DOT HILL SYSTEMS CORP
Form 10-Q
August 09, 2004

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the Quarterly Period Ended June 30, 2004

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.)
6305 El Camino Real, Carlsbad, California	**92009**
(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 Sections 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 ý No ¨

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Securities Act of 1934). Yes ý No o

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

Common Stock, $0.001 par value, 43,479,416 shares outstanding as of August 2, 2004.

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Item 1. Financial Statements

DOT HILL SYSTEMS CORP. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(In Thousands, Except Per Share Amounts)

(Unaudited)

	December 31, 2003	June 30, 2004
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 138,563	$ 46,693
Short-term investments	52,982	78,614
Accounts receivable, net of allowance of $467 and $611	14,558	38,369
Inventories	3,158	4,521
Prepaid expenses and other	1,836	2,372
Total current assets	211,097	170,569
Property and equipment, net	4,791	8,306
Goodwill	343	57,111
Other intangible assets, net		9,195
Other assets	2,212	1,306
Total assets	$ 218,443	$ 246,487
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities:		
Accounts payable	$ 24,533	$ 40,029
Accrued compensation	4,459	3,063
Accrued expenses	2,052	4,345
Deferred revenue	1,028	1,010
Income taxes payable	1,005	1,019
Current portion of restructuring accrual	370	168
Total current liabilities	33,447	49,634
Restructuring accrual, net of current portion	554	156
Note payable		6,000

Accrued interest		1,113
Borrowings under lines of credit	247	210
Other long-term liabilities	62	835
Total liabilities	34,310	57,948
Commitments and Contingencies (Note 14)		
Stockholders Equity:		
Preferred stock, $0.001 par value, 10,000 shares authorized, no shares issued or outstanding at December 31, 2003 and June 30, 2004, respectively		
Common stock, $0.001 par value, 100,000 shares authorized, 43,307 and 43,468 shares issued and outstanding at December 31, 2003 and June 30, 2004, respectively	43	43
Additional paid-in capital	275,827	276,488
Deferred compensation	(28)	(18)
Accumulated other comprehensive loss	(263)	(640)
Accumulated deficit	(91,446)	(87,334)
Total stockholders equity	184,133	188,539
Total liabilities and stockholders equity	$ 218,443	$ 246,487

See accompanying notes to condensed consolidated financial statements.

DOT HILL SYSTEMS CORP. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME

(In Thousands, Except Per Share Amounts)

(Unaudited)

	Three Months Ended June 30, 2003	Three Months Ended June 30, 2004	Six Months Ended June 30, 2003	Six Months Ended June 30, 2004
Net Revenue	$ 48,428	$ 69,604	$ 78,950	$ 118,385
Cost of Goods Sold	38,415	52,487	63,400	87,765
Gross Profit	10,013	17,117	15,550	30,620
Operating Expenses:				
Sales and marketing	3,391	4,623	6,812	9,238
Research and development	2,841	4,734	4,897	9,105
General and administrative	1,610	2,304	3,071	4,618
Restructuring, net		(391)		(391)
In-process research and development				4,700
Total operating expenses	7,842	11,270	14,780	27,270
Operating income	2,171	5,847	770	3,350
Other Income (Expense):				
Interest income	97	432	123	1,007
Interest expense	(23)	(145)	(70)	(285)
Gain (loss) on foreign currency transactions, net	320	(13)	302	154
Other income (expense), net	6		(18)	(23)
Total other income, net	400	274	337	853
Income Before Income Taxes	2,571	6,121	1,107	4,203
Income Tax Expense	11	126	11	91
Net Income	$ 2,560	$ 5,995	$ 1,096	$ 4,112
Net Income Attributable to Common Stockholders:				
Net income	$ 2,560	$ 5,995	$ 1,096	$ 4,112
Dividends on preferred stock	(36)		(141)	
Net income attributable to common stockholders	$ 2,524	$ 5,995	$ 955	$ 4,112

Net Income Per Share:				
Basic	$ 0.08	$ 0.14	$ 0.03	$ 0.09
Diluted	$ 0.07	$ 0.13	$ 0.03	$ 0.09
Weighted Average Shares Used to Calculate Net Income Per Share:				
Basic	31,576	43,383	28,877	43,349
Diluted	35,669	46,279	32,954	46,609
Comprehensive Income:				
Net income	$ 2,560	$ 5,995	$ 1,096	$ 4,112
Foreign currency translation adjustments	(92)	8	(177)	1
Net unrealized loss on short-term investments	(16)	(375)	(16)	(378)
Comprehensive income	$ 2,452	$ 5,628	$ 903	$ 3,735

See accompanying notes to condensed consolidated financial statements.

DOT HILL SYSTEMS CORP. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In Thousands)

(Unaudited)

	Six Months Ended June 30,	
	2003	**2004**
Cash Flows From Operating Activities:		
Net income	$ 1,096	$ 4,112
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,042	2,366
Write-off of in-process research and development		4,700
Non-cash settlement of restructuring charges		(391)
Loss on disposal of property and equipment	27	
Provision for doubtful accounts and note receivable	74	145
Stock-based compensation expense	10	10
(Gain) loss on sale of short-term investments	1	(20)
Changes in operating assets and liabilities (net of effects of Chaparral acquisition):		
Accounts receivable	(8,573)	(22,187)
Inventories	3,464	(408)
Prepaid expenses and other assets	(1,946)	517
Accounts payable	10,141	14,170
Accrued compensation and expenses	1,790	(190)
Deferred revenue	252	(296)
Income taxes payable	(78)	14
Restructuring accrual	(283)	(209)
Other liabilities	(16)	773
Net cash provided by operating activities	7,001	3,106
Cash Flows From Investing Activities:		
Purchases of property and equipment	(1,359)	(4,228)
Sales of short-term investments	1,530	21,999
Purchases of short-term investments	(11,592)	(47,989)
Cash paid in Chaparral acquisition, net of cash acquired		(65,383)
Net cash used in investing activities	(11,421)	(95,601)
Cash Flows From Financing Activities:		
Decrease in restricted cash and investments	2,000	
Proceeds from bank and other borrowings	22,848	13,660

Payments on bank and other borrowings	(27,409)	(13,697)
Proceeds from issuance of common stock and stock warrants, net of issuance costs	16,543	
Proceeds from exercise of stock options and warrants	958	661
Proceeds from sale of stock to employees	348	
Dividends paid to preferred stockholders	(141)	
Net cash provided by financing activities	15,147	624
Effect of Exchange Rate Changes on Cash	(177)	1
Net Increase (Decrease) in Cash and Cash Equivalents	10,550	(91,870)
Cash and Cash Equivalents, beginning of period	10,082	138,563
Cash and Cash Equivalents, end of period	$ 20,632	$ 46,693
Supplemental Disclosures of Cash Flow Information:		
Cash paid for interest	$ 61	$ 46
Cash paid for income taxes	$ 95	$ 65

See accompanying notes to condensed consolidated financial statements.

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. (Dot Hill , we , our or us) pursuant to the rules and regulations of the Securities and Exchange Commission (the SEC). Accordingly, they do not include all of the information and disclosures required by accounting principles generally accepted in the United States of America 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. Certain reclassifications have been made to the prior year financial statements to conform to the current year financial statement presentation. 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, 2003. Operating results for the three and six months ended June 30, 2004 are not necessarily indicative of the results that may be expected for the year ending December 31, 2004.

The preparation of our financial statements in conformity with accounting principles generally accepted in the United States of America 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 under different assumptions and conditions.

2. Recent Accounting Pronouncements

The Emerging Issues Task Force (EITF) deliberated Issue 03-01, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments. The Issue was intended to address the meaning of other-than-temporary impairment and its application to certain investments held at cost. A consensus was reached regarding disclosure requirements concerning unrealized losses on available-for-sale debt and equity securities accounted for under Statement of Financial Accounting Standards (SFAS) No. 115, Accounting for Certain Investments in Debt and Equity Securities and SFAS No. 124 Accounting for Certain Investments Held for Not-for-Profit Organizations. The guidance for evaluating whether an investment is other-than-temporarily impaired should be applied in reporting periods beginning after June 15, 2004. The disclosures are effective in annual financial statements for fiscal years ending after December 31, 2003, for investments accounted for under SFAS Nos. 115 and 124. For all other investments within the scope of this EITF, the disclosures are effective for fiscal years ending after June 15, 2004. Additional disclosures for cost method investments are effective for fiscal years ending after June 15, 2004. We are currently evaluating the effect of this pronouncement on our financial statements.

3. Acquisition

In accordance with SFAS No. 141, *Business Combinations* (SFAS No. 141), Dot Hill allocates the purchase price of its acquisitions to the tangible assets, liabilities and intangible assets acquired, including in-process research and development (IPR&D), based on their estimated fair values. The excess purchase price over those fair values is recorded as goodwill. The fair value assigned to intangible assets acquired is based on valuations prepared by independent third party appraisal firms using estimates and assumptions provided by management. Goodwill and purchased intangible assets with indefinite useful lives are not amortized but will be reviewed at least annually for impairment. Purchased intangible assets with finite lives are amortized on a straight-line basis over their respective useful lives.

On February 23, 2004, we completed the acquisition of Chaparral Network Storage, Inc. (Chaparral); a privately held developer of specialized storage appliances as well as high-performance, mid-range RAID controllers and data routers, pursuant to the Agreement and Plan of Merger between Dot Hill and Chaparral dated February 23 2004. The aggregate purchase price was $62 million in cash, the assumption of approximately $4.1 million related to obligations due certain employees covered by change in control agreements, direct transaction costs of approximately $.8 million and approximately $.7 million in accrued integration costs. The acquisition of

Chaparral is expected to enable Dot Hill to increase the amount of proprietary technology within its storage systems, broaden its product line and diversify its customer base.

The results of operations of Chaparral have been included in our results prospectively from February 23, 2004.

Based on our estimates and assumptions, the total purchase price of approximately $67.6 million has been allocated as follows (in thousands):

Assets:		
Cash and cash equivalents	$	2,202
Accounts receivable		1,769
Inventories		955
Prepaid expenses and other		147
Property and equipment		648
Goodwill		56,768
Intangible assets:		
Developed technology		2,600
Core technology		5,000
Customer relationships		2,500
Backlog		100
In-process research and development		4,700
Total assets		77,389
Liabilities:		
Current liabilities		2,859
Convertible debt and accrued interest		6,945
Total liabilities		9,804
Net assets acquired	$	67,585

No changes were made to the original purchase price allocation during the three months ended June 30, 2004.

Of the acquired intangible assets, $4.7 million pertained to in-process research and development (IPR&D) and was written off by our recognition of a charge to operations on the acquisition date. The remaining acquired intangible are being amortized using the straight-line method over their estimated useful lives as follows: developed and core technology, 2.5 to 4.5 years; customer relationships, 3.5 years, and backlog, 8 months. The goodwill recorded in this transaction has been allocated to our SANnet family operating segment. None of this goodwill will be deductible for tax purposes.

IPR&D recorded in connection with the acquisition of Chaparral represents the present value of the estimated after-tax cash flows expected to be generated by purchased technologies that, as of the acquisition dates, had not yet reached technological feasibility. The classification of the technology as complete or under development was made in accordance with the guidelines of SFAS No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*, and Financial Accounting Standards Board Interpretation No. 4, *Applicability of SFAS No. 2 to Business Combinations Accounted for by the Purchase Method*. In addition, the Fair Value, as defined below, of the IPR&D projects was determined in accordance with SFAS No. 141, and SFAS No. 142, *Goodwill and Other Intangible Assets*.

