

3PAR Inc.  
Form 10-Q  
August 13, 2008  
Table of Contents

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

Washington, D. C. 20549

**Form 10-Q**

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

For the quarterly period ended June 30, 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)

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

**4209 Technology Drive**  
**Fremont, CA**  
(Address of principal executive offices)  
**Registrant's telephone number, including area code: (510) 413-5999**

**94538**  
(Zip Code)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

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

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

(Do not check if a 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

The number of shares of the Registrant's Common Stock, \$.001 par value, outstanding at July 31, 2008 was: 60,640,709

**Table of Contents**

**QUARTERLY REPORT ON FORM 10-Q  
FOR THE THREE MONTHS ENDED JUNE 30, 2008**

**TABLE OF CONTENTS**

**PART I. FINANCIAL INFORMATION**

Item 1.	<u>Unaudited Condensed Consolidated Financial Statements</u>	3
	<u>Unaudited Condensed Consolidated Balance Sheets at June 30, 2008 and March 31, 2008</u>	
	<u>Unaudited Condensed Consolidated Statements of Operations and Comprehensive Income (Loss) for the Three Months Ended June 30, 2008 and 2007</u>	4
	<u>Unaudited Condensed Consolidated Statements of Cash Flows for the Three Months Ended June 30, 2008 and 2007</u>	5
	<u>Notes to Unaudited Condensed Consolidated Financial Statements</u>	6
Item 2.	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	21
Item 3.	<u>Quantitative and Qualitative Disclosures about Market Risk</u>	32
Item 4T.	<u>Controls and Procedures</u>	33

**PART II. OTHER INFORMATION**

Item 1.	<u>Legal Proceedings</u>	34
Item 1A.	<u>Risk Factors</u>	34
Item 2.	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	47
Item 3.	<u>Defaults upon Senior Securities</u>	47
Item 4.	<u>Submission of Matters to a Vote of Security Holders</u>	47
Item 5.	<u>Other Information</u>	47
Item 6.	<u>Exhibits</u>	48

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

(in thousands, except share data)

(unaudited)

	June 30, 2008	March 31, 2008
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 62,642	\$ 97,585
Short-term investments	45,103	18,058
Accounts receivable, net	33,911	34,596
Inventory	23,216	18,057
Deferred cost	5,032	4,273
Prepaid and other current assets	2,226	2,077
<b>Total current assets</b>	<b>172,130</b>	<b>174,646</b>
Property and equipment, net	14,948	14,781
Deferred cost, non-current		251
Other non-current assets	157	156
<b>Total assets</b>	<b>\$ 187,235</b>	<b>\$ 189,834</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Line of credit	\$	\$ 4,000
Accounts payable	12,526	12,527
Accrued compensation and benefits	9,781	11,651
Other accrued liabilities	4,547	5,020
Deferred revenue	29,163	26,051
Accrued warranty	3,315	3,371
Current portion of notes payable	447	883
<b>Total current liabilities</b>	<b>59,779</b>	<b>63,503</b>
Accrued warranty, non-current	2,771	2,813
Deferred revenue, non-current	5,235	5,945
Other long-term liabilities	1,129	1,173
<b>Total liabilities</b>	<b>68,914</b>	<b>73,434</b>
Commitments and contingencies (Note 11)		
Stockholders equity:		
Preferred stock, \$0.001 par value; 20,000,000 shares authorized at June 30, 2008 and March 31, 2008; No shares issued and outstanding at June 30, 2008 and March 31, 2008		
Common stock, \$0.001 par value; 300,000,000 shares authorized at June 30, 2008 and March 31, 2008; 60,616,928 and 60,539,612 shares issued and outstanding at June 30, 2008 and March 31, 2008, respectively		
	61	61
Additional paid-in capital	291,986	290,558
Stockholders notes receivable	(36)	(36)
Deferred stock-based compensation	(117)	(186)
Accumulated other comprehensive loss	(269)	(15)
Accumulated deficit	(173,304)	(173,982)

Edgar Filing: 3PAR Inc. - Form 10-Q

Total stockholders' equity	118,321	116,400
Total liabilities and stockholders' equity	\$ 187,235	\$ 189,834

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

**Table of Contents****3PAR Inc.****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND****COMPREHENSIVE INCOME (LOSS)****(in thousands, except per share amounts)****(unaudited)**

	<b>Three Months Ended June 30,</b>	
	<b>2008</b>	<b>2007</b>
<b>Revenue:</b>		
Product	\$ 39,924	\$ 23,123
Support	3,029	685
<b>Total revenue</b>	<b>42,953</b>	<b>23,808</b>
<b>Cost of revenue:</b>		
Product	14,021	8,110
Support	1,006	216
<b>Total cost of revenue (1)</b>	<b>15,027</b>	<b>8,326</b>
<b>Gross profit</b>	<b>27,926</b>	<b>15,482</b>
<b>Operating expenses:</b>		
Research and development (1)	10,157	7,807
Sales and marketing (1)	14,301	10,457
General and administrative (1)	3,373	2,054
<b>Total operating expenses</b>	<b>27,831</b>	<b>20,318</b>
<b>Income (loss) from operations</b>	<b>95</b>	<b>(4,836)</b>
<b>Other income (expense), net:</b>		
Interest income	778	448
Interest expense	(17)	(297)
Other, net	(8)	31
<b>Total other income (expense), net</b>	<b>753</b>	<b>182</b>
<b>Income (loss) before provision for income taxes</b>	<b>848</b>	<b>(4,654)</b>
<b>Provision for income taxes</b>	<b>(170)</b>	<b>(30)</b>
<b>Net income (loss)</b>	<b>\$ 678</b>	<b>\$ (4,684)</b>
<b>Other comprehensive loss:</b>		
Net income (loss)	\$ 678	\$ (4,684)
Unrealized loss on short-term investments, net	(254)	(17)
<b>Comprehensive income (loss)</b>	<b>\$ 424</b>	<b>\$ (4,701)</b>
<b>Net income (loss) per common share, basic</b>	<b>\$ 0.01</b>	<b>\$ (0.26)</b>

Edgar Filing: 3PAR Inc. - Form 10-Q

Net income (loss) per common share, diluted	\$ 0.01	\$ (0.26)
Shares used to compute basic net income (loss) per common share	60,233	18,335
Shares used to compute diluted net income (loss) per common share	63,088	18,335

(1) Includes stock-based compensation as follows:

Cost of revenue	\$ 48	\$ 43
Research and development	453	255
Sales and marketing	555	146
General and administrative	231	96

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

**Table of Contents****3PAR Inc.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(in thousands)****(unaudited)**

	<b>Three Months Ended June 30,</b>	
	<b>2008</b>	<b>2007</b>
<b>Cash flows from operating activities:</b>		
Net income (loss)	\$ 678	\$ (4,684)
<b>Adjustments to reconcile net income (loss) to net cash used in operating activities:</b>		
Depreciation and amortization	1,439	654
Stock-based compensation expense	1,287	540
Non-cash interest expense	19	19
Amortization of premium (accretion of purchase discounts) on short-term investments, net	(230)	(168)
Provision for doubtful accounts	95	9
Writedown for excess and obsolete inventory	220	79
<b>Changes in assets and liabilities:</b>		
Accounts receivable	590	3,565
Inventory	(5,379)	(1,538)
Deferred cost	(508)	303
Prepaid expenses and other current assets	(149)	(1,507)
Other non-current assets	(1)	(4)
Accounts payable	706	(3,923)
Accrued liabilities	(2,178)	848
Deferred revenue	2,402	(7)
Accrued warranty	(98)	140
Other long-term liabilities	(44)	(23)
<b>Net cash used in operating activities</b>	<b>(1,170)</b>	<b>(5,697)</b>
<b>Cash flows from investing activities:</b>		
Proceeds from sales and maturities of short-term investments	4,600	7,395
Purchases of short-term investments	(31,669)	(12,399)
Purchase of property and equipment	(2,313)	(561)
<b>Net cash used in investing activities</b>	<b>(29,382)</b>	<b>(5,565)</b>
<b>Cash flows from financing activities:</b>		
Proceeds from exercise of options and warrants	140	113
Repurchase of shares of unvested common stock	(95)	—
Proceeds from line of credit	—	4,500
Repayments on line of credit	(4,000)	(1,500)
Repayment of notes payable	(436)	(395)
<b>Net cash provided by (used in) financing activities</b>	<b>(4,391)</b>	<b>2,718</b>
<b>Net change in cash and cash equivalents</b>	<b>(34,943)</b>	<b>(8,544)</b>
<b>Cash and cash equivalents, beginning of period</b>	<b>97,585</b>	<b>16,722</b>
<b>Cash and cash equivalents, end of period</b>	<b>\$ 62,642</b>	<b>\$ 8,178</b>



