3PAR Inc.
Form 10-Q
August 09, 2010
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

Form 10-Q

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

For the quarterly period ended June 30, 2010

OR

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

For the transition period from ______ to ______

Commission file number: 001-33823

3PAR Inc.

(Exact name of registrant as specified in its charter)

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

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

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

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

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

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

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

The number of shares of the registrant s Common Stock, $.001 par value, outstanding at July 30, 2010 was 62,585,311

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QUARTERLY REPORT ON FORM 10-Q

FOR THE THREE MONTHS ENDED JUNE 30, 2010

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

3PAR Inc.

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands, except share data)

(unaudited)

	June 30, 2010	March 31, 2010
ASSETS		
Current assets:		
Cash and cash equivalents	$ 28,942	$ 39,047
Short-term investments	75,354	72,259
Accounts receivable, net	44,815	39,808
Inventory	29,852	29,752
Deferred cost	3,217	3,083
Prepaid and other current assets	4,134	4,204
Total current assets	186,314	188,153
Property and equipment, net	26,034	23,722
Restricted Cash	1,417	
Other non-current assets	408	423
Total assets	$ 214,173	$ 212,298
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 10,523	$ 15,462
Accrued compensation and benefits	10,761	10,102
Other accrued liabilities	4,048	4,700
Deferred revenue	31,807	27,648
Accrued warranty	4,034	3,891
Total current liabilities	61,173	61,803
Accrued warranty, non-current	2,968	3,043
Deferred revenue, non-current	10,285	9,072
Other long-term liabilities	1,074	1,150
Total liabilities	75,500	75,068
Commitments and contingencies (Note 13)		
Stockholders equity:		
Preferred stock, $0.001 par value; 20,000,000 shares authorized; none issued and outstanding at June 30, 2010 and March 31, 2010.		
Common stock, $0.001 par value; 300,000,000 shares authorized at June 30, 2010 and March 31, 2010; 62,569,252 and 62,393,897 shares issued and outstanding at June 30, 2010 and March 31, 2010, respectively	63	62
Additional paid-in capital	318,509	315,306

Accumulated other comprehensive income (loss)	67	(13)
Accumulated deficit	(179,966)	(178,125)
Total stockholders equity	138,673	137,230
Total liabilities and stockholders equity	$ 214,173	$ 212,298

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

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3PAR Inc.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share amounts)

(unaudited)

	Three Months Ended June 30, 2010	2009
Revenue:		
Product	$ 46,421	$ 38,802
Support	7,840	5,667
Total revenue	54,261	44,469
Cost of revenue:		
Product	17,082	13,714
Support	2,393	1,730
Total cost of revenue (1)	19,475	15,444
Gross profit	34,786	29,025
Operating expenses:		
Research and development (1)	13,000	11,632
Sales and marketing (1)	19,034	15,580
General and administrative (1)	4,318	3,901
Total operating expenses	36,352	31,113
Loss from operations	(1,566)	(2,088)
Other income (expense), net:		
Interest income	118	173
Other income (expense), net	(289)	203
Total other income (expense), net	(171)	376
Loss before income tax provision	(1,737)	(1,712)
Income tax provision	(104)	(87)
Net loss	$ (1,841)	$ (1,799)
Net loss per common share, basic and diluted	$ (0.03)	$ (0.03)
Shares used to compute net loss per common share:		
Basic and diluted	62,499	61,262

(1) Includes stock-based compensation as follows:

Cost of revenue	$ 218	$ 81
Research and development	814	641

Sales and marketing	1,037	677
General and administrative	781	441

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

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3PAR Inc.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(unaudited)

	Three Months Ended June 30, 2010	Three Months Ended June 30, 2009
Cash flows from operating activities:		
Net loss	$ (1,841)	$ (1,799)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	2,660	2,033
Stock-based compensation expense	2,850	1,840
Amortization of premium on short-term investments, net	152	159
Provision for doubtful accounts	257	163
Writedown for excess and obsolete inventory	128	400
Loss on disposal of fixed assets	18	
Realized loss on short-term investments	9	
Changes in assets and liabilities:		
Accounts receivable	(5,264)	(4,970)
Inventory	(228)	667
Deferred cost	(134)	5
Prepaid expenses and other current assets	70	(478)
Other non-current assets	15	
Accounts payable	(4,943)	(1,914)
Accrued liabilities	12	(5,825)
Deferred revenue	5,372	3,377
Accrued warranty	68	(57)
Other long-term liabilities	(76)	(49)
Net cash used in operating activities	(875)	(6,448)
Cash flows from investing activities:		
Proceeds from sales and maturities of short-term investments	14,444	27,714
Purchases of short-term investments	(17,621)	(15,920)
Purchase of property and equipment	(4,986)	(1,296)
Change in restricted cash	(1,417)	
Net cash provided by (used in) investing activities	(9,580)	10,498
Cash flows from financing activities:		
Proceeds from issuance of common stock under employee stock plans, net	350	733
Net cash provided by financing activities	350	733
Net change in cash and cash equivalents	(10,105)	4,783
Cash and cash equivalents, beginning of period	39,047	47,621
Cash and cash equivalents, end of period	$ 28,942	$ 52,404

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

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3PAR Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

1. The Company and its Significant Accounting Policies

The Company

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

Fiscal Year

The fiscal year ends on March 31. References to fiscal 2011, for example, refer to the fiscal year ending March 31, 2011.

Significant Accounting Policies

The Company s significant accounting policies are disclosed in the Company s Annual Report on Form 10-K (File No. 001-33823) for the year ended March 31, 2010 (Form 10-K) except as noted below in Recent Accounting Policy Changes .

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 the information and footnote disclosures 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 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, 2010, and the consolidated results of its operations for the three months ended June 30, 2010 and 2009, and the consolidated cash flows for the three months ended June 30, 2010 and 2009. The results of operations for the three months ended June 30, 2010 are not necessarily indicative of the results to be expected for the full year.

The condensed consolidated balance sheet at March 31, 2010 has been derived from the audited consolidated financial statements at that date but does not include all footnote disclosures required by GAAP.

Recent Accounting Policy Changes

Revenue Recognition for Arrangements with Multiple Deliverables

In October 2009, the Financial Accounting Standards Board (FASB) issued an accounting standards update, which removes tangible products containing software components and non-software components that function together to deliver the product s essential functionality from the scope of industry specific software revenue guidance. At the same time, FASB amended the accounting standard for multiple element revenue arrangements which are not in the scope of industry specific software revenue recognition guidance to provide updated guidance to separate the deliverables and to measure and allocate arrangement consideration to one or more units of accounting. The new guidance eliminates the use of the residual method and requires an entity to allocate arrangement consideration at the inception of the arrangement to all deliverables using the relative selling price method. In contrast to the residual method, this has the effect of allocating any inherent discount in a multiple element arrangement to each of the deliverables on a proportionate basis. The guidance also expands the disclosure requirements to require an entity to provide both qualitative and quantitative information about the significant judgments made in applying the revised guidance and subsequent changes in those judgments that may significantly affect the timing or amount of revenue recognition. The revised revenue recognition accounting standards are effective for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010.

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3PAR Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(unaudited)

The Company elected to early adopt the amended accounting guidance at the beginning of its first quarter of fiscal 2011 on prospective basis for applicable revenue transactions originating or materially modified after March 31, 2010.

The Company derives its revenue from sales of storage systems that include hardware, software and related support as well as professional services such as installation and training. Each of the Company s storage systems has an integrated hardware platform and a software operating system that function together to deliver the essential functionality of the storage system. Optional supplementary non-essential software applications that are designed to enhance the Company s storage systems are either bundled with the operating system or sold under perpetual license agreements that can be purchased either with or after the initial system purchase. Under the software support, 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 of generally one or three years. The Company s hardware maintenance agreements extend the hardware warranty beyond the basic warranty of 3 years and/or offer faster response time than the Company s basic hardware warranty over the term of the maintenance agreement.

The Company enters into revenue arrangements that may contain multiple deliverables of its product and support offerings. For example, a customer may purchase a storage system along with various supplementary software products and post-contract customer support (PCS). This arrangement would consist of multiple elements with the hardware and software products delivered in one reporting period and the PCS delivered across multiple reporting periods. Another customer may upgrade an existing storage system by purchasing additional hardware capacity and essential software only. In this case, all the elements are delivered within the same reporting period. Additionally, customers purchase PCS through annual renewals of their support agreements.

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, completion of installation and/or upon satisfaction of evaluation criteria or expiration of the evaluation period, as the case may be. The Company s hardware and software support revenue is deferred at the inception of the agreement and recognized ratably over the period during which the support is provided. 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 end customers, channel partners and resellers generally do not include rights of return or rebates and to-date product returns have been negligible. The Company assesses its ability to collect its receivables from its customers based on a number of factors, including creditworthiness of the customer and past transaction history.

