Super Micro Computer, Inc.
Form 10-Q
May 11, 2009
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 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 March 31, 2009

or

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

For the transition period from _________ to _________

Commission file number 001-33383

Super Micro Computer, Inc.

(Exact name of Registrant as specified in its charter)

Delaware	**77-0353939**
(State or other jurisdiction of	**(IRS Employer**
incorporation or organization)	**Identification Number)**

980 Rock Avenue

San Jose, CA 95131

(Address of principal executive offices)

(408) 503-8000

(Registrant s telephone number, including area code)

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

As of April 30, 2009 there were 34,698,395 shares of the registrant s common stock, $0.001 par value, outstanding, which is the only class of common or voting stock of the registrant issued.

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SUPER MICRO COMPUTER, INC.

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PART I: FINANCIAL INFORMATION

Item 1.

SUPER MICRO COMPUTER, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands, except share and per share amounts)

(unaudited)

	March 31, 2009	June 30, 2008
ASSETS		
Current assets:		
Cash and cash equivalents	$ 62,702	$ 51,481
Short-term investments	57	57
Accounts receivable, net of allowances of $1,045 and $1,173 at March 31, 2009 and June 30, 2008, respectively (including amounts receivable from a related party of $728 and $792 at March 31, 2009 and June 30, 2008, respectively)	42,771	49,501
Inventories, net	82,929	85,683
Deferred income taxes-current	8,530	8,663
Prepaid income taxes	5,838	2,661
Prepaid expenses and other current assets	1,488	1,837
Total current assets	204,315	199,883
Long-term investments	14,644	16,106
Property, plant and equipment, net	45,461	45,602
Deferred income taxes-noncurrent	1,450	939
Restricted assets	1,760	1,728
Other assets	120	127
Total assets	$ 267,750	$ 264,385
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable (including amounts due to a related party of $20,226 and $27,717 at March 31, 2009 and June 30, 2008, respectively)	$ 60,507	$ 80,962
Accrued liabilities	16,284	14,790
Income taxes payable	67	189
Advances from receivable financing arrangements	1,202	1,173
Current portion of capital lease obligations	43	57
Current portion of long-term debt	313	320
Total current liabilities	78,416	97,491
Long-term capital lease obligations-net of current portion	76	108
Long-term debt-net of current portion	9,779	9,981
Other long-term liabilities	4,737	4,934
Total liabilities	93,008	112,514
Commitments and contingencies (Note 14)		
Stockholders equity:		

Common stock and additional paid-in capital, $0.001 par value		
Authorized shares: 100,000,000		
Issued and outstanding shares: 35,136,423 and 32,668,731 at March 31, 2009 and June 30, 2008, respectively	80,492	69,434
Deferred stock-based compensation	(231)	(675)
Treasury stock (at cost), 445,028 and 0 shares at March 31, 2009 and June 30, 2008, respectively	(2,030)	
Accumulated other comprehensive loss	(801)	(451)
Retained earnings	97,312	83,563
Total stockholders equity	174,742	151,871
Total liabilities and stockholders equity	$ 267,750	$ 264,385

See accompanying notes to condensed consolidated financial statements.

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SUPER MICRO COMPUTER, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except share and per share amounts)

(Unaudited)

	Three Months Ended March 31,		Nine Months Ended March 31,	
	2009	**2008**	**2009**	**2008**
Net sales (including related party sales of $1,687 and $1,235 in the three months ended March 31, 2009 and 2008, respectively, and $4,446 and $4,834 in the nine months ended March 31, 2009 and 2008, respectively)	$ 109,540	$ 136,755	$ 382,156	$ 391,637
Cost of sales (including related party purchases of $16,843 and $30,687 in the three months ended March 31, 2009 and 2008, respectively, and $72,385 and $83,551 in the nine months ended March 31, 2009 and 2008, respectively)	93,213	111,929	313,901	316,511
Gross profit	16,327	24,826	68,255	75,126
Operating expenses:				
Research and development	8,632	8,050	25,678	21,743
Sales and marketing	3,999	4,602	13,047	12,891
General and administrative	3,281	3,903	10,001	10,799
Total operating expenses	15,912	16,555	48,726	45,433
Income from operations	415	8,271	19,529	29,693
Interest income	50	327	422	1,319
Interest expense	(208)	(248)	(710)	(748)
Income before income tax provision	257	8,350	19,241	30,264
Income tax provision (benefit)	(974)	3,326	5,492	11,693
Net income	$ 1,231	$ 5,024	$ 13,749	$ 18,571
Net income per share:				
Basic	$ 0.04	$ 0.16	$ 0.40	$ 0.60
Diluted	$ 0.03	$ 0.13	$ 0.35	$ 0.48
Shares used in per share calculation:				
Basic	34,684,369	31,759,958	34,046,037	30,958,660
Diluted	38,836,784	38,961,284	39,161,529	38,780,837

See accompanying notes to condensed consolidated financial statements.

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SUPER MICRO COMPUTER, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(Unaudited)

	Nine Months Ended March 31, 2009	Nine Months Ended March 31, 2008
OPERATING ACTIVITIES:		
Net income	$ 13,749	$ 18,571
Reconciliation of net income to net cash provided by operating activities:		
Depreciation and amortization	2,643	1,921
Stock-based compensation expense	3,978	2,849
Allowance for doubtful accounts	276	174
Allowance for sales returns	3,343	4,150
Provision for inventory	815	6,667
Loss on disposal of property, plant and equipment	18	
Deferred income taxes	(151)	(2,824)
Changes in operating assets and liabilities:		
Accounts receivable, net (including changes in related party balances of $64 and $197 during the nine months ended March 31, 2009 and 2008, respectively)	3,111	(13,039)
Inventories	1,939	(33,273)
Prepaid expenses and other current assets	349	(255)
Other assets	3	89
Accounts payable (including changes in related party balances of ($7,491) and $9,103 during the nine months ended March 31, 2009 and 2008, respectively)	(20,212)	17,080
Prepaid income taxes/income taxes payable	2,290	3,565
Accrued liabilities	1,494	241
Other long-term liabilities	(197)	3,395
Net cash provided by operating activities	13,448	9,311
INVESTING ACTIVITIES:		
Restricted assets	(32)	(1,670)
Proceeds from investments	885	18,824
Purchases of property, plant and equipment	(2,759)	(15,056)
Purchases of investments		(22,425)
Net cash used in investing activities	(1,906)	(20,327)
FINANCING ACTIVITIES:		
Proceeds from exercise of stock options	1,935	2,417
Repayment of long-term debt	(209)	(1,181)
Payment of obligations under capital leases	(46)	(107)
Advances under receivable financing arrangements	29	397
Payment to acquire treasury stock	(2,030)	
Payment of deferred offering costs		(20)
Net cash (used in) provided by financing activities	(321)	1,506
Net increase (decrease) in cash and cash equivalents	11,221	(9,510)

Cash and cash equivalents at beginning of period	51,481	50,864
Cash and cash equivalents at end of period	$ 62,702	$ 41,354
Supplemental disclosure of cash flow information:		
Cash paid for interest	$ 691	$ 748
Cash paid for taxes	$ 3,826	$ 7,685
Non-cash investing and financing activities:		
Equipment purchased under capital leases	$	$ 27
Reversal of deferred stock-based compensation for cancellation of stock options	$ 3	$ 22
Accrued costs for property, plant and equipment purchases	$ 720	$ 1,223
Changes in fair values of investments	$ (577)	$ (636)

See accompanying notes to condensed consolidated financial statements.

SUPER MICRO COMPUTER, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1. Organization

Super Micro Computer, Inc. was incorporated in California on September 28, 1993 and reincorporated in Delaware on March 19, 2007. Super Micro Computer develops and provides high performance server solutions based upon an innovative, modular and open-standard architecture. Super Micro Computer has wholly owned subsidiaries in the Netherlands, Taiwan, Cayman Islands and California, United States.

Note 2. Summary of Significant Accounting Policies

Basis of Presentation

The unaudited condensed consolidated financial statements included herein have been prepared by Super Micro Computer, Inc. pursuant to the rules and regulations of the United States Securities and Exchange Commission (SEC) and include the accounts of Super Micro Computer, Inc. and its wholly-owned subsidiaries (collectively Super Micro or the Company). Certain information and footnote disclosures normally included in financial statements prepared in accordance with United States generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations. The information included in this Quarterly Report on Form 10-Q should be read in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations, Risk Factors, Quantitative and Qualitative Disclosures About Market Risk, and the Consolidated Financial Statements and Notes thereto included in the Super Micro Annual Report on Form 10-K for the year ended June 30, 2008 (2008 Form 10-K) filed with the SEC.

The unaudited condensed consolidated financial statements included herein reflect all adjustments, including normal recurring adjustments, which are, in the opinion of management, necessary for a fair presentation of consolidated financial position, results of operations and cash flows for the periods presented. The condensed consolidated results of operations for the three and nine months ended March 31, 2009 and 2008 are not necessarily indicative of the results that may be expected for future quarters or for the year ending June 30, 2009.

Principles of Consolidation

The condensed consolidated financial statements reflect the condensed consolidated balance sheets, results of operations and cash flows of Super Micro Computer, Inc. and its wholly owned subsidiaries. All intercompany accounts and transactions have been eliminated.

Fair Value Measurements

Effective July 1, 2008, the Company adopted certain provisions of Statement of Financial Accounting Standards (SFAS) No. 157, Fair Value Measurements (SFAS 157), which the Financial Accounting Standards Board (FASB) issued in September 2006. SFAS 157 establishes specific criteria for the fair value measurement of financial and nonfinancial assets and liabilities that are already subject to fair value under current accounting rules. SFAS 157 also requires expanded disclosures related to fair value measurements. In February 2008, the FASB issued Staff Position (FSP) 157-2, which delays the effective date of SFAS 157 for nonfinancial assets and nonfinancial liabilities to fiscal years beginning after November 15, 2008, except for items that are recognized or disclosed at fair value on at least an annual basis. The Company elected to delay the adoption date for the portions of SFAS 157 impacted by FSP 157-2, and, as a result, it adopted a portion of the provisions of SFAS 157. The partial adoption of SFAS 157 was prospective and did not have a significant effect on the Company s consolidated results of operations and financial condition. The Company is currently evaluating the impact of measuring the remaining nonfinancial assets and nonfinancial liabilities under FSP No. 157-2 on its financial position, results of operations and cash flows.

SFAS 157 clarifies that fair value is 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. SFAS 157 also requires that a fair value measurement reflect the assumptions market participants would use in pricing an asset or liability based on the best information available. Assumptions include the risks inherent in a particular valuation technique (such as a pricing model) and/or the risks inherent in the inputs to the model.

SFAS 157 establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and

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the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy under SFAS 157 are described below:

Level 1- Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities;

Level 2 - Quoted prices in markets that are not active or financial instruments for which all significant inputs are observable, either directly or indirectly; and

Level 3 - Prices or valuations that require inputs that are both significant to the fair value measurement and unobservable.

A financial instrument s level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement.

Note 3. Recently Issued Accounting Standards

EITF 07-3

Effective July 1, 2008, the Company adopted Emerging Issues Task Force (EITF) Abstract No. 07-3, *Accounting for Nonrefundable Advance Payments for Goods or Services Received for Use in Future Research and Development Activities* (EITF 07-3). EITF 07-3 requires that nonrefundable advance payments for goods or services that will be used or rendered for future research and development activities be deferred and capitalized and recognized as an expense as the goods are delivered or the related services are performed. The adoption did not have a material impact on the Company s financial position, results of operations or cash flows.

SFAS No. 159

Effective July 1, 2008, the Company adopted SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities-including an amendment of FASB Statement No. 115* (SFAS 159), which the FASB issued in February 2007. SFAS 159 expands the use of fair value accounting but does not affect existing standards, which require assets or liabilities to be carried at fair value. Under SFAS 159, an entity may elect to use fair value to measure certain eligible items. The fair value option may be elected generally on an instrument-by-instrument basis as long as it is applied to the instrument in its entirety, even if an entity has similar instruments that it elects not to measure based on fair value. The Company has not elected to adopt the fair value option on eligible items under SFAS 159.

FSP 157-3

In October 2008, the FASB issued FASB Staff Position (FSP) 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active* (FSP 157-3). FSP 157-3 clarified the application of SFAS 157. FSP 157-3 demonstrated how the fair value of a financial asset is determined when the market for that financial asset is inactive. FSP 157-3 was effective upon issuance, including prior periods for which financial statements had not been issued. The implementation of this standard did not have a material impact on the Company s financial position, results of operations or cash flows.

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FSP FAS 157-4/FAS 115-2/FAS 124-2

In April 2009, the FASB issued three FSPs related to fair value measurements, disclosures and other-than-temporary impairments. FSP FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*, provides additional guidance for estimating fair value in accordance with SFAS 157 when the volume and level of activity for an asset or liability have significantly decreased. FSP FAS 157-4 also includes guidance on identifying circumstances that indicate a transaction is not orderly. FSP FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments*, amends the other-than-temporary impairment guidance in U.S. GAAP to make the guidance more operational and to improve the presentation of other-than-temporary impairments in the financial statements. Finally, FSP 107-1 and Accounting Principles Board (APB) 28-1, *Interim Disclosures About Fair Value of Financial Instruments*, amends SFAS No. 107, *Disclosures about Fair Value of Financial Instruments*, to require disclosures about fair value of financial instruments in interim financial statements as well as in annual financial statements and also amends APB Opinion No. 28, *Interim Financial Reporting*, to require those disclosures in all interim financial statements. The three FSPs are effective for periods ending after June 15, 2009. Early adoption is permitted for periods ending after March 15, 2009, however the Company expects to adopt the FSPs during the fourth quarter of fiscal year 2009. The Company is still evaluating the impact, if any, the FSPs will have on its financial position, results of operations and cash flows.

Note 4. Stock-based Compensation and Stockholders Equity

Treasury Stock

In November 2008, the Board of Directors approved a program to repurchase, from time to time, at management s discretion, shares of the Company s common stock. Under the plan, the Company is authorized to repurchase up to 2,000,000 of its outstanding shares of common stock in the open market or in private transactions during the period ending June 30, 2009 at prevailing market prices in compliance with applicable securities laws and other legal requirements. Repurchases will be made under the program using the Company s own cash resources. The plan does not obligate the Company to acquire any particular amount of common stock and the plan may be suspended or discontinued at any time. As of March 31, 2009, the Company had repurchased 445,028 shares of the Company s common stock at a weighted average price of $4.56 per share for approximately $2.0 million.

Repurchased shares of the Company s common stock are held as treasury shares until they are reissued or retired. When the Company reissues treasury stock, if the proceeds from the sale are more than the average price the Company paid to acquire the shares, the Company records an increase in additional paid-in capital. Conversely, if the proceeds from the sale are less than the average price the Company paid to acquire the shares, the Company records a decrease in additional paid-in capital to the extent of increases previously recorded for similar transactions and a decrease in retained earnings for any remaining amount.

Stock Option Plan

In August 2006, the Board of Directors approved the 2006 Equity Incentive Plan (the 2006 Plan) and reserved for issuance 4,000,000 shares of common stock for the granting of stock options, stock appreciation rights, restricted stock awards, restricted stock units and other equity-based awards. The number of shares reserved automatically increases on July 1, 2007 of each year through 2016, by an amount equal to the smaller of (a) three percent of the number of shares of stock issued and outstanding on the immediately preceding June 30, or (b) a lesser amount determined by the Board of Directors. The 2006 Plan was approved by the stockholders of the Company in January 2007. The exercise price per share for incentive stock options granted to employees owning shares representing more than 10% of the Company at the time of grant cannot be less than 110% of the fair value. Nonqualified stock options and incentive stock options granted to all other persons shall be granted at a price not less than 100% of the fair value. Options generally expire ten years after the date of grant and options vest over four years; 25% at the end of one year and one sixteenth per quarter thereafter. In the three and nine months ended March 31, 2009, the Company granted options for the purchase of 1,064,420 and 2,478,934 shares under the 2006 Plan, respectively. At March 31, 2009, 1,809,037 shares of common stock are available for future grant.

