as company-specific policies requiring data preservation, are contributing to the growing volumes of data that must be retained and managed for long periods of time or indefinitely.

### ***Computing Architecture Transitions Create a Need for New Storage Architectures***

The first storage technology used with general computing was based on directly attached disk drives. This computing paradigm evolved into mainframe computing with the development of mainframes by IBM, and other vendors using the MVS operating system. The first advanced storage systems were optimized building blocks designed to be attached to these mainframes. These storage systems, which became known as monolithic storage arrays, provide mainframe-specific storage features, such as large caches, as well as redundant disk protection, but at a significant up-front capital cost.

In the 1990s, distributed computing emerged as the predominant IT architecture. This approach uses open systems servers based on UNIX, Windows and Linux. As distributed computing emerged, monolithic storage arrays were modified to work in these new environments. In addition, a new design of storage array arose comprised of pairs of data storage engines, or controller nodes. This new design came to be known as a modular storage array. Modular storage arrays, which were designed specifically for distributed computing, emerged as the predominant way to store and manage data. Modular storage arrays were designed to be more affordable than monolithic storage arrays but were not equipped as well as monolithic storage arrays to handle the scalability requirements needed in rapidly growing data environments. The emergence of modular storage accelerated the development of networked storage in the form of both SANs and network attached storage, or NAS. SAN and NAS approaches can lead to many individual storage silos, which increases data center complexity. This growing number of storage silos required incremental networking equipment, such as switches and appliances, which in turn required management of more storage and networking resources and placed an additional strain on IT personnel and increased administrative costs.

Management and protection of data across an enterprise has been increasingly viewed as a mission-critical task. However, monolithic and modular storage arrays are increasingly challenged by the rapid rate of data growth and the need for regulatory data retention.

### ***The Need for Virtualization and Utility Computing***

Organizations face significant and increasing challenges in the current computing environment. Key challenges to distributed computing include:

suboptimal system utilization;

excessive power consumption;

implementation complexity; and

## **Table of Contents**

difficulty in keeping up with the demand for IT agility and responsiveness to address changing business requirements at an economic cost that appropriately matches business needs.

As a result, a new IT architecture called utility computing is emerging that leverages technologies that include virtualization, automation and clustering, which is the ability to aggregate processing capacity from a number of individual processing elements operating independently or in concert. Gartner, Inc., an information technology research and advisory company, states in its August 2006 report *Magic Quadrant for North American Web Hosting, 2006* that utility computing offerings are the most significant innovations taking place in the Web-hosting services industry. Virtualization, automation and clustering work together in a utility computing architecture to create shared infrastructures for flexible workload consolidation. By employing these new technologies, we believe that organizations are able to significantly improve their computing environment with higher server and storage utilization, better data management and more predictable administrative costs. We believe that utility computing therefore enables customers to respond more quickly to business requirements while lowering the total lifetime cost of ownership. The table below illustrates historical computing and storage architecture transitions.

### ***The Need for New Building Blocks for Utility Computing, Including Utility Storage***

New generations of server and storage building blocks are emerging to optimize the deployment of utility computing such as server virtualization technologies. These new server technologies have created their own challenges within storage environments. These challenges include:

storage performance bottlenecks from using server virtualization to combine a greater number of applications on individual servers;  
and

a requirement for higher capacity upfront storage deployments, which are oftentimes suboptimally utilized.

We believe that the traditional categories of storage systems—monolithic and modular arrays—are not adequately equipped to meet these challenges because they typically:

require the dedication of significant administrative resources associated with planning, configuration management, provisioning, performance tuning, service level optimization and ongoing change management. These tasks inhibit the speed and agility with which IT departments can respond to changing business needs and increase operating expenditures associated with additional personnel, training and professional services fees. According to The 451 Group, a technology research company, the ongoing management and support costs associated with traditional enterprise storage systems are often more than two times the initial capital expenditure associated with the procurement of these systems;

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## **Table of Contents**

use a dedicate-on-allocation approach to storage provisioning. This approach requires customers to purchase and pre-dedicate large quantities of storage capacity to applications and servers significantly ahead of when data is actually written. According to data published by GlassHouse Technologies, Inc., an independent IT consulting firm, storage utilization rates have been estimated at an average of 25%. This low utilization increases customers' capital expenditures, as well as operating expenditures associated with power, cooling and floor space consumption; and

create greater data center complexity through the proliferation of storage silos to address scalability requirements. In many cases, these silos require additional networking equipment and, due to this increased complexity, additional management software and appliances. This results in further costs, risks to service levels and increased administrative overhead.

In addition to these challenges, IT administrators need to accommodate the evolution towards IT architectures that can more quickly align and respond to changing business requirements, which are commonly referred to as Service Oriented Architectures, or SOA. We believe that organizations are increasingly interested in purchasing enterprise IT as a utility service because the variable cost basis more closely ties with their business needs and performance. Service providers, including those using Software as a Service, or SaaS, models, are emerging to fulfill this need for enterprises. We believe that utility computing will serve as the core IT infrastructure foundation for both the implementation of SOA in enterprise data centers and the delivery of enterprise IT, whether accomplished internally or through service providers.

We believe that the successful deployment of utility computing requires new architectural building blocks for storage provisioning. Using similar technologies to those used to create the new server building blocks for utility computing, we have designed and delivered a storage building block, which we call utility storage, that we believe is optimized for utility computing.

### **Our Solution**

Our utility storage solution delivers simple, efficient and massively scalable tiered storage to our customers. Tiered storage enables users to store data of varying business values on different classes of disk drives to reduce overall storage cost and provide varying levels of service in a single system. We believe that our utility storage products dramatically enhance the economics and performance of storage by provisioning storage services more rapidly than alternative approaches, reducing administrative costs, improving server and storage utilization, lowering power and cooling requirements and scaling efficiently to support the continuous growth of data. We have designed our solution to overcome the limitations of both monolithic and modular storage arrays.

Our utility storage solution is designed to provide significant advantages to our customers, including:

*Simplicity.* Rapid and self-executing, or autonomic, provisioning of storage volumes of varied service levels and size can be achieved in just a few seconds, as compared to minutes, hours or days with monolithic and modular approaches, and without equivalent pre-planning or configuration. Our software autonomically load balances data on physical disks to optimize application performance. We refer to this as dynamic optimization. These benefits are recognized in initial deployments as well as subsequent storage planning, provisioning and ongoing management. In addition, our Dynamic Optimization software enables IT administrators to define desired service levels to allow users to provision capacity and manage data lifecycle management policies simply. Our software is designed to reduce training requirements and simplify cross-platform interoperability for remote backup and replication.

*Efficiency.* Our software allows our customers to significantly improve their utilization of physical storage capacity by minimizing the use of pre-allocated, unused storage capacity that is common in traditional monolithic and modular storage provisioning methodologies. Our Thin Provisioning software allows an application to be allocated the virtual storage capacity it requires, without having to dedicate all of the associated physical capacity up front. The technology underlying thin provisioning uses a dedicate-on-write approach that differs from the traditional dedicate-on-allocation approach employed by monolithic and modular storage provisioning methodologies. Our Thin Provisioning

## **Table of Contents**

software dedicates storage capacity to a unit of storage allocation, or volume, only when an application actually writes data to it. As a result, each storage volume is driven towards full utilization. Our software also allows new applications to be implemented immediately using virtual capacity.

The graphic below illustrates how our Thin Provisioning software dedicates storage capacity. Traditional storage provisioning methodologies, such as those commonly used by monolithic and modular storage arrays, require the allocation and purchase of physical storage capacity up front even when an application only requires a fraction of this capacity to store actual written data. However, our thin provisioning methodology does not require the allocation of this volume-specific storage capacity up front. Instead, applications are able to draw upon a shared storage pool when those applications require additional physical storage capacity to write data to their volumes. As this shared pool is consumed, additional shared storage can be purchased as needed, thereby minimizing premature use of capital for storage.

*Scalability.* Our InServ Storage Server products can support up to 600 terabytes of storage in a single tightly clustered system. This storage capacity can be mixed between various types of enterprise-class and nearline disk drives to meet the differing needs of a variety of applications supported on a single system. Our clustered controller architecture is designed to enable non-disruptive scalability within a single, tiered storage system as customer storage needs change over time, without requiring a high initial cost of ownership. Our systems allow Fibre Channel and iSCSI host connectivity concurrently, which permits the consolidation of a wide variety of applications and servers. In addition, through our alliances with NAS gateway vendors, we are able to offer open, unified storage solutions for overall storage consolidation. Capacity can be purchased incrementally or on an as-needed basis, enabling customers to pay only for what they need when they need it.

*Availability.* Our clustered controller architecture allows our utility storage solutions to be configured to target demands for high availability. The architecture has been designed to tolerate component failures in hardware, including individual controller nodes, without servers losing access to storage volumes. We offer sophisticated, remote replication software to protect customers from single-system and site failures over both short and long geographic distances. Flexible copy-on-write snapshot technology, which captures only changes in written data, integrated with leading databases and backup software, is designed to allow rapid application recovery. This combination of features is designed to allow customers to maintain data availability, minimize the impact to customers of component failures and allow faster recovery if application failures require rapid retrieval of previous copies of data.



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## **Table of Contents**

*Faster Storage Provisioning.* We believe that our storage solution provides our customers with greater business agility, allowing our customers to provision storage more quickly for new applications and projects. Faster storage provisioning enables our customers to realize benefits and address new business opportunities more rapidly than with monolithic and modular storage arrays, which often take days or weeks to configure and provision.

### **Our Strategy**

Our mission is to provide storage solutions that are simple and efficient. Key elements of our strategy include:

*Promoting the Benefits and Adoption of Utility Storage.* We believe that the market for utility computing is in its early stages and developing strong momentum. We intend to increase market awareness of the benefits of utility storage by targeting organizations that can benefit from server virtualization and other aspects of utility computing. We believe that when compared to monolithic and modular storage solutions, our utility storage products enhance service delivery and storage economics by offering higher performance at a lower total cost of ownership.

*Building Substantial Repeat Business with Existing Customers.* We will seek to further penetrate our existing customer base as customers' data requirements increase and as customers increasingly realize the performance and cost benefits of our utility storage solution. We intend to continue generating significant repeat business by selling easily expandable tiered storage arrays as our customers' storage needs increase and by delivering a broad and interoperable product line suitable for a wide variety of deployments with a focus on achieving high levels of customer satisfaction. We believe that customer references have been, and will continue to be, an important factor in winning new business.

*Expanding Our Customer Base Through Direct Customer Relationships in Core Markets.* We are focused on developing relationships directly with large aggregators of storage demand using our direct sales force. Because of the importance of the data our customers and prospective customers are entrusting to our products, we believe that it is important to have a direct relationship with them. We have direct sales and customer service personnel in the United States, the United Kingdom, Germany and Japan. We plan to invest in the expansion of our direct sales force, both in the United States and internationally.

*Expanding Strategic Relationships.* We have developed strategic relationships with a variety of companies that provide servers, network infrastructure components and professional services to our target customer base. We intend to continue these relationships to provide our customers with the ability to more easily integrate our utility storage products within their existing and planned IT infrastructures, as well as to extend the range of applications for which the use of our storage solution is appropriate. In markets in which we do not have a direct presence, in addition to expanding our direct sales force, we intend to continue to engage resellers to broaden our distribution channels and develop strategic relationships to expand the distribution of our storage systems.

*Extending Our Technology Leadership Position in Utility Storage.* We intend to utilize our existing intellectual property, industry experience, internal research and development capabilities and our strategic industry relationships to extend our technology leadership in providing simple, efficient and scalable utility storage systems. Specifically, we intend to continue enhancing our InForm software suite, other software applications and our underlying clustered controller hardware architecture with greater levels of functionality, performance and availability.

*Offering the Highest Level of Customer Support.* We have developed advanced remote support capabilities that include event reporting and analysis as well as remote software maintenance. We believe that this enables us to cost-effectively deliver high levels of customer service. We intend to continue enhancing these tools in order to further differentiate our utility storage products.

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## **Table of Contents**

### **Products**

Our InServ Storage Server family, powered by our InForm Suite, consists of the E200, S400 and S800 models, and addresses the needs of customers ranging from small branch offices and departmental deployments to large data center locations.

#### ***InServ Storage Servers***

Our storage arrays support a wide range of open systems-based servers including various implementations of UNIX, Windows and Linux. Our storage servers are modular in design to enable our customers to add capacity and increase performance in a cost-efficient manner.

The following table outlines the features of each of our InServ Storage Servers:

<b>Model</b>	<b>E200</b>	<b>S400</b>	<b>S800</b>
Deployment Profile	Departmental or remote office consolidation	Enterprise storage consolidation	Large enterprises and service providers
Controller Nodes	2	2 4	2 8
Disk Drives	16 128	16 640	16 1,280
Maximum Capacity	96 Terabytes	300 Terabytes	600 Terabytes

#### ***InForm Suite***

The 3PAR InForm Suite is our proprietary software platform that provides the core intelligence for each of our InServ Storage Servers. Our InForm Suite, which includes our operating system software and other software products, is designed to enable the management and protection of data across a global IT environment simply and economically. Our InForm Suite is comprised of the following elements:

*3PAR InForm OS.* InForm OS is our core operating system that utilizes advanced internal virtualization capabilities within a massively scalable tiered storage array.

*3PAR Rapid Provisioning.* Rapid Provisioning provides built-in autonomic and load-balanced provisioning.

*3PAR Full Copy.* Full Copy offers flexible point-in-time cloning of storage volumes. It is built on thin copy technology and can clone both traditional and thin provisioned volumes.

*3PAR Access Guard.* Access Guard provides volume access security at the logical or physical level, or both.

*3PAR LDAP.* LDAP provides centralized authentication and authorization using industry standard lightweight directory access protocol.

#### ***Optional Software Applications***

We also provide our customers with a number of optional software applications, which we sell under perpetual license agreements and which customers may purchase with or after the initial system sale, including:

*3PAR Thin Provisioning.* Thin Provisioning improves storage utilization by reducing the need to over-allocate physical storage capacity by application. The software enables IT departments to over-allocate logical storage capacity while only utilizing physical

storage capacity on an as-needed basis.

*3PAR Dynamic Optimization.* Dynamic Optimization enables users to modify service levels across all stages of the disk-based lifecycle online and non-disruptively. With a single command, customers can increase service levels during peak demand and subsequently return to standard levels on demand.

## **Table of Contents**

*3PAR Virtual Copy.* Virtual Copy provides instant copy-on-write snapshots of data with no impact to applications. Virtual Copy uses thin copy technology that consumes minimal physical capacity by referring to existing data rather than duplicating it.

*3PAR Recovery Manager for Microsoft Exchange, Microsoft SQL Server and Oracle.* Recovery Manager creates and manages snapshots and allows users to quickly restore application data and files from disks. Recovery Manager integrates Virtual Copy with Microsoft Exchange and Microsoft SQL Server as well as Oracle databases to allow consistent snapshots and integrated backup.

*3PAR Remote Copy.* Remote Copy enables users to copy data from one InServ Storage Server to another in a remote location to maintain data availability for business continuity. Remote Copy is based on thin copy technology so it can replicate both traditional and thin provisioned volumes. Remote Copy offers both synchronous and periodic asynchronous remote replication over short and long geographic distances.

*3PAR System Reporter.* System Reporter is a web-based performance and data capacity management tool. System Reporter collects and analyzes historical system data from one or more InServ Storage Servers that can then be used for troubleshooting, consolidated monitoring and service level agreement reporting.

*3PAR System Tuner.* System Tuner automatically analyzes data on InServ Storage Servers to identify underperforming groupings of data. System Tuner targets underperforming groupings of data and non-disruptively relocates the data to help maintain optimal system performance.

*3PAR Multipath I/O for IBM AIX and Microsoft Windows.* Multipath I/O provides for path redundancy and helps to eliminate information bottlenecks, allowing data to be intelligently routed through multiple system paths between the host server and storage subsystem. Multipath I/O provides users with greater data availability and more efficient load balancing of data.

*3PAR Virtual Domains.* Virtual Domains is virtual machine software that delivers secure access and improved storage services for different applications and user groups. Since users (or groups) have access to only those virtual domains to which they have been granted access, they can independently and confidently administer and monitor the system without concern for the actions or visibility of other users.

## **Technology**

Our utility storage solution features an integrated system of software and hardware, enabled by our advanced InSpire architecture. Our InSpire architecture delivers a simple, tiered storage array for open systems. Central to the design is a high-bandwidth, low-latency backplane that unifies cost-effective, modular and expandable components into a highly available, fully and autonomically load-balanced cluster.

### ***InServ Storage Servers***

Our clustered InSpire architecture offers customers an alternative to the higher initial cost of ownership and scaling complexity typically associated with monolithic and modular array architectures, respectively. Customers can start small and affordably with as few as two controller nodes yet scale massively and non-disruptively within a single, fully tiered system. The core hardware elements of our InSpire architecture include the 3PAR ASIC, a full mesh backplane, storage controller nodes, host bus adaptors for server and disk connectivity, drive chassis, drive magazines and disk drives. All active hardware components can be configured redundantly within the system.

Our InServ Storage Server products utilize a cluster-based approach and feature a full mesh backplane that connects all storage controller nodes over low-latency, high-bandwidth links to form an active cluster. The low-latency, high-bandwidth interconnect means that all workloads are distributed and shared across all system resources in a massively parallel fashion. This is designed to deliver high and predictable levels of performance for all workloads even under failure conditions as well as high utilization of purchased resources.

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## **Table of Contents**

This combination of nodes and backplane forms our proprietary data movement engine that delivers performance and connectivity within the InServ Storage Server products. Each controller node contains several components, including one or more processors, separate control and data cache and our custom-designed ASIC. Unlike traditional designs that process commands and move data using the same processor, the 3PAR node design separates control command processing and data movement. Control command processing is managed by the on-board processors and dedicated control cache, while all data movement is executed by 3PAR's ASIC and dedicated data cache. We believe that this innovative design eliminates the performance bottlenecks of traditional storage systems when serving competing workloads such as online transaction processing and data warehousing simultaneously from a single processor complex.

Our InServ Storage Servers represent the first storage arrays to apply a full-mesh interconnect to reduce latencies and address scalability requirements. Our proprietary backplane on each of our InServ Storage Servers is a passive circuit board that contains connectors for our controller nodes. These connectors and associated paths on the backplane form a full-mesh connected network between the controller nodes. The availability of a low-latency, high-bandwidth backplane enabled us to develop an advanced volume management function that was both clustered and distributed across all available controller nodes. This enables the delivery of a cost-effective, cache-coherent architecture that permits a specific volume to be actively accessed through any number of controller nodes configured within a single system, delivering performance scalability and highly available access to data. The entire clustered storage architecture is managed as a single entity.

### ***InForm Suite***

The 3PAR InForm Suite provides the core intelligence and software for our InServ Storage Servers. At the heart of our InForm Suite is the 3PAR InForm OS, the operating system software that provides internal storage virtualization and volume management.

The 3PAR InForm OS employs a three-level mapping methodology similar to the virtual memory architectures of high-end enterprise operating systems. The first level of mapping virtualizes physical disk drives of any size into a pool of small uniform-sized data segments, or chunklets, and manages the dual paths between each chunklet and disk drive. We believe that the fine-grained nature of this mapping methodology, utilizing chunklets, significantly reduces under-utilization of storage assets. The second level of mapping associates chunklets with logical disks. This association allows logical devices to be created with template properties based upon RAID, or redundant array of independent disks, characteristics and the physical location of chunklets across the system. Logical disks can be tailored to meet a variety of cost, capacity, performance and availability characteristics, depending upon the quality of service required. The third level of mapping associates virtual volumes with all or portions of an underlying logical disk or of multiple logical disks. Virtual volumes are the capacity representations exported to hosts and applications. As a result of this approach, a very small portion of a virtual volume associated with a particular logical disk can be quickly and non-disruptively migrated to a different logical disk for performance or other policy-based reasons.

The underlying fine-grain virtualization of our mapping methodology allows us to support both dedicate-on-write and copy-on-write capabilities that are the foundation of our thin provisioning and thin copy technologies, respectively. Thin provisioning utilizes a shared storage pool from which applications are dedicated storage capacity only when these applications actually write data. Our thin technologies enable higher storage utilization rates than their traditional fat equivalents. Our thin copy technologies include the ability to make readable and writeable snapshots, thin clone copies and thin-provisioning-aware remote data replication.