Edgar Filing: 3PAR Inc. - Form 10-Q

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

---

**Table of Contents**

**3PAR Inc.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL**

**STATEMENTS**

**(unaudited)**

**1. The Company and its Significant Accounting Policies**

***The Company***

3PAR Inc. (the Company) began operations in May 1999 and is a provider of utility storage solutions for 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 2009, for example, refer to the fiscal year ending March 31, 2009.

***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.

***Significant Accounting Policies***

***Basis of Presentation***

The unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) and with the instructions to Securities and Exchange Commission (SEC) Form 10-Q and Article 10 of SEC Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. For further information, these financial statements should be read in conjunction with the audited consolidated financial statements and related notes contained in the Company's Annual Report on Form 10-K (File No. 001-33823) for the year ended March 31, 2008 (Form 10-K).

The unaudited condensed consolidated financial statements contain all normal recurring accruals and adjustments that, in the opinion of management, are necessary to state fairly the Company's consolidated financial position at June 30, 2008, and the consolidated results of its operations for the three months ended June 30, 2008 and 2007, and the consolidated cash flows for the three months ended June 30, 2008 and 2007. The results of operations for the three months ended June 30, 2008 are not necessarily indicative of the results to be expected for the full year.

The condensed consolidated balance sheet at March 31, 2008 has been derived from the audited consolidated financial statements at that date but does not include all of the information and footnotes required by GAAP.

---

**Table of Contents**

**3PAR Inc.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL**

**STATEMENTS (Continued)**

**(unaudited)**

The Company's significant accounting policies are disclosed in the Company's Form 10-K. With the exception of those discussed below, there have been no significant changes to these policies and no recent accounting pronouncements or changes in accounting pronouncements during the three months ended June 30, 2008 that are of significance or potential significance to us.

*Revenue Recognition*

The Company derives its revenue from sales of storage solutions that include hardware, software and related support. Because the embedded software of its storage solution is deemed to be more than incidental to the product as a whole, the Company accounts for revenue for the entire sale in accordance with the guidance provided by the American Institute of Certified Public Accountants (AICPA) Statement of Position 97-2 (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*.

The Company recognizes revenue when persuasive evidence of an arrangement exists, the product has been delivered, the fee is fixed or determinable, collection of the resulting receivable is reasonably assured and, if applicable, upon satisfaction of evaluation criteria or expiration of the evaluation period, as the case may be. The Company's 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. The Company's sales arrangements with customers and resellers do not include rights of return or rebates and to date, product returns have been negligible. The Company assesses its ability to collect from its customers based on a number of factors, including creditworthiness of the customer and past transaction history.

Prior to March 2007, the Company provided only basic and premium hardware warranty and software warranty, which was limited to bug fixes for any non-conforming software products. The Company also offered an extended hardware and software warranty after the initial contract term. The Company recognized as product revenue all revenue associated with sales of its products at the time of shipment or installation, depending on the terms of the arrangement, provided that all other revenue recognition criteria were met. In accordance with Financial Accounting Standard Board's (FASB) Technical Bulletin 90-1, (FTB 90-1), *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts*, the Company recognized revenue relating to its 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.

In March 2007, in anticipation of evolving customer requirements for software support, the Company changed its product offering 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, all systems are sold together with software support. This new software support is considered post-contract customer support (PCS) under SOP 97-2.

The Company's sales are comprised of multiple elements, which include hardware, software and PCS. The Company allocates revenue to each delivered element of the sale using the residual method. Under the residual method, when PCS is the only undelivered element, the Company defers revenue from the sale equivalent to the vendor specific objective evidence (VSOE) of fair value of PCS, or the undelivered element, and applies any discounts to the hardware and software elements in accordance with the provisions of SOP 97-2, as amended by SOP 98-9. VSOE of fair value of PCS within a sale is based upon stated renewal rates included within the evidence of arrangement with the customer. In circumstances where the arrangement does not include stated renewal rates, VSOE of fair value of PCS is based on actual renewal rates for separate sales of PCS to other customers.

---

**Table of Contents**

**3PAR Inc.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL**

**STATEMENTS (Continued)**

**(unaudited)**

During the first quarter of fiscal 2008, the Company established VSOE of the fair value for software support based on stated renewal rates offered to customers within the arrangement. As a result, beginning in the first quarter of fiscal 2008, the Company applied the residual method, as allowed by SOP 98-9, to revenue recognition of the software support. The Company defers revenue recognition of the software support and recognizes it on a straight-line basis over the support period, which is primarily one year. The Company allocates the remainder of the revenue associated with the sale to product revenue using the residual method. Premium and extended hardware warranties continue to be recognized in accordance with FTB 90-1 and are classified as support revenue.

During the month of March 2007, the Company did not have VSOE of fair value for its new software support model. Accordingly, through March 31, 2008, the Company was recognizing all of the hardware and support revenue from transactions that included software support during the month of March 2007 as product revenue ratably over the support period of one to three years. During the first quarter of fiscal 2009, the Company established VSOE of fair value of PCS for these March 2007 transactions based on actual renewal rates for separate sales of PCS to other customers. Accordingly, in the first quarter of fiscal 2009 the Company applied the residual method to the remaining deferred revenue associated with the March 2007 transactions.

The Company typically recognizes 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, the Company recognizes revenue upon the earlier of receipt of customer acceptance or the lapse of the acceptance period. For sales through its resellers, the Company generally recognizes 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

***Recent Accounting Pronouncements***

In March 2008, Financial Accounting Standard Board ( FASB ) issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities an amendment of FASB Statement No. 133* ( SFAS 161 ), which expands the disclosure requirements for derivative instruments and hedging activities. Entities are required to provide enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under Statement 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. The Company is required to adopt SFAS 161 effective April 1, 2009. SFAS 161 does not change the accounting treatment for derivative instruments and therefore, the Company does not expect the adoption of SFAS 161 to have a material effect on its financial position, results of operations, or cash flows.

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

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements, an Amendment of ARB 51* ( SFAS 160 ), which becomes effective for fiscal periods beginning after December 15, 2008. This statement amends Accounting Research Bulletin No. 51 to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary.



---

**Table of Contents**

**3PAR Inc.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL**

**STATEMENTS (Continued)**

**(unaudited)**

The statement requires consolidated net income to be reported at amounts that include the amounts attributable to both the parent and the noncontrolling interest. It also requires disclosure on the face of the consolidated statement of income, of the amounts of consolidated net income attributable to the parent and to the noncontrolling interest. In addition this statement establishes a single method of accounting for changes in a parent's ownership interest in a subsidiary that do not result in deconsolidation and requires that a parent recognize a gain or loss in net income when a subsidiary is deconsolidated. The Company is required to adopt SFAS 160 effective April 1, 2009. The Company does not expect the adoption of SFAS 160 to have a material effect on its financial position, results of operations, or cash flows.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* ( SFAS 157 ), which addresses how companies should measure fair value when they are required to use a fair value measure for recognition or disclosure purposes under GAAP. As a result of SFAS 157, there is now a common definition of fair value to be used throughout GAAP. The FASB believes that the new standard will make the measurement of fair value more consistent and comparable and improve disclosures about those measures. In February 2008, the FASB issued FASB Staff Position ( FSP ) 157-1, *Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13* ( FSP 157-1 ) and FSP 157-2, *Effective Date of FASB Statement No. 157* ( FSP 157-2 ). FSP 157-1 amends SFAS No. 157 to remove certain leasing transactions from its scope. FSP 157-2 delayed the effective date of SFAS No. 157 for all non-financial assets and non-financial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually), until the beginning of the first quarter of fiscal 2010. The measurement and disclosure requirements related to financial assets and financial liabilities became effective for the Company beginning in the first quarter of fiscal 2009. The adoption of SFAS No. 157 did not have a significant impact on the Company's consolidated financial statements.

