DOT HILL SYSTEMS CORP
Form 10-Q
August 08, 2012
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the Quarterly Period Ended June 30, 2012

OR

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

For the transition period from to

Commission file number 1-13317

DOT HILL SYSTEMS CORP.

(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	13-3460176 (I.R.S. Employer Identification No.)
1351 S. Sunset Street, Longmont, CO (Address of principal executive offices)	80501 (Zip Code)

(303) 845-3200
(Registrant’s telephone number, including area code)
(Former name, former address and former fiscal year, if changed since last report)

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

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

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

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

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

The registrant had 58,210,542shares of common stock, $0.000 par value, outstanding as of July 31, 2012.

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Part I. Financial Information
Item 1. Financial Statements
DOT HILL SYSTEMS CORP.
UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except par value data)

	December 31, 2011	June 30, 2012
ASSETS		
Current Assets:		
Cash and cash equivalents	$46,168	$40,499
Accounts receivable, net	31,697	27,085
Inventories	5,251	4,656
Prepaid expenses and other assets	7,896	4,681
Total current assets	91,012	76,921
Property and equipment, net	4,972	5,696
Intangible assets, net	2,601	245
Other assets	294	308
Total assets	$98,879	$83,170
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	$31,434	$23,045
Accrued compensation	5,049	4,840
Accrued expenses	10,860	7,889
Deferred revenue	883	1,480
Restructuring accrual	1,328	1,139
Current portion of long-term note payable	71	—
Total current liabilities	49,625	38,393
Other long-term liabilities	552	961
Total liabilities	50,177	39,354
Commitments and Contingencies		
Stockholders' Equity:		
Preferred stock, $.001 par value, 10,000 shares authorized, zero shares issued and outstanding at December 31, 2011 and June 30, 2012	—	—
Common stock, $.001 par value, 100,000 shares authorized, 57,699 and 58,245 shares issued and outstanding at December 31, 2011 and June 30, 2012, respectively	58	58
Additional paid-in capital	321,681	323,672
Accumulated other comprehensive loss	(3,662)	(3,623)
Accumulated deficit	(269,375)	(276,291)
Total stockholders' equity	48,702	43,816
Total liabilities and stockholders' equity	$98,879	$83,170

See accompanying notes to unaudited condensed consolidated financial statements.

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DOT HILL SYSTEMS CORP.
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS
(In thousands, except per share amounts)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2012	2011	2012
NET REVENUE	$53,179	$47,768	$102,353	$102,512
COST OF GOODS SOLD	39,984	36,813	77,056	76,383
GROSS PROFIT	13,195	10,955	25,297	26,129
OPERATING EXPENSES:				
Research and development	8,946	9,677	16,932	19,619
Sales and marketing	3,649	3,380	6,682	6,913
General and administrative	2,437	2,473	4,778	5,541
Restructuring charge (recovery)	37	73	(4)	674
Total operating expenses	15,069	15,603	28,388	32,747
OPERATING LOSS	(1,874)	(4,648)	(3,091)	(6,618)
OTHER INCOME:				
Interest expense, net	(5)	(7)	(11)	—
Other Income, net	(1)	7	1	11
Total other income (expense), net	(6)	—	(10)	11
LOSS BEFORE INCOME TAXES	(1,880)	(4,648)	(3,101)	(6,607)
INCOME TAX EXPENSE	65	400	115	309
NET LOSS	$(1,945)	$(5,048)	$(3,216)	$(6,916)
NET LOSS PER SHARE:				
Basic and diluted	(0.04)	(0.09)	(0.06)	(0.12)
WEIGHTED AVERAGE SHARES USED TO CALCULATE NET LOSS PER SHARE:				
Basic and diluted	54,737	56,934	54,536	56,484
COMPREHENSIVE LOSS:				
Net loss	$(1,945)	$(5,048)	$(3,216)	$(6,916)
Foreign currency translation adjustment	(19)	(36)	(28)	39
Comprehensive loss	$(1,964)	$(5,084)	$(3,244)	$(6,877)

See accompanying notes to unaudited condensed consolidated financial statements.

