DOT HILL SYSTEMS CORP
Form 10-Q
August 09, 2007

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

(Mark One)

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

For the Quarterly Period Ended June 30, 2007

OR

o **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 1-13317

DOT HILL SYSTEMS CORP.
(Exact name of registrant as specified in its charter)

Delaware	**13-3460176**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
2200 Faraday Avenue, Suite 100, Carlsbad, CA	**92008**
(Address of principal executive offices)	(Zip Code)

(760) 931-5500
(Registrant s telephone number, including area code)
(Former name, former address and former fiscal year, if changed since last report)

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 þ No o

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

Large accelerated filer o Accelerated filer þ Non-accelerated filer o

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

The registrant had 45,765,769 shares of common stock, $0.001 par value, outstanding as of August 2, 2007.

DOT HILL SYSTEMS CORP.
FORM 10-Q
For the Quarter Ended June 30, 2007
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Part I. Financial Information

Item 1. Financial Statements

DOT HILL SYSTEMS CORP. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(In Thousands Except Per Share Amounts)
(Unaudited)

	December 31, 2006	June 30, 2007
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 99,663	$ 88,397
Accounts receivable, net of allowance of $629 and $472	39,758	37,736
Inventories	2,210	3,038
Prepaid expenses and other	5,039	4,201
Total current assets	146,670	133,372
Property and equipment, net	9,738	9,164
Goodwill	40,725	40,725
Other intangible assets, net	4,382	3,212
Other assets	136	276
Total assets	$ 201,651	$ 186,749
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities:		
Accounts payable	$ 31,099	$ 27,742
Accrued compensation	3,231	3,083
Accrued expenses	8,652	5,808
Deferred revenue	521	579
Income taxes payable	226	221
Total current liabilities	43,729	37,433
Other long-term liabilities	2,010	2,387
Total liabilities	45,739	39,820
Commitments and Contingencies (Note 10)		
Stockholders Equity:		
Preferred stock, $0.001 par value, 10,000 shares authorized, no shares issued or outstanding		
Common stock, $0.001 par value, 100,000 shares authorized, 45,009 and 45,596 shares issued and outstanding at December 31, 2006 and June 30, 2007, respectively	45	46
Additional paid-in capital	290,705	292,323
Accumulated other comprehensive loss	(814)	(1,255)
Accumulated deficit	(134,024)	(144,185)

Total stockholders equity		155,912		146,929
Total liabilities and stockholders equity	$	201,651	$	186,749

See accompanying notes to condensed consolidated financial statements.

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DOT HILL SYSTEMS CORP. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
AND COMPREHENSIVE LOSS
(In Thousands, Except Per Share Amounts)
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2007	2006	2007
NET REVENUE	$ 66,265	$ 56,199	$ 124,951	$ 109,640
COST OF GOODS SOLD	52,495	49,275	100,020	96,042
GROSS PROFIT	13,770	6,924	24,931	13,598
OPERATING EXPENSES:				
Sales and marketing	4,144	3,871	8,297	7,779
Research and development	12,120	4,797	21,832	10,871
General and administrative	3,971	3,322	10,124	6,992
Legal settlement	3,350		3,350	
Total operating expenses	23,585	11,990	43,603	25,642
OPERATING LOSS	(9,815)	(5,066)	(18,672)	(12,044)
OTHER INCOME:				
Interest income, net	1,400	1,231	2,712	2,539
LOSS BEFORE INCOME TAXES	(8,415)	(3,835)	(15,960)	(9,505)
INCOME TAX EXPENSE (BENEFIT)	(1,789)	(93)	(4,359)	199
NET LOSS	$ (6,626)	$ (3,742)	$ (11,601)	$ (9,704)
NET LOSS PER SHARE:				
Basic	$ (0.15)	$ (0.08)	$ (0.26)	$ (0.21)
Diluted	$ (0.15)	$ (0.08)	$ (0.26)	$ (0.21)
WEIGHTED AVERAGE SHARES USED TO CALCULATE NET LOSS PER SHARE:				
Basic	44,632	45,472	44,575	45,315
Diluted	44,632	45,472	44,575	45,315
COMPREHENSIVE LOSS:				
Net loss	$ (6,626)	$ (3,742)	$ (11,601)	$ (9,704)
Foreign currency translation adjustments	(160)	163	(200)	(441)
Net unrealized gain on short-term investments	9		35	
Comprehensive loss	$ (6,777)	$ (3,579)	$ (11,766)	$ (10,145)

See accompanying notes to condensed consolidated financial statements.

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DOT HILL SYSTEMS CORP. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In Thousands)
(Unaudited)

	Six Months Ended June 30,	
	2006	**2007**
Cash Flows From Operating Activities:		
Net loss	$ (11,601)	$ (9,704)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	3,472	3,422
Loss on disposal of property and equipment	71	166
Provision for doubtful accounts	3	(41)
Stock-based compensation expense	2,061	977
Deferred taxes	(5,789)	
Changes in operating assets and liabilities:		
Accounts receivable	(14,708)	2,169
Inventories	713	(826)
Prepaid expenses and other assets	124	725
Legal settlement receivable	(5,720)	
Accounts payable	9,656	(3,824)
Accrued compensation and expenses	589	(3,005)
Legal settlement payable	10,500	
Deferred revenue	(998)	8
Income taxes payable	(51)	15
Restructuring accrual	(45)	
Other long-term liabilities	1,243	(65)
Net cash used in operating activities	(10,480)	(9,983)
Cash Flows From Investing Activities:		
Purchases of property and equipment	(2,993)	(1,914)
Sales and maturities of short-term investments	19,075	
Purchases of short-term investments	(10,337)	
Net cash provided by (used in) investing activities	5,745	(1,914)
Cash Flows From Financing Activities:		
Proceeds from sale of stock to employees	603	508
Proceeds from exercise of stock options and warrants	722	134
Net cash provided by financing activities	1,325	642
Effect of Exchange Rate Changes on Cash	67	(11)
Net Decrease in Cash and Cash Equivalents	(3,343)	(11,266)
Cash and Cash Equivalents, beginning of period	108,803	99,663

Cash and Cash Equivalents, end of period	$ 105,460	$ 88,397
Supplemental Disclosures of Cash Flow Information:		
Cash paid for interest	$	$
Cash paid for income taxes	$ 49	$ 172
Supplemental Disclosure of Non-Cash Investing and Financing Activities:		
Construction in progress costs incurred but not paid	$ 801	$ 350

See accompanying notes to condensed consolidated financial statements.

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DOT HILL SYSTEMS CORP. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared by Dot Hill Systems Corp. (referred to herein as Dot Hill, we, our or us) pursuant to the rules and regulations of the Securities and Exchange Commission, or SEC. Accordingly, they do not include all of the information and disclosures required by accounting principles generally accepted in the United States, or GAAP, for complete financial statements. In the opinion of management, all adjustments and reclassifications considered necessary for a fair and comparable presentation have been included and are of a normal recurring nature. The unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2006. Operating results for the three and six months ended June 30, 2007 are not necessarily indicative of the results that may be expected for the year ending December 31, 2007.

The preparation of our financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Revenues are recognized pursuant to applicable accounting standards, including SEC Staff Accounting Bulletin, or SAB, No. 104, *Revenue Recognition.* We recognize revenue when persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed or determinable, and collectibility is probable. Revenue is recognized for product sales upon transfer of title to the customer. Reductions to revenue for estimated sales returns are also recorded at that time. These estimates are based on historical sales returns, changes in customer demand and other factors. If actual future returns and allowances differ from past experience, additional allowances may be required. Certain of our sales arrangements include multiple elements. Generally, these arrangements include delivery of the product, installation, training and product maintenance. Maintenance related to product sales entitles the customer to basic product support and significantly greater response time in resolving warranty related issues. We allocate revenue to each element of the arrangement based on its relative fair value. For maintenance contracts this is typically the price charged when such contracts are sold separately or renewed. Since professional services related to installation and training can be provided by other third party organizations, we allocate revenue related to professional services based on rates that are consistent with other like companies providing similar services, i.e., the market rate for such services. Revenue from product maintenance contracts is deferred and recognized ratably over the contract term, generally 12 months. Revenue from installation, training and consulting is recognized as the services are performed.