**2. Net Income (Loss) per Common Share**

The Company applies the provisions of the Emerging Issues Task Force EITF Issue No. 03-6, *Participating Securities and the Two Class Method under FASB Statement 128* ( EITF No. 03-6 ), which established standards regarding the computation of earnings per share by companies with participating securities or multiple classes of common stock. Prior to its conversion to common stock upon the closing of the IPO, the Company's redeemable convertible preferred stock were participating securities due to their participation rights related to cash dividends declared by the Company.

EITF No. 03-6 requires net loss attributable to common stockholders for the period to be allocated to common stock and participating securities to the extent that the securities are required to share in the losses. The Company's redeemable convertible preferred stock did not have a contractual obligation to share in losses of the Company. Basic net loss per share is calculated by dividing net loss by the weighted average shares of common stock outstanding during the period that are not subject to vesting provisions. Diluted net loss per common share is calculated by giving effect to all potentially dilutive common shares, including options, common stock subject to repurchase, warrants and redeemable convertible preferred stock.

Table of Contents

## 3PAR Inc.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL

## STATEMENTS (Continued)

(unaudited)

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

	Three Months Ended June 30, 2008                      2007 (in thousands, except per share amounts)	
Basic net income (loss) per share		
Numerator:		
Net income (loss)	\$ 678	\$ (4,684)
Denominator:		
Weighted average common shares outstanding	60,233	18,335
Basic net income (loss) per share	0.01	(0.26)
Diluted net income (loss) per share		
Numerator:		
Net income (loss)	\$ 678	\$ (4,684)
Denominator:		
Weighted average common shares outstanding	60,233	18,335
Employee stock options and employee stock purchase plan shares	2,509	
Common stock subject to repurchase	266	
Warrants	80	
Weighted average number of shares outstanding	63,088	18,335
Diluted net income (loss) per share	\$ 0.01	\$ (0.26)

The following outstanding options, common stock subject to repurchase, warrants to purchase common stock and redeemable convertible preferred stock at June 30, 2007 were excluded from the computation of diluted net income (loss) per common share for the periods presented because including them would have had an antidilutive effect:

	June 30, 2007 (in thousands)
Options to purchase common stock	4,783
Common stock subject to repurchase	798
Warrants to purchase common stock	337
Redeemable convertible preferred stock (as converted basis)	33,257
	39,175

**3. Balance Sheet Components**

The following tables provide details of selected balance sheet accounts:

	<b>June 30, 2008</b>	<b>March 31, 2008</b>
	(in thousands)	
<b>Accounts Receivable, Net</b>		
Trade accounts receivable	\$ 34,223	\$ 34,823
Less: Allowance for doubtful accounts	(312)	(227)
 Total	 \$ 33,911	 \$ 34,596



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

	June 30, 2008	March 31, 2008
	(in thousands)	
<b>Inventory</b>		
Raw materials	\$ 12,545	\$ 8,725
Work in process	6,217	5,696
Finished goods	4,454	3,636
<b>Total</b>	<b>\$ 23,216</b>	<b>\$ 18,057</b>

**4. Short-term Investments**

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

	June 30, 2008			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
	(in thousands)			
<b>Short-term Investments</b>				
United States Government and agency securities	\$ 33,049	\$ 12	\$ (237)	\$ 32,824
Municipal bonds	5,173		(16)	5,157
Commercial paper	3,998		(8)	3,990
Corporate debt securities	3,152		(20)	3,132
<b>Total short-term investments</b>	<b>\$ 45,372</b>	<b>\$ 12</b>	<b>\$ (281)</b>	<b>\$ 45,103</b>

	March 31, 2008			
	Amortized Cost Basis	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
	(in thousands)			
<b>Short-term Investments</b>				
United States Government and agency securities	\$ 7,506	\$ 7		\$ 7,513
Municipal bonds	5,194		(23)	5,171
Commercial paper	4,567			4,567
Corporate debt securities	806	1		807
<b>Total short-term investments</b>	<b>\$ 18,073</b>	<b>\$ 8</b>	<b>\$ (23)</b>	<b>\$ 18,058</b>

## Edgar Filing: 3PAR Inc. - Form 10-Q

As of June 30, 2008, all of the Company's short-term investments were classified as available-for-sale and certain investments had contractual maturities of greater than one year. However, management has the ability and intent, if necessary, to liquidate any of these investments in order to meet the Company's liquidity needs within the next 12 months. Accordingly, all investments are classified as current assets on the consolidated balance sheets.

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

The cost basis and fair value of available-for-sale securities, by contractual maturity, are as follows:

<b>Due in</b>	<b>June 30, 2008</b>	
	<b>Cost Basis</b>	<b>Fair Value</b>
	<b>(in thousands)</b>	
Less than 1 year	\$ 26,159	\$ 26,113
1 to 2 years	4,140	4,138
2 to 5 years	15,074	14,852
Total short-term investments	\$ 45,373	\$ 45,103

<b>Due in</b>	<b>March 31, 2008</b>	
	<b>Cost Basis</b>	<b>Fair Value</b>
	<b>(in thousands)</b>	
Less than 1 year	\$ 10,470	\$ 10,469
1 to 2 years	2,602	2,586
2 to 5 years	5,001	5,003
Total short-term investments	\$ 18,073	\$ 18,058

The Company invests in securities that are rated investment grade or better. The unrealized losses at June 30, 2008 on the Company's investments are due to the current volatility in the credit markets. At June 30, 2008, none of these securities have been in a continuous unrealized loss position for more than 12 months. The Company has determined that these unrealized losses are temporary as the duration of the decline in value of investments has been short, the extent of the decline, in both dollars and as a percentage of costs, is not significant, and the Company has the ability to hold the investments until recovery, if necessary.

Unrealized gains and losses are recorded as a component of cumulative other comprehensive income (loss) in stockholders' equity. If these investments are sold at a loss or are considered to have other than temporarily declined in value, a charge to operations is recorded. The specific identification method is used to determine the cost of securities disposed of, with realized gains and losses reflected in other income (expense), net.

**5. Fair Value Measurements**

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

***Fair Value Hierarchy***

## Edgar Filing: 3PAR Inc. - Form 10-Q

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

*Level 1* Quoted prices in active markets for identical assets or liabilities. Level 1 assets consist of commercial paper, money market fund deposits and the Company's short term investments, that are traded in an active market with sufficient volume and frequency of transactions.

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

*Level 2* Observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets with insufficient volume or infrequent transactions (less active markets); or model-derived valuations in which all significant inputs are observable or can be derived principally from or corroborated by observable market data for substantially the full term of the assets or liabilities.

*Level 3* Unobservable inputs to the valuation methodology that are significant to the measurement of fair value of assets or liabilities. As of June 30, 2008, the Company had no financial assets or liabilities without observable market values that would require a high level of judgment to determine fair value.