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DOT HILL SYSTEMS CORP.
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

	Six Months Ended June 30,	
	2011	2012
Cash Flows From Operating Activities:		
Net loss	$(3,216)	(6,916)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	2,164	1,959
Provision for bad debt expense	—	25
Stock-based compensation expense	2,537	2,076
Write-off of intangible assets	—	1,647
Write-off of property and equipment	—	244
Changes in operating assets and liabilities, net of effects of business acquisition:		
Accounts receivable	4,298	4,582
Inventories	2,050	595
Prepaid expenses and other assets	(850)	3,194
Accounts payable	(5,305)	(9,162)
Accrued compensation and other expenses	1,254	(3,152)
Deferred revenue	23	602
Restructuring accrual	(481)	(189)
Other long-term liabilities	(355)	412
Net cash provided by (used in) operating activities	2,119	(4,083)
Cash Flows From Investing Activities:		
Purchases of property and equipment	(1,578)	(1,425)
Net cash used in investing activities	(1,578)	(1,425)
Cash Flows From Financing Activities:		
Principal payment on note payable	(136)	(71)
Shares withheld for tax purposes	(343)	(533)
Proceeds from sale of stock to employees	742	448
Net cash provided by (used in) financing activities	263	(156)
Effect of Exchange Rate Changes on Cash and Cash Equivalents	(28)	(5)
Net Increase (Decrease) in Cash and Cash Equivalents	776	(5,669)
Cash and Cash Equivalents, beginning of period	45,732	46,168
Cash and Cash Equivalents, end of period	46,508	40,499
Supplemental Disclosures of Non-Cash Investing Activities:		
Property and equipment acquired but not yet paid	$164	811

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 and certain write offs in the carrying value of our long-term assets) 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 for the year ended December 31, 2011. Operating results for the three and six months ended June 30, 2012 are not necessarily indicative of the results that may be expected for future quarters or the year ending December 31, 2012.

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, inventory valuation, recurring and specific issue warranty obligations (see Note 5), the valuation and recognition of stock-based compensation expense, and the valuation of long-lived assets, goodwill and other intangibles, as well as any other assets and liabilities acquired and accounted for under the purchase method of accounting for business combinations. In addition, we have other accounting policies that involve estimates such as the determination of useful lives of long-lived assets, accruals for restructuring and valuation allowance for deferred tax assets. Actual results may differ from these estimates and such differences could be material.

Concentration of Customers and Suppliers

A majority of our net revenue is derived from a limited number of customers. We currently have two customers that accounts for more than 10% of our total net revenue: Hewlett Packard, or HP, and Tektronix, Inc., or Tektronix. Our agreements with our original equipment manufacturers, or OEM, partners do not contain any minimum purchase commitments, do not obligate our OEM partners to purchase their storage solutions exclusively from us and may be terminated at any time upon notice from the applicable partner.

Net revenue by major customer is as follows (as a percentage of total net revenue):

	Three Months Ended June 30,				Six Months Ended June 30,			
	2011		2012		2011		2012	
HP	77	%	72	%	77	%	66	%
Tektronix	5		7		4		13	
Other customers less than 10%	18		21		19		21	
Total	100	%	100	%	100	%	100	%

HP continues to account for a significant percentage of our sales. If our relationship with HP 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 HP or our other customers will expand or not otherwise be disrupted.

We expect that the sale of our products to a limited number of customers will continue to account for a high percentage of net revenue for the foreseeable future. On October 31, 2011, we amended, or the Amendment, the Product Purchase Agreement originally entered into with HP on September 10, 2007. The Amendment extends the agreement with HP for a five year period through October 30, 2016. In addition, the Amendment provides that we will continue to comply with the contractually required cost reduction process and to support HP with respect to certain products or statements of work upon any assignment

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of the agreement for a specified period of time. The Amendment does not contain any minimum purchase commitments by HP. Simultaneously with the extension of the Product Purchase Agreement, we agreed to extend until October 30, 2016 the expiration date of the warrant previously issued to HP to purchase 1,602,489 shares of our common stock at the original exercise price of $2.40 per share.

We currently rely on a limited number of contract manufacturing partners to produce substantially all of our products. As a result, should any of our current manufacturing partners such as Foxconn Technology Group, or parts suppliers not produce and deliver inventory for us to sell on a timely basis, operating results may be adversely impacted.

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.

As of September 30, 2011, we identified a change in circumstances that indicated the carrying amount of our long-lived assets may not be recoverable, as our primary AssuredUVS customer informed us that the AssuredUVS software would no longer be a component of its business strategy, which would result in a significant decline in revenues for the Company. Our long-lived assets consist of the intangible assets associated with our acquisition of certain identified Cloverleaf Communications, Inc., or Cloverleaf, assets acquired in January 2010 with an original carrying value of $5.0 million and property and equipment of $1.2 million.

Since we did not have an immediate replacement for our AssuredUVS customer, management's forecasted undiscounted cash flows indicated that the assets were potentially not recoverable, and proceeded to estimate the fair value of each long-lived asset. Property and equipment comprised mostly machinery and equipment used for testing and development of our AssuredUVS technology. Management determined that carrying value approximated fair value, as property was either acquired in the 2010 acquisition of Cloverleaf, had been purchased subsequently, or could be re-deployed, establishing recent evidence of fair value. It was depreciated over a 3 – 5 year estimated useful life.