We have integrated our thin copy snapshot technology Virtual Copy with a variety of applications including Microsoft Exchange, Microsoft SQL Server and Oracle databases. This integration is designed to ensure that snapshots taken of data stores are consistent, enable integration with back-up products and facilitate rapid application recovery. Hundreds of copy-on-write snapshots of a single volume may be taken over consecutive periods to deliver a near-Continuous Data Protection, or CDP, facility with many recovery points.

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## **Table of Contents**

### **Alliances**

We have developed alliances with a variety of companies that provide servers, operating systems, host bus adapters, SAN Fabric components, NAS gateways, clustered file systems, databases, applications, networking infrastructure, appliances and professional services. The structure of these alliances varies but includes joint agreements that cover interoperability testing and certification, cooperative support (either direct agreements or through TSAnet, an industry consortium for collaborative support) and cooperative development, marketing and sales. We leverage these alliances to provide our customers with the ability to more easily integrate our utility storage within their existing and planned IT infrastructures, as well as extending the range of applications for which the use of our InServ Storage Servers is appropriate.

We have alliances with companies that include Brocade Communication Systems, Inc., Cisco Systems, Inc., Data Domain, Inc., Egenera, Inc., Emulex Corporation, FalconStor Software, Inc., Hewlett-Packard Company, or HP, IBM, IBRIX Inc., Incipient, Inc., Microsoft Corporation, NetApp, Inc., Novell Inc., ONStor, Inc., Oracle Corporation, QLogic Corp., Red Hat, Inc., Riverbed Technology, Inc., Sun Microsystems, Inc., or Sun, Symantec Corporation and VMware, Inc.

### **Customers**

As of March 31, 2008, we have sold our utility storage systems to over 300 end customers. Our customers include large to medium enterprises, business-oriented service providers, consumer-oriented Internet/Web 2.0 companies and government entities.

**Large to Medium Enterprises:** Across the spectrum of large to medium enterprises, there are IT organizations that have transformed, or are in the process of transforming themselves, into internal service bureaus that leverage shared, virtualized infrastructures for open systems-based workload consolidation and flexible resource allocation. This customer category includes companies such as Credit Suisse Group, Dow Jones & Company, Inc. and TransUnion LLC.

**Business-Oriented Service Providers:** Our business-oriented service provider customer category includes companies with a business-to-business focus, including infrastructure and application hosting providers, SaaS providers and business transaction and business information service providers. These customers include SAVVIS, Inc., USInternetworking, Inc. (an AT&T company) and Verizon Business.

**Consumer-Oriented Internet/Web 2.0 Companies:** Our consumer-oriented Internet/Web 2.0 customer category includes companies with a business-to-consumer focus. These include Web 2.0, social networking companies and other primarily Internet-based businesses serving the needs of a large number of consumers. These customers include MySpace.com, Omniture, Inc. and Priceline.com.

**Government Entities:** Our government end customers include the Department of Justice (FBI), United States Census Bureau and the Virginia Information Technologies Agency. Orders placed with our resellers by government end customers may generally be terminated unilaterally by the government end customer or may be subject to additional conditions not typically found in our other end customer contracts. During fiscal 2008 and 2007, approximately 9% and 7% of our revenue resulted from sales by our resellers to government end customers, respectively.

In our fiscal years ended March 31, 2008 and 2007, no customer represented more than 10% of our revenue. In our fiscal year ended March 31, 2006, IBM and MySpace.com represented 11% and 10% of our revenue, respectively. We do not have agreements in place with these customers, or any other customer, that obligate such customers to long-term purchase or repeat order requirements. The loss of any of these customers could have a material adverse effect on our results of operations and cash flows. In fiscal 2008, we derived 83% of our revenue from shipments to customer locations within the United States. See Note 12 to the Consolidated Financial Statements for a summary of revenue by geographic area.

## **Table of Contents**

### **Sales and Marketing**

We market and sell our products and support services primarily through our direct sales force but also use indirect resellers. Our sales and marketing team consisted of 157 employees as of March 31, 2008.

***Direct Sales:*** Our direct sales team, with assistance from our marketing team, sells directly to large enterprises worldwide. We maintain sales offices in the United States, the United Kingdom, Germany and Japan.

***Indirect Sales:*** Our indirect resellers primarily sell to United States government accounts, as well as in limited situations in our United States commercial business and in non-English speaking countries where we do not have a significant direct sales presence.

### ***Marketing and Product Management***

In addition to building brand awareness and broadly marketing our products, our marketing team actively supports our sales process and team. Our marketing activities include lead generation, tele-sales, advertising, website operations, direct marketing and public relations, as well as participation at technology conferences and trade shows.

### **Customer Services**

We offer different maintenance support programs depending upon the needs of our customers' deployments. Our customer service and support programs involve hardware support, software support and software upgrades on a when-and-if available basis for our InForm Suite and other software applications. Our customer services department includes support personnel located in California, the United Kingdom, Belgium, Switzerland, Singapore and Japan, who are available to respond 24 hours a day, every day of the year. We extend our support capabilities by qualifying and training resellers that can provide service and support to end customers in locations in which we do not provide direct support. We provide on-going support to our resellers through backline support maintenance programs.

### **Research and Development**

Continued investment in research and development is critical to our business. Because our utility storage solution is an integrated system of hardware and software, our research and development organization contains both hardware and software engineers. We employ ASIC and storage systems engineers in the design, development, test and certification of our storage systems. We also employ software engineers in the design, development and test of our InForm Suite. As of March 31, 2008, our research and development team consisted of 159 full-time employees primarily located in Fremont, California. In June 2007, we opened a software development office in Belfast, Northern Ireland, which as of March 31, 2008 had a team of 10 engineers. We test and certify our platforms against a variety of third-party servers, operating systems, drivers, gateways, host bus adaptors and SAN fabric components. We plan to continue to dedicate significant resources to these continued research and development efforts. Further, as we continue to expand internationally, we may incur additional costs to conform our products to comply with local laws and local product specifications.

Research and development expense totaled \$34.1 million, \$24.5 million and \$18.5 million for fiscal years ended March 31, 2008, 2007 and 2006, respectively.

### **Manufacturing**

Our manufacturing strategy is to supply high quality products in a timely fashion to our customers, while making efforts to maximize our gross margins. We perform manufacturing tasks internally that we believe cannot be outsourced and performed more effectively by specialized manufacturing partners. Our manufacturing operation located in our new 56,000 sq. ft facility in Fremont, California, consists primarily of materials procurement, product assembly, product testing, quality assurance and global logistics. As of March 31, 2008 our manufacturing operations team consisted of 24 full-time employees.

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## **Table of Contents**

We also rely on a number of key suppliers in the manufacture and assembly of our products. These suppliers include Xyratex Technology Limited, or Xyratex, and Hitachi Global Storage Technologies, from which we acquire our disk drives; Power-One, Inc., our supplier of power systems; and Renesas Technology Corp., our supplier of application-specific integrated circuits, or ASICs, which are a component of our processor nodes. In addition, we rely on Flash Electronics, Inc. and Xyratex as contract manufacturers of our disk chassis.

### **Competition**

The market for storage infrastructure is competitive and continually evolving. We compete against vendors in the data storage market that provide mid-range and high-end storage array solutions. We expect competition to persist and intensify. Our main competitors that provide monolithic storage arrays include EMC Corporation, or EMC, Hitachi Data Systems Corporation, or Hitachi, and IBM and their respective resellers and original equipment manufacturers, or OEMs. Our main competitors that provide modular storage arrays include EMC, HP, NetApp, Hitachi, IBM, Sun and Dell Inc. as well as their respective resellers and OEMs. As the storage market opportunity grows, we expect competition from emerging private companies and networking and telecommunications equipment suppliers that increasingly compete with our product offerings.

Many of our current and potential competitors may have significantly greater financial, technical, marketing and other resources than we do and may be able to devote greater resources to the development, promotion, sale and support of their products. Our competitors may have more extensive customer bases and broader customer relationships than we do, including long-standing relationships with our current or potential customers. In addition, these companies may have longer operating histories and greater name recognition than we do. Our competitors may be in a stronger position to respond quickly to new technologies and may be able to market and sell their products more effectively. Moreover, if one or more of our competitors were to merge or partner with another of our competitors, the change in the competitive landscape could adversely affect our ability to compete effectively.

We believe that the principal factors on which we compete are the ease of use and the scalability of our products, the total cost of ownership of our utility storage solution and the quality of our customer service and support. The product features that we emphasize from a competitive perspective are our ability to:

deliver rapid and autonomic provisioning of storage volumes;

autonomically load balance data on physical disks;

minimize the use of pre-allocated, unused storage capacity;

efficiently allocate an application the virtual storage capacity it requires;

scale non-disruptively within a single, tiered storage system; and

configure our utility storage solutions to target demands for high availability.

### **Intellectual Property and Proprietary Rights**

We rely on a combination of intellectual property rights, including patents, trade secrets, copyrights and trademarks, as well as customary contractual protections.

We have been issued 22 United States patents, which expire between 2020 and 2024. We have 19 United States utility patent applications pending. We also have counterparts granted and pending in other jurisdictions around the world. Our registered trademarks in the United States are the 3 design logo, 3PAR, InServ, InForm, InSpire and Serving Information. In Europe, the 3 design logo, 3PAR, InServ, InForm, InSpire and Serving Information are registered Community Trade Marks. In Japan, the 3 design logo, 3PAR, InServ and InSpire are registered trademarks. If not renewed, our



trademarks expire between 2012 and 2016.

## **Table of Contents**

In addition to the protections described above, we generally control access to and use of our proprietary software and other confidential information through the use of internal and external controls, including contractual protections with employees, contractors, customers and resellers, and our software is protected by United States and international copyright laws.

We may not receive competitive advantages from the rights granted under our patents and other intellectual property rights. Our competitors may develop technologies that are similar or superior to our proprietary technologies, duplicate our proprietary technologies or design around the patents we own or license. Our existing and future patents may be circumvented, blocked, licensed to others or challenged as to inventorship, ownership, scope, validity or enforceability. It is possible that literature we may advised of by third parties in the future could negatively affect the scope or enforceability of either our present or future patents. Furthermore, our pending and future patent applications may not issue with the scope of claims sought by us, if at all, or the scope of claims we are seeking may not be sufficiently broad to protect our proprietary technologies. Moreover, we have adopted a strategy of seeking limited patent protection with respect to the technologies used in or relating to our products. If our products, patents or patent applications are found to conflict with any patents held by third parties, we could be prevented from selling our products, our patents may be declared invalid or our patent applications may be denied. In foreign countries, our intellectual property rights may be substantially limited or entirely denied due to differences in applicable intellectual property laws or due to our inability to effectively enforce our rights under laws, or due to certain facts that are currently unforeseen or unforeseeable. We may be required to initiate litigation in order to enforce any patents issued to us, or to determine the scope or validity of a third-party's patent or other proprietary rights. Third parties could claim that our products or technology infringe their proprietary rights. We have in the past and may in the future be contacted by third parties suggesting that we seek a license to intellectual property rights that they may believe we are infringing. In addition, in the future, we may be subject to lawsuits by third parties seeking to enforce their own intellectual property rights, as described in Risk Factors Risks Related to Our Business and Industry Claims by other parties that we infringe their proprietary rights could harm our business.

We license our software pursuant to agreements that impose restrictions on customers' ability to use the software, such as prohibiting reverse engineering and limiting the use of copies. We also seek to avoid disclosure of our intellectual property by requiring employees and consultants with access to our proprietary information to execute nondisclosure and assignment of intellectual property agreements and by restricting access to our source code. Other parties may not comply with the terms of their agreements with us, and we may not be able to enforce our rights adequately against these parties.

## **Backlog**

We do not believe that our backlog at any particular time is meaningful because it is not necessarily indicative of future revenue. In particular, 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.

## **Employees**

As of March 31, 2008, we had 451 full-time employees consisting of 169 employees in research and development, 157 employees in sales and marketing, 44 employees in general and administration and 81 employees in customer services and manufacturing operations. A total of 41 of these employees were located outside of the United States. None of our employees are represented by labor unions or covered by a collective bargaining agreement. We have not experienced any work stoppages, and we consider our employee relations to be good.

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**Table of Contents**
**Executive Officers of the Registrant**

The following table shows the name, age and position as of March 31, 2008 of each of our executive officers:

<b>Name</b>	<b>Age</b>	<b>Position</b>
David C. Scott	46	President, Chief Executive Officer and Director
Adriel G. Lares	35	Vice President of Finance and Chief Financial Officer
Jeffrey A. Price	47	Vice President of Engineering, Co-Founder and Director
Ashok Singhal	48	Chief Technical Officer and Co-Founder
James L. Dawson	46	Vice President of Worldwide Sales
Paul L. Harvey	56	Vice President of Customer Service
Craig S. Nunes	46	Vice President of Marketing
Stephen F. Crimi	47	Vice President of Business Development and Alliances
Randall T. Gast	46	Vice President of Corporate Operations
Alastair A. Short	51	Vice President, General Counsel and Secretary
Jeannette Robinson	57	Vice President of Human Resources

**David C. Scott** has served as our president and chief executive officer since January 2001. From October 1991 to January 2001, Mr. Scott held various management positions at Hewlett-Packard Company, a computing technology solutions and services company, most recently as the general manager of the XP enterprise storage business in its Network Storage Solutions organization. Mr. Scott holds a B.S. degree in Computer Science and Mathematics from Bristol University in the United Kingdom.

**Adriel G. Lares** has served as our chief financial officer since January 2005. From March 2004 to January 2005, Mr. Lares served as our treasurer, and from March 2001 to March 2004, he served as our director of finance. From January 1999 to March 2001, Mr. Lares served as the chief financial officer of Techfuel Inc., a reseller of computer storage products. From February 1996 to December 1998, Mr. Lares was an investment banking analyst in the technology practice at Morgan Stanley, a financial services firm. From June 1994 to January 1996, Mr. Lares served as a treasury analyst at The Walt Disney Company, a diversified worldwide entertainment company. Mr. Lares holds a B.A. degree in Economics from Stanford University.

**Jeffrey A. Price** is one of our co-founders and has served as our vice president of engineering since May 1999 and as a member of our board of directors since May 2001. From February 1989 to April 1999, Mr. Price was a member of the architecture team at Sun Microsystems, Inc., a networking computing infrastructure solutions company, most recently as the director of systems engineering.

**Ashok Singhal** is one of our co-founders and has served as our chief technical officer since May 1999. From September 1990 to April 1999, Mr. Singhal was a member of the architecture team at Sun Microsystems, Inc. where he served as the chief architect for mid-range servers from 1993 until April 1999. Mr. Singhal holds a BTech degree in Electrical Engineering from the Indian Institute of Technology, Kanpur and an M.S. and a Ph.D. in Computer Science from the University of California at Berkeley.

**James L. Dawson** has served as our vice president of worldwide sales since April 2004. From April 2002 to March 2004, Mr. Dawson served as vice president, strategic sales and business development for Neoscale Systems, Inc., an enterprise storage security company. From May 2000 to March 2002, Mr. Dawson served as vice president of worldwide sales for Scale Eight, Inc., a storage solutions company. From October 1987 to February 2000, Mr. Dawson served in various positions with Data General Corporation, a supplier of storage and enterprise computing solutions, most recently as vice president of EMEA and Asia Pacific for its CLARiiON Storage Division. Mr. Dawson holds a B.A. degree in Economics from Weber State College.

**Paul L. Harvey** has served as our vice president of customer services since December 2000. From February 1997 to November 2000, Mr. Harvey served as vice president of customer service at Livingston Enterprises, Inc. and Lucent Technologies Inc., a communications technology and services company. From 1976 to 1997, Mr. Harvey held various customer service positions, including senior director of customer services, at Amdahl Corporation, a computer manufacturing company.

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## **Table of Contents**

**Craig S. Nunes** has served as our vice president of marketing since January 2005. From July 2000 to December 2004, Mr. Nunes served as our senior director of marketing. From June 1989 to July 2000, Mr. Nunes served in various positions with Hewlett-Packard Company, most recently as its director of enterprise storage marketing. Mr. Nunes holds B.S. and M.S. degrees in Petroleum Engineering from Stanford University and an M.B.A. from The Wharton School at the University of Pennsylvania.

**Stephen F. Crimi** has served as our vice president of business development and alliances since July 2006. From February 2005 to July 2006, Mr. Crimi served as our senior director of business development and alliances, and from October 2002 to February 2005, as our director of business development and alliances. From January 2002 to October 2002, Mr. Crimi was a principal in a management consulting company he founded. From February 2000 to December 2001, Mr. Crimi was vice president of business development and alliances at Acta Technology, Inc., a data integration vendor. Mr. Crimi holds a B.S. degree in Mechanical Engineering from Union College, an M.B.A. from the Haas School of Business at the University of California at Berkeley and an M.S. in Mechanical Engineering, also from the University of California at Berkeley.

**Randall T. Gast** has served as our vice president of corporate operations since May 2006. From August 2004 to April 2006, Mr. Gast served as vice president of global operations at Adaptec, Inc., an enterprise storage vendor. From October 2002 to July 2004, Mr. Gast was vice president of worldwide operations and customer support for Snap Appliance, Inc., a division of Adaptec, Inc. From September 1999 to September 2002, he served as acting vice president of worldwide operations and materials for Maxtor Corporation, a storage solution company. Mr. Gast holds a B.S. degree with a dual major in Manufacturing and Mechanical Engineering from Arizona State University.

**Alastair A. Short** has served as our vice president and general counsel since July 2002. From October 2001 to June 2002, Mr. Short served as vice president and general counsel of MetaTV, Inc., an interactive media software company. From April 2000 to September 2001, Mr. Short served as chief legal officer and assistant secretary for Netigy Corporation, a network infrastructure and services company. From July 1989 to March 2000, Mr. Short held various senior management positions at Hitachi Data Systems Corporation, a storage systems vendor, including executive vice president and general counsel. Mr. Short holds a Bachelor of Law Degree from the University of Warwick, England.

**Jeannette Robinson** has served as our vice president of human resources since March 2001. From January 1996 to February 2001, Ms. Robinson was vice president of human resources for Corsair Communications, a provider of business solutions for the wireless industry. From June 1990 to January 1996, Ms. Robinson held various human resources management positions at Cisco Systems, Inc., an Internet networking equipment and network management company. Ms. Robinson holds a B.A. degree in Sociology/Criminology and a B.S. degree in Business Administration/Marketing from San Jose State University.

## **Corporate Information**

We began operations in May 1999 and were incorporated in Delaware in May 2007. Our principal executive offices are located at 4209 Technology Drive, Fremont, California 94538, and our telephone number is (510) 413-5999. Our website address is [www.3PAR.com](http://www.3PAR.com).

## **Website Posting of SEC Filings**

Our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to such reports are available, free of charge, on our website and can be accessed by clicking on the [Investors](#) tab. Further, a copy of this annual report on Form 10-K is located at the SEC's Public Reference Room at 100 F Street, NE, Washington, D.C. 20549. Information on the operation of the Public Reference Room can be obtained by calling the SEC at 1-800-SEC-0330. The SEC maintains an internet site that contains reports, proxy and information statements and other information regarding our filings at [www.sec.gov](http://www.sec.gov).

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## **Table of Contents**

### **ITEM 1A. RISK FACTORS**

#### **Risks Related to Our Business and Industry**

*We have a history of losses and may never achieve profitability.*

Since our formation, we have recorded a net loss in all of our fiscal periods. We recorded a net loss of \$10.1 million, \$15.5 million and \$16.3 million in fiscal 2008, 2007 and 2006, respectively. As of March 31, 2008, our accumulated deficit was \$174.0 million. During fiscal 2009, we expect to significantly increase expenditures in connection with the expansion of our business, including the hiring of additional direct sales and engineering personnel. In addition, as a public company, we anticipate that we will incur additional legal, auditing, accounting and other expenses resulting from regulatory requirements that did not apply to us as a private company. As a result of these increased expenditures, we will be required to increase our revenue substantially in order to achieve profitability. We may not be able to improve our revenue as compared to prior fiscal periods, and therefore, may never achieve profitability.