The following table summarizes our financial assets measured at fair value on a recurring basis as of June 30, 2008 (in thousands):

<b>Description</b>	<b>Fair Value Measurements at Reporting Date Using Quoted Prices in Active Markets for Identical Assets (Level 1)</b>
Cash equivalents:	
Money market funds	\$ 16,739
Commercial paper	41,013
Short-term investments:	
United States Government and agency securities	32,824
Municipal bonds	5,157
Commercial paper	3,990
Corporate debt securities	3,132
	\$ 102,855

**6. Property and Equipment, Net**

Property and equipment, net consists of the following:

<b>Property and Equipment, Net</b>	<b>Estimated Useful Life</b>	<b>June 30, 2008</b>	<b>March 31, 2008</b>
		<b>(in thousands)</b>	
Computer equipment	3 years	\$ 21,423	\$ 21,344
Computer software	5 years	2,431	2,211
Machinery and equipment	3-5 years	2,851	1,715
Furniture and fixtures	7 years	1,983	1,913

Edgar Filing: 3PAR Inc. - Form 10-Q

Leasehold improvements	Shorter of lease term or 5 years	7,828	7,804
		36,516	34,987
Less: accumulated amortization and depreciation		(21,568)	(20,206)
Total		\$ 14,948	\$ 14,781

Depreciation and amortization expense totaled \$1.4 million and \$654,000 for the three months ended June 30, 2008 and 2007, respectively.

**Table of Contents****3PAR Inc.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL****STATEMENTS (Continued)****(unaudited)****7. Deferred Revenue**

Deferred revenue consists of the following:

	June 30, 2008	March 31, 2008
	(in thousands)	
<b>Deferred Revenue</b>		
Product	\$ 20,146	\$ 15,810
Support	9,017	8,132
Ratable product and related support		2,109
<b>Total deferred revenue, current</b>	<b>29,163</b>	<b>26,051</b>
Support, non-current	5,235	4,894
Ratable product and related support, non-current		1,051
<b>Total deferred revenue, non-current</b>	<b>5,235</b>	<b>5,945</b>
<b>Total deferred revenue</b>	<b>\$ 34,398</b>	<b>\$ 31,996</b>

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

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

The Company's sales are comprised of multiple elements, which include hardware, software and PCS. Deferred ratable product and related support revenue consists of revenue on transactions where VSOE of fair value of PCS had not been established and the entire arrangement fee was being recognized ratably over the support period of one to three years. During the first quarter of fiscal 2009, the Company established VSOE of fair value of PCS for these March 2007 transactions based on actual renewal rates for separate sales of PCS to other customers. Accordingly, in the first quarter of fiscal 2009 the Company applied the residual method to the remaining deferred revenue associated with the March 2007 transactions. As a result, the Company recognized a total of \$2.8 million of revenue associated with the March 2007 transactions in the first quarter of fiscal 2009. The remaining deferred revenue balance of \$387,000 associated with these transactions is included in support deferred revenue.

**8. Debt Obligations and Line of Credit**

*Notes Payable*

## Edgar Filing: 3PAR Inc. - Form 10-Q

In June 2005 and under amendments through March 2008, the Company entered into a loan and security agreement with a financial institution for borrowings of up to \$6.0 million (the Notes Payable). The borrowings were available through March 31, 2006. Borrowings under this agreement bear interest at the 3-year Treasury Note rate plus 5.97%, fixed at the time of each advance. The Company borrowed an aggregate of \$4.0 million on three notes through March 31, 2006, of which an aggregate of \$447,000 remained outstanding at June 30, 2008. Each note is repayable ratably over a 30-month-period from the date of the borrowing with final payment due in September 2008. The interest payable on these notes ranges from 9.66% to 10.28% per annum.



---

**Table of Contents**

**3PAR Inc.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL**

**STATEMENTS (Continued)**

**(unaudited)**

*Line of Credit*

In connection with the Notes Payable, the Company was granted an additional \$6.0 million revolving line of credit which provided for borrowings of up to 80% of eligible domestic accounts receivable. In fiscal 2007, the Company was extended an additional \$6.0 million under its revolving line of credit and the total borrowing capacity was increased to \$12.0 million. The line of credit bore interest at a variable rate which was linked to the prime lending rate. Under the terms of the revolving line of credit the Company was required to maintain a minimum tangible net worth level of \$1.5 million plus 50% of all issuances of new equity or subordinated debt after September 30, 2007. The Company was in compliance with this requirement as of March 31, 2008.

The revolving line of credit was repaid in full in April 2008. Prior to the expiration of the revolving line of credit on May 30, 2008, the Company entered into an amended and restated loan and security agreement, which provides for borrowings up to \$15.0 million. The revolving line of credit agreement contains a financial covenant that requires the Company 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, the Company is required to maintain a quick ratio of at least 1.25 to 1.0. The Company was in compliance with these financial covenants as of June 30, 2008. The revolving line of credit provides the Company two options for interest rate: (i) the lender's variable prime rate or (ii) LIBOR plus 200 basis points for the applicable period in effect at the time of the borrowing. The revolving line of credit expires on May 29, 2009. To date there have been no borrowings under the revolving line of credit.

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

**9. Income Taxes**

The Company has incurred annual operating losses since inception. As a result of those continuing losses, management has determined that it is more likely than not that the Company will not realize the benefits of the deferred tax assets and therefore has recorded a valuation allowance to reduce the carrying value of the deferred tax assets to zero. The Company's tax provision relates primarily to alternative minimum tax in the United States for the first quarter of fiscal 2009 and provisions for income tax related to the Company's international subsidiaries for both the first quarter of fiscal 2009 and 2008.

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

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

**Table of Contents**

**3PAR Inc.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL**

**STATEMENTS (Continued)**

**(unaudited)**

**10. Share Based Payments**

*Stock-Based Benefit Plans:*

*2007 Equity Incentive Plan:* In October 2007, the Company's stockholders approved the 2007 Equity Incentive Plan (the 2007 Plan), and the Company reserved 10,375,000 shares of common stock for future issuance thereunder. Additionally, the 2007 Plan provides for annual increases in the number of shares available for issuance thereunder on the first day of each fiscal year beginning with fiscal 2009, in an amount equal to the lesser of (A) five million shares, (B) five percent of the outstanding shares on the last day of the immediately preceding fiscal year or (C) such number of shares determined by the Company's board of directors. In accordance with these provisions, on April 1, 2008 shares available for issuance under the plan was increased by 3.0 million shares. The 2007 Plan provides for the grant of incentive stock options, nonstatutory stock options, restricted stock awards, restricted stock unit awards, stock appreciation rights, performance stock awards, and other forms of equity compensation, which may be granted to employees (including officers), directors, and service providers. Under the 2007 Plan, incentive options granted to an employee who owns more than 10% of the voting power of all classes of the Company's stock shall have an exercise price no less than 110% of the fair market value per share on the date of the grant. Options generally vest at the rate of 25% on each anniversary of the date of service contingent upon employment with the Company and expire no later than ten years after the date of grant. As of June 30, 2008, there were 12.3 million shares available for future issuance under the 2007 Plan.

*2007 Employee Stock Purchase Plan:* In October 2007, the Company's stockholders approved the 2007 Employee Stock Purchase Plan (the ESPP Plan) and the Company reserved 1,550,000 shares for future issuance plus an annual increase to be added on the first day of each fiscal year beginning with the 2009 fiscal year, equal to the lesser of (i) 1.5 million shares of common stock, (ii) two percent of the outstanding shares of common stock on such date or (iii) an amount determined by the administrator. Under the ESPP Plan, the Company grants stock purchase rights to all eligible employees during one-year overlapping offering periods with purchase dates at the end of each 6-month purchase period except for the first offering period. In accordance with these provisions, on April 1, 2008 shares available for issuance under the plan was increased by 1.2 million shares. The first offering period under the ESPP Plan commenced in November 2007 and will end on February 1, 2009 with the first purchase date on August 1, 2008. Shares are purchased through employees' payroll deductions, up to a maximum of 10% of an employee's compensation for each purchase period at a purchase price equal to 85% of the lesser of the fair market value of the Company's common stock at the first trading day of the applicable offering period or the purchase date. If the fair market value of the common stock on any purchase date in an offering period is lower than the fair market value of the common stock on the first trading day of the offering period, then all participants in the offering period will be automatically withdrawn from the offering period immediately after the stock has been purchased on the purchase date and automatically re-enrolled in the immediately following offering period. The number of shares that may be purchased by a participant during any purchase period is limited to 1,250 shares. The ESPP Plan is compensatory and results in compensation expense. Through June 30, 2008, no stock has been issued under the ESPP Plan. As of June 30, 2008, there were 2.7 million shares available for future issuance under the ESPP Plan.

