LAUREATE EDUCATION, INC.
Form SC 13G
February 10, 2017

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

SCHEDULE 13G

(Rule 13d-102)

INFORMATION TO BE INCLUDED IN STATEMENTS FILED PURSUANT TO

RULES 13d-1(b), (c), AND (d) AND AMENDMENTS THERETO FILED

PURSUANT TO 13d-2

(Amendment No.)*

Laureate Education, Inc.

(Name of Issuer)

Class A Common Stock, $.01 par value per share
(Title of Class of Securities)

518613203
(CUSIP Number)

February 1, 2017
(Date of Event Which Requires Filing of this Statement)

Check the appropriate box to designate the rule pursuant to which this Schedule is filed:

Rule 13d-1(b)

Rule 13d-1(c)

Rule 13d-1(d)

* The remainder of this cover page shall be filled out for a reporting person s initial filing on this form with respect to the subject class of securities, and for any subsequent amendment containing information which would alter the disclosures provided in a prior cover page.

The information required in the remainder of this cover page shall not be deemed to be filed for the purpose of Section 18 of the Securities Exchange Act of 1934 (Act) or otherwise subject to the liabilities of that section of the Act but shall be subject to all other provisions of the Act (however, see the Notes).

(1) NAME OF REPORTING PERSON

OZ Management LP

(2) CHECK THE APPROPRIATE BOX IF A MEMBER OF A GROUP

(a) (b)

(3) SEC USE ONLY

(4) CITIZENSHIP OR PLACE OF ORGANIZATION

Delaware

NUMBER OF SHARES BENEFICIALLY OWNED BY EACH REPORTING PERSON WITH	(5) SOLE VOTING POWER	0
	(6) SHARED VOTING POWER	1,900,000
	(7) SOLE DISPOSITIVE POWER	0
	(8) SHARED DISPOSITIVE POWER	1,900,000

(9) AGGREGATE AMOUNT BENEFICIALLY OWNED BY EACH REPORTING PERSON

1,900,000

(10) CHECK BOX IF THE AGGREGATE AMOUNT IN ROW (9) EXCLUDES CERTAIN SHARES

(11) PERCENT OF CLASS REPRESENTED BY AMOUNT IN ROW (9)

5.4%

(12) TYPE OF REPORTING PERSON

IA

(1) NAME OF REPORTING PERSON

Och-Ziff Holding Corporation

(2) CHECK THE APPROPRIATE BOX IF A MEMBER OF A GROUP

(a) (b)

(3) SEC USE ONLY

(4) CITIZENSHIP OR PLACE OF ORGANIZATION

Delaware

NUMBER OF SHARES BENEFICIALLY OWNED BY EACH REPORTING PERSON WITH		
	(5) SOLE VOTING POWER	0
	(6) SHARED VOTING POWER	1,900,000
	(7) SOLE DISPOSITIVE POWER	0
	(8) SHARED DISPOSITIVE POWER	1,900,000

(9) AGGREGATE AMOUNT BENEFICIALLY OWNED BY EACH REPORTING PERSON

1,900,000

(10) CHECK BOX IF THE AGGREGATE AMOUNT IN ROW (9) EXCLUDES CERTAIN SHARES

(11) PERCENT OF CLASS REPRESENTED BY AMOUNT IN ROW (9)

5.4%

(12) TYPE OF REPORTING PERSON

CO

(1)	NAME OF REPORTING PERSON Och-Ziff Capital Management Group LLC
(2)	CHECK THE APPROPRIATE BOX IF A MEMBER OF A GROUP (a) (b)
(3)	SEC USE ONLY
(4)	CITIZENSHIP OR PLACE OF ORGANIZATION Delaware

NUMBER OF SHARES BENEFICIALLY OWNED BY EACH REPORTING PERSON WITH	(5)	SOLE VOTING POWER 0
	(6)	SHARED VOTING POWER 1,900,000
	(7)	SOLE DISPOSITIVE POWER 0
	(8)	SHARED DISPOSITIVE POWER 1,900,000

(9)	AGGREGATE AMOUNT BENEFICIALLY OWNED BY EACH REPORTING PERSON 1,900,000
(10)	CHECK BOX IF THE AGGREGATE AMOUNT IN ROW (9) EXCLUDES CERTAIN SHARES
(11)	PERCENT OF CLASS REPRESENTED BY AMOUNT IN ROW (9)

5.4%

(12) TYPE OF REPORTING PERSON

OO

Schedule 13 G
CUSIP No. 518613203

(1) NAME OF REPORTING PERSON

Daniel S. Och

(2) CHECK THE APPROPRIATE BOX IF A MEMBER OF A GROUP

(a) (b)

(3) SEC USE ONLY

(4) CITIZENSHIP OR PLACE OF ORGANIZATION

United States

NUMBER OF SHARES BENEFICIALLY OWNED BY EACH REPORTING PERSON WITH	(5) SOLE VOTING POWER	0
	(6) SHARED VOTING POWER	1,900,000
	(7) SOLE DISPOSITIVE POWER	0
	(8) SHARED DISPOSITIVE POWER	1,900,000

(9) AGGREGATE AMOUNT BENEFICIALLY OWNED BY EACH REPORTING PERSON

1,900,000

(10) CHECK BOX IF THE AGGREGATE AMOUNT IN ROW (9) EXCLUDES CERTAIN SHARES

(11) PERCENT OF CLASS REPRESENTED BY AMOUNT IN ROW (9)

5.4%

(12) TYPE OF REPORTING PERSON

IN

ITEM 1 (a). NAME OF ISSUER:

Laureate Education, Inc.

ITEM 1 (b). ADDRESS OF ISSUER S PRINCIPAL EXECUTIVE OFFICES:

650 S. Exeter Street

Baltimore, MD 21202

ITEMS 2(a), 2(b) and 2(c). NAME OF PERSON FILING, ADDRESS OF PRINCIPAL BUSINESS OFFICE AND CITIZENSHIP:

This statement is filed by the entities and persons listed below, all of whom together are referred to herein as the Reporting Persons :

(i) OZ Management LP (OZ), a Delaware limited partnership, is the principal investment manager to a number of investment funds and discretionary accounts (collectively, the Accounts).

(ii) Och-Ziff Holding Corporation (OZHC), a Delaware corporation, serves as the general partner of OZ. The Shares reported in this Schedule 13G are held in the Accounts managed by OZ.

(iii) Och-Ziff Capital Management Group LLC (OZM), a Delaware limited liability company, is a holding company that is the sole shareholder of OZHC.

(iv) Daniel S. Och is the Chief Executive Officer of OZHC and the Chief Executive Officer, an Executive Managing Director and Chairman of OZM.

The citizenship of each of OZ, OZHC, and OZM is set forth above. Daniel S. Och is a United States citizen.

The address of the principal business office of each of the Reporting Persons is 9 West 57th Street, 39th Floor, New York, NY 10019.

ITEM 2 (d). TITLE OF CLASS OF SECURITIES:

Class A common stock, $.01 par value per share.

ITEM 2 (e). CUSIP NUMBER:

518613203

ITEM 3. IF THIS STATEMENT IS FILED PURSUANT TO §§ 240.13d-1(b) or 240.13d-2(b) OR (c), CHECK WHETHER THE PERSON FILING IS A:

(a) Broker or dealer registered under Section 15 of the Act;

(b) Bank as defined in Section 3(a)(6) of the Act;

(c) Insurance Company as defined in Section 3(a)(19) of the Act;

(d) Investment Company registered under Section 8 of the Investment Company Act of 1940;

(e) Investment Adviser registered under Section 203 of the Investment Advisers Act of 1940: see Rule 13d-1(b)(1)(ii)(E);

(f) Employee Benefit Plan, Pension Fund which is subject to the provisions of the Employee Retirement Income Security Act of 1974 or Endowment Fund; see Rule 13d-1(b)(1)(ii)(F);

(g) Parent Holding Company, in accordance with Rule 13d-1(b)(ii)(G);

(h) Savings Associations as defined in Section 3(b) of the Federal Deposit Insurance Act;

(i) Church Plan that is excluded from the definition of an investment company under Section 3(c)(14) of the Investment Company Act of 1940;

(j) Group, in accordance with Rule 13d-1(b)(1)(ii)(J).

IF THIS STATEMENT IS FILED PURSUANT TO Rule 13d-1(c), CHECK THIS BOX.

ITEM 4. OWNERSHIP.

OZ and OZ Management II LP (OZII) each serves as the principal investment manager to the Accounts. OZII is a wholly-owned subsidiary of OZ and, as such, OZ may be deemed to be the beneficial owner of Class A common stock, $.01 par value per share (the Shares) held in the Accounts managed by OZII. OZ is the sole member of Och-Ziff Holding II LLC (OZHII), the general partner of OZII. As a result, OZ has voting and dispositive authority over the Shares reported in this Schedule 13G. OZHC serves as the sole general partner of OZ. As such, OZHC may be deemed to control OZ and, therefore, may be deemed to be the beneficial owner of the Shares reported in this Schedule 13G. OZM is the sole shareholder of OZHC, and, for purposes of this Schedule 13G, may be deemed to be the beneficial owner of the Shares reported in this Schedule 13G. Mr. Daniel S. Och is the Chief Executive Officer, an Executive Managing Director and Chairman of OZM. As such, for purposes of this Schedule 13G, he may be deemed to control such entity and, therefore, may be deemed to be the beneficial owner of the Shares reported in this Schedule 13G.

The percentages used in this Item 4 are calculated based on 35,000,000 shares of Class A common stock, outstanding as of March 7, 2016, as reported in the Issuer s Form 424B4 filed on February 2, 2017. Beneficial ownership information is presented as of February 1, 2017.

A. OZ

(a) Amount beneficially owned:

1,900,000

(b) Percent of class:

5.4%

(c) Number of shares as to which such person has:

(i) sole power to vote or to direct the vote

0

(ii) shared power to vote or to direct the vote

1,900,000

(iii) sole power to dispose or to direct the disposition of

0

(iv) shared power to dispose or to direct the disposition of

1,900,000

B. OZHC

(a) Amount beneficially owned:

1,900,000

(b) Percent of class:

5.4%

(c) Number of shares as to which such person has:

(i) sole power to vote or to direct the vote

0

(ii) shared power to vote or to direct the vote

1,900,000

(iii) sole power to dispose or to direct the disposition of

0

(iv) shared power to dispose or to direct the disposition of

1,900,000

C. OZM

(a) Amount beneficially owned:
1,900,000

(b) Percent of class:
5.4%

(c) Number of shares as to which such person has:

(i) sole power to vote or to direct the vote
0

(ii) shared power to vote or to direct the vote
1,900,000

(iii) sole power to dispose or to direct the disposition of
0

(iv) shared power to dispose or to direct the disposition of
1,900,000

D. Daniel S. Och

(a) Amount beneficially owned:
1,900,000

(b) Percent of class:
5.4%

(c) Number of shares as to which such person has:

(i) sole power to vote or to direct the vote

0

(ii) shared power to vote or to direct the vote

1,900,000

(iii) sole power to dispose or to direct the disposition of

0

(iv) shared power to dispose or to direct the disposition of

1,900,000

ITEM 5. OWNERSHIP OF FIVE PERCENT OR LESS OF A CLASS.

If this statement is being filed to report the fact that as of the date hereof the reporting person has ceased to be the beneficial owner of more than five percent of the class of securities, check the following .

ITEM 6. OWNERSHIP OF MORE THAN FIVE PERCENT ON BEHALF OF ANOTHER PERSON.

See Item 4.

ITEM 7. IDENTIFICATION AND CLASSIFICATION OF THE SUBSIDIARY WHICH ACQUIRED THE SECURITY BEING REPORTED ON BY THE PARENT HOLDING COMPANY.

Not applicable.

ITEM 8. IDENTIFICATION AND CLASSIFICATION OF MEMBERS OF THE GROUP.

See Item 4.

ITEM 9. NOTICE OF DISSOLUTION OF GROUP.

Not applicable.

ITEM 10. CERTIFICATIONS. (if filing pursuant to Rule 13d-1(c))

Each of the Reporting Persons hereby make the following certification:

By signing below each Reporting Person certifies that, to the best of its knowledge and belief, the securities referred to above were not acquired and are not held for the purpose of or with the effect of changing or influencing the control of the issuer of the securities and were not acquired and are not held in connection with or as a participant in any transaction having that purpose or effect.

SIGNATURES

After reasonable inquiry and to the best of our knowledge and belief, the undersigned certify that the information set forth in this statement is true, complete and correct.

DATED: February 6, 2017

OZ MANAGEMENT LP
By: Och-Ziff Holding Corporation, its general partner

By: /s/ Daniel S. Och
Daniel S. Och
Chief Executive Officer

OCH-ZIFF HOLDING CORPORATION

By: /s/ Daniel S. Och
Daniel S. Och
Chief Executive Officer

OCH-ZIFF CAPITAL MANAGEMENT GROUP LLC

By: /s/ Daniel S. Och
Daniel S. Och
Chief Executive Officer

DANIEL S. OCH

By: /s/ Daniel S. Och
Daniel S. Och

">

Interest income (expense), net
(4
)

(13
)

(22
)

(27
)
Other income (expense), net
11

—

21

—

Total other income (expense), net
7

(13
)

(1
)

(27
)
INCOME (LOSS) BEFORE INCOME TAXES
(4
)

760

(415
)

4,641

INCOME TAX EXPENSE
74

75

75

85

NET INCOME (LOSS)

$
(78
)

$
685

$
(490
)

$
4,556

NET INCOME (LOSS) PER SHARE:

Net Income (Loss) per share - basic and diluted
$
(0.00
)

$
0.01

$
(0.01
)

$
0.07

WEIGHTED AVERAGE SHARES USED TO CALCULATE NET INCOME (LOSS) PER SHARE:

Basic
60,159

61,292

59,920

61,027

Diluted
60,159

66,562

59,920

65,611

COMPREHENSIVE INCOME (LOSS):

Net income (loss)
$
(78
)

$
685

$
(490
)

$
4,556

Foreign currency translation adjustment
1

27

(29
)

20

Reclassification of accumulated foreign currency translation losses into net income (loss) upon liquidation of foreign subsidiary
—

2,677

—

2,677

Comprehensive income (loss)
$
(77
)

$
3,389

$
(519
)

$
7,253

See accompanying notes to unaudited condensed consolidated financial statements.

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DOT HILL SYSTEMS CORP.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)
FOR THE SIX MONTHS ENDED JUNE 30, 2014 AND 2015
(In thousands)

	Six Months Ended June 30, 2014	2015
Cash Flows From Operating Activities:		
Net income (loss)	$(490)	$4,556
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	1,891	2,348
Share-based compensation expense	1,632	2,080
Provision for bad debt expense	2	9
Write-off of property and equipment	5	—
Foreign currency translation adjustment upon liquidation of foreign subsidiary	—	2,677
Changes in operating assets and liabilities:		
Accounts receivable	9,861	(1,533)
Inventories	(1,035)	2,140
Prepaid expenses and other assets	2,544	4,693
Accounts payable	(9,122)	(9,225)
Accrued compensation and other expenses	(3,213)	2,378
Deferred revenue	831	(1,480)
Other long-term liabilities	(143)	(622)
Net cash provided by operating activities	2,763	8,021
Cash Flows From Investing Activities:		
Purchases of property and equipment	(1,432)	(2,359)
Purchases of intangible assets	—	(2,177)
Net cash used in investing activities	(1,432)	(4,536)
Cash Flows From Financing Activities:		
Payments on bank borrowings	(2,000)	—
Shares withheld for tax purposes	(80)	(10)
Proceeds from sale of stock to employees	2,500	3,186
Net cash provided by financing activities	420	3,176
Effect of Exchange Rate Changes on Cash and Cash Equivalents	39	(16)
Net Increase in Cash and Cash Equivalents	1,790	6,645
Cash and Cash Equivalents, beginning of period	40,406	42,492
Cash and Cash Equivalents, end of period	$42,196	$49,137
Supplemental Disclosures of Non-Cash Investing and Financing Activities:		
Capital expenditures incurred but not yet paid	$832	$970
Property and equipment transferred from inventory	$42	$—
Supplemental Cash Flow Data:		
Cash paid for income taxes	$260	$262

See accompanying notes to unaudited condensed consolidated financial statements.