As the embedded software of the Company s storage systems was deemed to be more than incidental to the product as a whole, the Company previously accounted for revenue for the entire sale in accordance with the software revenue recognition guidance. For transactions entered into prior to the first quarter of fiscal 2011, the Company allocated revenue to the delivered elements of the sale, typically hardware and software, using the residual method. Under the residual method, the Company deferred revenue from the sale equivalent to the vendor specific objective evidence (VSOE) of the fair value of PCS and applied any discounts to the delivered elements. Since under the previous revenue recognition guidance, the Company was able to demonstrate fair value for the undelivered elements in a multiple element arrangement, the amended revenue recognition guidance does not generally change the Company s units of accounting. Starting in fiscal 2011, when a sales arrangement contains multiple elements and software and non-software components function together to deliver the tangible products essential functionality, the Company allocates revenue to each element based on the relative selling price of each element. Under this approach, the selling price of a deliverable is determined by using a selling price hierarchy which requires the use of VSOE of fair value if available, third party evidence (TPE) if VSOE is not available, or estimated selling price (ESP) if neither VSOE nor TPE is available.

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3PAR Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(unaudited)

VSOE is based on the price charged when the element is sold separately. In determining VSOE, the Company requires that a substantial majority of the selling prices fall within a reasonable price range. Since the Company generally does not have stand-alone sales of its hardware and software products, the use of VSOE is limited to PCS. TPE of selling price is established by evaluating largely interchangeable competitor products or services in stand-alone sales to similarly situated customers. However, since the Company s competitors do not generally sell tangible products and perpetual licenses on a stand-alone basis except for limited cases, no consistent pricing information is available. Therefore, the Company concluded that no reliable TPE is available for its products and services. The ESP is established considering multiple factors including, but not limited to, the Company s pricing practices in different geographies and through different sales channels, gross margin objectives, internal costs and competitor pricing strategies.

The Company continues to account for non-essential software applications and related PCS included in a multiple element arrangement under industry specific software revenue recognition guidance using the residual method. Revenue is first allocated to the non-software deliverables and to the software deliverables as a group using the relative selling prices of each of the deliverables in the arrangement based on the selling price hierarchy described above. Next, under the residual method, the Company defers revenue from the sale equivalent to the VSOE of the fair value of PCS and applies any inherent discounts to the delivered software element.

Revenue as reported and pro forma revenue that would have been reported during the quarter ended June 30, 2010, if the transaction entered into or materially modified after March 31, 2010 were subject to previous accounting guidance, are shown in the following table (in thousands):

	UNAUDITED	
Three Months Ended June 30, 2010	**As Reported**	**Pro Forma Basis as if the Previous Accounting Guidance Were in Effect**
Total revenue	$ 54,261	$ 54,247

The Company does not expect that the change in the revenue allocation methodology with regards to PCS related to software that is essential to the functionality of the delivered tangible products will have a significant effect on revenue in the future periods due to the existence of VSOE for the Company s PCS. However, this new accounting guidance will continue to facilitate the Company s efforts to optimize its offerings due to better alignment between the economics of an arrangement and the accounting. The Company regularly reviews VSOE, TPE and ESP and maintains internal controls over the establishment and updates of these estimates.

Revenue Recognition for Arrangements with Installation

As of April 1, 2010, the Company changed its business model by allowing its customers located in the U.S. to contract directly with the Company s installation team or to utilize one of the Company s third party service partners for the installation of its storage systems. For such arrangements, revenue related to tangible products is recognized upon shipment provided all other revenue recognition criteria described above have been met while installation revenue is deferred and recognized upon completion of the installation services. In territories where the Company has no installation service partners and for orders received prior to April 1, 2010 under the Company s old business model, the Company continues to recognize both tangible product and installation revenue upon completion of the installation.

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3PAR Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(unaudited)

2. Balance Sheet Components

The following tables provide details of selected balance sheet accounts:

	June 30, 2010	March 31, 2010
	(in thousands)	
Accounts Receivable, Net		
Trade accounts receivable	$ 47,116	$ 42,025
Less: Allowance for doubtful accounts	(2,301)	(2,217)
Total	$ 44,815	$ 39,808

	June 30, 2010	March 31, 2010
	(in thousands)	
Inventory		
Raw materials	$ 25,080	$ 25,009
Work in process	2,678	2,364
Finished goods	2,094	2,379
Total	$ 29,852	$ 29,752

3PAR Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(unaudited)

3. Short-term Investments

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

	June 30, 2010			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
	(in thousands)			
Short-term Investments				
U.S. treasury bills	$ 3,006	$ 6	$	$ 3,012
U.S. government agency securities	41,702	34	(9)	41,727
Corporate debt securities	12,613	38	(1)	12,650
Commercial paper	12,335		(1)	12,334
Certificate of deposit	5,631			5,631
Total short-term investments	$ 75,287	$ 78	$ (11)	$ 75,354

	March 31, 2010			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
	(in thousands)			
Short-term Investments				
U.S. treasury bills	$ 3,015	$ 5	$ (30)	$ 2,990
U.S. government agency securities	34,728	6		34,734
Corporate debt securities	12,426	4	(3)	12,427
Commercial paper	16,479	5		16,484
Certificate of deposit	5,624			5,624
Total short-term investments	$ 72,272	$ 20	$ (33)	$ 72,259

The Company invests in securities that are rated investment grade or better. Unrealized gains and losses are recorded as a component of accumulated other comprehensive income (loss) in stockholders equity. If these investments are sold at a loss or are considered to have other than temporarily declined in value, a charge to operations is recorded based on the likelihood of selling the security prior to recovering its cost basis. The specific identification method is used to determine the cost of securities disposed of, with realized gains and losses reflected in other income (expense), net. The company reported realized gross losses of $9,000 in the three months ended June 30, 2010. There were no gross realized gains or losses on the sales and maturities of short-term investments in the three months ended June 30, 2009.

The Company had 11 and 25 investments that were in an unrealized loss position as of June 30, 2010, and March 31, 2010, respectively. The gross unrealized losses related to these investments were due to changes in prevailing interest rates. At June 30, 2010, none of these securities have been in a continuous unrealized loss position for more than twelve months. The Company has determined that these unrealized losses are temporary as the duration of the decline in value of the 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.

As of June 30, 2010, 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.

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:

	June 30, 2010	
Due in	**Amortized Cost**	**Fair Value**
	(in thousands)	
Less than 1 year	$ 58,884	$ 58,910
1 to 2 years	16,403	16,444
2 to 5 years		
Total short-term investments	$ 75,287	$ 75,354

4. Fair Value Measurements

The Company measures its cash equivalents, short term investments and derivative assets and liabilities at fair value. Fair value is defined as an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or a liability, such as inherent risk, transfer restrictions and risk of nonperformance.

Fair Value Hierarchy

The Company established a three-tier value hierarchy, which prioritizes the inputs used in the valuation methodologies in 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.

Level 1 - Quoted prices in active markets for identical assets or liabilities.

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, 2010 and March 31, 2010, the Company had no financial assets or liabilities for which fair value was determined using Level 3 inputs.

3PAR Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(unaudited)

The following table summarizes our financial assets and liabilities measured at fair value on a recurring basis (in thousands):

	Fair Value Measurements at June 30, 2010 Using		
Description	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2) (in thousands)**	**Total Balance**
Assets:			
Cash equivalents:			
Money market funds	$ 10,348	$	$ 10,348
Commercial paper		6,448	6,448
Short-term investments:			
U.S. treasury bills	3,012		3,012
U.S. government agency securities	41,727		41,727
Corporate debt securities		12,650	12,650
Commercial paper		12,334	12,334
Certificates of deposit		5,631	5,631
Total	$ 55,087	$ 37,063	$ 92,150
Liabilities:			
Foreign currency contracts	$	$ 195	$ 195
Total	$	$ 195	$ 195

	Fair Value Measurements at March 31, 2010 Using		
Description	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2) (in thousands)**	**Total Balance**
Assets:			
Cash equivalents:			
Money market funds	$ 17,734	$	$ 17,734
Commercial paper		4,999	4,999
Short-term investments:			
U.S. treasury bills	3,020		3,020
U.S. government agency securities	34,704		34,704
Corporate debt securities		12,427	12,427
Municipal bonds		16,484	16,484
Commercial paper		5,624	5,624

Total	$ 55,458	$ 39,534	$ 94,992
Liabilities:			
Foreign currency contracts	$	$ 38	$ 38
Total	$	$ 38	$ 38

In the three months ended June 30, 2010, there were no changes in the classification from level 1 to level 2.