Restricted Stock Awards

Restricted stock awards are share awards that provide the rights to a set number of shares of the Company s stock on the grant date. In August 2008, the Compensation Committee of the Board of Directors of the Company (the Committee) approved the terms of an agreement (the Option Exercise Agreement) with Charles Liang, a director and President and Chief Executive Officer of the Company, pursuant to which Mr. Liang exercised a fully vested option previously granted to him for the purchase of 925,000 shares. The option was exercised using a net-exercise procedure in which he was issued a number of shares representing the spread between the option exercise price and the then current market value of the shares subject to the option (898,205 shares based upon the market value as of the date of exercise). The shares issued upon exercise of the option are subject to vesting over a five year vesting period. Vesting of the shares subject to the award may accelerate in certain circumstances pursuant to the terms of the Option Exercise Agreement. The Company determined that there is no incremental fair value of the option exchanged for the award.

In November 2008, the Committee approved the terms of an Option Exercise Agreement with Chiu-Chu Liang, a director and Vice President of Operations & Treasurer of the Company and Shiow-Meei Liaw, Senior Warehouse Manager of the Company, pursuant to which they exercised fully vested options previously granted to them for the purchase of 185,263 and 92,631 shares, respectively. They exercised the options using a net-exercise procedure in which they were issued a number of shares representing the spread between the option exercise price and the then current market value of the shares subject to the option (182,611 and 91,305 shares, respectively based upon the market value as of the date of exercise). The shares issued upon exercise of the options are subject to vesting over a two year vesting period. Vesting of the shares subject to the awards may accelerate in certain circumstances pursuant to the terms of the applicable Option Exercise Agreement. The Company determined that there is no incremental fair value of the option exchanged for the awards.

Stock-Based Compensation

The Company adopted SFAS No. 123 (revised 2004), *Share-Based Payment* (SFAS 123(R)), effective July 1, 2006 using the prospective transition method. Prior to the adoption of SFAS 123(R), the Company accounted for its stock options issued to employees in accordance with Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25), and related interpretations rather than the alternative fair value accounting provided for under SFAS No. 123, *Accounting for Stock-Based Compensation* (SFAS 123), as amended by SFAS No. 148. Under APB 25, when the exercise price of the Company s employee and director stock options is equal to or greater than the market price of the underlying stock on the date of grant, no compensation expense is recognized.

Determining Fair Value

Valuation and amortization method The Company estimates the fair value of stock options granted using the Black-Scholes-option-pricing formula and a single option award approach. This fair value is then amortized ratably over the requisite service periods of the awards, which is generally the vesting period.

Expected Term The Company s expected term represents the period that the Company s stock-based awards are expected to be outstanding and was determined based on an analysis of the relevant peer companies post-vest termination rates and the exercise factors.

Expected Volatility Expected volatility is based on a combination of the implied and historical volatility for its peer group.

Expected Dividend The Black-Scholes valuation model calls for a single expected dividend yield as an input and the Company has no plans to pay dividends.

Risk-Free Interest Rate The risk-free interest rate used in the Black-Scholes valuation method is based on the U.S. Treasury zero coupon issues in effect at the time of grant for periods corresponding with the expected term of option.

Estimated Forfeitures The estimated forfeiture rate is based on the Company s historical forfeiture rates and the estimate is revised in subsequent periods if actual forfeitures differ from the estimate.

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The fair value of stock option grants for the three and nine months ended March 31, 2009 and 2008 under SFAS 123(R) was estimated on the date of grant using the Black-Scholes option pricing model with the following assumptions:

	Three Months Ended March 31,		Nine Months Ended March 31,	
	2009	2008	2009	2008
Risk-free interest rate	1.42% - 3.01%	2.64%	1.42% - 3.09%	2.64% - 4.58%
Expected life	4.07 - 10 years	4.39 years	4.07 - 10 years	4.32 - 4.39 years
Dividend yield	0%	0%	0%	0%
Volatility	53.61% - 69.62%	48.43%	48.16% - 69.62%	43.03% - 48.43%
Estimated forfeitures	2.48% - 14.16%	3.30% - 15.16%	2.48% - 14.16%	3.30% - 15.16%
Weighted-average fair value per share	$ 2.98	$ 3.59	$ 2.99	$ 3.82

In March 2009, the Committee approved the grant of 720,000 refresh non-statutory stock options to Charles Liang, a director and President and Chief Executive Officer of the Company under the 2006 Plan. This option, which vests ratably over four years, was granted at an exercise price of $10.66 per share with grant date fair market value of $4.96. The fair value of this option was estimated at the date of grant using the Black-Scholes option pricing model with the following assumptions: risk-free interest rate of 3.01%, expected life of 10 years, expected dividend yield of zero, expected volatility of 69.62% and estimated forfeiture of 2.48% resulting in a fair value of $3.28 per share.

The following table shows total stock-based compensation expense included in the condensed consolidated statements of operations for the three and nine month periods ended March 31, 2009 and 2008 (in thousands).

	Three Months Ended March 31,		Nine Months Ended March 31,	
	2009	2008	2009	2008
Cost of sales	$ 145	$ 124	$ 421	$ 354
Research and development	675	465	1,871	1,220
Sales and marketing	201	161	589	453
General and administrative	412	291	1,097	822
Stock-based compensation expense before taxes	1,433	1,041	3,978	2,849
Income tax impact	(147)	(94)	(265)	(334)
Stock-based compensation expense, net	$ 1,286	$ 947	$ 3,713	$ 2,515

SFAS 123(R) requires the cash flows resulting from the tax benefits for tax deductions resulting from the exercise of stock options in excess of the compensation expense recorded for those options (excess tax benefits) accounted for under SFAS 123(R) to be classified as cash from financing activities. The Company had no excess tax benefits in the three and nine months ended March 31, 2009 and 2008 for options accounted for under SFAS 123(R). Excess tax benefits for stock options accounted for under APB 25 continue to be classified as cash from operating activities.

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Stock Option and Awards Activity

The following table summarizes stock option activity during the nine months ended March 31, 2009 under all stock option plans:

	Number of Shares	Weighted Average Exercise Price Per Share	Weighted-Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (in thousands)
Outstanding at July 1, 2008	13,300,972	$ 3.48	4.70	$ 59,996
Granted	2,478,934	$ 7.64		
Exercised	(3,670,586)	$ 0.61		
Forfeited or cancelled	(263,742)	$ 8.90		
Outstanding at March 31, 2009	11,845,578	$ 5.12	6.11	$ 19,459
Vested and expected to vest at March 31, 2009	11,159,302	$ 4.93	5.91	$ 19,452
Exercisable at March 31, 2009	8,031,471	$ 3.66	4.67	$ 19,287

The total intrinsic value of options exercised was $340,000 and $26,336,000 for the three and nine months ended March 31, 2009, respectively, and approximately $8,401,000 and $16,314,000 for the three and nine months ended March 31, 2008, respectively. Stock-based compensation expense accounted for in accordance with SFAS 123(R) in the three and nine months ended March 31, 2009 was approximately $1,305,000 and $3,537,000, respectively, and approximately $837,000 and $2,227,000 for the three and nine months ended March 31, 2008, respectively. As of March 31, 2009, the Company s total unrecognized compensation cost related to non-vested stock-based awards granted since July 1, 2006 to employees and non-employee directors was approximately $12,421,000, which will be recognized over a weighted-average vesting period of approximately 2.13 years.

The weighted-average fair value per share of options granted during fiscal year 2005 and 2006, and accounted for using the intrinsic value measurement provisions of APB 25, was $4.58. The intrinsic value per share is being recognized as compensation expense over the applicable vesting period (which equals the service period). The Company amortized $128,000 and $441,000 of stock-based compensation in the three and nine months ended March 31, 2009, respectively, and $198,000 and $617,000 in the three and nine months ended March 31, 2008, respectively. At March 31, 2009, the Company had deferred stock-based compensation under APB 25 of $231,000, which is comprised primarily of employee and director stock option grants prior to July 1, 2006 and is expected to be fully amortized in fiscal year 2010.

The following table summarizes the Company s restricted stock award activity for the nine months ended March 31, 2009:

	Restricted Stock Awards	
	Number of Shares	Weighted Average Grant Date Fair Value Per Share
Nonvested stock at July 1, 2008		$
Granted	1,172,121	9.39
Vested		
Forfeited		
Nonvested stock at March 31, 2009	1,172,121	$ 9.39

None of the restricted stock awards vested in the nine months ended March 31, 2009. The total intrinsic value of the outstanding restricted stock awards was $11,006,000 as of March 31, 2009. There is no incremental fair value to be recognized in connection with the restricted stock awards of 1,172,121 shares.

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Note 5. Comprehensive Income

The components of comprehensive income, net of taxes, are as follows (in thousands):

	Three Months Ended March 31,		Nine Months Ended March 31,	
	2009	2008	2009	2008
Net income	$ 1,231	$ 5,024	$ 13,749	$ 18,571
Unrealized gains or (losses) on investments, net of taxes	75	(386)	(350)	(386)
Total comprehensive income	$ 1,306	$ 4,638	$ 13,399	$ 18,185

Note 6. Net Income Per Share

Basic net income per share is computed by dividing net income by the weighted average number of common shares outstanding for the period.

Diluted net income per share is computed by dividing the net income for the period by the weighted average number of common and common equivalent shares outstanding during the period. Potentially dilutive securities, comprised of incremental common shares issuable upon the exercise of stock options, are included in diluted net income per share using the treasury stock method, to the extent such shares are dilutive.

A reconciliation of shares used in the calculation of basic and diluted net income per share is as follows (in thousands, except for per share amounts):

	Three Months Ended March 31,		Nine Months Ended March 31,	
	2009	2008	2009	2008
Numerator:				
Net income	$ 1,231	$ 5,024	$ 13,749	$ 18,571
Denominator:				
Basic weighted-average number of common shares outstanding	34,684	31,760	34,046	30,959
Dilutive common stock options	3,441	7,201	4,606	7,822
Dilutive restricted stock awards	712		510	
Diluted weighted-average number of common shares outstanding	38,837	38,961	39,162	38,781
Basic net income per share	$ 0.04	$ 0.16	$ 0.40	$ 0.60
Diluted net income per share	$ 0.03	$ 0.13	$ 0.35	$ 0.48

For the three and nine months ended March 31, 2009 and 2008, the Company had stock options outstanding that could potentially dilute basic earnings per share in the future, but were excluded from the computation of diluted net income per share in the periods presented, as their effect would have been anti-dilutive. The shares of common stock issuable upon exercise of such outstanding stock options were 4,918,000 and 4,194,000 for the three and nine months ended March 31, 2009, respectively, and 2,767,000 and 2,418,000 for the three and nine months ended March 31, 2008, respectively.

Note 7. Balance Sheet Components (in thousands)

Inventories:

	March 31, 2009	June 30, 2008
Finished goods	$ 55,025	$ 54,385
Work in process	654	648
Purchased parts and raw materials	27,250	30,650
Total inventories, net	$ 82,929	$ 85,683

The Company recorded a provision for excess and obsolete inventory totaling $488,000 and $815,000 in the three and nine months ended March 31, 2009, respectively, and $2,157,000 and $6,667,000 in the three and nine months ended March 31, 2008, respectively.

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Property, Plant and Equipment:

	March 31, 2009	June 30, 2008
Land	$ 19,220	$ 19,220
Buildings	19,108	19,108
Building and leasehold improvements	2,955	3,063
Machinery and equipment	9,880	8,424
Furniture and fixtures	2,680	2,212
Purchased software	1,629	1,203
	55,472	53,230
Accumulated depreciation and amortization	(10,011)	(7,628)
Property, plant and equipment, net	$ 45,461	$ 45,602

The cost of assets under capital leases was $286,000 and $411,000 as of March 31, 2009 and June 30, 2008, respectively, and related accumulated amortization was $96,000 and $115,000, respectively.

Restricted Assets:

Restricted assets consist primarily of certificates of deposits secured for two irrevocable letters of credit of $121,000 and $1,540,000 as of March 31, 2009 and June 30, 2008. In February 2008, the Company obtained an irrevocable standby letter of credit required by the landlord of its office lease totaling $121,000. In March 2008, the Company posted a bond in the amount of $3,080,000 required by the Paris Court of Appeals related to the Digitechnic lawsuit (see Note 14). The bond was collateralized by an irrevocable standby letter of credit totaling $1,540,000.

Product Warranties:

	Three Months Ended March 31,		Nine Months Ended March 31,	
	2009	2008	2009	2008
Balance, beginning of period	$ 3,420	$ 2,271	$ 2,920	$ 2,243
Provision for warranty	1,559	1,978	5,232	4,736
Costs charged to accrual	(1,520)	(1,724)	(4,795)	(4,139)
Change in estimated liability for pre-existing warranties	18	49	120	(266)
Balance, end of period	$ 3,477	$ 2,574	$ 3,477	$ 2,574

Note 8. Long-term Investments

As of March 31, 2009, the Company held approximately $14.6 million of long-term auction-rate securities (auction rate securities), net of unrealized losses, representing its interest in auction rate preferred shares in a closed end mutual fund invested in municipal securities and student loans guaranteed by the Federal Family Education Loan Program; such auction rate securities were rated AAA or BBB at March 31, 2009. These auction rate preferred shares have no stated maturity date and the stated maturity dates for these auction rate student loans range from 2010 to 2040.

During February 2008, the auctions for these auction rate securities began to fail to obtain sufficient bids to establish a clearing rate and the securities were not saleable in the auction, thereby losing the short-term liquidity previously provided by the auction process. As a result, the auction rate securities have been classified as long-term investments available-for-sale as of March 31, 2009 and June 30, 2008.

The Company has used a discounted cash flow model to estimate the fair value of the auction rate securities. The assumptions used in preparing the discounted cash flow model include estimates for interest rates which among other things incorporate, as applicable, creditworthiness of the associated insurers, timing of cash flows and expected holding periods of the auction-rate securities. Based on this assessment of fair value, for the three and nine months ended March 31, 2009, the Company determined there was a change in fair value of its auction rate securities of an increase of $122,000 and a decrease of $577,000, respectively, and a cumulative total decline of $1,321,000 which was deemed temporary. That amount has been recorded as a component of other comprehensive income. As of March 31, 2009 and June 30, 2008, accumulated unrealized loss related to investment valuation was $801,000 and $451,000, net of deferred income taxes.

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Additionally, the Company has the financial ability and intent to hold these investments in auction rate securities until successful auctions occur, a buyer is found to purchase the securities at par outside of the auction process or the preferred shares are redeemed. The Company plans to continue to monitor the liquidity situation in the marketplace and the creditworthiness of its holdings and will perform periodic impairment analysis.

Note 9. Fair Value Disclosure

The financial assets of the Company measured at fair value on a recurring basis are cash equivalents, short-term and long-term investments. The Company s money market funds are classified within Level 1 of the fair value hierarchy and certificates of deposits are classified within Level 2 of the fair value hierarchy. The Company s long-term investments are classified within Level 3 of the fair value hierarchy. Refer to Note 2, Summary of Significant Accounting Policies in the Notes to Condensed Consolidated Financial Statements for a discussion of the Company s policies regarding the fair value hierarchy.

The following table sets forth the Company s cash equivalents, short-term and long-term investments as of March 31, 2009 which are measured at fair value on a recurring basis by level within the fair value hierarchy. As required by SFAS 157, these are classified based on the lowest level of input that is significant to the fair value measurement, (in thousands):

	Level 1	Level 2	Level 3	Asset at Fair Value
Money market funds	$ 42,235	$	$	$ 42,235
Certificates of deposits		1,817		1,817
Auction rate securities			14,644	14,644
Total	$ 42,235	$ 1,817	$ 14,644	$ 58,696

The above table excludes $20,467,000 of cash held by the Company.

The Company s Level 3 assets consist of long-term auction-rate securities for which the Company used a discounted cash flow model to value these investments (See Note 8).

The following table provides a reconciliation of the Company s financial assets measured at fair value on a recurring basis, consisting of long-term auction rate securities, using significant unobservable inputs (Level 3) for the three and nine months ended March 31, 2009 (in thousands):

	Three Months Ended March 31, 2009	Nine Months Ended March 31, 2009
Balance as of beginning of period	$ 14,557	$ 16,106
Total realized gains or (losses) included in net income		
Total unrealized gains or (losses) included in other comprehensive income	122	(577)
Purchases, sales and settlements, net at par	(35)	(885)
Transfers in and/or out of Level 3		
Balance as of end of period	$ 14,644	$ 14,644

The Company measures the fair value of outstanding debt for disclosure purposes on a recurring basis and its long-term debt of $10.1 million is reported at amortized cost. The fair value of long-term debt is based on quoted market prices (Level 2) which approximates its fair value based on borrowing rates currently available to the Company for loans with similar terms.