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DOT HILL SYSTEMS CORP.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Summary of Significant Accounting Policies

Basis of Presentation

The financial statements of Dot Hill Systems Corp., referred to herein as Dot Hill, we, our or us, contained herein are unaudited and in the opinion of management contain all adjustments (consisting of normal recurring adjustments) necessary for a fair presentation of financial position, results of operations and cash flows for the periods presented. The interim unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America, or GAAP, for interim financial information and with the instructions to Securities and Exchange Commission, or SEC, Form 10-Q and Article 10 of SEC Regulation S-X. They do not include all of the information and disclosures required by GAAP for complete financial statements. 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 and Form 10-K/A for the year ended December 31, 2014. Operating results for the three and six months ended June 30, 2015 are not necessarily indicative of the results that may be expected for future quarters or the year ending December 31, 2015.

Use of Accounting Estimates

The preparation of our unaudited condensed consolidated financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the dates of the financial statements and the reported amounts of net revenue and expenses in the reporting periods. The accounting estimates that require management’s most significant and subjective judgments include revenue recognition, income taxes, including the valuation allowance for deferred tax assets, inventory valuation (refer to Note 3, Inventories) and recurring and specific issue warranty obligations (refer to Note 5, Product Warranties). In addition, we have other accounting policies that involve estimates such as the determination of useful lives of long-lived assets, the valuation of long-lived assets, accruals for restructuring, capitalization of software development costs, contingent liabilities and recognition of share-based compensation expense. Actual results may differ from these estimates and such differences could be material.

Revenue Recognition

We derive our revenue from sales of our hardware products, software and services.

Hardware

Hardware product revenue consists of revenue from sales of our AssuredSAN storage systems that are integrated with our original equipment manufacturers', or OEM, customers' industry standard hardware and which become essential to the integrated system product. We recognize hardware product revenue when the following fundamental criteria are met: (i) persuasive evidence of an arrangement exists; (ii) delivery has occurred; (iii) the price is fixed or determinable; and (iv) collectability is reasonably assured. Revenue is recognized for hardware product sales upon transfer of title and risk of loss to the customer. We record reductions to revenue for estimated product returns and pricing adjustments in the same period that the related revenue is recorded. These estimates are based on contractual return rights, historical sales returns, analysis of credit memo data and other factors known at the time. If actual future returns and pricing adjustments differ from past experience and our estimates, adjustments to revenue reserves may be required.

We exclude from revenues taxes collected from customers on behalf of governmental authorities.

Software

In accordance with the specific guidance for recognizing software revenue, where applicable, we recognize revenue from perpetual software licenses at the inception of the license term assuming all revenue recognition criteria have been met. We use the relative fair value method to allocate revenue to software licenses at the inception of the license term when vendor-specific objective evidence, or VSOE, of fair value for all elements related to our products is available. We have established VSOE for the fair value of our software licenses and support services as measured by the prices paid by our customers when the licenses and services are sold separately on a standalone basis. Software revenue represents less than 5% of our net revenue for all periods presented.

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Specific long-term software contracts may contain multiple deliverables including software licenses, services, training and post-contract support, or PCS, for which we have not established VSOE of fair value of any of the elements. Under specific guidance for recognizing software revenue, we defer all revenue related to each deliverable until the only undelivered element is PCS. We then begin recognizing revenue ratably over the PCS period.

We defer all the direct and incremental costs related to the deliverables in these contracts until delivery of all the elements except PCS. The deferred costs are then recognized ratably over the contractual PCS support periods as a component of Costs of Goods Sold.

Services

Our service revenue primarily relates to out-of-warranty repairs and product maintenance contracts. Out-of-warranty repairs primarily consist of product repair services performed by our contract manufacturers for those customers that allowed their original product warranty to expire without purchasing one of our higher level support service plans. Revenue from these out-of-warranty repairs, and the associated cost of sales, is recognized in the period these services are provided. Service revenue also consists of product maintenance contracts purchased by our customers as an extension of our standard warranty. Revenue from our product maintenance contracts is deferred and recognized ratably over the contract term, generally 12 to 36 months. Net revenue derived from services was less than 10% of total revenue for all periods presented.

Revenue Recognition for Arrangements with Multiple Deliverables

For multi-element arrangements that include hardware products containing software essential to the hardware product's functionality and undelivered non-software services (all non-software related elements), we allocate the transaction price to all deliverables based on their relative selling prices. In such circumstances, we use a hierarchy to determine the selling price to be used for allocating the transaction price to deliverables: (i) VSOE of fair value, (ii) third-party evidence of selling price, or TPE, and (iii) best estimate of the selling price, or ESP. VSOE of fair value generally exists only when we sell the deliverable separately and represents the actual price charged by us for that deliverable. ESPs reflect our best estimates of what the selling prices of each of the deliverables would be if they were sold regularly on a standalone basis.

Revenue Recognition for Sales to Channel Partners

On sales to channel partners, we evaluate whether fees are considered fixed or determinable by considering a number of factors, including our ability to estimate returns, payment terms and our relationship and past history with the particular channel partner. If fees are not considered fixed or determinable at the time of sale to a channel partner, revenue recognition is deferred until there is persuasive evidence indicating the product has sold through to an end-user. Persuasive evidence of sell-through may include reports from channel partners documenting sell-through activity or data indicating an order has shipped to an end-user.

Deferred Revenue

We defer revenue on upfront nonrefundable payments from our customers and recognize it ratably over the term of the agreement, unless the payment is in exchange for products delivered that represent the culmination of a separate earnings process. When we provide consideration to a customer, we recognize the value of that consideration as a reduction in net revenue. We may be required to maintain inventory with certain of our largest OEM customers, which we refer to as "hubbing" arrangements. Pursuant to these arrangements we deliver products to a customer or a designated third-party warehouse based upon the customer's projected needs, but do not recognize product revenue unless and until the customer has taken legal title of our product from the warehouse to incorporate into its end products.

Research and Development and Capitalized Software Development Costs

Research and development costs are expensed as incurred. In conjunction with the development of our products, we incur certain software development costs. For the majority of our software development projects, no costs have been capitalized because the period between achieving technological feasibility and completion of such software is relatively short and software development costs qualifying for capitalization have been insignificant. On a specific software project under development, it was determined that the period between achieving technological feasibility and completion of the software development is not relatively short and the development costs qualifying for capitalization will be significant. For this project, since technological feasibility has been established, all software costs are capitalized until the product is available for general release to customers. Judgment is required in determining when technological feasibility of a product is established. We have determined that technological feasibility for our software products is reached after all high-risk development issues have been resolved through

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coding and testing. The amortization of these costs will be included in cost of revenue over the estimated life of the products. Refer to Note 4, Intangible Assets.

Income Taxes

We recognize deferred tax assets and liabilities for the expected tax effects of temporary differences between the tax bases of assets and liabilities and their reported amounts using enacted tax rates in effect for the year the differences are expected to reverse. We record a valuation allowance to reduce the deferred tax assets to the amount that is more likely than not to be realized. We periodically evaluate the likelihood of the realization of deferred tax assets. We consider many factors when assessing the likelihood of future realization of our deferred tax assets, including our recent cumulative earnings experience by taxing jurisdiction, expectations of future taxable income or loss, the amount of our net operating loss carryforwards not subject to limitations, the number of periods it will take to realize our net operating loss carryforwards and other relevant factors. Based upon our analysis of these factors, we have not concluded that our principal tax paying entity has attained a sustained level of profitability sufficient to reduce our valuation allowance. However, given our current earnings and anticipated future earnings, we believe that it is possible that within the next twelve months, we may reduce all or a portion of the valuation allowance if the Company determines that it is more likely than not that a material amount of our deferred tax assets will be realized. The exact timing and amount of any valuation allowance reduction is subject to change on the basis of the level of profitability that we are able to actually achieve. Any future reduction of the valuation allowance will be recorded as a tax benefit increasing our net income.

Contingent Liabilities

We are involved in certain claims from time to time arising in the ordinary course of business involving our products, suppliers, and/or customers. We may incur settlements, fines, penalties or judgments in connection with some of these matters. While we may be unable to estimate the ultimate dollar amount of exposure or loss in connection with these matters, we make accruals as warranted. The amounts we accrue could vary substantially from amounts we pay due to several factors including the following: possible third-party contributions, the inherent uncertainties of the estimation process, and the uncertainties involved in litigation. We believe that we have adequately provided in our consolidated financial statements for the impact of these contingencies. We also believe that the outcomes will not materially affect our results of operations, our financial position or our cash flows, except as disclosed. Refer to Note 8, Commitments and Contingencies.

Concentration of Customers and Suppliers

A majority of our net revenue is derived from a limited number of customers. For the three months ended June 30, 2014, we had one customer, and for the three months ended June 30, 2015, we had three customers, that accounted for 10% or more of our total net revenue. For the six months ended June 30, 2014, we had two customers, and for the six months ended June 30, 2015, we had four customers, that accounted for 10% or more of our total net revenue. Our agreements with our customers do not contain any minimum purchase commitments, do not obligate them to purchase their storage solutions exclusively from us and may be terminated at any time upon notice.

Net revenue consists of all product and services revenue. Net revenue by major customer, or a customer who has accounted for 10% or more of our total net revenue in the current quarter and/or any quarter in the prior fiscal year, is as follows (as a percentage of total net revenue):

	Three Months Ended June 30,				Six Months Ended June 30,			
	2014		2015		2014		2015	
Customer A	50	%	45	%	50	%	40	%

Customer B	2	%	14	%	2	%	10	%
Customer C	4	%	8	%	10	%	13	%
Customer D	9	%	11	%	8	%	14	%

If our relationship with our major customers were disrupted or declined significantly, we would lose a substantial portion of our anticipated net revenue and our business could be materially harmed. We cannot guarantee that our relationship with our major customers or our other customers will expand or not otherwise be disrupted.

We currently rely on one contract manufacturing partner, Foxconn Technology Group, or Foxconn, to produce substantially all of our products. As a result, should Foxconn not produce and deliver inventory for us to sell on a timely basis,

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operating results may be adversely impacted. Our agreement with Foxconn is currently set to expire on September 1, 2015. We are currently in negotiations to extend our contract with Foxconn. If the agreement is not extended, pursuant to terms in the existing agreement, we can continue to operate with Foxconn for a period of six months following the expiration of the agreement. In the event the Company does not extend its agreement with Foxconn, we have developed plans with an alternative contract manufacturer.

Cash and Cash Equivalents

We classify investments as cash equivalents if they are readily convertible to cash and have original maturities of three months or less at the time of acquisition. Cash and cash equivalents consist primarily of money market mutual funds issued or managed in the United States. At December 31, 2014 and June 30, 2015, the carrying value of cash and cash equivalents approximates fair value due to the short period of time to maturity.

As of June 30, 2015, $1.0 million of the $49.1 million of cash and cash equivalents was held by our foreign subsidiaries, as compared to $3.0 million of the $42.5 million of cash and cash equivalents held by our foreign subsidiaries as of December 31, 2014. On June 17, 2015, we repatriated approximately $2.0 million of our cash and cash equivalents when we liquidated our Netherlands subsidiary. We obtained a favorable ruling from the Netherlands and were not charged foreign taxes on the repatriation, and we expect that our net operating loss carryforwards and foreign tax credits will be available to offset any United States tax liability, should one arise.

We anticipate that future foreign earnings will be permanently reinvested, although we could elect to repatriate funds held in one or more foreign jurisdictions. If applicable, withholding taxes could reduce the net amount repatriated, and we could be required to accrue and remit applicable United States income taxes to the extent a tax liability results after the utilization of net operating loss carryforwards and available tax credits.

Allowance for Doubtful Accounts

We establish an allowance for doubtful accounts for accounts receivable amounts that may not be collectible. We determine the allowance for doubtful accounts based on the aging of our accounts receivable balances and an analysis of our historical experience of bad debt write-offs. Allowance for doubtful accounts was $0.1 million and $0.1 million at December 31, 2014 and June 30, 2015, respectively.

Long-lived Asset Impairment

We periodically review the recoverability of the carrying value of long-lived assets for impairment whenever events or changes in circumstances indicate that their carrying value may not be recoverable. An impairment in the carrying value of an asset group is recognized whenever anticipated future undiscounted cash flows from an asset group are estimated to be less than its carrying value. The amount of impairment recognized is the difference between the carrying value of the asset group and its fair value. Fair value estimates are based on assumptions concerning the amount and timing of estimated future cash flows and assumed discount rates, reflecting varying degrees of perceived risk. There were no impairment charges for the three and six months ended June 30, 2014 or 2015.

Recent Accounting Pronouncements

From time to time, new accounting pronouncements are issued that we adopt as of the specified effective date. We believe that, other than the matter described below, the impact of recently issued standards that are not yet effective will not have a material impact on our results of operations and financial position.

In May 2014, the Financial Accounting Standards Board, or FASB, issued Accounting Standards Update 2014-09, Revenue from Contracts with Customers (Topic 606), or ASU 2014-09. This update creates modifications to various revenue accounting standards for specialized transactions and industries. ASU 2014-09 is intended to conform revenue accounting principles with a concurrently issued International Financial Reporting Standards with previously differing treatment between United States practice and those of much of the rest of the world, as well as, to enhance disclosures related to disaggregated revenue information. The updated guidance may be applied retrospectively to each prior period presented or retrospectively with the cumulative effect recognized as of the date of initial application. The updated guidance is effective for public entities for annual reporting periods beginning on or after December 15, 2016, and interim periods within those annual periods. Early adoption is not permitted and entities have the choice to apply ASU 2014-09 either retrospectively to each reporting period presented or by recognizing the cumulative effect of applying ASU 2014-09 at the date of initial application and not adjusting comparative information. In July 2015, the FASB officially reaffirmed its April 2015 decision to defer for one year the effective

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date of ASU 2014-09, which will extend the effective date for public entities to annual reporting periods beginning on or after December 15, 2017, and determined that it will be permissible to early adopt the standard as of the original effective date of ASU 2014-09. The Company is currently evaluating the requirements of ASU 2014-09 and has not yet determined its impact on the Company's unaudited condensed consolidated financial statements. The Company does not expect to early adopt the standard.

In April 2015, the FASB issued ASU 2015-05, Intangibles - Goodwill and Other - Internal-Use Software (Subtopic 350-40), or ASU 2015-05. This update provides guidance to customers about whether a cloud computing arrangement includes a software license, and if so, to apply the accounting requirements for other intangible assets. If the cloud computing arrangement does not include a software license, ASU 2015-05 indicates that the arrangement should be accounted for as a service contract. The updated guidance is effective for public entities for annual reporting periods beginning on or after December 15, 2015, and interim periods within those annual periods, with early adoption permitted. The Company does not expect the adoption to have a material impact on the Company's unaudited condensed consolidated financial statements.

2. Earnings Per Share

Basic earnings per share is calculated by dividing net income (loss) for the period by the weighted average number of common shares outstanding during the period. Diluted earnings per share is computed by dividing net income (loss) for the period by the weighted average number of shares of common stock outstanding during the period and including the dilutive effect of common stock that would be issued assuming conversion or exercise of outstanding warrants, stock options, share based compensation awards and other dilutive securities.