*1999 Stock Plan and 2000 Management Stock Option Plan:* The Company's 1999 Stock Plan (the 1999 Plan) and the 2000 Management Stock Option Plan (the 2000 Plan) authorize the board of directors to grant incentive and nonstatutory stock options and stock purchase rights to employees, directors and consultants of the Company. Under the 1999 Plan and the 2000 Plan, incentive and nonstatutory stock options may be granted at prices not less than 100% of the estimated fair value of the stock at the date of grant, as determined by the board of directors. For options granted to an employee who owns more than 10% of the voting power of all classes of stock of the Company, the exercise price shall be no less than 110% of the fair market value of the stock at the date of grant. Options generally vest over a four year period and expire no later than ten years after the date of grant. The Company's board of directors concluded not to grant any additional options or other awards under the 1999 Plan and 2000 Plan following the IPO. However, the 1999 Plan and 2000 Plan will continue to govern the terms and conditions of the outstanding awards previously granted under these plans.



**Table of Contents****3PAR Inc.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL****STATEMENTS (Continued)****(unaudited)***Stock Option Activity:*

The following table summarizes information about stock options outstanding:

	Options Outstanding	Weighted Average Exercise Price per Share
	Number of Shares	
Balance at March 31, 2008	6,417,924	5.69
Options granted	776,716	8.56
Options exercised	(82,526)	1.70
Options cancelled	(155,826)	7.92
Balance at June 30, 2008	6,956,288	\$ 6.01

*Fair Value Disclosures:*

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

	Three Months Ended June 30, 2008	2007
<b>Employee Stock Options</b>		
Risk-free interest rate	2.53%	4.76%
Expected life (years)	4.13	4.34
Dividend yield	0.00%	0.00%
Expected volatility	52.0%	43.0%

	Three Months Ended March 31, 2008
<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%

## Edgar Filing: 3PAR Inc. - Form 10-Q

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

### *Shares Subject to Repurchase:*

Certain stock options granted by the Company are exercisable at the date of grant, with unvested shares subject to repurchase by the Company in the event of voluntary or involuntary termination of employment of the stockholder. Such exercises are recorded as a liability on the balance sheet and reclassified into equity as the options vest. As of June 30, 2008 and March 31, 2008, a total of 265,863 shares and 410,275 shares of common

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

stock, respectively, were subject to repurchase by the Company at the original exercise price of the related stock option. The corresponding exercise value of \$157,000 and \$329,000 as of June 30, 2007 and March 31, 2008, respectively, was recorded in accrued liabilities.

The activity of non-vested shares for the three months ended June 30, 2008 as a result of early exercise of options granted to employees is as follows:

	<b>Number of Shares</b>
Non-vested as of March 31, 2008	410,275
Vested	(118,363)
Repurchased	(26,049)
Non-vested as of June 30, 2008	265,863

**11. Commitments***Legal Matters*

From time to time, third parties assert claims against the Company arising from the normal course of business activities. There are no claims as of June 30, 2008 that, in the opinion of management, might have a material adverse effect on the Company's financial position, results of operations or cash flows.

*Lease Obligations*

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

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

	<b>Rent Commitment</b>
<b>For the years ending March 31,</b>	
2009 (remaining nine months)	\$ 1,396
2010	1,818
2011	1,732
2012	1,527
2013	1,445
Thereafter	1,365

Total minimum lease payments	\$ 9,283
------------------------------	----------

*Warranties*

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

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

Table of Contents

## 3PAR Inc.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL

## STATEMENTS (Continued)

(unaudited)

Changes in the warranty liability are as follows:

	Three Months Ended June 30,	
	2008	2007
	(in thousands)	
<b>Beginning balance</b>	\$ 6,184	\$ 5,548
Provision	870	842
Settlements made	(968)	(702)
<b>Ending balance</b>	\$ 6,086	\$ 5,688

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

	June 30,	
	2008	2007
	(in thousands)	
Current	\$ 3,315	\$ 3,371
Non-current	2,771	2,813
<b>Total</b>	\$ 6,086	\$ 6,184

*Noncancelable Purchase Commitments*

The Company outsources the production of its hardware to third-party contract manufacturers. In addition, the Company enters into various inventory related purchase commitments with these contract manufacturers and suppliers. The Company had \$18.1 million and \$13.6 million in noncancelable purchase commitments with these providers as of June 30, 2008 and March 31, 2008, respectively. The Company records a liability for firm, noncancelable purchase commitments with contract manufacturers and suppliers for quantities in excess of its future demand forecasts. As of June 30, 2008 and March 31, 2008, the liability for these purchase commitments was \$295,000.

*Guarantees and Indemnifications*

The Company indemnifies its officers and directors for certain events or occurrences, subject to certain limits, while the officer or director is or was serving at the Company's request in such capacity. The maximum amount of potential future indemnification is unlimited; however, the Company has a director and officer insurance policy that limits its exposure and enables it to recover a portion of any future amounts paid. The Company is unable to reasonably estimate the maximum amount that could be payable under these arrangements since these obligations are not capped but are conditional to the unique facts and circumstances involved. Accordingly, the Company has no liabilities recorded for these agreements as of June 30, 2008 and March 31, 2008.



## Edgar Filing: 3PAR Inc. - Form 10-Q

In its sales agreements, the Company may agree to indemnify its indirect sales channels and end-user customers for any expenses or liability resulting from claimed infringements of patents, trademarks or copyrights of third parties. The terms of these indemnification agreements are generally perpetual any time after execution of the agreement. The maximum amount of potential future indemnification is unlimited. To date the Company has not paid any amounts to settle claims or defend lawsuits. The Company is unable to reasonably

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

estimate the maximum amount that could be payable under these arrangements since these obligations are not capped but are conditional to the unique facts and circumstances involved. Accordingly, the Company has no liabilities recorded for these agreements as of March 31, 2007 and December 31, 2007.

**12. Segment Information and Significant Customers**

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

The following presents total revenues by geographic region:

	<b>Three Months Ended June 30,</b>	
	<b>2008</b>	<b>2007</b>
	<b>(in thousands)</b>	
United States	\$ 39,381	\$ 21,092
International	3,572	2,716
<b>Total</b>	<b>\$ 42,953</b>	<b>\$ 23,808</b>

One customer accounted for 20% and 25% of total revenue in the three months ended June 30, 2008 and 2007, respectively. One customer accounted for 21% of accounts receivable, net at June 30, 2008, and one customer accounted for 11% of accounts receivable, net at March 31, 2008.

**13. Subsequent Events**

On July 31, 2008, the Board of Directors of the Company approved the investment of up to \$10 million for the purchase of shares of the Company's common stock in the open market under a stock repurchase program, subject to applicable securities laws, rules and regulations. The shares may be repurchased at the Company's discretion from time to time in the open market. Such purchases will be made at times and in amounts as the Company deems appropriate, based on factors such as market conditions, legal requirements, and other corporate considerations.