2. Stock-Based Compensation

We account for stock-based compensation in accordance with Statement of Financial Accounting Standard, or SFAS No. 123(R), *Share-Based Payment*, which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees, directors and consultants, including stock option grants and purchases of stock made pursuant to our 2000 Amended and Restated Equity Incentive Plan, or the 2000 EIP, our 2000 Amended and Restated Non-Employee Directors Stock Option Plan, or the 2000 NEDSOP, and our 2000 Amended and Restated Employee Stock Purchase Plan, or the 2000 ESPP, based on estimated fair values.

SFAS No. 123(R) requires us to estimate the fair value of share-based payment awards on the date of grant using an option-pricing model. The value of the award s portion that is ultimately expected to vest is recognized as expense over the requisite service periods in the accompanying unaudited condensed consolidated financial statements for the three and six months ended June 30, 2006 and 2007.

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As of June 30, 2007, total unrecognized share-based compensation cost related to unvested stock options was $7.1 million, which is expected to be recognized over a weighted average period of approximately 2.7 years. We have included the following amounts for share-based compensation cost, including the cost related to the 2000 EIP, 2000 NEDSOP and 2000 ESPP, in the accompanying unaudited condensed consolidated statement of operations for the three and six months ended June 30, 2006 and 2007 (amounts in thousands):

	Three Months Ended		Six Months Ended	
	June 30, 2006	June 30, 2007	June 30, 2006	June 30, 2007
Cost of goods sold	$ 89	$ 67	$ 140	$ 170
Sales and marketing	57	120	144	225
Research and development	125	174	305	367
General and administrative	468	391	1,378	215
Share-based compensation expense before taxes	739	752	1,967	977
Related deferred income tax benefits	(111)		(294)	
Share-based compensation expense, net of income taxes	$ 628	$ 752	$ 1,673	$ 977
Net share-based compensation expense per basic and diluted common share	$ 0.01	$ 0.02	$ 0.04	$ 0.02

	Three Months Ended		Six Months Ended	
	June 30, 2006	June 30, 2007	June 30, 2006	June 30, 2007
Share based compensation expense is derived from:				
Stock options	$ 694	$ 661	$ 1,750	$ 791
2000 ESPP	45	91	217	186
Share-based compensation expense before taxes	739	752	1,967	977

Share-based compensation expense recognized during the six months ended June 30, 2007 included (1) compensation expense for awards granted prior to, but not fully vested as of, January 1, 2006 and (2) compensation expense for the share-based payment awards granted subsequent to December 31, 2005, based on the grant date fair values estimated in accordance with the provisions of SFAS No. 123(R). SFAS No. 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. In our pro forma disclosures required under SFAS No. 123, *Accounting for Stock based Compensation*, for the periods prior to 2006, we accounted for forfeitures as they occurred. We have historically and continue to estimate the fair value of share-based awards using the Black-Scholes option-pricing model. Total unrecognized share-based compensation cost related to unvested stock options as of June 30, 2007 has been adjusted for estimated forfeitures.

To estimate compensation expense that was recognized under SFAS No. 123(R) for the six months ended June 30, 2006 and 2007, we used the Black-Scholes option-pricing model with the following weighted-average assumptions for equity awards granted:

2000 ESPP

	2000 EIP and 2000 NEDSOP Six Months Ended June 30,		Six Months Ended June 30,	
	2006	2007	2006	2007
Risk-free interest rate	4.90%	4.50%	4.47%	5.16%
Expected dividend yield	%	%	%	%
Volatility	68%	68%	68%	68%
Expected life	5.5 years	5.4 years	0.5 years	0.5 years

The risk-free interest rate is based on the implied yield available on U.S. Treasury issues with an equivalent remaining term. We have not paid dividends in the past and do not plan to pay any dividends in the future. The expected volatility is based on implied volatility of our stock for the related vesting period. The expected life of the equity award is based on historical experience.

Stock Incentive Plans

2000 EIP. During 2006 and 2007, we primarily granted options to purchase common stock to our employees under the 2000 EIP. These options expire 10 years from the date of grant and typically vest over four years, with 25% of the shares subject to the option vesting one year from the date of grant and the remaining shares subject to the option vesting ratably thereafter on a monthly basis. The number of shares of common stock reserved for issuance under the 2000 EIP is increased annually on the date of our meeting of stockholders by an amount equal to the lesser of (A) two percent of our outstanding shares as of the date of our annual meeting of stockholders, (B) 1,000,000 shares or (C) an amount determined by our board of directors. If an option is surrendered or for any other reason ceases to be exercisable in whole or in part, the shares with respect to which the option was not exercised shall continue to be available under the 2000 EIP. As of June 30, 2007, options to purchase 5,791,423 shares of common stock were outstanding under the 2000 EIP and the options to purchase 1,376,826 shares of common stock remained available for grant under the 2000 EIP.

2000 NEDSOP. Under the 2000 NEDSOP, nonqualified stock options to purchase common stock are automatically granted to our non-employee directors upon appointment to our board of directors (initial grants) and upon each of our annual meetings of stockholders (annual grants). Options granted under the 2000 NEDSOP expire 10 years from the date of the grant. Initial grants vest over four years, with 25% of the shares subject to the option vesting one year from the date of grant and the remaining shares subject to the option vesting ratably thereafter on a monthly basis. Annual grants are fully vested on the date of grant. 1,000,000 shares of common stock are reserved for issuance under the 2000 NEDSOP. As of June 30, 2007, options to purchase 540,000 shares of common stock were outstanding under the 2000 NEDSOP and options to purchase 373,124 shares of common stock remained available for grant under the 2000 NEDSOP.

2000 ESPP. The 2000 ESPP qualifies under the provisions of Section 423 of the Internal Revenue Code, or IRC, and provides our eligible employees, as defined in the 2000 ESPP, with an opportunity to purchase shares of our common stock at 85% of fair market value, as defined in the 2000 ESPP. There were 121,341 and 191,594 shares issued for the 2000 ESPP periods that ended in the six months ended June 30, 2006 and 2007, respectively.

Activity and pricing information regarding all options to purchase shares of common stock are summarized as follows:

	Number of shares	Weighted average exercise price	Weighted average remaining contractual term (in years)	Aggregate intrinsic value (in thousands)
Outstanding at December 31, 2006	5,435,930	$ 6.12		
Granted	1,181,696	3.58		
Exercised	(51,344)	2.60		
Forfeited	(87,290)	4.35		
Expired	(145,566)	9.09		
Outstanding at June 30, 2007	6,333,426	$ 5.63	7.26	$ 1,216
Vested and expected to vest at June 30, 2007	5,802,558	$ 5.75	7.09	$ 1,172
Exercisable at June 30, 2007	3,702,900	$ 6.53	6.00	$ 1,003

As of June 30, 2006, approximately 3,316,215 options were exercisable at a weighted average exercise price of $6.81.

The weighted average grant-date fair values of options granted during the three months ended June 30, 2006 and 2007 were $2.47 per share and $2.40 per share, respectively.

The weighted average grant-date fair values of options granted during the six months ended June 30, 2006 and 2007 were $3.50 per share and $2.22 per share, respectively. The total intrinsic value of options exercised during the six months ended June 30, 2006 and 2007 was $0.1 million and $0.2 million, respectively.

During the six months ended June 30, 2007, financing cash generated from share-based compensation arrangements amounted to $0.1 million for the purchase of shares upon exercise of options and $0.5 million collected for the purchase of shares through the 2000 ESPP. We issue new shares from the respective plan share reserves upon exercise of options to purchase common stock and for purchases through the 2000 ESPP.

During the first quarter of 2007, we granted performance-based stock options to certain executives, the vesting of which is tied to the achievement of financial and non-financial objectives during 2007. Compensation expense recognized related to these performance based options for the six months ended June 30, 2007 was less than $0.1 million.