The following is a reconciliation of weighted-average shares outstanding used in the calculation of basic and diluted earnings from continuing operations per share for the three and six months ended June 30, 2014 and 2015 (in thousands, except per share data):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2015	2014	2015
Net income (loss)	$(78)	$685	$(490)	$4,556
Basic weighted-average common shares outstanding	60,159	61,292	59,920	61,027
Assumed exercise of dilutive stock options, warrants and restricted stock	—	5,270	—	4,584
Diluted weighted-average common shares outstanding	60,159	66,562	59,920	65,611
Net income (loss):				
Basic income (loss) per share	$(0.00)	$0.01	$(0.01)	$0.07
Diluted income (loss) per share	$(0.00)	$0.01	$(0.01)	$0.07

Outstanding equity awards not included in the calculation of diluted net income (loss) per share because their effect was anti-dilutive were as follows:

	Three Months Ended June 30,			
	2014		2015	
	Number of Potential Shares	Range of Exercise Prices	Number of Potential Shares	Range of Exercise Prices
Stock options	10,573,585	$0.47 - $7.84	2,384,500	$4.75 - $7.04

Unvested stock awards	34,845	$—	—	$—
Warrants	1,602,489	$2.40	—	$—

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	Six Months Ended June 30, 2014		2015	
	Number of Potential Shares	Range of Exercise Prices	Number of Potential Shares	Range of Exercise Prices
Stock options	10,573,585	$0.47 - $7.84	3,969,113	$4.00-$7.04
Unvested stock awards	34,845	$—	—	$—
Warrants	1,602,489	$2.40	—	$—

Shares issued

Common stock activity during the period is as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2015	2014	2015
Shares issued:				
Options exercised	273	938	905	1,000
Restricted stock awards granted	30	50	30	333
Shares purchased under stock plan	68	143	266	143
Share decreases:				
Shares repurchased for tax purposes	(2)	(1)	(17)	(2)

3. Inventories

The components of inventories consist of the following (in thousands):

	December 31, 2014	June 30, 2015
Purchased parts and materials	$2,273	$3,303
Finished goods	9,069	5,898
Total inventory	$11,342	$9,201

Inventories are comprised of finished goods and purchased parts and assemblies, which include costs to purchase assembled units and overhead, and are valued at the lower of cost (first-in, first-out method) or market value. The valuation of inventory requires us to estimate excess or obsolete inventory. The determination of excess or obsolete inventory requires us to estimate the future demand for our products. Our customers may require us to purchase and stock material amounts of inventory to ensure availability to meet forecasts, which increases our risk of excess quantities. Because our markets are volatile and are subject to technological risks, price changes and inventory reduction programs by our customers, and because we are required to make last-time buys of certain components on occasion, there is a risk that we will forecast incorrectly and produce excess inventories of particular products or have commitments to purchase excess inventory components from our suppliers. As a result, actual demand will differ from forecasts, and such a difference has in the past and may in the future have a material adverse effect on our gross margin and our results of operations. Any write downs to inventory due to the existence of excess quantities, physical obsolescence, changes in pricing, damage, or other causes result in a new cost basis for the inventory. When we sell or dispose of this inventory, the new cost basis is charged to cost of sales. The decrease in inventory from December 31, 2014 to June 30, 2015 is due to lower required levels of inventory for a significant customer maintained at a vendor managed inventory location.

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4. Intangible Assets

Identifiable intangible assets are as follows (in thousands):

	December 31, 2014			
	Estimated Useful Life	Gross	Accumulated Amortization	Net
Technology-based intangible assets	Not yet determined	$2,680	$—	$2,680
Total intangible assets		$2,680	$—	$2,680

	June 30, 2015			
	Estimated Useful Life	Gross	Accumulated Amortization	Net
Technology-based intangible assets	Not yet determined	$4,512	$—	$4,512
Total intangible assets		$4,512	$—	$4,512

Technology-based intangible assets consist of software to be sold, leased or otherwise marketed, and includes capitalized software development costs. The estimated useful life and projected date that the intangible assets will be generally available for release to customers is not readily determinable as of December 31, 2014 or June 30, 2015. Intangible assets have not been allocated to reporting segments as they are used across the operating segments.

There was no amortization of intangible assets for the three and six months ended June 30, 2014 as there were no technology-based intangible assets as of June 30, 2014, and there was no amortization of intangible assets for the three and six months ended June 30, 2015 as the intangible assets product was not generally available for release to customers.

5. Product Warranties

Our standard warranty provides that if our systems do not function to published specifications, we will repair or replace the defective component, system or firmware without charge generally for a period of approximately three years. 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 typically intended to be covered by corresponding 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 or that our warranty obligations to our customers will be covered by corresponding warranties from our suppliers, the absence of which could have a material effect on our financial statements. Estimated liabilities for product warranties are included in accrued expenses.

Our warranty accrual and cost activity is as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2015	2014	2015
Balance, beginning of period	$3,244	$3,469	$2,965	$3,363
Charges to operations	412	447	826	789
Deductions for payments made	(175)	(318)	(350)	(704)
Changes in estimates	(118)	(382)	(78)	(232)

Balance, end of period	$3,363	$3,216	$3,363	$3,216

6. Credit Facilities

We maintain a credit facility with Silicon Valley Bank for cash advances and letters of credit of up to an aggregate of $30.0 million based upon an advance rate dependent on certain concentration limits within eligible accounts receivable. These limits exclude certain eligible customer receivables if an individual customer account balance exceeds 25, 50 or 85 percent of the total eligible accounts receivable, depending on the customer, as defined by our Loan and Security Agreement with Silicon Valley Bank. Borrowings under the credit facility bear interest at the Silicon Valley Bank's prime rate, which was 4.0% as of

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June 30, 2015, and are secured by substantially all of our accounts receivable, deposit and securities accounts. The agreement provides for a negative pledge on our inventory and intellectual property, subject to certain exceptions, agreeing that other than in the ordinary course of business, we will not convey, sell, lease, transfer or otherwise dispose of these assets without the prior written consent of Silicon Valley Bank, and contains usual and customary covenants for an arrangement of its type, including an obligation that we maintain at all times a net worth, as defined in the agreement. As of June 30, 2015, the Company had significant coverage in regard to this covenant. The agreement also includes provisions to increase the financing facility by $20.0 million subject to our meeting certain requirements, including $40.0 million in borrowing base for the immediately preceding 90 days, and Silicon Valley Bank locating a lender willing to finance the additional facility. In addition, if our cash and cash equivalents, net of the total amount outstanding under the credit facility fall below $20.0 million (measured on a rolling three-month basis), the interest rate will increase to the Silicon Valley Bank's prime rate plus 1.0% and additional restrictions will apply. The maturity date of the credit facility is July 21, 2017.

As of June 30, 2015, the Company had no outstanding borrowings under the Silicon Valley Bank line of credit. There was $30.0 million available for borrowing under the agreement as of June 30, 2015. We are currently in compliance with all covenant requirements.

7. Fair Value Measurements

The short-term nature of our financial instruments expose the Company to limited credit risk and have no stated maturities or have short-term maturities and carry interest rates that approximate market interest rates.

Fair Value of Financial Instruments

The Company’s financial instruments consist of cash and cash equivalents, accounts receivable, accounts payable and credit facility borrowings. The carrying values on our balance sheet of our cash and cash equivalents, accounts receivable and accounts payable approximate their fair values due to the short maturities.

The Company had no outstanding borrowings on the credit facility as of December 31, 2014 or June 30, 2015, and as such, no fair value estimate was required.

8. Commitments and Contingencies

Legal Proceedings

We are not party to any significant legal proceedings, except as described below, but are involved in certain legal actions and claims from time to time arising in the ordinary course of business. Although occasional adverse decisions or settlements may occur, the Company believes that the final disposition of such matters will not have a material adverse effect on its financial position or results of operations.

Crossroads, Inc. - On September 11, 2013, Crossroads Inc., or Crossroads, filed suit against the Company in the United States District Court for the Western District of Texas alleging non-payment of royalties and breach of the Amended Settlement and License Agreement dated October 2006, and infringement of United States Patent No. 6425035. During the quarter ended September 30, 2014, the Company met with Crossroads to establish a framework to resolve the dispute regarding the Amended Settlement and License Agreement dated October 2006. On September 19, 2014, the United States District Court for the Western District of Texas partially granted the Company’s motion for partial summary judgment as to Crossroads’ claims concerning royalty payments on product sales to Hewlett Packard, or HP, for the period after the Fall of 2011 and at the same time held that the Company is not entitled to the benefit of a license Crossroads granted to HP for the period prior to fall 2011. On February 27, 2015, the Company filed motions to join two inter partes reviews of the validity of the patent that are being conducted by the United States Patent Office and filed a motion to stay the district court litigation pending the entry of final written decisions in the inter partes reviews. On June 16, 2015, the District Court for the Western District of Texas granted the Company's motion to stay the lawsuit and suspended all litigation activity. No trial date has been set. Based on the United States District Court’s response to the Company’s motion for partial summary judgment and prior discussions with Crossroads, it is probable that the Company will resolve this contractual dispute for royalty payments from 2009 to the current period for a total amount in the range of $1.0 million to $3.4 million. As of June 30, 2015, there was a $1.0 million balance accrued, which was charged to general and administrative expense for the year ended December 31, 2014. The actual amount of any settlement could be different than the amount accrued or the currently estimated maximum amount and the difference could be material.

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9. Accumulated Other Comprehensive Loss

Foreign currency translation adjustments comprise the entire amount of our accumulated other comprehensive loss as of December 31, 2014 and June 30, 2015. Effective June 17, 2015, we liquidated our Netherlands subsidiary, which had no active operations, and the cumulative translation adjustment loss of $2.7 million recorded in accumulated other comprehensive loss was reclassified into operating income (loss). Refer to Note 1, Summary of Significant Accounting Policies - Cash and Cash Equivalents for further discussion.

The amounts reclassified into operating income (loss) from accumulated other comprehensive loss are reflected in the Condensed Consolidated Statements of Operations and Comprehensive Income (Loss) as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2015	2014	2015
OPERATING EXPENSES:				
General and administrative	$—	$2,677	$—	$2,677

The components of accumulated other comprehensive loss, net of tax, as of June 30, 2015 and changes during the three and six months ended June 30, 2015 are as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2015	2014	2015
Cumulative Foreign Currency Translation Adjustment:				
Balance, beginning of period	$3,284	$3,159	$3,254	$3,152
Foreign currency translation adjustment	(1)	(27)	29	(20)
Reclassification of accumulated foreign currency translation losses into net income (loss)	—	(2,677)	—	(2,677)
Balance, end of period	$3,283	$455	$3,283	$455

10. Segment Information

Operating segments, as defined in ASC 280, Segment Reporting, are components of an enterprise for which separate financial information is available and is evaluated regularly by the Chief Operating Decision Maker, or CODM, in deciding how to allocate resources and in assessing performance.
The Company's CODM is the President and Chief Executive Officer. The CODM manages the Company's business as three reportable operating segments: Server OEM, Vertical Markets, and Corporate.

Server OEM - The Server OEM segment consists primarily of large OEMs who purchase products from us to sell along with their server products. Our products are typically sold in server led sales into their end-user customers' corporate information technology infrastructure. Server OEM customers include Customer A (refer to Note 1, Summary of Significant Accounting Policies - Concentration of Customers and Suppliers).

Vertical Markets - The Vertical Markets segment consists of strategically selected Vertical Markets, that are recognized as processing large amounts of data. Our target Vertical Markets include Media and Entertainment, Telecommunications Infrastructure, Oil and Gas, Big Data Analytics and Digital Imaging, among others. These customers typically embed their products into their customer solutions, which quite often generate revenue for their end-user customers. We sell to these customers through both Vertical Markets OEM partners that include embedded solutions integrators, as well as through channel partners. Vertical Markets customers include Customer B, Customer C and Customer D (refer to Note 1, Summary of Significant Accounting Policies - Concentration of Customers and Suppliers).

Corporate - The Corporate segment consists primarily of costs that support both the Server OEM and Vertical Markets segments.

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Net revenues by segment are as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2015	2014	2015
Net revenue:				
Server OEM	$27,463	$36,733	$53,317	$61,911
Vertical Markets	20,759	24,806	43,112	60,749
Corporate	—	—	—	—
Total net revenue	$48,222	$61,539	$96,429	$122,660

Operating income (loss) by segment and a reconciliation to consolidated income (loss) before income taxes is as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2015	2014	2015
Operating income (loss):				
Server OEM	$6,242	$9,189	$11,364	$14,583
Vertical Markets	6,762	8,287	14,169	20,773
Corporate	(13,015)	(16,703)	(25,947)	(30,688)
Total operating income (loss)	(11)	773	(414)	4,668
Total other income (expense), net	7	(13)	(1)	(27)
Income (loss) before income taxes	$(4)	$760	$(415)	$4,641

The segments use many of the same assets. For internal reporting purposes, we do not allocate assets by segment and therefore asset, depreciation and amortization, or capital expenditure by segment information is not provided to our CODM.

Operating income (loss) for the Corporate segment for the three and six months ended June 30, 2015 includes accumulated foreign currency translation amounts reclassified into earnings from accumulated other comprehensive income. Refer to Note 9, Accumulated Other Comprehensive Loss.

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

Cautionary Statement for Forward-Looking Information

In this quarterly report on Form 10-Q, "Dot Hill", "we", "us" and "our" refer to Dot Hill Systems Corp. and our wholly owned subsidiaries on a consolidated basis, unless the context otherwise provides. Certain statements contained in this quarterly report on Form 10-Q, including statements regarding the development, growth and expansion of our business, our intent, belief or current expectations, primarily with respect to our future operating performance and the products we expect to offer, and other statements regarding matters that are not historical facts, are “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, or the Exchange Act, and are subject to the “safe harbor” created by these sections. Because such forward-looking statements are subject to risks and uncertainties, many of which are beyond our control, actual results may differ materially from those expressed or implied by such forward-looking statements. Some of the factors that could cause actual results to differ materially from those expressed or implied by such forward-looking statements can be found in Part II, Item 1A, “Risk Factors” and in our reports filed with the Securities and Exchange Commission, or SEC, including our Annual Report on Form 10-K for the year ended December 31, 2014 filed with the SEC on March 11, 2015, or Form 10-K, as amended by Form 10-K/A for the year ended December 31, 2014 filed with the SEC on March 13, 2015, or Form 10-K/A. 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, except as required by applicable law, we undertake no obligation to update any forward-looking statement to reflect events or circumstances after the date on which the statement is made or to reflect the occurrence of unanticipated events.

The following discussion of our financial condition and results of operations should be read in conjunction with our unaudited condensed consolidated financial statements and notes thereto included in the preceding pages in this Quarterly Report on Form 10-Q and our audited consolidated financial statements and notes thereto included in our Annual Report on Form 10-K and Form 10-K/A for the year ended December 31, 2014.

Overview

We design, manufacture and market a range of storage systems, including hybrid storage arrays, for the entry and mid-range storage markets. We focus on selling through Server-based original equipment manufacturers, or OEMs, such as Hewlett-Packard, or HP, Lenovo Group Limited, or Lenovo, Advanced Micro Devices, Inc., or AMD and Stratus Technologies, or Stratus; as well as into Vertical Markets through embedded solution OEMs, such as Flextronics, Teradata Corporation or Teradata, Motorola, Inc., or Motorola, Tektronix Inc., or Tektronix, Samsung Electronics, or Samsung, Concurrent Computer Corporation, or Concurrent, Autodesk Inc., or Autodesk, Imagine Communications, Quantum Corp., or Quantum and Nokia Solutions and Networks US LLC , or Nokia, which primarily include media and entertainment, telecommunications, high performance computing, digital image archive, big data and oil and gas.