---

**Table of Contents**

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

*This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, which are subject to the safe harbor created by those sections. Forward-looking statements are based on our management's beliefs and assumptions and on information currently available to our management. In some cases, you can identify forward-looking statements by terms such as may, will, should, could, would, expect, plan, anticipate, believe, estimate, project, predict, potential and similar expressions intended to identify forward-looking statements. These statements involve known and unknown risks, uncertainties and other factors, which may cause our actual results, performance, time frames or achievements to be materially different from any future results, performance, time frames or achievements expressed or implied by the forward-looking statements. We discuss many of these risks, uncertainties and other factors in this Quarterly Report on Form 10-Q in greater detail under the heading Risk Factors. Given these risks, uncertainties and other factors, you should not place undue reliance on these forward-looking statements. Also, these forward-looking statements represent our estimates and assumptions only as of the date of this filing. You should read this Quarterly Report on Form 10-Q completely and with the understanding that our actual future results may be materially different from what we expect. We hereby qualify our forward-looking statements by these cautionary statements. Except as required by law, we assume no obligation to update these forward-looking statements publicly, or to update the reasons actual results could differ materially from those anticipated in these forward-looking statements, even if new information becomes available in the future.*

*The following discussion should be read in conjunction with our financial statements and the related notes contained elsewhere in this Quarterly Report on Form 10-Q and in our other Securities and Exchange Commission, or SEC, filings, including our Annual Report on Form 10-K for the year ended March 31, 2008.*

**Overview**

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 initial public offering, or 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.

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.

## **Table of Contents**

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 2009, will end on March 31, 2009.

### **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.

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.

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.

During the month of March 2007, the Company did not have VSOE of fair value for its new software support model. Accordingly, through March 31, 2008, the Company was recognizing all of the hardware and support revenue from transactions that included software support during the month of March 2007 as product revenue ratably over the support period of one to three years. During the first quarter of fiscal 2009, the Company established VSOE of fair value of PCS for these March 2007 transactions based on actual renewal rates for separate sales of PCS to other customers. Accordingly, in the first quarter of fiscal 2009 the Company applied the residual method to the remaining deferred revenue associated with the March 2007 transactions.

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



---

## **Table of Contents**

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.

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 312 employees at March 31, 2007 to 451 employees at March 31, 2008 and to 492 employees at June 30, 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 expense research and development expense as incurred. We expect to continue to devote substantial resources to the development of our products. We believe that these investments are necessary to maintain and improve our competitive position. 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.

---

**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.

With the exception of the discussion noted below a description of our critical accounting policies that involve significant management judgment appears in our 2008 Annual Report on Form 10-K under Management's Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies and Estimates.

***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*

## Table of Contents

*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.

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 PCS within a sale is based upon stated renewal rates included within the evidence of the arrangement with the customer. In circumstances where the arrangement does not include stated renewal rates, VSOE of fair value of PCS is based on actual renewal rates for separate sales of PCS to other customers.

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.

During the month of March 2007, the Company did not have VSOE of fair value for its new software support model. Accordingly, through March 31, 2008, the Company was recognizing all of the hardware and support revenue from transactions that included software support during the month of March 2007 as product revenue ratably over the support period of one to three years. During the first quarter of fiscal 2009, the Company established VSOE of fair value of PCS for these March 2007 transactions based on actual renewal rates for separate sales of PCS to other customers. Accordingly, in the first quarter of fiscal 2009 the Company applied the residual method to the remaining deferred revenue associated with the March 2007 transactions.

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.

### *Income Taxes*

The Company uses the asset and liability method of accounting for income taxes in accordance with SFAS No. 109, *Accounting for Income Taxes* ( SFAS 109 ). Deferred tax assets and liabilities are recognized 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. Deferred tax assets are recognized for deductible temporary differences, along with net operating loss carry- forwards, if it is more likely than not that the tax benefits will be realized. To the extent a deferred tax asset cannot be recognized under the preceding criteria, a valuation allowance is established. Deferred tax assets and liabilities are measured using enacted tax rates in effect for the year in which those temporary differences are expected to be recovered or settled.

Effective April 1, 2007, the Company adopted FASB Interpretation No. 48 ( 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.



**Table of Contents****Results of Operations for the Three Months Ended June 30, 2008 and 2007****Revenue**

The following tables present period over period comparisons of our revenue by revenue source for the three months ended June 30, 2008 and 2007 (dollars in thousands):

Types of Revenue:	Three Months Ended June 30,		Change in	
	2008	2007	\$	%
Product	\$ 39,924	\$ 23,123	\$ 16,801	73%
<i>As % of total revenue</i>	<i>92.9%</i>	<i>97.1%</i>		
Support	3,029	685	2,344	342%
<i>As % of total revenue</i>	<i>7.1%</i>	<i>2.9%</i>		
<b>Total revenue</b>	<b>\$ 42,953</b>	<b>\$ 23,808</b>	<b>\$ 19,145</b>	<b>80%</b>

Revenue by geography:	Three Months Ended June 30,		Change in	
	2008	2007	\$	%
United States	\$ 39,381	\$ 21,092	\$ 18,289	87%
<i>As % of total revenue</i>	<i>91.7%</i>	<i>88.6%</i>		
International	3,572	2,716	856	32%
<i>As % of total revenue</i>	<i>8.3%</i>	<i>11.4%</i>		
<b>Total revenue</b>	<b>\$ 42,953</b>	<b>\$ 23,808</b>	<b>\$ 19,145</b>	<b>80%</b>

Our total revenue increased by \$19.1 million, or 80%, to \$43.0 million in the first quarter of fiscal 2009 from \$23.8 million in the first quarter of fiscal 2008. Product revenue increased by \$16.8 million, or 73%, to \$39.9 million in the first quarter of fiscal 2009 from \$23.1 million in the first quarter of fiscal 2008. The increases in fiscal 2009 were principally due to an increase in repeat sales to existing customers and the expansion of our customer base. Revenue in the first quarter of fiscal 2009 also benefited from the recognition of \$2.8 million of deferred revenue associated with certain March 2007 transactions that we were previously recognizing on a ratable basis. The \$2.8 million includes \$2.2 million associated with the establishment of VSOE of fair value of PCS for the March 2007 transactions during the first quarter of fiscal 2009. Revenue from our existing customers represented 88% of total revenue in the first quarter of 2009 as compared to 79% of total revenue in the respective prior year period. We increased the number of our sales and marketing personnel to 167 at June 30, 2008, from 123 at June 30, 2007, which contributed to our ability to expand our customer base.

Support revenue increased by \$2.3 million to \$3.0 million in the first quarter of fiscal 2009 from \$685,000 in the first quarter of fiscal 2008. The \$2.3 million increase in support revenue in the first quarter of fiscal 2009 compared to the first quarter of fiscal 2008, is primarily attributable to 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 agreements and an increase in our support renewals.

In the three months ended June 30, 2008, we derived 86% of our total revenue from direct sales to customers, compared to 78% in the three months ended June 30, 2007. The increase in direct sales as a

**Table of Contents**

percentage of revenue in the first quarter of fiscal 2009 compared to the first quarter of fiscal 2008 reflects our increased 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 153 at June 30, 2008 from 113 at June 30, 2007. We generated 8% of our total revenue from shipments to international locations compared to 11% in the three months ended June 30, 2007.

**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 three months ended June 30, 2008 and 2007 (dollars in thousands):

	Three Months Ended June 30,		Change in	
	2008	2007	\$	%
Cost of product revenue	\$ 14,021	\$ 8,110	\$ 5,911	73%
As % of product revenue	35%	35%		
Cost of support revenue	1,006	216	790	366%
As % of support revenue	33%	32%		
<b>Total cost of revenue</b>	<b>15,027</b>	<b>8,326</b>	<b>6,701</b>	<b>80%</b>
Gross profit	\$ 27,926	\$ 15,482	\$ 12,444	80%
Gross margin	65%	65%		

Cost of revenue increased by \$6.7 million, or 80%, to \$15.0 million in the first quarter of fiscal 2009 from \$8.3 million in the first quarter of fiscal 2008 primarily due to increased product shipments.

Cost of product revenue increased by \$5.9 million, or 73%, to \$14.0 million in the first quarter of fiscal 2009 from \$8.1 million in the first quarter of fiscal 2008, which was in line with the 73% increase in our product revenue during the same period.