Additional information regarding options outstanding for all plans as of June 30, 2007, is as follows:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	**Number Outstanding**	**Weighted Average Remaining Contractual Life (yrs.)**	**Weighted Average Exercise Price**	**Number Exercisable**	**Weighted Average Exercise Price**
$1.34 3.35	1,273,095	6.33	$ 2.69	819,901	$ 2.41
$3.38 3.80	1,123,294	8.79	3.58	178,292	3.48
$3.83 5.20	1,058,437	8.74	4.19	475,382	4.31
$5.26 6.25	1,084,904	6.32	6.01	871,335	5.99
$6.36 9.94	1,066,725	6.83	7.30	631,019	7.66
$9.98 17.14	726,971	6.35	13.02	726,971	13.02
Total	6,333,426	7.26	$ 5.63	3,702,900	$ 6.53

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The aggregate intrinsic value in the prior table is based on our closing stock price of $3.60 per share as of the last business day of the six months ended June 30, 2007, which amount would have been received by the optionees had all options been exercised on that date. The total fair value of options to purchase common stock that vested during the three months ended June 30, 2006 and 2007 was $0.5 million and $1.0 million, respectively. The total fair value of options to purchase common stock that vested during the six months ended June 30, 2006 and 2007 was $2.1 million and $1.8 million, respectively.

3. Net Loss Per Share

Basic net loss per share is calculated by dividing net loss by the weighted average number of common shares outstanding during the period.

Diluted net loss per share reflects the potential dilution by including common stock equivalents, such as stock options and stock warrants in the weighted average number of common shares outstanding for a period, if dilutive.

The following table sets forth a reconciliation of the basic and diluted number of weighted average shares outstanding used in the calculation of net loss per share (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2007	2006	2007
Shares used in computing basic net loss per share	44,632	45,472	44,575	45,315
Dilutive effect of warrants and common stock equivalents				
Shares used in computing diluted net loss per share	44,632	45,472	44,575	45,315

For the three months ended June 30, 2006, outstanding options to purchase 5,634,808 shares of common stock with exercise prices ranging from $1.34 to $17.14 per share and outstanding warrants to purchase 1,696,081 shares of common stock at prices ranging from $2.97 to $4.50 were not included in the calculation of diluted loss per share because their effect was antidilutive. For the six months ended June 30, 2006, outstanding options to purchase 5,319,744 shares of common stock with exercise prices ranging from $1.34 to $17.14 per share and outstanding warrants to purchase 1,705,329 shares of common stock at prices ranging from $2.97 to $4.50 were not included in the calculation of diluted loss per share because their effect was antidilutive.

For the three months ended June 30, 2007, outstanding options to purchase 6,275,531 shares of common stock with exercise prices ranging from $1.34 to $17.14 per share and outstanding warrants to purchase 1,109,084 shares of common stock at prices ranging from $2.97 to $4.50 were not included in the calculation of diluted loss per share because their effect was antidilutive. For the six months ended June 30, 2007, outstanding options to purchase 5,984,137 shares of common stock with exercise prices ranging from $1.34 to $17.14 per share and outstanding warrants to purchase 1,400,961 shares of common stock at prices ranging from $2.97 to $4.50 were not included in the calculation of diluted loss per share because their effect was antidilutive.

During May 2007, an outstanding warrant to purchase up to 1,239,527 shares of our common stock at $2.97 per share was exercised on a cash-less basis. In accordance with the cashless exercise terms, the warrant was exchanged for 343,374 shares of our common stock based on the average closing bid price of our stock for the five days preceding the exercise.

4. Inventories

Inventories are stated at the lower of cost (first-in, first-out) or market value. The following is a summary of inventories (in thousands):

	December 31, 2006	June 30, 2007

Purchased parts and materials	$	612	$	496
Finished goods		1,598		2,542
Total inventory	$	2,210	$	3,038

5. Goodwill and Other Intangible Assets

Under the provisions of SFAS No. 142, *Goodwill and Other Intangible Assets,* goodwill and intangible assets with indefinite lives are not amortized, but instead are tested for impairment at least annually or more frequently if impairment indicators arise. All of our remaining identified intangible assets are considered to have finite lives and are being amortized in accordance with this statement.

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Intangible assets that are subject to amortization under SFAS No. 142 consist of the following as of June 30, 2007 (in thousands):

	Gross	Accumulated Amortization	Net
Core technology	$ 5,000	$ (3,704)	$ 1,296
Developed technology	2,600	(2,600)	
Customer relationships	2,500	(2,380)	120
Backlog	100	(100)	
Licensed Patent Portfolio	2,570	(774)	1,796
Total other intangible assets	$ 12,770	$ (9,558)	$ 3,212

As of June 30, 2007, the weighted average amortization period for the above intangibles is 2.4 years.

Estimated future amortization expense related to other intangible assets as of June 30, 2007 is as follows (in thousands):

Years ending December 31,	
2007 (remaining 6 months)	932
2008	1,255
2009	514
2010	511
Total	$ 3,212

6. Product Warranties

We generally extend to our customers the warranties provided to us by our suppliers and, accordingly, the majority of our warranty obligations to customers are covered by supplier warranties. For warranty costs not covered by our suppliers, we provide for estimated warranty costs in the period the revenue is recognized. There can be no assurance that our suppliers will continue to provide such warranties to us in the future, which could have a material adverse effect on our operating results and financial condition if these warranties are eliminated. Estimated liabilities for product warranties are included in accrued expenses. The changes in our aggregate product warranty liability are as follows for the three and six months ended June 30, 2007 (in thousands):

	Three Months Ended June 30, 2007	Six Months Ended June 30, 2007
Balance, beginning of period	$ 1,033	$ 663
Charged to operations	1,058	2,102
Deductions for costs incurred	(711)	(1,385)
Balance, end of period	$ 1,380	$ 1,380

7. Income Taxes

We recorded an income tax benefit of $1.8 million and $0.1 million for the three months ended June 30, 2006 and 2007, respectively. Our effective income tax rate was 2.4% for the three months ended June 30, 2007 which differs from the federal statutory rate due to our U.S. and foreign deferred tax asset valuation allowance position, foreign taxes and state taxes.

For the six months ended June 30, 2006 and 2007, we recorded an income tax benefit of $4.4 million and an income tax expense of $0.2 million, respectively. Our effective income tax rate of (2.1)% for the six months ended June 30, 2007 differs from the federal statutory rate due to our U.S. and foreign deferred tax asset valuation allowance position, foreign taxes and state taxes.

On January 1, 2007, we adopted Financial Accounting Standards Board, or FASB, Interpretation No., or FIN, 48 *Accounting for Uncertainty in Income Taxes*. FIN 48 prescribes a recognition threshold that a tax position is required to meet before being recognized in the financial statements and provides guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition issues.

We had cumulative unrecognized tax benefits of approximately $11.2 million as of January 1, 2007. The cumulative effects of adopting FIN 48 resulted in a decrease of $0.5 million to retained earnings and an increase in other long term liabilities of $0.5 million. Included in the balance of unrecognized tax benefits at January 1, 2007 are approximately $0.6 million of tax benefits that, if recognized, would affect the effective tax rate. At January 1, 2007 we also had approximately $10.6 million of unrecognized tax benefits that will have no impact on the effective tax rate due to the existence of a valuation allowance. Consistent with previous

periods, penalties and tax related interest expense are reported as a component of income tax expense. As of January 1, 2007, the total amount of accrued income tax related interest and penalties included in the condensed consolidated balance sheet was less than $0.1 million. Accrued income tax related interest and penalties recognized during the three and six months ended June 30, 2007 was not significant. During the six months ended June 30, 2007, we reduced our unrecognized tax benefit and correspondingly reduced income tax expense by $0.1 million as a result of the expiration of a state tax statute of limitations. We do not reasonably estimate that the unrecognized tax benefit will change significantly within the next 12 months. There have been no material changes to the unrecognized tax benefit during the three month period ending June 30, 2007.

Due to net operating losses and other tax attributes carried forward, we are currently open to audit under the statute of limitations by the Internal Revenue Service for the years ending March 31, 1994 through December 31, 2006. With few exceptions, our state income tax returns are open to audit for the years ended December 31, 1999 through 2006.