Typical customers for our storage systems products, which include our AssuredSAN™ line of storage array products, include organizations requiring high reliability, high performance networked or direct attached storage and data management solutions in an open systems architecture. Most of our sales through our Server OEMs go into the information technology, or IT, infrastructure of companies and organizations to support a wide variety of internal applications, including email, Enterprise Resource and Planning, file sharing and retail transactions. On the other hand, much of our product sales into Vertical Markets support the revenue streams of embedded solution partners' end-user customers, such as the infrastructure of telco providers, video editing and streaming appliances, and big data analytics solutions. Our storage solutions consist of integrated hardware, firmware and software products employing a modular system that allows end-users to add various protocol, performance, capacity or data protection schemes as needed. Our broad range of products, from small capacity direct attached to complete multi-hundred terabyte, or TB, storage area networks, or SANs, provide end-users with a cost-effective means of addressing increasing storage demands at compelling price-performance points. Our current product family based on our AssuredSAN architecture provides high performance and large disk array capacities with both hard disk drives, or HDDs, and flash-based Solid State Drives, or SSDs, for a broad variety of environments, employing Fibre Channel, Internet Small Computer Systems Interface, or iSCSI or Serial Attached SCSI, or SAS, interconnects to switches and/or hosts. In addition, our Assured family of data protection software products provides additional layers of data protection options to complement our line of storage disk arrays. Our current mainstream AssuredSAN family of entry-level and mid-range storage products and Just a Bunch of Disks, or JBOD, arrays are targeted primarily at mainstream enterprise and small-to-medium business, or SMB, applications. Some of our AssuredSAN products have been distinguished by certification as Network Equipment Building System, or NEBS, Level 3 (a telecommunications standard for equipment used in central offices) and are MIL-STD-810F (a military standard created by the United States government) compliant based on their ruggedness and reliability.

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Our products span Price Bands 2 through 6 as defined by International Data Corporation, or IDC. Our AssuredSAN 3000 Series product addresses the entry level market (bands 2 and 3) and AssuredSAN 4000 and 6000 Series products address the mid-range market (bands 4 through 6). AssuredSAN 4000 Series products include RealStor™ software that incorporates autonomic real-time data tiering via a virtualized back-end. With RealStor, businesses gain the advantage of using very high performance SSDs to their maximum benefit, while storing less frequently accessed data on larger and much less expensive HDDs. Our AssuredSAN 3000 Series products are typically, but not exclusively, sold through our Server OEM partners, our AssuredSAN 4000 Series products are sold through both Server OEM partners and Vertical Markets OEM partners, and our AssuredSAN 6000 Series are typically, but not exclusively, sold through our Vertical Market OEM partners.

Our agreements with our customers do not contain any minimum purchase commitments and may be terminated at any time upon notice from the applicable customer. Our ability to achieve and maintain profitability will depend on, among other things:

- the level and mix of orders we actually receive from such customers;
- the actual amounts we spend on marketing support;
- the actual amounts we spend for inventory support and incremental internal investment to develop or enhance our products;
- our ability to reduce product cost;
- our product lead time;
- our ability to meet delivery schedules required by our customers; and
- the economic environment.

Our products and services are sold worldwide to facilitate server and SAN storage implementations, primarily through Server OEMs, Vertical Markets OEM partners that include embedded solution OEMs that integrate our products into their solutions, and value-added resellers, or VARs. Our storage system products' Server OEM partners currently include, among others, HP, Lenovo and Stratus, who purchase our AssuredSAN products, and AMD, among others, who purchase our AssuredVRA products. Our Vertical Markets OEM partners include Flextronics, Teradata, Motorola, Tektronix, Samsung, Concurrent, Autodesk, Imagine Communications, Quantum and Nokia. Although our products and services are sold worldwide, the majority of our net revenue is derived from our United States operations.

We began shipping products to HP in the fourth quarter of 2007. In 2008, we amended our agreement with HP to allow for sales of additional products to additional divisions within HP. Our products are primarily sold as HP’s MSA product family. HP launched its third generation product line, called the P2000 product line, in 2010. Sales to HP increased in 2010 as we began selling our next generation host interfaces across the HP P2000 product line. HP launched its fourth generation product line with the introduction of the 2040 line in mid-2013, and extended the portfolio in early 2014 with the 1040 line. In late 2014, HP introduced firmware with the ability of autonomic real time tiering. The agreement with HP does not contain any minimum purchase commitments. In 2011, we extended our supply agreement with HP by five years to expire in October 2016 and also extended the expiration of 1.6 million warrants granted to HP in 2008 to expire concurrently with the supply agreement in October 2016.

The demand for our products has been affected in the past, and may continue to be affected in the future, by various factors, including, but not limited to, the following:

- our ability to maintain and enhance relationships with our Server OEM and Vertical Markets OEM customers, as well as our ability to win new business;
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- our ability to source critical components such as integrated circuits, hard disk drives, memory and other components on a timely basis;
- the amount of field failures resulting in product replacements or recalls;
- our ability to launch new products in accordance with OEM specifications, schedules and milestones;
- our ability to sell Dot Hill branded products through resellers;
- our ability to win new Server OEM and Vertical Markets OEM customers who embed our products into their solutions;
- general economic and political conditions and specific conditions in the markets we address, including the continuing volatility in the technology sector, current general economic volatility and trends in the data storage markets in various geographic regions;
- the timing, rescheduling or cancellation of significant customer orders and our ability, as well as the ability of our customers, to manage inventory;
- our customer's product launch timelines and sales cycle; and

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- the inability of certain of our customers who depend on credit to have access to their traditional sources of credit to finance the purchase of products from us, particularly in the current global economic environment, which may lead them to reduce their level of purchases or to seek credit or other accommodations from us.

For these and other reasons, our net revenue and results of operations for the three and six months ended June 30, 2015 and prior periods may not necessarily be indicative of future net revenue and results of operations.

Our manufacturing strategy includes outsourcing substantially all of our manufacturing to third-party manufacturers in order to reduce sales cycle times and manufacturing infrastructure, enhance working capital and improve margins by taking advantage of the third parties' manufacturing and procurement economies of scale. In September 2008, we entered into a manufacturing agreement with Foxconn Technology Group, or Foxconn. Under the terms of the agreement, Foxconn supplies us with manufacturing, assembly and test services from its facilities in China and final integration services including final assembly, testing and configure-to-order services through its worldwide facilities. In November 2011, we amended our agreement with Foxconn to extend the manufacturing agreement for a period of three years. In addition, Foxconn agreed to waive the requirement for a letter of credit and improved payment terms. In November 2014, we extended the agreement to March 11, 2015, and in March 2015, we extended the agreement to September 1, 2015. We are currently in negotiations to extend our contract with Foxconn. If the agreement is not further extended, pursuant to terms in the existing agreement, we can continue to operate with Foxconn for a period of six months following the expiration of the agreement. In the event the Company does not extend its agreement with Foxconn, we have developed plans with an alternative contract manufacturer. The majority of our products sold in 2014 and to date in 2015 were manufactured by Foxconn. We expect Foxconn to manufacture substantially all of our products throughout 2015.

Critical Accounting Policies and Estimates

An accounting policy is deemed to be critical if it requires an accounting estimate to be made based on assumptions about matters that are highly uncertain at the time the estimate is made, if different estimates reasonably could have been used, or if changes in the estimate that are reasonably likely to occur could materially impact the unaudited condensed consolidated financial statements. Management has added income taxes, including the valuation allowance for deferred tax assets, as a critical accounting policy and estimate during the three and six months ended June 30, 2015, as listed below. Management believes that other than the addition of income taxes, there have been no significant changes during the three and six months ended June 30, 2015 to the items that we disclosed as our critical accounting policies and estimates in Management's Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the fiscal year ended December 31, 2014. Refer to Note 1, Summary of Significant Accounting Policies, of the notes to unaudited condensed consolidated financial statements included in the preceding pages in this Quarterly Report on Form 10-Q.

Income Taxes

We recognize deferred tax assets and liabilities for the expected tax effects of temporary differences between the tax bases of assets and liabilities and their reported amounts using enacted tax rates in effect for the year the differences are expected to reverse. We record a valuation allowance to reduce the deferred tax assets to the amount that is more likely than not to be realized. We periodically evaluate the likelihood of the realization of deferred tax assets. We consider many factors when assessing the likelihood of future realization of our deferred tax assets, including our recent cumulative earnings experience by taxing jurisdiction, expectations of future taxable income or loss, the amount of our net operating loss carryforwards not subject to limitations, the number of periods it will take to realize our net operating loss carryforwards and other relevant factors. Based upon our analysis of these factors, we have not concluded that our principal tax paying entity has attained a sustained level of profitability sufficient to reduce our valuation allowance. However, given our current earnings and anticipated future earnings, we believe that it is possible that within the next twelve months, we may reduce all or a portion of the valuation allowance if the Company determines that it is more likely than not that a material amount of our deferred tax assets will be realized. The exact timing and amount of any valuation allowance reduction is subject to change on the basis of the level of profitability that we are able to actually achieve. Any future reduction of the valuation allowance will be recorded as a tax benefit increasing our net income.

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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 (percentages may not recalculate due to rounding):

	Three Months Ended June 30, 2014		Three Months Ended June 30, 2015		Six Months Ended June 30, 2014		Six Months Ended June 30, 2015	
NET REVENUE	100.0	%	100.0	%	100.0	%	100.0	%
COST OF GOODS SOLD	66.8		67.3		67.6		66.4	
GROSS PROFIT	33.2		32.7		32.4		33.6	
OPERATING EXPENSES:								
Research and development	19.4		16.2		19.5		16.4	
Sales and marketing	8.0		5.6		7.4		5.9	
General and administrative	5.9		9.7		6.0		7.5	
Total operating expenses	33.3		31.5		32.9		29.8	
OPERATING INCOME (LOSS)	(0.1	)	1.3		(0.5	)	3.8	
Other income (expense), net	0.0		(0.0	)	(0.0	)	(0.0	)
INCOME (LOSS) BEFORE INCOME TAXES	(0.1	)	1.2		(0.5	)	3.8	
INCOME TAX EXPENSE	0.2		0.1		0.1		0.1	
NET INCOME (LOSS)	(0.3	)%	1.1	%	(0.6	)%	3.7	%

Three and Six Months Ended June 30, 2014 Compared to the Three and Six Months Ended June 30, 2015

Net Revenue

	Three Months Ended June 30,									
	2014	% of Net Revenue		2015	% of Net Revenue		Increase(Decrease)	% Change		
	(in thousands, except percentages)									
Net Revenue:										
Server OEM	$27,463	57.0	%	$36,733	59.7	%	$ 9,270	33.8	%	
Vertical Markets	20,759	43.0	%	24,806	40.3	%	4,047	19.5	%	
Consolidated Net Revenue	$48,222	100.0	%	$61,539	100.0	%	$ 13,317	27.6	%	

	Six Months Ended June 30,								
	2014	% of Net Revenue		2015	% of Net Revenue		Increase(Decrease)	% Change	
	(in thousands, except percentages)								
Net Revenue:									
Server OEM	$53,317	55.3	%	$61,911	50.5	%	$ 8,594	16.1	%
Vertical Markets	43,112	44.7	%	60,749	49.5	%	17,637	40.9	%
Consolidated Net Revenue	$96,429	100.0	%	$122,660	100.0	%	$ 26,231	27.2	%

Revenues from our largest Server OEM customer increased in the three months ended June 30, 2015 as compared to the three months ended June 30, 2014 due to additional demand for our current product line. However, the revenues from this customer declined from approximately 50% of our total consolidated net revenue for the three months ended June 30, 2014 to 45% of our total consolidated net revenue for the three months ended June 30, 2015. The decline as a percentage of consolidated net revenue is due to the increase in consolidated net revenues from other new and existing customers, and the associated revenue diversification. We expect sales to our largest Server OEM customer to continue to represent a substantial

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portion of our Server OEM net revenue during the remainder of 2015. The remainder of the increase in Server OEM revenues was due to an increase in sales to another large Server OEM customer.

Net revenue from the Vertical Markets segment increased primarily due to a ramp in sales to existing and new customers. The ramp in sales was due to a combination of factors, including additional demand for our existing product line and the addition of our higher density chassis options. We expect the growth trend in sales to Vertical Markets to continue during the remainder of 2015.

Revenues from our largest Server OEM customer increased in the six months ended June 30, 2015 as compared to the six months ended June 30, 2014 due to increased demand for our existing product line. However, the revenues from this customer declined from approximately 50% of our total consolidated net revenue for the six months ended June 30, 2014 to 40% of our total consolidated net revenue for the six months ended June 30, 2015. The decline as a percentage of consolidated net revenue is due to the increase in consolidated net revenues from other new and existing customers, and the associated revenue diversification. We expect sales to this customer to continue to represent a substantial portion of our Server OEM net revenue during the remainder of 2015. The remainder of the increase in Server OEM revenues was due to an increase in sales to other existing Server OEM customers.

Net revenue from the Vertical Markets segment for the six months ended June 30, 2015 as compared to the six months ended June 30, 2014 increased primarily due to a ramp in sales to existing and new Vertical Markets customers. The ramp in sales was due to a combination of factors, including additional demand for our existing product line and the addition of our higher density chassis options. We expect the growth trend in sales to Vertical Markets to continue during the remainder of 2015.

Cost of Goods Sold

	Three Months Ended June 30,									
	2014	% of Net Revenue		2015	% of Net Revenue		Increase(Decrease)	% Change	
	(in thousands, except percentages)								
Cost of Goods Sold:									
Server OEM	$20,680	42.9	%	$26,930	43.8	%	$ 6,250	30.2	%
Vertical Markets	11,519	23.9	%	14,475	23.5	%	2,956	25.7	%
Consolidated Cost of Goods Sold	$32,199	66.8	%	$41,405	67.3	%	$ 9,206	28.6	%

	Six Months Ended June 30,								
	2014	% of Net Revenue		2015	% of Net Revenue		Increase(Decrease)	% Change	
	(in thousands, except percentages)								
Cost of Goods Sold:									
Server OEM	$40,930	42.4	%	$46,112	37.6	%	$ 5,182	12.7	%
Vertical Markets	24,211	25.1	%	35,384	28.8	%	11,173	46.1	%
Consolidated Cost of Goods Sold	$65,141	67.6	%	$81,496	66.4	%	$ 16,355	25.1	%

Server OEM cost of goods sold increased largely as a result of the increase in revenue from Server OEM customers during the three months ended June 30, 2015, with the increase partially offset by a change in product mix for the first quarter of 2015.

Vertical Markets cost of goods sold increased mainly as a result of the increase in Vertical Markets revenue during the three months ended June 30, 2015, as well as the change in product and customer mix during the quarter.

During the six months ended June 30, 2015, Server OEM cost of goods sold increased largely as a result of the increase in revenue from Server OEM customers, with the increase partially offset by a change in product mix for the first half of 2015.

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During the six months ended June 30, 2015, Vertical Markets cost of goods sold increased mainly as a result of the increase in Vertical Markets revenue, as well as a change in product and customer mix during the quarter.

Gross Profit

	Three Months Ended June 30,								
	2014	% of Segment Net Revenue		2015	% of Segment Net Revenue		Increase(Decrease)	% Change	
	(in thousands, except percentages)								
Gross Profit:									
Server OEM	$6,783	24.7	%	$9,803	26.7	%	$ 3,020	44.5	%
Vertical Markets	9,240	44.5	%	10,331	41.6	%	1,091	11.8	%
Consolidated Gross Profit	$16,023	33.2	%	$20,134	32.7	%	$ 4,111	25.7	%

	Six Months Ended June 30,								
	2014	% of Segment Net Revenue		2015	% of Segment Net Revenue		Increase(Decrease)	% Change	
	(in thousands, except percentages)								
Gross Profit:									
Server OEM	$12,387	23.2	%	$15,799	25.5	%	$ 3,412	27.5	%
Vertical Markets	18,901	43.8	%	25,365	41.8	%	6,464	34.2	%
Consolidated Gross Profit	$31,288	32.4	%	$41,164	33.6	%	$ 9,876	31.6	%

The primary driver of the increase in gross profit percentage for Server OEM for the three months ended June 30, 2015 as compared to the three months ended June 30, 2014 was the mix of product sales.