Cost of support revenue increased by \$790,000, or 366%, to \$1.0 million in the first quarter of fiscal 2009 from \$216,000 in the first quarter of fiscal 2008 primarily due to increased personnel cost and outside vendor cost required to support premium and extended warranties.

**Research and Development**

The following table presents period over period comparisons of our research and development expense for the three months ended June 30, 2008 and 2007 (dollars in thousands):

	Three Months Ended June 30,		Change in	
	2008	2007	\$	%
Research and development	\$ 10,157	\$ 7,807	\$ 2,350	30%
As % of total revenue	24%	33%		

Our research and development expense increased by \$2.4 million, or 30%, to \$10.2 million in the first quarter of fiscal 2009 from \$7.8 million in the first quarter of fiscal 2008. The increase in fiscal 2009 was primarily due to increases in research and development personnel to 176 employees at June 30, 2008 from 130 employees at June 30, 2007 resulting in an increase in employee compensation and related cost.

As a percentage of our total revenue, research and development expense decreased to 24% in the first quarter of fiscal 2009 from 33% in the first quarter of fiscal 2008. This percentage decrease is attributable principally to the significant increase in our total revenue, which grew at a higher rate than our research and development expenses in the first quarter of fiscal 2009 as compared to the first quarter of fiscal 2008.



**Table of Contents**

Of the \$2.4 million increase in research and development expense in the first quarter of fiscal 2009, salaries and employee-related benefits and allocated facilities/IT expense accounted for \$1.8 million and \$561,000, respectively.

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 three months ended June 30, 2008 and 2007 (dollars in thousands):

	Three Months Ended June 30,		Change in	
	2008	2007	\$	%
Sales and marketing	\$ 14,301	\$ 10,457	\$ 3,844	37%
As % of total revenue	33%	44%		

Our sales and marketing expense increased by \$3.8 million, or 37%, to \$14.3 million in the first quarter of fiscal 2009 from \$10.5 million in the first quarter of fiscal 2008. This increase reflects in part the increase in sales and marketing personnel to 167 employees at June 30, 2008 from 123 employees at June 30, 2007.

As a percentage of our total revenue, sales and marketing revenue decreased to 33% in the three months ended June 31, 2008, from 44% in the three months ended June 30, 2007 principally due to the significant increase in our total revenue, which grew at a higher rate than our sales and marketing expense in the first quarter of fiscal 2009.

Of the \$3.8 million increase in sales and marketing expense in the first quarter of fiscal 2008, salaries and employee-related benefits, travel and commission expense accounted for \$2.2 million, \$785,000, and \$691,000, respectively.

**General and Administrative**

The following table presents period over period comparisons of general and administrative expense for the three months ended June 30, 2008 and 2007 (dollars in thousands):

	Three Months Ended June 30,		Change in	
	2008	2007	\$	%
General and administrative	\$ 3,373	\$ 2,054	\$ 1,319	64%
As % of total revenue	8%	9%		

Our general and administrative expense increased by \$1.3 million, or 64%, to \$3.4 million in the first quarter of fiscal 2009 from \$2.1 million in the first quarter of fiscal 2008. This increase reflects in part the increase in general and administrative personnel to 57 employees at June 30, 2008 from 37 employees at June 30, 2007.

As a percentage of our total revenue, general and administrative expenses decreased to 8% in the first quarter of fiscal 2009 from 9% in the first quarter of fiscal 2008 principally due to the significant increase in our total revenue, which grew at a higher rate than general and administrative expense in the first quarter of fiscal 2009.

The \$1.3 million increase in general and administrative expense in the first quarter of fiscal 2009 is primarily due to a \$448,000 increase in payroll related costs as a result of increased headcount. The remainder of the increase relates primarily to higher professional fees and allocated infrastructure costs.



**Table of Contents****Other Income, net**

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

	Three Months Ended		Change in	
	2008	2007	\$	%
Other income (expense), net:				
Interest income	\$ 778	\$ 448	\$ 330	74%
Interest expense	(17)	(297)	280	(94)%
Other, net	(8)	31	(39)	(126)%
<b>Total other income (expense), net:</b>	<b>\$ 753</b>	<b>\$ 182</b>	<b>\$ 571</b>	<b>314%</b>

Other income, net increased by \$571,000, or 314%, to \$753,000 in the first quarter of fiscal 2009 from \$182,000 in the first quarter of fiscal 2008. The increase in other income, net in the three months ended June 30, 2008 compared to the same period in the prior year relates to higher interest income due to higher average cash and investment balances during the first quarter of fiscal 2009 compared to the same period in the prior year. In addition, interest expense decreased due to lower debt balances in the first quarter of fiscal 2009 compared to the same period in the prior year.

**Liquidity and Capital Resources**

The following table summarizes our cash, cash equivalents and short-term investments for the three months ended June 30, 2008 and 2007 (dollars in thousands):

	June 30, 2008	March 31, 2008	Increase/ (Decrease)
Cash and cash equivalents	\$ 62,642	\$ 97,585	\$ (34,943)
Short-term investments	45,103	18,058	27,045
<b>Total</b>	<b>\$ 107,745</b>	<b>\$ 115,643</b>	<b>\$ (7,898)</b>

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

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

On July 31, 2008, the Board of Directors of the Company approved the investment of up to \$10 million for the purchase of shares of the Company's common stock in the open market under a stock repurchase program, subject to applicable securities laws, rules and regulations. The shares may be repurchased at the Company's discretion from time to time in the open market. Such purchases will be made at times and in amounts as the Company deems appropriate, based on factors such as market conditions, legal requirements, and other corporate considerations.

We have a term loan agreement with a venture lending firm under which borrowings were available through March 31, 2006. On May 30, 2008, we entered into a loan and security agreement with a commercial bank, which provides for a revolving line of credit, under which the aggregate amount available for borrowing is \$15.0 million. The borrowings are collateralized by all of our assets with the exception of intellectual property. Our 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



**Table of Contents**

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. We were in compliance with these financial covenants as of June 30, 2008. The interest rate on the line of credit equals, at our election, 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 June 30, 2008, we had \$447,000 outstanding for notes payable under our term loan agreement. There have been no borrowings under the revolving line of credit.

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

	<b>Three Months Ended</b>	
	<b>June 30,</b>	
	<b>2008</b>	<b>2007</b>
Net cash used in operating activities	\$ (1,170)	\$ (5,697)
Net cash used in investing activities	(29,382)	(5,565)
Net cash provided by (used in) financing activities	(4,391)	2,718

***Cash Flows from Operating Activities***

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 \$1.2 million and \$5.7 million in the first three months of fiscal 2009 and 2008, respectively. The \$4.5 million decrease in net cash used in operating activities in the first three months of fiscal 2009 from the first three months of fiscal 2008 was primarily attributable to net income of \$678,000 in the first three months of fiscal 2009 versus a net loss of \$4.7 million in the comparable prior year period and an increase in our non-cash expenses such as depreciation and amortization, bad debt expense and stock-based compensation expense offset by an increase in inventory in the first three months of fiscal 2009 compared to the first three months of fiscal 2008.

***Cash Flows from Investing Activities***

Cash flows from investing activities primarily relate to investments of our available cash and cash equivalent balances and capital expenditures to support our growth. Net cash used in investing activities was \$29.4 million and \$5.6 million in the first three months of fiscal 2009 and 2008, respectively.

The \$23.8 million increase in net cash used in investing activities in the first three months of fiscal 2009 from the first three months of fiscal 2008 was primarily attributable to an increase in purchases of short-term investments of \$19.3 million and a \$1.7 million increase in capital expenditures offset by a decrease in the sale and maturity of short-term investments of \$2.8 million. The purchases of property and equipment in the first three months of fiscal 2009 were due to an increase in our headcount and purchases related to the continual build out of our infrastructure to support our growth.