We periodically evaluate the likelihood of the realization of deferred tax assets, and adjust the carrying amount of the deferred tax assets by the valuation allowance to the extent the future realization of the deferred tax assets is not judged to be more likely than not. We consider many factors when assessing the likelihood of future realization of our deferred tax assets, including our recent cumulative earnings experience by taxing jurisdiction, expectations of future taxable income or loss, the carryforward periods available to us for tax reporting purposes, and other relevant factors.

At June 30, 2007, based on the weight of available evidence, including cumulative losses in recent years and expectations of future taxable income, we determined that it was not more likely than not that our United States deferred tax assets would be realized and have a $47.1 million valuation allowance associated with our United States deferred tax assets.

As of December 31, 2006, we had federal and state net operating loss carryforwards of approximately $122.4 million and $57.0 million, which begin to expire in the tax years ending 2013 and 2007, respectively. In addition, we had federal tax credit carryforwards of $3.7 million, of which approximately $0.5 million can be carried forward indefinitely to offset future taxable income, and the remaining $3.2 million began to expire in the tax year ending 2007. We also had state tax credit carryforwards of $3.9 million, of which $3.7 million can be carried forward indefinitely to offset future taxable income, and the remaining $0.2 million began to expire in the tax year ending 2007.

As a result of our equity transactions, an ownership change, within the meaning of IRC Section 382, occurred on September 18, 2003. As a result, annual use of our federal net operating loss and credit carry forwards is limited to (i) the aggregate fair market value of Dot Hill immediately before the ownership change multiplied by (ii) the long-term tax-exempt rate (within the meaning of Section 382 (f) of the IRC) in effect at that time. The annual limitation is cumulative and, therefore, if not fully utilized in a year, can be utilized in future years in addition to the Section 382 limitation for those years.

As a result of our acquisition of Chaparral Network Storage, Inc., or Chaparral, a second ownership change, within the meaning of IRC Section 382, occurred on February 23, 2004. As a result, annual use of Chaparral s federal net operating loss and credit carry forwards may be limited. The annual limitation is cumulative and, therefore, if not fully utilized in a year, can be utilized in future years in addition to the Section 382 limitation for those years.

We have not provided for any residual U.S. income taxes on the earnings from our foreign subsidiaries because such earnings are intended to be indefinitely reinvested. Such residual U.S. income taxes, if any, would be insignificant.

8. Accumulated Other Comprehensive Loss

The components of accumulated other comprehensive loss are as follows (in thousands):

	Foreign Currency Items
Balance, December 31, 2006	$ (814)
Quarterly change	(604)

Balance, March 31, 2007	$ (1,418)
Quarterly change	163
Balance, June 30, 2007	$ (1,255)

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9. Credit Facilities

Effective July 1, 2007, we amended our credit agreement to extend our term for two years with Wells Fargo Bank, National Association, or Wells Fargo, which allows us to borrow up to $30.0 million under a revolving line of credit that expires July 1, 2009. Amounts loaned under the credit agreement bear interest at our option at a fluctuating rate per annum equal to the prime rate in effect from time to time, or at a fixed rate per annum determined by Wells Fargo to be 0.65% above LIBOR in effect on the first day of the applicable fixed rate term. In connection with the credit agreement, to the extent we have outstanding borrowings, we have granted Wells Fargo a security interest in our investment management account maintained with Wells Capital Management Incorporated. As of December 31, 2006 and June 30, 2007, there were no balances outstanding under this line of credit. The credit agreement limits any new borrowings, loans or advances outside of the credit agreement to an amount less than $1.0 million and annual capital expenditures to an amount less than $10.0 million.

10. Commitments and Contingencies

Commitments

Consulting Agreement with Former Executive

In March 2006, we entered into a consulting agreement with our former Chief Executive Officer, James L. Lambert. Pursuant to the consulting agreement, Mr. Lambert will perform consulting services for us during a three-year period beginning as of March 1, 2006 for a consulting fee of $16,666 per month. The vesting of 218,125 of Mr. Lambert s stock options, with an average exercise price of $5.63 per share, was accelerated in full in connection with the consulting agreement, and such stock options will continue to be exercisable during the consulting period in accordance with their terms. Mr. Lambert will be restricted from competing with us during the consulting period, and the consulting period will terminate early upon an acquisition of us, Mr. Lambert s election or Mr. Lambert s death or permanent disability. In the event of any such early termination, Mr. Lambert will receive a lump sum payment equal to the amount he would have been eligible to receive if the consulting period continued for the full original three-year period. Based on the terms of this agreement, we recognized a non-cash stock option expense of $0.7 million related to the acceleration of stock options and consulting fees of $0.6 million during the three months ended March 31, 2006.

New Longmont Research and Development Facility Lease

On April 12, 2007, we entered into a lease contract with Circle Capital Longmont LLC, under which we will lease approximately 44,300 square feet of office and laboratory space located at 1351 South Sunset in Longmont, Colorado. We will use this office and laboratory space as our new research and development facility. The lease contract provides for a term of 65 months, tentatively commencing in August 2007 and ending December 2012. The lease contract provides for two renewal terms of 5 years each. Rental obligations will be payable on a monthly basis. Future minimum lease payments associated with this lease are as follows:

Year		Minimum Lease Payment
2007 (Remaining 6 months)	$	
2008		382,000
2009		393,000
2010		405,000
2011		417,000
2012		424,000
Total	$	2,021,000

In addition to our rental obligations, we will be responsible for certain costs and charges specified in the contract, including certain operating and utility expenses.

The lease for our current research and development faculty located in Longmont, Colorado expired in accordance with the lease terms on July 31, 2007.

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Contingencies

Crossroads Systems Litigation

On October 27, 2003, we were served with a lawsuit filed by Crossroads in the United States District Court in Austin, Texas, alleging that our products infringe two United States patents assigned to Crossroads, Patent Numbers 5,941,972 and 6,425,035. The patents involve the use of access controls in storage routers. The court has interpreted storage routers to include RAID controllers.

On June 28, 2006, we entered into a Settlement and License Agreement with Crossroads that settled the lawsuit and licenses to us the family of patents from which it stemmed. We concurrently entered into an Agreement Between Dot Hill Systems and Infortrend Re Settlement of Crossroads Lawsuit with Infortrend Technology, Inc., or Infortrend. In accordance with the Crossroads and Infortrend agreements, on July 14, 2006, we paid $3.35 million to Crossroads for alleged past damages and Crossroads agreed to dismiss, with prejudice, all patent claims against us. In addition, Infortrend was expected to pay Crossroads an additional $7.15 million on our behalf. However, Infortrend withheld $1.43 million from that payment for the payment of Taiwan taxes. This withholding is included in income tax expense on our statement of operations. Going forward, Crossroads will receive a running royalty of 2.5% based on a percentage of net sales of RAID products sold by us, but only those with functionality that is covered by licensed patents. For RAID products that use a controller sourced by Infortrend, we will pay 0.8125% of the 2.5% royalty, and Infortrend will be responsible for the remainder. For RAID products that use our proprietary controller, we alone will be paying the 2.5% running royalty. No royalty payments will be required with respect to the sale of storage systems that do not contain RAID controllers, known as JBOD systems, or systems that use only the SCSI protocol end-to-end, even if those perform RAID. Further, royalty payments with respect to the sale of any products that are made, used and sold outside of the United States will only be required if and when Crossroads is issued patents that cover the products and that are issued by countries in which the products are manufactured, used or sold.

In July 2006, Crossroads filed two lawsuits against us in the United States District Court for the Western District of Texas based on the alleged breach of the June 28, 2006 Settlement and License Agreement due to the withholding of the $1.43 million for Taiwanese taxes. On September 28, 2006 the Court indicated that it would grant Crossroads Motion to Enforce. Therefore, on October 5, 2006, Crossroads and Dot Hill amended the original Settlement and License Agreement to state that Dot Hill would pay to Crossroads the $1.43 million, plus $45,000 in late fees, and would not make deductions based on taxes on royalty payments in the future. The payment of the $1.475 million was made on October 5, 2006. As required by the amended settlement, Crossroads has dismissed with prejudice the original patent action as well as the second lawsuit based on the enforcement of the original settlement.