*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. We typically receive a substantial portion of our orders in the last two weeks of each fiscal quarter, which makes forecasting our future operating results difficult. In addition, many of the orders we receive may include conditions, such as customer acceptance provisions, 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. Many of our orders are conditioned upon 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 any quarter, our revenue may be largely attributable to a single customer's orders. For example, in the first quarter of fiscal 2008, 25% of our revenue was attributable to sales to one customer. 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. For these reasons, comparing our operating 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 information technology purchases and delays in their budgeting and purchasing cycles, such as occurred earlier in this decade and which 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 requirements and IT infrastructures;

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

reductions in the size of our individual sale transactions, because smaller transactions tend to have a smaller software component and, therefore, could decrease our gross margins;

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.



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## **Table of Contents**

***We face significant competition from a number of established companies, which may 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 Corporation, Hitachi Data Systems Corporation, IBM, NetApp, Inc., Hewlett-Packard Company, Sun Microsystems, Inc. and Dell Inc. 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 acceptance of a particular industry standard or competing technology. These companies 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 lower price than our products. In addition, they may be able to adopt more aggressive pricing policies than we can adopt. For example, our competitors may offer their products at significant discounts 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.

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**Table of Contents**

***Our ability to increase our revenue will depend substantially on our ability to attract and retain key sales and engineering 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, and our ability to offer competitive products will require that we attract and retain additional qualified engineers. In particular, we anticipate hiring a significant number of direct sales and engineering personnel in fiscal 2009, and our operating plan assumes that we will be able to attract and retain required employees. These positions require candidates with specific sales and engineering backgrounds in the storage industry, and competition for employees with this required expertise is intense. In addition, we believe that there are only a limited number of individuals with the specific skills required for many of our key positions in these areas. We face substantial competition in our hiring efforts and also in our retention efforts as our personnel are frequently recruited by other companies, including our competitors. As a result, we may be unable to locate, hire, and retain sufficient numbers of 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 is 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 recently been targets of aggressive recruiting efforts, which could continue and which could result in a loss of additional 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 key sales, system engineers, or management personnel could harm our business, operating results and financial condition.

Our future success depends on the continued service of our key management personnel. All of the members of our management and other employees can terminate their employment at any time, and the loss of the services of any of our executive officers or other key employees could harm our business. 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, approval processes, and a variety of unpredictable administrative, processing and other delays. 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.



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## **Table of Contents**

***We purchase our disk drives, power supplies and certain components for our processor nodes from a limited number of qualified suppliers. If these or any of our other suppliers are not able to meet our requirements, it could harm our business.***

We purchase sophisticated components from a limited number of qualified suppliers. We purchase our disk drives from Xyratex Technology Limited or Hitachi Global Storage Technologies, our power supplies from Power-One Inc., and application-specific integrated circuits, or ASICs, for our processor nodes from Renesas Technology Corp. 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, 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. 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 underlying components and products due to new technologies that have been incorporated into such components and products. Such discontinuance often occurs unexpectedly and our suppliers may require a significant amount of time to qualify the new technologies to ensure that they are compatible with our products.

***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 processor 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 Flash Electronics, Inc., or Flash, to assemble our processor nodes and on Flash and Xyratex Technology Limited to assemble our disk chassis. Our reliance on our contract manufacturers for these disk chassis and processor 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. 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 the agreement. If we are required to change contract manufacturers or assume internal manufacturing operations for any reason, including 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.

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## **Table of Contents**

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.

***Because of a recent change to our business model, our past results may not be meaningful as compared to our current and future results, and you should not rely on them as an indication of our future performance.***

Beginning in March 2007, in connection with sales of our products, we began offering our customers post-contract customer support, which we refer to as PCS, that includes obligations to provide unspecified software upgrades and enhancements to our customers on a when-and-if-available basis. Thus, beginning with the first quarter of fiscal 2008, we began recognizing software support revenue ratably over the term of our software support contract, rather than recognizing the entire arrangement at the time of shipment or installation as we had done previously, provided that the remaining revenue recognition criteria were satisfied. As a result of this change to our business model, comparing our operating results on a period-to-period basis may not be meaningful, and you should not rely on our past results, particularly the growth in our revenue in absolute dollars on a year-over-year basis, as an indication of our future performance. In addition, if for whatever reason we are unable to maintain vendor-specific objective evidence, or VSOE, of the fair value of our software support, decide to discontinue offering PCS or otherwise change our business model, it could further complicate period-to-period comparisons of our operating results.

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

Once our products are deployed within our customers' networks, 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 post-sale support is necessary to maintain our customer relationships. We rely on authorized service providers in certain locations in the United States to deliver our initial level of customer support. 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 our support and service offerings. Our ability to provide effective support and service offerings is largely dependent on our ability to attract, train and retain qualified service personnel. 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. In addition, our sales process is highly dependent on strong word-of-mouth recommendations from our existing customers. We believe that communication among our customers is both rapid and frequent. Any failure to maintain high-quality support and services, or a market perception that we do not maintain high-quality 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 resellers and authorized service providers to sell, service and support our products in markets where we do not have a direct sales force or support and service personnel. Any disruptions to, or failure to develop and manage, our relationships with resellers and authorized service providers could have an adverse effect on our existing customer relationships and on our ability to increase revenue.***

Our future success is highly dependent upon establishing and maintaining successful relationships with a variety of resellers and authorized service providers in markets where we do not have a direct sales force or service and support personnel. We currently have a direct sales force in the United States, the United Kingdom, Germany and Japan. In other markets, we rely and expect to continue to rely on establishing relationships with resellers and authorized service providers. Our ability to maintain or grow our revenue will depend, in part, on

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**Table of Contents**

our ability to manage and expand our relationships with our existing resellers and authorized service providers and to establish relationships with new resellers and authorized service providers. In addition to their sales activities, our resellers also, in certain instances, provide 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, provide delivery and installation of our products as well as post-sale service and support on our behalf in their local markets. In markets where we rely on resellers and authorized service providers, we have less contact with our end customers and less control over the sales process and the quality and responsiveness of our 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 our service and support offerings. Any failure on our part to train our resellers and authorized service providers and to manage their sales, service and support activities could harm our business, operating results and financial condition. For example, many of our customers are large, multinational organizations that may from time to time purchase products intended for deployment in markets where we do not have operations, which would require us to qualify and retain reliable service and support offerings in those markets. If our resellers or authorized service providers, as the case may be, fail to provide high-quality service and support in those local markets, it could harm our relationships with key customers in our principal markets.

Recruiting and retaining qualified resellers and authorized service providers and training them in our technology and product offerings requires significant time and resources. In order to develop and expand our relationships with our resellers and authorized service providers, we must continue to scale and improve our processes and procedures that support our resellers and authorized service providers, including investments in systems and training. Those processes and procedures may become increasingly complex, difficult and expensive to manage, particularly as the geographic scope of our customer base expands.

We typically enter into non-exclusive, written distribution and service agreements with our 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 resellers and authorized service providers from offering products and services that compete with ours. Accordingly, our 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. Our competitors may provide incentives to our existing and potential resellers and authorized service providers to use or purchase 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 future 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. From March 31, 2004 to March 31, 2008, our number of employees increased from 139 to 451, and we currently anticipate hiring additional employees in future periods. We have also expanded the geographic scope of our business during that period, including the recent establishment of research and development operations in Northern Ireland. We expect to continue to expand internationally through direct sales efforts and by establishing indirect sales and support relationships with vendors in select international markets. Continued growth in the size and scope, including the geographic scope, of our business operations will require substantial management attention with respect to recruiting, hiring, integrating and retaining highly skilled and motivated individuals; managing increasingly dispersed geographic locations and facilities; establishing an integrated information technology infrastructure; and establishing company-wide processes and procedures to address human resource, financial reporting and financial management matters that are consistent across our organization but that address both U.S. and international regulatory and legal requirements. If we are not successful in effectively managing any future growth, it could harm our business, operating results and financial condition.

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**Table of Contents**

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

In fiscal 2008, 2007 and 2006, we derived 17%, 10% and 14% of our revenue, respectively, from end customers outside the United States, and we expect to continue to expand our international operations. We have direct sales personnel in the United States, the United Kingdom, Germany and Japan, and agreements with third-party resellers in Poland, Japan, the United Kingdom, Korea, Italy, the Netherlands, Australia and South Africa. In addition, we currently have international subsidiaries in the United Kingdom, Germany and Japan. We expect to continue to hire additional personnel and enter into agreements with third-party resellers in additional countries, 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 attract, hire and retain 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.

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

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**Table of Contents**

various European Union, or EU, member countries. For example, the EU has enacted the Restriction of the Use of Certain Hazardous Substances in Electrical and Electronic Equipment, or RoHS, and the Waste Electrical and Electronic Equipment, or WEEE, directives. RoHS prohibits the use of certain substances, 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 recently established a wholly owned subsidiary through which we intend 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 companies to develop 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

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## **Table of Contents**

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.

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**Table of Contents**

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

Developing our products is expensive. In fiscal 2008, 2007 and 2006, our research and development expenses were \$34.1 million, or 29% of our total revenue, \$24.5 million, or 37% of our total revenue and \$18.5 million, or 48% 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 IT 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 cost, 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.



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## **Table of Contents**

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.

### ***Adverse changes in economic conditions and reduced information technology spending may adversely impact our business.***

Our business depends on the overall demand for information technology, and in particular for storage infrastructure, and on the economic health of our current and prospective customers. In addition, the purchase of our products is often discretionary and may require our customers to make significant initial commitments of capital and other resources. During the most recent economic downturn, business spending on technology infrastructure decreased dramatically. Weak economic conditions, or a reduction in information technology spending even if economic conditions improve, could adversely impact our business, operating results and financial condition in a number of ways, including longer sales cycles, lower prices for our products and services and reduced unit sales.

### ***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 future acquisitions, 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 management from day-to-day responsibilities and increase our expenses. Future 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 significantly increased 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 Arca have imposed various new requirements on public companies, including requiring changes in corporate governance practices. Our management and other personnel are required to devote a substantial amount of time to these new compliance initiatives. Moreover, these rules and regulations have increased our legal and financial compliance

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**Table of Contents**

costs and made some activities more time-consuming and costly. For example, these new rules and regulations made it more expensive for us to obtain director and officer liability insurance. These rules and regulations could also make it more difficult for us to attract and retain qualified persons to serve on our board of directors, our board committees or as executive officers.

In addition, Sarbanes-Oxley requires, among other things, that we maintain effective internal control over financial reporting and disclosure controls and procedures. In particular, for our fiscal year ending on March 31, 2009, we must perform 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 will require that we incur substantial expenses and expend significant management time on compliance-related issues.

In order to respond to additional regulations applicable to public companies, such as Section 404, we hired a controller in fiscal 2007 and have recently added a number of other finance and accounting personnel. We are also currently using independent contractors to fill certain positions and provide certain accounting functions. We intend to hire additional full-time accounting employees in fiscal 2009 to fill these and other related finance and accounting positions. Some of these positions require candidates with public company experience, and we may be unable to locate and hire such individuals as quickly as needed, if at all. In addition, new employees will require time and training to learn our business and operating processes and procedures. If our finance and accounting organization is unable for any reason to respond adequately to the increased demands that result from being a public company, the quality and timeliness of our financial reporting may suffer, which could result in identification of internal control weaknesses. Any consequences resulting from inaccuracies or delays in our reported financial statements could have an adverse effect on the trading price of our common stock as well as an adverse effect on our business, operating results, and financial condition.

Moreover, if we are not able to comply with the requirements of Section 404 in a timely manner, or if we or our independent registered public accounting firm identifies deficiencies in our internal control over financial reporting that are 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 Arca 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 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

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## **Table of Contents**

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.

### **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 limited trading history. Factors that could affect the trading price of our common stock include:

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;

changes in the estimates of our operating results or changes in recommendations by any securities analysts that elect to follow our common stock;

market conditions in our industry, the industries of our customers and the economy as a whole; 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.

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

## **Table of Contents**

### ***Future sales of shares by our existing stockholders could cause our stock price to decline.***

The lock-up agreements that most of our stockholders entered into at the time of our initial public offering, or IPO, expired on May 24, 2008. If our existing stockholders sell, or indicate an intention to sell, substantial amounts of our common stock in the public market that were subject to such lock-up agreements or that otherwise become freely tradable upon the expiration of other legal restrictions on resale, the trading price of our common stock could decline.

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

At March 31, 2008, our directors and executive officers and their affiliates beneficially own, in the aggregate, approximately 57.5% 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, as amended and restated upon the closing of our IPO, 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;

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

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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 1B. UNRESOLVED STAFF COMMENTS**

Not applicable.

**Table of Contents**

**ITEM 2. PROPERTIES**

We lease approximately 180,000 square feet of office space in Fremont, California pursuant to leases that expire in 2010 and 2014. We also maintain domestic sales offices in New York, Maryland and Texas, and international sales offices in the United Kingdom, Germany, Switzerland, Singapore and Japan. We lease office space for research and development in Northern Ireland and Washington. We believe that our facilities are suitable and adequate to meet our current needs. We intend to add new facilities or expand existing facilities as we add employees, and we believe that suitable additional or substitute space will be available as needed to accommodate any such expansion of our operations.

**ITEM 3. 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 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

No matters were submitted to a vote of our security holders during the quarter ended March 31, 2008.

**Table of Contents****PART II****ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER REPURCHASES OF EQUITY SECURITIES**

Our common stock has been listed on NYSE Arca under the symbol PAR since our initial public offering, or IPO, in November 2007. The following table sets forth, for the periods indicated, the high and low intra-day prices for our common stock as reported on NYSE Arca.

	High	Low
<b>2008</b>		
Third Quarter (beginning November 16, 2007)	\$ 17.99	\$ 11.75
Fourth Quarter	\$ 14.50	\$ 6.07

As of May 31, 2008 the number of stockholders of record of our common stock was 379.

**Stock Performance Graph**

The graph set forth below shows a comparison of the cumulative total stockholder return on our common stock between November 16, 2007 (the date of our IPO) and March 31, 2008, with the cumulative total return of (i) the NYSE Arca Tech 100 Index and (ii) the NYSE Composite Index, over the same period. This graph assumes the investment of \$100 on November 16, 2007 in our common stock, the NYSE Arca Tech 100 Index and the NYSE Composite Index, and assumes the reinvestment of dividends, if any. The graph assumes the initial value of our common stock on November 16, 2007 was the closing sales price of \$15.75 per share. The stockholder return shown in the graph below is not necessarily indicative of, nor is it intended to forecast, the potential future performance of our common stock, and we do not make or endorse any predictions as to future stockholder returns. Information used in the graph was obtained from NYSE MarkeTrac®, a source believed to be reliable, but we are not responsible for any errors or omissions in such information.

	11/16/2007	12/31/2007	3/31/2008
3PAR Inc.	100.00	81.90	43.68
NYSE Composite	100.00	100.40	90.68
NYSE Arca Tech 100	100.00	98.85	88.36



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## **Table of Contents**

### **Use of Proceeds from Public Offering of Common Stock**

On November 15, 2007, our registration statement (No. 333-145437) on Form S-1 was declared effective for our IPO, pursuant to which we registered the offering and sale of an aggregate of 8,625,000 shares of common stock, including the underwriters' over-allotment option, at a public offering price of \$14.00 per share or aggregate offering price of \$120.8 million. The offering, which closed on November 21, 2007, did not terminate until after the sale of 7,702,479 of the shares registered on the registration statement for an aggregate offering price of \$107.8 million. The managing underwriters were Goldman, Sachs & Co., Credit Suisse, UBS Investment Bank, Thomas Weisel Partners LLC, and RBC Capital Markets.

As a result of the offering, we received net proceeds of approximately \$97.4 million, after deducting underwriting discounts and commissions of \$7.5 million and additional offering-related expenses of approximately \$2.9 million. No payments for such expenses were made directly or indirectly to (i) any of our officers or directors or their associates, (ii) any persons owning 10% or more of any class of our equity securities, or (iii) any of our affiliates. In November 2007 we used \$5.8 million of the net proceeds to repay outstanding balances under our revolving line of credit with Silicon Valley Bank. We anticipate that we will use the remaining net proceeds from our IPO for working capital and other general corporate purposes, including to finance our growth, develop new products, fund capital expenditures, or to expand our existing business through acquisitions of other businesses, products or technologies. However, we do not have agreements or commitments for acquisitions at this time. Pending such uses, we plan to invest the net proceeds in short-term, interest-bearing, investment grade securities. There has been no material change in the planned use of proceeds from our IPO from that described in the final prospectus filed with the SEC pursuant to Rule 424(b) of the Exchange Act.

### **Dividend Policy**

We have never declared or paid any cash dividend on our capital stock. We currently intend to retain any future earnings and do not expect to pay any dividends in the foreseeable future.

### **Recent Sales of Unregistered Securities**

Between April 1, 2007 and November 27, 2007 (the date of the filing of our registration statement on Form S-8, No. 333-147632), we issued an aggregate of 106,424 shares of common stock that were not registered under the Securities Act of 1933 to our employees and directors pursuant to the exercise of stock options for cash consideration with aggregate exercise proceeds of approximately \$296,000. These issuances were undertaken in reliance upon the exemption from registration requirements of Rule 701 of the Securities Act of 1933. The recipients of these shares of common stock represented their intentions to acquire the shares for investment only and not with a view to or for sale in connection with any distribution, and appropriate legends were affixed to the share certificates issued in these transactions. All recipients had adequate access, through their relationships with us, to information about us.

On December 4, 2007 we issued an aggregate of 117,211 shares of common stock upon net issuance exercise of warrants to purchase 134,742 shares of our common stock at an exercise price of \$1.88 per share originally issued to a lender of the company from June 2005 through October 2005. We received no cash consideration at the time such shares were issued. We believe the issuance was exempt from the registration requirements of the Securities Act of 1933 in reliance on Section 4(2) thereof, as transactions by an issuer not involving a public offering. The lender agreed that the shares would be subject to the standard restrictions applicable to a private placement of securities under applicable state and federal securities laws, and appropriate legends were affixed to the share certificate issued to the lender. We believe that the lender received adequate information about the company or had access, through its relationship with the company, to such information.

On December 17, 2007 we issued an aggregate of 96,630 shares of common stock upon net issuance exercise of warrants to purchase 35,458 shares of our common stock at an exercise price of \$1.88 per share and 66,485 shares of our common stock at an exercise price of \$0.02 per share originally issued to a lender of the company from June 2005 through October 2005. We received no cash consideration at the time such shares were

**Table of Contents**

issued. We believe the issuance was exempt from the registration requirements of the Securities Act of 1933 in reliance on Section 4(2) thereof, as transactions by an issuer not involving a public offering. The lender agreed that the shares would be subject to the standard restrictions applicable to a private placement of securities under applicable state and federal securities laws, and appropriate legends were affixed to the share certificate issued to the lender. We believe that the lender received adequate information about the company or had access, through its relationship with the company, to such information.

**Purchases of Equity Securities by the Issuer and Affiliated Purchasers**

		<b>Total Number of Shares Purchased</b>	<b>Average Price Paid per Share</b>	<b>Shares Purchased as Part of Publicly Announced Plans or Programs</b>	<b>Maxium Number of Shares that May Yet Be Purchased Under the Plans or Programs</b>
January 1	January 31, 2008	4,583(1)	\$ 0.58		
February 1	February 29, 2008	2,239(1)	0.02		
March 1	March 31, 2008	803(1)	0.46		
Total		7,625	\$ 0.40		

- (1) Represents unvested shares of common stock repurchased by us upon the termination of employment or service pursuant to the provisions of our 1999 and 2000 Stock Option Plans.

**Table of Contents****ITEM 6. SELECTED CONSOLIDATED FINANCIAL DATA**

You should read the following selected consolidated historical financial data below in conjunction with the section titled "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the consolidated financial statements, related notes and schedule, and other financial information included in this Form 10-K. The selected consolidated financial data in this section is not intended to replace the consolidated financial statements and is qualified in its entirety by the consolidated financial statements and related notes and schedule included in this Form 10-K.