Vertical Markets gross profit percentage declined from the three months ended June 30, 2014 as compared to the three months ended June 30, 2015 due to the change in product and customer mix.

The primary driver of the increase in gross profit percentage for Server OEM for the six months ended June 30, 2015 as compared to the six months ended June 30, 2014 was the mix of product sales.

Vertical Markets gross profit percentage declined slightly from the six months ended June 30, 2014 to the six months ended June 30, 2015 due to the change in product and customer mix.

Research and Development Expenses

	Three Months Ended June 30,								
	2014	% of Net Revenue		2015	% of Net Revenue		Increase(Decrease)	% Change	
	(in thousands, except percentages)								
Research and Development Expenses	$9,340	19.4	%	$9,960	16.2	%	$ 620	6.6	%

	Six Months Ended June 30,							
	2014	% of Net Revenue	2015	% of Net Revenue	Increase(Decrease)	% Change		

	(in thousands, except percentages)								
Research and Development Expenses	$18,816	19.5	%	$20,079	16.4	%	$	1,263	6.7 %

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Research and development expenses are included in the Corporate segment and not allocated between the Server OEM and Vertical Markets segments as most research and development efforts are deployed across both of these segments. The increase in consolidated research and development expenses for the three months ended June 30, 2015 as compared to the three months ended June 30, 2014 was due to a combination of an increase in compensation expense of $1.1 million, with associated increases in share-based compensation expense of $0.1 million, due to an increase in headcount necessary to support the research and development function. These headcount related increases were partially offset by the capitalization of software development costs of $0.8 million. In addition, there was an increase in depreciation and other expenses of $0.2 million.

The increase in consolidated research and development expenses for the six months ended June 30, 2015 as compared to the six months ended June 30, 2014 was due to a combination of an increase in compensation expense of $1.6 million, with associated increases in share-based compensation expense of $0.3 million, travel expenses of $0.1 million and allocated common costs of $0.4 million, due to an increase in headcount necessary to support the research and development function. These headcount related increases were partially offset by the capitalization of software development costs of $1.5 million. In addition, there was an increase in depreciation and other expenses of $0.4 million.

We expect that the timing of our engineering headcount requirements and material purchases to support new product releases will affect the amount of research and development expenses in future periods. In addition, we expect that future levels of capitalized software development costs will fluctuate significantly dependent upon the type of software development projects undertaken.

Sales and Marketing Expenses

	Three Months Ended June 30,					
	2014	% of Net Revenue	2015	% of Net Revenue	Increase(Decrease)	% Change
	(in thousands, except percentages)					
Sales and Marketing Expenses:						
Server OEM	$541	1.1 %	$614	1.0 %	$ 73	13.5 %
Vertical Markets	2,478	5.1 %	2,044	3.3 %	(434)	(17.5)%
Corporate	824	1.7 %	783	1.3 %	(41)	(5.0)%
Consolidated Sales and Marketing Expenses	$3,843	8.0 %	$3,441	5.6 %	$ (402)	(10.5)%

	Six Months Ended June 30,					
	2014	% of Net Revenue	2015	% of Net Revenue	Increase(Decrease)	% Change
	(in thousands, except percentages)					
Sales and Marketing Expenses:						
Server OEM	$1,023	1.1 %	$1,216	1.0 %	$ 193	18.9 %
Vertical Markets	4,732	4.9 %	4,592	3.7 %	(140)	(3.0)%
Corporate	1,382	1.4 %	1,437	1.2 %	55	4.0 %
Consolidated Sales and Marketing Expenses	$7,137	7.4 %	$7,245	5.9 %	$ 108	1.5 %

Server OEM sales and marketing expense for the three months ended June 30, 2015 increased slightly as compared to the three months ended June 30, 2014 primarily due to an increase in non-capitalized equipment costs necessary to support product sales.

Vertical Markets sales and marketing expense decreased during the three months ended June 30, 2015 as compared to the three months ended June 30, 2014 due to a decrease in compensation expense, as well as travel and advertising expenses, due to the Company's entry in April 2015 into an agreement with Quantum, whereby Quantum is providing global channel sales and marketing resources, services and support that was previously a component of the Company's sales and marketing expenses.

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Corporate sales and marketing expense for the three months ended June 30, 2015 was relatively flat as compared to the three months ended June 30, 2014.

Server OEM sales and marketing expense for the six months ended June 30, 2015 increased as compared to the six months ended June 30, 2014 primarily due to an increase in non-capitalized equipment costs necessary to support product sales.

Vertical Markets sales and marketing expense for the six months ended June 30, 2015 decreased as compared to the six months ended June 30, 2014 primarily due to a decrease in compensation expense, as well as travel and advertising expenses, partially offset by an increase in evaluation unit expenses and professional fees, due to the Company's entry in April 2015 into an agreement with Quantum, whereby Quantum is providing global channel sales and marketing resources, services and support that was previously a component of the Company's sales and marketing expenses.

Corporate sale and marketing expense for the six months ended June 30, 2015 was relatively flat as compared to the six months ended June 30, 2014.

General and Administrative Expenses

	Three Months Ended June 30,									
	2014	% of Net Revenue		2015	% of Net Revenue		Increase(Decrease)		% Change	
	(in thousands, except percentages)									
General and Administrative Expenses	$2,851	5.9	%	$5,960	9.7	%	$	3,109	109.0	%

	Six Months Ended June 30,									
	2014	% of Net Revenue		2015	% of Net Revenue		Increase(Decrease)		% Change	
	(in thousands, except percentages)									
General and Administrative Expenses	$5,749	6.0	%	$9,172	7.5	%	$	3,423	59.5	%

General and administrative expenses are included in the Corporate segment. The increase in general and administrative expenses for the three months ended June 30, 2014 as compared to the three months ended June 30, 2015 was primarily due to recognition of $2.7 million in cumulative foreign currency translation losses previously recorded to other comprehensive income. The losses were reclassified from accumulated other comprehensive income to general and administrative expenses during the three months ended June 30, 2015 as the Company's Netherlands subsidiary which generated the losses was liquidated. The remaining increase was due to an increase of $0.4 million in compensation expense primarily due to increases in other compensation, as well as additional headcount to support growth in the Company.

The increase in general and administrative expenses for the six months ended June 30, 2014 as compared to the six months ended June 30, 2015 was primarily due to recognition of $2.7 in cumulative foreign currency translation losses previously recorded to other comprehensive income, which were reclassified from accumulated other comprehensive income to general and administrative expenses during the three months ended June 30, 2015 as the Netherlands subsidiary which generated the losses was liquidated. The remaining increase was due to an increase of $0.6 million in compensation expense primarily due to increases in other compensation, as well as additional headcount to support growth in the Company.

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Other Income (Expense), net

	Three Months Ended June 30,					
	2014	% of Net Revenue	2015	% of Net Revenue	Increase(Decrease)	% Change
	(in thousands, except percentages)					
Other Income (Expense):						
Interest Income (Expense), Net	$(4)	0.0%	$(13)	0.0%	$ (9)	225.0%
Other Income (Expense), Net	11	0.0%	—	—%	(11)	(100.0)%
Other Income (Expense), Net	$7	0.0%	$(13)	0.0%	$ (20)	(285.7)%

	Six Months Ended June 30,					
	2014	% of Net Revenue	2015	% of Net Revenue	Increase(Decrease)	% Change
	(in thousands, except percentages)					
Other Income (Expense):						
Interest Income (Expense), Net	$(22)	0.0%	$(27)	0.0%	$ (5)	22.7%
Other Income (Expense), Net	21	0.0%	—	—%	(21)	(100.0)%
Other Income (Expense), Net	$(1)	0.0%	$(27)	0.0%	$ (26)	2,600.0%

Other income (expense), net, for the three and six months ended June 30, 2015, consists of interest income on our cash and cash equivalents, interest expense related to our note payable and other miscellaneous items.

Income Taxes

We recorded income tax expense of $0.1 million and $0.1 million for the three and six months ended June 30, 2014, as compared to $0.1 million and $0.1 million for the three and six months ended June 30, 2015. Our current period provision primarily includes estimated liabilities relating to tax expense in certain states and foreign jurisdictions in which we operate, offset partially by a favorable adjustment to uncertain tax positions.

The Company maintains a valuation allowance against substantially all of its deferred tax assets primarily related to various net operating loss and tax credit carry forwards. We periodically evaluate the likelihood of the realization of deferred tax assets. We consider many factors when assessing the likelihood of future realization of our deferred tax assets, including our recent cumulative earnings experience by taxing jurisdiction, expectations of future taxable income or loss, the amount of our net operating loss carryforwards not subject to limitations, the number of periods it will take to realize our net operating loss carryforwards and other relevant factors. Based upon our analysis of these factors, we have not concluded that our principal tax paying entity has attained a sustained level of profitability sufficient to reduce our valuation allowance. However, given our current earnings and anticipated future earnings, we believe that it is possible that within the next twelve months, we may reduce all or a portion of the valuation allowance if the Company determines that it is more likely than not that a material amount of our deferred tax assets will be realized. The exact timing and amount of any valuation allowance reduction is subject to change on the basis of the level of profitability that we are able to actually achieve. Any future reduction of the valuation allowance will be recorded as a tax benefit increasing our net income.

Liquidity and Capital Resources

The primary drivers affecting cash and liquidity are net income (loss), working capital requirements and capital expenditures. Historically, the payment terms we have had to offer our customers have been relatively similar to the terms received from our suppliers. If our net revenue increases, it is likely that our accounts receivable balance will also increase. Conversely, if our net revenue decreases, it is likely that our accounts receivable will also decrease. Our accounts receivable could increase if customers, such as large OEM customers, delay their payments or if intra quarter timing of revenues is back-end loaded within a particular quarter. During the fourth quarter of 2013, we increased payment terms to a large OEM customer. We granted an additional but smaller increase in payment terms to the same OEM customer commencing in the second quarter of 2014. While this did delay collection of our accounts receivable and correspondingly reduced cash, our net working capital was not impacted. In addition, we expect our cash to be impacted in the future due to increases in inventory

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related to ramp in sales to new or existing customers. In March 2015, we agreed to shorten our payment terms to our primary contract manufacturer, which will reduce our cash, but our net working capital will not be impacted. Our accounts payable may also increase or decrease in connection with changes in volumes as well as our cash conservation strategies. In connection with our contingent liabilities, our cash could be impacted to the extent we incur settlements, fines, penalties or judgments in connection with some of these matters. Refer to Note 8, Commitments and Contingencies, of the notes to unaudited condensed consolidated financial statements included in the preceding pages in this Quarterly Report on Form 10-Q.

As of June 30, 2015, we had $49.1 million of cash and cash equivalents and $63.4 million of working capital compared to $42.5 million of cash and cash equivalents and $53.5 million of working capital as of December 31, 2014. The changes in cash and cash equivalents are further described below.

Cash equivalents include highly liquid investments purchased with original maturities of 90 days or less and consist principally of money market funds. As of June 30, 2015, $1.0 million of the $49.1 million of cash and cash equivalents was held by our foreign subsidiaries. During the quarter ended June 30, 2015, we repatriated approximately $2.0 million of our cash and cash equivalents when we liquidated our Netherlands subsidiary. We obtained a favorable ruling from the Netherlands and were not charged foreign taxes on the repatriation, and we expect that our net operating loss carryforwards and foreign tax credits will be available to offset any United States tax liability, should one arise.

We anticipate that future foreign earnings will be permanently reinvested, although we could elect to repatriate funds held in one or more foreign jurisdictions. If applicable, withholding taxes could reduce the net amount repatriated, and we could be required to accrue and remit applicable United States income taxes to the extent a tax liability results after the utilization of net operating loss carryforwards and available tax credits.

Operating Activities

Net cash provided by operating activities for the six months ended June 30, 2014 was $2.8 million compared to $8.0 million for the six months ended June 30, 2015. The operating activity that affected cash was primarily net loss of $0.5 million for the six months ended June 30, 2014 compared to net income of $4.6 million for the six months ended June 30, 2015.

The adjustments to reconcile net income to net cash provided by operating activities for the six months ended June 30, 2015 for items that did not affect cash consisted of depreciation of $2.3 million, share-based compensation expense of $2.1 million and the reclassification from accumulated other comprehensive income of $2.7 million related to the liquidation of our Netherlands subsidiary.

Cash flows from operations reflects the positive impact of a decrease in inventory, which positively impacted cash flows from operations by $2.1 million. The inventory decrease in the six months ended June 30, 2015 primarily relates to lower levels of inventory purchases and utilization of inventories due to ramping of sales to certain customers. The decrease in prepaid expenses and other assets had a $4.7 million positive impact to cash from operations from December 31, 2014 to June 30, 2015 due to decreases in non-trade accounts receivable and decreases in certain other annual prepaid contracts. Accrued compensation and other expenses had a $2.4 million positive impact on cash flows due primarily to timing of payments for vendor obligations and compensation amounts.

Cash flows from operations reflect a negative impact of $1.5 million related to an increase in accounts receivable from December 31, 2014 to June 30, 2015, which was primarily due to timing of revenues in the second quarter of 2015 being weighted to the last month of the quarter. Days Sales Outstanding increased from 63 days at the end of the fourth quarter of 2014 to 67 days at the end of the second quarter of 2015. Cash flows from operations were also negatively impacted by $9.2 million related to a decrease in accounts payable from December 31, 2014 to June 30, 2015, primarily driven by timing of payments and relative levels of revenues for the quarter ended June 30, 2015 as compared to the fourth quarter of 2014. Days Payable Outstanding decreased from 72 days at the end of the fourth quarter of 2014 to 62 days at the end of the second quarter of 2015 due to a change in terms with our contract manufacturer. Cash flows from operations also reflects the negative impact of a $1.5 million decrease in deferral of revenue for certain software contracts recognized over the contract term, and an overall decrease of $0.6 million in other long-term liabilities, primarily due to a decrease in long-term deferred revenue.

Investing Activities

Cash used in investing activities for the six months ended June 30, 2014 was $1.4 million compared to $4.5 million for the six months ended June 30, 2015. Cash used in investing activities for the six months ended June 30, 2015 was due to test and other equipment used in internal laboratories and at our contract manufacturing partners for use in the production of our products, and also the capitalization of costs associated with software development.

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Financing Activities

Cash provided by financing activities for the six months ended June 30, 2014 was $0.4 million compared to $3.2 million for the six months ended June 30, 2015. Cash provided by financing activities for the six months ended June 30, 2015 was primarily from the sale of stock to employees under our employee stock plans of $3.2 million.

Based on current macro-economic conditions and conditions in the state of the data storage systems markets, our own organizational structure and our current outlook, we presently expect our cash and cash equivalents will be sufficient to fund our operations, working capital and capital requirements for at least the next 12 months. However, we may deem it necessary to invest in our business, our technologies or other businesses, in which case we may need to raise additional funds through debt or equity financing. Also, our capital resources could be negatively impacted by unforeseen future events.

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 intra quarter timing and overall levels of net revenue;
- expenditures from our core business and strategic investments;
- the overall level of net profits or losses;
- our ability to manage our relationships with our contract manufacturers;
- the potential growth or decline in inventory to support our customers;
- costs associated with product quality issues and the recovery, if any, of such costs from a supplier;
- the status of our relationships with key customers, partners and suppliers;
- the timing and extent of the introduction of new products and services;
- the growth in operations;
- legal settlements; and
- the economic environment.

In addition, the actual amount and timing of working capital will depend on our ability to maintain payment terms with our suppliers consistent with the credit terms of our customers. For example, if Foxconn, our major contract manufacturing partner, were to further shorten our payment terms with them, or if significant customers were to further lengthen their payment terms with us, our financial condition could be negatively impacted.