Thereafter, we gave notice to Infortrend of our intent to bring a claim alleging breach of the settlement agreement seeking reimbursement of the $1.475 million from Infortrend. On November 13, 2006, Infortrend filed a lawsuit in the Superior Court of California, County of Orange for declaratory relief. The complaint seeks a court determination that Infortrend is not obligated to reimburse Dot Hill for the $1.475 million. On December 12, 2006, we answered the complaint and filed a cross complaint alleging breach of contract, fraud, breach of implied covenant of good faith and fair dealing, breach of fiduciary duty and declaratory relief. Infortrend demurred to the cross complaint. The Court denied the demurrer as to the fraud cause of action and sustained the demurrer as to the claims for breach of the covenant of good faith and fair dealing and breach of fiduciary duty. The Court granted Dot Hill leave to amend the cross complaint as to those two causes of action. No trial date has been scheduled.

Chaparral Securities Class Action

In August 2004, a class action lawsuit was filed against, among others, Chaparral and a number of its former officers and directors in the United States District Court for the Central District of California. The lawsuit, among other things, alleges violations of federal and state securities laws and purports to seek damages on behalf of a class of shareholders who held interests in limited liability companies that had purchased, among other securities, Chaparral stock during a defined period prior to our acquisition of Chaparral. In May 2005, the Second Amended Complaint was dismissed with leave to amend. Plaintiffs filed a Third Amended Complaint, which the Court again dismissed with leave to amend in November of 2005 as to Chaparral and certain other defendants. Plaintiffs declined to amend within the proscribed period, and final judgment was entered in February 2006. Plaintiffs filed a notice of appeal in the United States District Court of Appeals for the Ninth Circuit, though they have not filed their opening papers.

Plaintiffs filed a related action in the Superior Court of the State of California, Orange County, in December of 2005, alleging many of the same claims. That action was stayed pending the outcome of the federal appeal. The parties have reached a settlement of the securities class actions. That settlement was preliminarily approved by the Orange County Superior Court on March 19, 2007, and the final settlement approval hearing is set for October 1, 2007. We expect the case to be dismissed following final approval of settlement.

Dot Hill Securities Class Actions and Derivative Suits

In late January and early February 2006, numerous purported class action complaints were filed against us in the United States District Court for the Southern District of California. The complaints allege violations of federal securities laws related to alleged inflation in our stock price in connection with various statements and alleged omissions to the public and to the securities markets and declines in our stock price in connection with the restatement of certain of our quarterly financial statements for fiscal year 2004, and seeking damages therefore. The complaints were consolidated into a single action, and the Court appointed as lead plaintiff a group comprised of the Detroit Police and Fire Retirement System and the General Retirement System of the City of Detroit. The consolidated complaint was filed on August 25, 2006, and we filed a motion to dismiss on October 5, 2006. The Court granted our motion to dismiss on March 15, 2007. Plaintiffs filed their Second Amended Consolidated Complaint on April 20, 2007. We filed our motion to dismiss on May 29, 2007 and expect it to be heard on August 27, 2007.

In addition, three complaints purporting to be derivative actions have been filed in California state court against certain of our directors and executive officers. These complaints are based on the same facts and circumstances described in the federal class action complaints and generally allege that the named directors and officers breached their fiduciary duties by failing to oversee adequately our financial reporting. Each of the complaints generally seeks an unspecified amount of damages. Our demurrer to two of those cases, in which we sought dismissal, was overruled (i.e., denied). We have formed a Special Litigation Committee, or SLC, of disinterested directors to investigate the alleged wrongdoing. On January 12, 2007, another derivative action similar to the previous derivative actions with the addition of allegations regarding purported stock option backdating was served on us. On April 16, 2007, the SLC concluded its investigation and based on its findings directed us to file a motion to dismiss the derivative matters. On June 27, 2007, the parties stipulated to consolidate all of the derivative matters for pre-trial proceedings. We expect to file a motion to dismiss the consolidated matters pursuant to the SLC s directive in late August 2007. The outcome of these actions is uncertain, and no amounts have been accrued as of June 30, 2007.

Other Litigation

We are involved in certain other legal actions and claims arising in the ordinary course of business. Management believes that the outcome of such other litigation and claims will not have a material adverse effect on our financial condition or operating results.

11. Segments and Geographic Information

Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by our chief operating decision-maker, or decision making group, in deciding how to allocate resources and in assessing performance. Our chief operating decision-maker is our Chief Executive Officer. Our operating segments are managed separately because each segment represents a strategic business unit that offers different products or services.

Our operating segments are organized on the basis of products and services. We have identified operating segments that consist of our SANnet® family of systems, legacy and other systems, and services. We currently evaluate performance based on stand-alone segment revenue and gross margin. Because we do not currently maintain information regarding operating income at the operating segment level, such information is not presented.

Information concerning revenue and gross profit by product and service is as follows (in thousands):

	SANnet Family	Legacy and Other	Services	Total
Three months ended:				
June 30, 2006:				
Net revenue	$63,775	$1,649	$ 841	$66,265
Gross profit	$13,390	$ 255	$ 125	$13,770
June 30, 2007:				
Net revenue	$54,665	$ 63	$1,471	$56,199
Gross profit	$ 6,197	$ 25	$ 702	$ 6,924

	SANnet Family	Legacy and Other	Services	Total
Six months ended:				
June 30, 2006:				
Net revenue	$120,921	$2,288	$1,742	$124,951
Gross profit	$ 23,988	$ 317	$ 626	$ 24,931
June 30, 2007:				
Net revenue	$106,613	$ 240	$2,787	$109,640
Gross profit	$ 12,392	$ 67	$1,139	$ 13,598

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Information concerning operating assets by product and service, derived by specific identification for assets related to specific segments and an allocation based on segment volume for assets related to multiple segments, is as follows (in thousands):

	SANnet Family	Legacy and Other	Services	Total
As of:				
December 31, 2006	$195,332	$3,024	$3,295	$201,651
June 30, 2007	$184,684	$ 504	$1,561	$186,749

Information concerning principal geographic areas in which we operate is as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2007	2006	2007
Net revenue:				
United States	$ 62,945	$ 48,573	$ 117,964	$ 94,186
Europe	2,235	6,112	4,469	12,705
Asia	1,085	1,514	2,518	2,749
	$ 66,265	$ 56,199	$ 124,951	$ 109,640
Operating income (loss):				
United States	$ (8,980)	$ (3,457)	$ (17,704)	$ (7,128)
Europe	(712)	(1,526)	(847)	(4,928)
Asia	(123)	(83)	(121)	12
	$ (9,815)	$ (5,066)	$ (18,672)	$ (12,044)

	As of December 31, 2006	As of June 30, 2007
Assets:		
United States	$ 192,539	$ 177,788
Europe	6,358	6,965
Asia	2,754	1,996
	$ 201,651	$ 186,749

Net revenue is recorded in the geographic area in which the sale is originated.

12. Recent Accounting Pronouncements

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, which establishes guidelines for measuring fair value and expands disclosures regarding fair value measurements. SFAS No. 157 does not require any new fair value measurements but rather it eliminates inconsistencies in the guidance found in various prior accounting pronouncements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. Although we are still evaluating the potential effects of this standard, we do not expect the adoption of SFAS No. 157 to have a material impact on our results of operations or financial condition.

In February 2007, the FASB issued SFAS No. 159, *The Fair Option for Financial Assets and Financial Liabilities including an amendment of FASB Statement No. 115*, which allows measurement at fair value of eligible financial assets and liabilities that are not otherwise measured at fair value. If the fair value option for an eligible item is elected, unrealized gains and losses for that item shall be reported in current earnings at each subsequent reporting date. SFAS No. 159 also establishes presentation and disclosure requirements designed to draw comparison between the different measurement attributes the company elects for similar types of assets and liabilities. This statement is effective for fiscal years beginning after November 15, 2007. We are in the process of evaluating the application of the fair value option and its effect on its financial position and results of operations.