	Years Ended March 31,				2004
	2008 (2)	2007 (2)(3)	2006	2005	
<b>Consolidated Statements of Operations Data:</b>					
Revenue:					
Product	\$ 111,683	\$ 64,977	\$ 37,876	\$ 23,698	\$ 8,833
Support	6,335	1,191	308	75	
<b>Total revenue</b>	<b>118,018</b>	<b>66,168</b>	<b>38,184</b>	<b>23,773</b>	<b>8,833</b>
Cost of revenue:					
Product	39,439	23,644	15,617	12,108	6,407
Support	1,545	228	104	27	
<b>Total cost of revenue (1)</b>	<b>40,984</b>	<b>23,872</b>	<b>15,721</b>	<b>12,135</b>	<b>6,407</b>
Gross profit	77,034	42,296	22,463	11,638	2,426
Operating expenses:					
Research and development (1)	34,071	24,519	18,459	15,203	15,773
Sales and marketing (1)	45,283	28,096	16,602	12,380	10,908
General and administrative (1)	9,676	6,104	3,390	2,043	2,494
<b>Total operating expenses</b>	<b>89,030</b>	<b>58,719</b>	<b>38,451</b>	<b>29,626</b>	<b>29,175</b>
Loss from operations	(11,996)	(16,423)	(15,988)	(17,988)	(26,749)
Other income (expense), net	2,058	1,010	(241)	554	(473)
Loss before provision for income taxes	(9,938)	(15,413)	(16,229)	(17,434)	(27,222)
Provision for income taxes	(158)	(72)	(23)		
<b>Net loss</b>	<b>\$ (10,096)</b>	<b>\$ (15,485)</b>	<b>\$ (16,252)</b>	<b>\$ (17,434)</b>	<b>\$ (27,222)</b>
<b>Net loss per common share basic and diluted</b>	<b>(\$0.30)</b>	<b>(\$0.87)</b>	<b>(\$1.01)</b>	<b>(\$1.26)</b>	<b>(\$3.56)</b>
Shares used to compute basic and diluted net loss per common share	34,141	17,746	16,101	13,826	7,638

(1) Includes stock-based compensation as follows:

Cost of revenue	188	160	96	4
Research and development	1,262	591	692	29
Sales and marketing	1,397	439	403	17
General and administrative	777	577	730	31

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- (2) Effective April 1, 2006, we adopted the fair value recognition provisions of Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment*, or SFAS 123(R), using the prospective transition method, which requires the application of the provisions of SFAS 123(R) only to share-based payment awards granted, modified, repurchased or cancelled on or after the modification date. Under this method, we recognize stock-based compensation expense for all share-based payment awards granted after March 31, 2006 in accordance with SFAS 123(R).
- (3) We implemented our new software support model in March 2007. See Revenue Recognition under Critical Accounting Policies and Estimates within Management's Discussion and Analysis of Financial Condition and Results of Operations.

**Table of Contents**

	2008	2007	As of March 31, 2006 (in thousands)	2005	2004
<b>Consolidated Balance Sheet Data:</b>					
Cash, cash equivalents and short-term investments	\$ 115,643	\$ 34,710	\$ 37,273	\$ 20,595	\$ 39,507
Working capital	111,143	26,356	41,035	21,935	37,051
Total assets	189,834	78,561	60,748	34,700	48,619
Long-term portion of notes payable		860	2,462	1,154	579
Redeemable convertible preferred stock		94,343	94,343	64,435	64,435
Common stock and additional paid-in capital	290,619	95,493	94,904	92,129	90,493
Total stockholders' equity (deficit)	116,400	(69,270)	(55,687)	(41,756)	(24,270)

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**Table of Contents**

**ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

*The following discussion of our financial condition and results of operations should be read together with the financial statements and the related notes set forth under Item 8. Financial Statements and Supplementary Data. The following discussion also contains trend information and other forward looking statements that involve a number of risks and uncertainties. The Risk Factors set forth in Item 1A. Risk Factors are hereby incorporated into the discussion by reference.*

We are the leading global provider of utility storage for large to medium enterprises, business-oriented service providers, consumer-oriented Internet/Web 2.0 companies and government entities. Our utility storage products offer simple, efficient and scalable tiered-storage arrays enabling the delivery of computing as a utility service to organizations with significant data storage requirements. Our 3PAR InSpire Architecture delivers a modular, highly scalable storage solution that we believe can significantly reduce the total lifetime cost of storage for our customers.

Our company was founded by engineers with substantial experience in the high-end server and storage markets and began operations in 1999. From 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 and by providing our customers with systems that are simpler and less expensive to maintain and operate on an ongoing basis. Our utility storage solution is comprised of the 3PAR InServ Storage Servers and the 3PAR InForm Suite, which includes the 3PAR InForm OS and other software applications.

In November 2007, we completed an IPO of our common stock in which we sold and issued 7,702,479 shares of common stock, including 202,479 shares issued in December 2007 in connection with the partial exercise of the underwriters' over-allotment option, at an issue price of \$14.00 per share. A total of \$107.8 million in gross proceeds was raised from the IPO, or approximately \$97.4 million in net proceeds after deducting underwriting discounts and commissions of \$7.5 million and other offering costs of \$2.9 million. Upon the closing of the offering, all shares of our then-outstanding convertible preferred stock automatically converted into 33,256,720 shares of common stock.

From 1999 until 2002, our operations focused principally on product development. During this time we generated no revenue, and we funded research and development of the initial versions of our storage server products principally from the proceeds of venture capital equity financings. In April 2002, we recognized our first revenue from product sales to our initial customers. Our revenue has grown significantly, from \$4.2 million in our fiscal year ended March 31, 2003, or fiscal 2003, to \$118.0 million in fiscal 2008. As of March 31, 2008, our products had been purchased by more than 300 end customers worldwide, including many global organizations with substantial data storage requirements.

We have continued to experience significant losses as we have continued to invest significantly in our product development, customer services and sales and marketing organizations in anticipation of growth in our business. Prior to our IPO, we funded these activities through additional venture capital equity financings and, to a lesser extent, with borrowings under notes payable and a revolving line of credit. As of March 31, 2008, we had an accumulated deficit of \$174.0 million. We expect to continue to incur significant research and development, sales and marketing, and general and administrative expenses to fund our anticipated growth for the foreseeable future. As a result, we anticipate that we will incur net losses for at least the next several quarters, and we will need to increase our revenue substantially in order to achieve and maintain profitability.

We sell our products primarily through our direct sales force in the United States, United Kingdom, Germany and Japan. In Asia and select European markets, we sell our products indirectly through resellers. We anticipate that we will need to recruit and retain substantial additional direct sales personnel in order to increase our revenue. We expect that revenue from our direct sales force, in particular revenue from direct sales in North America, will continue to contribute a substantial majority of our revenue for the foreseeable future, although it could decrease as a percentage of our total revenue as we expand our international sales through resellers. Sales in North America represented 83%, 90% and 86%, of our total revenue in fiscal 2008, 2007 and 2006, respectively.

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## **Table of Contents**

Early in our history, our revenue was concentrated with a few customers. As our revenue base has grown, our customer concentration has decreased. In fiscal 2006, our two largest customers accounted for 11% and 10% of our revenue, respectively. In fiscal 2007 and 2008, no customer accounted for more than 10% of our revenue. Despite this decrease in customer concentration on an annual basis, we have experienced and continue to experience customer concentration on a quarterly basis. For example, in the first quarter of fiscal 2008, 25% of our revenue was attributable to sales to one customer. In addition, we have experienced increases in the size of our orders, which could result in future increased customer concentration depending on the timing of the fulfillment of those orders.

Our revenue growth is driven primarily by increased purchases from existing customers, coupled with the expansion of our customer base. Revenue from repeat business comprised 79%, 66% and 62% of our total revenue in fiscal 2008, 2007 and 2006, respectively. Our customers typically follow an initial purchase of our storage solution with additional subsequent purchases after they have had an opportunity to implement our solution and realize benefits from its ease of deployment, efficiency and performance. In particular, we believe that many of our customers make additional purchases because our products are highly scalable and capable of consolidating storage requirements across multiple departments or divisions. We believe that customer references have been, and will continue to be, an important factor in winning new business.

A typical initial order requires three to six months of selling effort as we educate prospective customers about the technical merits and capabilities and potential cost savings of our products as compared to our competitors' solutions. Repeat orders are usually less time-consuming. Because we generally receive a substantial portion of our orders late in the quarter and the time from order to shipment can vary substantially, we often recognize revenue from these orders in subsequent quarters. Factors affecting the timing of revenue recognition include the time required to build the system to the customer's configuration requirements and the readiness of the customer's physical site with required power, cooling and information technology infrastructure. For new customers, factors such as meeting technical performance specifications and negotiating contract terms and conditions also affect timing of shipment and revenue recognition.

We assemble our products at a single location in Fremont, California from components supplied to us by a limited number of manufacturers. Some of those components can only be purchased from our current suppliers or would require significant lead time to source from another. We are heavily dependent on the availability of components and the reliability of our current suppliers. We have experienced in the past, and could experience in the future, quality control issues and delivery delays with our suppliers due to factors such as high industry demand and the inability of some suppliers to consistently meet our quality or delivery requirements. Although these problems have not historically adversely affected our revenue, if they occur again in the future, our revenue could be adversely impacted.

We have sales offices in the United States, United Kingdom, Germany and Japan and research and development facilities in California and Northern Ireland. We expect to continue to add sales, engineering and customer services personnel in the United States and internationally.

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 2008, ended on March 31, 2008.

### **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. The software warranty was limited to bug fixes for any non-conforming software products. We generally recognized as product revenue all revenue associated with sales of our products at the time of shipment or installation, depending on the terms of the arrangement, provided that all other revenue recognition criteria were met.

## **Table of Contents**

During this period, we also offered a premium hardware warranty and an extended hardware and software warranty beyond the initial contract term. Our premium hardware warranty offers faster service response time than our basic hardware warranty. We recognized as support revenue all revenue attributable to these premium and extended warranties on a ratable basis over the contract term, which was typically three years for premium warranty and one year from termination of the basic warranty for extended warranty.

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. Commencing in March 2007, we sell all of our systems together with software support.

However, during the month of March 2007, we did not have vendor-specific objective evidence, or VSOE, of the fair value of our new software support. Therefore, as of March 31, 2007, we had \$6.3 million of deferred revenue from product sales with software support that occurred in March 2007, including the hardware, software and support components. We are recognizing this \$6.3 million as product revenue on a ratable basis over the applicable software support period, which ranges from one year to three years. Product revenue in March 2007 that was not recognized ratably was for additional products for existing systems that did not include software support. The implementation of our software support model had an adverse impact on our revenue recognized during the quarter ended March 31, 2007 and resulted in a substantial increase to our deferred revenue at March 31, 2007.

During the first quarter of fiscal 2008, we established VSOE of the fair value of our new software support based on the rates we offer to our customers for renewal in our arrangements with them, or stated renewal rates. Accordingly, commencing April 1, 2007, we recognize revenue attributable to our software support as support revenue on a straight-line basis over the software support period. We sell a significant portion of our software support with a one-year term. Support revenue continues to include our premium and extended hardware warranties. We generally recognize the balance of the sale as product revenue at the time of shipment or installation, depending on the terms of the arrangement, provided that all other revenue recognition criteria are met. See *Revenue Recognition* under *Critical Accounting Policies and Estimates* below.

As a result of the implementation of our software support model in March 2007, we expect support revenue to increase significantly in future periods. Therefore, comparing the elements of our revenue on a period-to-period basis may not be meaningful and should not be relied upon as an indication of our future performance.

### ***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.

Prior to March 2007, we recognized all our hardware and software warranty costs as cost of product revenue at the time of revenue recognition based on our estimated time and material costs of providing hardware and software warranty support. In March 2007, during the implementation of our software support model, we deferred all hardware related costs associated with product sales bundled with software support for which we had not been able to establish VSOE of fair value at the outset of the arrangement. The hardware related costs associated with these sales are recognized ratably together with the product revenue. We no longer incur software warranty cost beginning March 2007, as this was replaced by our new software support sold together with our systems. For periods subsequent to March 2007, we continue to recognize hardware warranty costs as cost of product revenue at the time of revenue recognition.



## **Table of Contents**

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 significantly 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 204 employees at March 31, 2006, to 312 employees at March 31, 2007 and to 451 employees at March 31, 2008. We expect to continue to hire a significant number of new employees to support our growth. The timing of these additional hires could materially affect our operating expenses, both in absolute dollars and as a percentage of revenue, in any particular period.

#### ***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 recognize research and development expense when 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. In particular, we anticipate that we will hire substantial additional engineering personnel in future periods.

#### ***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 invest heavily in sales and marketing by increasing the number of sales and marketing 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 incur significant additional accounting and legal costs related to compliance with rules and regulations implemented by the SEC, as well as additional insurance, investor relations and other costs associated with being a public company.

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## **Table of Contents**

### ***Other Income (Expense), net***

Other income (expense), 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 remeasurement of non-United States dollar transactions into United States dollars. Our gains or losses on currency remeasurement have not been material to date due to the size of our international operations. If we are successful in increasing our international sales we may be subject to 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.

### **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.

### ***Revenue Recognition***

We derive our revenue from sales of storage solutions that include hardware, software and related support. Because the embedded software of our storage solution is deemed to be more than incidental to the product as a whole, we account for revenue for the entire sale in accordance with the guidance provided by American Institute of Certified Public Accountants Statement of Position, or SOP, 97-2, *Software Revenue Recognition*, as amended by SOP 98-9, Modification of SOP 97-2, *Software Revenue Recognition with Respect to Certain Transactions*.

We recognize 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 satisfaction of evaluation criteria or expiration of the evaluation period, as the case may be. Our fees are considered fixed or determinable at the execution of an agreement, which comprises the final terms of sale including the description, quantity and price of each product purchased. Our sales arrangements with customers and resellers do not include rights of return or rebates and to date, product returns have been negligible. We assess our ability to collect from our customers based on a number of factors, including creditworthiness of the customer and past transaction history.

Prior to March 2007, we typically sold our products with a three-year basic hardware warranty and software warranty. The software warranty was limited to bug fixes for any non-conforming software products. We generally recognized as product revenue all revenue associated with sales of our products at the time of shipment or installation, depending on the terms of the arrangement, provided that all other revenue recognition criteria were met. During this period, we also offered a premium hardware warranty and an extended hardware and software warranty after the initial contract term. Our premium hardware warranty offers faster response time than our basic hardware warranty. In accordance with Financial Accounting Standards Board, or FASB, Technical Bulletin 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts*, we recognized revenue relating to our premium hardware warranty and extended hardware and software warranties ratably as support revenue over the warranty period, which was typically three years for premium warranty and one year from termination of the basic warranty for extended warranty.

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## **Table of Contents**

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. Commencing in March 2007, we sell all of our systems together with software support. This new software support is considered post-contract customer support, or PCS, under SOP 97-2.

Our sales are comprised of multiple elements, which include hardware, software and PCS. We allocate revenue to the delivered elements of the sale, typically hardware and software, using the residual method. Under the residual method, we defer revenue from the sale equivalent to the VSOE of the fair value of the PCS and apply any discounts to the delivered elements in accordance with the provisions of SOP 97-2, as amended by SOP 98-9. VSOE of the fair value of the PCS within a sale is based upon stated renewal rates included within the evidence of the arrangement with the customer.

During the month of March 2007, we did not have VSOE of the fair value of our new software support. Accordingly, we are recognizing revenue from our March 2007 transactions that included software support as product revenue ratably over the support period. The support period for these transactions was typically between one year and three years. Product revenue that was not recognized ratably was for additional products for existing systems that did not include software support.

During the first quarter of fiscal 2008, we established VSOE of the fair value of our new software support based on stated renewal rates offered to customers within the arrangement. As a result, beginning in the first quarter of fiscal 2008, we defer revenue recognition of the software support and recognize it as support revenue on a straight-line basis over the support period, which is primarily one year. We allocate the remainder of the revenue associated with the sale to product revenue using the residual method, as allowed by SOP 98-9. Support revenue also continues to include our premium and extended hardware warranties.

We typically recognize product revenue upon installation for transactions sold directly to end users, provided that the remaining revenue recognition criteria discussed above are satisfied. In cases where the arrangement includes acceptance criteria, we recognize revenue upon the earlier of receipt of customer acceptance or the lapse of the acceptance period. For sales through our resellers, we generally recognize product revenue upon shipment, based on freight terms of FOB Shipping Point or FOB Destination, assuming all other criteria for revenue recognition discussed above have been satisfied.

### ***Stock-Based Compensation***

Prior to April 1, 2006, we accounted for stock-based employee compensation arrangements in accordance with the provisions of Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, or APB 25, and FASB Interpretation No. 44, *Accounting for Certain Transactions Involving Stock Compensation*, an Interpretation of APB Opinion No. 25, or FIN 44, and had adopted the disclosure provisions of Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation*, or SFAS 123, and SFAS No. 148, *Accounting for Share-Based Compensation Transition and Disclosure*, or SFAS 148. For stock options granted during fiscal 2005 and fiscal 2006, we determined the fair value at the grant date using the minimum value method for purposes of our pro forma disclosures under SFAS 123.

In accordance with APB 25, we recorded stock-based compensation expense under the intrinsic value method resulting from stock options that were granted to employees from January 2005 through February 2006 with exercise prices that, for financial reporting purposes, were deemed to be below the estimated fair market value of the underlying common stock on the date of grant. We amortize stock-based compensation expense resulting from the application of APB 25 over the vesting period of the options using an accelerated basis, in accordance with FASB Interpretation No. 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans*. For the years ended March 31, 2008, 2007 and 2006, we recorded stock-based compensation expense under APB 25 of \$556,000, \$1.3 million and \$1.9 million, respectively. The unrecognized expense related to these grants as of March 31, 2008 is \$186,000 which will be amortized over the remaining vesting periods.

**Table of Contents**

Effective April 1, 2006, we adopted the fair value recognition provisions of SFAS No. 123(R), *Share-Based Payment*, using the prospective transition method, which requires us to apply the provisions of SFAS 123(R) only to awards granted, modified, repurchased or cancelled after the adoption date. Upon adoption of SFAS 123(R), we selected the Black-Scholes option pricing model as the most appropriate method for determining the estimated fair value for stock-based awards. The Black-Scholes model requires the use of highly subjective and complex assumptions to determine the fair value of stock-based awards, including the option's expected term and the price volatility of the underlying stock. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite vesting periods on a straight-line basis in our consolidated statements of operations and the expense has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. For the years ended March 31, 2008 and 2007 we recorded stock-based compensation expense under SFAS 123(R) of \$3.1 million and \$476,000 respectively. As of March 31, 2008, we had \$12.1 million of total unrecognized compensation cost related to unvested stock options to be recognized over a weighted-average period of approximately 3.2 years. Additionally, as of March 31, 2008, we had unrecognized expense related to the Employee Stock Purchase Plan of \$969,000, which we expect to be recognized over one year.

The weighted average grant-date fair value per share of options granted in fiscal years ended March 31, 2008 and 2007 was \$4.18 and \$2.08, respectively, based on the provisions of SFAS 123(R). Based upon the closing price of our common stock as reported on NYSE Arca of \$6.88 per share at March 31, 2008, the aggregate intrinsic value of options outstanding as of March 31, 2008 was \$17.3 million, of which \$13.0 million related to vested options and \$4.3 million to unvested options.

For share-based awards granted during fiscal 2008 and 2007, we determined the fair value at date of grant using the Black-Scholes option pricing model. The following table summarizes the weighted average assumptions used in determining the fair value of stock options and employee stock purchase rights granted.

	<b>Years Ended March 31,</b>	
	<b>2008</b>	<b>2007</b>
<b>Employee Stock Options</b>		
Risk-free interest rate	4.18%	4.81%
Expected life (years)	4.30	4.18
Dividend yield	0.00%	0.00%
Expected volatility	44.5%	47.0%

	<b>Year Ended March 31, 2008</b>
<b>Employee Stock Purchase Plan</b>	
Risk-free interest rate	3.50%
Expected life (years)	1.00
Dividend yield	0.00%
Expected volatility	53.9%

The risk-free interest rate for the expected term of the option was 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 stock-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 our limited operating history, we compared this estimated term to those of comparable companies from a representative peer group selected based on industry data to determine the expected term. The computation of expected volatility was based on the historical volatility of comparable companies from a representative peer group that we selected based on industry data.