We maintain a credit facility with Silicon Valley Bank for cash advances and letters of credit of up to an aggregate of $30.0 million based upon an advance rate dependent on certain concentration limits within eligible accounts receivable. These limits exclude certain eligible customer receivables if an individual customer account balance exceeds 25, 50 or 85 percent of the total eligible accounts receivable, depending on the customer, as defined by our Loan and Security Agreement with Silicon Valley Bank. Borrowings under the credit facility bear interest at the Silicon Valley Bank's prime rate, which was 4.0% as of June 30, 2015, and are secured by substantially all of our accounts receivable, deposit and securities accounts. The agreement provides for a negative pledge on our inventory and intellectual property, subject to certain exceptions, agreeing that other than in the ordinary course of business, we will not convey, sell, lease, transfer or otherwise dispose of these assets without the prior written consent of Silicon Valley Bank, and contains usual and customary covenants for an arrangement of its type, including an obligation that we maintain at all times a net worth, as defined in the agreement. As of June 30, 2015, the Company had significant coverage in regard to this covenant. The agreement also includes provisions to increase the financing facility by $20 million subject to our meeting certain requirements, including $40.0 million in borrowing base for the immediately preceding 90 days, and Silicon Valley Bank locating a lender willing to finance the additional facility. In addition, if our cash and cash equivalents, net of the total amount outstanding under the credit facility fall below $20.0 million (measured on a rolling three-month basis), the interest rate will increase to the Silicon Valley Bank's prime rate plus 1% and additional restrictions will apply. The maturity date of the credit facility is July 21, 2017.

As of June 30, 2015, the Company had no outstanding borrowings under the Silicon Valley Bank line of credit. There was $30.0 million available for borrowing under the agreement as of June 30, 2015. We are currently in compliance with all covenant requirements.

At June 30, 2015, our long-term commitments had not materially changed from those disclosed in our Annual Report on Form 10-K for the year ended December 31, 2014.

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Off-Balance Sheet Arrangements

At June 30, 2015, we did not have any relationship with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance variable interest, or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. In addition, we did not engage in trading activities involving non-exchange traded contracts. As a result, we are not exposed to any financing, liquidity, market or credit risk that could arise if we had engaged in such relationships. We do not have relationships and transactions with persons and entities that derive benefits from their non-independent relationship with us or our related parties except as disclosed herein or in our Annual Report on Form 10-K for the year ended December 31, 2014.

We enter into indemnification agreements with third parties in the ordinary course of business that generally require us to reimburse losses suffered by the third party due to various events, such as lawsuits arising from patent or copyright infringement. These indemnification obligations are considered off-balance sheet arrangements under accounting guidance. It is not possible to determine the maximum potential exposure under these indemnification agreements due to the limited history of prior indemnification claims and the unique facts and circumstances involved in each particular agreement. Such indemnification agreements may not be subject to maximum loss clauses. Historically, we have not incurred material costs as a result of obligations under these agreements.

Recent Accounting Pronouncements

Refer to Note 1, Summary of Significant Accounting Policies, of the notes to unaudited condensed consolidated financial statements included in the preceding pages in this Quarterly Report on Form 10-Q.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Interest Rate Risk

We place our cash equivalents with high-credit-quality financial institutions, investing primarily in money market accounts. We have established guidelines relative to credit ratings, diversification and maturities that seek to maintain safety and liquidity. Our investment strategy generally results in lower yields on investments but reduces the risk to principal in the short term prior to these funds being invested in our business. Our interest income is sensitive to changes in the general level of interest rates. In this regard, changes in interest rates can affect the interest earned on our cash equivalents. A 10% unfavorable change in the interest rate would not materially impact our June 30, 2015 financial statements.

We have a line of credit agreement, which accrues interest on any outstanding balances at the prime rate. As of June 30, 2015, there was zero outstanding under this line. As we make borrowings under this line, we are exposed to interest rate risk on such debt.

Indicated changes in interest rates are based on hypothetical movements and are not necessarily indicative of the actual results that may occur. Future earnings and losses will be affected by actual fluctuations in interest rates.

Foreign Currency Exchange Rate Risk

We conduct a portion of our business in currencies other than the United States Dollar, the currency in which our unaudited condensed consolidated financial statements are reported. The most significant foreign currencies that subjected us to foreign currency exchange rate risk for the six months ended June 30, 2015 were the Euro, British Pound and the Japanese Yen. Correspondingly, our operating results could be adversely affected by foreign currency exchange rate volatility relative to the United States Dollar. In the quarter ended June 30, 2015, we recognized $2.7 million in losses for cumulative foreign currency translation adjustment amounts previously recorded to other comprehensive income as the Company's Netherlands subsidiary which generated the losses was liquidated. Although we continue to evaluate strategies to mitigate risks related to the effect of fluctuations in currency exchange rates, we will likely continue to recognize gains or losses from international transactions and foreign currency changes. Foreign currency transaction gains and losses have not historically been material and we incurred less than $0.1 million in foreign currency transaction gains during the six months ended June 30, 2015. Future changes in foreign currency rates could adversely impact our financial statements. A 10% unfavorable change in exchange rates could result in foreign currency losses of approximately $0.1 million.

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Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Based on management’s evaluation (with the participation of our Chief Executive Officer and Chief Financial Officer), as of the end of the period covered by this report, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)), were effective to provide reasonable assurance that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in SEC rules and forms, and is accumulated and communicated to management, including our Principal Executive Officer and Principal Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

Changes in Internal Control over Financial Reporting

There were no changes to our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that occurred during the period covered by this quarterly report on Form 10-Q that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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Part II. Other Information

Item 1. Legal Proceedings

The information required by this Item is incorporated by reference from Note 8, Commitments and Contingencies, of the notes to unaudited condensed consolidated financial statements included in the preceding pages in this Quarterly Report on Form 10-Q.

Item 1A. Risk Factors

The following sets forth risk factors that may affect our future results, including certain revisions to the risk factors included in our annual report on Form 10-K and Form 10-K/A for the fiscal year ended December 31, 2014. Our business, results of operations and financial condition may be materially and adversely affected due to any of the following risks. 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 quarterly report on Form 10-Q, including our unaudited condensed consolidated financial statements and notes thereto included in the preceding pages in this Quarterly Report on Form 10-Q.

We are dependent on sales to a relatively small number of customers and a disruption in sales to any one of these customers could materially harm our financial results.

Our business is highly dependent on a limited number of customers. If our relationship with certain of our customers were disrupted or declined significantly, we would lose a substantial portion of our anticipated net revenue and our business could be materially harmed. We cannot guarantee that our relationship with our customers will expand or not otherwise be disrupted. Refer to Note 1, Summary of Significant Accounting Policies - Concentration of Customers and Suppliers, of the notes to unaudited condensed consolidated financial statements included in the preceding pages in this Quarterly Report on Form 10-Q for further details on our customers. Going forward, we expect to generate additional revenue from our Vertical Markets partners and from potential new Server OEM customers. However, if we are unable to generate sufficient revenue and gross profit from these sources, our financial results could be harmed.

Factors that could influence our relationship with our significant customers and other potential new customers include:

- our ability to maintain our products at prices that are competitive with those of our competitors;
- our ability to maintain quality levels for our products sufficient to meet the expectations of our customers;
- our ability to produce, ship and deliver a sufficient quantity of our products in a timely manner to meet the needs of our customers;
- our ability to continue to develop and launch new products that our customers feel meet their needs and requirements, with respect to cost, timeliness, features, performance and other factors;
- our ability to provide timely, responsive and accurate customer support to our customers;
- the ability of our customers to effectively deliver, market and increase sales of their own solutions based on our products; and
- our customers' ability to develop and produce competing products to replace our technology.

Product recalls, epidemic failures, post-manufacture repairs of our products, liability claims and associated costs could harm our reputation, divert resources, reduce sales and increase costs and could have a material adverse effect on our financial condition and our results of operations.

Our products may contain undetected errors, or failures that become epidemic failures (as defined in our customer agreements), which may be discovered after shipment, resulting in a loss of net revenue, an increase in costs to rework or replace failed products, product liability claims, a tarnished reputation, a loss of customers, or a loss or delay in market acceptance of our products, any of which could harm or disrupt our business. Product failures or recalls could be the result of components purchased from our suppliers not meeting the required specifications or containing undetected quality errors and manufacturing defects despite our quality controls, or from our own design deficiencies.

Even if the errors are detected before shipment, such errors still could result in the halting of production, delay of shipments, delay of recovery costs, loss of goodwill, tarnishment of reputation and/or a substantial decrease in net revenue. Our standard warranty provides that if our systems do not function to published specifications, we will repair or replace the

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defective component or system without charge generally for a period of approximately three years. 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 intended to be covered by corresponding supplier warranties. There can be no assurance that our suppliers will continue to provide such warranties to us in the future or that our warranty obligations to our customers will be covered by corresponding warranties from our suppliers, which could have a material adverse effect on our operating results and financial condition. Significant warranty costs could decrease our gross margin and negatively impact our business, financial condition and results of operations. In addition, defects in our products could result in our customers claiming property damages, consequential damages, or bodily injury, which could also result in loss of customers and goodwill. Our customers may assert claims that our products have failed to meet agreed-to specifications or that they have sustained injuries from our products, and we may be subject to lawsuits relating to these claims. There is a risk that these claims or liabilities may exceed, or fall outside of the scope of our insurance coverage. Significant claims exceeding our expected warranty provisions could distract management's attention from operating our business and, if successful, result in material claims against us that might not be covered by our insurance. Refer to Note 5, Product Warranties, of the notes to unaudited condensed consolidated financial statements included in the preceding pages in this Quarterly Report on Form 10-Q for further details.

Potential future acquisitions may not be successfully integrated or produce the results we anticipate.

As part of our strategy, we are continuously evaluating opportunities to buy other businesses or technologies that would complement our current products, expand the breadth of our markets, or enhance our technical capabilities. Any such acquisition and ongoing integration of the new business into our business may adversely affect our operations or profitability.

Turmoil in the global economy, credit markets and the financial services industry may negatively impact our net revenue, access to capital, our customers' access to capital and ability to pay for their purchases in a timely manner, and our suppliers' access to capital and ability to provide us with goods and timely delivery, or willingness to provide credit terms to us.

The global economic condition could affect the demand for our products and negatively impact our net revenue and operating profit. We are unable to predict changes in general macroeconomic conditions and when, or if, global IT spending rates will be affected and to what degree they will be impacted. Furthermore, even if IT spending rates increase, we cannot be certain that the market for external storage solutions will be positively impacted. If there are future reductions in either domestic or international IT spending rates, or if IT spending rates do not increase, our net revenue, operating results and financial condition may be adversely affected. In addition, the global economic condition could also adversely impact our customers', and/or their customers', ability to finance the purchase of storage systems from us, or our suppliers' ability to provide us with product, any of which may negatively impact our business, financial condition and results of operations.

Our smaller customers may not be as well capitalized as, nor do they have the financial resources of, our larger customers. In addition, sales to all our customers are typically made on credit without collateral. There is a risk that customers will not pay, or that payment may be delayed, because of their liquidity constraints or because they are awaiting payment from their customers, or other factors beyond our control, which could increase our exposure to losses from bad debts or increase accounts receivable, and thus reduce cash.

Our third-party manufacturers rely on other third parties to supply key components of our storage products. Some of these components are available only from one or limited sources in the quantities and quality we require. Should any of the component suppliers cease to operate due to current economic conditions or otherwise, we would have to qualify and locate alternative suppliers. We estimate that replacing key components we currently use in our products with those of another supplier could 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.

Our manufacturing suppliers provide us with credit terms that have in some cases been negotiated and documented in our manufacturing agreements. The credit terms we receive from these suppliers vary amongst our manufacturing partners but they all provide for adequate credit limits and credit terms. Should any of our manufacturing partners reduce our credit limits or shorten payment terms, due to their inability to purchase credit insurance or due to uncertainty regarding our financial position, our cash resources and working capital could be significantly impacted.

Our contracts with customers do not include minimum purchase requirements and are not exclusive, and we cannot provide assurance that our relationship with these customers will not be terminated or will generate significant sales.

None of our contracts with our existing customers contain minimum purchase commitments and while our contracts typically contain a specified term, our customers may cancel purchase orders at any time, cease making purchases or elect not to renew the applicable contract upon the expiration of the current term. Consequently, our customers generally order only

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through written purchase orders. Further, we do not expect that future contracts with customers, if any, will include any minimum purchase commitments. Changes in the timing or volume of purchases by our major customers could result in lower net revenue. For example, we cannot be certain that our sales to any of our customers will continue at historical levels or will reach expected levels. In addition, our existing contracts do not require our customers to purchase our products exclusively or on a preferential basis over the products of any of our competitors. Consequently, to the extent they are not sole sourced, our customers may sell the products of our competitors. The decision by any of our customers to cancel purchase orders, cease making purchases or terminate their respective contracts could cause our net revenue to decline substantially, and our business, financial condition and results of operations could be significantly harmed.

We sell on a purchase order basis, making us subject to uncertainties and variability in demand by our customers, and our component suppliers may make obsolete certain components we incorporate into our products, either of which could decrease net revenue and adversely affect our operating results.

We sell to our customers on a purchase order basis rather than pursuant to long-term contracts or contracts with minimum purchase requirements. Consequently, our sales are subject to demand variability by our customers. The level and timing of orders placed by our customers vary for a variety of reasons, including seasonal buying by end-users, the introduction of new technologies and general economic conditions.

Customers submitting a purchase order may cancel, reduce or delay their orders. If we are unable to anticipate and respond to the demands of our customers, we may lose customers because we have an inadequate supply of products, or we may have excess inventory which may have to be sold in the open market at a substantial discount, if at all possible, either of which may harm our business, financial position and operating results.

In addition, there are occasions when some of our component suppliers make obsolete certain components that we incorporate into our products. In these situations we may be required to purchase such components on a “last time buy” basis, based on our forecasts of customer demand. If we incorrectly forecast customer demand or if our customers' over- or under-forecast demand, we may have an inadequate supply of products, or we may have excess inventory which may have to be sold in the open market at a substantial discount, if at all possible, either of which may harm our business, financial position and operating results.

Furthermore, we are contractually obligated to purchase excess and obsolete material and finished goods from our contract manufacturer if not consumed within 90 days of our contract manufacturer’s purchase, which could have a material effect on our financial results.

Our sales cycle varies substantially from customer to customer and future net revenue in any period may be lower than our historical net revenue 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 fall into two categories: OEM sales and Dot Hill branded sales through the channel. For the OEM business, the length of time between initial contact with a potential customer and the sale of our product may last from 6 to 36 months. This is particularly true during times of economic slowdown and when selling products that require complex installations. For the branded sales business through the channel, sales cycles can range from 30 days to three months or more for individual deals. With Dot Hill's new products in the mid-range segment, sales cycles are expected to increase to a range of 60 days to six months. This can increase the time for product decisions in both the OEM and channel business for customers taking our new products.

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;
- our engineering work necessary to integrate a storage solution with a customer's system;
- the complexity of technical challenges that need to be overcome during the development, testing and/or qualification process for new products and/or new customers;
- our ability to meet unique customer specifications and requirements;
- difficulties by our customers in integrating our products and technologies into their own products;
- the timing of our customer's product launches and their sales cycles;

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- the ability of our customers to ramp sales of our products including the desire of customer's to purchase legacy products; and
- the total available market for our products within each specific customer.

Our net revenue is difficult for us to predict since it is directly affected by the timing of large orders. We may ship products representing a significant portion of our net revenue 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 provide assurance that our sales will not decline in future periods.

Our inability to manage our relationship with our channel sales reseller may significantly impact our ability to increase net revenue, gross margin and operating income.

We have recently changed our channel distribution model to utilize an exclusive reseller for channel sales, which will utilize the reseller's global distribution marketing, sales, support and services. If we cannot successfully manage, develop and generate sufficient net revenue through our reseller, our net revenue, gross margin and our results of operations could be adversely affected.