Note 10. Advances from Receivable Financing Arrangements

The Company has accounts receivable financing agreements with certain financing companies whereby the financing companies pay the Company for sales transactions that have been pre-approved by these financing companies. The financing companies then collect the receivable from the customers. Such sales transactions totaled approximately $4,697,000 and $17,130,000 for the three and nine months ended March 31, 2009, respectively, and $6,694,000 and $17,517,000 for the three and nine months ended March 31, 2008, respectively. At March 31, 2009 and June 30, 2008, approximately $1,202,000 and $1,173,000, respectively, remained uncollected from customers subject to these arrangements. Such amounts have been recorded as advances from receivable financing arrangements as the Company has obligations to repurchase inventories seized by the financing companies from defaulting customers. Historically, the Company has not been required to repurchase inventories from the financing companies. These financing arrangements bear interest at rates ranging from 11.10% to 14.76% and 11.70% to 21.48% per annum, depending on the customers credit ratings, at March 31, 2009 and June 30, 2008, respectively.

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Note 11. Long-term Obligations

Long-term obligations consisted of the following (in thousands):

	March 31, 2009	June 30, 2008
Building loans	$ 10,092	$ 10,301
Capital leases	119	165
Total	10,211	10,466
Current portion, debt and capital leases	(356)	(377)
Long-term portion, debt and capital leases	$ 9,855	$ 10,089

In April 2004, the Company borrowed $4,275,000 from a bank to purchase a building in San Jose, California. The loan is secured by the property purchased and principal and interest are payable monthly through May 1, 2029. As of March 31, 2009 and June 30, 2008, the total outstanding borrowings were $3,849,000 and $3,912,000, respectively, with interest at 7.23% per annum through July 2012 and then it is adjusted every five years to equal the index of 5-Year United States Treasury Notes as publish in the Wall Street Journal plus 2.75% per annum.

In September 2005, the Company borrowed $6,930,000 from a bank to purchase a building in San Jose, California. The loan is secured by the property purchased. The loan is repayable in equal monthly installments through September 2025. As of March 31, 2009 and June 30, 2008, the total outstanding borrowings were $6,243,000 and $6,389,000, respectively, with interest at 5.77% per annum through September 2010, and then it is adjusted every five years to equal the index of 5-Year United States Treasury Notes plus 1.65% per annum.

As of March 31, 2009, the gross cost and net book value of the land, building and related improvements collateralizing the borrowings were approximately $17,122,000 and $16,209,000, respectively. As of June 30, 2008, the gross cost and net book value of the land, building and related improvements collateralizing the borrowings were approximately $17,111,000 and $16,375,000, respectively.

In February 2008, the Company obtained an irrevocable standby letter of credit required by the landlord of its office lease totaling $121,000 that expires on September 1, 2009. As of March 31, 2009, the Company had an unused revolving line of credit totaling $5,000,000 that expires on December 1, 2009 with an interest rate at Prime Rate plus 0.5% per annum. As of March 31, 2009, the Company was in compliance with the financial covenants associated with the line of credit.

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Note 12. Related-party and Other Transactions

Ablecom Technology Inc. Ablecom, a Taiwan corporation, together with its subsidiaries (Ablecom), is one of the Company s major contract manufacturers. Ablecom s chief executive officer, Steve Liang, is the brother of Charles Liang, the Company s President, Chief Executive Officer and Chairman of the Board of Directors, and owns approximately 2.5% of the Company s common stock. Charles Liang served as a Director of Ablecom during the Company s fiscal 2006, but is no longer serving in such capacity. In addition, Charles Liang and his wife, also an officer of the Company, collectively own approximately 30.7% of Ablecom and Yih-Shyan (Wally) Liaw, an officer and director of the Company, and his spouse collectively own approximately 5.2% of Ablecom, while Steve Liang and other family members own approximately 49.3% of Ablecom at March 31, 2009.

The Company has product design and manufacturing services agreements (product design and manufacturing agreements) and a distribution agreement (distribution agreement) with Ablecom.

Under the product design and manufacturing agreements, the Company outsources a portion of its design activities and a significant part of its manufacturing of components such as server chassis to Ablecom. Ablecom agrees to design products according to the Company s specifications. Additionally, Ablecom agrees to build the tools needed to manufacture the products. Under the product design and manufacturing agreements, the Company commits to purchase a minimum quantity over a set period. The purchase price of the products manufactured by Ablecom is negotiated on a purchase order by purchase order basis at each purchase date. However, a fixed charge is added to the price of each unit purchased until the agreed minimum number of units is purchased. In August 2007, the Company entered into a new product development, manufacturing and service agreement with Ablecom. Under the new agreement, the Company has agreed to pay for the cost of blade server tooling and engineering services and will pay for those items when the work has been completed. In this case no fixed charge is added to future purchases for reimbursement of tooling costs. The Company made payments for tooling assets of $17,000 and $28,000 to Ablecom in the three and nine months ended March 31, 2009, respectively. The Company made payments for tooling assets of $697,000 to Ablecom in the three months ended March 31, 2008 and tooling assets of $2,135,000 and engineering services of $708,000 to Ablecom in the nine months ended March 31, 2008.

Under the distribution agreement, Ablecom purchases server products from the Company for distribution in Taiwan. The Company believes that the pricing and terms under the distribution agreement are similar to the pricing and terms of distribution arrangements the Company has with similar, third party distributors.

Ablecom s net sales to the Company and its net sales of the Company s products to others comprise a substantial majority of Ablecom s net sales. The Company purchased products from Ablecom totaling approximately $16,843,000 and $72,385,000 and sold products to Ablecom totaling approximately $1,687,000 and $4,446,000 for the three and nine months ended March 31, 2009, respectively. The Company purchased products from Ablecom totaling approximately $30,687,000 and $83,551,000, and sold products to Ablecom totaling approximately $1,235,000 and $4,834,000, for the three and nine months ended March 31, 2008, respectively.

Amounts owed to the Company by Ablecom as of March 31, 2009 and June 30 2008, were approximately $728,000 and $792,000, respectively. Amounts owed to Ablecom by the Company as of March 31, 2009 and June 30, 2008, were approximately $20,226,000 and $27,717,000, respectively. Historically, the Company has paid Ablecom the majority of invoiced dollars between 59 and 112 days of invoice. For the three and nine months ended March 31, 2009, the Company received no penalty charges from Ablecom and paid approximately $1,044,000 and $2,029,000, respectively, in tooling and other miscellaneous cost to Ablecom which included $17,000 and $28,000, respectively, of tooling for blade servers referred to above. For the three and nine months ended March 31, 2008, the Company received $30,000 and $100,000, respectively, from Ablecom for penalty charges, and paid approximately $976,000 and $3,491,000, respectively, in tooling and other miscellaneous costs to Ablecom which included $697,000 and $2,135,000, respectively, of tooling and $0 and $708,000, respectively, of engineering services for the blade servers referred to above. Penalty charges are assessments relating to delayed deliveries or quality issues.

The Company s exposure to loss as a result of its involvement with Ablecom is limited to (a) potential losses on its purchase orders in the event of an unforeseen decline in the market price and/or demand of the Company s products such that the Company incurs a loss on the sale or cannot sell the products and (b) potential losses on outstanding accounts receivable from Ablecom in the event of an unforeseen deterioration in the financial condition of Ablecom such that Ablecom defaults on its payable to the Company. Outstanding purchase orders with Ablecom were $14,936,000 and $27,999,000 at March 31, 2009 and June 30, 2008, respectively, representing the maximum exposure to loss relating to (a) above. The Company does not have any direct or indirect guarantees of losses, if any, of Ablecom.

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Note 13. Income Taxes

The Company recorded provisions (benefits) for income taxes of $(974,000) and $5,492,000 for the three and nine months ended March 31, 2009, respectively, and $3,326,000 and $11,693,000 for the three and nine months ended March 31, 2008, respectively. The effective tax rate for the three and nine months ended March 31, 2009 and 2008 differs from the federal and state statutory rate primarily due to release of an unrecognized tax liability on research and development credits of $0.7 million resulting from lapsing statutes of limitations, tax exempt interest income, research and development credits, domestic production activities deduction and certain stock compensation expenses for which deferred tax assets cannot be recorded in accordance with SFAS 123(R).

As of March 31, 2009, the Company had a liability for gross unrecognized tax benefits of $4,737,000, substantially all of which, if recognized, would affect the Company s effective tax rate. During the nine months ended March 31, 2009, there was a change in the amount of the liability for gross unrecognized tax benefits and it was primarily related to the release of an unrecognized tax liability on research and development credits of $0.7 million resulting from lapsing statutes of limitations.

At March 31, 2009, the Company had a liability for accrued interest and penalties related to the unrecognized tax benefits of $409,000. During the nine months ended March 31, 2009, there was no material change in the total amount of the liability for accrued interest and penalties related to the unrecognized tax benefits.

The Company files U.S. federal, U.S. state, and foreign income tax returns. The Company is generally no longer subject to tax examinations for years prior to the fiscal year beginning July 1, 2002.

In connection with the regular examination of the Company s California tax returns for the fiscal years ended June 30, 2002 and 2003 the Franchise Tax Board has presented certain adjustments to the amounts reflected by the Company on those returns. Although the timing of the resolution and/or closure on audits is highly uncertain, the Company does not believe that its unrecognized tax benefits would materially change in the next 12 months.

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Note 14. Commitments and Contingencies

Litigation and Claims The Company has been a defendant in a lawsuit with Digitechnic, S.A., a former customer, before the Bobigny Commercial Court in Paris, France, in which Digitechnic alleged that certain products purchased from the Company were defective. In September 2003, the Bobigny Commercial Court found in favor of Digitechnic and awarded damages totaling $1,178,000. The Company accrued for these damages in its consolidated financial statements as of June 30, 2004, as the best estimate of its loss in this situation. In February 2005, the Paris Court of Appeals reversed the trial court s ruling, dismissed all of Digitechnic s claims and awarded $11,000 to the Company for legal expenses. Accordingly, the Company reversed the $1,178,000 accrued in fiscal 2005. Digitechnic has appealed the Paris Court of Appeals decision to the French Supreme Court and asked for $2,416,000 for damages. On February 13, 2007, the French Supreme Court reversed the decision of the Paris Court of Appeals, ordering a new hearing before a different panel of the Paris Court of Appeals. Pending a new hearing, the trial court ruling is reinstated. In March 2008, the Company posted a bond in the amount of $3,040,000 required by the court. The bond was collateralized by an irrevocable standby letter of credit totaling $1,540,000. Although the Company cannot predict with certainty the final outcome of this litigation, it believes the claim to be without merit and intends to continue to defend it vigorously. Management believes that the ultimate resolution of this matter will not result in a material adverse impact on the Company s results of operations, cash flows or financial position.

In addition to the above, the Company is involved in various legal proceedings arising from the normal course of business activities. In management s opinion, resolution of these matters is not expected to have a material adverse impact on the Company s consolidated results of operations, cash flows or financial position. However, depending on the amount and timing, an unfavorable resolution of a matter could materially affect the Company s future results of operations, cash flows or financial position in a particular period.

Lease Commitments The Company leases equipment and a warehouse facility under noncancelable operating leases which expire at various dates through 2016. In addition, the Company leases certain of its equipment under capital leases.

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Note 15. Segment Reporting

The Company operates in one operating segment that develops and provides high performance server solutions based upon an innovative, modular and open-standard architecture. The Company s chief operating decision maker is the Chief Executive Officer.

International net sales are based on the country to which the products were shipped. The following is a summary for the three and nine months ended March 31, 2009 and 2008, of net sales by geographic region (in thousands):

	Three Months Ended March 31, 2009	Three Months Ended March 31, 2008	Nine Months Ended March 31, 2009	Nine Months Ended March 31, 2008
Net sales:				
United States	$ 65,536	$ 79,367	$ 244,581	$ 237,127
United Kingdom	6,236	5,009	15,982	17,263
Germany	5,072	7,776	20,845	21,295
Rest of Europe	14,391	18,619	46,817	51,390
China	4,576	12,084	13,985	20,565
Rest of Asia	8,596	11,828	28,558	36,284
Other	5,133	2,072	11,388	7,713
	$ 109,540	$ 136,755	$ 382,156	$ 391,637

The Company s long-lived assets located outside the United States are not significant.

The following is a summary of net sales by product type (dollars in thousands):

	Three Months Ended March 31,				Nine Months Ended March 31,			
	2009		2008		2009		2008	
	Amount	Percent of Revenues	Amount	Percent of Net Sales	Amount	Percent of Net Sales	Amount	Percent of Net Sales
Server systems	$ 42,845	39.1%	$ 47,882	35.0%	$ 151,364	39.6%	$ 151,463	38.7%
Serverboards and other components	66,695	60.9%	88,873	65.0%	230,792	60.4%	240,174	61.3%
Total	$ 109,540	100.0%	$ 136,755	100.0%	$ 382,156	100.0%	$ 391,637	100.0%

Serverboards and other components are comprised of serverboards, chassis and accessories. Server systems constitute an assembly of components done by the Company.

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

This section and other parts of this Form 10-Q contain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, as amended that involve risks and uncertainties. These statements relate to future events or our future financial performance. In some cases, you can identify forward-looking statements by terminology including would, could, may, will, should, expect, intend, plan, anticipate, believe, estimate, predict, potential, or continue, the negative of these terms or other comparable terminology. In evaluating these statements, you should specifically consider various factors, including the risks described under Risk Factors below and in other parts of this Form 10-Q as well as in our other filings with the SEC. These factors may cause our actual results to differ materially from those anticipated or implied in the forward-looking statements. We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. We cannot guarantee future results, levels of activity, performance or achievements.

Overview

We design, develop, manufacture and sell application optimized, high performance server solutions based on an innovative, modular and open-standard x86 architecture. Our solutions include a range of complete rackmount and blade server systems, as well as components which can be used by distributors, OEMs and end customers to assemble server systems. To date, we have generated the majority of our net sales from components. Since 2000, we have gradually shifted our focus and resources to designing, developing, manufacturing and selling application optimized server systems. In recent years our growth in net sales has been driven by the growth in the market for application optimized server systems. Net sales of optimized servers were $42.8 million and $151.4 million for the three and nine months ended March 31, 2009, respectively, and $47.9 million and $151.5 million for the three and nine months ended March 31, 2008, respectively. Net sales of serverboards and components were $66.7 million and $230.8 million for the three and nine months ended March 31, 2009, respectively, and $88.9 million and $240.2 million for the three and nine months ended March 31, 2008, respectively. In the three and nine months ended March 31, 2009, we experienced a decline in net sales compared with the three and nine months ended March 31, 2008 which we believe was primarily attributable to reductions in information technology spending in response to the global economic downturn.

We commenced operations in 1993 and have been profitable every year since inception. Our net sales were $109.5 million and $382.2 million for the three and nine months ended March 31, 2009, respectively, and $136.8 million and $391.6 million for the three and nine months ended March 31, 2008, respectively. Our net income was $1.2 million and $13.7 million for the three and nine months ended March 31, 2009, respectively, and $5.0 million and $18.6 million for the three and nine months ended March 31, 2008, respectively. Our decline in profitability for the three and nine months ended March 31, 2009 was primarily attributable to the reduction in our net sales and to a lesser extent attributable to a reduction in our gross profit as a percentage of net sales as a result of increasing pricing pressure, offset in part by cost saving programs.

We sell our server systems and components primarily through distributors and to a lesser extent to OEMs as well as through our direct sales force. We derived approximately 65.9% and 64.8% of our net sales from products sold to distributors, and 34.1% and 35.2% from sales to OEMs and to end customers for the three and nine months ended March 31, 2009, respectively. We derived approximately 62.8% and 61.6% of our net sales from products sold to distributors, and 37.2% and 38.4% from sales to OEMs and to end customers for the three and nine months ended March 31, 2008. None of our customers accounted for 10% or more of our net sales in the three and nine months ended March 31, 2009 and 2008. We derived approximately 59.8% and 64.0% of our net sales from customers in the United States for the three and nine months ended March 31, 2009, respectively, and approximately 58.0% and 60.5% of our net sales from customers in the United States for the three and nine months ended March 31, 2008, respectively. We derived approximately 40.2% and 36.0% of our net sales from customers outside the United States for the three and nine months ended March 31, 2009, respectively, and approximately 42.0% and 39.5% of our net sales from customers outside the United States for the three and nine months ended March 31, 2008, respectively. We perform the majority of our research and development efforts in-house. Research and development expenses represented approximately 7.8% and 6.8% of our net sales for the three and nine months ended March 31, 2009, respectively, compared to approximately 5.8% and 5.5% of our net sales for the three and nine months ended March 31, 2008, respectively.