13. Stock Option Expense related to Historical Grant Practices

In response to recently reported industry issues around option pricing in July 2006, our Audit Committee, which is comprised of independent directors initiated a review of our historical stock option grant practices and related accounting dating back to our merger with Artecon, Inc. in 1999. As a result, we recognized $0.1 million of cost of goods sold and sales and marketing expenses for the three months ended June 30, 2006 associated with the errors identified by our Audit Committee s review that was not recognized in prior periods. The expenses associated with the errors were not material in any of the prior periods during which the expenses should have been recognized nor was the cumulative adjustment material to the three or six months ended June 30, 2006. The $0.1 million stock option expense that was recognized for the three months ended June 30, 2006 was in addition to the $2.0 million share-based compensation cost resulting from adoption of SFAS No. 123(R) for the six months ended June 30, 2006.

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations
Cautionary Statement for Forward-Looking Information

Certain statements contained in this quarterly report on Form 10-Q, including, statements regarding the development, growth and expansion of our business, our intent, belief or current expectations, primarily with respect to our future operating performance and the products we expect to offer, and other statements regarding matters that are not historical facts, are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, or the Exchange Act, and are subject to the safe harbor created by these sections. Because such forward-looking statements are subject to risks and uncertainties, many of which are beyond our control, actual results may differ materially from those expressed or implied by such forward-looking statements. Some of the factors that could cause actual results to differ materially from those expressed or implied by such forward-looking statements can be found in Part II, Item 1A, Risk Factors and in our reports filed with the Securities and Exchange Commission, or SEC, including our Annual Report on Form 10-K for the year ended December 31, 2006. Readers are cautioned not to place undue reliance on forward-looking statements. The forward- looking statements speak only as of the date on which they are made, and we undertake no obligation to update such statements to reflect events that occur or circumstances that exist after the date on which they are made.

The following discussion of our financial condition and results of operations should be read in conjunction with our condensed consolidated financial statements and notes thereto included elsewhere in this quarterly report on Form 10-Q and our consolidated financial statements and notes thereto included in our annual report on Form 10-K for the year ended December 31, 2006.

Overview

We are a provider of storage systems for organizations requiring high reliability, high performance networked storage and data management solutions in an open systems architecture. Our storage solutions consist of integrated hardware and software products employing a modular system that allows end-users to add capacity as needed. Our products provide end-users with a cost-effective means of addressing increasing storage demands without sacrificing performance. Our new product family based on our R/Evolution architecture provides high performance and large capacities for a broad variety of environments. Our SANnet ® products have been distinguished by certification as Network Equipment Building System, or NEBS, Level 3 (a telecommunications standard for equipment used in central offices) and are MIL-STD-810F (a military standard created by the U.S. government) compliant based on their ruggedness and reliability.

Our products and services are sold worldwide to end-users primarily through our channel partners, including original equipment manufacturers, or OEMs, systems integrators, or SIs, and value added resellers, or VARs. We have been shipping our products to Sun Microsystems, or Sun, for resale to Sun s customers since October 2002 and continue to do so, having shipped over 138,000 units to date. We are developing products for Fujitsu Siemens, or Fujitsu, and Network Appliance, or NetApp. We began shipping products to Fujitsu in July 2006 and to NetApp in June 2007.

In February 2004, we acquired all the outstanding shares of Chaparral Network Storage, Inc., or Chaparral, a privately held storage system provider. This acquisition provided us with a core of redundant array of independent disks, or RAID, hardware and software technology and a team of hardware and software professionals located in Longmont, Colorado.

As part of our focus on indirect sales channels, we have historically outsourced substantially all of our manufacturing operations to Solectron Corporation, or Solectron. Our agreement with Solectron allows us to reduce sales cycle times and our manufacturing infrastructure, enhance working capital and improve margins by taking advantage of Solectron s manufacturing and procurement economies of scale.

In February 2007, we entered into a manufacturing agreement with MiTAC International Corporation, or MiTAC, a leading provider of contract manufacturing and original design manufacturing services, and SYNNEX Corporation, or SYNNEX, a leading global IT supply chain services company. Under the terms of the agreement, MiTAC will supply Dot Hill with manufacturing, assembly and test services from its facilities in China, and SYNNEX will provide Dot Hill with final assembly, testing and configure-to-order services through its facilities in Fremont, California and

Telford, United Kingdom. We believe that the agreement with MiTAC and SYNNEX will help to expand our global capabilities and reduce our manufacturing costs. We began shipping products under the MiTAC and SYNNEX agreement in April 2007.

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We derive a portion of our revenue from services associated with the maintenance service we provide for our installed products. Earlier this year, we entered into an agreement with GAVS Information Services, LLC, or GAVS, to provide telephonic warranty and non-warranty support for customers for either our more mature SANnet product family or products designed under our new R/Evolution platform. We also entered into an agreement earlier in the year with Glasshouse Technologies INC, to become an authorized service provider of on-site support on a global basis for customers who purchase maintenance agreements for either our mature SANnet product family or products designed under our new R/Evolution platform.

Cost of goods sold includes costs of materials, subcontractor costs, salary and related benefits for the production and service departments, depreciation and amortization of equipment used in the production and service departments, production facility rent and allocation of overhead.

Sales and marketing expenses consist primarily of salaries and commissions, advertising and promotional costs and travel expenses. Research and development expenses consist primarily of project-related expenses and salaries for employees directly engaged in research and development. General and administrative expenses consist primarily of compensation to officers and employees performing administrative functions, expenditures for administrative facilities and expenditures for legal and accounting services.

Other income is comprised primarily of interest income earned on our cash, cash equivalents, and short-term investments and other miscellaneous income and expense items.

Our headquarters are located in Carlsbad, California, and we maintain international offices in Germany, Japan, the Netherlands, China and the United Kingdom.

Critical Accounting Policies and Estimates

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated 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 use judgment that may impact the reported amounts of assets, liabilities, revenues, expenses and related disclosure of contingent assets and liabilities. As a part of our on-going internal processes, we evaluate our estimates, including those related to inventory write-downs, warranty cost accruals, revenue recognition, bad debt allowances, long-lived assets valuation, goodwill and intangible assets valuation, income taxes, including deferred income tax asset valuation, stock based compensation, litigation and contingencies. We base these estimates upon both historical information and other assumptions that we believe are valid and reasonable under the circumstances. These assumptions form the basis for making judgments and determining the carrying values of assets and liabilities that are not apparent from other sources. Actual results could vary from those estimates under different assumptions and conditions.

We believe that the policies set forth below may involve a higher degree of judgment and complexity in their application than our other accounting policies and represent the critical accounting policies used in the preparation of our financial statements.

Revenue Recognition

Revenues are recognized pursuant to applicable accounting standards, including SEC Staff Accounting Bulletin, or SAB, No. 104, *Revenue Recognition.*

We recognize revenue when persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed or determinable, and collectibility is probable. We recognize revenue for product sales upon transfer of title to the customer. Reductions to revenue for estimated sales returns are also recorded at that time. These estimates are based on historical sales returns, changes in customer demand and other factors. If actual future returns and allowances differ from past experience, additional allowances may be required. Certain of our sales arrangements include multiple elements. Generally, these arrangements include delivery of the product, installation, training and product maintenance. Maintenance related to product sales entitles the customer to basic product support and faster response time in resolving warranty related issues. We allocate revenue to each element of the arrangement based on its relative fair value. For maintenance contracts this is typically the price charged when such contracts are sold separately or renewed. Because professional services related to installation and training can be provided by other third party organizations, we allocate revenue related to professional services based on rates that are consistent with other like companies providing similar services, i.e., the market rate for such services. Revenue from product maintenance contracts is deferred and recognized ratably over the contract term, generally 12 months. Revenue from installation, training and consulting is recognized as the services are performed.