Chaparral s IPR&D projects were valued through the application of discounted cash flow analyses, taking into account many key characteristics of Chaparral as well as its future prospects, the rate technology changes in the industry, product life cycles, risks specific to each project, and various projects stage of completion. Stage of completion was estimated by considering the time, cost, and complexity of tasks completed prior to the acquisition verses the project s overall expected cost, effort and risks required for achieving technological feasibility. In the application of the discounted cash flow analyses, Chaparral s management provided distinct revenue forecasts for each IPR&D project. The projections were based on the expected date of market introduction, an assessment of customer needs, the expected pricing and cost structure of the related product(s), product life cycles, and the importance of the existing technology relative to the in-process technology. In addition, the costs expected to complete each project were added to the operating expenses to calculate the operating income for each IPR&D project. As certain other assets contribute to the cash flow attributable to the assets being valued, returns to these other assets were calculated and deducted from the pre-tax operating income to isolate the economic benefit solely attributable to each of the in-process technologies. The present value of IPR&D was calculated based on discount rates recommended by the American Institute of Certified Public Accountants IPR&D Practice Aid, which depend on the stage of completion and the additional risk associated with the completion of each of the IPR&D projects. We also considered venture capital rates of return and the weighted average cost of capital for Chaparral, which was based on a capital asset pricing model as an appropriate measure of the discount rates associated with each IPR&D project. As a result, the earnings associated with the incomplete technology were discounted at a rate of approximately 22%.

Certain of our employees are former Chaparral employees who were party to agreements with Chaparral providing for payment in the event of a change in control of Chaparral, 50% of which was payable immediately and 50% of which was payable after 18 months of service following the acquisition date. As a result of our acquisition of Chaparral, these employees were paid approximately $3.1 million in March 2004, and we assumed the obligation to make remaining aggregate cash payments of approximately $1.2 million to these employees through 2005. As of June 30, 2004, approximately $0.3 million has been paid related to these agreements and approximately $0.7 million is included in other long-term liabilities at June 30, 2004. Approximately $0.2 million will be recorded as compensation expense over the 18 month service period. During the three and six months ended June 30, 2004, we recorded compensation expense of approximately $41,000 and $54,000, respectively, relating to these agreements.

Pro Forma Results of Operations

The following pro forma results of operations present the impact on our results of operations for the three and six months ended June 30, 2004 and 2003 as if the acquisition of Chaparral had been completed as of the beginning of the period reported on. The charge of $4.7 million related to the write-off of IPR&D has been excluded from the pro forma results of operations, as it is nonrecurring in nature:

			Three Months Ended June 30,					
			2004				**2003**	
	2004 Historical		**Pro Forma**		**2003 Historical**		**Pro Forma**	
Revenues	$	69,604	$	69,604	$	48,428	$	51,301
Net income attributable to common stockholders	$	5,995	$	5,995	$	2,524	$	147
Basic income per share	$	0.14	$	0.14	$	0.08	$	
Diluted income per share	$	0.13	$	0.13	$	0.07	$	
			Six Months Ended June 30,					
			2004				**2003**	
	2004 Historical		**Pro Forma**		**2003 Historical**		**Pro Forma**	
Revenues	$	118,385	$	120,141	$	78,950	$	83,773

Net income (loss) attributable to common stockholders	$ 4,112	$ 6,838	$ 955	$ (5,319)
Basic income (loss) per share	$ 0.09	$ 0.16	$ 0.03	$ (0.18)
Diluted income (loss) per share	$ 0.09	$ 0.15	$ 0.03	$ (0.18)

4. Stock-Based Compensation

SFAS No. 123, *Accounting for Stock-Based Compensation,* encourages, but does not require, us to record compensation cost for stock-based employee compensation plans at fair value. We have chosen to continue to account for stock-based compensation using the intrinsic value method prescribed in APB Opinion No. 25, *Accounting for Stock Issued to Employees,* and related interpretations for all periods presented. Accordingly, compensation cost for stock options is measured as the excess, if any, of the fair value of our stock at the date of grant over the amount an employee must pay to acquire the stock.

Had compensation cost for our stock option awards been determined based upon the fair value at the date of grant in accordance with SFAS No. 123, our net income and basic and diluted net income per share would have been adjusted to the following amounts for the three and six months ended June 30, 2003 and 2004 (in thousands, except per share information):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	**2004**	**2003**	**2004**
Net income attributable to common stockholders as reported	$ 2,524	$ 5,995	$ 955	$ 4,112
Stock-based employee compensation expense included in reported net income attributable to common stockholders	5	5	10	10
Stock-based employee compensation expense determined under fair value based method	(530)	(924)	(1,304)	(1,874)
Pro forma net income (loss) attributable to common stockholders	$ 1,999	$ 5,076	$ (339)	$ 2,248
Basic net income (loss) per share:				
As reported	$ 0.08	$ 0.14	$ 0.03	$ 0.09
Pro forma	$ 0.06	$ 0.12	$ (0.01)	$ 0.05
Diluted net income (loss) per share:				
As reported	$ 0.07	$ 0.13	$ 0.03	$ 0.09
Pro forma	$ 0.06	$ 0.11	$ (0.01)	$ 0.05

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

	Six Months Ended June 30,	
	2003	**2004**
Risk free interest rate	2.69%	3.17%
Expected dividend yield		
Expected life	7.5 years	7.5 years

Expected volatility		84%	69%

5. Net Income Per Share

Basic net income per share is calculated by dividing net income or net income attributable to common stockholders by the weighted average number of common shares outstanding during the period. Diluted net income per share reflects the potential dilution of securities by including common stock equivalents, such as stock options, stock warrants and convertible preferred stock, 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 income per share (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2004	2003	2004
Shares used in computing basic net income per share	31,576	43,383	28,877	43,349
Dilutive effect of stock options and stock warrants	3,464	2,896	2,843	3,260
Dilutive effect of convertible preferred stock	629		1,234	
Shares used in computing diluted net income per share	35,669	46,279	32,954	46,609

For the three months ended June 30, 2003 and 2004, outstanding options to purchase 290,437 and 1,761,841 shares of our common stock, respectively were not included in the calculation of diluted net income per share because their effect was antidilutive.

For the six months ended June 30, 2003 and 2004, outstanding options to purchase 480,691 and 1,697,562 shares of our common stock, respectively, were not included in the calculation of diluted net income per share because their effect was antidilutive.

6. Short-Term Investments

The following table summarizes our short-term investments as of June 30, 2004 (in thousands):

	Cost	Net Unrealized Losses	Net Unrealized Gains	Fair Value
U.S. Government securities	$ 39,112	$ (364)	1	$ 38,749
Municipal securities and private debt	7,400			7,400
Commercial paper	32,455	(41)	51	32,465
	$ 78,967	$ (405)	$ 52	$ 78,614

The cost and fair value of short-term investments at June 30, 2004 by contractual maturity are shown below (in thousands). Expected maturities will differ from contractual maturities because the issuers of the securities may have the right to prepay obligations without prepayment penalties.

	Cost	Fair Value
Due in one year or less	$ 53,860	$ 53,599

Due after one year through five years	17,708	17,615
Due after five years through ten years		
Due after ten years	7,399	7,400
	$ 78,967	$ 78,614

7. Inventories

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

	December 31, 2003	June 30, 2004
Purchased parts and materials	$ 1,706	$ 1,761
Work-in-process	24	98
Finished goods	1,428	2,662
	$ 3,158	$ 4,521

8. Credit Facilities

We had an agreement with Wells Fargo Bank, National Association, which allowed us to borrow up to $15.0 million under a revolving line of credit that expired May 1, 2004. As of June 30, 2004, there was no balance outstanding under this line of credit. We are presently in negotiations to replace this line of credit.

In connection with the acquisition of Chaparral, we assumed a $6 million promissory note, or the Note, payable to a third party manufacturer utilized by Chaparral. The Note incurs interest at an annual rate of 8% with principal and accrued interest payable on May 15, 2005 and 2008, and is secured by rights to certain technology developed by Chaparral. Total purchases by us from the third party manufacturer were $0.3 and $0.5 million for the three and six months ended June 30, 2004, respectively. During July 2004, we communicated to the holder of the Note our intent to repay the Note in full during the third quarter of fiscal year 2004.

The Note has the following scheduled principal payments due for the years ending December 31 (in thousands):

2004	$	
2005		3,000
2006		
2007		
2008		3,000
	$	6,000

9. Goodwill and Intangible Assets

Under the provisions of SFAS No. 142, 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 intangible assets are considered to have finite lives and are being amortized in accordance with this statement. All of our goodwill has been allocated to our SANnet family-operating segment.

Intangible assets that are subject to amortization under SFAS No. 142 consist of the following as of June 30, 2004 (in thousands):

	Gross	Accumulated Amortization	Net
Core technology	$ 5,000	$ (370)	$ 4,630
Developed technology	2,600	(347)	2,253
Customer relationships	2,500	(238)	2,262
Backlog	100	(50)	50

Total other intangible assets	$	10,200	$	(1,005)	$	9,195

Estimated future amortization expense related to intangible assets at June 30, 2004 is as follows (in thousands):

Years ending December 31,		
2004 (remaining 6 months)	$	1,483
2005		2,866
2006		2,518
2007		1,588
2008		740
Total	$	9,195

10. 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. The changes in Dot Hill s aggregate product warranty liabilities are as follows for the three and six months ended June 30, 2004 (in thousands):

	Three Months Ended June 30, 2004	Six Months Ended June 30, 2004
Balance, beginning of period	$ 847	$ 262
Current period accrual	72	852
Amounts charged to accrual		(195)
Balance, end of period	$ 919	$ 919

11. Restructurings

In March 2001, we announced plans to reduce our full-time workforce by up to 30% and reduce other expenses in response to delays in customer orders, lower than expected revenues and slowing global market conditions. The cost reduction actions were designed to reduce our breakeven point in light of an economic downturn. The cost reductions resulted in a charge for employee severance, lease termination costs and other office closure expenses related to the consolidation of excess facilities. We recorded restructuring expenses in the first quarter of 2001 of approximately $2.9 million, as follows (in thousands):

Employee termination costs	$ 1,271
Impairment of property and equipment	1,007
Facility closures and related costs	637
Professional fees and other	20
Total	$ 2,935

In June 2001, we announced plans to further reduce our full-time workforce by up to 17% and reduce other expenses in response to a continuing economic downturn and overall decrease in revenue. As a result of these additional restructuring actions, we recorded additional restructuring expenses during the second quarter of 2001 of approximately $1.5 million, as follows (in thousands):

Employee termination costs	$ 259
Impairment of property and equipment	350
Facility closures and related costs	861
Total	$ 1,470

Employee termination costs consist primarily of severance payments for 180 employees. Impairment of property and equipment consists of the write-down of certain fixed assets associated with facility closures. The facility closures and related costs consist of lease termination costs for five sales offices and closure of the New York City office.

During the fourth quarter of 2001, we increased our March 2001 related restructuring accrual by approximately $0.2 million and our June 2001 Restructuring accrual by approximately $0.3 million due to the continuing deterioration of various real estate markets and the inability to sublet excess space in our Carlsbad and New York City facilities.

During the fourth quarter of 2002, we again increased our March 2001 related restructuring accrual by approximately $0.7 million and our June 2001 related restructuring accrual by approximately $0.9 million to reflect additional deterioration of real estate markets in Carlsbad and New York City, as well as the effects of lease buyouts negotiated on several facilities and a sublease arrangement reached on another facility.