Intangible assets consisted primarily of acquired software of $4.9 million and a trade name of $0.1 million. We determined the fair value of the acquired software by estimating the replacement cost of the software, taking into account both the software as acquired and subsequent development work, as well as the business alternatives we were considering and the corresponding value of the software in these alternative approaches. We estimated the value of the software based on the probabilities of each of the business alternatives. We determined the fair value of the trade name using an income approach and considered the fact that the software's trade name at the time of acquisition was no longer being used. All estimates were based on management using appropriate assumptions and projections.

Our impairment analysis at September 30, 2011 identified $2.9 million of impaired long-lived assets, consisting entirely of intangible assets recognized as part of the Cloverleaf acquisition in 2010. Long-lived asset impairment charges are recorded consistent with our treatment of related amortization expense specific to each acquired intangible assets. We recorded $2.8 million of impaired acquired software and $0.1 million of impaired acquired trade name as a component of cost of goods sold for the year ended December 31, 2011.

In February 2012, our Board of Directors approved a plan to exit our AssuredUVS business and close down our Israel Technology Development Center (see Note 6). We evaluated the potential impact, if any, on our valuation of our acquired software and other long-lived assets maintained at our Israel Technology Development Center, and based on the facts and circumstances in existence at March 31, 2012, we believed that the valuations at that date were appropriate.

During the second quarter of 2012, we explored the potential sale of the AssuredUVS business but were unsuccessful in locating a buyer and ended efforts to sell the business or its component assets as of June 30, 2012. Accordingly, we recognized an impairment of $0.2 million of property, plant and equipment and $1.6 million for the remaining value of acquired software as a component of cost of goods sold as of June 30, 2012.

Valuation of Goodwill

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We review goodwill for impairment on an annual basis at November 30 and whenever events or changes in circumstances indicate the carrying value of an asset may not be recoverable. Our ITC reporting unit, which was developing our AssuredUVS software, is a component of the Standalone Storage Software reporting segment identified in the notes to our consolidated financial statements. During September 2011, our primary AssuredUVS customer became delinquent on the settlement of its payables to us and upon our investigation it became evident that its financial resources were limited. It also informed us that they were changing their strategy which would result in a significant decline in revenue for the Company, and we determined it was “more-likely-than-not” that the reporting unit was less than its carrying value.

Current accounting standards require that a two-step impairment test be performed on goodwill. In the first step, we compare the fair value of our reporting unit to its carrying value. We determine the fair value of our reporting unit using a combination of the income approach and market capitalization approach. If the fair value of the reporting unit exceeds the carrying value of the net assets, goodwill is not impaired, and we are not required to perform further testing. If the carrying value of the net assets exceeds the fair value of the reporting unit, then we must perform the second step in order to determine the implied fair value of the reporting unit’s goodwill and compare it to the carrying value of the reporting unit’s goodwill. If the carrying value of the reporting unit’s goodwill exceeds its implied fair value, then we must record an impairment charge equal to the difference.

Under the income approach, we calculate the fair value of a reporting unit based on the present value of estimated future discounted cash flows. Under the market capitalization approach, valuation multiples are calculated based on operating data from publicly traded companies within our industry. Multiples derived from companies within our industry provide an indication of how much a knowledgeable investor in the marketplace would be willing to pay for a company. These multiples are applied to the operating data for the reporting unit to arrive at an indicated fair value. Significant management judgment is required in the forecasts of future operating results that are used in the estimated future discounted cash flow method of valuation. The estimates we have used are consistent with the plans and estimates that we use to manage our business. We base our fair value estimates on forecasted revenue and operating costs along with business plans. Our forecasts consider the effect of a number of factors including, but not limited to, the current future projected competitiveness and market acceptance of the product, technological risk, the ease of use and ease of implementation of the product, the likely outcome of sales and marketing efforts and projected costs associated with product development, customer support and selling, general and administrative costs. It is possible, however, that the plans may change and that actual results may differ significantly from our estimates. The valuation resulted in the recognition of an impairment charge to goodwill of $4.1 million during the year ended December 31, 2011. No additional goodwill remains on the balance sheet of the Company as of June 30, 2012.

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. Bad debt expense was $0.0 million and $0.0 million for the six months ended June 30, 2011 and 2012, respectively.