We use several suppliers and contract manufacturers to design and manufacture components in accordance with our specifications, with most final assembly and testing performed at our manufacturing facility in San Jose, California. This arrangement enables us to maintain our cost structure and to benefit from our suppliers and contract manufacturers research and development and economies of scale.

One of our key suppliers is Ablecom, which supplies us with contract design and manufacturing support. For the three and nine months ended March 31, 2009, our purchases from Ablecom represented approximately 18.1% and 23.1% of our cost of sales, respectively, compared to approximately 27.4% and 26.4% of our cost of sales for the three and nine months ended March 31, 2008, respectively. The decrease in percentage of cost of sales was primarily related to higher product mix of server systems and system accessories which were purchased from other suppliers. Ablecom s sales to us constitute a substantial majority of Ablecom s net sales. We continue to maintain our manufacturing relationship with Ablecom in Asia in an effort to reduce our product costs and do not have any current plans to reduce our reliance on Ablecom product purchases. In addition to providing a larger volume of contract manufacturing services for us, Ablecom continues to warehouse for us an increasing number of components and subassemblies manufactured by multiple suppliers prior to shipment to our facilities in the U.S. and Europe. We typically negotiate the price of products that we purchase from Ablecom on a quarterly basis; however, either party may re-negotiate the price of products with each order. As a result of our relationship with Ablecom, it is possible that Ablecom may in the future sell products to us at a price higher or lower than we could obtain from an unrelated third party supplier. This may result in our reporting for one or more periods gross profit as a percentage of net sales less than or in excess of what we might have obtained absent our relationship with Ablecom.

In order to continue to increase our net sales and profits, we believe that we must continue to develop flexible and customizable server solutions and be among the first to market with new features and products. We measure our financial success based on various indicators, including growth in net sales, gross profit as a percentage of net sales, operating income as a percentage of net sales, levels of inventory, and days sales outstanding, or DSOs. In connection with these efforts, we monitor daily and weekly sales and shipment reports. Among the key non-financial indicators of our success is our ability to rapidly introduce new products and deliver the latest application optimized server solutions. In this regard, we work closely with microprocessor and other component vendors to take advantage of new technologies as they are introduced. Historically, our ability to introduce new products rapidly has allowed us to benefit from the introduction of new microprocessors and as a result we monitor the introduction cycles of Intel and AMD carefully. This also impacts on our research and development expenditures. For example, Intel recently introduced its Nehalem line of microprocessors. Our results for the quarter ended March 31, 2009 were in part adversely impacted by customer order delays in anticipation of the introduction and research and development expenditures necessary for us to prepare for the introduction. We expect to benefit from the introduction with an increase in sales for the quarter ending June 30, 2009. We also solicit input from our customers to understand their future needs as we design and develop our products.

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Other Financial Highlights

The following is a summary of other financial highlights of the third quarter and first nine months of fiscal 2009:

- We generated cash flows from operations of $3.5 million and $13.4 million during the three and nine months ended March 31, 2009, respectively. Our cash and cash equivalents, together with our investments, were $77.4 million at the end of the third quarter of fiscal 2009, compared with $67.6 million at the end of fiscal 2008.

- We repurchased 54,528 shares of our common stock for $0.2 million during the third quarter of fiscal 2009 and 445,028 shares of our common stock for $2.0 million for the first nine months of fiscal 2009.

- Days sales outstanding in accounts receivable (DSO) at the end of the third quarter of fiscal 2009 was 35 days, compared with 28 days at the end of fiscal 2008.

- Our inventory balance was $82.9 million at the end of the third quarter of fiscal 2009, compared with $85.7 million at the end of fiscal 2008. Days sales of inventory (DSI) at the end of the third quarter of fiscal 2009 was 85 days, compared with 68 days at the end of fiscal 2008. Our purchase commitments with contract manufacturers and suppliers were $38.9 million at the end of the third quarter of fiscal 2009 and $49.4 million at the end of fiscal 2008.

We believe that our cash position, our balance sheet, our visibility into our supply chain and our financing capabilities provide a key competitive advantage and position us well to manage through the current economic downturn.

Fiscal Year

Our fiscal year ends on June 30. References to fiscal year 2009, for example, refer to the fiscal year ending June 30, 2009.

Revenues and Expenses

Net sales. Net sales consist of sales of our server solutions, including server systems and components. The main factors which impact our net sales are unit volumes shipped and average selling prices. The prices for server systems range widely depending upon the configuration, and the prices for our components vary based on the type of component. As with most electronics-based products, average selling prices typically are highest at the time of introduction of new products which utilize the latest technology and tend to decrease over time as such products mature in the market and are replaced by next generation products.

Cost of sales. Cost of sales primarily consists of the costs to manufacture our products, including the costs of materials, contract manufacturing, shipping, personnel and related expenses, equipment and facility expenses, warranty costs and inventory excess and obsolete provisions. The primary factors that impact our cost of sales are the mix of products sold and cost of materials, which include raw material costs, shipping costs and salary and benefits related to production. Cost of sales as a percentage of net sales may increase over time if decreases in average selling prices are not offset by corresponding decreases in our costs. Our cost of sales, as a percentage of net sales, is generally lower on server systems than on components. Because we do not have long-term fixed supply agreements, our cost of sales is subject to change based on market conditions.

Research and development expenses. Research and development expenses consist of the personnel and related expenses of our research and development teams, and materials and supplies, consulting services, third party testing services and equipment and facility expenses related to our research and development activities. All research and development costs are expensed as incurred. We occasionally receive non-recurring engineering, or NRE funding from certain suppliers and customers towards our development efforts. Under these programs, we are reimbursed for certain research and development costs that we incur as part of the joint development of our products and those of our suppliers and customers. These amounts offset a portion of the related research and development expenses and have the effect of reducing our reported research and development expenses.

Sales and marketing expenses. Sales and marketing expenses consist primarily of salaries and commissions for our sales and marketing personnel, costs for tradeshows, independent sales representative fees and marketing programs. From time to time, we receive cooperative marketing funding from certain suppliers. Under these programs, we are reimbursed for certain marketing costs that we incur as part of the joint promotion of our products and those of our suppliers. These amounts offset a portion of the related expenses and have the effect of reducing our reported sales and marketing expenses. Similarly, we from time to time offer our distributors cooperative marketing funding which has the effect of increasing our expenses. The timing, magnitude and estimated usage of our programs and those of our suppliers can result in significant variations in reported sales and marketing expenses from period to period. Spending on cooperative marketing, either by us or our suppliers, typically increases in connection with significant product releases by us or our suppliers.

General and administrative expenses. General and administrative expenses consist primarily of general corporate costs, including personnel expenses, financial reporting, corporate governance and compliance and outside legal, audit and tax fees.

Interest and other income, net. Interest and other income, net, represents the net of our interest income on investments or interest expense on the building loans for our owned facilities offset by interest earned on our cash balances.

Income tax provision. Our income tax provision is based on our taxable income generated in the jurisdictions in which we operate, currently primarily the United States and the Netherlands and to a lesser extent, Taiwan. Our effective tax rate differs from the statutory rate primarily due to release of an unrecognized tax liability on research and development credits resulting from lapsing statutes of limitations, tax benefits of tax exempt interest income, research and development tax credits and the domestic production activities deduction.

Critical Accounting Policies

Our discussion and analysis of our financial condition and results of operations are based upon our financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amount of assets, allowances for doubtful accounts and sales returns, liabilities, revenues and expenses. We evaluate our estimates on an on-going basis, including those related to cooperative marketing accruals, investment valuations, inventory valuations, income taxes, warranty obligations and stock-based compensation. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making the judgments we make about the carrying values of assets and liabilities that are not readily apparent from other sources. Because these estimates can vary depending on the situation, actual results may differ from the estimates.

We believe the following are our most critical accounting policies as they require our more significant judgments in the preparation of our financial statements.

Revenue recognition. We account for revenue under the provisions of Staff Accounting Bulletin (SAB) No. 104, *Revenue Recognition in Financial Statements*. Under the provisions of SAB No. 104, we recognize revenue from sales of products, when persuasive evidence of an arrangement exists, shipment has occurred and title has transferred, the sales price is fixed or determinable, collection of the resulting receivable is reasonably assured, and all significant obligations have been met. Generally this occurs at the time of shipment when risk of loss and title has passed to the customer. Our standard arrangement with our customers includes a signed purchase order or contract, free-on-board shipping point terms, except for a few customers who have free-on-board destination terms and revenue is recognized when the products arrive at the destination, 30 to 60 days payment terms, and no customer acceptance provisions. We generally do not provide for non-warranty rights of return except for products which have Out-of-box failure, where customers could return these products for credit within 30 days of receiving the items. Certain distributors and OEMs are also permitted to return products in unopened boxes, limited to purchases over a specified period of time, generally within 60 to 90 days of the purchase, or to products in the distributor s or OEM s inventory at certain times (such as the termination of the agreement or product obsolescence). In addition, we have a sale arrangement with an OEM that has limited product return rights. To estimate reserves for future sales returns, we regularly review our history of actual returns for each major product line. We also communicate regularly with our distributors to gather information about end customer satisfaction, and to determine the volume of inventory in the channel. Reserves for future returns are adjusted as necessary, based on returns experience, returns expectations and communication with our distributors.

Probability of collection is assessed on a customer-by-customer basis. Customers are subjected to a credit review process that evaluates the customers financial position and ability to pay. If it is determined from the outset of an arrangement that collection is not probable based upon the review process, the customers are required to pay cash in advance of shipment. We provide for price protection to certain distributors. We assess the market competition and product technology obsolescence, and make price adjustments based on our judgment. Upon each announcement of price reductions, the accrual for price protection is calculated based on our distributors inventory on hand. Such reserves are recorded as a reduction to revenue at the time we reduce the product prices in accordance with Emerging Issues Task Force Issue No. 01-9, *Accounting for Consideration Given by a Vendor to a Customer (including a Reseller of the Vendor s Products)*. Credits that we issued pursuant to these provisions were $101,000 and $324,000 for the three and nine months ended March 31, 2009, respectively, and $70,000 and $198,000 for the three and nine months ended March 31, 2008, respectively. We do not commit to future price reductions with any of our customers.

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We have an immaterial amount of service revenue relating to non-warranty repairs, which is recognized upon shipment of the repaired units to customers. Service revenue has been less than 10% of net sales for all periods presented and is not separately disclosed.

Cooperative marketing accruals. We follow Emerging Issues Task Force (EITF) Issue No. 01-9, *Accounting for Consideration Given by a Vendor to a Customer (including a Reseller of the Vendor s Products).* We have arrangements with resellers of our products to reimburse the resellers for cooperative marketing costs meeting specified criteria. In accordance with EITF Issue No. 01-9, we record advertising costs meeting such specified criteria within sales and marketing expenses in the accompanying condensed consolidated statements of operations. For those advertising costs that do not meet the criteria set forth in EITF Issue No. 01-9, the amounts are recorded as a reduction to sales in the accompanying condensed consolidated statements of operations.

Impairment of long-term investments. Impairment of long-term investments relates to the unrealized loss on the carrying value of our investments in auction-rate securities; such securities were rated AAA at the date of purchase. The liquidity and fair value of these securities has been negatively impacted by the uncertainty in the credit markets and exposure of these securities to the financial condition of bond insurance companies. We have received all interest payments due on these instruments on a timely basis. Each of these securities has been subject to auction processes for which there had been insufficient bidders on the scheduled rollover dates and the auctions have subsequently failed. When these securities lost the short-term liquidity previously provided by the auction processes, we reclassified these securities as non-current investments. We have used a discounted cash flow model to estimate the fair value of these investments as of March 31, 2009. The material factors used in preparing the discounted cash flow model are 1) the discount rate utilized to present value the cash flows, 2) the time period until redemption and 3) the estimated rate of return. Management derives the estimates by obtaining input from market data on the applicable discount rate, estimated time to maturity and estimated rate of return. The changes in fair value have been primarily due to changes in the estimated rate of return and a change in the estimated redemption period (increasing by one year at quarter end). The fair value of our investment portfolio may range between 2% to 4% by increasing or decreasing the rate of return used by 1% or by increasing or decreasing the term used by 1 year. Changes in these estimates or in the market conditions for these investments are likely in the future based upon the then current market conditions for these investments and may affect the fair value of these non-current investments. As of March 31, 2009 we have recorded an accumulative unrealized loss of $801,000, net of deferred income taxes, on the securities. We deem this loss to be temporary due to our ability and intention to hold the securities until full recovery.

Product warranties. We offer product warranties ranging from 15 to 39 months against any defective product. We accrue for estimated returns of defective products at the time revenue is recognized, based on historical warranty experience and recent trends. We monitor warranty obligations and may make revisions to our warranty reserve if actual costs of product repair and replacement are significantly higher or lower than estimated. Accruals for anticipated future warranty costs are charged to cost of sales and included in accrued liabilities. The liability for product warranties was $3.5 million as of March 31, 2009, compared with $2.6 million as of March 31, 2008. The provision for warranty reserve was $1.6 million and $5.2 million for the three and nine months ended March 31, 2009, respectively, and $2.0 million and $4.7 million for the three and nine months ended March 31, 2008, respectively. Our estimates and assumptions used have been historically close to actual. The change in estimated liability for pre-existing warranties was $18,000 and $0.1 million for the three and nine months ended March 31, 2009, respectively, and $49,000 and ($0.3) million for the three and nine months ended March 31, 2008, respectively. As we experienced a decrease in cost of warranty claims and lower unit volume in the three months ended March 31, 2009 compared with our historical experience, the provision for warranty reserve decreased $0.4 million compared to the three months ended March 31, 2008. As we experienced an increase in cost of warranty claims in the nine months ended March 31, 2009 compared with our historical experience, the provision for warranty reserve increased $0.5 million compared to the nine months ended March 31, 2008. If in future periods, we experience or anticipate an increase in warranty claims as a result of new product introductions or increases in unit volumes compared with our historical experience, or if the cost of servicing warranty claims is greater than expected, we intend to adjust our estimates appropriately.

Inventory valuation. Inventory is valued at the lower of cost or market. We evaluate inventory on a quarterly basis for lower of cost or market and excess and obsolescence and, as necessary, write down the valuation of units to lower of cost or market or for excess and obsolescence based upon the number of units that are unlikely to be sold based upon estimated demand for the following twelve months. This evaluation takes into account matters including expected demand, anticipated sales price, product obsolescence and other factors. If actual future demand for our products is less than currently forecasted, additional inventory adjustments may be required. Once a reserve is established, it is maintained until the product to which it relates is sold or scrapped. If a unit that has been written down is subsequently sold, the cost associated with the revenue from this unit is reduced to the extend of the write down, resulting in an increase in gross profit. We monitor the extent to which previously written down inventory is sold at amounts greater or less than carrying value, and based on this analysis, adjust our estimate for determining future write downs. In the three and nine months ended March 31, 2009, the historical analysis of sales of previously written down inventory was such that we decreased our estimate for reserving excess and obsolete inventory. If in future periods, we experience or anticipate a change in recovery rate compared with our historical experience, our gross margin would be affected. Our provision for inventory was $0.5 million and $0.8 million for the three and nine months ended March 31, 2009, respectively, and $2.2 million and $6.7 million for the three and nine months ended March 31, 2008, respectively.

Accounting for income taxes. We account for income taxes under an asset and liability approach. Deferred income taxes reflect the impact of temporary differences between assets and liabilities recognized for financial reporting purposes and such amounts recognized for income tax reporting purposes, net operating loss carry-forwards and other tax credits measured by applying currently enacted tax laws. Valuation allowances are provided when necessary to reduce deferred tax assets to an amount that is more likely than not to be realized.

Effective July 1, 2007, we adopted FASB Interpretation No. 48, *Accounting for Uncertainties in Income Taxes An Interpretation of FASB Statement No. 109* (FIN 48). FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition of tax benefits, classification on the balance sheet, interest and penalties, accounting in interim periods, disclosure, and transition. As a result of the implementation of FIN 48, we recognize the tax liability for uncertain income tax positions on the income tax return based on the two-step process prescribed in the interpretation. The first step is to determine whether it is more likely than not that each income tax position would be sustained upon audit. The second step is to estimate and measure the tax benefit as the amount that has a greater than 50% likelihood of being realized upon ultimate settlement with the tax authority. Estimating these amounts requires us to determine the probability of various possible outcomes. We evaluate these uncertain tax positions on a quarterly basis. This evaluation is based on the consideration of several factors, including changes in facts or circumstances, changes in applicable tax law, settlement of issues under audit and new exposures. If we later determine that our exposure is lower or that the liability is not sufficient to cover our revised expectations, we adjust the liability and effect a related change in our tax provision during the period in which we make such determination. See Note 13 of Notes to Condensed Consolidated Financial Statements for the impact of FIN 48 on our condensed consolidated financial statements.