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 and if we fail to develop and market new software and hardware products that meet customer requirements, our business will be harmed.

The open systems data storage market in which we operate is characterized by rapid technological change, frequent new product introductions, new interface protocol, 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, or new entrants into the open systems storage market, could render our existing products obsolete or uncompetitive. 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, such as the market shift to cloud-related infrastructure. 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 the number of customer-purchasing decisions.

We believe that to remain competitive, we will need to continue to develop new hardware and software products, which will require a significant investment in new product development. Our competitors and new market participants may be developing alternative technologies, which may adversely affect the market acceptance of our products. If alternative technologies and interface protocols are adopted by the industry that we have not incorporated into our products, we may become uncompetitive and not have product offerings for select market segments. Even if our new products are developed on time, we may not be able to manufacture them at competitive prices or in sufficient volumes.

We may not be able to reduce expenses timely in response to any shortfalls in net revenue or gross margin.

We primarily sell to large customers and other OEMs and thus do not need to make substantial incremental investments in sales and marketing to generate demand for our products to our customers. Additionally, we outsource substantially all of our manufacturing to very large contract manufacturing partners in Asia. Hence, there is little incremental cost required to increase our production capacity. Furthermore, we have an adopted modular architecture to our storage system products and consequently if our customers do not require substantial customization, we are able to launch products based on existing product platforms for new OEMs or channel partners at modest incremental expenditures.

In the past, we have taken and may have to take further measures to reduce expenses if net revenue or gross margins decline and we experience greater operating losses or do not achieve profitable results. A number of factors could preclude us from successfully bringing variable costs and expenses in line with our net revenue, such as the fact that our variable expense levels are based in part on our expectations as to future sales. This limits our ability to reduce expenses quickly in response to any shortfalls in net revenue or gross margin. Consequently, if net revenue does not generate enough gross margin to cover operating expenses, our operating results may be negatively affected.

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The market for storage products is intensely competitive and subject to substantial pricing pressure that may harm our net revenue, gross margin and operating results.

The storage market is intensely competitive and is characterized by rapidly changing technology. For our AssuredSAN storage hardware products, we compete primarily against independent storage system suppliers, including EMC Corporation, Hitachi Data Systems Corp., Infortrend, Nimble Storage, Inc., Promise Technology, Inc., NEC and NetApp, Inc. as a result of its acquisition of LSI's Engenio Division in May 2011. We also compete with traditional suppliers of computer systems, including International Business Machines Corporation, Oracle Corporation, Dell Inc. and HP, 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 we do. In addition, some of our competitors have much lower labor costs than we do. As a result, they may have more advanced technology, larger distribution channels, stronger brand names, better customer service, more financial leverage 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 public and privately held companies are currently attempting to enter the storage market, some of which may become significant competitors in the future. In the future, it is conceivable that we could compete with some of the original design manufacturers, one of whom is currently our manufacturing partner, as they develop expertise in chassis design and power and cooling technologies.

We could also lose current or future business to certain of our suppliers or manufacturers, some of which directly and indirectly compete with us. Currently, we leverage our supply and manufacturing relationships to provide substantially all 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, and may reduce operating margins and create a 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: performance, features, scalability and reliability; price; product breadth; product availability and quality; timeliness of new product introductions; interoperability; and ease of management.

We cannot provide assurance 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 cost effectively develop and market products to compete with the products of competitors, our business will be materially and adversely affected. In addition, if major customers who are also competitors cease purchasing our products in order to concentrate on sales of their own products, our business will be harmed.

Additional pricing pressures are due, in part, to continuing decreases in component prices, such as those of disks, memory, semiconductors and RAID controllers. Decreases in component prices are typically passed on to customers by storage companies through a continuing decrease in the price of storage hardware systems.

Pricing pressures could also result when we cannot pass increased material costs on to our customers. For example, a significant increase in fuel prices could result in higher steel and freight costs which we may not be able to pass on to our customers.

Pricing pressures also exist from our significant customers that may attempt to change the terms, including pricing, payment terms and post sales obligations with us. For example, during the fourth quarter of 2013, we increased payment terms to a large OEM customer. We granted an additional but smaller increase in payment terms to the same OEM customer commencing in the second quarter of 2014. As our customers are pressured to reduce prices as a result of competitive factors, we may be required to contractually, or otherwise, commit to price reductions for our products prior to determining if we can implement corresponding cost reductions. If we are unable to achieve such cost reductions, or are unable to pass along cost increases to our customers, and have to reduce the pricing of our products, our gross margin may be negatively impacted which could have a material adverse effect on our business, financial condition and results of operations.

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Our inability to lower product costs or changes in the mix of products we sell may significantly impact our gross margin and results of operations.

Our gross margin is determined in large part based on our contract manufacturing costs, our component costs, the timing and magnitude of product cost reductions, and our ability to include RAID controllers and value added features into our products, such as DMS and RealStor, as well as the prices at which we sell our products. The amount of revenue recognized from software and service sales and the relative mix of such sales in comparison to sales of our other products will also impact our gross margin, as the gross margin on sales of software and services is higher than that of our other products. If we are unable to lower production costs to be consistent with our projections or if we experience any decline in selling prices, such as with certain customers with whom we have negotiated periodic price reductions based on specific criteria, our gross margin and results of operations may suffer. Some of the new products we are currently shipping or expect to begin shipping are in the early stages of their life cycle. Our historical experience indicates that gross margin on new products are low initially and increase over time as a result of maturing manufacturing processes, component cost reductions and re-engineering the products to reduce costs. If we fail to achieve these improvements, our gross margin will be negatively impacted and our business, financial condition and results of operations could be significantly harmed.

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. Such forecasts have not historically demonstrated a high degree of accuracy. 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 may result in excess inventory levels or unanticipated inventory write-downs due to expected orders that fail to materialize.

Additional factors which could adversely impact gross margin dollars and gross margin percentage include:

- changes in the mix of products we sell to our customers;
- increased price competition;
- introduction of new products by us or our competitors, including products with price performance advantages;
- our inability to reduce production or component costs;
- entry into new markets or the acquisition of new customers;
- sales discounts and marketing development funds;
- increases in material or labor costs;
- excess inventory, inventory shrinkages and losses and inventory holding charges;
- the timing of purchase price variances resulting from reductions in component costs purchased on our behalf by our contract manufacturers or owned by us in inventory versus the original cost of those components;
- increased warranty costs and costs associated with any potential future product quality and product defect issues;
- our inability to sell our higher performance products, or our software products and our services;
- component shortages which can result in expedite fees, overtime or increased use of air freight; and
- increased freight costs resulting from higher fuel prices, or from the need to expedite shipments of components to our contract manufacturers or finished goods to some of our customers and their hub locations.

Our customers may have very aggressive product launch and ramp schedules and our efforts to accommodate these schedules may divert our management’s attention, cause component shortages and force us to allocate products across many customers, all of which could harm our customer relationships.

Our efforts to accommodate our customers’ aggressive launch and ramp schedules can divert management’s attention from the rest of our business and force us to allocate product volumes across many customers due to component shortages, all of which could harm our relations with customers. In addition, we could incur overtime, expedite charges, and other charges such as shipping products by air as opposed to by ocean, as a result of efforts to meet such schedules. Any of these factors could result in lower net revenue and gross margin as well as increased operating expenses which could have an impact on our business, financial condition and results of operations.

Manufacturing and supplier disruptions could harm our business.

We primarily rely on Foxconn to manufacture our products. In November 2011, we amended our agreement with Foxconn to extend the manufacturing agreement for three years. In November 2014, we extended the agreement to March 11, 2015, and in March 2015, we extended the agreement to September 1, 2015. We are currently in negotiations to further extend our contract. If the agreement is not further extended, pursuant to terms in the existing agreement, we can continue to operate with Foxconn for a period of six months following the expiration of the agreement. However, if they do not perform their obligations under our agreement, or if we otherwise determine to transition manufacturing of our products to another third party

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manufacturer, it could take several months to establish and qualify alternative manufacturing for our products and we may not be able to fulfill our customers' orders in a timely manner. If Foxconn fails to meet their obligations under the agreement, we cannot be certain that we will be able to identify a suitable alternative manufacturing partner that meets the requirements of our customers and one that is cost competitive. Failure to identify a suitable alternative manufacturing partner could impact our customer relationships and our financial condition.

Due to our use of third-party manufacturers, our ability to control the timing of shipments could 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 also impact cash flow or result in a decline in our stock price. To the extent we establish a relationship with an alternative manufacturer for our products, we may be able to partially mitigate potential disruptions to our business. We may also suffer manufacturing disruptions as we ramp up manufacturing processes for newly introduced products, or if our contract manufacturer experiences other disruptions in the manufacturing process, such as disruptions that may be caused by the ongoing move of manufacturing facilities from Longhua, China, to Tianjin, China, there could be delays in the delivery of these products to our customers that adversely affect our results of operations. We also 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 reserve for estimated warranty costs in the period the net revenue is recognized. There can be no assurance that our suppliers will continue to provide such warranties to us in the future, or that we have estimated these costs correctly, which could have a material adverse effect on our business, financial condition and results of operations.

Any shortage of disk drives, memory or other components could increase our costs or harm our ability to manufacture and deliver our storage products to our customers in a timely manner.

From time to time there is significant market demand for disk drives, semiconductors, memory 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, and we cannot be certain that alternative sources of supplies will be available on competitive terms. Even if alternative sources of supply for critical components such as disk drives and memory become available, incorporating substitute components into our products could delay our ability to deliver our products in a timely manner.

Demand for disk drives and memory has at times surpassed supply, forcing drive, memory and component suppliers, including those who supply the components that are integrated into many of our storage products, to manage allocation of their inventory. If such a shortage were prolonged, we may be forced to pay higher prices for disk drives, memory or components or may be unable to purchase sufficient quantities of these components to meet our customers' demand for our storage products in a timely manner or at all.

We may experience losses in the future, and may have difficulty forecasting future operating results, which could result in revenue and earnings volatility, which could cause our stock price to decline.

For the years ended December 31, 2013 and 2014, we generated income from continuing operations of $5.5 million and $8.1 million, respectively. We expect our business to remain volatile as we are often unable to reliably predict net revenue from our customers. Net revenue from our customers, the mix of products sold to our customers, our ability to introduce new products as planned and our ability to reduce product costs and manage our operating expenses and manufacturing variances will continue to affect our financial results for 2015. Consequently, we cannot provide assurance that we will be profitable in any future period.

Our future operating results and profitability will depend on, and could vary substantially as a result of many factors, including:

- our ability to maintain and enhance relationships with our customers, in particular our OEM customers, as well as our ability to win new business;
- our ability to implement and achieve targeted gross margin and cost reduction objectives;
- our ability to contain operating expenses and manufacturing variances;
- our ability to meet product delivery schedules for our customers which could result in increased air freight, expedite and overtime charges;
- the extent to which we invest in new initiatives such as channel sales and software development;
- our plans to maintain and enhance our engineering, research, development and product testing programs;
- the success of our manufacturing strategy and relationships with our contract manufacturing partners;

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- the success of our sales and marketing efforts;
- the amount of field failures resulting in product replacements, recalls or customer penalties;
- the extent and terms of any development, marketing or other arrangements;
- changes in economic, regulatory or competitive conditions, including the current worldwide economic crisis;
- costs of filing, prosecuting, defending and enforcing intellectual property rights;
- costs of litigating and defending law suits; and
- our ability to capitalize on new customer opportunities resulting from industry consolidation.

Our success depends significantly upon our ability to protect our intellectual property and to avoid infringing the intellectual property of third parties, which has already resulted in costly, time-consuming litigation and could result in 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. 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.

Furthermore, third parties may assert infringement claims against us, which would require us to incur substantial license fees, legal fees and other expenses, and distract management from the operations of our business. In addition, we enter into indemnification agreements with third parties in the ordinary course of business that generally require us to reimburse losses suffered by the third party due to various events, such as lawsuits arising from patent or copyright infringement.

We expect that providers of storage products will increasingly be subject to infringement claims as the number of products and competitors increase. 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 be required to purchase licenses that could have a material impact on our business, or, 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 selling and 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.

We are currently involved in an ongoing dispute with Crossroads Inc. It is probable that we will resolve this contractual dispute for royalty payments from 2009 to the current period for a total amount in the range of $1.0 million to $3.4 million. Refer to Note 8, Commitments and Contingencies, of the notes to unaudited condensed consolidated financial statements included in the preceding pages in this Quarterly Report on Form 10-Q for further details.

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 Dana Kammersgard, our Chief Executive Officer and President, and Hanif Jamal, our Senior Vice President, Chief Financial Officer, Treasurer and Corporate Secretary. If either of these individuals were to terminate his employment with us, we would be required to locate and hire a suitable replacement. In addition, if any of our key engineering, sales and general and administrative employees were to terminate their employment with us, our business could be harmed. Competition for attracting talented employees in the technology industry can be 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 executives or 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.

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Protective provisions in our charter and bylaws 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. Each of these charter and bylaw provisions give 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.

Unanticipated changes in tax laws or adverse outcomes resulting from examination of our income tax returns could adversely affect our results of operations.

We are subject to income taxes in the United States and various foreign jurisdictions. Our effective income tax rates have recently been and could in the future be adversely affected by changes in tax laws or interpretations of those tax laws, by changes in the mix of earnings in countries with differing statutory tax rates, by discovery of new information in the course of our tax return preparation process, or by changes in the valuation of our deferred tax assets and liabilities. Our effective income tax rates are also affected by intercompany transactions for licenses, services, funding and other items. Additionally, we are subject to the continuous examination of our income tax returns by the Internal Revenue Service and other tax authorities which may result in the assessment of additional income taxes. We regularly assess the likelihood of adverse outcomes resulting from these examinations. However, there can be no assurance that the outcomes from these examinations will not have a material adverse effect on our business, financial condition and results of operations.

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

We have a large number of outstanding stock options and warrants. Dilution of the per share value of our common stock could result from the exercise of outstanding stock options and warrants. When the exercise price of outstanding stock options and warrants is less than the trading price of our common stock, the exercise of such stock options and warrants would have a dilutive effect on our stockholders. The possibility of the issuance of shares of our common stock upon exercise of stock options and warrants could cause the trading price of our common stock to decline.

Furthermore, it is also possible that future large customers or suppliers may make our relationship with them contingent on receiving warrants to purchase shares of our common stock. The impact of potentially issuing additional warrants could have a dilutive effect on our stockholders.

Our stock price may be highly volatile and could decline substantially and unexpectedly, which can and has in some cases resulted in litigation.

The market price of our common stock has fluctuated substantially, and there can be no assurance that such volatility will not continue. Several factors could impact our stock price including, but not limited to:

- differences between our actual operating results and the published expectations of analysts;
- quarterly fluctuations in our operating results;
- mergers and acquisitions in the data storage marketplace;
- introduction of new products or changes in product pricing policies by our competitors or us;
- conditions in the markets in which we operate;

- changes in market projections by industry forecasters;
- changes in estimates of our earnings by us or industry analysts;
- overall market conditions for high technology equities;
- rumors or dissemination of false information; and
- general economic and geopolitical conditions.

It is often the case that securities class action litigation is brought against a company following periods of volatility in the market price of its securities. 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.

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

A significant portion of our common stock is owned by a few institutional stockholders. As a result, a substantial number of shares of our common stock may become available for resale. If these or other of 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.

Our system of internal controls may be inadequate.