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**Table of Contents**

We account for equity instruments issued in exchange for the receipt of goods or services from non-employees in accordance with the consensus reached by the Emerging Issues Task Force, or EITF, in Issue No. 96-18, *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services*. Costs are measured at the fair market value of the consideration received or the fair value of the equity instruments issued, whichever is more reliably measurable. The value of equity instruments issued for consideration other than employee services is determined on the earlier of the date on which there first exists a firm commitment for performance by the provider of goods or services or on the date performance is complete, using the Black Scholes pricing model.

***Inventory Valuation***

Inventory consists of raw materials, work in process and finished goods stated at the lower of cost or market. Cost is computed using the standard cost, which approximates actual cost, on a first-in, first-out basis. We record inventory write-downs for potentially excess inventory based on forecasted demand, economic trends and technological obsolescence of our products or component parts. At the point of the loss recognition, a new, lower-cost basis for that inventory is established. Subsequent changes in facts or circumstances do not result in the restoration or increase in that newly established cost basis. Inventory write-downs were \$582,000, \$528,000 and \$93,000 in fiscal 2008, 2007 and 2006, respectively. In addition, we record a liability for firm, noncancelable purchase commitments with contract manufacturers and suppliers for quantities in excess of our future demand forecasts. The liability related to the adverse purchase commitments with contract manufacturers and suppliers was \$295,000 as of March 31, 2008. If there were to be a sudden and significant decrease in demand for our products, or if there were a higher incidence of inventory obsolescence because of rapidly changing technology and customer requirements, we could be required to increase our inventory write downs and our liability for purchase commitments with contract manufacturers and suppliers, and our gross margin could be adversely affected.

***Warranty Provision***

We provide for future warranty costs upon revenue recognition. The specific terms and conditions of those warranties vary depending upon the product sold and country in which we do business. The warranties are generally for three years from the date of installation of equipment. Factors that affect our warranty liability include the number of installed units, historical experience and management's judgment regarding anticipated rates of warranty claims and cost per claim. Should actual product failures and warranty claims differ significantly from our historical experience, our warranty liability will have to be adjusted, and our gross margin could be adversely affected.

***Allowances for Doubtful Accounts***

We record a provision for doubtful accounts based on our historical experience and a detailed assessment of the collectability of our accounts receivable. In estimating the allowance for doubtful accounts, our management considers, among other factors, (1) the aging of the accounts receivable, including trends within and ratios involving the age of the receivables, (2) our historical write-offs, (3) the credit worthiness of each customer, (4) the economic conditions of the customer's industry and (5) general economic conditions. Our allowance for doubtful accounts was \$227,000 and \$128,000 at March 31, 2008 and 2007, respectively. In the event we were to experience unanticipated collections issues, it could have an adverse affect on our operating results in future periods.

***Income Taxes***

We use the asset and liability method of accounting for income taxes in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. We recognize deferred tax assets and liabilities for the estimated future tax consequences attributable to differences between the consolidated financial statement carrying amounts of existing assets and liabilities and their respective tax bases. We recognize deferred tax assets for deductible temporary differences, along with net operating loss carryforwards, if it is more likely than not that the tax

## **Table of Contents**

benefits will be realized. Our ultimate realization of our deferred tax assets is dependent upon our generation of future taxable income during the periods in which those temporary differences become deductible or the net operating loss carryforwards may be utilized. To the extent that we cannot recognize a deferred tax asset under the preceding criteria, we establish a valuation allowance.

Effective April 1, 2007, we adopted FASB Interpretation No. 48, or FIN 48, *Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109*. FIN 48 provides a comprehensive model for the recognition, measurement and disclosure in financial statements of uncertain income tax positions that a company has taken or expects to take on a tax return. Under FIN 48, a company can recognize the benefit of an income tax position only if it is more likely than not (greater than 50%) that the tax position will be sustained upon tax examination, based solely on the technical merits of the tax position. Otherwise, no benefit can be recognized. The tax benefits recognized are measured based on the largest benefit that has a greater than fifty percent likelihood of being realized upon ultimate settlement. Additionally, companies are required to accrue interest and related penalties, if applicable, on all tax exposures for which reserves have been established consistent with jurisdictional tax laws. We reevaluate these uncertain tax positions on a quarterly basis. This evaluation is based on factors including, but not limited to, changes in facts or circumstances, changes in tax law, effectively settled issues under audit, and new audit activity. Such a change in recognition or measurement would result in the recognition of a tax benefit or an additional charge to the tax provision.

Based on the available objective evidence, including the fact that we have generated losses since inception, management believes that it is more likely than not that our deferred tax assets will not be realized. Accordingly, we have provided a full valuation allowance against our deferred tax assets at March 31, 2008 and 2007.

As of March 31, 2008, we had \$144.0 million and \$81.0 million of federal and state net operating loss carryforwards available to reduce our future taxable income. These carryforwards expire between 2019 and 2027 for federal purposes and between 2011 and 2019 for state purposes. Under Section 382 of the Internal Revenue Code of 1986, as amended, or the Internal Revenue Code, the amounts of and benefits from our net operating loss carryforwards may be impaired or limited in certain circumstances. Events which cause limitations in the amount of net operating losses that we may utilize in any one year include, but are not limited to, a cumulative ownership change of more than 50%, as defined in Section 382, over a three-year period.

We also had \$4.6 million and \$5.6 million of federal and state research and development tax credit carryovers at March 31, 2008. The federal research and development tax credit carryovers will begin to expire in 2020. The state research and development tax credit carryovers can be carried forward indefinitely.

**Table of Contents****Results of Operations****Revenue**

The following tables present period over period comparisons of our revenue by revenue source for the periods presented (dollars in thousands):

	Years Ended March 31,		Change in		Years Ended March 31,		Change in	
	2008	2007	\$	%	2007	2006	\$	%
<b>Types of Revenue :</b>								
Product	\$ 111,683	\$ 64,977	\$ 46,706	72%	\$ 64,977	\$ 37,876	\$ 27,101	72%
<i>As % of total revenue</i>	<i>94.6%</i>	<i>98.2%</i>			<i>98.2%</i>	<i>99.2%</i>		
Support	6,335	1,191	5,144	432%	1,191	308	883	287%
<i>As % of total revenue</i>	<i>5.4%</i>	<i>1.8%</i>			<i>1.8%</i>	<i>0.8%</i>		
Total revenue	\$ 118,018	\$ 66,168	\$ 51,850	78%	\$ 66,168	\$ 38,184	\$ 27,984	73%

	Years Ended March 31,		Change in		Years Ended March 31,		Change in	
	2008	2007	\$	%	2007	2006	\$	%
<b>Revenue by geography:</b>								
North America	\$ 98,329	\$ 59,347	\$ 38,982	66%	\$ 59,347	\$ 32,804	\$ 26,543	81%
<i>As % of total revenue</i>	<i>83.3%</i>	<i>89.7%</i>			<i>89.7%</i>	<i>85.9%</i>		
Europe	15,348	4,260	11,088	260%	\$ 4,260	1,742	2,518	145%
<i>As % of total revenue</i>	<i>13.0%</i>	<i>6.4%</i>			<i>6.4%</i>	<i>4.6%</i>		
Asia	4,341	2,561	1,780	70%	\$ 2,561	3,638	(1,077)	-30%
<i>As % of total revenue</i>	<i>3.7%</i>	<i>3.9%</i>			<i>3.9%</i>	<i>9.5%</i>		
Total revenue	\$ 118,018	\$ 66,168	\$ 51,850	78%	\$ 66,168	\$ 38,184	\$ 27,984	73%

Our total revenue increased by \$51.9 million, or 78%, to \$118.0 million in fiscal 2008 from \$66.2 million in fiscal 2007 and by \$28.0 million in fiscal 2007, or 73%, from \$38.2 million in fiscal 2006.

Product revenue increased by \$46.7 million, or 72%, to \$111.7 million in fiscal 2008 from \$65.0 million in fiscal 2007 and by \$27.1 million in fiscal 2007, or 72%, from \$37.9 million in fiscal 2006. The increases in fiscal 2008 and 2007 were principally due to an increase in repeat sales to existing customers, the expansion of our customer base and the impact of the introduction of our new E200 systems in early fiscal 2007. Revenue from our existing customers represented 79% of total revenue in fiscal 2008 as compared to 66% of total revenue in fiscal 2007 and 62% of total revenue in fiscal 2006. Approximately \$9.5 million of the increase in revenue in fiscal 2008 compared to fiscal 2007 and \$2.5 million of the increase in revenue from fiscal 2006 to fiscal 2007 was attributable to incremental sales of E200 systems. We increased the number of our sales and marketing personnel to 157 at March 31, 2008, from 101 at March 31, 2007 and 62 at March 31, 2006, which contributed to our ability to expand our customer base.

As a result of the implementation of our software support model in March 2007, beginning with the first quarter of fiscal 2008, we recognize software support revenue as support revenue. Because we did not have VSOE of the fair value of software support in March 2007, we deferred revenue from product sales that were bundled with software support in the month of March 2007, which was equal to \$6.3 million as of March 31, 2007, and we are recognizing that revenue on a ratable basis over the term of the software support period. Of the \$6.3 million deferred revenue, we recognized \$3.2 million as product revenue in fiscal 2008.

During the first quarter of fiscal 2008, we established VSOE of the fair value of our software support. As a result, beginning with that quarter, we now recognize all hardware and software license revenue upon shipment or installation, provided that the remaining revenue recognition criteria are satisfied. We recognize software support revenue as support revenue over the term of the support period.





**Table of Contents**

Support revenue increased by \$5.1 million to \$6.3 million in fiscal 2008 from \$1.2 million in fiscal 2007 and by \$883,000 in fiscal 2007 from \$308,000 in fiscal 2006. Of the \$5.1 million increase in support revenue in fiscal 2008 compared to fiscal 2007, recognition of software support following our establishment of VSOE of fair value of PCS in the first quarter of fiscal 2008, an increase in our premium warranty, an increase in our extended warranty and an increase in our support renewals accounted for \$2.7 million, \$616,000, \$1.1 million and \$726,000, respectively. Of the \$883,000 increase in support revenue in fiscal 2007 compared to fiscal 2006, an increase in our premium warranty, an increase in our support renewals and an increase in our extended warranty accounted for \$394,000, \$379,000 and \$110,000, respectively.

In fiscal 2008 and 2007, we derived 73% of our total revenue from direct sales to customers, compared to 72% in fiscal 2006. We continued our focus on expanding our direct sales by hiring dedicated sales personnel for both domestic and international markets. We increased the number of our direct sales personnel to 140 at March 31, 2008 from 92 at March 31, 2007 and 56 at March 31, 2006. We generated 17% of our total revenue in fiscal 2008 from shipments to international locations compared to 10% in fiscal 2007 and 14% in fiscal 2006.

**Cost of Revenue and Gross Margin**

The following table presents period over period comparisons of our cost of revenue by cost of revenue source for the periods presented (dollars in thousands):

	Years Ended March 31,		Change in		Years Ended March 31,		Change in	
	2008	2007	\$	%	2007	2006	\$	%
Cost of product revenue	\$ 39,439	\$ 23,644	\$ 15,795	67%	\$ 23,644	\$ 15,617	\$ 8,027	51%
<i>As % of product revenue</i>	35%	36%			36%	41%		
Cost of support revenue	1,545	228	1,317	578%	228	104	124	119%
<i>As % of support revenue</i>	24%	19%			19%	34%		
<b>Total cost of revenue</b>	<b>40,984</b>	<b>23,872</b>	<b>17,112</b>	<b>72%</b>	<b>23,872</b>	<b>15,721</b>	<b>8,151</b>	<b>52%</b>
Gross profit	\$ 77,034	\$ 42,296	\$ 34,738	82%	\$ 42,296	\$ 22,463	\$ 19,833	88%
Gross margin	65%	64%			64%	59%		

Cost of revenue increased by \$17.1 million, or 72%, to \$41.0 million in fiscal 2008 from \$23.9 million in fiscal 2007 and by \$8.2 million in fiscal 2007, or 52%, from \$15.7 million in fiscal 2006 primarily due to increased product shipments.

Cost of product revenue increased by \$15.8 million, or 67%, to \$39.4 million in fiscal 2008 from \$23.6 million in fiscal 2007 and by \$8.0 million in fiscal 2007, or 51%, from \$15.6 million in fiscal 2006. During both fiscal 2008 and 2007, our product revenue increased by 72% from the respective prior fiscal year. The slower increase in cost of product revenue compared to the increase in product revenue in fiscal 2008 and 2007 is primarily attributable to our ability to spread relatively fixed manufacturing overhead costs over increased unit volumes. Additionally, in fiscal 2008 our cost of product revenue increased slower than our product revenue because we no longer accrue the software warranty cost as cost of product revenue as a result of the implementation of our software support model in March 2007. In fiscal 2007, we realized additional cost savings due to our engagement of a contract manufacturer in January 2006.

Cost of support revenue increased by \$1.3 million to \$1.5 million in fiscal 2008 from \$228,000 in fiscal 2007 and by \$124,000 in fiscal 2007 from \$104,000 in fiscal 2006. The cost of support revenue increased in fiscal 2008 as a result of the implementation of our software support model in March 2007. The increase in fiscal 2007 as compared to fiscal 2006 is due primarily to increased personnel cost and outside vendor cost required to support premium and extended warranties associated with increased revenue.

**Table of Contents**

Gross margin increased to 65% in fiscal 2008 from 64% during fiscal 2007 and 59% in fiscal 2006 primarily as a result of realization of manufacturing economies of scale. In addition, direct sales which have higher margins than indirect sales through resellers accounted for a higher percentage of our revenue in fiscal 2008 and 2007 when compared to fiscal 2006.

**Research and Development**

The following table presents period over period comparisons of our research and development expense for the periods presented (dollars in thousands):

	Years Ended March 31,		Change in		Years Ended March 31,		Change in	
	2008	2007	\$	%	2007	2006	\$	%
Research and development	\$ 34,071	\$ 24,519	\$ 9,552	39%	\$ 24,519	\$ 18,459	\$ 6,060	33%
As % of total revenue	29%	37%			37%	48%		

Our research and development expense increased by \$9.6 million, or 39%, to \$34.1 million in fiscal 2008 from \$24.5 million in fiscal 2007 and by \$6.1 million in fiscal 2007, or 33%, from \$18.5 million in fiscal 2006. The increases in fiscal 2008 and 2007 compared to the respective prior fiscal year were primarily due to an increase in research and development personnel to 169 employees at March 31, 2008 from 122 employees at March 31, 2007 and 92 at March 31, 2006 resulting in an increase in employee compensation and related costs including allocated corporate infrastructure costs. As a percentage of our total revenue, research and development expense decreased to 29% in fiscal 2008 from 37% in fiscal 2007 and 48% in fiscal 2006. These percentage decreases are attributable principally to the significant increase in our total revenue, which grew at a higher rate than our research and development expense.

Of the \$9.6 million increase in research and development expense in fiscal 2008 compared to fiscal 2007, salaries, bonus and employee-related benefits, allocated corporate infrastructure costs and stock-based compensation accounted for \$5.6 million, \$1.8 million and \$739,000, respectively. The remainder of the increase related to higher engineering prototype and equipment expenses in fiscal 2008 compared to fiscal 2007. Of the \$6.1 million increase in research and development expense in fiscal 2007 compared to fiscal 2006, salaries and employee-related benefits and expensed prototype equipment accounted for \$2.9 million and \$1.2 million, respectively. The remainder of the increase in fiscal 2007 was primarily attributable to higher depreciation of development equipment, consulting services and allocated facilities and infrastructure costs.

We expect research and development expense to increase on an absolute dollar basis for the foreseeable future as we increase the number of our engineering personnel and continue to devote substantial resources to the development of our products.

**Sales and Marketing**

The following table presents period over period comparisons of our sales and marketing expense for the periods presented (dollars in thousands):

	Years Ended March 31,		Change in		Years Ended March 31,		Change in	
	2008	2007	\$	%	2007	2006	\$	%
Sales and marketing	\$ 45,283	\$ 28,096	\$ 17,187	61%	\$ 28,096	\$ 16,602	\$ 11,494	69%
As % of total revenue	38%	42%			42%	43%		

Our sales and marketing expense increased by \$17.2 million, or 61%, to \$45.3 million in fiscal 2008 from \$28.1 million in fiscal 2007, and by \$11.5 million in fiscal 2007, or 69%, from \$16.6 million in fiscal 2006. These increases reflect in part the increase in sales and marketing personnel to 157 employees at March 31, 2008 from 101 employees at March 31, 2007 and 62 at March 31, 2006.

**Table of Contents**

As a percentage of our total revenue, sales and marketing expense decreased to 38% in fiscal 2008 and to 42% in fiscal 2007 from 43% in fiscal 2006. The percentage decrease between fiscal 2008, 2007 and 2006 is attributable principally to the significant increase in our total revenue, which grew at a higher rate than our sales and marketing expense.

Of the \$17.2 million increase in sales and marketing expense in fiscal 2008 compared to fiscal 2007, salaries and employee-related benefits, commission expense, travel and pre-sales customer support accounted for \$8.1 million, \$2.9 million, \$1.5 million and \$1.4 million, respectively. The remainder of the increase relates to higher advertising, professional services, stock-based compensation and recruiting fees in fiscal 2008 compared to fiscal 2007. Of the \$11.5 million increase in sales and marketing expense in fiscal 2007 compared to fiscal 2006, salaries and employee-related benefits, commission expense, professional services and travel expense accounted for \$6.4 million, \$2.2 million, \$1.3 million, \$519,000, respectively.

**General and Administrative**

The following table presents period over period comparisons of general and administrative expense for the periods presented (dollars in thousands):

	Years Ended March 31,		Change in		Years Ended March 31,		Change in	
	2008	2007	\$	%	2007	2006	\$	%
General and administrative	\$ 9,676	\$ 6,104	\$ 3,572	59%	\$ 6,104	\$ 3,390	\$ 2,714	80%
As % of total revenue	8%	9%			9%	9%		

Our general and administrative expense increased by \$3.6, or 59%, to \$9.7 million in fiscal 2008 from \$6.1 million in fiscal 2007, and by \$2.7 million in fiscal 2007, or 80%, from \$3.4 million in fiscal 2006. These increases reflect in part the increase in general and administrative personnel to 44 full-time employees at March 31, 2008 from 34 employees at March 31, 2007 and 17 employees at March 31, 2006.

As a percentage of our total revenue, general and administrative expense decreased to 8% in fiscal 2008 from 9% in fiscal 2007 and 2006 as a result of the significant increase in our total revenue, which grew at a higher rate than our general and administrative expense.

Of the \$3.6 million increase in general and administrative expense in fiscal 2008 compared to fiscal 2007, salaries, bonus and employee related benefits and professional services accounted for \$1.1 million and \$1.6 million, respectively. The remainder of the increase in general and administrative expense in fiscal 2008 related to higher bad debt expense, insurance and allocated infrastructure costs. Of the \$2.7 million increase from fiscal 2006 to fiscal 2007, salaries and employee-related benefits and professional services accounted for \$1.6 million and \$920,000, respectively.

**Other Income (Expense), net**

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

	Years Ended March 31		Change in		Years Ended March 31		Change in	
	2008	2007	\$	%	2007	2006	\$	%
Other income (expense), net:								
Interest income	\$ 2,878	\$ 1,767	\$ 1,111	63%	\$ 1,767	\$ 341	\$ 1,426	418%
Interest expense	(958)	(769)	(189)	25%	(769)	(606)	(163)	27%
Other, net	138	12	126	1,050%	12	24	(12)	50%
Total other income (expense), net:	\$ 2,058	\$ 1,010	\$ 1,048	104%	\$ 1,010	\$ (241)	\$ 1,251	519%

**Table of Contents**

Other income (expense), net increased by \$1.0 million, or 104%, to \$2.1 million in fiscal 2008 from \$1.0 million in fiscal 2007 and by \$1.3 million, or 519%, from \$(241,000) in fiscal 2006. The increases in other income (expense), net in fiscal 2008 and 2007 compared to the respective prior fiscal year relate to higher interest income due to higher average cash and investment balances in fiscal 2008 and 2007 partially offset with higher interest expense due to higher debt balances in fiscal 2008 and 2007.