The following is a summary of restructuring activity recorded during the period from January 1, 2004 to June 30, 2004 (in thousands):

March 2001 Restructuring

	Accrued Restructuring Expenses at December 31, 2003	Additional Restructuring Expenses (Settlement)	Current Amounts Utilized	Accrued Restructuring Expenses at June 30, 2004
Employee termination costs	$	$	$	$
Impairment of property and equipment				
Facility closures and related costs	401	(71)	(86)	244
Professional fees and other				
Total	$ 401	$ (71)	$ (86)	$ 244

June 2001 Restructuring

	Accrued Restructuring Expenses at December 31, 2003	Additional Restructuring Expenses (Settlement)	Current Amounts Utilized	Accrued Restructuring Expenses at June 30, 2004
Employee termination costs	$	$	$	$
Impairment of property and equipment				
Facility closures and related costs	523	(320)	(123)	80
	$ 523	$ (320)	$ (123)	$ 80

In June 2004, we negotiated an exit from our lease of the 10th floor of our former New York City office thereby eliminating our related rent exposure. Accordingly, during the three months ended June 30, 2004, we recorded a reduction of approximately $0.5 million to our restructuring reserve previously established in connection with the closure of our New York City office. Additionally, we have evaluated certain factors pertaining to our remaining sublease tenant; accordingly, during the three months ended June 30, 2004, we recorded an additional restructuring accrual of approximately $0.1 million. We are not aware of any further unresolved issues or additional liabilities that may result in a significant adjustment to restructuring expenses accrued as of June 30, 2004.

12. Stockholders Equity

In May 2004, our shareholders ratified an amendment to the Company s 2000 Amended and Restated Employee Stock Purchase Plan, as amended, to increase the aggregate number of shares of common stock authorized for issuance under the plan by 2,000,000 shares.

During the three and six months ended June 30, 2004, we received proceeds of approximately $0.2 million from the exercise of warrants to purchase 67,692 shares of our common stock. As of June 30, 2004, there were outstanding warrants to purchase 1,996,849 shares of our common stock. The warrants have exercise prices ranging from $2.97 to $4.50 per share and expire at various dates through March 14, 2008.

13. Income Taxes

For the three and six months ended June 30, 2004, our effective income tax rate was 2%. The effective income tax rate is based upon the expected income for the year and the expected composition of that income in different tax jurisdictions. For the three and six months ended June 30, 2004, the effective tax rate varied from the statutory tax rate primarily because of the expected use of our net operating loss carryforwards, for which a valuation allowance has previously been recorded.

We have federal and state net operating loss carryforwards as of December 31, 2003 of approximately $80.7 million and $53.8 million, respectively. These net operating loss carryforwards are available to offset taxable income generated in 2004 and future years, and such federal and state amounts will begin to expire in the tax years ending 2009 and 2004, respectively. In addition, we have federal tax credit carryforwards as of December 31, 2003 of approximately $2.4 million of which $0.2 million can be carried forward indefinitely to offset future taxable income, and the remaining $2.2 million will begin to expire in 2008. We also have state tax credit carryforwards as of December 31, 2003 of approximately $2.3 million, of which $2.1 million can be carried forward indefinitely to offset future taxable income, and the remaining $0.2 million will begin to expire in 2006. Pursuant to current tax regulations, the annual use of certain of our federal and state net operating loss and tax credit carryforwards is limited as a result of a cumulative change in ownership of more than 50%. Future additional changes in ownership may further limit the use of such amounts.

As a result of 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.

14. Commitments and Contingencies

Operating Leases

In connection with the acquisition of Chaparral, we assumed the operating lease for Chaparral s Longmont, Colorado facility, which expires in July 2007. Lease payments are approximately $29,000 per month through June 2004. Effective July 1, 2004, pursuant to a contractual agreement between Chaparral and the landlord, both parties agree to negotiate in good faith a new lease rate reflecting the current market and economic conditions in the surrounding Boulder, Colorado area. We are currently in negotiations with our landlord the final outcome of which has not yet been determined.

Purchase Commitments

We enter into firm purchase commitments with suppliers and third party manufacturers for our estimated inventory requirements for succeeding months. The Company had purchase commitments for approximately $0.5 million of inventory as of June 30, 2004.

Legal Matters

On October 17, 2003, Crossroads Systems, or Crossroads, filed a lawsuit against us 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. We were served with the lawsuit on October 27, 2003. Chaparral was added as a party to the lawsuit in March 2004. The patents involve storage routers and methods for providing virtual local storage. Patent Number 5,941,972 involves the interface of SCSI storage devices and the Fiber Channel protocol and Patent Number 6,425,035 involves the interface of any one-transport medium and a second transport medium. We believe that we have meritorious defenses to Crossroads claims and are in the process of vigorously defending against them. We believe that the outcome will not have a material adverse effect on our financial condition or operating results. However, we expect to incur significant legal expenses in connection with this litigation. These defense costs, and other expenses related to this litigation, will be expensed as incurred and will negatively affect our operating results.

In addition to the action discussed above, we are subject to various legal proceedings and claims, asserted or unasserted, which arise from time to time in the ordinary course of business. The outcome of such claims against us cannot be predicted with certainty. We believe that such litigation and claims will not have a material adverse effect on our financial condition or operating results.

15. 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 the 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.

Sales to our largest channel partner accounted for approximately 85% and 87% of our net revenue for the three months ended June 30, 2003 and 2004 and 81% and 86% for the six months ended June 30, 2003 and 2004.

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

	SANnet Family	Legacy and Other	Services	Total
Three months ended:				
June 30, 2003:				
Net revenue	$ 46,174	$ 1,258	$ 996	$ 48,428
Gross profit (loss)	$ 11,213	$ (1,648)	$ 448	$ 10,013
June 30, 2004:				
Net revenue	$ 66,155	$ 2,583	$ 866	$ 69,604
Gross profit (loss)	$ 17,741	$ (655)	$ 31	$ 17,117

Six months ended:				
June 30, 2003:				
Net revenue	$ 74,103	$ 3,117	$ 1,730	$ 78,950
Gross profit (loss)	$ 17,975	$ (3,137)	$ 712	$ 15,550
June 30, 2004:				
Net revenue	$ 112,021	$ 4,960	$ 1,404	$ 118,385
Gross profit (loss)	$ 32,326	$ (1,736)	$ 30	$ 30,620

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, 2003	$ 207,686	$ 6,553	$ 4,204	$ 218,443
June 30, 2004	$ 235,574	$ 7,855	$ 3,058	$ 246,487

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	**2004**	**2003**	**2004**
Net revenue:				
United States	$ 45,725	$ 65,972	$ 73,868	$ 112,004
Europe	1,694	2,001	3,324	3,338
Asia	1,009	1,631	1,758	3,043
	$ 48,428	$ 69,604	$ 78,950	$ 118,385
Operating income (loss):				
United States	$ 1,816	$ 5,596	$ 691	$ 3,290
Europe	59	16	(165)	(316)
Asia	296	235	244	376
	$ 2,171	$ 5,847	$ 770	$ 3,350

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

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 report, 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, and are subject to the safe harbor created by these sections. Because such forward-looking statements include 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 under the caption Certain Risk Factors

Related to the Company s Business, and elsewhere in this quarterly report on Form 10-Q. 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, 2003.

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 broad range of products, from medium capacity stand-alone storage units to complete turn-key, multi-terabyte storage area networks, provides end-users with a cost-effective means of addressing increasing storage demands without sacrificing performance.

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. In May 2002, we entered into a three-year OEM agreement with Sun Microsystems, or Sun, to provide our storage hardware and software products for private label sales by Sun. We have been shipping our products to Sun for resale to Sun s customers since October 2002. We have continued to develop new products primarily for resale by Sun, such as our SANnet II FC, which began shipping to Sun in March 2003 and our SANnet II SATA product which began shipping in June 2004. We are discussing with Sun the extent and timing of additional new product shipments. In January 2004, our existing three-year OEM partner agreement with Sun, first announced in May 2002, was extended. The agreement will now continue through May 22, 2007, a two-year extension to the original agreement subject to the terms of the agreement including early termination provisions. We intend to continue expanding our non-OEM sales channels through SIs and VARs in order to decrease our revenue concentration with OEMs.

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

We derive revenue primarily from sales of our SANnet II family of products. In prior periods, we derived a significant portion of our revenue from sales of our legacy products and SANnet I family of products. Except for one OEM customer to whom we continue to sell our SANnet I products, we have transitioned all customers to our SANnet II products.

We derive a portion of our revenue from services associated with the maintenance service we provide for our installed products. In May 2003, we entered into a services agreement with Anacomp, Inc. to provide all maintenance, warranty and non-warranty services for our SANnet I and certain legacy products.

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 and expenditures for administrative facilities. Restructuring expenses consist primarily of employee severance, lease termination costs and other office closure expenses related to the consolidation of excess facilities.

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 interest expense primarily relates to a $6.0 million note payable that we assumed in connection with our acquisition of Chaparral described below.

In August 1999, Box Hill Systems Corp. merged with Artecon, Inc. and we changed our name to Dot Hill Systems Corp. We reincorporated in Delaware in 2001. Our headquarters is located in Carlsbad, California, and we maintain international offices in Germany, Japan, the Netherlands, Singapore and the United Kingdom.

On February 23, 2004, we completed the acquisition of Chaparral Network Storage, Inc., a privately held developer of specialized storage appliances as well as high-performance, mid-range RAID controllers and data routers. The total transaction cost of approximately $67.6 million consisted of a payment of approximately $62 million in cash, the assumption of approximately $4.1 million related to obligations due certain employee covered by change in control agreements, approximately $0.8 million of direct transaction costs and approximately $0.7 million of accrued integration costs. The acquisition of Chaparral is expected to enable Dot Hill to increase the amount of proprietary technology within its storage systems, broaden its product line and diversify its customer base.

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, intangible assets valuation, income taxes, including deferred income tax asset valuation, 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 the following critical accounting policies affect our more significant estimates and assumptions used in the preparation of our consolidated financial statements.

Revenue Recognition

We recognize revenue for non-software 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. 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 twelve months. Revenue from installation, training and consulting is recognized as the services are performed.

For software sales, we apply Statement of Position No. 97-2, *Software Revenue Recognition,* whereby revenue is recognized from software licenses at the time the product is delivered, provided there are no significant obligations related to the sale, the resulting receivable is deemed collectible and there is vendor-specific objective evidence supporting the value of the separate contract elements. For arrangements with multiple elements, we allocate revenue to each element using the residual method based on vendor specific objective evidence of the undelivered items. A portion of the arrangement fee equal to the fair value of the undelivered elements, typically software maintenance contracts, is deferred and recognized ratably over the contract term, generally twelve months. Vendor specific objective evidence is based on the price charged when the element is sold separately. A typical arrangement includes a software-licensing fee and maintenance agreement.

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 SFAS No. 142. 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 loss 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

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. We maintain a valuation allowance against the deferred tax asset due to uncertainty regarding the future realization based on historical taxable income, projected future taxable income, and the expected timing of the reversals of existing temporary differences. If we operate at a loss or are unable to generate sufficient future taxable income, we could be required to proportionally increase the valuation allowance against our deferred tax assets, which would result in a substantial increase to our effective tax rate and could result in a material adverse impact on our operating results. Conversely, if we continue to generate profits and ultimately determine that it is more likely than not that all of the remaining deferred tax assets will be utilized to offset future taxable income, the valuation allowance of a portion thereof could be eliminated.

At June 30, 2004, our net deferred tax asset is approximately $58 million (including approximately $22 million net deferred tax asset acquired in the Chaparral transaction), and we have provided for a valuation allowance against the entire net deferred tax asset. An elimination of the valuation allowance as of June 30, 2004 would have resulted in a decrease to goodwill to the extent of our acquired net deferred tax asset, an increase to equity for net operating losses arising from stock option deductions, with the remaining deferred tax asset decreasing income tax expense, resulting in a one-time, non-cash increase in earnings.