We maintain a system of internal controls in order to ensure we are able to collect, process, summarize, and disclose the information required by the Securities and Exchange Commission within the time periods specified. Any system of controls, however well designed and operated, can provide only reasonable, and not absolute, assurance that the objectives of the system are met. In addition, the design of any control system is based in part upon certain assumptions about the likelihood of future events. Due to these and other inherent limitations of control systems, there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions, regardless of how remote. Additionally, public companies in the United States are required to review their internal controls under the Sarbanes-Oxley Act of 2002. If the internal controls put in place by us, including a wide range of manual internal controls, are not adequate or fail to perform as anticipated, errors could occur that would not be detected, which could require us to restate our consolidated financial statements, receive an adverse audit opinion on the effectiveness of our internal controls, and/or take other actions that will divert significant financial and managerial resources, as well as be subject to fines and/or other government enforcement actions. Furthermore, the price of our stock could be adversely affected.

Environmental compliance costs could adversely affect our results of operations.

Many of our products are subject to various laws governing chemical substances in products, including those regulating the manufacture and distribution of chemical substances and those restricting the presence of certain substances in electronic products. We could incur substantial costs, or our products could be restricted from entering certain countries, if our products become non-compliant with environmental laws.

We face increasing complexity in our product design and procurement operations as we adjust to new and future requirements relating to the materials composition of our products, including the restrictions on lead and certain other substances that apply to specified electronic products put on the market in the European Union as of July 1, 2006 (Restriction of Hazardous Substances Directive, or RoHS). We design our products to ensure that they comply with these requirements as well as related requirements imposed by our customers. We are also working with our suppliers to provide us with compliant materials, parts and components. If our products do not comply with the European substance restrictions, we could become subject to fines, civil or criminal sanctions, and contract damage claims. In addition, we could be prohibited from shipping non-compliant products into the European Union, and required to recall and replace any products already shipped, if such products were found to be non-compliant, which would disrupt our ability to ship products and result in reduced net revenue, increased obsolete or excess inventories and harm to our business and customer relationships. Various other countries and states in the United States have issued, or are in the process of issuing, other environmental regulations that may impose additional restrictions or obligations and require further changes to our products. These regulations could impose a significant cost of doing business in those countries and states.

The European Union has enacted the Waste Electrical and Electronic Equipment Directive, which makes producers of electrical goods financially responsible for specified collection, recycling, treatment and disposal of past and future covered products. Similar legislation has been or may be enacted in other jurisdictions, including in the United States, Canada, Mexico, China and Japan, the cumulative impact of which could be significant.

Some of our products are subject to state, federal and international laws governing protection of the environment, governing proper handling and disposal of materials used to manufacture our products, governing human health and safety, regulating the use of certain chemical substances and requiring disclosure of the use of certain “conflict minerals.” We endeavor to comply with these environmental and other laws, yet compliance with such laws could increase our product design, development, procurement, manufacturing and administration costs, limit our ability to manage excess and obsolete non-compliant inventory, change our sales activities, damage our reputation if we are required to disclose the use of certain "conflict minerals" or otherwise impact future financial results of our business. Any violation of these laws can subject us to significant liability, including fines, penalties and possible prohibition of sales of our products into one or more states or countries and result in a material adverse effect on our financial condition or results of operations.

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Due to the global nature of our business, risks inherent in our international operations could have a material adverse effect on our business.

Although a substantial portion of our business is located and conducted in the United States, a significant portion of our operations are located outside of the United States. The majority of our products are manufactured outside of the United States, and we have research and development and service centers overseas. Accordingly, our business and our future operating results could be adversely affected by a variety of factors affecting our international operations, some of which are beyond our control, including regulatory, political, or economic conditions in a specific country or region, trade protection measures and other regulatory requirements, government spending patterns, and acts of terrorism and international conflicts. In addition, we may not be able to maintain or increase international market demand for our products.

We face exposure to adverse movements in foreign currency exchange rates as a result of our international operations. These exposures may change over time as business practices evolve, and they could have a material adverse impact on our financial results and cash flows. Our international sales are denominated in United States Dollars and in foreign currencies. An increase in the value of the United States Dollar relative to foreign currencies could make our products more expensive and therefore, potentially less competitive in foreign markets. Conversely, lowering our price in local currency may result in lower United States-based revenues. A decrease in the value of the United States Dollar relative to foreign currencies could increase operating expenses in foreign markets. Prices for our products are substantially United States Dollar denominated, even when sold to customers that are located outside the United States. Therefore, as a substantial portion of our sales are from countries outside the United States, fluctuations in currency exchange rates, most notably the strengthening of the United States Dollar against other foreign currencies, contribute to variations in sales of products in impacted jurisdictions and could adversely impact demand and revenue growth. In addition, currency variations can adversely affect margins on sales of our products in countries outside the United States.

Additional risks inherent in our international business activities generally include, among others, difficulties in managing international operations and compliance with complex tax regulations in each tax jurisdiction.

In addition, due to the global nature of our business, we are subject to complex legal, tax and regulatory requirements in the United States and the foreign jurisdictions in which we operate and sell our products, including antitrust and anti-competition laws, rules and regulations, and regulations related to data privacy. We are also subject to the potential loss of proprietary information due to piracy, misappropriation or laws that may be less protective of our intellectual property rights than United States laws. Such factors could have an adverse impact on our business, operating results and financial position.

Moreover, in many foreign countries, particularly in those with developing economies, it is common to engage in business practices that are prohibited by our internal policies and procedures, or Unites States laws and regulations applicable to us, such as the Foreign Corrupt Practices Act. There can be no assurance that all of our employees, contractors and agents, as well as those companies to which we outsource certain of our business operations, will comply with these policies, procedures, laws and/or regulations. Any such violation could subject us to fines and other penalties, which could have a material adverse effect on our business, financial condition or results of operations.

Our business could be materially and adversely affected as a result of a natural disaster, terrorist acts or other catastrophic events.

We depend on the ability of our personnel, raw materials, equipment and products to move reasonably unimpeded around the world. Any political, military, terrorism, global trade, world health or other issue that hinders this movement or restricts the import or export of materials could lead to significant business disruptions. Furthermore, any strike, economic failure or other material disruption caused by fire, floods, hurricanes, earthquakes, volcanoes, power loss, power shortages, environmental disasters, telecommunications or business information systems failures, break-ins and similar events, could also adversely affect our ability to conduct business. If such disruptions result in cancellations of customer orders or contribute to a general decrease in economic activity or corporate spending on information technology, or directly impact our marketing, manufacturing, financial and logistics functions, or impair our ability to meet our customer demands, our results of operations and financial condition could be materially adversely affected.

Our business is subject to increasingly complex corporate governance, public disclosure, and accounting and tax requirements that have increased both our costs and the risk of noncompliance.

Because our common stock is publicly traded, we are subject to certain rules and regulations of federal, state and financial market exchange entities charged with the protection of investors and the oversight of companies whose securities are publicly traded. These entities, including the Public Company Accounting Oversight Board, the SEC, and NASDAQ have

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implemented requirements and regulations and continue developing additional regulations and requirements in response to corporate scandals and laws enacted by Congress, most notably the Sarbanes-Oxley Act of 2002. Our efforts to comply with these regulations have resulted in, and are likely to continue resulting in, increased general and administrative expenses and diversion of management time and attention from revenue-generating activities to compliance activities.

On July 21, 2010, the President signed into law the Dodd-Frank Act. Many aspects of the Dodd-Frank Act are subject to rulemaking and will take effect over several years, making it difficult to anticipate the overall financial impact on us. However, as we continue to implement changes in response to this new law and its associated regulations, we expect to incur additional operating costs that could have a material adverse effect on our financial condition and results of operations.

A change in accounting standards or practices and varying interpretations of existing accounting pronouncements, such as the changes to revenue recognition standards, the increased use of fair value measures, additional proposed changes to revenue recognition, lease accounting, financial instruments and other accounting standards, and the potential requirement that United States registrants prepare financial statements in accordance with International Financial Reporting Standards, could have a significant effect on our reported financial results or the way we conduct our business. Implementation of accounting regulations and related interpretations and policies, particularly those related to revenue recognition, could cause us to defer recognition of revenue or recognize lower revenue, which may affect our results of operations.

Because new and modified laws, regulations, and standards are subject to varying interpretations in many cases due to their lack of specificity, their application in practice may evolve over time as new guidance is provided by regulatory and governing bodies. This evolution may result in continuing uncertainty regarding compliance matters and additional costs necessitated by ongoing revisions to our disclosure and governance practices.

We are subject to risks related to the provision of employee health care benefits and recent health care reform legislation.

In March 2010, comprehensive health care reform legislation under the Patient Protection and Affordable Care Act (HR 3590) and the Health Care Education and Affordability Reconciliation Act (HR 4872) was passed and signed into law. Among other things, the health care reform legislation includes guaranteed coverage requirements, eliminates pre-existing condition exclusions and annual and lifetime maximum limits, restricts the extent to which policies can be rescinded and imposes new and significant taxes on health insurers and health care benefits. Provisions of the health care reform legislation become effective at various dates over the next several years. The Department of Health and Human Services, the National Association of Insurance Commissioners, the Department of Labor and the Treasury Department have yet to issue necessary enabling regulations and guidance with respect to the health care reform legislation.

Due to the breadth and complexity of the health care reform legislation, the lack of implementing regulations and interpretive guidance, and the phased-in nature of the implementation, it is difficult to predict the overall impact of the health care reform legislation on our business over the coming years. Our results of operations, financial position and cash flows could be materially adversely affected due to this health care reform legislation. We expect to experience significant increases in health care costs into the foreseeable future.

We are exposed to the credit and non-payment risk of our customers, resellers, and distributors, especially during times of economic uncertainty and tight credit markets, which could result in material losses.

Most of our sales to customers are on an open credit basis. While we monitor individual customer payment capability in granting such open credit arrangements, and seek to limit such open credit to amounts we believe are reasonable, we may experience losses due to a customer's inability to pay.

In the past, there have been bankruptcies by our customers to whom we had extended open credit, causing us to incur bad debt charges. We may be subject to similar losses in future periods. Any future losses could harm our business and have a material adverse effect on our operating results and financial condition. Additionally, to the extent that the recent turmoil in the credit markets makes it more difficult for customers to obtain open credit or financing, those customers' ability to purchase our products could be adversely impacted, which in turn could have a material adverse impact on our financial condition and operating results.

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We make significant investments in research and development to improve our technology and develop new technologies, and unsuccessful investments could materially adversely affect our business, financial condition and results of operations.

Over the past several years, our business strategy has been to derive a competitive advantage by moving from being a follower of new technologies to being a leader in the innovation and development of new technologies. This strategy requires us to make significant investments in research and development and, in attempting to remain competitive, we may increase our capital expenditures and expenses above our historical run-rate model, including the capitalization of a software project under development discussed more fully in Note 4, Intangible Assets, of the notes to unaudited condensed consolidated financial statements included in the preceding pages in this Quarterly Report on Form 10-Q. There can be no assurance that these investments will result in viable technologies or products, or if these investments do result in viable technologies or products, that they will be profitable or accepted by the market. Significant investments in unsuccessful research and development efforts could materially adversely affect our business, financial condition and results of operations. In addition, increased investments in technology could cause our cost structure to fall out of alignment with demand for our products, which would have a negative impact on our financial results.

Violation of applicable laws, including labor or environmental laws, and certain other practices by our suppliers could harm our business.

We expect our suppliers to operate in compliance with applicable laws and regulations, including labor and environmental laws, and to otherwise meet our required supplier standards of conduct. While our internal operating guidelines promote ethical business practices, we do not control our suppliers or their labor or environmental practices. The violation of labor, environmental or other laws by any of our suppliers, or divergence of a supplier’s business practices from those generally accepted as ethical in the United States, could harm our business by:

- interrupting or otherwise disrupting the shipment of our product components;
- damaging our reputation;
- forcing us to find alternate component sources;
- reducing demand for our products (for example, through a consumer boycott); or
- exposing us to potential liability for our supplier’s wrongdoings.

We are vulnerable to system failures or attacks, which could harm our business.

We are heavily dependent on our technology infrastructure, among other functions, to operate our factories, sell our products, fulfill orders, manage inventory and bill, collect and make payments. Our systems are vulnerable to damage or interruption from natural disasters, power loss, telecommunication failures, computer viruses, computer denial-of-service attacks and other events. Our business is also subject to break-ins, sabotage and intentional acts of vandalism by third parties as well as employees. Despite any precautions we may take, such problems could result in, among other consequences, interruptions in our business, which could harm our reputation and financial condition.

Cybersecurity breaches could expose us to liability, damage our reputation, compromise our ability to conduct business, require us to incur significant costs or otherwise adversely affect our financial results.

We retain sensitive data in our secure data centers and on our networks, including intellectual property, proprietary business information and personally identifiable information. We face a number of threats to our data centers and networks from unauthorized access, security breaches and other system disruptions. As with any company with an internet presence, our infrastructure may be vulnerable to attacks by hackers or other disruptive problems. Any such security breach may compromise information stored on our networks and may result in significant data losses or theft of our, our customers’, our business partners’ or our employees’ intellectual property, proprietary business information or personally identifiable information. In addition, we have outsourced a number of our business functions to third party contractors, and any breach of their security systems could adversely affect us.

It is critical to our business strategy that our infrastructure remains secure and is perceived by customers and partners to be secure. A cybersecurity breach could negatively affect our reputation as a trusted provider of information infrastructure by adversely affecting the market's perception of the security or reliability of our products or services. In addition, a cyber-attack could result in other negative consequences, including remediation costs, disruption of internal operations, increased cybersecurity protection costs, lost revenues or litigation.

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

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

None.

Item 5. Other Information

None.

Item 6. Exhibits

The following exhibits are included as part of this quarterly report on Form 10-Q:

2.1	Agreement and Plan of Merger and Reorganization dated as of January 4, 2010, among Dot Hill Systems Corp., Telluride Acquisition Sub, Inc., Cloverleaf Communications Inc., Cloverleaf Communications (Israel) Ltd., Cloverleaf Communications Corporation (BVI) and E. Shalev Management 2000 (1999) Ltd. (1)
3.1	Certificate of Incorporation of Dot Hill Systems Corp. (2)
3.2	Amended and Restated Bylaws of Dot Hill Systems Corp. (3)
4.1	Form of Common Stock Certificate. (4)
4.2	Certificate of Designation of Series A Junior Participating Preferred Stock, as filed with the Secretary of State of Delaware on May 19, 2003. (5)
4.3	Form of Rights Certificate. (5)
4.4	Warrant to Purchase Shares of Common Stock dated January 4, 2008. (6)
10.1	2000 Amended and Restated Non-Employee Director's Stock Option Plan. +
10.2	Non-Employee Director Compensation Policy. +
10.3	Strategic Supplier Master Purchase Agreement - First Amendment by and between Dot Hill Systems Corp. and Teradata Operations, Inc. ‡
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.
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document

101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document

‡Confidential treatment has been granted by, or requested from, the SEC.

+Indicates management or compensatory plan or arrangement.

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* These certifications are being furnished solely to accompany this quarterly report pursuant to 18 U.S.C. Section 1350, and are not being filed for purposes of Section 18 of the Securities Exchange Act of 1934 and are not to be incorporated by reference into any filing of the registrant, whether made before or after the date hereof, regardless of any general incorporation language in such filing.

(1) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on January 5, 2010 and incorporated herein by reference.
(2) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on September 19, 2001 and incorporated herein by reference.
(3) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on December 26, 2007 and incorporated herein by reference.
(4) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on January 14, 2003 and incorporated herein by reference.
(5) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on May 19, 2003 and incorporated herein by reference.
(6) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on January 7, 2008 and incorporated herein by reference.

Dot Hill’s Current Reports on Form 8-K have a Commission File Number of 001-13317.

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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.

Dot Hill Systems Corp.

Date: August 6, 2015

By: /s/ DANA W. KAMMERSGARD
Dana W. Kammersgard
Chief Executive Officer, President and Director
(Principal Executive Officer)

Date: August 6, 2015

By: /s/ HANIF I. JAMAL
Hanif I. Jamal
Senior Vice President, Chief Financial Officer,
Treasurer and Corporate Secretary
(Principal Financial and Accounting Officer)