**Quarterly Results of Operations (unaudited)**

The following table sets forth our unaudited quarterly consolidated statement of operations data for each of our eight fiscal quarters ended March 31, 2008. The quarterly data have been prepared on the same basis as the audited consolidated financial statements included in this report, and reflect all necessary adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of this data. Our results of these quarterly periods are not necessarily indicative of the results of operations for a full year or any future period.

**Fiscal 2008:**

	March 31, 2008	Three Months Ended		
		December 31, 2007	September 30, 2007	June 30, 2007
(in thousands, except per share amounts)				
<b>Revenue:</b>				
Product	\$ 32,824	\$ 28,961	\$ 26,775	\$ 23,123
Support	2,643	1,801	1,206	685
Total revenue	35,467	30,762	27,981	23,808
<b>Cost of revenue:</b>				
Product	11,802	10,401	9,126	8,110
Support	746	344	239	216
Total cost of revenue	12,548	10,745	9,365	8,326
Gross profit	22,919	20,017	18,616	15,482
Gross margin	65%	65%	66%	65%
<b>Operating expenses:</b>				
Research and development	9,035	8,320	8,909	7,807
Sales and marketing	13,128	11,762	9,936	10,457
General and administrative	3,126	2,284	2,212	2,054
Total operating expenses	25,289	22,366	21,057	20,318
Loss from operations	(2,370)	(2,349)	(2,441)	(4,836)
Other income (expense), net	1,250	510	116	182
Loss before provision for income taxes	(1,120)	(1,839)	(2,325)	(4,654)
Provision for income taxes	(52)	(38)	(38)	(30)
Net loss	\$ (1,172)	\$ (1,877)	\$ (2,363)	\$ (4,684)
Net loss per common share, basic and diluted	\$ (0.02)	\$ (0.05)	\$ (0.13)	\$ (0.25)

**Table of Contents****Fiscal 2007:**

	March 31, 2007	Three Months Ended		
		December 31, 2006	September 30, 2006	June 30, 2006
		(in thousands, except per share amounts)		
<b>Revenue:</b>				
Product	\$ 11,268	\$ 19,969	\$ 18,992	\$ 14,748
Support	388	422	222	159
Total revenue	11,656	20,391	19,214	14,907
<b>Cost of revenue:</b>				
Product	4,480	6,322	7,501	5,341
Support	83	60	45	40
Total cost of revenue	4,563	6,382	7,546	5,381
Gross profit	7,093	14,009	11,668	9,526
Gross margin	61%	69%	61%	64%
<b>Operating expenses:</b>				
Research and development	8,244	6,074	5,233	4,968
Sales and marketing	8,883	6,637	6,767	5,809
General and administrative	1,880	1,597	1,395	1,232
Total operating expenses	19,007	14,308	13,395	12,009
Loss from operations	(11,914)	(299)	(1,727)	(2,483)
Other income (expense), net	243	274	229	264
Loss before provision for income taxes	(11,671)	(25)	(1,498)	(2,219)
Provision for income taxes	(22)	(20)	(11)	(19)
Net loss	\$ (11,693)	\$ (45)	\$ (1,509)	\$ (2,238)
Net loss per common share, basic and diluted	\$ (0.65)	\$ (0.00)	\$ (0.09)	\$ (0.13)

**Liquidity and Capital Resources**

The following table summarizes our cash, cash equivalents and short-term investments for the periods presented (in thousands):

	March 31,		Increase
	2008	2007	
Cash and cash equivalents	\$ 97,585	\$ 16,722	\$ 80,863
Short-term investments	18,058	17,988	70
Total	\$ 115,643	\$ 34,710	\$ 80,933

Our cash equivalents and short-term investments are invested primarily in money market funds, short-term United States Government and agency obligations, municipal bonds, 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

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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.

**Table of Contents**

We have a term loan agreement with a venture lending firm. Borrowings under the term loan agreement were available through March 31, 2006. In addition, prior to the expiration of our \$12.0 million revolving line of credit on May 30, 2008, we entered into an amended and restated loan and security agreement with a commercial bank. The amended agreement provides for a revolving line of credit, under which the aggregate amount available for borrowing is \$15.0 million. The borrowings are secured by all of our assets with the exception of intellectual property. Our new revolving line of credit agreement expires on May 29, 2009 and it contains a financial covenant that requires us to maintain a minimum tangible net worth of \$70.0 million, which is increased by 50% of any new net equity proceeds and/or 50% of quarterly profits. 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, we are required to maintain a quick ratio of at least 1.25 to 1.0. 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 in effect at the time of the borrowing. As of March 31, 2008, we had \$883,000 outstanding for notes payable under our term loan agreement and \$4.0 million under our revolving line of credit, which we repaid in full in April 2008. There have been no borrowings under the new revolving line of credit.

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

	Years Ended March 31,		
	2008	2007	2006
Net cash used in operating activities	\$ (2,965)	\$ (2,380)	\$ (13,799)
Net cash provided by (used in) investing activities	(10,440)	(15,312)	6,288
Net cash provided by financing activities	94,268	4,765	31,600
<b><i>Cash Flows from Operating Activities</i></b>			

We continue to experience negative cash flows from operations as we expand our business and build our infrastructure domestically and internationally. 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 and 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.

Net cash used in operating activities was \$3.0 million, \$2.4 million and \$13.8 million in fiscal 2008, 2007 and 2006, respectively. The \$585,000 increase in net cash used in operating activities in fiscal 2008 from fiscal 2007 was primarily attributable to an \$8.7 million increase in our accounts receivable balance due to higher sales along with \$566,000 used in other operating assets and liabilities offset by a reduction in our net loss of \$5.4 million and a \$3.3 million increase in our non-cash expenses relating to depreciation and amortization, bad debt expense and stock-based compensation expense in fiscal 2008 compared to fiscal 2007. The decrease in our net loss reflects our increased customer penetration and the expansion of our customer base resulting in higher revenue, which grew at a faster rate than expenses.

The \$11.4 million decrease in net cash used in operating activities in fiscal 2007 from fiscal 2006 was primarily attributable to changes in working capital. Within changes in assets and liabilities, changes in accounts receivable used \$7.1 million in cash in fiscal 2007 compared to \$9.2 million in fiscal 2006 because of improved collections in fiscal 2007, demonstrated by the decrease in accounts receivable from fiscal 2006 to fiscal 2007 compared to the increase in revenue over the same period. Changes in inventory used \$7.2 million in cash in fiscal 2007 compared to \$24,000 in fiscal 2006 primarily as a result of the growth of our business and, to a lesser extent, purchases of certain inventory due to end-of-life and RoHS requirements. Changes in accounts payable provided \$4.5 million in cash in fiscal 2007 compared to \$1.1 million in fiscal 2006 due to the timing of

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**Table of Contents**

payments. Changes in accrued liabilities provided \$5.6 million in cash in fiscal 2007 compared to \$2.0 million in fiscal 2006, primarily due to a \$1.8 million accrual for our fiscal 2007 cash bonus plan, which was the first year in which we had a cash bonus plan, and increased accrual of sales commissions. Changes in deferred revenue provided \$14.6 million in cash in fiscal 2007 compared to \$3.9 million in fiscal 2006, primarily due to the significant deferral of revenue in the fourth quarter of fiscal 2007 arising from the implementation of our software support model in March 2007. These changes in deferred revenue were offset in part by an increase in related deferred costs of \$2.8 million, \$1.5 million of which was attributable to the implementation of our software support model in March 2007. See Revenue Recognition under Critical Accounting Policies and Estimates above.

***Cash Flows from Investing Activities***

Cash flows from investing activities primarily relate to capital expenditures to support our growth and investments of our available cash and cash equivalent balances. Net cash used in investing activities was \$10.4 million and \$15.3 million in fiscal 2008 and 2007, respectively. Net cash provided by investing activities was \$6.3 million in fiscal 2006.

The \$4.9 million decrease in net cash used in investing activities in fiscal 2008 from fiscal 2007 was primarily attributable to an increase in the sale and maturity of short-term investments of \$22.0 million offset by an \$11.5 million increase in purchases of short-term investments and a \$5.9 million increase in capital expenditures. The increase in capital expenditure during fiscal 2008 was due to purchases of new test equipment to support our next generation of products and purchases related to the continual build out of our infrastructure and expansion of premises to support our growth and the increase in our headcount. The \$21.6 million increase in cash used in investing activities in fiscal 2007 from fiscal 2006 was primarily attributable to the investment of available cash in higher yielding short-term investments and the purchase of property and equipment, which included InServ Storage servers for our own use and as test equipment.

We expect that in fiscal 2009 we will continue to invest in our infrastructure and in test equipment to support our growth and research and development efforts.

***Cash Flows from Financing Activities***

Prior to our IPO in November 2007, we financed our operations primarily with net proceeds from private sales of convertible preferred stock totaling \$183 million and borrowings under various debt arrangements with aggregate proceeds of \$14.7 million, including the \$4.9 million outstanding at March 31, 2008.

Net cash provided by financing activities in fiscal 2008, 2007 and 2006 was \$94.3 million, \$4.8 million and \$31.6 million, respectively. The increase in cash provided by financing activities in fiscal 2008 consisted principally of the net proceeds of our IPO of approximately \$97.4 million, offset in part by \$5.8 million higher repayments on the line of credit and notes payable. The \$26.8 million decrease in cash provided by financing activities in fiscal 2007 compared to fiscal 2006 primarily relates to the issuance of preferred stock in fiscal 2006.

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.



**Table of Contents****Contractual Obligations**

The following table summarizes our contractual obligations as of March 31, 2008 (in thousands):

	Total	Payments due by period			
		Less than 1 Year	1 to 3 Years	3 to 5 Years	More than 5 Years
Operating lease obligations	9,733	1,846	3,550	2,972	1,365
Non-cancellable inventory purchase commitments	13,567	13,567			
<b>Total</b>	<b>\$ 23,300</b>	<b>\$ 15,413</b>	<b>\$ 3,550</b>	<b>\$ 2,972</b>	<b>\$ 1,365</b>

As of March 31, 2008, our unrecognized tax benefits amounted to \$2,892,000 of which the timing of the resolution is uncertain; therefore, there are no amounts presented in the above table.

We lease office space under non-cancelable operating leases with various expiration dates through May 2014. In April 2005, our primary facilities lease was renegotiated with a new lease expiration date in May 2014 with 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 we elect to terminate the lease in 2010, we will be required to pay an early termination fee of approximately \$1.0 million. We currently have no plans to exercise the early termination option.

We outsource the production of our hardware to third-party contract manufacturers. In addition, we enter into various inventory related purchase commitments with these contract manufacturers and suppliers. Generally these inventory purchase commitments are non-cancelable.

**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 March 31, 2008, we believe that our exposure related to these guarantees and indemnities as of March 31, 2008 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 agreement.

**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 Consolidated Financial Statements for recent accounting pronouncements that could have an effect on us.

**Table of Contents****ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK*****Foreign Currency Risk***

Most of our sales contracts have been denominated in United States dollars, and therefore, our revenue historically has not been subject to foreign currency risk. 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 exchange rates. Our international sales and marketing operations incur expenses that are denominated in foreign currencies. These expenses could be materially affected by currency fluctuations. Our exposures are to fluctuations in exchange rates for the United States Dollar versus the British Pound, the Euro, the Swiss Franc, the Japanese Yen and, to a lesser extent, the Korean Won and the Chinese Yuan.

Changes in currency exchange rates could adversely affect our consolidated operating results or financial position. Additionally, our international sales and marketing operations maintain cash balances denominated in foreign currencies. In order to decrease the inherent risk associated with translation of foreign cash balances into our reporting currency, we have not maintained excess cash balances in foreign currencies. We have not hedged our exposure to changes in foreign currency exchange rates because expenses in foreign currencies have been insignificant to date, and exchange rate fluctuations have had little impact on our operating results and cash flows.

***Interest Rate Sensitivity***

We had cash and cash equivalents totaling \$97.6 million at March 31, 2008. These amounts were invested primarily in money market funds, municipal bonds and commercial paper. We believe that our cash and 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 and cash equivalents. Declines in interest rates, however, would reduce future interest income. Based on our cash and cash equivalents at March 31, 2008, a hypothetical 100 basis points decline in interest rates would reduce our interest income by approximately \$1.0 million.

Short-term investments consist of United States Government and agency obligations, municipal bonds, 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 and cash equivalents, held at March 31, 2008 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	
	100 BPS	50 BPS		100 BPS	50 BPS
	United States Government and agency securities	\$ 7,671		\$ 7,592	\$ 7,513
Municipal bonds	5,218	5,194	5,171	5,121	5,146
Commercial paper	4,578	4,572	4,567	4,557	4,562
Corporate debt securities	808	808	807	806	807
<b>Total short-term investments</b>	<b>\$ 18,275</b>	<b>\$ 18,166</b>	<b>\$ 18,058</b>	<b>\$ 17,841</b>	<b>\$ 17,950</b>

**Table of Contents**

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	
	100 BPS	50 BPS		100 BPS	50 BPS
United States Government and agency securities	\$ 7,828	\$ 7,671	\$ 7,513	\$ 7,200	\$ 7,357
Municipal bonds	5,267	5,218	5,171	5,073	5,121
Commercial paper	4,588	4,578	4,567	4,547	4,557
Corporate debt securities	809	808	807	805	806
<b>Total short-term investments</b>	<b>\$ 18,492</b>	<b>\$ 18,275</b>	<b>18,058</b>	<b>\$ 17,625</b>	<b>\$ 17,841</b>

At March 31, 2008, we had \$4.0 million outstanding under our revolving line of credit, which we repaid in full in April 2008 prior to the expiration of the credit facility on May 30, 2008. At March 31, 2008, we also had \$883,000 in outstanding principal under our subordinated term loan agreement, which bears interest at the three year Treasury Note rate plus applicable margins, which were fixed at the time of advance. Because of the fixed nature of our interest payments on the outstanding principal under our subordinated term loan agreement, we do not have rising interest rate exposure to our existing obligations. However, we could be exposed to increased interest rate risk if we make any borrowings under our new revolving line of credit, which we entered into on May 30, 2008. The new revolving line of credit bears interest, at the election of the borrower, at either the lender's variable prime rate or LIBOR plus 200 basis points for the applicable period in effect at the time of the borrowing.

**Table of Contents**

**ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**  
**INDEX TO CONSOLIDATED FINANCIAL STATEMENTS**

The following financial statements are filed as part of this Annual Report

<u>Report of Independent Registered Public Accounting Firm</u>	59
<u>Consolidated Balance Sheets</u>	60
<u>Consolidated Statements of Operations</u>	61
<u>Consolidated Statements of Redeemable Convertible Preferred Stock and Stockholders' Equity (Deficit)</u>	62
<u>Consolidated Statements of Cash Flows</u>	64
<u>Notes to Consolidated Financial Statements</u>	65

**Table of Contents**

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Stockholders of

3PAR Inc.

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations, redeemable convertible preferred stock and stockholders' equity (deficit), and cash flows present fairly, in all material respects, the financial position of 3PAR Inc. and its subsidiaries at March 31, 2008 and 2007, and the results of their operations and their cash flows for each of the three years in the period ended March 31, 2008, in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule appearing under Item 15(a)(2) presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 1 to the consolidated financial statements, the Company adopted Statement of Financial Accounting Standards No. 123(R), Share-Based Payment as of April 1, 2006 and changed the manner in which it accounts for share-based compensation in fiscal 2007.

As discussed in Note 1 to the consolidated financial statements, the Company adopted FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109 as of April 1, 2008 and changed the manner in which it accounted for uncertain tax positions in fiscal 2008.

/s/ PricewaterhouseCoopers LLP

San Jose, California

June 12, 2008

**Table of Contents****3PAR Inc.****CONSOLIDATED BALANCE SHEETS**

(in thousands, except share data)

	March 31,	
	2008	2007
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 97,585	\$ 16,722
Short-term investments	18,058	17,988
Accounts receivable, net	34,596	19,037
Inventory	18,057	13,507
Deferred cost	4,273	3,012
Prepaid and other current assets	2,077	1,203
<b>Total current assets</b>	<b>174,646</b>	<b>71,469</b>
Property and equipment, net	14,781	5,988
Deferred cost, non-current	251	747
Other non-current assets	156	357
<b>Total assets</b>	<b>\$ 189,834</b>	<b>\$ 78,561</b>
<b>LIABILITIES, REDEEMABLE CONVERTIBLE PREFERRED STOCK AND STOCKHOLDERS EQUITY (DEFICIT)</b>		
Current liabilities:		
Line of credit	\$ 4,000	\$ 5,830
Accounts payable	12,527	7,957
Accrued liabilities	16,671	11,494
Deferred revenue	26,051	15,018
Accrued warranty	3,371	3,212
Current portion of notes payable	883	1,602
<b>Total current liabilities</b>	<b>63,503</b>	<b>45,113</b>
Long-term portion of notes payable		860
Accrued warranty, non-current	2,813	2,336
Deferred revenue, non-current	5,945	4,184
Other long-term liabilities	1,173	995
<b>Total liabilities</b>	<b>73,434</b>	<b>53,488</b>
Commitments and contingencies (Note 11)		
Redeemable convertible preferred stock, \$0.001 par value; none and 66,513,511 shares authorized at March 31, 2008 and 2007, respectively; none and 33,256,720 issued and outstanding at March 31, 2008 and 2007, respectively; liquidation preference: none and \$94,343 at March 31, 2008 and 2007, respectively		94,343
Stockholders' equity (deficit):		
Preferred stock, \$0.001 par value; 20,000,000 shares and none authorized at March 31, 2008 and 2007, respectively; No shares issued and outstanding at March 31, 2008 and 2007		
Common stock, \$0.001 par value; 300,000,000 and 163,000,000 shares authorized at March 31, 2008 and 2007, respectively; 60,539,612 and 19,212,596 issued and outstanding at March 31, 2008 and 2007, respectively	61	19
Additional paid-in capital	290,558	95,474

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Stockholders' notes receivable	(36)	(48)
Deferred stock-based compensation	(186)	(839)
Accumulated other comprehensive income (loss)	(15)	10
Accumulated deficit	(173,982)	(163,886)
Total stockholders' equity (deficit)	116,400	(69,270)
Total liabilities, redeemable convertible preferred stock and stockholders' equity (deficit)	\$ 189,834	\$ 78,561

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

**Table of Contents****3PAR Inc.****CONSOLIDATED STATEMENTS OF OPERATIONS**

(in thousands, except per share amounts)

	Years Ended March 31,		
	2008	2007	2006
<b>Revenue:</b>			
Product	\$ 111,683	\$ 64,977	\$ 37,876
Support	6,335	1,191	308
<b>Total revenue</b>	<b>118,018</b>	<b>66,168</b>	<b>38,184</b>
<b>Cost of revenue:</b>			
Product	39,439	23,644	15,617
Support	1,545	228	104
<b>Total cost of revenue (1)</b>	<b>40,984</b>	<b>23,872</b>	<b>15,721</b>
<b>Gross profit</b>	<b>77,034</b>	<b>42,296</b>	<b>22,463</b>
<b>Operating expenses:</b>			
Research and development (1)	34,071	24,519	18,459
Sales and marketing (1)	45,283	28,096	16,602
General and administrative (1)	9,676	6,104	3,390
<b>Total operating expenses</b>	<b>89,030</b>	<b>58,719</b>	<b>38,451</b>
<b>Loss from operations</b>	<b>(11,996)</b>	<b>(16,423)</b>	<b>(15,988)</b>
<b>Other income (expense), net:</b>			
Interest income	2,878	1,767	341
Interest expense	(958)	(769)	(606)
Other, net	138	12	24
<b>Total other income (expense), net</b>	<b>2,058</b>	<b>1,010</b>	<b>(241)</b>
<b>Loss before provision for income taxes</b>	<b>(9,938)</b>	<b>(15,413)</b>	<b>(16,229)</b>
<b>Provision for income taxes</b>	<b>(158)</b>	<b>(72)</b>	<b>(23)</b>
<b>Net loss</b>	<b>\$ (10,096)</b>	<b>\$ (15,485)</b>	<b>\$ (16,252)</b>
<b>Net loss per common share, basic and diluted</b>	<b>(\$0.30)</b>	<b>(\$0.87)</b>	<b>(\$1.01)</b>
<b>Shares used to compute basic and diluted net loss per common share</b>	<b>34,141</b>	<b>17,746</b>	<b>16,101</b>
(1) Includes stock-based compensation as follows:			
Cost of revenue	\$ 188	\$ 160	\$ 96
Research and development	1,262	591	692
Sales and marketing	1,397	439	403
General and administrative	777	577	730