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3PAR Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(unaudited)

5. Derivative Instruments and Hedging Activities

The functional currency of the Company s foreign subsidiaries is the United States (U.S.) Dollar. However, in countries outside the U.S., the Company transacts business in various currencies besides the U.S. Dollar. In addition, the Company has certain cash accounts, receivables and payables balances denominated in currencies other than the U.S. Dollar. The Company hedges certain British Pound and Euro denominated receivables held by the Company using foreign exchange contracts to reduce the risk that its earnings would be adversely affected by changes in the British Pound and Euro exchange rates. The Company accounts for the derivative instruments as either assets or liabilities on the balance sheet and measures them at fair value. Gains and losses on these foreign exchange contracts as well as the related costs are included in other income (expense), net along with the foreign currency gains and losses of the related hedged items. At June 30, 2010, the notional principal of the foreign exchange contract to sell British Pounds and Euro for U.S Dollars was £5.8 million (or approximately $8.7 million) and 1.9 million (or approximately $2.3 million), respectively, with an original maturity of 30 days and a fair value of $195,000 recorded in accrued liabilities.

The Company recorded a net gain of $82,000 in the other income (expense), net related to its foreign currency contracts in the three months ended June 30, 2010 and a net loss of $492,000 in the other income (expense), net related to its foreign currency contracts in the three ended June 30, 2009.

6. Property and Equipment, Net

Property and equipment, net consists of the following:

	Estimated Useful Life	June 30, 2010	March 31, 2010
		(in thousands)	
Property and Equipment, Net			
Computer equipment	3 years	$ 42,735	$ 39,091
Computer software	5 years	5,045	4,575
Machinery and equipment	3-5 years	4,715	3,944
Furniture and fixtures	7 years	2,219	2,219
Leasehold improvements	Shorter of lease term or 5 years	8,586	8,585
		63,300	58,414
Less: accumulated amortization and depreciation		(37,266)	(34,692)
Total property and equipment, net		$ 26,034	$ 23,722

7. Deferred Revenue

Deferred revenue consists of the following:

	June 30, 2010	March 31, 2010
	(in thousands)	

Deferred Revenue		
Product	$ 11,887	$ 10,430
Support	19,920	17,218
Total deferred revenue, current	31,807	27,648
Support, non-current	10,285	9,072
Total deferred revenue	$ 42,092	$ 36,720

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

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3PAR Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(unaudited)

As of April 1, 2010, the Company changed its business model by allowing its customers located in the U.S. to contract directly with the Company s installation team or to utilize one of the Company s third party service partners for the installation of its storage systems. For such arrangements, revenue related to tangible products is recognized upon shipment provided all other revenue recognition criteria described above have been met while installation revenue is deferred and recognized upon completion of the installation services. For direct customer orders in territories where the Company has no installation service partners and for orders received prior to April 1, 2010 under the Company s old business model, the Company continues to recognize both tangible product and installation revenue upon completion of the installation.

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

8. Line of Credit

On May 30, 2008, the Company entered into an amended and restated loan and security agreement, which provides for borrowings up to $15.0 million. This agreement was amended and extended through May 28, 2010 on May 29, 2009 and through May 27, 2011 on May 27, 2010. The revolving line of credit agreement contains a financial covenant that requires the Company to maintain a minimum tangible net worth of $85.0 million, which is increased by 50% of any new net equity proceeds and/or 50% of quarterly profits since March 31, 2009. Tangible net worth is defined as the consolidated total assets minus any amounts attributable to goodwill and intangible assets, reserves not already deducted from assets and total liabilities including all subordinated debt. In addition, the Company is required to maintain a quick ratio of at least 1.25 to 1.0. As of June 30, 2010, the Company was in compliance with these covenants. The revolving line of credit provides the Company two options for interest rate: (i) the lender s variable prime rate of at least 4.00% or (ii) LIBOR plus 200 basis points for the applicable period in effect at the time of the borrowing. To date there have been no borrowings under the revolving line of credit.

The revolving line of credit is 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 and continued to generated consolidated losses under U.S. GAAP during the three months ended June 30, 2010 and 2009. As a result of those continuing losses, management has determined that it is more likely than not that the Company will not realize the benefits of the deferred tax assets and therefore has recorded a valuation allowance to reduce the carrying value of the deferred tax assets in the U.S. to zero. Although, the Company is expecting to generate taxable income for U.S. federal and state tax purposes in the current fiscal year, the Company continues to maintain that it is more likely than not that its U.S. net deferred tax asset balance is not realizable and continues to maintain a full valuation allowance.

The Company s tax provision relates primarily to state income taxes and provisions for income tax related to the Company s international subsidiaries. The Company recorded an income tax provision for foreign and state income taxes of $104,000 and $87,000 in the three months ended June 30, 2010 and June 30, 2009, respectively.

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

The Company files annual income tax returns in the U.S. federal jurisdiction, various U.S. state and local jurisdictions, and in various foreign jurisdictions. The Company remains subject to tax authority review for all jurisdictions for all years after March 31, 2000.

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3PAR Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(unaudited)

10. Share Based Payments

Stock Option Activity:

Activity with respect to outstanding stock options for the first three months of fiscal 2011 is as follows:

	Number of Shares	Weighted Average Exercise Price per Share
Balance at March 31, 2010	9,305,010	$ 7.44
Options granted	714,480	9.91
Options exercised	(137,227)	4.31
Options cancelled	(152,358)	9.21
Balance at June 30, 2010	9,729,905	$ 7.64

Restricted Stock Unit Awards

Restricted stock unit awards may be granted under the 2007 Plan on terms approved by the Board of Directors. Stock awards generally provide for the issuance of restricted stock which vests over a fixed period. Activity with respect to outstanding restricted stock units for the first three months of fiscal 2011 is as follows:

	Number of Shares	Weighted Average Grant Date Fair Value
Balance at March 31, 2010	947,544	8.78
Granted	253,000	9.89
Vested	(61,000)	9.36
Cancelled	(7,000)	9.50
Balance at June 30, 2010	1,132,544	8.99

During the three months ended June 30, 2010, the Company awarded non-vested restricted stock units to its executive officers under the 2007 Plan. Under the grant agreements, 25% of the restricted stock unit will vest and will be released to the recipients on the first anniversary of the grant date. The restricted stock units will continue to vest as to 25% of the restricted stock unit annually thereafter and shares will be distributed to the recipients on each vest date net of the minimum statutory withholding requirements that are paid in cash by the Company to the appropriate taxing authorities. If the executive officer terminates employment prior to the vesting date, the unvested restricted stock will be canceled and returned to the 2007 Plan.

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3PAR Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(unaudited)

Fair Value Disclosures

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

	Three Months Ended June 30, 2010	2009
Employee Stock Options		
Risk-free interest rate	1.81%	1.64%
Expected life (years)	3.92	4.18
Dividend yield	0.00%	0.00%
Expected volatility	61.4%	55.7%

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

The risk-free interest rate for the expected term of the option is based on the yield available on United States Treasury Zero Coupon issues with an equivalent expected term. The expected term represents the period of time that share-based awards are expected to be outstanding, giving consideration to the contractual terms of the awards, vesting schedules and expectations of future employee behavior. Given the Company s limited operating history as a public company, comparable companies from a representative peer group selected on industry data were used to determine the expected term. The computation of expected volatility was based on the historical volatility of the Company s stock price along with comparable companies from a representative peer group selected based on industry data. The Company makes an estimate of expected forfeitures and is recognizing stock-based compensation expense only for those equity awards expected to vest.

11. Net Loss per Common Share

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

	Three Months Ended June 30, 2010 (in thousands, except per share amounts)	2009
Numerator:		
Net loss	$ (1,841)	$ (1,799)
Denominator:		
Weighted average number of shares outstanding - basic and diluted	62,499	61,262
Net loss per share - basic and diluted	$ (0.03)	$ (0.03)

The following potential shares of common stock (prior to application of treasury method) outstanding at June 30, 2010 and 2009 were excluded from the computation of diluted net loss per common share because including them would have had an antidilutive effect:

	June 30, 2010	June 30, 2009
	(in thousands)	
Employee share based awards	11,287	9,348
Common stock subject to repurchase	1	12
	11,288	9,360

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3PAR Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(unaudited)

12. Comprehensive Loss

Comprehensive loss consists of net loss and changes in accumulated other comprehensive loss. Comprehensive loss for the three months ended June 30, 2010 and 2009 was as follows:

	Three Months Ended June 30, 2010	2009
	(in thousands)	
Net loss	$ (1,841)	$ (1,799)
Change in unrealized gain (loss) on short-term investments	80	104
Comprehensive (loss)	$ (1,761)	$ (1,695)

13. Commitments and Contingencies

Legal Matters

From time to time, third parties assert claims against the Company arising from the normal course of business activities. As of June 30, 2010, there are no claims that in the opinion of management might have a material adverse effect on the Company s financial position, results of operations or cash flows.