Stock-based compensation. Effective July 1, 2006, we adopted the fair value recognition provisions of SFAS No. 123(R), *Share-Based Payment*, using the prospective transition method, which establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services, primarily focusing on accounting for transactions where an entity obtains employee services in share-based payment transactions. Prior to July 1, 2006, we accounted for stock-based compensation awards issued to our employees using the intrinsic value measurement provisions of Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, or Opinion 25. Accordingly, we have recorded compensation expense for stock options granted prior to the adoption of SFAS No. 123(R) with exercise prices less than the fair value of the underlying common stock at the option grant date. Amortization of deferred stock compensation, resulting from such stock options granted to employees and directors, when the exercise price of our stock options was less than the deemed market price of the underlying stock on the date of the grant, for the three and nine months ended March 31, 2009 was $0.1 million and $0.4 million, respectively, compared to $0.2 million and $0.6 million for the three and nine months ended March 31, 2008, respectively. SFAS No. 123(R) supersedes our previous accounting under APB No. 25 for periods beginning in fiscal year 2007. SFAS No. 123(R) requires enterprises to measure the cost of employee services received in exchange for an award of equity instruments, including stock options, based on the grant-date fair value of the award. That cost will be recognized over the period during which an employee is required to provide services in exchange for the award, known as the requisite service period (usually the vesting period). Compensation expense under SFAS No. 123(R) for options granted to employees after July 1, 2006, was $1.3 million and $3.5 million for the three and nine months ended March 31, 2009, respectively, and $0.8 million and $2.2 million for the three and nine months ended March 31, 2008, respectively.

As of March 31, 2009, the total unrecognized compensation cost, adjusted for estimated forfeitures, related to unvested stock options granted since July 1, 2006 to employees and non-employee directors, was $12.4 million, which is expected to be recognized as an expense over a weighted-average period of approximately 2.13 years. See Note 4 to our condensed consolidated financial statements for additional information.

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We estimated the fair value of stock options granted using a Black-Scholes option-pricing formula and a single option award approach. This model requires us to make estimates and assumptions with respect to the expected term of the option, the expected volatility of the price of our common stock and the expected forfeiture rate. The fair value is then amortized on a straight-line basis over the requisite service periods of the awards, which is generally the vesting period.

The expected term represents the period that our stock-based awards are expected to be outstanding and was determined based on an analysis of the relevant peer companies post-vest termination rates and the exercise factors. The expected volatility is based on a combination of the implied and historical volatility of our relevant peer group. In addition, SFAS No. 123(R) requires forfeitures of share-based awards to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. We use historical data to estimate pre-vesting option forfeitures and record stock-based compensation expense only for those awards that are expected to vest.

Variable interest entities. We have analyzed our relationship with Ablecom and its subsidiaries and we have concluded that Ablecom is a variable interest entity as defined by FIN No. 46R; however, we are not the primary beneficiary of Ablecom and, therefore, we do not consolidate Ablecom. In performing our analysis, we considered our explicit arrangements with Ablecom including the supplier and distributor arrangements. Also, as a result of the substantial related party relationship between the two companies, we considered whether any implicit arrangements exist that would cause us to protect those related parties interests in Ablecom from suffering losses. We determined that no implicit arrangements exist with Ablecom or its shareholders. Such an arrangement would be inconsistent with the fiduciary duty that we have towards our stockholders who do not own shares in Ablecom.

Results of Operations

The following table sets forth our financial results, as a percentage of net sales for the periods indicated:

	Three Months Ended March 31,		Nine Months Ended March 31,	
	2009	**2008**	**2009**	**2008**
Net sales	100.0%	100.0%	100.0%	100.0%
Cost of sales	85.1	81.8	82.1	80.8
Gross profit	14.9	18.2	17.9	19.2
Operating expenses:				
Research and development	7.8	5.8	6.8	5.5
Sales and marketing	3.7	3.4	3.4	3.3
General and administrative	3.0	2.9	2.6	2.8
Total operating expenses	14.5	12.1	12.8	11.6
Income from operations	0.4	6.1	5.1	7.6
Interest income	0.0	0.2	0.1	0.3
Interest expense	(0.2)	(0.2)	(0.2)	(0.2)
Income before income tax provision	0.2	6.1	5.0	7.7
Income tax provision (benefit)	(0.9)	2.4	1.4	3.0
Net income	1.1%	3.7%	3.6%	4.7%

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Comparison of Three Months Ended March 31, 2009 and 2008

Net sales. Net sales decreased by $27.2 million, or 19.9%, to $109.5 million from $136.8 million, for the three months ended March 31, 2009 and 2008, respectively. This was due primarily to a decrease in unit volumes of serverboards, chassis and server systems partially offset by an increase in unit volumes of system accessories. For the three months ended March 31, 2009, the approximate number of server system units sold decreased 4.9% to 39,000 compared to 41,000 for the three months ended March 31, 2008. The average selling price of server system units decrease 8.3% to approximately $1,100 in the three months ended March 31, 2009 compared to approximately $1,200 in the three months ended March 31, 2008. The average selling prices of our server systems decreased principally driven by lower average selling prices of 6000 Series configurations of servers and OEM bundled server solutions and the declines in average selling prices of more mature products sold to distributors. Sales of server systems decreased by $5.0 million or 10.5% from the three months ended March 31, 2008 to the three months ended March 31, 2009, primarily due to lower sales of 6000 Series configurations of servers offset by higher sales of our OEM and bundled server solutions. Sales of server systems represented 39.1% of our net sales for the three months ended March 31, 2009 as compared to 35.0% of our net sales for the three months ended March 31, 2008. We believe that the decline in our net sales in the three months ended March 31, 2009 was primarily attributable to reductions in information technology spending in response to the global economic downturn and to a lesser extent was impacted by delayed customer orders in anticipation of the release by Intel of its Nehalem line of microprocessors. For the three months ended March 31, 2009 and 2008, we derived approximately 65.9% and 62.8%, respectively, of our net sales from products sold to distributors and we derived approximately 34.1% and 37.2%, respectively, from sales to OEMs and to end customers. For the three months ended March 31, 2009, customers in the United States, Asia, Germany and rest of Europe accounted for approximately 59.8%, 12.0%, 4.6% and 18.8%, of our net sales, respectively, as compared to 58.0%, 17.5%, 5.7% and 17.3%, respectively, for the three months ended March 31, 2008.

Cost of sales. Cost of sales decreased by $18.7 million, or 16.7%, to $93.2 million from $111.9 million, for the three months ended March 31, 2009 and 2008, respectively. Cost of sales as a percentage of net sales was 85.1% and 81.8% for the three months ended March 31, 2009 and 2008, respectively. The decrease in absolute dollars of cost of sales was primarily attributable to the decrease in net sales, a decrease of $1.7 million in inventory provision, a decrease of $1.6 million in freight-in charges and a decrease of $0.4 million in provision for warranty reserve. The higher cost of sales as a percentage of net sales was primarily due to a decrease in standard gross margin as a result of lower margins in server systems and chassis due to competitive pricing pressures as we grew market share during the economic downturn combined with lower prices for our maturing product line in advance of the Intel Nehalem launch. In the three months ended March 31, 2009, we recorded a $1.6 million expense, or 1.4% of net sales, related to the provision for warranty reserve as compared to $2.0 million, or 1.4% of net sales, in the three months ended March 31, 2008. The decrease in the provision for warranty reserve was primarily due to lower repair costs and decreases in unit volume during the three months ended March 31, 2009. We believe that lower repair costs during the three months ended March 31, 2009 are not indicative of future results and we do not anticipate any further significant decrease. If in future periods we experience or anticipate an increase in warranty claims as a result of new product introductions or increases in unit volumes compared with our historical experience, or if the cost of servicing warranty claims is greater than expected, our gross margin would be affected. In the three months ended March 31, 2009, we recorded a $0.5million expense, or 0.4% of net sales, related to the inventory provision as compared to $2.2 million expense, or 1.6% of net sales, in the three months ended March 31, 2008. The decrease in the inventory provision was primarily due to the improvement of our inventory management to reduce excess and slow moving inventory through product conversion and increasing sales efforts. In the three months ended March 31,2009, the historical analysis of sales of previously written down inventory was such that we decreased our estimate for reserving excess and obsolete inventory. If in future periods we experience or anticipate a change in recovery rate compared with our historical experience, our gross margin would be affected.

Research and development expenses. Research and development expenses increased by $0.6 million, or 7.2%, to $8.6 million from $8.1 million, for the three months ended March 31, 2009 and 2008, respectively. Research and development expenses were 7.8% and 5.8% of net sales for the three months ended March 31, 2009 and 2008, respectively. The increase in absolute dollars was primarily due to an increase of $0.8 million in compensation and benefits resulting from growth in research and development personnel, including higher stock-based compensation expense offset in part by a decrease of $0.2 million in development costs associated with new products. Although we reduced the rate of growth of our research and development expenses in the quarter ended March 31, 2009 in light of reduced net sales, we increased our expenditures in part to continue to support the development of new products utilizing the Nehalem microprocessor.

Research and development expenses include stock-based compensation expense of $675,000 and $465,000 for the three months ended March 31, 2009 and 2008, respectively. The increase in absolute dollars was primarily due to the growth in research and development personnel.

Sales and marketing expenses. Sales and marketing expenses decreased by $0.6 million, or 13.1%, to $4.0 million from $4.6 million, for the three months ended March 31, 2009 and 2008, respectively. Sales and marketing expenses were 3.7% and 3.4% of net sales for the three months ended March 31, 2009 and 2008, respectively. The decrease in absolute dollars was primarily due to a decrease of $0.3 million in compensation and benefits and a decrease of $0.2 million in cooperative marketing funding to customers resulting from lower net sales in the three months ended March 31, 2009.

Sales and marketing expenses include stock-based compensation expense of $201,000 and $161,000 for the three months ended March 31, 2009 and 2008, respectively.

General and administrative expenses. General and administrative expenses decreased by $0.6 million, or 15.9%, to $3.3 million from $3.9 million, for the three months ended March 31, 2009 and 2008, respectively. General and administrative expenses were 3.0% and 2.9% of net sales for the three months ended March 31, 2009 and 2008, respectively. The decrease in absolute dollars was primarily due to a decrease of $0.4 million in consulting fees related to Sarbanes-Oxley 404 (SOX) compliance and lower taxes of $0.1 million related to Delaware franchise tax payments.

General and administrative expenses include stock-based compensation expense of $412,000 and $291,000 for the three months ended March 31, 2009 and 2008, respectively.

Interest and other expense, net. Interest and other expense, changed by $0.2 million to $0.2 million of expense from $0.1 million of income, for the three months ended March 31, 2009 compared to the same period in 2008, of which $0.2 million was interest expenses for both three months ended March 31, 2009 and 2008, respectively. The net change was due to lower interest income of $0.3 million resulting from lower interest rates.

Provision for income taxes. Provision for income taxes changed by $4.3 million, or 129.3%, to a ($1.0) million benefit from $3.3 million provision, for the three months ended March 31, 2009 and 2008, respectively. The effective tax rate was (379.0)% and 39.8% for the three months ended March 31, 2009 and 2008, respectively. The decrease in the effective tax rate primarily was the result of the release of an unrecognized tax liability on research and development credits of $0.7 million resulting from lapsing statues of limitations in the three months ended March 31, 2009. We expect that the effective tax rate will increase in future periods.

Comparison of Nine Months Ended March 31, 2009 and 2008

Net sales. Net sales decreased by $9.5 million, or 2.4%, to $382.2 million from $391.6 million, for the nine months ended March 31, 2009 and 2008, respectively. This was due primarily to a decrease in unit volumes of serverboards and chassis offset in part by an increase in unit volumes of system accessories and server systems. For the nine months ended March 31, 2009, the approximate number of server system units sold increased 0.8% to 124,000 compared to 123,000 for the nine months ended March 31, 2008. The average selling price of server system units was approximately $1,200 in both nine months ended March 31, 2009 and 2008. The average selling prices of our server systems remained constant principally driven by an increase in sales of Superblades and 6000 Series configurations of servers offset in part by declines in average selling prices of more mature products to OEMs and end customers and declines in average selling prices of 5000 and 7000 Series configurations of servers. Sales of server systems decreased by $0.1 million or 0.1% from the nine months ended March 31, 2008 to the nine months ended March 31, 2009, primarily due to lower sales of 5000 and 6000 Series configuration of servers offset in part by higher sales of our OEM and bundled server solutions utilizing our high efficiency power supplies and higher sales of Superblades. Sales of server systems represented 39.6% of our net sales for the nine months ended March 31, 2009 as compared to 38.7% of our net sales for the nine months ended March 31, 2008. We believe that the decline in our net sales in the nine months ended March 31, 2009 was primarily attributable to reductions in information technology spending in response to the global economic downturn and to a lesser extent was impacted by delayed customer orders in anticipation of the release by Intel of its Nehalem line of microprocessors. For the nine months ended March 31, 2009 and 2008, we derived approximately 64.8% and 61.6%, respectively, of our net sales from products sold to distributors and we derived approximately 35.2% and 38.4%, respectively, from sales to OEMs and end customers. For the nine months ended March 31, 2009, customers in the United States, Asia, Germany and rest of Europe accounted for approximately 64.0%, 11.1%, 5.5% and 16.4%, of our net sales, respectively, as compared to 60.5%, 14.5%, 5.4% and 17.5%, respectively, for the nine months ended March 31, 2008.

Cost of sales. Cost of sales decreased by $2.6 million, or 0.8%, to $313.9 million from $316.5 million, for the nine months ended March 31, 2009 and 2008, respectively. Cost of sales as a percentage of net sales was 82.1% and 80.8% for the nine months ended March 31, 2009 and 2008, respectively. The decrease in absolute dollars of cost of sales was primarily attributable to the decrease in net sales and a decrease of $5.9 million in inventory provision, a decrease of $2.1 million in freight-in charges offset in part by an increase of $0.5 million in provision for warranty reserve. The higher cost of sales as a percentage of net sales was primarily due to a decrease in standard gross margin as a result of lower margins across our product lines due to competitive pricing pressures as we grew market share during the economic downturn combined with lower prices for our maturing product line in advance of the Intel Nehalem launch. In the nine months ended March 31, 2009, we recorded a $5.2 million expense, or 1.4% of net sales, related to the provision for warranty reserve as compared to $4.7 million, or 1.2% of net sales, in the nine months ended March 31, 2008. The increase in the provision for warranty reserve was primarily due to higher repair costs in the nine months ended March 31, 2009. If in future periods we experience or anticipate an increase in warranty claims as a result of new product introductions or increases in unit volumes compared with our historical experience, or if the cost of servicing warranty claims is greater than expected, our gross margin would be affected. In the nine months ended March 31, 2009, we recorded a $0.8 million expense, or 0.2% of net sales, related to the inventory provision as compared to $6.7 million, or 1.7% of net sales, in the nine months ended March 31, 2008. The decrease in the inventory provision was primarily due to the improvement of our inventory management to reduce excess and slow moving inventory through product conversion and increasing sales efforts. In the nine months ended March 31, 2009, the historical analysis of sales of previously written down inventory was such that we decreased our estimate for reserving excess and obsolete inventory. If in future periods, we experience or anticipate a change in recovery rate compared with our historical experience, our gross margin would be affected.

Research and development expenses. Research and development expenses increased by $3.9 million, or 18.1%, to $25.7 million from $21.7 million, for the nine months ended March 31, 2009 and 2008, respectively. Research and development expenses were 6.8% and 5.5% of net sales for the nine months ended March 31, 2009 and 2008, respectively. The increase in absolute dollars and percentage of sales was primarily due to an increase of $4.4 million in compensation and benefits resulting from growth in research and development personnel, including higher stock-based compensation expense offset in part by a decrease of $0.8 million in development costs associated with new products and Superblade.

Research and development expenses include stock-based compensation expense of $1,871,000 and $1,220,000 for the nine months ended March 31, 2009 and 2008, respectively. The increase in absolute dollars was primarily due to the growth in research and development personnel.