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

**Table of Contents****3PAR Inc.****CONSOLIDATED STATEMENT OF REDEEMABLE CONVERTIBLE PREFERRED STOCK AND STOCKHOLDERS' EQUITY (DEFICIT)**

(in thousands)

	Redeemable Convertible Preferred Stock		Common Stock		Accumulated Other Comprehensive Income		Deferred Stock-based Compensation	Accumulated Deficit	Total	
	Shares	Amount	Shares	Amount	Paid-in Capital	(Loss) Notes Receivable				
Balance at March 31, 2005	28,336	\$ 64,435	18,805	\$ 19	\$ 92,110	\$ (160)	\$ (48)	\$ (1,528)	\$ (132,149)	\$ (41,756)
Issuance of Series C-1 preferred stock, net of issuance cost of \$92	4,921	29,908								
Exercise of stock options			169		64					64
Repurchase of common stock			(61)		(1)					(1)
Issuance of warrants					189					189
Deferred compensation related to issuance of common stock options					2,523			(2,523)		
Amortization of deferred stock-based compensation								1,921		1,921
Comprehensive loss:										
Unrealized gain on available-for-sale investments								148		148
Net loss									(16,252)	(16,252)
Total comprehensive loss										(16,104)
Balance at March 31, 2006	33,257	94,343	18,913	19	94,885	(12)	(48)	(2,130)	(148,401)	(55,687)
Exercise of stock options			319		118					118
Repurchase of common stock			(20)		(5)					(5)
Stock-based compensation expense					476					476
Amortization of deferred stock-based compensation								1,291		1,291
Comprehensive loss:										
Unrealized gain on available-for-sale investments								22		22
Net loss									(15,485)	(15,485)
Total comprehensive loss										(15,463)
Balance at March 31, 2007	33,257	94,343	19,212	19	95,474	10	(48)	(839)	(163,886)	(69,270)

**Table of Contents****3PAR Inc.****CONSOLIDATED STATEMENT OF REDEEMABLE CONVERTIBLE PREFERRED STOCK AND STOCKHOLDERS' EQUITY (DEFICIT) (Continued)**

(in thousands)

	Redeemable Convertible Preferred Stock		Common Stock		Accumulated Other Comprehensive Income		Deferred Stock-based Compensation		Accumulated Deficit	Total
	Shares	Amount	Shares	Amount	Paid-in Capital	(Loss) Notes Receivable				
Balance at March 31, 2007	33,257	94,343	19,212	19	95,474	10	(48)	(839)	(163,886)	(69,270)
Exercise of stock options			171	1	419					420
Repurchase of common stock			(17)		(11)					(11)
Stock-based compensation expense					3,055					3,055
Amortization of deferred stock-based compensation								557		557
Reversal of deferred stock-based compensation related to cancellations					(96)			96		
Forgiveness of shareholder note receivable							12			12
Proceeds from initial public offering of common stock, net of issuance costs of \$2,871			7,702	8	97,407					97,415
Exercise of warrants, net			214							
Conversion of redeemable convertible preferred stock into common stock upon completion of initial public offering	(33,257)	(94,343)	33,257	33	94,310					94,343
Comprehensive loss:										
Unrealized loss on available-for-sale investments						(25)				(25)
Net loss									(10,096)	(10,096)
Total comprehensive loss										(10,121)
Balance at March 31, 2008		\$	60,539	\$ 61	\$ 290,558	\$ (15)	\$ (36)	\$ (186)	\$ (173,982)	\$ 116,400

The accompanying notes are integral part of these consolidated financial statements

**Table of Contents****3PAR Inc.****CONSOLIDATED STATEMENTS OF CASH FLOWS**

(in thousands)

	Years Ended March 31,		
	2008	2007	2006
Cash flows from operating activities:			
Net loss	\$ (10,096)	\$ (15,485)	\$ (16,252)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization	3,332	2,177	1,670
Stock-based compensation expense	3,624	1,767	1,921
Gain on disposal of fixed assets			(11)
Non-cash interest expense	59	76	85
Amortization of premium (accretion of purchase discounts) on short-term investments, net	(529)	(329)	120
Provision for doubtful accounts	313	128	
Write down for excess and obsolete inventory	582	528	93
Loss contingency for purchase commitments	295		
Changes in assets and liabilities:			
Accounts receivable	(15,872)	(7,135)	(9,160)
Inventory	(5,132)	(7,232)	(24)
Deferred cost	(765)	(2,754)	(768)
Prepaid expenses and other current assets	(874)	(786)	(74)
Other non-current assets	(132)	(3)	136
Accounts payable	3,651	4,541	1,124
Accrued liabilities	4,971	5,586	2,023
Deferred revenue	12,794	14,623	3,850
Accrued warranty	636	1,516	897
Other long-term liabilities	178	402	571
<b>Net cash used in operating activities</b>	<b>(2,965)</b>	<b>(2,380)</b>	<b>(13,799)</b>
Cash flows from investing activities:			
Proceeds from maturities of short-term investments	44,133	23,862	14,039
Proceeds from sales of short-term investments	1,688		
Purchases of short-term investments	(45,387)	(33,875)	(6,600)
Purchase of property and equipment	(11,207)	(5,305)	(1,485)
Proceeds from disposal of property and equipment			34
Restricted cash	333	6	300
<b>Net cash provided by (used in) investing activities</b>	<b>(10,440)</b>	<b>(15,312)</b>	<b>6,288</b>
Cash flows from financing activities:			
Proceeds from issuance of common stock, net of issuance costs	97,415		
Proceeds from exercise of options and warrants	332	433	64
Repurchase of shares of unvested common stock	(11)	(5)	(1)
Proceeds from issuance of redeemable convertible preferred stock, net of issuance costs			29,908
Proceeds from line of credit	6,500	8,500	2,400
Repayments on line of credit	(8,330)	(2,670)	(2,400)
Proceeds from notes payable			4,700
Repayment of notes payable	(1,638)	(1,493)	(3,071)
<b>Net cash provided by financing activities</b>	<b>94,268</b>	<b>4,765</b>	<b>31,600</b>

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Net change in cash and cash equivalents	80,863	(12,927)	24,089
Cash and cash equivalents, beginning of period	16,722	29,649	5,560
Cash and cash equivalents, end of period	\$ 97,585	\$ 16,722	\$ 29,649

**Supplemental disclosures of cash flow information**

Cash paid for income taxes	\$ 65	\$ 14	\$ 5
Cash paid for interest	\$ 906	\$ 648	\$ 521

**Supplemental disclosure of non-cash activities:**

Conversion of redeemable convertible preferred stock to common stock	\$ 94,343	\$	\$
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The accompanying notes are integral part of these consolidated financial statements

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**Table of Contents**

**3PAR Inc.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**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 large to medium enterprises, business-oriented 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 2008, for example, refer to the fiscal year ending March 31, 2008.

***Initial Public Offering***

In November 2007, the Company completed an initial public offering (IPO) of its common stock in which it sold and issued 7,702,479 shares of common stock, including 202,479 shares issued in December 2007 in connection with the partial exercise of the underwriters' over-allotment option, at an issue price of \$14.00 per share. A total of \$107.8 million in gross proceeds was raised from the IPO, or approximately \$97.4 million in net proceeds after deducting underwriting discounts and commissions of \$7.5 million and other offering costs of \$2.9 million. Upon the closing of the offering, all shares of the Company's then-outstanding convertible preferred stock automatically converted into 33,256,720 shares of common stock.

***Summary of Significant Accounting Policies***

***Basis of Presentation***

During the three months ended December 31, 2007, the Company determined that expenses related to sales commissions were not being recognized correctly. During the third fiscal quarter of 2008, the Company corrected the error resulting in additional sales commission expense of \$130,000 within sales and marketing expense and an increase in accrued compensation of \$130,000. The Company concluded that the error was not material to the prior fiscal years nor was it material to the three and nine months ended December 31, 2007; therefore, the correction was recorded in the third fiscal quarter of 2008.

***Principles of Consolidation***

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

***Use of Estimates***

The preparation of these financial statements requires that the Company make estimates and judgments that affect the reported amounts of assets, liabilities, revenues, expenses and related disclosures of contingent assets and liabilities. On an on-going basis, the Company evaluates its estimates, including those related to revenue recognition, provisions for doubtful accounts and product warranties, valuation of inventory, useful lives of property and equipment, obligation for income taxes, the measurement of stock-based compensation and contingencies, among others. The Company bases its estimates on historical experience and on various other

assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for



**Table of Contents****3PAR Inc.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results could differ significantly from the estimates made by management with respect to these and other items.

*Foreign Currency Accounting*

While the majority of the Company's contracts are denominated in United States dollars, the Company has sales and operating expenses in various foreign currencies. The functional currency of the Company's subsidiaries in the United Kingdom, Germany and Japan is the United States dollar. Monetary assets and liabilities maintained in currencies other than the United States dollar are remeasured using the current exchange rate at the balance sheet date. Nonmonetary assets and liabilities and capital accounts are remeasured using historical exchange rates. Revenues and expenses are remeasured using the average exchange rates in effect during the period. Foreign currency remeasurement gains and losses and gains and losses on non United States dollar denominated transactions, all of which have not been significant to date, are included in the consolidated statements of operations.

*Risks and Uncertainties*

The Company is subject to all of the risks inherent in an early stage business operating in the information storage industry. These risks include, but are not limited to, a limited operating history, new and rapidly evos, of which \$1.7 million were classified as nonperforming TDRs and \$4.7 million were classified as performing TDRs at December 31, 2017. Both performing and nonperforming TDRs are considered impaired loans. When an individual loan is determined to be a TDR, the amount of impairment is based upon the present value of expected future cash flows discounted at the loan's effective interest rate or the fair value of the underlying collateral less applicable selling costs. The net decrease in total TDRs from December 31, 2017 to March 31, 2018 was primarily due to one TDR totaling \$48,000 that went to foreclosure and \$95,000 of payments on TDR's received.

**Allowance for Loan Losses and Provision***Allowance for Loan Losses*

The following table is a summary of the allocation of the allowance for loan losses:

(In thousands)	March 31, 2018	December 31, 2017
Allocation of allowance for loan losses at end of period:		
Commercial, financial, and agricultural	\$ 3,261	\$ 3,325
Real estate construction - residential	240	170
Real estate construction - commercial	895	807
Real estate mortgage - residential	2,057	1,689
Real estate mortgage - commercial	4,008	4,437
Installment and other consumer	352	345



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Unallocated	134	79
Total	\$ 10,947	\$ 10,852

The allowance for loan losses (ALL) was \$10.9 million, or 1.01%, of loans outstanding at March 31, 2018 compared to \$10.9 million, or 1.02%, at December 31, 2017, and \$10.3 million, or 1.02%, of loans outstanding at March 31, 2017. The ratio of the allowance for loan losses to nonperforming loans, excluding performing TDR's, was 198.32% at March 31, 2018, compared to 180.87% at December 31, 2017.

The following table is a summary of the general and specific allocations of the allowance for loan losses:

(In thousands)	March 31, 2018	December 31, 2017
Allocation of allowance for loan losses:		
Individually evaluated for impairment - specific reserves	\$ 1,336	\$ 1,333
Collectively evaluated for impairment - general reserves	9,611	9,519
Total	\$ 10,947	\$ 10,852

The *specific reserve component* applies to loans evaluated individually for impairment. The net carrying value of impaired loans is generally based on the fair values of collateral obtained through independent appraisals and/or internal evaluations, or by discounting the total expected future cash flows. Once the impairment amount is calculated, a specific reserve allocation is recorded. At March 31, 2018, \$1.3 million of the Company's ALL was allocated to impaired loans totaling approximately \$10.1 million compared to \$1.3 million of the Company's ALL allocated to impaired loans totaling approximately \$10.4 million at December 31, 2017. Management determined that \$2.0 million, or 20%, of total impaired loans required no reserve allocation at March 31, 2018 compared to \$2.4 million, or 23%, at December 31, 2017 primarily due to adequate collateral values, acceptable payment history and adequate cash flow ability.

The *incurred loss component* of the general reserve, or loans collectively evaluated for impairment, is determined by applying loss rates to pools of loans by asset type. Loans not individually evaluated are aggregated by risk characteristics and reserves are recorded using a consistent methodology that considers historical loan loss experience by loan type. Beginning in the first quarter of 2016, the Company began to lengthen its look-back period with the intent to increase such period from three to five years by December 31, 2017. The Company believes that the five-year look-back period, which is consistent with the Company's practices prior to the start of the economic recession in 2008, provides a representative historical loss period in the current economic environment. These historical loss rates for each risk group are used as the starting point to determine loss rates for measurement purposes. The historical loan loss rates are multiplied by loss emergence periods (LEP) which represent the estimated time period between a borrower first experiencing financial difficulty and the recognition of a loss.

The Company's methodology includes qualitative risk factors that allow management to adjust its estimates of losses based on the most recent information available and to address other limitations in the quantitative component that is based on historical loss rates. Such risk factors are generally reviewed and updated quarterly, as appropriate, and are adjusted to reflect changes in national and local economic conditions and developments, the nature, volume and terms of loans in the portfolio, including changes in volume and severity of past due loans, the volume of nonaccrual loans, and the volume and severity of adversely classified or graded loans, loan concentrations, assessment of trends in collateral values, assessment of changes in the quality of the Company's internal loan review department, and changes in lending policies and procedures, including underwriting standards and collections, charge-off and recovery practices.

The specific and general reserve allocations represent management's best estimate of probable losses inherent in the loan portfolio at the evaluation date. Although the allowance for loan losses is comprised of specific and general allocations, the entire allowance is available to absorb any credit losses.

*Provision*

A \$300,000 provision was required for the three months ended March 31, 2018 compared to a \$350,000 provision for the three months ended March 31, 2017. The decrease was primarily due to loan growth slowing during the current quarter compared to the quarter ended March 31, 2017.

The following table summarizes loan loss experience for the periods indicated:

(In thousands)	Three Months Ended	
	March 31,	
	2018	2017
Analysis of allowance for loan losses:		
Balance beginning of period	\$ 10,852	\$ 9,886
Charge-offs:		
Commercial, financial, and agricultural	110	28
Real estate construction - residential	48	-
Real estate construction - commercial	30	-
Real estate mortgage - residential	20	20
Real estate mortgage - commercial	14	14
Installment and other consumer	57	51
Total charge-offs	279	113
Recoveries:		
Commercial, financial, and agricultural	\$ 13	\$ 19
Real estate construction - residential	12	50
Real estate mortgage - residential	19	36
Real estate mortgage - commercial	6	7
Installment and other consumer	24	27
Total recoveries	74	139
Net charge-offs (recoveries)	205	(26 )
Provision for loan losses	300	350
Balance end of period	\$ 10,947	\$ 10,262

*Net Loan Charge-offs (Recoveries)*

The Company's net loan charge-offs were \$205,000, or 0.02%, of average loans for the three months ended March 31, 2018, compared to net loan recoveries of \$26,000, or 0.00%, of average loans for the three months ended March 31, 2017. The increase in charge-offs quarter over quarter primarily related to one commercial loan relationship and two real estate construction loans.

***Liquidity and Capital Resources***

**Liquidity Management**

The role of liquidity management is to ensure funds are available to meet depositors' withdrawal and borrowers' credit demands while at the same time maximizing profitability. This is accomplished by balancing changes in demand for funds with changes in the supply of those funds. Liquidity to meet the demands is provided by maturing assets, short-term liquid assets that can be converted to cash and the ability to attract funds from external sources, principally depositors. Due to the nature of services offered by the Company, management prefers to focus on transaction accounts and full service relationships with customers.

The Company's Asset/Liability Committee (ALCO), primarily made up of senior management, has direct oversight responsibility for the Company's liquidity position and profile. A combination of daily, weekly, and monthly reports provided to management detail the following: internal liquidity metrics, composition and level of the liquid asset portfolio, timing differences in short-term cash flow obligations, available pricing and market access to the financial markets for capital, and exposure to contingent draws on the Company's liquidity.

The Company has a number of sources of funds to meet liquidity needs on a daily basis. The Company's most liquid assets are comprised of available for sale investment securities, federal funds sold, and excess reserves held at the Federal Reserve.

(In thousands)	March 31, 2018	December 31, 2017
Federal funds sold and other overnight interest-bearing deposits	\$ 65,449	\$ 39,553
Certificates of deposit in other banks	4,812	3,460
Available-for-sale investment securities	215,720	226,542
Total	\$ 285,981	\$ 269,555

Federal funds sold and resale agreements normally have overnight maturities and are used for general daily liquidity purposes. The fair value of the available-for-sale investment portfolio was \$215.7 million at March 31, 2018 and included an unrealized net loss of \$5.3 million. The portfolio includes projected maturities and mortgage backed securities pay-downs of approximately \$10.1 million over the next twelve months, which offer resources to meet either new loan demand or reductions in the Company's deposit base.

The Company pledges portions of its investment securities portfolio to secure public fund deposits, federal funds purchase lines, securities sold under agreements to repurchase, borrowing capacity at the Federal Reserve Bank, and for other purposes required by law. At March 31, 2018 and December 31, 2017, the Company's unpledged securities in the available for sale portfolio totaled approximately \$21.5 million and \$44.8 million, respectively.

Total investment securities pledged for these purposes were as follows:

(In thousands)	March 31, 2018	December 31, 2017
Investment securities pledged for the purpose of securing:		
Federal Reserve Bank borrowings	\$ 9,002	\$ 9,570
Federal funds purchased and securities sold under agreements to repurchase	47,728	40,931
Other deposits	137,538	131,197
Total pledged, at fair value	\$ 194,268	\$ 181,698

Liquidity is available from the Company's base of core customer deposits, defined as demand, interest checking, savings, money market deposit accounts, and time deposits less than \$250,000, less all brokered deposits under \$250,000. At March 31, 2018, such deposits totaled \$1.0 billion and represented 88.4% of the Company's total deposits. These core deposits are normally less volatile and are often tied to other products of the Company through long lasting relationships. Time deposits and certificates of deposit of \$250,000 and over totaled \$136.4 million at March 31, 2018. These accounts are normally considered more volatile and higher costing representing 11.6% of total deposits at March 31, 2018.

Core deposits at March 31, 2018 and December 31, 2017 were as follows:

(In thousands)	March 31, 2018	December 31, 2017
Core deposit base:		
Non-interest bearing demand	\$ 244,835	\$ 245,380
Interest checking	246,008	229,862

Savings and money market	364,779	345,593
Other time deposits	188,361	191,563
Total	\$1,043,983	\$ 1,012,398

The total amount of certificates of deposit of \$250,000 and greater at March 31, 2018 and December 31, 2017 were \$84.7 million and \$63.2 million, respectively. The Company had brokered deposits totaling \$48.9 million and \$48.5 million at March 31, 2018 and December 31, 2017, respectively

Other components of liquidity are the level of borrowings from third party sources and the availability of future credit. The Company's outside borrowings are comprised of securities sold under agreements to repurchase, Federal Home Loan Bank advances, and subordinated notes. Federal funds purchased are overnight borrowings obtained mainly from upstream correspondent banks with which the Company maintains approved credit lines. As of March 31, 2018, under agreements with these unaffiliated banks, the Bank may borrow up to \$40.0 million in federal funds on an unsecured basis and \$16.2 million on a secured basis. There were no federal funds purchased outstanding at March 31, 2018. Securities sold under agreements to repurchase are generally borrowed overnight and are secured by a portion of the Company's investment portfolio. At March 31, 2018, there was \$34.8 million in repurchase agreements. The Company may periodically borrow additional short-term funds from the Federal Reserve Bank through the discount window; although no such borrowings were outstanding at March 31, 2018.