Lease Obligations

The Company leases equipment and office space under non-cancelable operating leases with various expiration dates through September 2015. In November 2009, the lease for the Company s primary facilities with a lease term that terminates in May 2014 was amended with an option to cancel the lease in May 2012. To the extent the Company elects to terminate the lease in 2012, 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):

For the years ending March 31,	Rent Commitment
2011 (remaining nine months)	$ 1,922
2012	2,432
2013	2,094
2014	1,479
2015	272
Thereafter	38
Total minimum lease payments	$ 8,237

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.

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3PAR Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(unaudited)

Changes in the warranty liability are as follows:

	Three Months Ended June 30, 2010	2009
	(in thousands)	
Beginning balance	$ 6,934	$ 7,030
Provision	1,399	1,061
Settlements made	(1,331)	(1,118)
Ending balance	$ 7,002	$ 6,973

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, 2010	March 31, 2010
	(in thousands)	
Current	$ 4,034	$ 3,891
Non-current	2,968	3,043
Total	$ 7,002	$ 6,934

Non-cancelable Purchase Commitments

The Company outsources the production of its hardware to third-party contract manufacturers. In addition, the Company enters into various inventory related purchase commitments with these contract manufacturers and suppliers. The Company had $16.4 million and $18.1 million in non-cancelable purchase commitments with these providers as of June 30, 2010 and March 31, 2010, respectively. As of June 30, 2010, the Company had no liability for adverse purchase commitments

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, 2010 and March 31, 2010.

In its sales agreements, the Company may agree to indemnify its indirect sales channels and end-user customers for any expenses or liability resulting from claimed infringements of patents, trademarks or copyrights of third parties. The terms of these indemnification agreements are generally perpetual any time after execution of the agreement. The maximum amount of potential future indemnification is unlimited. To date the Company has not paid any amounts to settle claims or defend lawsuits. The Company is unable to reasonably estimate the maximum amount that could be payable under these arrangements since these obligations are not capped but are conditional to the unique facts and circumstances involved. Accordingly, the Company has no liabilities recorded for these agreements as of June 30, 2010 and March 31, 2010.

14. Segment Information and Significant Customers

The Company operates in one business segment, the development, marketing and sale of information storage solutions. The Company s headquarters and most of its operations are located in the U.S.; however, it conducts limited sales, marketing and customer service activities through small offices in Europe and Asia. Revenue is attributed by geographic location based on the ship-to location of the Company s reseller or customer, as applicable. The Company s assets are primarily located in the U.S. and/or not allocated to any specific region. Therefore, geographic information is presented for total revenue only.

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3PAR Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(unaudited)

The following presents total revenues by geographic region:

	Three Months Ended June 30, 2010	2009
	(in thousands)	
United States	$ 42,328	$ 35,519
International	11,933	8,950
Total	$ 54,261	$ 44,469

No customer represented 10% or more of revenue in the three months ended June 30, 2010. One customer represented 10% of total revenue in the three months ended June 30, 2009. No customer accounted for 10% or more of accounts receivable, net at June 30, 2010 and March 31, 2010.

15. Stock Repurchase Program

On July 29, 2008, the Company s board of directors authorized a stock repurchase program for up to $10.0 million worth of the Company s common stock. The Company is authorized to make purchases in the open market and any such purchases will be funded from available working capital. The number of shares to be purchased and the timing of purchases will be based on the price of the Company s common stock, general business and market conditions, and other investment considerations. Shares are retired upon repurchase. During fiscal year 2009, the Company purchased 227,200 shares under this program for an aggregate purchase price of $1.5 million. There were no purchases of shares under this program during fiscal year 2010 or the three months ended June 30, 2010. The Company is authorized to purchase up to an additional $8.5 million worth of shares under this program as of June 30, 2010. The Company s policy related to repurchases of its common stock is to charge any excess of cost over par value entirely to additional paid-in capital in absence of retained earnings.

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

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

- *the growth and growth rate of our operations, business, revenues, operating margins, costs and expenses;*
- *our ability to successfully transition to offshore centers;*
- *fluctuations in our gross margins;*
- *the effect of recent accounting pronouncements on our financial position, results of operations, and cash flows;*
- *the potential impact of changes in our revenue recognition policy on the timing or amount of our revenue recognition;*
- *our future stock-based compensation charges;*
- *our foreign exchange risk and our practices related to hedging those risks;*
- *our future uncertain tax positions;*
- *the potential impact of our storage solution on the total lifetime cost of storage for our customers;*
- *the increase of research and development, sales and marketing and general and administrative expenses in the future;*
- *our future capital expenditures, including investments in our infrastructure and in test and development equipment to support our research and development efforts;*
- *the availability of individuals with the specific skills required for key positions, as well as our ability to attract, hire and retain sales employees and key personnel;*
- *our hiring of sales and other key personnel and the impact such hiring may have on our business, growth and competitive position;*
- *the future yield on our investment portfolio;*

- *the sufficiency of our existing cash balances to meet our future capital requirements*;
- *our ability to introduce new products;*
- *the materiality of our exposure related to contractual guarantees and indemnities;*
- *the materiality of the exposure of our cash equivalents to changes in value and the projected value of our investment portfolio;*
- *future changes in competitive practices and landscape in our industry*;
- *our future reliance on establishing relationships with resellers and authorized service providers to sell, service and support our products in select markets;*
- *our continued investments in international markets and our expansion strategies in those markets;*
- *the contribution of international sales as a percentage of our total revenue on an annual basis;*

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

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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, 2010.

Overview

We are the leading global provider of utility storage systems for mid-sized to large enterprises, financial services firms, cloud computing service providers, consumer-oriented Internet/Web 2.0 companies, and government entities. Utility storage is a category of data storage systems built for utility computing, an emerging approach to information technology architecture that enables organizations to build virtual datacenters to support cloud computing service delivery models. As organizations move away from the use of physically dedicated resources to a lower-cost shared model, we help organizations build infrastructures that support the delivery of cloud-based services both internally, and at the scale required by service providers that make a business of selling such services to their external customers. The category of utility storage exists as a segment of the larger global market for Fibre Channel and iSCSI open storage area networks, where we compete with larger and more established companies.

Established by engineers with substantial experience in the high-end server and storage markets, we began operations in 1999. From our inception, our corporate and product development objectives have focused on finding ways to use physical storage resources more efficiently and effectively by reducing unused storage and power consumption. Our utility storage solutions are comprised of the 3PAR InServ Storage Servers and the 3PAR InForm Suite, which includes the 3PAR InForm Operating System and other software applications. We have experienced a history of net losses in each fiscal year since our inception as we have invested significantly in our product development, customer services and sales and marketing organizations to support the growth of our business. While we plan to continue focusing on constraining discretionary operating expenses, we plan to continue to invest heavily into our sales, customer service, and engineering organizations, which could limit our ability to generate profitability. We believe this strategy will better position us in the market to achieve substantial, long-term growth and market share in our business.

We have sales operations in the United States, Canada, Germany, France, Netherlands, United Kingdom, Australia, India, Japan, Korea, China and Singapore, customer service operations in Switzerland and India and research and development facilities in California and Northern Ireland.

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 2011, will end on March 31, 2011.

Revenue, Cost of Revenue, Gross Margin and Operating Expense

Revenue

We derive our revenue from sales of our InServ Storage Servers, licenses of our InForm Suite operating system and other software applications and related support. Under the post contract support arrangement, 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, which is generally for one or three years. Support revenue also includes our extended and enhanced hardware warranties. Our enhanced hardware warranty offers faster service response time than our basic hardware warranty. To augment our support offerings, we recently launched mission-critical support for our hardware and software products to ensure that our storage systems remain available, secure and are operating at optimal performance. We anticipate that our mission critical support will not contribute significantly to our support revenue until later in fiscal year 2011 and in future years. As a result of the growth in the installed base of our utility storage solutions, we expect our support revenue to increase in future periods.

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We market and sell our products and support services primarily through our direct sales force but we also sell indirectly through resellers and channel partners. We maintain sales operations in the United States, Canada, the United Kingdom, Germany, France, Japan, India, Australia, China, Korea and Singapore. Our channel partners and resellers primarily sell our products in markets, including non-English speaking countries, where we do not have a significant direct sales presence. Additionally, we rely largely on resellers to sell our products to public sector accounts in the United States, including federal and state government entities.