Valuation of Inventories

Inventories are comprised of purchased parts and assemblies, which include direct labor and overhead. We record inventories at the lower of cost or market value, with cost generally determined on a first-in, first-out basis. We perform periodic valuation assessments based on projected sales forecasts and analyzing upcoming changes in future configurations of our products and record inventory write-downs for excess and obsolete inventory. Although we strive to ensure the accuracy of our forecasts, we periodically are faced with uncertainties. The outcomes of these uncertainties are not within our control, and may not be known for prolonged periods of time. Any significant unanticipated changes in demand or technological developments could have a significant impact on the value of our inventories and commitments, and consequently, on our operating results. If actual market conditions become less favorable than those forecasted, additional inventory write-downs might be required, adversely affecting operating results.

Valuation of Goodwill

We review goodwill for impairment annually and whenever events or changes in circumstances indicate the carrying value of an asset may not be recoverable in accordance with Statement of Financial Accounting Standards, or SFAS, No. 142, *Goodwill and Other Intangible Assets.* The provisions of SFAS No. 142 require that a two-step impairment test be performed on goodwill. In the first step, we compare the fair value of each reporting unit to its carrying value. Our reporting units are consistent with the reportable segments identified in the notes to our consolidated financial statements. We determine the fair value of our reporting units using the income approach. Under the income approach, we calculate the fair value of a reporting unit based on the present value of estimated future cash flows. If the fair value of the reporting unit exceeds the carrying value of the net assets assigned to that unit, goodwill is not impaired and we are not required to perform further testing. If the carrying value of the net assets assigned to the reporting unit exceeds the fair value of the reporting unit, then we must perform the second step in order to determine the implied fair value of the reporting unit s goodwill and compare it to the carrying value of the reporting unit s goodwill. If the carrying value of a reporting unit s goodwill exceeds its implied fair value, then we must record an impairment charge equal to the difference.

The income approach is dependent on a number of factors including estimates of future market growth and trends, forecasted revenue and costs, expected periods the assets will be utilized, appropriate discount rates and other variables. We base our fair value estimates on assumptions we believe to be reasonable, but which are unpredictable and inherently uncertain. Actual future results may differ from those estimates.

Deferred Income Taxes

We account for income taxes under the asset and liability method, under which deferred tax assets, including net operating loss carryforwards, and liabilities are determined based on temporary differences between the book and tax

basis of assets and liabilities. We periodically evaluate the likelihood of the realization of deferred tax assets, and adjust the carrying amount of the deferred tax assets by the valuation allowance to the extent we believe a portion will be realized, or not realized. We consider many factors when assessing the likelihood of future realization of our deferred tax assets, including our recent cumulative earnings experience by taxing

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jurisdiction, expectations of future taxable income, the carryforward periods available to us for tax reporting purposes, and other relevant factors.

At June 30, 2007, based on the weight of available evidence, including cumulative losses in recent years and expectations of future taxable income, we determined that it was not more likely than not that our United States deferred tax assets would be realized and have a $47.1 million valuation allowance associated with our United States deferred tax assets.

Due to our equity transactions, an ownership change, within the meaning of Internal Revenue Code, or IRC, Section 382, occurred on September 18, 2003. As a result, annual use of our federal net operating loss and credit carry forwards is limited to (i) the aggregate fair market value of Dot Hill immediately before the ownership change multiplied by (ii) the long-term tax-exempt rate (within the meaning of IRC Section 382 (f)) in effect at that time. The annual limitation is cumulative and, therefore, if not fully utilized in a year, can be utilized in future years in addition to the Section 382 limitation for those years.

As a result of our acquisition of Chaparral, a second ownership change, within the meaning of IRC Section 382, occurred on February 23, 2004. As a result, annual use of the acquired Chaparral s federal net operating loss and credit carry forwards may be limited. The annual limitation is cumulative and, therefore, if not fully utilized in a year, can be utilized in future years in addition to the Section 382 limitation for those years.

Stock-Based Compensation

We account for stock-based compensation in accordance with SFAS No. 123(R), *Share-Based Payment*, which requires us to record stock compensation expense for equity based awards granted, including stock options, for which expense will be recognized over the service period of the equity based award based on the fair value of the award, at the date of grant. The estimation of stock option fair value requires management to make complex estimates and judgments about, among other things, employee exercise behavior, forfeiture rates, and the volatility of our common stock. These judgments directly affect the amount of compensation expense that will ultimately be recognized.

As of June 30, 2007, total unrecognized share-based compensation cost related to unvested stock options was $7.1 million, which is expected to be recognized over a weighted average period of approximately 2.7 years.

Contingencies

We are subject to various legal proceedings and claims and tax matters, the outcomes of which are subject to significant uncertainty. SFAS No. 5, *Accounting for Contingencies*, requires that an estimated loss from a loss contingency should be accrued by a charge to income if it is probable that an asset has been impaired or a liability has been incurred and the amount of the loss can be reasonably estimated. Disclosure of a contingency is required if there is at least a reasonable possibility that a loss has been incurred. We evaluate, among other factors, the degree of probability of an unfavorable outcome and the ability to make a reasonable estimate of the amount of loss. Changes in these factors could materially impact our financial position or our results of operations. See Note 10 to our condensed consolidated financial statements for further information regarding contingencies.

Results of Operations

The following table sets forth certain items from our statements of operations as a percentage of net revenue for the periods indicated:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	**2007**	**2006**	**2007**
Net revenue:	100.0%	100.0%	100.0%	100.0%
Cost of goods sold	79.2	87.7	80.0	87.6
Gross profit	20.8	12.3	20.0	12.4
Operating expenses:				
Sales and marketing	6.3	6.9	6.6	7.1

Research and development	18.3	8.5	17.5	9.9
General and administrative	6.0	5.9	8.1	6.4
Legal settlement	5.1		2.7	
Total operating expenses	35.7	21.3	34.9	23.4
Operating loss	(14.8)	(9.0)	(14.9)	(11.0)
Other income, net	2.1	2.2	2.2	2.3
Income tax benefit	(2.7)		(3.5)	
Net loss	(10.0)%	(6.7)%	(9.3)%	(8.9)%

(percentages may not aggregate due to rounding)

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Three Months Ended June 30, 2007 Compared to Three Months Ended June 30, 2006

Net Revenue

Net revenue decreased $10.1 million, or 15.2%, to $56.2 million for the three months ended June 30, 2007 from $66.3 million for the three months ended June 30, 2006. The decrease in net revenue was primarily attributable to decreased orders for our products from our largest OEM customer, Sun, which accounted for 65.4% of our net revenue for the three months ended June 30, 2007, as compared to 84.0% of our revenue for the three months ended June 30, 2006, that was partially offset by sales of our 2730 product, a new product introduced during the third quarter of 2006, and sales to another large OEM customer which began in June 2007. Fibre Channel units shipped were 2,217 for the three months ended June 30, 2007 compared to 2,867 units for the three months ended June 30, 2006. Small Computer Systems Interface, or SCSI, units shipped were 2,592 for the three months ended June 30, 2007 compared to 3,811 units for the three months ended June 30, 2006. Blade units shipped were 3,716 for the three months ended June 30, 2007 compared to 3,840 units for the three months ended June 30, 2006. SATA units shipped were 37 for the three months ended June 30, 2007 compared to 743 units for the three months ended June 30, 2006. We shipped 1,880 units of our 2730 product for the three months ended June 30, 2007 compared to none for the three months ended June 30, 2006. Non-Sun revenue was $19.5 million for the three months ended June 30, 2007 compared to $10.6 million for the three months ended June 30, 2006.

Cost of Goods Sold

Cost of goods sold decreased $3.2 million, or 6.1%, to $49.3 million for the three months ended June 30, 2007 from $52.5 million for the three months ended June 30, 2006. As a percentage of net revenue, cost of goods sold increased to 87.7% for the three months ended June 30, 2007 from 79.2% for the three months ended June 30, 2006. The decrease in the dollar amount of cost of goods sold was primarily attributable to a decrease in net revenue. The increase in the cost of goods sold as a percentage of net revenue for the three months ended June 30, 2007 compared to the three months ended June 30, 2006 was primarily due to a change in the composition of product sales. The shift in product sales mix was due to a reduction in sales to our largest OEM customer that was partially offset by sales of our 2730 product, which is in early-production and currently shipping at depressed margins, and sales to another large OEM customer which began in June 2007. Cost of goods sold was further impacted by a $0.6 million increase in warranty expense primarily related to our 2730 product, a $0.3 million increase in inventory reserves primarily due to revaluing our inventory and $0.2 million of royalty payments related to the Crossroads agreement entered into in June 2006.