We are continually assessing the valuation allowance related to our deferred tax assets. We will continue weighing various factors throughout the year to assess the need for any valuation allowance. Recoverability of the deferred tax assets is dependent on continued profitability from operations. Should our level of profitability continue as expected, we would likely remove the entire valuation allowance in 2005. Although we would experience a substantial temporary decrease to our effective tax rate in the period in which we remove the valuation allowance, our effective tax rate in subsequent periods is likely to more closely resemble the applicable federal and state statutory tax rates.

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,	
	2004	2003	2004	2003
Net revenue:	100.0%	100.0%	100.0%	100.0%
Cost of goods sold	75.4	79.3	74.1	80.3
Gross profit	24.6	20.7	25.9	19.7
Operating expenses:				
Sales and marketing	6.6	7.0	7.8	8.6
Research and development	6.8	5.9	7.7	6.2
General and administrative	3.3	3.3	3.9	3.9
Restructuring, net	(0.5)		(0.4)	
In-process research and development			4.0	
Total operating expenses	16.2	16.2	23.0	18.7
Operating income	8.4	4.5	2.8	1.0
Net income	8.6%	5.3%	3.5%	1.4%

Three Months Ended June 30, 2004 Compared to Three Months Ended June 30, 2003

Net Revenue

Net revenue increased $21.2 million, or 43.7%, to $69.6 million for the three months ended June 30, 2004 from $48.4 million for the three months ended June 30, 2003. The increase in net revenue was primarily attributable to increased orders for our product from our channel partner, Sun, which accounted for 87% or $60.8 million of our net revenue for the three months ended June 30, 2004. Total fibre channel units shipped were 3,298 for the three months ended June 30, 2004 compared to 2,429 fibre channel units shipped for the three months ended June 30, 2003. Small computer systems interface, or SCSI, units shipped were 4,160 for the three months ended June 30, 2004 compared to 2,134 SCSI units for the three months ended June 30, 2003. In March 2004, we announced that our existing OEM partner agreement with Sun was expanded to include new advanced technology storage products to be designed and engineered by us to Sun s specifications. Our SANnet II SATA, or SATA, and SANnet II Blade Ultra320, or Blade, products began shipping in the second quarter of 2004. We recorded revenue of approximately

$4.2 million related to such products during the three months ended June 30, 2004. Based on initial sales, we continue to anticipate a favorable market reception for these products. Although we remain unable to determine the precise impact that such product sales will have on revenue for future quarters, we believe that such product sales will be incremental to our 2004 revenue and will not result in decreased sales of our other products. The increase in revenue from sales to Sun for the quarter ended June 30, 2004 also reflects the positive impact of seasonality associated with Sun s fiscal year-end. Non-Sun revenue was $8.8 million for the three months ended June 30, 2004 compared to non-Sun revenue of $7.3 million for the three months ended June 30, 2003.

Cost of Goods Sold

Cost of goods sold increased $14.1 million, or 36.6%, to $52.5 million for the three months ended June 30, 2004 from $38.4 million for the three months ended June 30, 2003. As a percentage of net revenue, cost of goods sold decreased to 75.4% for the three months ended June 30, 2004 from 79.3% for the three months ended June 30, 2003. As described above, the increase in the dollar amount of cost of goods sold was attributable to greater volume of product sales during the three months ended June 30, 2004 compared to the quarter ended June 30, 2003. This increase also reflects the incremental increase to costs of good sold related to the introduction during the three months ended June 30, 2004 of our SATA and Blade products. The decrease in cost of goods sold, as a percentage of our net revenue is primarily attributable to cost reductions related to production materials achieved during the three months ended June 30, 2004 when compared to the three months ended June 30, 2003. Such cost reductions primarily reflect the decreasing price of component parts due to competitive market factors; predetermined contractual cost reductions and the transition from soft to hard tooling compared to the three months ended June 30, 2003. The decrease in cost of good sold as a percentage of revenue also reflects start up costs incurred during the three months ended June 30, 2003 to outsource the manufacturing of certain fibre channel products. We did not incur similar start up costs for the three months ended June 30, 2004.

Gross Profit

Gross profit increased $7.1 million, or 70.9%, to $17.1 million for the three months ended June 30, 2004 from $10.0 million for the three months ended June 30, 2003. As a percentage of net revenue, gross profit increased to 24.6% for the three months ended June 30, 2004 from 20.7% for the three months ended June 30, 2003. The increase in the dollar amount of gross profit was attributable to greater volume of product sales during the three months ended June 30, 2004 compared to the three months ended June 30, 2003. The increase in gross profit as a percentage of our net revenue for the three months ended June 30, 2004 when compared to the three months ended June 30, 2003 reflects cost reductions related to production materials achieved during the three months ended June 30, 2004. Such cost reductions primarily reflect the decreasing price of component parts due to competitive market factors; predetermined contractual cost reductions and the transition from soft to hard tooling compared to the three months ended June 30, 2003. Sequentially, our gross profit margin for the three months ended June 30, 2004 was negatively impacted by the introduction of our SATA and Blade products. The cost associated with the introduction of these products such as expedite charges, soft tooling, domestic production combined with the relatively low start-up volumes resulted in a lower gross margin compared to three months ended March 31, 2004. We anticipate that margins related to these product will improve over the next several quarters as we achieve volume purchases and planned cost reductions. Gross profit margin for the three months ended June 30, 2004 was also negatively impacted by $0.6 million of amortization expense related to intangible assets acquired in connection with the acquisition of Chaparral in February 2004 and a charge of $0.4 million for inventory write-offs related to discontinued SANnet II NAS inventory.

Sales and Marketing Expenses

Sales and marketing expenses increased $1.2 million, or 36.3%, to $4.6 million for the three months ended June 30, 2004 from $3.4 million for the three months ended June 30, 2003. As a percentage of net revenue, sales and marketing expenses decreased to 6.6% for the three months ended June 30, 2004 from 7.0% for the three months ended June 30, 2003 primarily reflecting the increase in revenue described above. The increase in the dollar amount of sales and marketing related expenses is primarily attributable to increased salaries and related expenses of approximately $0.5 million and increased travel and lodging expense of $0.2 million compared to the three months ended June 30, 2003. The increase in sales and marketing expense also reflects $0.2 million from the amortization of the customer relationship intangible asset acquired in connection with the Chaparral transaction. Marketing expenses also increased approximately $0.1 million for the three months ended June 30, 2004 compared to the three months ended June 30, 2003 due to our participation in various tradeshows during the past three months. The remaining increase in sales and marketing expenses for the three months ended June 30, 2004 relates to an increase in a variety of sales and marketing activities none of which are significant on an individual basis.

Research and Development Expenses

Research and development expenses increased $1.9 million, or 66.6%, to $4.7 million for the three months ended June 30, 2004 from $2.8 million for the three months ended June 30, 2003. As a percentage of net revenue, research and development expenses increased to 6.8% for the three months ended June 30, 2004 from 5.9% for the three months ended June 30, 2003. The dollar and percentage increase in research and development expense primarily reflects an increase in salary and related expenses attributable to an increase in the number of our full-time direct engineering team members compared to the quarter ended June 30, 2003. During the quarter ended June 30, 2003, we averaged approximately 51 full-time direct engineering employees compared to an average that increased to approximately 100 full-time direct engineering employees for the three months ended June 30, 2004. The increase includes the addition of approximately 20 employees to our corporate headquarters in Carlsbad, California resulting in an increase in salary and related expenses of approximately $0.5 million compared to the three months ended June 30, 2003. The establishment of our Longmont Technology Center in connection with the acquisition of Chaparral resulted in the addition of approximately 30 new direct engineering employees. Salary and related expenses and expenditures related to on-going research and development activities conducted at Longmont were approximately $1.1 million for the three months ended June 30, 2004. There were no comparable expenses for the three months ended June 30, 2003. The remaining increase in the dollar amount of research and development primarily reflects the development effort on our new SATA product completed during the three months ended June 30, 2004. Depending on the timing of certain activities, we anticipate that research and development expense for the remaining quarters of the year ending December 31, 2004 will likely exceed research and development expenditures incurred during the quarter ended June 30, 2004.

General and Administrative Expenses

General and administrative expenses increased $0.7 million, or 43.1%, to $2.3 million for the three months ended June 30, 2004 from $1.6 million for the three months ended June 30, 2003. As a percentage of net revenue, general and administrative expenses were 3.3% for both the three months ended June 30, 2004 and 2003. The increase in the dollar amount of general and administrative expense during the three months ended June 30, 2004 is primarily due to an increase in salary and related expenses of $0.3 million reflecting the increase in general and administrative employees. The remaining increase of $0.3 million is attributable to an increase in professional services and legal expenses. General and administrative expenses are expected to increase over the next several quarters reflecting the additional cost of compliance with the Sarbanes-Oxley Act of 2002.

Restructuring expenses

In June 2004, we negotiated an exit from our lease of the 10^{th} floor of our former New York City office thereby eliminating our related rent exposure. Accordingly, during the three months ended June 30, 2004, we recorded a reduction of approximately $0.5 million to our restructuring reserve previously established in connection with the closure of our New York City office. Additionally, we have evaluated certain factors pertaining to our remaining sublease tenant; accordingly, during the three months ended June 30, 2004, we recorded an additional restructuring accrual of approximately $0.1 million. We are not aware of any further unresolved issues or additional liabilities that may result in a significant adjustment to restructuring expenses accrued as of June 30, 2004.

Other Income

Other income decreased by $0.1 million to $0.3 million for the three months ended June 30, 2004 from $0.4 million for the three months ended June 30, 2003. The decrease was primarily attributable to an increase in interest expense of $0.1 million related to the $6 million note payable assumed in our acquisition of Chaparral, $0.3 million in losses on foreign currency transactions, off-set by an increase in interest income of $0.3 million as a result of our increased cash, cash equivalents and short-term investments balances.

Income Taxes

For the three months ended June 30, 2004, our effective income tax rate was 2%. Our effective income tax rate is based upon the expected income for the year and the expected composition of that income in different countries. For the three months ended June 30, 2004, the effective tax rate varied from the statutory tax rate primarily because of the expected use of our net operating loss carryforwards for which a valuation allowance has previously been recorded.

Six Months Ended June 30, 2004 Compared to Six Months Ended June 30, 2003

Net Revenue

Net revenue increased $39.4 million, or 50%, to $118.4 million for the six months ended June 30, 2004 from $79.0 million for the six months ended June 30, 2003. The increase in net revenue was primarily attributable to increased orders for our product from our channel partner, Sun, which accounted for 86% or $102.1 million of our net revenue for the six months ended June 30, 2004. Total fibre channel units shipped were 5,569 for the six months ended June 30, 2004 compared to 3,124 fibre channel units shipped for the six months ended June 30, 2003. Small computer systems interface, or SCSI, units shipped were 6,937 for the six months ended June 30, 2004 compared to 4,533 SCSI units for the six months ended June 30, 2003. In March 2004, we announced that our existing OEM partner agreement with Sun was expanded to include new advanced technology storage products to be designed and engineered by us to Sun s specifications. Our SANnet II SATA, or SATA, and SANnet II Blade Ultra320, or Blade products began shipping in the second quarter of 2004. We recorded revenue of approximately $4.7 million related to such products during the six months ended June 30, 2004. Based on initial sales, we continue to anticipate a favorable market reception for these products. Although we remain unable to determine the precise impact that such product sales will have on revenue for future quarters, we believe that such product sales will be incremental to our 2004 revenue and will not result in decreased sales of our other products. Non-Sun branded revenue was $16.3 million for the six months ended June 30, 2004 compared to non-Sun revenue of $15.0 million for the six months ended June 30, 2003.