Cost of Revenue

We utilize third parties to manufacture sub-components of our products, which are then shipped to our Fremont, California operations facility for final assembly and testing prior to customer shipment. Cost of product revenue consists primarily of component hardware cost, manufacturing overhead, shipping and logistics costs, writedowns for inventory excess and obsolescence and estimated warranty obligations for our basic 3-year warranty.

Cost of support revenue consists of spare parts, personnel costs associated with our internal support organization and outside vendor costs to complement our internal support resources to provide uplift and extended hardware warranties as well as software support. As a result of the expansion of our installed base, we expect our cost of support revenue to increase in future periods.

Gross Margin

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

- product mix and average selling prices;
- pricing pressures in response to our competitors discounting practices;
- writedowns for inventory excess and obsolescence;
- growth in the headcount and other related costs incurred in our manufacturing and customer service organizations.
- increase in channel mix

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 591 employees at March 31, 2009 to 657 at March 31, 2010 and 668 at June 30, 2010. During fiscal 2011, we expect to incur an increase in our operating expenses due to our recent international expansion and the discontinuance of certain cost control measures that we instituted during fiscal 2010. Additionally, we plan to invest in our research and development, sales and customer services organizations to reignite growth.

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 costs as incurred. We expect to continue to devote substantial resources to the development of our products. We believe that these investments are necessary to maintain and improve our competitive position.

Sales and Marketing Expense

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

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General and Administrative Expense

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

Other Income (Expense), Net

Other income (expense), net includes interest income on cash balances and short-term investments, and losses or gains on our hedging activities and remeasurement of non-United States dollar transactions into United States dollars. If we are successful in growing our international sales we may be subject to increased currency transaction 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, certificates of deposit and commercial paper.

Income Tax Provision

Our tax provision relates primarily to state income taxes and provisions for income tax related to our international subsidiaries.

Critical Accounting Policies and Estimates

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

With the exception of the discussion below, a description of our critical accounting policies that involve significant management judgment appears in our 2010 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 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 completion of installation and/or satisfaction of evaluation criteria or expiration of the evaluation period, as the case may be. Our support revenue is deferred at the inception of the agreement and recognized ratably over the period during which the support is provided. 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 end customers, channel partners and resellers generally do not include rights of return or rebates and to-date product returns have been negligible. We assess our ability to collect receivables from customers based on a number of factors, including creditworthiness of the customer and past transaction history.

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As of April 1, 2010 we changed our business model by allowing our customers located in the U.S. to contract directly with our installation team or to utilize one our third party service partners for the installation of our storage systems. For such arrangements, revenue related to tangible products is recognized upon shipment provided all other revenue recognition criteria described above have been met while installation revenue is deferred and recognized upon completion of the installation services. In territories where we have no installation service partners and for orders received prior to April 1, 2010 under our old business model, we continue to recognize both tangible product and installation revenue upon completion of the installation.

Starting fiscal 2011, when a sales arrangement contains multiple elements and software and non-software components function together to deliver the tangible products essential functionality, we allocate revenue to each element based on a selling price hierarchy. The selling price for a deliverable is based on its VSOE if available, third party evidence (TPE) if VSOE is not available, or estimated selling price (ESP) if neither VSOE nor TPE is available.

VSOE is based on the price charged when the element is sold separately. In determining VSOE, we require that a substantial majority of the selling prices fall within a reasonable price range. Since we generally do not have stand-alone sales of our hardware and software products, obtaining VSOE is limited to PCS. TPE of selling price is established by evaluating largely interchangeable competitor products or services in stand-alone sales to similarly situated customers. However, as we are unable to reliably determine what competitors products selling prices are on a stand-alone basis, we are not typically able to determine TPE. The ESP is established considering multiple factors including, but not limited to, our pricing practices in different geographies and through different sales channels, gross margin objectives, internal costs and competitor pricing strategies.

We continue to account for non-essential software applications and related PCS included in a multiple element arrangement under industry specific software revenue recognition guidance using the residual method. Revenue is first allocated to the non-software deliverables and to the software deliverables as a group using the relative selling prices of each of the deliverables in the arrangement based on the selling price hierarchy described above. Next, under the residual method, we defer revenue from the sale equivalent to the VSOE of the fair value of PCS and apply any inherent discounts to the delivered software element.

Results of Operations for the Three Months Ended June 30, 2010 and 2009

Revenue

The following tables present period over period comparisons of our revenue by revenue source for the three months ended June 30, 2010 and 2009 (dollars in thousands):

	Three Months Ended June 30,		Change in	
	2010	**2009**	**$**	**%**
Types of Revenue:				
Product	$ 46,421	$ 38,802	$ 7,619	20%
As % of total revenue	*85.6%*	*87.3%*		
Support	7,840	5,667	2,173	38%
As % of total revenue	*14.4%*	*12.7%*		
Total revenue	$ 54,261	$ 44,469	$ 9,792	22%

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	Three Months Ended June 30,		Change in	
	2010	2009	$	%
Revenue by geography:				
United States	$ 42,328	$ 35,519	$ 6,809	19%
As % of total revenue	*78.0%*	*79.9%*		
International	11,933	8,950	2,983	33%
As % of total revenue	*22.0%*	*20.1%*		
Total revenue	$ 54,261	$ 44,469	$ 9,792	22%

	Three Months Ended June 30,		Change in	
	2010	2009	$	%
Revenue by Sales Channel:				
Direct	$ 37,767	$ 27,175	$ 10,592	39%
As % of total revenue	*69.6%*	*61.1%*		
Indirect	16,494	17,294	(800)	-5%
As % of total revenue	*30.4%*	*38.9%*		
Total revenue	$ 54,261	$ 44,469	$ 9,792	22%

The increase in product revenue during the three months ended June 30, 2010 when compared to the three months ended June 30, 2009 related primarily to an increased demand for our storage systems which lead to higher number of systems and upgrades sold during first quarter of fiscal 2011 when compared to first quarter of fiscal 2010. The higher sales volume was partially offset by slightly lower average selling prices per system sold. Product revenue from our existing customers accounted for 76% of product revenue in the three months ended June 30, 2010 compared to 73% of product revenue in the three months ended June 30, 2009. We expect that the product revenue split between new and existing customers will continue to fluctuate.

The increase in support revenue in the three months ended June 30, 2010 compared to the three months ended June 30, 2009 is primarily attributable to the growth in the installed base of our storage solutions and higher support renewals, which resulted in higher support revenue from post-contract customer support as well as extended and premium warranty contracts. While it is part of our strategy to enhance our support offerings, the current rate of growth is not indicative of our future performance.

The increase in international revenue in the three months ended June 30, 2010 compared to the same period in the prior year is primarily due to increased revenue from our recent expansion into Asia Pacific. While we have expanded our international presence and customer base during fiscal 2011, the level of revenue attributable to any one country or region may vary from period to period. However, we expect that our international revenue will grow at a faster rate than our domestic revenue.

We derived 70% and 61% of our total revenue from direct sales to customers in the three months ended June 30, 2010 and 2009, respectively, while indirect sales represented 30% and 39% of total revenue during the same periods, respectively. The increase in direct sales as a percentage of total revenue in the three months ended June 30, 2010 compared to the same period in the prior year is mainly due to higher revenue from sales to the business-to-business service provider segment. We continued our focus on expanding our direct sales by hiring dedicated sales personnel for both domestic and international markets. We increased the number of our direct sales personnel to 219 employees at June 30, 2010 from 198 employees at June 30, 2009.

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Cost of Revenue and Gross Margin

The following table presents period over period comparisons of our cost of revenue by cost category for the three months ended June 30, 2010 and 2009 (dollars in thousands):

	Three Months Ended June 30,		Change in	
	2010	**2009**	**$**	**%**
Cost of product revenue	$ 17,082	$ 13,714	$ 3,368	25%
As % of product revenue	*36.8%*	*35.3%*		
Cost of support revenue	2,393	1,730	663	38%
As % of support revenue	*30.5%*	*30.5%*		
Total cost of revenue	19,475	15,444	4,031	26%
Gross profit	$ 34,786	$ 29,025	$ 5,761	20%
Gross margin	64.1%	65.3%		

Cost of product revenue increased by $3.4 million, or 25%, to $17.1 million in the three months ended June 30, 2010 from $13.7 million in the three months ended June 30, 2009, compared to a 20% increase in our product revenue during the same period. The deterioration in product margin and increase in cost of product revenue is primarily due to pricing pressures and increased component hardware costs as a result of higher storage capacity of the systems we sold during three months ended June 30, 2010 compared to three months ended June 30, 2009, offset by higher software content included in the systems sold in the three months ended June 30, 2010 with no associated cost.