The Bank is a member of the Federal Home Loan Bank of Des Moines (FHLB). As a member of the FHLB, the Bank has access to credit products of the FHLB. As of March 31, 2018, the Bank had \$84.3 million in outstanding borrowings with the FHLB. In addition, the Company has \$49.5 million in outstanding subordinated notes issued to wholly-owned grantor trusts, funded by preferred securities issued by the trusts.

Borrowings outstanding at March 31, 2018 and December 31, 2017 were as follows:

(In thousands)	March 31, 2018	December 31, 2017
Borrowings:		
Federal funds purchased and securities sold under agreements to repurchase	\$ 34,795	\$ 27,560
Federal Home Loan Bank advances	84,296	121,352
Subordinated notes	49,486	49,486
Other borrowings	31	30
Total	\$ 168,608	\$ 198,428

The Company pledges certain assets, including loans and investment securities to the Federal Reserve Bank, FHLB, and other correspondent banks as security to establish lines of credit and borrow from these entities. Based on the type and value of collateral pledged, the FHLB establishes a collateral value from which the Company may draw advances against this collateral. This collateral is also used to enable the FHLB to issue letters of credit in favor of public fund depositors of the Company. The Federal Reserve Bank also establishes a collateral value of assets pledged to support borrowings from the discount window. The following table reflects collateral value of assets pledged, borrowings, and letters of credit outstanding, in addition to the estimated future funding capacity available to the Company as follows:

(In thousands)	March 31, 2018				December 31, 2017			
	FHLB	Federal Reserve Bank	Federal Funds Purchased Lines	Total	FHLB	Federal Reserve Bank	Federal Funds Purchased Lines	Total
Advance equivalent	\$294,216	\$ 8,796	\$ 47,435	\$350,447	\$294,081	\$ 9,364	\$ 47,825	\$351,270
Letters of credit	(72,750 )	0	0	(72,750 )	(70,000 )	0	0	(70,000 )
Advances outstanding	(84,296 )	0	0	(84,296 )	(121,352)	0	0	(121,352)
Total available	\$137,170	\$ 8,796	\$ 47,435	\$193,401	\$102,729	\$ 9,364	\$ 47,825	\$159,918

At March 31, 2018, loans of \$479.4 million were pledged at the Federal Home Loan Bank as collateral for borrowings and letters of credit. At March 31, 2018, investments totaling \$18.6 million were pledged to secure federal funds purchase lines and borrowing capacity at the Federal Reserve Bank.



## Sources and Uses of Funds

Cash and cash equivalents were \$81.4 million at March 31, 2018 compared to \$62.9 million at December 31, 2017. The \$18.5 million increase resulted from changes in the various cash flows produced by operating, investing, and financing activities of the Company, as shown in the accompanying consolidated statement of cash flows for the three months ended March 31, 2018. Cash flow provided from operating activities consists mainly of net income adjusted for certain non-cash items. Operating activities provided cash flow of \$2.3 million for the three months ended March 31, 2018.

Investing activities consisting mainly of purchases, sales and maturities of available-for-sale securities, and changes in the level of the loan portfolio used total cash of \$8.0 million. The cash outflow primarily consisted of \$16.2 million increase in loans and \$28.1 million purchases of investment securities, partially offset by \$36.5 million from maturities, calls, and sales of investment securities.

Financing activities provided cash of \$24.2 million, resulting primarily from a \$32.4 million increase in interest bearing transaction accounts and \$22.7 million increase in time deposits, partially offset by a net \$37.1 million repayment of FHLB advances. Future short-term liquidity needs arising from daily operations are not expected to vary significantly during 2018.

In the normal course of business, the Company enters into certain forms of off-balance sheet transactions, including unfunded loan commitments and letters of credit. These transactions are managed through the Company's various risk management processes. Management considers both on-balance sheet and off-balance sheet transactions in its evaluation of the Company's liquidity. The Company had \$308.6 million in unused loan commitments and standby letters of credit as of March 31, 2018. Although the Company's current liquidity resources are adequate to fund this commitment level the nature of these commitments is such that the likelihood of such a funding demand is very low.

The Company is a legal entity, separate and distinct from the Bank, which must provide its own liquidity to meet its operating needs. The Company's ongoing liquidity needs primarily include funding its operating expenses and paying cash dividends to its shareholders. The Company paid cash dividends to its shareholders totaling approximately \$406,000 and \$336,000 for the three months ended March 31, 2018 and 2017, respectively. A large portion of the Company's liquidity is obtained from the Bank in the form of dividends. The Bank declared and paid \$1.0 million and \$0 in dividends to the Company during the three months ended March 31, 2018 and 2017, respectively. At March 31, 2018 and December 31, 2017, the Company had cash and cash equivalents totaling \$1.6 million and \$1.4 million, respectively.

## Capital Management

The Company and the Bank are subject to various regulatory capital requirements administered by federal and state banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional discretionary, actions by regulators that, if undertaken, could have a direct material effect on the Company's consolidated financial statements. Under capital adequacy guidelines, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The capital amounts and classification of the Company and the Bank are subject to qualitative judgments by the regulators about components, risk-weightings, and other factors.

In July 2013, the federal banking agencies issued final rules to implement the Basel III regulatory capital reforms and changes required by the Dodd-Frank Act. The phase-in period for the Company began on January 1, 2015. The Federal Reserve System's (FRB) capital adequacy guidelines require that bank holding companies maintain a Common Equity Tier 1 risk-based capital ratio equal to at least 4.5% of its risk-weighted assets, a Tier 1 risk-based capital ratio equal to at least 6% of its risk-weighted assets and a total risk-based capital ratio equal to at least 8% of its risk-weighted assets. In addition, bank holding companies generally are required to maintain a Tier 1 leverage ratio of at least 4%.

In addition, the final rules establish a common equity tier 1 capital conservation buffer of 2.5% of risk-weighted assets applicable to all banking organizations. Institutions that do not maintain the required capital buffer will become subject to progressively more stringent limitations on the percentage of earnings that can be paid out in dividends or used for stock repurchases and on the payment of discretionary bonuses to senior executive management. The capital conservation buffer requirement will be phased in over four years beginning in 2016. On January 1, 2016, the first phase of the requirement went into effect at 0.625% of risk-weighted assets, and the requirement will increase each subsequent year by an additional 0.625 percentage points, to reach its final level of 2.5% of risk weighted assets on January 1, 2019. Once fully phased in, the capital conservation buffer requirement effectively raises the minimum required risk-based capital ratios to 7% Common Equity Tier 1 Capital, 8.5% Tier 1 Capital and 10.5% Total Capital on a fully phased-in basis.

Under the Basel III requirements, at March 31, 2018 and December 31, 2017, the Company met all capital adequacy requirements and had regulatory capital ratios in excess of the levels established for well-capitalized institutions, as shown in the following table as of periods indicated:

(in thousands)	Actual		Required for Capital Adequacy Purposes		Well-Capitalized Under Prompt Corrective Action Provision			
	Amount	Ratio	Amount	Ratio	Amount	Ratio		
March 31, 2018								
Total Capital (to risk-weighted assets):								
Company	\$ 157,713	12.87 %	\$ 98,069	8.00 %	\$ N.A.	N.A.	%	
Bank	156,390	12.79	97,794	8.00	122,243	10.00		
Tier I Capital (to risk-weighted assets):								
Company	\$ 130,070	10.61 %	\$ 73,551	6.00 %	\$ N.A.	N.A.	%	
Bank	145,283	11.80	73,346	6.00	97,794	8.00		
Common Equity Tier I Capital (to risk-weighted assets)								
Company	\$ 98,606	8.04 %	\$ 55,164	4.50 %	\$ N.A.	N.A.	%	
Bank	145,283	11.88	55,009	4.50	79,458	6.50		
Tier I Capital (to adjusted average assets):								
Company	\$ 130,070	9.17 %	\$ 56,715	4.00 %	\$ N.A.	N.A.	%	
Bank	145,283	10.37	56,028	4.00	70,035	5.00		
<b>(in thousands)</b>								
December 31, 2017								
Total Capital (to risk-weighted assets):								
Company	\$ 156,045	12.93 %	\$ 96,577	8.00 %	\$ N.A.	N.A.	%	
Bank	154,495	12.83	96,326	8.00	120,408	10.00		
Tier I Capital (to risk-weighted assets):								
Company	\$ 129,369	10.72 %	\$ 72,433	6.00 %	\$ N.A.	N.A.	%	
Bank	143,483	11.92	72,245	6.00	96,326	8.00		
Common Equity Tier I Capital (to risk-weighted assets)								
Company	\$ 97,033	8.04 %	\$ 54,325	4.50 %	\$ N.A.	N.A.	%	
Bank	143,483	11.92	54,184	4.50	78,265	6.50		
Tier I leverage ratio:								
Company	\$ 129,369	9.33 %	\$ 55,488	4.00 %	\$ N.A.	N.A.	%	
Bank	143,483	10.38	55,315	4.00	69,144	5.00		

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

#### Interest Sensitivity

Market risk arises from exposure to changes in interest rates and other relevant market rate or price risk. The Company faces market risk in the form of interest rate risk through transactions other than trading activities. The Company uses financial modeling techniques to measure interest rate risk. These techniques measure the sensitivity of future earnings due to changing interest rate environments. Guidelines established by the Company's Asset/Liability

Committee and approved by the board of directors are used to monitor exposure of earnings at risk. General interest rate movements are used to develop sensitivity as the Company feels it has no primary exposure to specific points on the yield curve. For the three months ended March 31, 2018, our Company utilized a 400 basis point immediate and gradual move in interest rates (both upward and downward) applied to both a parallel and proportional yield curve. However, there are no assurances that the change will not be more or less than this estimate.

The following table represents estimated interest rate sensitivity and periodic and cumulative gap positions calculated as of March 31, 2018. Significant assumptions used for this table included: loans will repay at historic repayment rates; certain interest-bearing demand accounts are interest sensitive due to immediate repricing, and fixed maturity deposits will not be withdrawn prior to maturity. A significant variance in actual results from one or more of these assumptions could materially affect the results reflected in the table.

(In thousands)	Year 1	Year 2	Year 3	Year 4	Year 5	Over 5 Years or No stated Maturity	Total
<b>ASSETS</b>							
Investment securities	\$51,824	\$41,093	\$36,763	\$27,061	\$19,751	\$39,228	\$215,720
Federal funds sold and other over-night interest-bearing deposits	65,449	-	-	-	-	-	65,449
Certificates of deposit in other banks	-	863	1,230	741	1,978	-	4,812
Other investments and securities, at cost	6,725	-	3,000	-	-	-	9,725
Loans	411,214	171,789	161,525	130,168	118,235	91,395	1,084,326
<b>Total</b>	<b>\$535,212</b>	<b>\$213,745</b>	<b>\$202,518</b>	<b>\$157,970</b>	<b>\$139,964</b>	<b>\$130,623</b>	<b>\$1,380,032</b>
<b>LIABILITIES</b>							
Savings, interest checking, and money market deposits	\$358,209	\$-	\$258,685	\$-	\$-	\$-	\$616,894
Time deposits	211,852	47,850	17,813	10,808	30,319	10	318,652
Federal funds purchased and securities sold under agreements to repurchase	34,795	-	-	-	-	-	34,795
Federal Home Loan Bank advances	26,227	28,232	21,237	4,242	4,389	-	84,327
Subordinated notes	49,486	-	-	-	-	-	49,486
<b>Total</b>	<b>\$680,569</b>	<b>\$76,082</b>	<b>\$297,735</b>	<b>\$15,050</b>	<b>\$34,708</b>	<b>\$10</b>	<b>\$1,104,154</b>
<b>Interest-sensitivity GAP</b>							
Periodic GAP	\$(145,357)	\$137,663	\$(95,217)	\$142,920	\$105,256	\$130,613	\$275,878
Cumulative GAP	\$(145,357)	\$(7,694)	\$(102,911)	\$40,009	\$145,265	\$275,878	\$275,878
<b>Ratio of interest-earning assets to interest-bearing liabilities</b>							
Periodic GAP	0.79	2.81	0.68	10.50	4.03	NM	1.25
Cumulative GAP	0.79	0.99	0.90	1.04	1.13	1.25	1.25

### Effects of Inflation

The effects of inflation on financial institutions are different from the effects on other commercial enterprises since financial institutions make few significant capital or inventory expenditures, which are directly affected by changing prices. Because bank assets and liabilities are virtually all monetary in nature, inflation does not affect a financial institution as much as do changes in interest rates. The general level of inflation does underlie the general level of most interest rates, but interest rates do not increase at the rate of inflation as do prices of goods and services. Rather, interest rates react more to changes in the expected rate of inflation and to changes in monetary and fiscal policy.

Inflation does have an impact on the growth of total assets in the banking industry, often resulting in a need to increase capital at higher than normal rates to maintain an appropriate capital to asset ratio. In the opinion of management, inflation did not have a significant effect on the Company's operations for the three months ended March 31, 2018.

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

Our Company's management has evaluated, with the participation of our principal executive and principal financial officers, the effectiveness of our disclosure controls and procedures as defined in Rules 13a – 15(e) or 15d – 15(e) of the Securities Exchange Act of 1934 as of March 31, 2018. Based upon and as of the date of that evaluation, our principal executive and principal financial officers concluded that our disclosure controls and procedures were effective to ensure that information required to be disclosed in the reports we file and submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported as and when required. It should be noted that any system of disclosure controls and procedures, however well designed and operated, can provide only reasonable, and not absolute, assurance that the objectives of the system are met. In addition, the design of any system of disclosure controls and procedures is based in part upon assumptions about the likelihood of future events. Because of these and other inherent limitations of any such system, there can be no assurance that any design will always succeed in achieving its stated goals under all potential future conditions, regardless of how remote.

There has been no change in our Company's internal control over financial reporting that occurred during the three months ended March 31, 2018 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## **Impact of New Accounting Standards**

**Financial Instruments** In June 2016, the FASB issued ASU 2016-13, *Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments* (CECL). The revised accounting guidance will remove all recognition thresholds and will require a company to recognize an allowance for credit losses for the difference between the amortized cost basis of a financial instrument and the amount of amortized cost that the company expects to collect over the instrument's contractual life. It also amends the credit loss measurement guidance for available-for-sale debt securities and beneficial interests in securitized financial assets. This new accounting guidance will be effective for interim and annual reporting periods beginning after December 15, 2019. While the Company generally expects to recognize a one-time cumulative effect adjustment to the allowance for loan losses as of the beginning of the first reporting period in which the new standard is effective, the Company has not determined the magnitude of any such one-time adjustment or the overall impact of the new guidance on the Company's consolidated financial statements. The Company has formed a committee and is continuing to evaluate the impact of the ASU's adoption on the Company's consolidated financial statements.

**Leases** In February 2016, the FASB issued ASU 2016-02, *Leases*, in order to increase transparency and comparability by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. The ASU primarily affects lessee accounting, which requires the lessee to recognize a right-of-use asset and a liability to make lease payments for those leases classified as operating leases under previous GAAP. For leases with a term of 12 months or less, an election by class of underlying asset not to recognize lease assets and lease liabilities is permitted. The ASU also provides additional guidance as to the definition of a lease, identification of lease components, and sale and leaseback transactions. The amendments in the ASU are effective for interim and annual periods beginning January 1, 2019. The Company expects to adopt this ASU in the first quarter of 2019 and is in the process of evaluating the impact of the ASU's adoption on the Company's consolidated financial statements.

In January 2018, the FASB issued ASU 2018-01, *Leases: Land Easement Practical Expedient for Transition to Topic 842*. This update provides an optional practical expedient that affects entities with land easements that existed or expired before an entity's adoption of Topic 842, provided that the entity does not account for those land easements as leases under Topic 840. The amendments in this ASU affect the amendments in ASU 2016-02, which are not yet effective but may be early adopted. The effective date and transition requirements for the amendments are the same as the effective date and transition requirements in ASU 2016-02. The Company will adopt this guidance as required, in conjunction with the adoption of ASU 2016-02 described above, however this update is not expected to materially alter the implementation of ASU 2016-02, or to have a material impact on the Company's consolidated financial statements.

***Derivatives and Hedging*** The FASB issued guidance within ASU 2017-12, *Targeted Improvements to Accounting for Hedging Activities (Topic 815)* in August 2017. The amendments in ASU 2017-12 to Topic 815, Derivatives and Hedging, are intended to more closely align hedge accounting with companies' risk management strategies, simplify the application of hedge accounting, and increase transparency as to the scope and results of hedging programs. The guidance also amends the presentation and disclosure requirements and changes how companies assess effectiveness. Under the new guidance, public companies will have until the end of the first quarter in which a hedge is designated to perform an initial assessment of a hedge's effectiveness. After initial qualification, the new guidance permits a qualitative effectiveness assessment for certain hedges instead of a quantitative test if the company can reasonably support an expectation of high effectiveness throughout the term of the hedge. Additional disclosures include cumulative basis adjustments for fair value hedges and the effect of hedging on individual income statement line items. The amendments in this Update are effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted in any interim period after issuance of the Update. The ASU is not expected to have a significant effect on the Company's Consolidated Financial Statements.



**PART II - OTHER INFORMATION**

## Item 1. Legal Proceedings

The information required by this Item is set forth in *Commitments and Contingencies, Pending Litigation*, in our Company's Notes to Consolidated Financial Statements (*unaudited*).

## Item 1A. Risk Factors None

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

The following table summarizes the purchases made by or on behalf of the Company or certain affiliated purchasers of shares of the Company's common stock during the three months ended March 31, 2018:

Period	(a) Total Number of Shares (or Units) Purchased	(b) Average Price Paid per Share (or Unit)	(c) Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs	(d) Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs *
January 1-31, 2018	-	\$ -	-	\$ 1,965,562
February 1-28, 2018	-	\$ -	-	\$ 1,965,562
March 1-31, 2018	5,468	\$ 20.51	-	\$ 1,853,415
Total	5,468	\$ 20.51	-	\$ 1,853,415

\* On August 6, 2015, the Company announced that its Board of Directors authorized the purchase, through open market transactions, of up to \$2.0 million market value of the Company's common stock. On August 8, 2017, the Board authorized the repurchase of an additional \$1.5 million market value of the Company's common stock. Management was given discretion to determine the number and pricing of the shares to be purchased, as well as, the timing of any such purchases.

Item 3. Defaults Upon Senior Securities None

Item 4. Mine Safety Disclosures None

Item 5. Other Information None

Item 6. Exhibits

<b>Exhibit No.</b>	<b>Description</b>
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<u>3.1</u>	<u>Restated Articles of Incorporation of the Company (filed as Exhibit 3.1 to the Company's current report on Form 8-K on August 9, 2007 and incorporated herein by reference).</u>
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<u>3.2</u>	<u>Amended and Restated Bylaws of the Company (filed as Exhibit 3.1 to the Company's current report on Form 8-K on June 8, 2009 and incorporated herein by reference).</u>
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<u>4.1</u>	<u>Specimen certificate representing shares of the Company's \$1.00 par value Common Stock (filed as Exhibit 4.1 to the Company's current report on Form 8-K/A on June 23, 2017 and incorporated herein by reference).</u>
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53

31.1 Certificate of the Chief Executive Officer of the Company pursuant to Rule 13a-14(a) or 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Certificate of the Chief Financial Officer of the Company pursuant to Rule 13a-14(a) or 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32.1 Certificate of the Chief Executive Officer of the Company pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

32.2 Certificate of the Chief Financial Officer of the Company pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

101 Interactive data files pursuant to Rule 405 of Regulation S-T: (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Income, (iii) the Consolidated Statements of Changes in Equity, (iv) the Consolidated Statements of Cash Flows and (v) the Notes to Consolidated Financial Statements, tagged as blocks of text and in detail (XBRL).

## 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.

### HAWTHORN BANCSHARES, INC.

Date

/s/ David T. Turner

May 10, 2018 David T. Turner, Chairman of the Board and  
Chief Executive Officer (Principal Executive Officer)

/s/ W. Bruce Phelps

May 10, 2018 W. Bruce Phelps, Chief Financial Officer (Principal Financial  
Officer and Principal Accounting Officer)

HAWTHORN BANCSHARES, INC.

INDEX TO EXHIBITS

March 31, 2018 Form 10-Q

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\* This information is furnished and not filed for purposes of Sections 11 and 12 of the Securities Act of 1933, as amended, and Section 18 of the Securities Exchange Act of 1934, as amended.