Cost of Goods Sold

Cost of goods sold increased $24.4 million, or 38.4%, to $87.8 million for the six months ended June 30, 2004 from $63.4 million for the six months ended June 30, 2003. As a percentage of net revenue, cost of goods sold decreased to 74.1% for the six months ended June 30, 2004 from 80.3% for the six months ended June 30, 2003. As described above, the increase in the dollar amount of cost of goods sold was attributable to greater volume of product sales during the three months ended June 30, 2004 compared to the quarter ended June 30, 2003 and incremental cost of goods sold attributable to the introduction of our SATA and Blade products. The decrease in cost of goods sold, as a percentage of our net revenue was primarily attributable to cost reductions related to production materials achieved during the six months ended June 30, 2004. Such cost reductions primarily reflect the decreasing price of component parts due to competitive market factors; predetermined contractual cost reductions and the transition from soft to hard tooling compared to the six months ended June 30, 2003. The decrease in cost of sales as a percentage of revenue also reflects costs incurred during the six months ended June 30, 2003 to outsource the manufacturing of certain fibre channel products. We did not incur similar costs for the six months ended June 30, 2004.

Gross Profit

Gross profit increased $15.1 million, or 96.9%, to $30.6 million for the six months ended June 30, 2004 from $15.6 million for the six months ended June 30, 2003. As a percentage of net revenue, gross profit increased to 25.9% for the six months ended June 30, 2004 from 19.7% for the six months ended June 30, 2003. The increase in

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the dollar amount of gross profit was attributable to greater volume of product sales during the six months ended June 30, 2004 compared to the six months ended June 30, 2003. The increase in gross profit as a percentage of our net revenue for the six months ended June 30, 2004 when compared to the six months ended June 30, 2003 reflects cost reductions related to production materials achieved during the six months ended June 30, 2004. Such cost reductions primarily reflect the decreasing price of component parts due to competitive market factors, predetermined contractual cost reductions and the transition from soft to hard tooling compared to the six months ended June 30, 2003. Sequentially, our gross profit margin for the six months ended June 30, 2004 was negatively impacted by the introduction of our SATA and Blade products. The cost associated with the introduction of these products such as expedite charges, soft tooling, domestic production combined with the relatively low start-up volumes resulted in a lower gross margin compared to three months ended March 31, 2004. We anticipate that margins related to these product will improve over the next several quarters as we achieve volume purchases and planned cost reductions. Gross profit margin for the six months ended June 30, 2004 was also negatively impacted by $0.8 million of amortization expense related to intangible assets acquired in connection with the acquisition of Chaparral in February 2004 and a charge of $0.4 million for discontinued SANnet II NAS inventory.

Sales and Marketing Expenses

Sales and marketing expenses increased $2.4 million, or 35.6%, to $9.2 million for the six months ended June 30, 2004 from $6.8 million for the six months ended June 30, 2003. As a percentage of net revenue, sales and marketing expenses decreased to 7.8% for the six months ended June 30, 2004 from 8.6% for the six months ended June 30, 2003 primarily reflecting the increase in revenue described above. The increase in the dollar amount of sales and marketing related expense compared to the six months ended June 30, 2003 is primarily attributable to increased salaries and related expenses of approximately $0.8 million, an increase in travel and lodging expense of $0.4 million and $0.3 million related to the expensing of SATA demonstration units. During the first six months of fiscal year 2004, we continued our efforts to grow our non-OEM commercial sales. We expect that such costs will remain at or slightly above spending levels for the six months ended June 30, 2004. Marketing expenses also increased approximately $0.2 million for the six months ended June 30, 2004 compared to the six months ended June 30, 2003 due to our participation in various tradeshows during the past six months. The increase in sales and marketing expense also reflects $0.2 million from the amortization of the customer relationship intangible asset acquired in connection with the acquisition of Chaparral. The remaining increase in sales and marketing expenses for the six months ended June 30, 2004 relates to an increase in a variety of sales and marketing activities none of which are significant on an individual basis.

Research and Development Expenses

Research and development expenses increased $4.2 million, or 85.9%, to $9.1 million for the six months ended June 30, 2004 from $4.9 million for the six months ended June 30, 2003. As a percentage of net revenue, research and development expenses increased to 7.7% for the six months ended June 30, 2004 from 6.2% for the six months ended June 30, 2003 primarily reflecting the increase in revenue for the six months ended June 30, 2004 as discussed above. The dollar increase in research and development expense primarily reflects an increase in salary and related expenses attributable to an increase in the number of our full-time direct engineering team members compared to the six months ended June 30, 2003. During the six months ended June 30, 2003, we averaged approximately 46 full-time direct engineering employees compared to an average of approximately 95 full-time direct engineering employees for the six months ended June 30, 2004. The increase includes the addition of approximately 20 employees to our corporate headquarters in Carlsbad, California resulting in an increase in salary and related expenses of approximately $1.2 million compared to the six months ended June 30, 2003. The establishment of our Longmont Technology Center in connection with the acquisition of Chaparral resulted in the addition of approximately 30 new direct engineering employees. Salary and related expenses for such employees and expenditures to support ongoing development effort amount to an increase of approximately $1.7 million compared to the six months ended June 30, 2003. The remaining increase in the dollar amount of research and development primarily reflects the development effort on our new Serial ATA product.

General and Administrative Expenses

General and administrative expenses increased $1.5 million, or 50.4%, to $4.6 million for the six months ended June 30, 2004 from $3.1 million for the six months ended June 30, 2003. As a percentage of net revenue, general and administrative expenses were 3.9% for the six months ended June 30, 2004 and 2003. The increase in the dollar amount of general and administrative expense during the six months ended June 30, 2004 reflects an increase of payroll-related expenses of $0.4 million related to acquisition of Chaparral personnel and an increase of $0.7 million of legal expenses compared to the six months ended June 30, 2003.

Restructuring expenses

In June 2004, we negotiated an exit from our lease of the 10th floor of our former New York City office thereby eliminating our related rent exposure. Accordingly, during the three months ended June 30, 2004, we recorded a reduction of approximately $0.5 million to our restructuring reserve previously established in connection with the closure of our New York City office. Additionally, we have evaluated certain factors pertaining to our remaining sublease tenant; accordingly, during the three months ended June 30, 2004, we recorded an additional restructuring accrual of approximately $0.1 million. We are not aware of any further unresolved issues or additional liabilities that may result in a significant adjustment to restructuring expenses accrued as of June 30, 2004.

In-Process Research and Development Charges

Projects that qualify as in-process research and development represent those that have not yet reached technological feasibility and for which no future alternative uses exist. Technological feasibility is defined as being equivalent to a beta-phase working prototype in which there is no remaining risk relating to the development. For the six months ended June 30, 2004 we recorded an IPR&D charge of $4.7 million, in connection with the acquisition of Chaparral.

Other Income

Other income (expense) increased by $0.6 million to $0.9 million for the six months ended June 30, 2004 from $0.3 million for the six months ended June 30, 2003. The increase was primarily attributable to an increase in interest income of $0.9 million as a result of our increased cash, cash equivalents and short-term investments balances offset by interest expense of $0.2 million related to the $6.0 million note payable assumed in connection with our acquisition of Chaparral.

Income Taxes

For the six months ended June 30, 2004, the effective income tax rate was 2%. The effective income tax rate is based upon the expected income for the year and the expected composition of that income in different countries. For the six months ended June 30, 2004, the effective tax rate varied from the statutory tax rate primarily because of the expected use of our net operating loss carryforwards for which a valuation allowance has previously been recorded.

Liquidity and Capital Resources

As of June 30, 2004, we had $125.3 million of cash, cash equivalents and short-term investments and working capital of $120.9 million.

During the quarter February 2004, we consummated the acquisition of Chaparral for a cash purchase price of approximately $62 million plus the assumption of approximately $4.1 million in liabilities.

For the six months ended June 30, 2004, cash provided by operating activities was $3.1 million compared to cash provided by operating activities of $7.0 million for the same period in 2003. The net cash provided by operating activities for the six months ended June 30, 2004 is primarily attributable to net income of $4.1 million increased by the add back of a non-cash charge of $4.7 million related to the write-off of in-process research and development in connection with our acquisition of Chaparral and depreciation and amortization of $2.4 million. Additionally, cash provided by operating activities reflect a $14.2 increase in accounts payable, a $0.8 million increase in other liabilities and an increase in prepaid and other assets of $0.5 million. Cash provided by operating activities decreased due to a $22.2 million increase in accounts receivable a $0.4 million increase in inventory and an aggregate decrease in accrued compensation, deferred revenue and our restructuring accrual of $0.7 million. The increase in accounts receivable reflects the payment terms for our largest OEM channel partner increasing from net 10 days to net 20 days during the first three months of fiscal year 2004 and then to net 30 days for the three months ended June 30, 2004. Although such payment terms may continue to increase, we expect to also increase our payment terms to our third party manufacturer and therefore do not anticipate further changes in cash flow as a result.

Cash used in investing activities for the six months ended June 30, 2004 was $95.6 million compared to $11.4 million for the same period in 2003. The increase in the use of cash for the six months ended June 30, 2004 compared to the six months ended June 30, 2003 is primarily attributable to the acquisition of Chaparral that reduced cash by $65.4 million net of cash acquired from Chaparral. We also made capital expenditures of $4.2 million during the six months ended June 30, 2004 primarily to support new product development and made purchases of $48.0 million in short-term investments. These decreases in our cash were offset by proceeds received from $22.0 million in sales of short-term investments during the six months ended June 30, 2004.

Cash provided by financing activities for the six months ended June 30, 2004 was $0.6 million compared to $15.1 million for the six months ended June 30, 2003. The cash provided by financing activities is attributable to proceeds of approximately $0.7 million received from exercises of stock options under the Company s 2000 Stock Incentive Plan, offset by net payments made on bank and other borrowings of $37,000.

In connection with the acquisition of Chaparral, we assumed a $6 million promissory note, or the Note, payable to a third party manufacturer utilized by Chaparral. The Note incurs interest at an annual rate of 8% with principal and accrued interest payable on May 15, 2005 and 2008 and is secured by rights to certain technology developed by Chaparral. In July 2004, we notified the holder of the Note of our intent to repay the Note and the related accrued interest of $1.1 million in full. We anticipate the repayment of the Note will occur in the third quarter of fiscal year 2004.

We had an agreement with Wells Fargo Bank, National Association, which allowed us to borrow up to $15.0 million under a revolving line of credit that expired May 1, 2004. As of June 30, 2004, there was no balance outstanding under this line of credit. We are presently in negotiations to replace this line of credit.

Our Japanese subsidiary has two lines of credit with Tokyo Mitsubishi Bank and one line of credit with National Life Finance Corporation in Japan, for borrowings of up to an aggregate of 45 million yen, or approximately $0.4 million as of June 30, 2004, at interest rates ranging from 1.7% to 1.8%. Interest is due monthly, with principal due and payable on various dates through August 2008. Borrowings are secured by the inventories of our Japanese subsidiary. As of June 30, 2004, the total amount outstanding under the three credit lines was approximately $0.2 million.

For the six months ended June 30, 2004, capital expenditures amounted to $4.2 million primarily for test equipment and assembly line tooling related to the development of our SATA and Blade products and in preparation for the manufacture of our fiber channel product line in Budapest, Hungary. Capital expenditures are expected to be approximately $1.5 million to $2.0 million per quarter for the remaining quarters of fiscal year 2004.