The increase in cost of support revenue in the three months ended June 30, 2010 compared to the three months ended June 30, 2009 is primarily due to increased salaries, employee benefits and stock-based compensation expense related to growth in our internal customer service support headcount to 105 employees at June 30, 2010 from 83 employees at June 30, 2009 and increased charges paid to our third-party service vendors to support the growth in our installed base as well as an increased number of extended warranties.

As a percentage of total cost of support revenue, our support revenue remains consistent at 38% in the three months ended June 30, 2010 and 2009.

Research and Development

The following table presents period over period comparisons of our research and development expense for the three months ended June 30, 2010 and 2009 (dollars in thousands):

	Three Months Ended June 30,		Change in	
	2010	**2009**	**$**	**%**
Research and development	$ 13,000	$ 11,632	$ 1,368	12%
As % of total revenue	*24%*	*26%*		

The $1.4 million increase in research and development expense in the three months ended June 30, 2010 compared to the same period in the prior year was primarily due to approximately $417,000 higher compensation expense related to higher bonus accrual and stock-based compensation expense and approximately $517,000 higher depreciation expense. The remainder of the increase was related to higher engineering prototype and professional services expense. The research and development personnel decreased to 204 employees at June 30, 2010 from 211 employees at June 30, 2009.

As a percentage of our total revenue, research and development expense decreased to 24% in the three months ended June 30, 2010 from 26% in the three months ended June 30, 2009. We expect research and development expense to increase on an absolute dollar basis for the near future as we continue to devote substantial resources to the development of our products.

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Sales and Marketing

The following table presents period over period comparisons of our sales and marketing expense for the three months ended June 30, 2010 and 2009 (dollars in thousands):

	Three Months Ended June 30, 2010	Three Months Ended June 30, 2009	Change in $	Change in %
Sales and marketing	$ 19,034	$ 15,580	$ 3,454	22%
As % of total revenue	*35%*	*35%*		

The increase in sales and marketing expense in the three months ended June 30, 2010 when compared to the three months ended June 30, 2009 was primarily due to an increase in sales and marketing personnel to 242 employees at June 30, 2010 from 216 employees at June 30, 2009, resulting in a $1.8 million increase in salaries, commission, employee benefits and stock-based compensation expense. The majority of the remaining increase in sales and marketing expense related to $442,000 higher marketing expenses and $451,000 higher travel expense.

As a percentage of our total revenue, sales and marketing expense was 35% of revenue in the three months ended June 30, 2010 and 2009.

General and Administrative

The following table presents period over period comparisons of general and administrative expense for the three months ended June 30, 2010 and 2009 (dollars in thousands):

	Three Months Ended June 30, 2010	Three Months Ended June 30, 2009	Change in $	Change in %
General and administrative	$ 4,318	$ 3,901	$ 417	11%
As % of total revenue	*8%*	*9%*		

The increase in general and administrative expense in the three months ended June 30, 2010 when compared to the three months ended June 30, 2009 was primarily due to an increase in our general and administrative personnel to 76 employees at June 30, 2010 from 70 employees at June 30, 2009, resulting in a net $491,000 increase in salaries, bonus accrual and stock-based compensation expense.

As a percentage of our total revenue, general and administrative expenses decreased to 8% of revenue in the three months ended June 30, 2010 from 9% in the three months ended June 2009.

Other Income (Expense), Net

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

	Three Months Ended June 30, 2010	Three Months Ended June 30, 2009	Change in $	Change in %
Other income (expense), net:				
Interest income	$ 118	$ 173	$ (55)	-32%
Other, net	(289)	203	(492)	-242%
Total other income (expense), net:	$ (171)	$ 376	$ (547)	-145%

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The decrease in other income (expense), net in the three months ended June 30, 2010 compared to the three months ended June 30, 2009 is primarily due to lower yield on our investment portfolio and higher foreign currency losses primarily related to our British Pound and Euro denominated monetary assets.

We expect the yield on our investment portfolio to remain at a low level for the near future. The hedging activity we implemented during fiscal 2009 is intended to reduce, but not eliminate, the risk that our other income (expense), net will be adversely affected by the fluctuations in the foreign currency exchange rates. We believe that the foreign currency gains or losses will continue to impact other income.

Income Tax Provision

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

	Three Months Ended June 30,		Change in	
	2010	2009	$	%
Income tax provision	$ (104)	$ (87)	$ (17)	20%

We have incurred annual operating losses since inception and continued to generated consolidated losses under U.S. GAAP during the three months ended June 30, 2010 and 2009. As a result of those continuing losses, management has determined that it is more likely than not that we will not realize the benefits of the deferred tax assets and therefore has recorded a valuation allowance to reduce the carrying value of the deferred tax assets in the U.S. to zero. Although, we are expecting to generate taxable income for U.S. federal and state tax purposes in the current fiscal year, we continue to maintain that it is more likely than not that our U.S. net deferred tax asset balance is not realizable and continues to maintain a full valuation allowance.

Our tax provision relates primarily to state income taxes and provisions for income tax related to our international subsidiaries. We recorded an income tax provision for foreign and state income taxes of $104,000 and $87,000 in the three months ended June 30, 2010 and June 30, 2009, respectively.

Our only material uncertain tax position is our research and development credits, none of which would affect our income tax expense if recognized to the extent that we continue to maintain a full valuation allowance against our deferred tax assets. We estimate that there will be no material changes in our uncertain tax positions in the next 12 months. We recognize interest and penalties related to income tax matters as part of the provision for income taxes. To date, we have incurred no such charges.

We file annual income tax returns in the U.S. federal jurisdiction, various U.S. state and local jurisdictions, and in various foreign jurisdictions. We remain subject to tax authority review for all jurisdictions for all years after March 31, 2000.

Liquidity and Capital Resources

The following table summarizes our cash and cash equivalents and short-term investments at June 30, 2010 and March 31, 2010 (dollars in thousands):

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

	June 30, 2010	March 31, 2010	Increase/ (Decrease)
Cash and cash equivalents	$ 28,942	$ 39,047	$ (10,105)
Short-term investments	75,354	72,259	3,095
Total	$ 104,296	$ 111,306	$ (7,010)

On July 29, 2008, our board of directors approved the investment of up to $10 million for the purchase of shares of our common stock in the open market under a stock repurchase program. Subject to applicable securities laws, rules and regulations, the shares may be repurchased at our discretion from time to time in the open market. Such purchases will be made at times and in amounts as we deem appropriate, based on factors such as market conditions, legal requirements, and other corporate considerations. As of March31, 2010, we had purchased 227,200 shares under this program at an average purchase price of $6.77 per share. There were no purchases of shares under this program during the first fiscal quarter of 2011.

We have a loan and security agreement with a commercial bank with a revolving line of credit, under which the aggregate amount available for borrowing is $15.0 million. The borrowings are collateralized by all of our assets with the exception of intellectual property. Our amended revolving line of credit agreement expires on May 27, 2011 and it contains financial covenants that require us to maintain a quick ratio of no less than 1.25 to 1.00. In addition, we are required to maintain a quarterly tangible net worth of not less than $85.0 million, which is increased by 50% of any new net equity proceeds and/or 50% of quarterly profits since March 31, 2009. The interest rate on the line of credit equals, at the election of the borrower, either the lender s variable prime rate or LIBOR plus 200 basis points for the applicable period in effect at the time of the borrowing. There have been no borrowings under the current revolving line of credit.

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

	Three Months Ended June 30,	
	2010	**2009**
Net cash used in operating activities	$ (875)	$ (6,448)
Net cash provided by (used in) investing activities	(9,580)	10,498
Net cash provided by financing activities	350	733

Cash Flows from Operating Activities

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

During the first three months of fiscal 2011, operating activities used $875,000 of cash compared to $6.4 million in the first three months of fiscal 2010. The decrease in cash used in operating activities in the first three months of fiscal 2011 was driven by absence of payout of employee incentive compensation in fiscal 2011, higher deferred revenue due to increased demand for our storage systems and a $1.6 million increase in non-cash expenses including depreciation and stock-based compensation expense partially offset by lower accounts payable due to timing of invoice processing and payments.

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.

During the three months ended June 30, 2010 we used the proceeds from the sales and maturities of our short-term investments, as well as some of the cash generated from our operating activities, to reinvest in additional short-term investments. The decrease in net cash used in investing activities in the first three months of fiscal 2011 compared to the same period in the prior year is attributable to a $15.0 million higher investment in additional short-term investments, a $3.7 million increase in capital expenditures due to the purchase of new test equipment to support our new generation of products and the continued build out of our infrastructure and expansion of premises and opening of a $1.4 million restricted cash account to provide financial security for deferment of the duty and VAT payments in the UK.