Sales and marketing expenses. Sales and marketing expenses increased by $0.2 million, or 1.2%, to $13.0 million from $12.9 million, for the nine months ended March 31, 2009 and 2008, respectively. Sales and marketing expenses were 3.4% and 3.3% of net sales for nine months ended March 31, 2009 and 2008, respectively. The increase in absolute dollars was primarily due to a decrease of $0.2 million in cooperative marketing funding from vendors and an increase of $0.2 million in marketing trade show expenses offset in party by a decrease of $0.3 million in cooperative marketing funding to customers.

Sales and marketing expenses include stock-based compensation expense of $589,000 and $453,000 for the nine months ended March 31, 2009 and 2008, respectively.

General and administrative expenses. General and administrative expenses decreased by $0.8 million, or 7.4%, to $10.0 million from $10.8 million, for the nine months ended March 31, 2009 and 2008. General and administrative expenses were 2.6% and 2.8% of net sales for the nine months ended March 31, 2009 and 2008, respectively. The decrease in absolute dollars was primarily due to a decrease of $0.7 million in consulting fees related to Sarbanes-Oxley 404 (SOX) compliance, a decrease of $0.5 million in legal expenses offset in part by an increase of $0.7 million in compensation and benefits, including higher stock-based compensation expense.

General and administrative expenses include stock-based compensation expense of $1,097,000 and $822,000 for the nine months ended March 31, 2009 and 2008, respectively.

Interest and other expense, net. Interest and other expense, changed by $0.9 million, to $0.3 million of expense from $0.6 million of income, for the nine months ended March 31, 2009 compared to the same period in 2008, respectively, of which $0.7 million was interest expense for both nine months ended March 31, 2009 and 2008, respectively. The net change was due to lower interest income of $0.9 million resulting from lower interest rates.

Provision for income taxes. Provision for income taxes decreased by $6.2 million, or 53.0%, to $5.5 million from $11.7 million, for the nine months ended March 31, 2009 and 2008, respectively. The effective tax rate was 28.5% and 38.6% for the nine months ended March 31, 2009 and 2008, respectively. The decrease in the effective tax rate was primarily the result of the reinstatement of the federal research and development tax credit and the release of an unrecognized tax liability on research and development credits of $0.7 million resulting from lapsing statues of limitations in the nine months ended March 31, 2009.

Liquidity and Capital Resources

Since our inception, we have financed our growth primarily with funds generated from operations and from the proceeds of our initial public offering. Our cash and cash equivalents and short term investments were $62.8 million and $51.5 million as of March 31, 2009 and June 30, 2008, respectively.

Operating Activities. Net cash provided by operating activities was $13.4 million and $9.3 million for the nine months ended March 31, 2009 and 2008, respectively. Net cash provided by our operating activities for the nine months ended March 31, 2009 was primarily due to our net income of $13.7 million, stock-based compensation expense of $4.0 million, an allowance for sales returns of $3.3 million, a decrease in accounts receivable of $3.1 million, an increase in prepaid income taxes/income taxes payable of $2.3 million, a decrease in inventory of $1.9 million and an increase in accrued liabilities of $1.5 million, which was substantially offset by a decrease in accounts payable of $20.2 million.

The decreases for the nine months ended March 31, 2009 in accounts receivable and sales returns were primarily due to lower net sales in the three months ended March 31, 2009 and timing of customer payments. The decrease for the nine months ended March 31, 2009 in inventory was primarily due to our reduction of X7 products as new X8 Nahalem products were launched at the end of the quarter. The decreases for the nine months ended March 31, 2009 in accounts payable was primarily due to lower inventory purchases and timing of payments to our vendors. The increase for the nine months ended March 31, 2009 in accrued liabilities was primarily due to an increase in accrued employee benefits, accrued warranty expense and accrued customers credit related to customers prepayment for products to be shipped in the fourth quarter of fiscal year 2009.

Net cash provided by our operating activities in the nine months ended March 31, 2008 was primarily due to our net income of $18.6 million, an increase in accounts payable of $17.1 million, an increase in the provision for inventory of $6.7 million, an increase in the allowance for sales returns of $4.2 million, an increase in income tax payable of $3.6 million and an increase in other long-term liabilities of $3.4 million relating to our FIN 48 liability, which was substantially offset by an increase in inventory of $33.3 million and an increase in accounts receivable of $13.0 million.

Investing activities. Net cash used in our investing activities was $1.9 million and $20.3 million for the nine months ended March 31, 2009 and 2008, respectively. In the nine months ended March 31, 2009, $2.8 million was related to the purchase of property, plant and equipment offset in part by the redemption at par of investments in auction rate securities of $0.9 million. In the nine months ended March 31, 2008, $22.4 million was related to the purchase of short-term investments in auction rate securities and variable rate demand notes and $18.8 million was related to the proceeds from maturity of the short-term investments in auction rate securities and variable rate demand notes, and $15.1 million was related to the purchase of property and equipment to support our growth.

Financing activities. Net cash provided by (used in) our financing activities was ($0.3) million and $1.5 million for the nine months ended March 31, 2009 and 2008, respectively. In the nine months ended March 31, 2009, we repurchased 445,028 shares of treasury stock for $2.0 million. In the nine months ended March 31, 2009 and 2008, $1.9 million and $2.4 million, respectively, were related to the proceeds from the exercise of stock options. We repaid $0.2 million and $1.2 million in loans during the nine months ended March 31, 2009 and 2008, respectively.

We have historically generated cash from our operating activities as we have grown. We expect to experience continued growth in our working capital requirements as we continue to expand our business. We intend to fund this continued expansion though cash generated by operations. We anticipate that working capital will constitute a material use of our cash resources. We have sufficient cash on hand to continue to operate for at least the next 12 months.

Other factors affecting liquidity and capital resources

We have entered into two building loans to purchase two facilities located in San Jose, California. Total balance outstanding on these loans was $10.1 million as of March 31, 2009. The first loan was entered into in April 2004 under which we borrowed $4.3 million. The second loan was entered into in September 2005 under which we borrowed a total of $6.9 million. The loans require us to comply with customary covenants related to business and financial condition. They also have customary restrictions on business and financial activity in which we cannot engage without the prior written consent of the bank. For example, under the terms of the building loans, we generally may not, without the lenders prior written consent, incur certain indebtedness and liens, engage in business activities substantially different from our present business, liquidate or dissolve our business, lease or dispose of all or a substantial part of our business or assets, sell assets for less than fair market price, enter into any consolidation, merger or other business combination, or make certain loans, acquisitions and guaranties.

As of March 31, 2009, we have an unused revolving line of credit totaling $5,000,000 that expires on December 1, 2009 with an interest rate at Prime Rate plus 0.5% per annum. As of March 31, 2009, we were in compliance with the financial covenants associated with the line of credit.

In addition, we have historically paid our contract manufacturers within 39 to 77 days of invoice and Ablecom between 59 and 112 days of invoice. Ablecom, a Taiwan corporation, is one of our major contract manufacturers and a related party. As of March 31, 2009 and June 30, 2008 amounts owed to Ablecom by us were approximately $20.2 million and $27.7 million, respectively.

In February 2008, we leased an office building of approximately 246,000 square feet in Fremont, California with total payment obligations of approximately $10.3 million over the next 6.3 years as of March 31, 2009. We also obtained an irrevocable standby letter of credit required by the landlord of the office lease totaling $121,000. This amount has been classified as a restricted asset as of March 31, 2009.

In March 2008, we posted a bond in the amount of $3,080,000 required by the Paris Court of Appeals related to the Digitechnic lawsuit (see Note 14 of the Notes to the Condensed Consolidated Financial Statements). The bond was collateralized by an irrevocable standby letter of credit totaling $1,540,000. This amount has been classified as a restricted asset as of March 31, 2009.

As of March 31, 2009, we held approximately $14.6 million of long-term auction-rate securities (auction rate securities), net of unrealized losses, representing our interest in auction rate preferred shares in a closed end mutual fund invested in municipal securities and auction rate student loans guaranteed by the Federal Family Education Loan Program; such auction rate securities were rated AAA or BBB at March 31, 2009. These auction rate preferred shares have no stated maturity date and stated maturity dates for these auction rate student loans range from 2010 to 2040. During February 2008, the auctions for these auction rate securities began to fail to obtain sufficient bids to establish a clearing rate and were not saleable in the auction, thereby losing the short-term liquidity previously provided by the auction process. As a result, the auction rate securities have been classified as non-current investments available-for-sale as of March 31, 2009 and we have recorded an accumulated unrealized loss of $801,000, net of deferred income taxes, on such securities. The unrealized loss was deemed to be temporary and has been recorded as a component of accumulated other comprehensive loss. Although we have the financial ability and intent to hold these investments in auction rate securities until successful auctions occur, a buyer is found to purchase the securities at par outside of the auction process or the preferred shares are redeemed, these investments are not currently liquid and in the event we need to access these funds, we will not be able to do so without a loss of principal. There can be no assurances that these investments will be settled in the short term or that they will not become other-than-temporarily impaired subsequent to March 31, 2009, as the market for these investments is presently uncertain. In any event, we do not have a present need to access these funds for operational purposes. We will continue to monitor and evaluate these investments as there is no assurance as to when the market for these investments will allow us to liquidate them. We may be required to record impairment charges in periods subsequent to March 31, 2009 with respect to these securities and, if a liquid market does not develop for these investments, we could be required to hold them to maturity.

In November 2008, our Board of Directors approved a program to repurchase, from time to time, at management s discretion, shares of our common stock. Under the plan, we are authorized to repurchase up to 2,000,000 of our outstanding shares of common stock in the open market or in private transactions during the period ending June 30, 2009 at prevailing market prices in compliance with applicable securities laws and other legal requirements. Repurchases will be made under the program using our own cash resources. The plan does not obligate us to acquire any particular amount of common stock and the plan may be suspended or discontinued at any time. As of March 31, 2009, we had repurchased 445,028 shares of our common stock at a weighted average price of $4.56 per share for approximately $2.0 million.

Our long-term future capital requirements will depend on many factors, including our level of revenues, the timing and extent of spending to support our product development efforts, the expansion of sales and marketing activities, the timing of our introductions of new products, the costs to ensure access to adequate manufacturing capacity and the continuing market acceptance of our products. We could be required, or could elect, to seek additional funding through public or private equity or debt financing and additional funds may not be available on terms acceptable to us or at all.

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Contractual Obligations

The following table describes our contractual obligations as of March 31, 2009:

	Payments Due by Period				
	Less Than 1 Year	1 to 3 Years	3 to 5 Years	More Than 5 Years	Total
	(in thousands)				
Operating leases	$ 2,117	$ 3,930	$ 3,875	$ 2,946	$ 12,868
Capital leases, including interest	45	60	25		130
Building loans, including interest	953	1,906	1,906	12,481	17,246
License arrangement	836	911	911	342	3,000
Purchase commitments	38,927				38,927
Total	$ 42,878	$ 6,807	$ 6,717	$ 15,769	$ 72,171

The table above excludes liabilities for unrecognized tax benefits and an accrual for the related interest and penalties totaling $5.1 million. The Company has not provided a detailed estimate of the payment timing due to the uncertainty of when the related tax settlements are due.

We expect to fund these obligations from our ongoing operations and existing cash and cash equivalents on hand.

Recent Accounting Pronouncements

EITF 07-3

Effective July 1, 2008, we adopted EITF 07-3, *Accounting for Nonrefundable Advance Payments for Goods or Services Received for Use in Future Research and Development Activities* (EITF 07-3). EITF 07-3 requires that nonrefundable advance payments for goods or services that will be used or rendered for future research and development activities be deferred and capitalized and recognized as an expense as the goods are delivered or the related services are performed. The adoption did not have a material impact on our financial position, results of operations or cash flows.

SFAS No. 159

Effective July 1, 2008, we adopted SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities-including an amendment of FASB Statement No. 115* (SFAS 159), which the FASB issued in February 2007. SFAS 159 expands the use of fair value accounting but does not affect existing standards, which require assets or liabilities to be carried at fair value. Under SFAS 159, an entity may elect to use fair value to measure certain eligible items. The fair value option may be elected generally on an instrument-by-instrument basis as long as it is applied to the instrument in its entirety, even if an entity has similar instruments that it elects not to measure based on fair value. Upon adoption, we did not elect to adopt the fair value option on eligible items under SFAS 159.

FSP 157-3

In October 2008, the FASB issued FASB staff position (FSP) 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active* (FSP 157-3). FSP 157-3 clarified the application of SFAS 157. FSP 157-3 demonstrated how the fair value of a financial asset is determined when the market for that financial asset is inactive. FSP 157-3 was effective upon issuance, including prior periods for which financial statements had not been issued. The implementation of this standard did not have a material impact on our financial position, results of operations or cash flows.

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FSP FAS 157-4 / FAS 115-2 / FAS 124-2

In April 2009, the FASB issued three FSPs related to fair value measurements, disclosures and other-than-temporary impairments. FSP FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*, provides additional guidance for estimating fair value in accordance with SFAS 157 when the volume and level of activity for an asset or liability have significantly decreased. FSP FAS 157-4 also includes guidance on identifying circumstances that indicate a transaction is not orderly. FSP FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments*, amends the other-than-temporary impairment guidance in U.S. GAAP to make the guidance more operational and to improve the presentation of other-than-temporary impairments in the financial statements. Finally, FSP 107-1 and Accounting Principles Board (APB) 28-1, *Interim Disclosures About Fair Value of Financial Instruments*, amends SFAS No. 107, *Disclosures about Fair Value of Financial Instruments*, to require disclosures about fair value of financial instruments in interim financial statements as well as in annual financial statements and also amends APB Opinion No. 28, *Interim Financial Reporting*, to require those disclosures in all interim financial statements. The three FSPs are effective for periods ending after June 15, 2009. Early adoption is permitted for periods ending after March 15, 2009, however we will adopt the FSPs during the fourth quarter of fiscal year 2009. We are still evaluating the impact, if any, the FSPs will have on our financial position, results of operations or cash flows.

Off-Balance Sheet Arrangements

We do not have any off-balance sheet arrangements.

Item 3. Quantitative and Qualitative Disclosure About Market Risks
Interest Rate Risk

The primary objectives of our investment activities are to preserve principal, provide liquidity and maximize income without significantly increasing the risk. Some of the securities we invest in are subject to market risk. This means that a change in prevailing interest rates may cause the principal amount of the investment to fluctuate. To minimize this risk, we maintain our portfolio of cash equivalents and short-term investments in money market funds and certificates of deposit. Since our results of operations are not dependent on investments, the risk associated with fluctuating interest rates is limited to our investment portfolio, and we believe that a 10% change in interest rates would not have a significant impact on our results of operations. As of March 31, 2009, our investments were in money market funds, certificates of deposit and auction rate securities (see Liquidity Risk below).

We had $10.1 million of indebtedness under our credit facilities as of March 31, 2009 and $10.3 million of indebtedness under our credit facilities as of June 30, 2008. The annual interest rate on our credit facilities is based on various indexes as defined in the loan agreements. At March 31, 2009, the interest rates ranged from 5.77% to 7.23%. An immediate 10% increase in the index rates would not have a material effect on our interest expense.

Liquidity Risk

As of March 31, 2009, we held approximately $14.6 million of long-term auction-rate securities, net of unrealized losses, representing our interest in auction rate preferred shares in a closed end mutual fund invested in municipal securities and auction rate student loans guaranteed by the Federal Family Education Loan Program; such auction rate securities were rated AAA or BBB at March 31, 2009. These auction rate preferred shares have no stated maturity date and the stated maturity dates for these auction rate student loans range from 2010 to 2040. During February 2008, the auctions for these auction rate securities began to fail to obtain sufficient bids to establish a clearing rate and were not saleable in the auction, thereby losing the short-term liquidity previously provided by the auction process. As a result, the auction rate securities have been classified as non-current investments available-for-sale as of March 31, 2009 and we have recorded an accumulated unrealized loss of $801,000, net of deferred income taxes, on such securities. The unrealized loss was deemed to be temporary and has been recorded as a component of accumulated other comprehensive loss.

Although we have the financial ability and intent to hold our investments in auction rate securities until successful auctions occur, a buyer is found to purchase the securities at par outside of the auction process or the preferred shares are redeemed, these investments are not currently liquid and in the event we need to access these funds, we will not be able to do so without a loss of principal. There can be no assurances that these investments will be settled in the short term or that they will not become other-than-temporarily impaired subsequent to March 31, 2009, as the market for these investments is presently uncertain. In any event, we do not have a present need to access these funds for operational purposes. We will continue to monitor and evaluate these investments as there is no assurance as to when the market for these investments will allow us to liquidate them. We may be required to record impairment charges in periods subsequent to March 31, 2009 with respect to these securities and, if a liquid market does not develop for these investments, we could be required to hold them to maturity.