We presently expect cash, cash equivalents, short-term investments and cash generated from operations to be sufficient to meet our operating and capital requirements for at least the next twelve months and to enable us to pursue acquisitions or significant capital improvements. The actual amount and timing of working capital and capital expenditures that we may incur in future periods may vary significantly and will depend upon numerous factors, including the amount and timing of the receipt of revenues from continued operations, our ability to manage our relationships with third party manufacturers, the status of our relationships with key customers, partners and suppliers, the timing and extent of the introduction of new products and services and growth in personnel and operations.

Recent Accounting Pronouncements

The Emerging Issues Task Force (EITF) deliberated Issue 03-01, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments. The Issue was intended to address the meaning of other-than-temporary impairment and its application to certain investments held at cost. A consensus was reached regarding disclosure requirements concerning unrealized losses on available-for-sale debt and equity securities accounted for under SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities and SFAS No. 124 Accounting for Certain Investments Held for Not-for-Profit Organizations. The guidance for evaluating whether an investment is other-than-temporarily impaired should be applied in reporting periods beginning after June 15, 2004. The disclosures are effective in annual financial statements for fiscal years ending after December 31, 2003, for investments accounted for under SFAS Nos. 115 and 124. For all other investments within the scope of this EITF, the disclosures are effective for fiscal years ending after June 15, 2004. Additional disclosures for cost method investments are effective for fiscal years ending after June 15, 2004. We are currently evaluating the effect of this pronouncement on our financial statements.

Certain Risk Factors Related to the Company s Business

Our business, results of operations and financial condition may be materially and adversely affected due to any of the following risks. The risks described below are not the only ones we face. Additional risks we are not presently aware of or that we currently believe are immaterial may also impair our business operations. The trading price of our common stock could decline due to any of these risks. In assessing these risks, you should also refer to the other information contained or incorporated by reference in this Form 10-Q, including our financial statements and related notes.

Under our OEM agreement with Sun, Sun is not required to make minimum purchases or purchase exclusively from us, and we cannot assure you that our relationship with Sun will not be terminated or will generate significant sales.

Our business is highly dependent on our relationship with Sun. Sales to Sun accounted for 83.4% and 86.3% of our net revenue for the year ended December 31, 2003 and the six months ended June 30, 2004, respectively. Our OEM agreement with Sun had an initial term of three years and was extended in January 2004 for an additional two years through May 2007. However, there are no minimum purchase requirements or guarantees in our agreement with Sun, the agreement does not obligate Sun to purchase its storage solutions exclusively from us and Sun may cancel purchase orders submitted under the agreement at any time. Sun may terminate the entire contract prior to the contract expiration date upon the occurrence of certain events that are not remedied within a specified cure period. The decision by Sun not to renew its contract with us, to terminate the contract, to cease making purchases or to cancel purchase orders would cause our revenues to decline substantially. We cannot be certain if, when or to what extent Sun might terminate its contract with us, cancel purchase orders, cease making purchases or elect not to renew the contract upon the expiration of the initial term. We expect to receive a substantial majority of our projected net revenue for the year ended December 31, 2004 from sales of our products to Sun. We cannot assure you that we will achieve these expected sales levels. If we do not achieve the sales levels we expect to receive from Sun, our business and result of operations will be significantly harmed.

Any decline in Sun s sales could harm our business.

A substantial majority of our revenues are generated by sales to Sun, which sells our products as separate units or bundled with its servers. If Sun s storage related sales decline, our revenues will also decline and our business could be materially harmed. In addition, Sun s quarterly operating results typically fluctuate downward in the first quarter of their fiscal year when compared with the immediately preceding fourth quarter. If these fluctuations cause Sun to decrease purchases of our storage products, our results in the first quarter of Sun s fiscal years, which is our third quarter, could be harmed.

We are dependent on sales to a relatively small number of customers.

Because we intend to expand sales to channel partners, we expect to experience continued concentration in our customer base. As a result, if our relationship with any of our customers were disrupted, we would lose a significant portion of our anticipated net revenue. We cannot guarantee that our relationship with Sun or other channel partners will expand or not otherwise be disrupted. Factors that could influence our relationship with significant channel partners, including Sun, include:

our ability to maintain our products at prices that are competitive with those of other storage system suppliers;

our ability to maintain quality standards for our products sufficient to meet the expectations of our channel partners; and

our ability to produce, ship and deliver a sufficient quantity of our products in a timely manner to meet the needs of our channel partners.

None of our contracts with our existing channel partners, including Sun, contain any minimum purchasing commitments. Further, we do not expect that future contracts with channel partners, if any, will include any minimum purchasing commitments. Changes in the timing or volume of purchases by our major customers could result in lower revenue. In addition, our existing contracts do not require our channel partners to purchase our products exclusively or on a preferential basis over the products of any of our competitors. Consequently, our channel partners may sell the products of our competitors.

The loss of one or more suppliers could slow or interrupt the production and sales of our products.

Solectron, our third party manufacturer, relies on third parties to supply key components of our storage products. Many of these components are available only from limited sources in the quantities and quality we require. Solectron purchases the majority of our redundant arrays of independent disks, or RAID, controllers from Infortrend Technology, Inc., or Infortrend. Solectron may not be able to purchase the type or quantity of components from third party suppliers as needed in the future.

From time to time there is significant market demand for disk drives, RAID controllers and other components, and we may experience component shortages, selective supply allocations and increased prices of such components. In such event, we may be required to purchase our components from alternative suppliers. Even if alternative sources of supply for critical components such as disk drives and controllers become available, incorporating substitute components into our products could delay our ability to deliver our products in a timely manner. For example, we estimate that replacing Infortrend s RAID controllers with those of another supplier would involve several months of hardware and software modification, which could significantly harm our ability to meet our customers orders for our products, damage our customer relationships and result in a loss of sales.

Manufacturing disruptions could harm our business.

We rely on Solectron to manufacture substantially all of our products. If our agreement with Solectron is terminated or if Solectron does not perform its obligations under our agreement, it could take several months to establish alternative manufacturing for our products and we may not be able to fulfill our customers   orders in a timely manner. Under our OEM agreement with Sun, Sun has the right to require that we use a third party to manufacture our products. Such an external manufacturer must meet Sun   s engineering, qualification and logistics requirements. If our agreement with Solectron terminates, we may be unable to find another external manufacturer that meets Sun   s requirements.

With our increased use of third-party manufacturers, our ability to control the timing of shipments has continued and will continue to decrease. Delayed shipment could result in the deferral or cancellation of purchases of our products. Any significant deferral or cancellation of these sales would harm our results of operations in any particular quarter. Net revenue for a period may be lower than predicted if large orders forecasted for that period are delayed or are not realized, which could result in cash flow problems or a decline in our stock price.

We experienced losses in 2001 and 2002 and may continue to experience losses in the future.

In 2003, we recorded net income attributable to common shareholders of $12.0 million, however, for the years ended December 31, 2001 and 2002, we incurred net losses of $43.4 million and $34.3 million, respectively. We cannot assure you that we will be profitable in any future period. We have expended, and will continue to be required to expend, substantial funds to pursue engineering, research and development projects, enhance marketing efforts and otherwise operate our business. Our future capital requirements will depend on, and could increase substantially as a result of, many factors, including:

- our plans to maintain and enhance our engineering, research, development and product testing programs;
- the success of our manufacturing strategy;
- the success of our sales and marketing efforts;
- the extent and terms of any development, marketing or other arrangements;
- changes in economic, regulatory or competitive conditions; and
- costs of filing, prosecuting, defending and enforcing intellectual property rights.

Our available cash, cash equivalents and short-term investments as of June 30, 2004 totaled $125.3 million. We presently expect cash, cash equivalents, short-term investments and cash generated from operations to be sufficient to meet our operating and capital requirements through at least the next twelve months. However, unanticipated events, such as Sun   s failure to meet its product purchase forecast or extraordinary expenses or operating expenses in excess of our projections, may require us to raise additional funds. We may not be able to raise additional funds on commercially reasonable terms or at all. Any sales of our debt or equity securities in the future may have a substantial dilutive effect on our existing stockholders. If we are able to borrow funds, we may be required to grant liens on our assets to the provider of any source of financing or enter into operating, debt service or working capital covenants with any provider of financing that could hinder our ability to operate our business in accordance with our plans. As a result, our ability to borrow money on a secured basis may be impaired, and we may not be able to issue secured debt on commercially reasonable terms or at all.

Our quarterly operating results have fluctuated significantly in the past and are not a good indicator of future performance.

Our quarterly operating results have fluctuated significantly in the past as shown in the following table and are not a good indicator of future performance.

Quarter	Net Revenue	Net Income (Loss)
	(in millions)	
First Quarter 2001	$ 18.6	$ (28.7)
Second Quarter 2001	14.9	(5.7)
Third Quarter 2001	12.3	(3.3)
Fourth Quarter 2001	10.5	(5.7)
First Quarter 2002	10.9	(6.2)
Second Quarter 2002	11.2	(8.9)
Third Quarter 2002	8.6	(7.3)
Fourth Quarter 2002	16.3	(11.9)
First Quarter 2003	30.5	(1.5)
Second Quarter 2003	48.4	2.6
Third Quarter 2003	51.0	4.3
Fourth Quarter 2003	57.5	6.7
First Quarter 2004	48.8	(1.9)
Second Quarter 2004	69.6	6.0

In addition, the announcement of financial results that fall short of the results anticipated by the public markets could have an immediate and significant negative effect on the trading price of our common stock in any given period.

We may have difficulty predicting future operating results due to both internal and external factors affecting our business and operations, which could cause our stock price to decline.

Our operating results may vary significantly in the future depending on a number of factors, many of which are out of our control, including:

the size, timing, cancellation or rescheduling of significant orders;
the cost of litigation involving intellectual property and other issues;

product configuration, mix and quality issues;

market acceptance of our new products and product enhancements and new product announcements or introductions by our competitors;

manufacturing costs;

deferrals of customer orders in anticipation of new products or product enhancements;

changes in pricing by us or our competitors;

our ability to develop, introduce and market new products and product enhancements on a timely basis;

hardware component costs and availability, particularly with respect to hardware components obtained from Infortrend, a sole-source provider;

our success in creating brand awareness and in expanding our sales and marketing programs;

the level of competition;

potential reductions in inventories held by channel partners;

slowing sales of the products of our channel partners;

technological changes in the open systems storage market;

levels of expenditures on research, engineering and product development;

changes in our business strategies;

costs of litigation and settlements;

personnel changes; and

general economic trends and other factors.

If our customers delay or cancel orders or return products, our results of operations could be harmed.

We generally do not enter into long-term purchase contracts with customers, and customers usually have the right to extend or delay shipment of their orders, return products and cancel orders. As a result, sales in any period are generally dependent on orders booked and shipped in that period. Delays in shipment orders, product returns and order cancellations in excess of the levels we expect would harm our results of operations.

Our sales cycle varies substantially and future net revenue in any period may be lower than our historical revenues or forecasts.

Our sales are difficult to forecast because the open systems storage market is rapidly evolving and our sales cycle varies substantially from customer to customer. Customer orders for our products can range in value from a few thousand dollars to over a million dollars. The length of time between initial contact with a potential customer and the sale of our product may last from three to 24 months. This is particularly true during times of economic slowdown, for sales to channel partners and for the sale and installation of complex solutions. We have shifted our business strategy to focus primarily on channel partners, with whom sales cycles are generally lengthier, more costly and less certain than direct sales to end-users.

Additional factors that may extend our sales cycle, particularly orders for new products, include:

- the amount of time needed for technical evaluations by customers;
- customers budget constraints and changes to customers budgets during the course of the sales cycle;
- customers internal review and testing procedures; and
- our engineering work necessary to integrate a storage solution with a customer s system.