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



## **Table of Contents**

### ***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 \$447,000 outstanding at June 30, 2008.

Net cash used in financing activities in the first three months of fiscal 2009 was \$4.4 million as compared to net cash provided by financing activities of \$2.7 million for the same period of fiscal 2008 due primarily to a \$4 million repayment of our line of credit.

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

### ***Contractual Obligations***

The following table summarizes our contractual obligations as of June 30, 2008:

	<b>Total</b>	<b>Payments due by period</b>			
		<b>Less than 1 Year</b>	<b>1 to 3 Years</b>	<b>3 to 5 Years</b>	<b>More than 5 Years</b>
Operating lease obligations	9,283	1,396	3,550	2,972	1,365
Non-cancellable inventory purchase commitments	18,129	18,129			
<b>Total</b>	<b>\$ 27,412</b>	<b>\$ 19,525</b>	<b>\$ 3,550</b>	<b>\$ 2,972</b>	<b>\$ 1,365</b>

### ***Guarantees***

In the ordinary course of business, we have entered into agreements with, among others, customers, resellers, system integrators and distributors that include guarantees or indemnity provisions. Based on our historical experience and information known to us as of June 30, 2008, we believe that our exposure related to these guarantees and indemnities as of June 30, 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 potential case.

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

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

### ***Recent Accounting Pronouncements***

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

**Table of Contents****Item 3. Quantitative and Qualitative Disclosures about Market Risk****Foreign Currency Risk**

Most of our sales contracts are denominated in United States dollars, and therefore, our reported 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 reported operating results and cash flows.

**Interest Rate Sensitivity**

We had cash and cash equivalents totaling \$62.6 million at June 30, 2008. These amounts were invested primarily in money market funds 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 June 30, 2008, a hypothetical 100 basis points decline in interest rates would reduce our interest income by approximately \$1.0 million over a one year period.

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 June 30, 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	\$ 33,352		\$ 33,088	\$ 32,824
Municipal bonds	5,192	5,175	5,157	5,122	5,139
Commercial paper	4,008	3,999	3,990	3,971	3,981
Corporate debt securities	3,167	3,149	3,132	3,097	3,114
<b>Total short-term investments</b>	<b>\$ 45,719</b>	<b>\$ 45,411</b>	<b>\$ 45,103</b>	<b>\$ 44,488</b>	<b>\$ 44,796</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	\$ 33,878		\$ 33,352	\$ 32,824
Municipal bonds	5,227	5,192	5,157	5,087	5,122
Commercial paper	4,026	4,008	3,990	3,953	3,971
Corporate debt securities	3,202	3,167	3,132	3,062	3,097
<b>Total short-term investments</b>	<b>\$ 46,333</b>	<b>\$ 45,719</b>	<b>45,103</b>	<b>\$ 43,874</b>	<b>\$ 44,488</b>

At June 30, 2008, we had \$447,000 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 this outstanding balance, 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 borrowings under our revolving line of credit.

**Item 4T. Controls and Procedures***(a) Evaluation of disclosure controls and procedures*

Our management evaluated, with the participation of our Chief Executive Officer and our Chief Financial Officer, the effectiveness of our disclosure controls and procedures as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on this evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that as of the end of the period covered by this Quarterly Report on Form 10-Q, our disclosure controls and procedures were effective to provide reasonable assurance that information we are required to disclose in reports that we file or submit under the Securities Exchange Act of 1934 (i) is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms, and (ii) is accumulated and communicated to our management, including our Chief Executive Officer and our Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

*(b) Changes in internal control over financial reporting.*

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

---

**Table of Contents**

**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings**

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

**Item 1A. Risk Factors**

**Risks Related to Our Business and Industry**

*We have a history of annual losses and we may not be able to sustain profitability.*

Since our formation, we have recorded a net loss in all of our annual 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 June 30, 2008, our accumulated deficit was \$173.3 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 sustain profitability in future fiscal periods.

*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 2009, 20% 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, given current economic conditions, 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;

---

**Table of Contents**

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.

***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

---

**Table of Contents**

better-known and more established competitors. In the event that we are unable to successfully sell our products to new customers, persuade customers of our competitors to purchase our products instead, or prevent our competitors from persuading our customers to purchase our competitors' products, we may not be able to maintain or increase our market share. This would have a negative impact on our future operating results.

***Our ability to increase our revenue will depend substantially on our ability to attract and retain 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,

---

**Table of Contents**

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.

***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.

---

**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, and because revenue in the first quarter of fiscal 2009 benefited from the recognition of an incremental \$2.2 million of deferred revenue associated with the establishment of VSOE on March 2007 transactions that we were previously recognizing on a ratable basis, 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



---

**Table of Contents**

resellers and authorized service providers. Our ability to maintain or grow our revenue will depend, in part, on 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 June 30, 2008, our number of employees increased from 139 to 492, 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.

---

**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

## Edgar Filing: 3PAR Inc. - Form 10-Q

products, including various European Union, or EU, member countries. For example, the EU has enacted the Restriction of the Use of Certain Hazardous Substances in Electrical and Electronic Equipment, or RoHS, and the Waste Electrical and Electronic Equipment, or WEEE, directives. RoHS prohibits the use of certain substances, including lead,

---

**Table of Contents**

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 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

---

**Table of Contents**

costs or may refuse to pay us for outstanding balances related to the improper allocation. An unfavorable audit could reduce our revenue, and may result in civil or criminal liability if the audit uncovers improper or illegal activities. This could harm our business, operating results and financial condition.

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

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

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

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

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

Developing our products is expensive. In fiscal 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.

---

**Table of Contents**

*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.

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.

---

**Table of Contents**

***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 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.

---

## **Table of Contents**

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 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;



**Table of Contents**

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.

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

***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 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.



## **Table of Contents**

*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

require a super-majority of votes to amend certain of the above-mentioned provisions.

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

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

### *Sales of Unregistered Securities*

On May 9, 2008 we issued an aggregate of 19,948 shares of common stock upon net issuance exercise of warrants to purchase 20,000 shares of our common stock at an exercise price of \$0.02 per share originally issued to a lender. 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.

**Item 3. Defaults Upon Senior Securities**  
None

**Item 4. Submission of Matters to a Vote of Security Holders**  
None

**Item 5. Other Information**  
None

**Table of Contents**

**Item 6. Exhibits**

<b>Exhibit No.</b>	<b>Description</b>
10.25*	Amended and Restated Loan and Security Agreement by and between the Registrant and Silicon Valley Bank dated May 30, 2008.
31.1	Certification of Principal Executive Officer Pursuant to Exchange Act Rule 13a-14(a) or 15d-14(a), as Adopted Pursuant to Section 302 of The Sarbanes Oxley Act of 2002.
31.2	Certification of Principal Financial Officer Pursuant to Exchange Act Rule 13a-14(a) or 15d-14(a), as Adopted Pursuant to Section 302 of The Sarbanes Oxley Act of 2002.
32.1	Certifications of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

\* Incorporated by reference to Exhibit 10.25 filed with the Registrant's Annual Report on Form 10-K for the fiscal year ended March 31, 2008.

**Table of Contents**

**SIGNATURES**

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

Dated: August 13, 2008

**3PAR Inc.**

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

**Table of Contents**

**EXHIBIT INDEX**

<b>Exhibit No.</b>	<b>Description</b>
10.25*	Amended and Restated Loan and Security Agreement by and between the Registrant and Silicon Valley Bank dated May 30, 2008.
31.1	Certification of Principal Executive Officer Pursuant to Exchange Act Rule 13a-14(a) or 15d-14(a), as Adopted Pursuant to Section 302 of The Sarbanes Oxley Act of 2002.
31.2	Certification of Principal Financial Officer Pursuant to Exchange Act Rule 13a-14(a) or 15d-14(a), as Adopted Pursuant to Section 302 of The Sarbanes Oxley Act of 2002.
32.1	Certifications of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

\* Incorporated by reference to Exhibit 10.25 filed with the Registrant's Annual Report on Form 10-K for the fiscal year ended March 31, 2008.