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Cash Flows from Financing Activities

The decrease in net cash provided by financing activities was related primarily to lower proceeds from stock option exercises during the first three months of fiscal 2011 when compared to the same period in the prior year.

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 and profitability, 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, 2010 (in thousands):

		Payments due by period			
	Total	Less than 1 Year	1 to 3 Years	3 to 5 Years	More than 5 Years
Operating lease obligations	$ 8,237	$ 1,922	$ 4,526	$ 1,751	$ 38
Non-cancellable inventory purchase commitments	16,395	16,395			
Total	$ 24,632	$ 18,317	$ 4,526	$ 1,751	$ 38

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, 2010, we believe that our exposure related to these guarantees and indemnities as of June 30, 2010 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.

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Recent Accounting Pronouncements

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

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Foreign Currency Risk

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

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

We do not enter into foreign exchange forward contracts for speculative or trading purposes. Foreign currency transaction losses, including the impact of hedging, were $264,000 in the three months ended June 30, 2010. In the three months ended June 30, 2009, we recorded a gain of $203,000 on foreign currency transaction, including the impact of hedging.

Interest Rate Sensitivity

We had cash equivalents totaling $16.8 million at June 30, 2010. These amounts are invested primarily in money market funds and commercial paper. We believe that our cash equivalents do not have a material exposure to changes in the fair value as a result of changes in interest rates due to the short term nature of our cash equivalents. Declines in interest rates, however, would reduce future interest income. Based on our cash equivalents at June 30, 2010, a hypothetical 100 basis points decline in interest rates would reduce our interest income by approximately $170,000 over a one year period.

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

The following tables present the hypothetical changes in fair values in the securities, excluding cash equivalents, held at June 30, 2010 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 nine and twelve-month time horizons.

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

12-Month Period	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		50 BPS	100 BPS
U.S. treasury bills	$ 3,032	$ 3,023	$ 3,012	$ 3,003	$ 2,993
U.S. government agency securities	42,017	$ 41,872	$ 41,727	$ 41,582	$ 41,437
Commercial paper	12,363	12,349	12,334	12,319	12,304
Corporate debt securities	12,787	12,718	12,650	12,582	12,513
Certificate of deposits	5,642	5,636	5,631	5,625	5,620
Total short-term investments	$ 75,841	$ 75,598	$ 75,354	$ 75,111	$ 74,867

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

6-Month Period	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		50 BPS	100 BPS
U.S. treasury bills	$ 3,052	$ 3,032	$ 3,012	$ 2,993	$ 2,974
U.S. government agency securities	$ 42,307	$ 42,017	$ 41,727	$ 41,437	$ 41,146
Commercial paper	12,393	12,363	12,334	12,304	12,275
Corporate debt securities	12,923	12,787	12,650	12,513	12,377
Certificate of deposits	5,653	5,642	5,631	5,620	5,608
Total short-term investments	$ 76,328	$ 75,841	$ 75,354	$ 74,867	$ 74,380

At June 30, 2010, we had no interest rate exposure to our existing obligations since we had no borrowings under our revolving line of credit. However, we could be exposed to interest rate risk if we make borrowings under our revolving line of credit.

Item 4. Controls and Procedures

(a) Disclosure Controls and Procedures

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

(b) Changes in Internal Control over Financial Reporting.

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

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings

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

Item 1A. Risk Factors

Set forth below and elsewhere in this report and in other documents we file with the SEC are descriptions of the risks and uncertainties that could cause our actual results to differ materially from the results contemplated by the forward-looking statements contained in this report. The descriptions below include any material changes to and supersede the description of the risk factors affecting our business previously disclosed in Part I, Item 1A. Risk Factors of our Annual Report on Form 10-K for the fiscal year ended March 31, 2010.

Risks Related to Our Business and Industry

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

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

During the year ended March 31, 2010 and the three months ended June 30, 2010, we experienced a generally weaker demand environment as capital spending by our customers remained under pressure. Continued or increased weakness in general economic conditions, a reduction in storage infrastructure spending even if general economic conditions improve, or deterioration in the financial condition of our customers and customer prospects will adversely impact our business, revenues, rates of revenue growth (if any), operating results and financial condition, including as a result of potential inventory writedowns, longer sales cycles, potential increases in price competition, reduced unit sales, increased number of days of sales outstanding and customer payment defaults.

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

As of April 1, 2010, we changed our business model by allowing our customers located in the U.S. to contract directly with our installation team or to utilize one of our third party service partners for the installation of its storage systems. For such arrangements, revenue related to tangible products will be recognized primarily upon shipment provided all other revenue recognition criteria described above have been met while installation revenue is deferred and recognized upon completion of the installation services

Under our previous accounting policy, product shipments to U.S. customers that had not been installed by us at the period end were recorded as deferred revenue. Consequently, in any given quarter, a substantial portion of our revenue was derived from prior quarters shipments that had been deferred due to unperformed installation. For orders received prior to April 1, 2010 under our old business practice, we continue to recognize revenue upon installation. As a result, our revenue may fluctuate unexpectedly during the transition period and our future revenue may significantly differ from our historical result for similar periods. Additionally, since our deferred product revenue is likely to decrease significantly in the future, we may have reduced visibility into our future quarters and forecasting our revenue may be more difficult.

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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 or the change in our revenue recognition policy in April 2010, may adversely affect our reported results, cause unexpected financial reporting fluctuations and make comparability between periods less meaningful.

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

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

In any quarter, a substantial portion of our revenue may be largely attributable to orders from a limited number of customers, which can result in our recognizing a substantial amount of revenue without a corresponding increase in operating expenses. Although in fiscal year 2010, 2009 and 2008, no customer represented 10% or more of our total revenue, in the first and third quarter of fiscal 2010, first and fourth quarters of fiscal 2009 and the first quarter of fiscal 2008, 10%, 12%, 20%, 12% and 25% of our revenue, respectively, was attributable to sales to single customers. For these reasons, comparing our operating results, particularly our gross profit results, on a period-to-period basis may not be meaningful. You should not rely on our past results as an indication of our future performance.

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

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

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

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

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

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

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

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

We have a history of annual losses.

Since our formation, we have recorded a net loss in all of our annual fiscal periods. In fiscal 2010 and in the three months ended June 30, 2010 our net losses were $3.2 million and, $1.8 million, respectively. As of June 30, 2010 and March 31, 2010, our accumulated deficit was $180.0 million and $178.1 million, respectively. During the remainder of fiscal 2011, we expect to incur an increase in our expenditures in connection with our recent international expansion and the discontinuance of certain cost control measures that we instituted during fiscal 2010. Additionally, we will continue to invest in our research and development, sales and customer services organizations. As a result of these increased expenditures, we will be required to increase our revenue in order to achieve profitability. If we fail to increase revenues and manage our cost structure, we may not achieve or sustain profitability in the future. As a result, our business could be harmed, and our stock price could decline.

We intend to continue focusing on revenue growth and increasing market penetration and international presence at the expense of profitability by re-investing heavily in our operations.

Our chosen strategy is to increase our investments in our marketing services and sales operations and to continue investing significantly in research and development at the expense of profitability. We believe our decision to continue investing heavily in these operations will be critical to our revenue growth and our increased market penetration and international presence. Accordingly, we anticipate that our operating costs and expenses will increase substantially for the foreseeable future. However, we cannot be assured that this strategy will result in any revenue growth. Even if we achieve significant revenue growth, we may continue to experience net losses and operating losses, similar to those we have incurred historically. Additionally, as long as we pursue this strategy, we may not achieve profitability again or, if achieved, we may not be able to sustain profitability.

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

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

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

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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 developed a storage technology that directly competes 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. Additionally, most of our prospective customers have existing storage systems manufactured by our competitors. This gives an incumbent competitor an advantage in retaining the customer because the incumbent competitor already understands the customer s network infrastructure, user demands and information technology needs. These factors may cause our current or prospective customers to be unwilling to purchase our products and instead to purchase the products of our better-known and more established competitors. In the event that we are unable to successfully sell our products to new customers, persuade customers of our competitors to purchase our products instead, or prevent our competitors from persuading our customers to purchase our competitors products, we may not be able to maintain or increase our market share. This would have a negative impact on our future operating results.