Our net revenue is difficult for us to predict since it is directly affected by the timing of large orders. Due to the unpredictable timing of customer orders, we may ship products representing a significant portion of our net sales for a quarter during the last month of that quarter. In addition, our expense levels are based, in part, on our expectations as to future sales. As a result, if sales levels are below expectations, our operating results may be disproportionately affected. We cannot assure you that we will experience sales growth in future periods.

The market for our products is subject to substantial pricing pressure that decreases our margins.

Pricing pressures exist in the data storage market and have harmed and may in the future continue to harm our net revenue and earnings. These pricing pressures are due, in part, to continuing decreases in component prices, such as those of disks and RAID controllers. Decreases in component prices are customarily passed-on to customers by storage companies through a continuing decrease in price of storage hardware systems. In addition, because we expect to continue to make most of our sales to a small number of customers, we are subject to continued pricing pressures from our customers, particularly our OEM customers. Pricing pressures are also due, in part, to the current difficult economic conditions, which have led many companies in our industry to pursue a strategy of decreasing prices in order to win sales, the narrowing of functional differences among competitors, which forces companies to compete on price as opposed to features of products, and the introduction of new technologies, which leaves older technology more vulnerable to pricing pressures. To the extent we are unable to offset those pressures with commensurate cost reductions from our suppliers or by providing new products and features, our margins will be harmed.

Our success depends significantly upon our ability to protect our intellectual property and to avoid infringing the intellectual property of third parties, which could result in costly, time-consuming litigation or even the inability to offer certain products.

We rely primarily on patents, copyrights, trademarks, trade secrets, nondisclosure agreements and common law to protect our intellectual property. For example, we have registered trademarks for SANnet, SANpath, SANscape, Stratis, Dot Hill and the Dot Hill logo and, with the acquisition of Chaparral; we acquired registered trademarks for Raidar, Rio, Riva and Stratis. Despite our efforts to protect our intellectual property, unauthorized parties may attempt to copy aspects of our products or obtain and use information that we regard as proprietary. In addition, the laws of foreign countries may not adequately protect our intellectual property rights. Our efforts to protect our intellectual property from third party discovery and infringement may be insufficient and third parties may independently develop technologies similar to ours, duplicate our products or design around our patents.

On October 17, 2003, Crossroads Systems, or Crossroads, filed a lawsuit against us 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. We were served with the lawsuit on October 27, 2003. In March 2004, Chaparral was added as a party to the lawsuit. The patents involve storage routers and methods for providing virtual local storage. Patent Number 5,941,972 involves the interface of SCSI storage devices and the Fibre Channel protocol and Patent Number 6,425,035 involves the interface of any one-transport medium and a second transport medium. We believe that we have meritorious defenses to Crossroads claims and intend to vigorously defend against them. We expect to incur significant legal expenses in connection with this litigation. These defense costs, and other expenses related to this litigation, will be expensed as incurred and will negatively affect our future operating results. Further, parties may assert additional infringement claims against us in the future, which would similarly require us to incur substantial legal fees and expenses, and distract management from the operations of our business.

We expect that providers of storage products will increasingly be subject to infringement claims as the number of products and competitors increases. In addition to the formal claims brought against us by Crossroads, we receive, from time to time, letters from third parties suggesting that we may require a license from such third parties to manufacture or sell our products. We evaluate all such communications to assess whether to seek a license from the patent owner. We may require licenses that could have a material impact on our business. We may not be able to obtain the necessary license from a third party on commercially reasonable terms, or at all. Consequently, we could be prohibited from marketing products that incorporate the protected technology or incur substantial costs to redesign our products in a manner to avoid infringement of third party intellectual property rights.

The market for storage systems is intensely competitive and our results of operations, pricing and business could be harmed if we fail to maintain or expand our market position.

The storage market is intensely competitive and is characterized by rapidly changing technology. We compete primarily against independent storage system suppliers, including EMC Corporation, Hitachi Data Systems, Engenio Information Technologies, Inc. and Network Appliance. We also compete with traditional suppliers of computer systems, including Dell Computer Corporation, Hewlett-Packard Company, and IBM Corporation, which market storage systems as well as other computer products.

Many of our existing and potential competitors have longer operating histories, greater name recognition and substantially greater financial, technical, sales, marketing and other resources than us. As a result, they may have more advanced technology, larger distribution channels, stronger brand names, better customer service and access to more customers than we do. Other large companies with significant resources could become direct competitors, either through acquiring a competitor or through internal efforts. Additionally, a number of new, privately held companies are currently attempting to enter the storage market, some of which may become significant competitors in the future. Any of these existing or potential competitors may be able to respond more quickly to new or emerging technologies and changes in customer requirements, devote greater resources to the development, promotion and sale of products or deliver competitive products at lower prices than us.

We could also lose current or future business to any of our suppliers or manufacturers, some of which directly and indirectly compete with us. Currently, we leverage our supply and manufacturing relationships to provide a significant share of our products. Our suppliers and manufacturers are very familiar with the specific attributes of our products and may be able to provide our customers with similar products.

We also expect that competition will increase as a result of industry consolidation and the creation of companies with new, innovative product offerings. Current and potential competitors have established or may establish cooperative relationships among themselves or with third parties to increase the ability of their products to address the needs of our prospective customers. Accordingly, it is possible that new competitors or alliances among competitors may emerge and rapidly acquire significant market share. Increased competition is likely to result in price reductions, reduced operating margins and potential loss of market share, any of which could harm our business. We believe that the principal competitive factors affecting the storage systems market include:

- Product performance, features, scalability and reliability;
- Price;
- Product breadth;
- Timeliness of new product introductions; and
- Interoperability and ease of management.

We cannot assure you that we will be able to successfully incorporate these factors into our products and compete against current or future competitors or that competitive pressures we face will not harm our business. If we are unable to develop and market products to compete with the products of competitors, our business will be materially and adversely affected. In addition, if major channel partners who are also competitors cease purchasing our products in order to concentrate on sales of their own products, our business will be harmed.

The open systems storage market is rapidly changing and we may be unable to keep pace with or properly prepare for the effects of those changes.

The open systems data storage market in which we operate is characterized by rapid technological change, frequent new product introductions, evolving industry standards and consolidation among our competitors, suppliers and customers. Customer preferences in this market are difficult to predict and changes in those preferences and the introduction of new products by our competitors or us could render our existing products obsolete. Our success will depend upon our ability to address the increasingly sophisticated needs of customers, to enhance existing products, and to develop and introduce on a timely basis, new competitive products, including new software and hardware, and enhancements to existing software and hardware, that keep pace with technological developments and emerging industry standards. If we cannot successfully identify, manage, develop, manufacture or market product enhancements or new products, our business will be harmed. In addition, consolidation among our competitors, suppliers and customers may harm our business by increasing the resources of our competitors, reducing the number of suppliers available to us for our product components and increasing competition for customers by reducing customer-purchasing decisions.

A significant percentage of our expenses are fixed, and if we fail to generate revenues in associated periods, our operating results will be harmed.

Although we have taken a number of steps to reduce operating costs, we may have to take further measures to reduce expenses if we continue to experience operating losses or do not achieve a stable net income. A number of factors could preclude us from successfully bringing costs and expenses in line with our net revenue, such as the fact that our expense levels are based in part on our expectations as to future sales, and that a significant percentage of our expenses are fixed, which limits our ability to reduce expenses quickly in response to any shortfalls in net revenue. As a result, if net revenue does not meet our projections, operating results may be negatively affected. We may experience shortfalls in net revenue for various reasons, including:

- significant pricing pressures that occur because of declines in selling prices over the life of a product or because of increased competition;

- sudden shortages of raw materials or fabrication, test or assembly capacity constraints that lead our suppliers and manufacturers to allocate available supplies or capacity to other customers, which, in turn, may harm our ability to meet our sales obligations; and

- the reduction, rescheduling or cancellation of customer orders.

In addition, we typically plan our production and inventory levels based on internal forecasts of customer demand, which is highly unpredictable and can fluctuate substantially. From time to time, in response to anticipated long lead times to obtain inventory and materials from our outside suppliers, we may order materials in advance of anticipated customer demand. This advance ordering has continued and may result in excess inventory levels or unanticipated inventory write-downs due to expected orders that fail to materialize.

Our business and operating results may suffer if we encounter significant product defects.

Our products may contain undetected errors or failures when first introduced or as we release new versions. During 2004, we plan to introduce a number of new products. We may discover errors in our products after shipment, resulting in a loss of or delay in market acceptance, which could harm our business. Our standard warranty provides that if the system does not function to published specifications, we will repair or replace the defective component or system without charge. Significant warranty costs, particularly those that exceed reserves, could adversely impact our business. In addition, defects in our products could result in our customers claiming damages against us for property damage or consequential damage and could also result in our loss of customers and goodwill. Any such claim could distract management s attention from operating our business and, if successful, result in damage claims against us that might not be covered by our insurance.

Our success depends on our ability to attract and retain key personnel.

Our performance depends in significant part on our ability to attract and retain talented senior management and other key personnel. Our key personnel include James Lambert, our President and Chief Executive Officer, Dana Kammersgard, our Chief Technical Officer, and Preston Romm, our Chief Financial Officer. If any one of these individuals were to terminate his employment with us, we would be required to locate and hire a suitable replacement. Competition for attracting talented employees in the technology industry is intense. We may be unable to identify suitable replacements for any employees that we lose. In addition, even if we are successful in locating suitable replacements, the time and cost involved in recruiting, hiring, training and integrating new employees, particularly key employees responsible for significant portions of our operations, could harm our business by delaying our production schedule, our research and development efforts, our ability to execute on our business strategy and our client development and marketing efforts.

Many of our customer relationships are based on personal relationships between the customer and our sales representatives. If these representatives terminate their employment with us, we may be forced to expend substantial resources to attempt to retain the customers that the sales representatives serviced. Ultimately, if we were unsuccessful in retaining these customers, our net revenue would decline.

We have recently made several reductions in our workforce. Although the reductions were designed to reduce our operating costs, the reductions have increased the responsibilities of our remaining employees. As a result, we face risks associated with transferring the duties of our former employees to our remaining employees. In addition to the expense involved in retraining employees, there is a risk that our current work force will be unable to effectively manage all of the duties of our former employees, which could adversely impact our research and development efforts, our general accounting and operating activities, our sales efforts and our production capabilities.

Our executive officers and directors and their affiliates own a significant percentage of our outstanding shares, which could prevent us from being acquired and adversely affect our stock price.

As of June 30, 2004, our executive officers, directors and their affiliates beneficially owned approximately 8.4% of our outstanding shares of common stock. These individual stockholders may be able to influence matters requiring approval by our stockholders, including the election of a majority of our directors. The voting power of these stockholders under certain circumstances could have the effect of delaying or preventing a change in control of us. This concentration of ownership may also make it more difficult or expensive for us to obtain financing. Further, any substantial sale of shares by these individuals could depress the market price of our common stock and impair our ability to raise capital in the future through the sale of our equity securities.

Protective provisions in our charter and bylaws and the existence of our stockholder rights plan could prevent a takeover which could harm our stockholders.

Our certificate of incorporation and bylaws contain a number of provisions that could impede a takeover or prevent us from being acquired, including, but not limited to, a classified board of directors, the elimination of our stockholders ability to take action by written consent and limitations on the ability of our stockholders to remove a director from office without cause. Our board of directors may issue additional shares of common stock or establish one or more classes or series of preferred stock with such designations, relative voting rights, dividend rates, liquidation and other rights, preferences and limitations as determined by our board of directors without stockholder approval. In addition, we adopted a stockholder rights plan in May 2003 that is designed to impede takeover transactions that are not supported by our board of directors.