Foreign Currency Risk

To date, our international customer agreements have been denominated solely in U.S. dollars, and accordingly, we have not been exposed to foreign currency exchange rate fluctuations from customer agreements, and do not currently engage in foreign currency hedging transactions. However, the functional currency of our operations in Netherlands and Taiwan is the U.S. dollar and our local accounts are maintained in the local currency in the Netherlands and Taiwan, respectively, and thus we are subject to foreign currency exchange rate fluctuations associated with re-measurement to U.S. dollars. Such fluctuations have not been significant historically. For example, foreign exchange gain or (loss) was $24,000 and $27,000 for the three and nine months ended March 31, 2009, respectively, and $(44,000) and $(71,000) for the three and nine months ended March 31, 2008, respectively.

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Item 4. Controls and Procedures

Evaluation of Effectiveness of Disclosure Controls and Procedures

Under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, the Company evaluated the effectiveness of its disclosure controls and procedures, as such term is defined under Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended (the Exchange Act). The evaluation considered the procedures designed to ensure that information required to be disclosed by us in the reports filed or submitted by the Company under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms and communicated to our management as appropriate to allow timely decisions regarding required disclosure. Based on that evaluation, our Chief Executive Officer and our Chief Financial Officer concluded that our disclosure controls and procedures were effective at a reasonable assurance level as of March 31, 2009.

Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting as defined in Exchange Act Rule 13a-15(f) during the quarter ended March 31, 2009 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 subject to a suit brought by Digitechnic, S.A. which was filed in the Bobigny Commercial Court in Paris, France in 1999. The claims involve allegations of damages stemming from allegedly defective products. In September 2003, the Bobigny Commercial Court awarded damages of approximately $1.2 million against us. In February 2005, the Paris Court of Appeals reversed the trial court s ruling, dismissed all of Digitechnic s claims and awarded costs to us. Digitechnic appealed the decision to the French Supreme Court and asked for $2,416,000 for damages. On February 13, 2007, the French Supreme Court reversed the decision of the Paris Court of Appeals, ordering a new hearing before a different panel of the Paris Court of Appeals. Pending a new hearing, the trial court ruling is reinstated. In March 2008, we posted a bond in the amount of $3,040,000 required by the court. The bond was collateralized by an irrevocable standby letter of credit totaling $1,540,000. Although we cannot predict with certainty the final outcome of this litigation, we believe the claim to be without merit and intend to continue to defend it vigorously.

In addition to the above, from time to time, we may be involved in various legal proceedings arising from the normal course of business activities. In our opinion, resolution of the above matters is not expected to have a material adverse impact on our consolidated results of operations, cash flows or our financial position. However, depending on the amount and timing, an unfavorable resolution of a matter could materially affect our future results of operations, cash flows or financial position in a particular period.

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Item 1a. Risk Factors.

The Risk Factors included in our Annual Report on Form 10-K for the year ended June 30, 2008 have not materially changed except for the addition of a new risk factor relating to the uncertain global economic environment and the removal of a risk factor relating to the compliance with certain Nasdaq independent director requirements. You should carefully consider the following risk factors, as well as the other information in this Form 10-Q, before deciding whether to invest in shares of our common stock. If any of the following risks actually occurs, our business, financial condition and results of operations would suffer. In this case, the trading price of our common stock would likely decline and you might lose all or part of your investment in our common stock. Additional risks that we currently do not know about or that we currently believe to be immaterial may also impair our business operations.

Risks Related to Our Business and Industry

Our operating results may be adversely affected by a downturn in the global economic environment

The ongoing crises in global credit and capital markets have resulted in and are expected to lead to further reductions in economic activity. Our results of operations for the three and nine months ended March 31, 2009 were adversely impacted in part due to reduced information technology spending in light of the economic downturn. Although we cannot predict the level of such reductions or the impact on our business in future periods, such reduced economic activity could lead to:

- Reduced demand for our products as a result of continued constraints on IT-related capital spending and limitations on available financing;
- Increased price competition for our products;
- Risk of excess and obsolete inventories;
- Excess facilities and manufacturing capacity;
- Higher overhead costs as a percentage of revenue and higher interest expense; and
- Risk of uncollectible accounts receivable

Our operating results may also be affected by uncertain or changing economic conditions relating to specific geographical or product market segments. If global economic and market conditions, or economic conditions in the United States or other key markets, remain uncertain or persist, spread, or deteriorate further, we may experience material negative impacts on our business, operating results, and financial condition.

Our significant growth makes it difficult to evaluate our current business and future prospects and may increase the risk of your investment.

Although we have been operating since 1993, our significant growth in revenues over time makes it difficult to evaluate our current business and future prospects. You must consider our business and prospects in light of the risks and difficulties we encounter as a rapidly growing technology company in a very competitive market. These risks and difficulties include, but are not limited to, the risks identified in this section and in particular the following factors:

- our focus on a single market, the market for application optimized server systems and components;

- our increasing focus on the sales of server systems as compared to components;
- the success of our blade server systems, which were first introduced in September 2007;
- the difficulties we face in managing rapid growth in personnel and operations;
- the timing and success of new products and new technologies introduced by us and our competitors;
- our ability to build brand awareness in a highly competitive market; and
- our ability to market new and existing products on our own and with our partners.

We may not be able to successfully address any of these risks or others. Failure to do so adequately could seriously harm our business and cause our operating results to suffer.

Our quarterly operating results will likely fluctuate in the future, which could cause rapid declines in our stock price.

As our business continues to grow, we believe that our quarterly operating results will be subject to greater fluctuation due to various factors, many of which are beyond our control. Factors that may affect quarterly operating results in the future include:

- our ability to attract new customers, retain existing customers and increase sales to such customers;

unpredictability of the timing and size of customer orders, since most of our customers purchase our products on a purchase order basis rather than pursuant to a long term contract;

fluctuations in availability and costs associated with materials needed to satisfy customer requirements;

variability of our margins based on the mix of server systems and components we sell;

variability of operating expenses as a percentage of net sales;

the timing of the introduction of new products by leading microprocessor vendors and other suppliers;

our ability to introduce new and innovative server solutions that appeal to our customers;

our ability to address technology issues as they arise, improve our products functionality and expand our product offerings;

changes in our product pricing policies, including those made in response to new product announcements and pricing changes of our competitors;

- mix of whether customer purchases are of full systems or components and whether made directly or through indirect sales channels;
- fluctuations based upon seasonality;
- the rate of expansion, domestically and internationally;
- the effectiveness of our sales force and the efforts of our distributors;
- the effect of mergers and acquisitions among our competitors, suppliers or partners;
- general economic conditions in our geographic markets; and
- impact of regulatory changes on our cost of doing business.

Accordingly, it is difficult for us to accurately forecast our growth and results of operations on a quarterly basis. If we fail to meet expectations of investors or analysts, our stock price may fall rapidly and without notice. Furthermore, the fluctuation of quarterly operating results may render less meaningful period-to-period comparisons of our operating results, and you should not rely upon them as an indication of future performance.

If the demand for application optimized server solutions does not continue to develop as we anticipate, demand for our server solutions may not grow as we expect.

The success of our business depends on the continued adoption of application optimized server solutions by businesses for running their critical business applications. The market for application optimized server solutions has begun to develop in recent years. As the market for general purpose servers has grown and matured, leading general purpose server vendors have focused on providing a limited range of models that could be mass produced, thereby creating an opportunity for the development of a market focused on more application optimized servers. This new market has been marked by frequent introductions of new technologies and products. Many of these technologies and products have not yet gained, and may not gain, significant customer acceptance. We expect to devote significant resources to identifying new market trends and developing products to meet anticipated customer demand for application optimized server solutions. Ultimately, however, customers may not purchase application optimized server solutions and instead select general purpose lower-cost servers and components. We are also part of a broader market for server solutions and demand for these server solutions may decline or fail to grow as we expect. Accordingly, we can not assure you that demand for the type of server solutions we offer and plan to offer will continue to develop as we anticipate, or at all.

Our future financial performance will depend on the timely introduction and widespread acceptance of new server solutions and increased functionality of our existing server solutions.

Our future financial performance will depend on our ability to meet customer specifications and requirements by enhancing our current server solutions and developing server solutions with new and better functionality. The success of new features and new server solutions depends on several factors, including their timely introduction and market acceptance. We may not be successful in developing enhancements or new server solutions, or in timely bringing them to market. Customers may also defer purchases of our existing products pending the introduction of anticipated new products. For example, we experienced customer order delays in advance of Intel s Nehalem microprocessor release at the end of the quarter ended March 31, 2009. If our new server solutions are not competitive with solutions offered by other vendors, we may not be perceived as a technology leader and could miss market opportunities. If we are unable to enhance the functionality of our server solutions or introduce new server solutions which achieve widespread market acceptance, our reputation will be damaged, the value of our brand will diminish, and our business will suffer. In addition, uncertainties about the timing and nature of new features and products could result in increases in our research and development expenses with no assurance of future sales.

We may not be able to successfully manage our planned growth and expansion.

We are pursuing new customers and expanding our product offerings to grow our business rapidly. In connection with this growth, we expect that our annual operating expenses will increase significantly during the foreseeable future as we invest in sales and marketing, research and development, manufacturing and production infrastructure, and strengthen customer service and support resources for our customers. Our failure to expand

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operational and financial systems timely or efficiently could result in additional operating inefficiencies, which could increase our costs and expenses more than we had planned and prevent us from successfully executing our business plan. We may not be able to offset the costs of operation expansion by leveraging the economies of scale from our growth in negotiations with our suppliers and contract manufacturers. Additionally, if we do increase our operating expenses in anticipation of the growth of our business and this growth does not meet our expectations, our financial results will be negatively impacted.

If our business grows, we will have to manage additional product design projects, materials procurement processes, and sales efforts and marketing for an increasing number of SKUs, as well as expand the number and scope of our relationships with suppliers, distributors and end customers. If we fail to manage these additional responsibilities and relationships successfully, we may incur significant costs, which may negatively impact our operating results.

Additionally, in our efforts to be first to market with new products with innovative functionality and features, we may devote significant research and development resources to products and product features for which a market does not develop quickly, or at all. If we are not able to predict market trends accurately, we may not benefit from such research and development activities, and our results of operations may suffer.

The market in which we participate is highly competitive, and if we do not compete effectively, we may not be able to increase our market penetration, grow our net sales or improve our gross margins.

The market for server solutions is intensely competitive and rapidly changing. Barriers to entry in our market are relatively low and we expect increased challenges from existing as well as new competitors. Some of our principal competitors offer server solutions at a lower price, which has resulted in pricing pressures on sales of our server solutions. We expect further downward pricing pressure from our competitors and expect that we will have to price some of our server solutions aggressively to increase our market share with respect to those products. If we are unable to maintain the margins on our server solutions, our operating results could be negatively impacted. In addition, if we do not develop new innovative server solutions, or enhance the reliability, performance, efficiency and other features of our existing server solutions, our customers may turn to our competitors for alternatives. In addition, pricing pressures and increased competition generally may also result in reduced sales, lower margins or the failure of our products to achieve or maintain widespread market acceptance, any of which could have a material adverse effect on our business, results of operations and financial condition.

Our principal competitors include global technology companies such as Dell, Inc., Hewlett-Packard Company, International Business Machines Corporation and Intel. In addition, we also compete with a number of smaller vendors who also sell application optimized servers, such as Rackable Systems, Inc., and original design manufacturers, or ODMs, such as Quanta Computer Incorporated. ODMs sell server solutions marketed or sold under a third party brand.

Many of our competitors enjoy substantial competitive advantages, such as:

- greater name recognition and deeper market penetration;
- longer operating histories;
- larger sales and marketing organizations and research and development teams and budgets;
- more established relationships with customers, contract manufacturers and suppliers and better channels to reach larger customer bases;
- larger customer service and support organizations with greater geographic scope;
- a broader and more diversified array of products and services; and

substantially greater financial, technical and other resources.

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As a result, our competitors may be able to respond more quickly and effectively than we can to new or changing opportunities, technologies, standards or customer requirements. Furthermore, because of these advantages, even if our application optimized server solutions are more effective than the products that our competitors offer, potential customers might accept competitive products in lieu of purchasing our products. The challenges we face from larger competitors will become even greater if consolidation or collaboration between or among our competitors occurs in our industry. For all of these reasons, we may not be able to compete successfully against our current or future competitors, and if we do not compete effectively, our ability to increase our net sales may be impaired.

Our sales cycle is lengthy and expensive, and could adversely affect the amount, timing and predictability of future net sales.

Our end customers generally need three to six months after an initial contact to make a final purchase decision with respect to our products. As customers weigh their purchase options, we may expend significant resources in pursuit of a sale that may ultimately fail to close. We have little control over our customers budget cycles and approval processes, or the strength of competitors relationships with our potential customers, all of which could adversely affect our sales efforts. The introduction of new products and product enhancements may lengthen our sales cycle as customers defer a decision on purchasing existing products and evaluate our new products. If we are unsuccessful in closing sales after expending significant resources, our net sales and operating expenses will be adversely affected.

As we increasingly target larger customers, our customer base may become less diversified, our cost of sales may increase, and our sales may be less predictable.

We expect that selling our server solutions to larger customers will create new challenges. No one customer represented 10% or more of our revenues for fiscal years 2008 and 2007 or the three and nine months ended March 31, 2009. However, if certain customers buy our products in greater volumes, and their business becomes a larger percentage of our net sales, we may grow increasingly dependent on those customers to maintain our growth. If our largest customers do not purchase our products at the levels or in the timeframes that we expect, our ability to maintain or grow our net sales will be adversely affected.

Additionally, as we and our distribution partners focus increasingly on selling to larger customers and attracting larger orders, we expect greater costs of sales. Our sales cycle may become longer and more expensive, as larger customers typically spend more time negotiating contracts than smaller customers. In addition, larger customers often seek to gain greater pricing concessions, as well as greater levels of support in the implementation and use of our server solutions. These factors can result in lower margins for our products.

Increased sales to larger companies may also cause fluctuations in results of operations. A larger customer may seek to fulfill all or substantially all of its requirements in a single order, and not make another purchase for a significant period of time. Accordingly, a significant increase in revenue during the period in which we recognize the revenue from the sale may be followed by a period of time during which the customer purchases none or few of our products. A significant decline in net sales in periods following a significant order could adversely affect our stock price.

We must work closely with our suppliers to make timely new product introductions.

We rely on our close working relationships with our suppliers, including Intel and AMD, to anticipate and deliver new products on a timely basis when new generation materials and core components are made available. Intel and AMD are the only suppliers of the microprocessors we use in our server systems. If we are not able to maintain our relationships with our suppliers or continue to leverage their research and development capabilities to develop new technologies desired by our customers, our ability to quickly offer advanced technology and product innovations to our customers would be impaired. We have no long term agreements that obligate our suppliers to continue to work with us or to supply us with products.

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Our suppliers failure to improve the functionality and performance of materials and core components for our products may impair or delay our ability to deliver innovative products to our customers.

We need our material and core component suppliers, such as Intel and AMD, to provide us with core components that are innovative, reliable and attractive to our customers. Due to the pace of innovation in our industry, many of our customers may delay or reduce purchase decisions until they believe that they are receiving best of breed products that will not be rendered obsolete by an impending technological development. Accordingly, demand for new server systems that incorporate new products and features is significantly impacted by our suppliers new product introduction schedules and the functionality, performance and reliability of those new products. If our materials and core component suppliers fail to deliver new and improved materials and core components for our products, we may not be able to satisfy customer demand for our products in a timely manner, or at all. If our suppliers components do not function properly, we may incur additional costs and our relationships with our customers may be adversely affected.

Our time to market advantage is dependent upon our suppliers ability to continue to introduce improved components for our products.

We are dependent upon our material and core component suppliers, such as Intel and AMD, to continue to introduce improved products with additional features that our customers will find attractive. If the pace of innovation from our suppliers slows, our products may face increased competition if our competitors are able to introduce products that use the latest technology offered by other suppliers in the industry. This price competition could lead to reduced margins and could adversely affect our results of operations.

As our business grows, we expect that we may be exposed to greater customer credit risks.