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

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

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

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Our future success depends on our ability to attract and retain key management personnel or to quickly fill any management vacancies that may arise. Our management personnel and other key employees can terminate their employment at any time, and our business could suffer if we are unable to replace any departing management personnel or other key employees. Our future success is also dependent upon our ability to attract additional personnel for all other areas of our organization, including our customer services and finance department. Competition for qualified personnel is intense, and we may not be successful in attracting and retaining such personnel on a timely basis, on competitive terms, or at all. If we are unable to attract and retain the necessary technical, sales and other personnel on a cost-effective basis, we may be unable to grow our business and increase our revenue.

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

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

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

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

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

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

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

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

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

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

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

Once our products are deployed, our customers depend on our support organization to resolve any issues relating to our products. Our products provide mission-critical services to our customers and a high level of customer support is necessary to maintain our customer relationships. We rely on authorized service providers in certain locations in the United States to install our products and deliver initial levels of on-site customer support and services. While we carefully identify, train, and certify our authorized service providers, it may be more difficult for us to ensure the proper delivery and installation of our products or the quality or responsiveness of the support and services being provided.

As we grow our business, our ability to provide effective customer support and services will continue to be largely dependent on our ability to attract, train and retain qualified direct customer service personnel and our ability to maintain and grow our network of authorized service providers. As we look to improve our ability to deliver customer services effectively and efficiently, we recently formed a subsidiary in India, based in Bangalore, where we employ direct customer service personnel to deliver customer support and services. Additionally, as we continue to expand our operations internationally, our support organization will face additional challenges, including those associated with delivering support, training and documentation in languages other than English, as well as identifying, training, and certifying international authorized service providers to support products we may deploy in geographical areas in which we may not currently have authorized service providers.

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

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

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

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

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

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

In recent years, we have experienced substantial growth in the size and scope of our business, and if that growth continues, it will place significant demands on our management, infrastructure and other resources. In fiscal 2010, our number of employees increased from 591 to 657 and in the three months ended June 30, 2010 to 668. We have also expanded the geographic scope of our business, including the establishment of research and development operations in Northern Ireland in fiscal 2008, a sales office in Singapore in fiscal 2009, new sales operations in Australia, China, France and Korea and a sales and customer services center in India in fiscal 2010. We expect to continue to expand internationally through direct sales efforts and by establishing indirect sales and support relationships with channel partners, resellers and authorized service providers in select international markets. Continued growth in the size and scope of our business operations will require substantial management attention. For example, our management will have to increasingly dedicate its time and attention to oversee our efforts to recruit, integrate and retain highly-skilled personnel to join our growing internal departments; to manage a growing and dispersed geography to support the expansion of our research and development, sales and customer support organizations; and to expand and improve our information technology infrastructure and network of facilities to support a growing employee and customer base. In addition, our management will have to enhance and improve company-wide processes and procedures to address human resource, financial reporting and financial management matters that are consistent across our organization and comply with applicable U.S. and international regulatory and legal requirements. If we are not successful in effectively managing our growth, it could harm our business, operating results and financial condition.

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

In fiscal 2010 and the three months ended June 30, 2010 we derived 20% and 22% of our revenue from end customers outside the United States, respectively. We expect that our international sales will continue to contribute a similar percentage of our total revenue on an annual basis. We have direct sales personnel in the United States, Australia, Canada, China, France, Germany, Japan, Korea, and Singapore and the United Kingdom and agreements with third-party resellers or channel partners in Belgium, France, China, Czech Republic, Hong Kong, India, Italy, Japan, Korea, Luxembourg, Malaysia, The Netherlands, Norway, Poland, Spain, the United Kingdom, Singapore, South Africa and Taiwan. In addition, we have international subsidiaries in Australia, Germany, Hong Kong, India, Japan, Singapore and the United Kingdom. We expect to continue to hire additional sales personnel and expand our network of channel partners and resellers internationally and as a result may need to establish additional international subsidiaries and offices. Our international operations subject us to a variety of risks, including:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Developing our products is expensive. In fiscal 2010 and the three months ended June 30, 2010 our research and development expenses were $47.6 million, or 24% of our total revenue and $13.0 million, or 24% of our total revenue, respectively. Our future plans include significant investments in research and development and related product opportunities. We believe that we must continue to dedicate a significant amount of resources to our research and development efforts to maintain our competitive position. However, our ability to generate positive returns on these investments may take several years, if we are able to do so at all.

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

We compete in a market characterized by rapid technological change, frequent new product introductions, evolving industry standards and changing customer needs. We cannot assure you that we will be able to anticipate future market needs or be able to develop new products or product enhancements to meet those needs in a timely manner, or at all. For example, our failure to develop additional features that our competitors are able to provide could adversely affect our business. In addition, although we invest a considerable amount of money into our research and development efforts, any new products or product enhancements that we develop may not achieve widespread market acceptance. As competition increases in the storage industry and the information technology industry in general, it may become even more difficult for us to stay abreast of technological changes or develop new technologies or introduce new products as quickly as our competitors, many of which have substantially greater financial and engineering resources than we do. Additionally, risks associated with the introduction of new products or product enhancements include difficulty in predicting customer needs or preferences, transitioning existing products to incorporate new technologies, the capability of our suppliers to deliver high-quality components required by such new products or product enhancements in a timely fashion, and unknown defects in such new products or product enhancements. If we are unable to keep pace with rapid industry, technological or market changes or effectively manage the transitions to new products or new technologies, it could harm our business, operating results and financial condition.

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

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

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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.

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

In the future, we may seek to acquire companies or assets that we believe may enhance our market position. We may not be able to find suitable acquisition candidates and we may not be able to complete acquisitions on favorable terms, if at all. If we do complete acquisitions, we cannot assure you that they will not be viewed negatively by customers, financial markets or investors. In addition, any acquisitions that we make could lead to difficulties in integrating personnel and operations from the acquired businesses and in retaining and motivating key personnel from these businesses. Acquisitions may disrupt our ongoing operations, divert management from day-to-day responsibilities and increase our expenses. Any acquisitions may reduce our cash available for operations and other uses and could result in an increase in amortization expense related to identifiable assets acquired, potentially dilutive issuances of equity securities or the incurrence of debt, any of which could harm our business, operating results and financial condition.

If we fail to maintain effective internal control over financial reporting, the accuracy and timing of our financial reporting may be adversely affected.

We are required to comply with the Sarbanes-Oxley Act of 2002, or Sarbanes-Oxley. Sarbanes-Oxley requires, among other things, that we maintain effective internal control over financial reporting and disclosure controls and procedures. In particular, we must perform annual system and process evaluation and testing of our internal control over financial reporting to allow management and our independent registered public accounting firm to report on the effectiveness of our internal control over financial reporting, as required by Section 404 of Sarbanes-Oxley. Our testing, or the subsequent testing by our independent registered public accounting firm, may not reveal deficiencies in our internal control over financial reporting that are deemed to be material weaknesses. Our compliance with Section 404 requires that we incur substantial expenses and expend significant management time on compliance-related issues.

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

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

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

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

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

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

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

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

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

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

At April 30, 2010, our directors and executive officers and their affiliates beneficially own, in the aggregate, approximately 38% of our outstanding common stock. In addition, a former affiliate of one of our directors beneficially owns approximately 10% of our outstanding common stock. As a result, these stockholders are able to exercise significant influence over all matters requiring stockholder approval, including the election of directors and approval of significant corporate transactions, such as a merger or other sale of our company or its assets. This concentration of ownership limits our stockholders ability to influence corporate matters and may have the effect of delaying or preventing a third party from acquiring control over us.

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

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

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

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Item 2. Unregistered Sales of Equity Securities and Use of Proceeds
There were no unregistered sales of equity securities during the period covered by this report.

(c) Issuer Purchases of Equity Securities

	Total Number of Shares Purchased[1]	Average Price Paid per Share	Shares Purchased as Part of Publicly Announced Plans or Programs	Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs
April 1 - April 30, 2010		$		
May 1 - May 31, 2010				
June 1 - June 30, 2010	22,873	10.57		
Total	22,873	$ 10.57		

Amount represent repurchases of the Company s common stock from its employees in connection with net issuance of shares to satisfy the employee tax withholding obligations for the vesting of certain restricted stock units. All shares of common stock that have been repurchased from its employees in connection with net issuances have been retired.

Item 3. Defaults Upon Senior Securities
None

Item 4. Removed and Reserved None
Item 5. Other Information

None

Item 6. Exhibits

Exhibit No.	Description
10.10	Offer Letter Agreement by and between the Registrant and Peter Slocum dated April 16, 2009.
10.11	Revised Offer Letter Agreement by and between the Registrant and Randall Weigel dated May 1, 2009.
10.12	Offer Letter Agreement by and between the Registrant and Rusty Walther dated July 27, 2009.
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.

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 9, 2010

3PAR Inc.

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

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