Gross Profit

Gross profit decreased $6.9 million, or 50.0%, to $6.9 million for the three months ended June 30, 2007 from $13.8 million for the three months ended June 30, 2006. As a percentage of net revenue, gross profit decreased to 12.3% for the three months ended June 30, 2007 from 20.8% for the three months ended June 30, 2006. The decrease in the dollar amount of gross profit was primarily attributable to lower total sales. The decrease in gross profit as a percentage of net revenue for the three months ended June 30, 2007 compared to the three months ended June 30, 2006 was primarily attributable to a change in the composition of product sales. The shift in product sales mix was due to a reduction in sales to our largest OEM customer that was partially offset by sales of our 2730 product, which is in early-production and currently shipping at depressed margins and sales to another large OEM customer which began in June 2007 . Gross profit was further impacted by a $0.7 million increase in warranty reserves primarily related to our 2730 product, a $0.3 million increase in inventory reserves primarily due to revaluing our inventory and $0.2 million of royalty payments related to the Crossroads agreement entered into in June 2006.

Sales and Marketing Expenses

Sales and marketing expenses decreased $0.2 million, or 4.9%, to $3.9 million for the three months ended June 30, 2007 from $4.1 million for the three months ended June 30, 2006. As a percentage of net revenue, sales and marketing expenses increased to 6.9% for the three months ended June 30, 2007 from 6.3% for the three months ended June 30, 2006. The decrease in the dollar amount of sales and marketing expenses was primarily attributable to a decrease in headcount at our subsidiaries in Japan and Europe. The increase in sales and marketing expenses as a percentage of net revenue was primarily due to a decrease in revenue for the three months ended June 30, 2007 compared to the three months ended June 30, 2006. We expect sales and marketing expenses for the year ending December 31, 2007 to

remain consistent with spending levels incurred during 2006.

Research and Development Expenses

Research and development expenses decreased $7.3 million, or 60.3%, to $4.8 million for the three months ended June 30, 2007 from $12.1 million for the three months ended June 30, 2006. As a percentage of net revenue, research and development expenses decreased to 8.5% for the three months ended June 30, 2007 from 18.3% for the three months ended June 30, 2006. The decrease in research and development expenses was primarily due to a reduction of $6.1 million in investment in prototypes and project materials, reduction of $0.7 million in testing expenses and a reduction of $0.4 million in compensation related expenses. We expect research and development expenses for the year ending December 31, 2007 will continue to decrease from spending levels incurred during 2006 as much of our investment in prototypes and project materials for our new products has been completed.

General and Administrative Expenses

General and administrative expenses decreased $0.7 million, or 17.5%, to $3.3 million for the three months ended June 30, 2007 from $4.0 million for the three months ended June 30, 2006. As a percentage of net revenue, general and administrative expenses decreased to 5.9% for the three months ended June 30, 2007 from 6.0% for the three months ended June 30, 2006. The decrease was primarily attributable to a $1.0 million reduction in legal expenses, offset by an increase of $0.3 million in consulting fees.

Legal Settlement Expense

On June 28, 2006, we entered into a Settlement and License Agreement with Crossroads Systems, Inc., or Crossroads, that settles Crossroads lawsuit against us and licenses to us the family of patents from which it stemmed. We concurrently entered into an Agreement Between Dot Hill Systems and Infortrend Re Settlement of Crossroads Lawsuit with Infortrend Technology Inc., or Infortrend. In accordance with the Crossroads and Infortrend agreements, on July 14, 2006, we paid $3.35 million to Crossroads for alleged past damages and Crossroads agreed to dismiss all patent claims against us. As part of the agreement between Dot Hill and Infortrend, Infortrend paid Crossroads $5.72 million on behalf of Dot Hill on July 17, 2006. $1.43 million was paid by Dot Hill for Taiwan taxes and is included in income tax expense on our statement of operations. Please refer to note 10 in the accompanying condensed consolidated financial statements.

Income Taxes

We recorded an income tax benefit of $0.1 million for the three months ended June 30, 2007 compared to $1.8 million for the three months ended June 30, 2006. Our effective income tax rate of 2.4% for the three months ended June 30, 2007 differs from the U.S. federal statutory rate due to our U.S. and foreign deferred tax asset valuation allowance position, foreign taxes and state taxes. For the three months ended June 30, 2006, we recorded a tax benefit of $1.8 million, reflecting an effective tax rate of 21.3%. Our effective tax rate for the three months ended June 30, 2006 differs from the U.S. federal statutory rate primarily due to our valuation allowance against deferred tax assets in foreign jurisdictions, state taxes and the impact of share-based compensation expense recognized under SFAS No. 123(R).

At June 30, 2007, based on the weight of available evidence, including cumulative losses in recent years and expectations of future taxable income, we determined that it was not more likely than not that our United States deferred tax assets would be realized and have a $47.1 million valuation allowance associated with our United States deferred tax assets.

As of December 31, 2006, we had federal and state net operating losses of approximately $122.4 million and $57.0 million, which begin to expire in the tax years ending 2013 and 2007, respectively. In addition, we had federal tax credit carryforwards of $3.7 million, of which approximately $0.5 million can be carried forward indefinitely to offset future taxable income, and the remaining $3.2 million began to expire in the tax year ending 2007. We also had state tax credit carryforwards of $3.9 million, of which $3.7 million can be carried forward indefinitely to offset future taxable income, and the remaining $0.2 million began to expire in the tax year ending 2007.

As a result of our equity transactions, an ownership change, within the meaning of IRC Section 382, occurred on September 18, 2003. As a result, annual use of our federal net operating loss and credit carry forwards is limited to (i) the aggregate fair market value of Dot Hill immediately before the ownership change multiplied by (ii) the long-term tax-exempt rate (within the meaning of Section 382 (f) of the IRC) in effect at that time. The annual limitation is cumulative and, therefore, if not fully utilized in a year, can be utilized in future years in addition to the

Section 382 limitation for those years.

As a result of our acquisition of Chaparral Network Storage, Inc., or Chaparral, a second ownership change, within the meaning of IRC Section 382, occurred on February 23, 2004. As a result, annual use of Chaparral s federal net operating loss and credit carry forwards may be limited. The annual limitation is cumulative and, therefore, if not fully utilized in a year, can be utilized in future years in addition to the Section 382 limitation for those years.

We have not provided for any residual U.S. income taxes on the earnings from our foreign subsidiaries because such earnings are intended to be indefinitely reinvested. Such residual U.S. income taxes, if any, would be insignificant.

Six Months Ended June 30, 2007 Compared to Six Months Ended June 30, 2006

Net Revenue

Net revenue decreased $15.4 million, or 12.3%, to $109.6 million for the six months ended June 30, 2007 from $125.0 million for the six months ended June 30, 2006. The decrease in net revenue was primarily attributable to decreased orders for our products from our largest OEM customer, Sun, which accounted for 70.6% of our net revenue for the six months ended June 30, 2007, as compared to 86.0% of our revenue for the six months ended June 30, 2006, that was partially offset by sales of our 2730 product, a new product introduced during the third quarter of 2006, and sales to another large OEM customer which began in June 2007. Fibre Channel units shipped were 4,434 for the six months ended June 30, 2007 compared to 5,181 units for the six months ended June 30, 2006. SCSI units shipped were 5,440 for the six months ended June 30, 2007 compared to 7,076 units for the six months ended June 30, 2006. Blade units shipped were 6,459 for the six months ended June 30, 2007 compared to 5,798 units for the six months ended June 30, 2006. SATA units shipped were 170 for the six months ended June 30, 2007 compared to 1,417 units for the six months ended June 30, 2006. We shipped 2,920 units of our 2730 product for the six months ended June 30, 2007 compared to none for the six months ended June 30, 2006