Historically, we have offered limited credit terms to our customers. As our customer base expands, as our orders increase in size, and as we obtain more direct customers, we expect to offer increased credit terms and flexible payment programs to our customers. Doing so may subject us to increased credit risk, higher accounts receivable with longer days outstanding, and increases in charges or reserves, which could have a material adverse effect on our business, results of operations and financial condition.

Our ability to develop our brand is critical to our ability to grow.

We believe that acceptance of our server solutions by an expanding customer base depends in large part on increasing awareness of the Supermicro brand and that brand recognition will be even more important as competition in our market develops. In particular, we expect an increasing proportion of our sales to come from sales of server systems, the sales of which we believe may be particularly impacted by brand strength. Successful promotion of our brand will depend largely on the effectiveness of our marketing efforts and on our ability to develop reliable and useful products at competitive prices. To date, we have not devoted significant resources to building our brand, and have limited experience in increasing customer awareness of our brand. Our future brand promotion activities, including any expansion of our cooperative marketing programs with strategic partners, may involve significant expense and may not generate desired levels of increased revenue, and even if such activities generate some increased revenue, such increased revenue may not offset the expenses we incurred in endeavoring to build our brand. If we fail to successfully promote and maintain our brand, or incur substantial expenses in our attempts to promote and maintain our brand, we may fail to attract enough new customers or retain our existing customers to the extent necessary to realize a sufficient return on our brand-building efforts, and as a result our operating results and financial condition could suffer.

We principally rely on indirect sales channels for the sale and distribution of our products and any disruption in these channels could adversely affect our sales.

Historically, a substantial majority of our revenues have resulted from sales of our server solutions through third party distributors and resellers, which sales accounted for approximately 65.9% and 64.8% of our net sales in the three and nine months ended March 31, 2009, respectively, as compared to approximately 62.8% and 61.6% of our net sales in the three and nine months ended March 31, 2008, respectively. We depend on our distributors to assist us in promoting market acceptance of our products and anticipate that a majority of our revenues will continue to result from sales through indirect channels.

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To maintain and potentially increase our revenue and profitability, we will have to successfully preserve and expand our existing distribution relationships as well as develop new distribution relationships. Our distributors also sell products offered by our competitors and may elect to focus their efforts on these sales. If our competitors offer our distributors more favorable terms or have more products available to meet the needs of their customers, or utilize the leverage of broader product lines sold through the distributors, those distributors may de-emphasize or decline to carry our products. In addition, our distributors order decision-making process is complex and involves several factors, including end customer demand, warehouse allocation and marketing resources, which can make it difficult to accurately predict total sales for the quarter until late in the quarter. We also do not control the pricing or discounts offered by distributors to end customers. To maintain our participation in distributors marketing programs, in the past we have provided cooperative marketing arrangements or made short-term pricing concessions. The discontinuation of cooperative marketing arrangements or pricing concessions could have a negative effect on our business. Our distributors could also modify their business practices, such as payment terms, inventory levels or order patterns. If we are unable to maintain successful relationships with distributors or expand our distribution channels or we experience unexpected changes in payment terms, inventory levels or other practices by our distributors, our business will suffer.

We may be unable to accurately predict future sales through our distributors, which could harm our ability to efficiently manage our resources to match market demand.

Since a significant portion of our sales are made through domestic and international distributors, our financial results, quarterly product sales, trends and comparisons are affected by fluctuations in the buying patterns of end customers and our distributors, and by the changes in inventory levels of our products held by these distributors. We generally record revenue based upon a sell-in model which means that we generally record revenue upon shipment to our distributors. For more information regarding our revenue recognition policies, see Management s Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies. While we attempt to assist our distributors in maintaining targeted stocking level of our products, we may not consistently be accurate or successful. This process involves the exercise of judgment and use of assumptions as to future uncertainties including end customer demand. Our distributors also have various rights to return products which could, among other things, result in our having to repurchase inventory which has declined in value or is obsolete. Consequently, actual results could differ from our estimates. Inventory levels of our products held by our distributors may exceed or fall below the levels we consider desirable on a going-forward basis. This could adversely affect our distributors or our ability to efficiently manage or invest in internal resources, such as manufacturing and shipping capacity, to meet the demand for our products.

If we are required to change the timing of our revenue recognition, our net sales and net income could decrease.

We currently record revenue based upon a sell-in model with revenues generally recorded upon shipment of products to our distributors. This is in contrast to a sell-through model pursuant to which revenues are generally recognized upon sale of products by distributors to their customers. This requires that we maintain a reserve to cover the estimated costs of any returns or exercises of stock rotation rights, which we estimate primarily based on our historical experience. If facts and circumstances change such that the rate of returns of our products exceeds our historical experience, we may have to increase our reserve, which, in turn, would cause our revenue to decline. Similarly, if facts and circumstances change such that we are no longer able to determine reasonable estimates of our sales returns, we would be required to defer our revenue recognition until the point of sale from the distributors to their customers. Any such change may negatively impact our net sales or net income for particular periods and cause a decline in our stock price. For additional information regarding our revenue recognition policies, see Management s Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies.

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The average selling prices for our existing server solutions are subject to decline if customers do not continue to purchase our latest generation products, which could harm our results of operations.

As with most electronics based products, average selling prices of servers typically are highest at the time of introduction of new products, which utilize the latest technology, and tend to decrease over time as such products become commoditized and are ultimately replaced by even newer generation products. Although we have not been impacted by this phenomenon to any material extent to date, we experienced greater pricing pressure in the quarter ended March 31, 2009 in anticipation of the release of new products incorporating Intel s Nehalem microprocessor. However, as our business continues to grow, we may increasingly be subject to this industry risk. We cannot predict the timing or amount of any decline in the average selling prices of our server solutions that we may experience in the future. In some instances, our agreements with our distributors limit our ability to reduce prices unless we make such price reductions available to them, or price protect their inventory. If we are unable to decrease per unit manufacturing costs faster than the rate at which average selling prices continue to decline, our business, financial condition and results of operations will be harmed.

Our cost structure and ability to deliver server solutions to customers in a timely manner may be adversely affected by volatility of the market for core components and materials for our products.

Prices of materials and core components utilized in the manufacture of our server solutions, such as serverboards, chassis, central processing units, or CPUs, memory and hard drives represent a significant portion of our cost of sales. We generally do not enter into long-term supply contracts for these materials and core components, but instead purchase these materials and components on a purchase order basis. Prices of these core components and materials are volatile, and, as a result, it is difficult to predict expense levels and operating results. In addition, if our business growth renders it necessary or appropriate to transition to longer term contracts with materials and core component suppliers, our costs may increase and our gross margins could correspondingly decrease.

Because we often acquire materials and core components on an as needed basis, we may be limited in our ability to effectively and efficiently respond to customer orders because of the then-current availability or the terms and pricing of materials and core components. Our industry has experienced materials shortages and delivery delays in the past, and we may experience shortages or delays of critical materials in the future. From time to time, we have been forced to delay the introduction of certain of our products or the fulfillment of customer orders as a result of shortages of materials and core components. If shortages or delays arise, the prices of these materials and core components may increase or the materials and core components may not be available at all. In addition, in the event of shortages, some of our larger competitors may have greater abilities to obtain materials and core components due to their larger purchasing power. We may not be able to secure enough core components or materials at reasonable prices or of acceptable quality to build new products to meet customer demand, which could adversely affect our business and financial results.

We may lose sales or incur unexpected expenses relating to insufficient, excess or obsolete inventory.

As a result of our strategy to provide greater choice and customization of our products to our customers, we are required to maintain a high level of inventory. If we fail to maintain sufficient inventory, we may not be able to meet demand for our products on a timely basis, and our sales may suffer. If we overestimate customer demand for our products, we could experience excess inventory of our products and be unable to sell those products at a reasonable price, or at all. As a result, we may need to record higher inventory reserves. If we are later able to sell such products at a profit, it may increase the quarterly variances in our operating results. Additionally, the rapid pace of innovation in our industry could render significant portions of our existing inventory obsolete. Certain of our distributors and OEMs have rights to return products, limited to purchases over a specified period of time, generally within 60 to 90 days of the purchase, or to products in the distributor s or OEM s inventory at certain times, such as termination of the agreement or product obsolescence. Any returns under these arrangements could result in additional obsolete inventory. In addition, server systems and components that have been customized and later returned by those of our customers and partners who have return rights or stock rotation rights may be unusable for other purposes or may require reformation at additional cost to be made ready for sale to other customers. Excess or obsolete inventory levels for these or other reasons could result in unexpected expenses or increases in our reserves against potential future charges which would adversely affect our business and financial results. For example, during the three and nine months ended March 31, 2009, we recorded inventory write-downs charged to cost of sales of $0.5 million and $0.8 million, respectively, for excess and obsolete inventory. For additional information regarding customer return rights, see Management s Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies Revenue Recognition.

Our focus on internal development and customizable server solutions could delay our introduction of new products and result in increased costs.

Our strategy is to rely to a significant degree on internally developed components, even when third party components may be available. We believe this allows us to develop products with a greater range of features and functionality and allows us to develop solutions that are more customized to customer needs. However, if not properly managed, this reliance on internally developed components may be more costly than use of third party components, thereby making our products less price competitive or reducing our margins. In addition, our reliance on internal development may lead to delays in the introduction of new products and impair our ability to introduce products rapidly to market. We may also experience increases in our inventory costs and obsolete inventory, thereby reducing our margins.

Our research and development expenditures, as a percentage of our net sales, are considerably higher than many of our competitors and our earnings will depend upon maintaining revenues and margins that offset these expenditures.

Our strategy is to focus on being consistently rapid-to-market with flexible and customizable server systems that take advantage of our own internal development and the latest technologies offered by microprocessor manufacturers and other component vendors. Consistent with this strategy, we spend higher amounts, as a percentage of revenues, on research and development costs than many of our competitors. If we can not sell our products in sufficient volume and with adequate gross margins to compensate for such investment in research and development, our earnings may be materially and adversely affected.

If our limited number of contract manufacturers or suppliers of materials and core components fail to meet our requirements, we may be unable to meet customer demand for our products, which could decrease our revenues and earnings.

We purchase many sophisticated materials and core components from one or a limited number of qualified suppliers and rely on a limited number of contract manufacturers to provide value added design, manufacturing, assembly and test services. We generally do not have long-term agreements with these vendors, and instead obtain key materials and services through purchase order arrangements. We have no contractual assurances from any contract manufacturer that adequate capacity will be available to us to meet future demand for our products.

Consequently, we are vulnerable to any disruptions in supply with respect to the materials and core components provided by limited-source suppliers, and we are at risk of being harmed by discontinuations of design, manufacturing, assembly or testing services from our contract manufacturers. We have occasionally experienced delivery delays from our suppliers and contract manufacturers because of high industry demand or because of inability to meet our quality or delivery requirements. For example, in the quarter ended September 30, 2006, we experienced delays in the delivery of printed circuit board material as a result of the loss of two of our five printer circuit board vendors. One of the vendors filed for bankruptcy and the other changed its business model and ceased supplying us. The delays in delivery of the materials resulted in a reduction of net sales for the quarter of approximately two to three million dollars. If our relationships with our suppliers and contract manufactures are negatively impacted by late payments or other issues, we may not receive timely delivery of materials and core components. If we were to lose any of our current supply or contract manufacturing relationships, the process of identifying and qualifying a new supplier or contract manufacturer who will meet our quality and delivery requirements, and who will appropriately safeguard our intellectual property, may require a significant investment of time and resources, adversely affecting our ability to satisfy customer purchase orders and delaying our ability to rapidly introduce new products to market. Similarly, if any of our suppliers were to cancel or materially change contracts or commitments to us or fail to meet the quality or delivery requirements needed to satisfy customer demand for our products, our reputation and relationships with customers could be damaged. We could lose orders, be unable to develop or sell some products cost-effectively or on a timely basis, if at all, and have significantly decreased revenues, margins and earnings, which would have a material adverse effect on our business.

Our failure to deliver high quality server solutions could damage our reputation and diminish demand for our products.

Our server solutions are critical to our customers business operations. Our customers require our server solutions to perform at a high level, contain valuable features and be extremely reliable. The design of our server solutions is sophisticated and complex, and the process for manufacturing, assembling and testing our server solutions is challenging. Occasionally, our design or manufacturing processes may fail to deliver products of the quality that our customers require. For example, in 2000, a vendor provided us with a defective capacitor that failed under certain heavy use applications. As a result, our product needed to be repaired. Though the vendor agreed to pay for a large percentage of the costs of the repairs, we incurred costs in connection with the recall and diverted resources from other projects.

New flaws or limitations in our server solutions may be detected in the future. Part of our strategy is to bring new products to market quickly, and first-generation products may have a higher likelihood of containing undetected flaws. If our customers discover defects or other performance problems with our products, our customers businesses, and our reputation, may be damaged. Customers may elect to delay or withhold payment for defective or underperforming server solutions, request remedial action, terminate contracts for untimely delivery, or elect not to order additional server solutions. Additionally, customers may make warranty claims against us, which could result in an increase in our provision for doubtful accounts, an increase in collection cycles for accounts receivable or subject us to the expense and risk of litigation. We may incur expense in recalling, refurbishing or repairing defective server solutions. If we do not properly address customer concerns about our products, our reputation and relationships with our customers may be harmed. For all of these reasons, customer dissatisfaction with the quality of our products could substantially impair our ability to grow our business.

Conflicts of interest may arise between us and Ablecom Technology Inc., one of our major contract manufacturers, and those conflicts may adversely affect our operations.

We use Ablecom Technology, a related party, for contract design and manufacturing coordination support. We work with Ablecom to optimize modular designs for our chassis and certain of other components. Our purchases from Ablecom represented approximately 18.1% and 23.1% of our cost of sales for the three and nine months ended March 31, 2008, respectively, and approximately 27.4% and 26.4% of our cost of sales for the three and nine months ended March 31, 2008, respectively. Ablecom s sales to us constitute a substantial majority of Ablecom s net sales. Ablecom is a privately-held Taiwan-based company.

Steve Liang, Ablecom s Chief Executive Officer and largest shareholder, is the brother of Charles Liang, our President, Chief Executive Officer and Chairman of the Board. Charles Liang, and his spouse, Chiu-Chu (Sara) Liu Liang, our Vice President of Operations, Treasurer and director, jointly own approximately 30.7% of Ablecom s outstanding common stock. Charles Liang served as a director of Ablecom during our fiscal 2006, but is not currently serving in such capacity. In addition, Yih-Shyan (Wally) Liaw, our Vice President of International Sales and Secretary, and a director, and his wife jointly own approximately 5.2% of Ablecom s outstanding common stock, and collectively, Mr. Charles Liang, Ms. Liang, Mr. Liaw, Mr. Steve Liang and relatives of these individuals own over 80% of Ablecom s outstanding common stock. Mr. and Mrs. Charles Liang, as directors, officers and significant stockholders, and Mr. Liaw, as an officer, director and significant stockholder, of the Company, have considerable influence over the management of our business relationships. Accordingly, we may be disadvantaged by their economic interests as stockholders of Ablecom and their personal relationship with Ablecom s Chief Executive Officer. We may not negotiate or enforce contractual terms as aggressively with Ablecom as we might with an unrelated party, and the commercial terms of our agreements may be less favorable than we might obtain in negotiations with third parties. If our business dealings with Ablecom are not as favorable to us as arms-length transactions, our results of operations may be harmed.

In addition, our relationships with Ablecom could be adversely affected by declines in our stock price or divestments by Ablecom of its shares of our common stock. Steve Liang, Ablecom s Chief Executive Officer, held approximately 2.5% of our outstanding common stock as of March 31, 2009. If the value of the shares that Steve Liang holds should decline, by decrease in our stock price or by disposition of the shares, if Steve Liang ceases to have significant influence over Ablecom, or if those of our stockholders who hold shares of Ablecom cease to hold a majority of the outstanding shares of Ablecom, the terms and conditions of our agreements with Ablecom may not be as favorable as those in our existing contracts. As a result, our costs could increase and adversely affect our margins and results of operations.

Our relationship with Ablecom may allow us to benefit from favorable pricing which may result in reported results more favorable than we might report in the absence of our relationship.

Although we generally re-negotiate the price of products that we purchase from Ablecom on a quarterly basis, pursuant to our agreements with Ablecom either party may re-negotiate the price of products for each order. As a result of our relationship with Ablecom, it is possible that Ablecom may in the future sell products to us at a price lower than we could obtain from an unrelated third party supplier. This may result in our reporting for one or more periods gross profit as a perce