Each of these charter and bylaw provisions and the stockholder rights plan gives our board of directors, acting without stockholder approval, the ability to prevent, or render more difficult or costly, the completion of a takeover transaction that our stockholders might view as being in their best interests.

The exercise of outstanding warrants may result in dilution to our stockholders.

Dilution of the per share value of our common stock could result from the exercise of outstanding warrants. As of June 30, 2004 there were outstanding warrants to purchase 1,996,849 shares of our common stock. The warrants have exercise prices ranging from $2.97 to $4.50 per share and expire at various dates through March 14, 2008. When the exercise price of the warrants is less than the trading price of our common stock, exercise of the warrants would have a dilutive effect on our stockholders. The possibility of the issuance of shares of our common stock upon exercise of the warrants could cause the trading price of our common stock to decline.

Any failure by us to manage the integration of Chaparral into our operations could harm our financial results, business and prospects.

In February 2004, we completed the acquisition of Chaparral. The related integration issues are complex, time-consuming and expensive and, without proper planning and implementation, could significantly disrupt our business. The challenges involved in integration include:

combining product offerings or entering into new markets in which we are not experienced and preventing customers and distributors from deferring purchasing decisions or switching to other suppliers, which could result in our incurring additional obligations in order to address customer uncertainty;

demonstrating to customers and distributors that the transaction will not result in adverse changes in client service standards or business focus and coordinating sales, marketing and distribution efforts;

consolidating and rationalizing corporate IT infrastructure, including implementing information management and system processes that enable increased customer satisfaction, improved productivity, lower costs, accurate financial reporting, more direct sales and improved inventory management;

minimizing the diversion of management attention from ongoing business concerns;

persuading employees that business cultures are compatible, maintaining employee morale and retaining key employees, integrating employees into Dot Hill, and correctly estimating employee benefit costs; and

coordinating and combining administrative, manufacturing, research and development and other operations, subsidiaries, facilities and relationships with third parties in accordance with local laws and other obligations while maintaining adequate standards, controls and procedures.

Managing the acquisition of Chaparral may divert our attention from other business operations. This transaction also has resulted and in the future may result in significant costs and expenses and charges to earnings, including those related to severance pay, employee benefit costs, asset impairment charges, charges from the elimination of duplicative facilities and contracts, in-process research and development charges, inventory adjustments, legal, accounting and financial advisory fees, and required payments to executive officers and key employees under retention plans. Moreover, Dot Hill has incurred and will incur additional depreciation and amortization expense over the useful lives of certain assets acquired in connection with transactions, and, to the extent the value of goodwill or intangible assets with indefinite lives acquired in connection with a transaction becomes impaired, we may be required to incur additional material charges relating to the impairment of those assets. As a result, the Chaparral transaction may contribute to financial results that differ from the investment community s expectations in a given quarter.

Our stock price may be highly volatile and could decline substantially and unexpectedly.

The trading price of our shares of common stock has been affected by the factors disclosed in this section as well as prevailing economic and financial trends and conditions in the public securities markets. Share prices of companies in technology-related industries, such as ours, tend to exhibit a high degree of volatility. The announcement of financial results that fall short of the results anticipated by the public markets could have an immediate and significant negative effect on the trading price of our shares in any given period. Such shortfalls may result from events that are beyond our immediate control, can be unpredictable and, since a significant proportion of our sales during each fiscal quarter tend to occur in the latter stages of the quarter, may not be discernible until the end of a financial reporting period. These factors may contribute to the volatility of the trading value of our shares regardless of our long-term prospects. The trading price of our shares may also be affected by developments, including reported financial results and fluctuations in trading prices of the shares of other publicly-held companies, in our industry generally and our business segment in particular, which may not have any direct relationship with our business or prospects.

In the past, securities class action litigation has often been brought against a company following periods of volatility in the market price of its securities. We could be the target of similar litigation in the future. Securities litigation could result in the expenditure of substantial funds, divert management s attention and resources, harm our reputation in the industry and the securities markets and reduce our profitability.

Future sales of our common stock may hurt our market price.

A substantial number of shares of our common stock may become available for resale. If our stockholders sell substantial amounts of our common stock in the public market, the market price of our common stock could decline. These sales might also make it more difficult for us to sell equity securities in the future at times and prices that we deem appropriate. In addition, we are obligated to file a registration statement with respect to the resale of up to 1,394,279 shares of our common stock issuable upon exercise of warrants held by Sun.

Geopolitical military conditions, including terrorist attacks and other acts of war, may materially and adversely affect the markets on which our common stock trades, the markets in which we operate, our operations and our profitability.

Terrorist attacks and other acts of war, and any response to them, may lead to armed hostilities and such developments would likely cause instability in financial markets. Armed hostilities and terrorism may directly impact our facilities, personnel and operations that are located in the United States and internationally, as well as those of our channel partners, suppliers, third party manufacturer and customers. Furthermore, severe terrorist attacks or acts of war may result in temporary halts of commercial activity in the affected regions, and may result in reduced demand for our products. These developments could have a material adverse effect on our business and the trading price of our common stock.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Interest Rate and Credit Risk

Our exposure to market rate risk for changes in interest rates relates to our investment portfolio. Our primary investment strategy is to preserve the principal amounts invested, maximize investment yields, and maintain liquidity to meet projected cash requirements. Accordingly, we invest in instruments such as money market funds, certificates of deposit, U.S. Government/Agencies bonds, notes, bills and municipal bonds that meet high credit quality standards, as specified in our investment policy guidelines. Our investment policy also limits the amount of credit exposure to any one issue, issuer, and type of instrument. We do not currently use derivative financial instruments in our investment portfolio and we do not enter into market risk sensitive instruments for trading purposes. We do not expect to incur any material losses with respect to our investment portfolio. An immediate 10% change in interest rates would have no material impact on our financial condition, results of operations or cash flows. Declines in interest rates over time would, however, reduce our interest income.

The following table provides information about our investment portfolio at December 31, 2003 and June 30, 2004. For investment securities, the table presents carrying values at December 31, 2003 and June 30, 2004 and, as applicable, and related weighted average interest rates by expected maturity dates.

	December 31, 2003	June 30, 2004
	(amounts in thousands)	
Cash and Cash equivalents	$ 127,790	$ 26,671
Average interest rate	1.0%	1.1%
Short-term investments	$ 52,982	$ 78,614
Average interest rate	1.6%	1.5%
Total portfolio	$ 180,772	$ 105,285
Average interest rate	1.2%	1.4%

We have a line of credit agreement, which accrues interest at a variable rate. As of June 30, 2004, we had no balance under this line. Were we to incur a balance under this line, we would be exposed to interest rate risk on such debt.

Foreign Currency Exchange Rate Risk

A portion of our international business is presently conducted in currencies other than the U.S. dollar. Foreign currency transaction gains and losses arising from normal business operations are credited to or charged against earnings in the period incurred. As a result, fluctuations in the value of the currencies in which we conduct our business relative to the U.S. dollar will cause currency transaction gains and losses, which we have experienced in the past and continue to experience. Due to the substantial volatility of currency exchange rates, among other factors, we cannot predict the effect of exchange rate fluctuations upon future operating results. There can be no assurances that we will not experience currency losses in the future. We have not previously undertaken hedging transactions to cover currency exposure and we do not intend to engage in hedging activities in the future.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Our chief executive officer and chief financial officer, after evaluating the effectiveness of our disclosure controls and procedures (as defined in the Securities Exchange Act of 1934, as amended, Rule 13a-15(e) as of the end of the period covered by this Periodic Report on Form 10-Q, have concluded that as of the end of such period, our disclosure controls and procedures are effective to ensure that information required to be disclosed by us in the reports that we file under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time period specified in the Commission s rules and forms.

Changes in Internal Controls

There has been no change in our internal control over financial reporting that occurred during the quarter covered by this Periodic Report on Form 10-Q that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Part II. Other Information

Item 1. Legal Proceedings

On October 17, 2003, Crossroads Systems, or Crossroads, filed a lawsuit against us 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. We were served with the lawsuit on October 27, 2003. Chaparral was added as a party to the lawsuit in March 2004. The patents involve storage routers and methods for providing virtual local storage. Patent Number 5,941,972 involves the interface of SCSI storage devices and the Fiber Channel protocol and Patent Number 6,425,035 involves the interface of any one-transport medium and a second transport medium. We believe that we have meritorious defenses to Crossroads claims and are in the process of vigorously defending against them. We believe that the outcome will not have a material adverse effect on our financial condition or operating results. However, we expect to incur significant legal expenses in connection with this litigation. These defense costs, and other expenses related to this litigation, will be expensed as incurred and will negatively affect our operating results.

In addition to the action discussed above, we are subject to various legal proceedings and claims, asserted or unasserted, which arise in the ordinary course of business. The outcome of the claims against us cannot be predicted with certainty. We believe that such litigation and claims will not have a material adverse effect on our financial condition or operating results.

Item 2. Changes in Securities, Use of Proceeds and Issuer Purchases of Equity Securities

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Submission of Matters to a Vote of Security Holders

We held our Annual Meeting of Stockholders on May 3, 2004. Out of 43,308,802 shares of common stock entitled to vote at such meeting, there were present in person or by proxy 36,910,649 shares. At the Annual Meeting, our stockholders approved the following matters:

Proposal 1. The election of the following director to serve for three years. The vote for the nominated director was as follows:

Director s Name	**Votes For**	**Votes Against**
Chong Sup Park	36,192,763	717,866

Proposal 2. Ratification of an amendment to the Company s 2000 Amended and Restated Employee Stock Purchase Plan, as amended, to increase the aggregate number of shares of common stock authorized for issuance under the plan by 2,000,000 shares. 24,344,376 votes were cast for, 1,109,166 votes were cast against, 699,270 votes were abstained and 10,757,837 shares were unvoted..

Proposal 3. Ratification of the selection by the Audit Committee of the Board of Directors of Deloitte & Touche LLP as independent auditors of the Company for its fiscal year ending December 31, 2004. 36,008,731 votes were cast for, 897,018 votes were cast against, 4,900 votes were abstained and there were no broker non-votes.

Item 5. Other Information

None.

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Item 6. Exhibits and Reports on Form 8-K

a. List of Exhibits

Exhibit Number		Description	
10.1		2000 Amended and Restated Employee Stock Purchase Plan	
31.1		Certification pursuant to 17 CFR 240.13a-14(a) or 17-CFR 240.15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.	
31.2		Certification pursuant to 17 CFR 240.13a-14(a) or 17 CFR 240.15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.	
32.1		Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.	

b. Reports on Form 8-K.

1. We filed a current report on Form 8-K, dated April 5, 2004, pre-announcing our expectation of earnings for the quarter ended March 31, 2004.

2. We filed a current report on Form 8-K, dated April 28, 2004, announcing our earnings for the quarter ended March 31, 2004.

3. We filed a current report on Form 8-K/A, dated May 7, 2004, to amend the Current Report announcing the acquisition of Chaparral Network Storage Systems, Inc filed with the Securities and Exchange Commission on February 24, 2004 in order to file the required financial statements and pro foma financial information required by Item 7 of Form 8-K.

4. We filed a current report on Form 8-K, dated June 14, 2004, announcing that Joseph D. Markee has been elected to our board of directors.

SIGNATURES

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

Date: August 9, 2004	By /s/ JAMES L. LAMBERT James L. Lambert *Chief Executive Officer* *(Principal Executive Officer)*
Date: August 9, 2004	By /s/ PRESTON S. ROMM Preston S. Romm *Chief Financial Officer and Treasurer* *(Principal Financial and Accounting Officer)*