Balance sheet details are as follows, (in thousands):

	June 30, 2011	June 30, 2012
Balance, beginning of the year	$—	$203
Additions to allowance	—	25

Balance, quarter ended	$—	$228

Recent Accounting Pronouncements

In May 2011, the FASB issued ASU 2011-04, Fair Value Measurement Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs. The pronouncement was issued to provide a uniform framework for fair value measurements and related disclosures between U.S. GAAP and IFRS. ASU 2011-04 changes certain fair value measurement principles and enhances the disclosure requirements particularly for Level 3 fair value measurements. This pronouncement is effective for interim and annual reporting periods beginning after December 15, 2011. The adoption of ASU 2011-04 resulted in additional required disclosures within the Notes to the Unaudited Condensed Consolidated Financial Statements, but did not have a material impact on our Unaudited Condensed Consolidated Financial Statements.

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In June 2011, the FASB issued ASU 2011-05, Comprehensive Income Presentation of Comprehensive Income. ASU 2011-05 allows an entity the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In both choices, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. ASU 2011-05 eliminates the option to present the components of other comprehensive income as part of the statement of changes in stockholders' equity. The amendments to the Codification in the ASU do not change the items that must be reported in other comprehensive income or when an item of other comprehensive income must be reclassified to net income and are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. In December 2011, the FASB issued ASU 2011-12, Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05. The provisions of ASU 2011-12 indefinitely defer portions of ASU 2011-05 related to the presentation of reclassifications of items out of accumulated other comprehensive income. The adoption of ASU 2011-05 and ASU 2011-12 did not have a material impact on our Unaudited Condensed Consolidated Financial Statements.

2. Net Loss Per Share

Basic net loss per share is calculated by dividing net loss for the period by the weighted average number of common shares outstanding during the period. Diluted net loss per share is computed by dividing net 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. No such items were included in the computation of diluted loss per share in the three and six months ended June 30, 2011 or 2012 because we incurred a net loss in each of these periods and the effect of inclusion would have been anti-dilutive.

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

	June 30, 2011 Number of Potential Shares	Range of Exercise Prices	June 30, 2012 Number of Potential Shares	Range of Exercise Prices
Stock options	7,254,690	$0.47 - $16.36	9,298,263	$0.47 - $16.36
Unvested stock awards	2,303,779	$—	1,132,568	$—
Warrants	1,602,489	$2.40	1,602,489	$2.40

3. Inventories

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

	December 31, 2011	June 30, 2012
Purchased parts and materials	$3,994	$2,982
Finished goods	1,257	1,674
Total inventory	$5,251	$4,656

Inventories are valued at the lower of cost (first-in, first-out method) or market value. The valuation of production 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 markets are volatile, subject to technological risks and price changes and inventory reduction programs by our customers. In addition, we are required to make last time buys of certain components on occasion. These factors result in a risk that we will forecast incorrectly and purchase 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 effect on our financial statements. Any write downs to inventory due to the existence of excess quantities, physical obsolescence, changes in pricing, damage, or other causes establish a new cost basis for the inventory. When we sell or dispose of reserved inventory the new cost basis is charged to cost of sales. Service inventory is amortized ratably over the estimated life of the related product series.

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4. Intangible Assets

Identifiable intangible assets are as follows (in thousands):

	December 31, 2011			
	Estimated Useful Life	Gross	Accumulated Amortization	Net
RaidCore technology	4 years	$4,256	$(3,477)	$779
NAS technology	3 years	214	(214)	—
Software	3 years	2,050	(228)	1,822
Total intangible assets		$6,520	$(3,919)	$2,601

	June 30, 2012			
	Estimated Useful Life	Gross	Accumulated Amortization	Net
RaidCore technology	4 years	$4,256	$(4,011)	245
Total intangible assets		$4,256	$(4,011)	$245

As of December 31, 2011, we recorded a $2.8 million impairment of our acquired internally developed software and $0.1 million impairment of our trade name (see Note 1). Effective with the February 6, 2012 announced restructuring plan, the AssuredUVS product family would no longer be marketed to customers and the underlying UVS technology would either be disposed of through a sale to a potential acquiror or, in the event a buyer could not be located, abandoned. Accordingly, the acquired software was temporarily idled, and no additional amortization expense incurred subsequent to the February 6, 2012 announcement of the 2012 restructuring plan. In accordance with ASC 350, we evaluated the software for impairment as of February 6, 2012. At the time of that evaluation we were actively marketing the software for sale and believed the cash flows from a potential sale would have recovered the recorded book value. We continued actively marketing the software through June 2012. However, we were unsuccessful and all efforts toward locating a potential acquirer ceased as of June 30, 2012. Accordingly, we recognized an impairment for the remaining $1.6 million of acquired software as a component of cost of goods sold as of June 30, 2012. Additionally, we expect to report the underlying business as discontinued operations commencing in the third quarter of 2012. Amortization expense related to intangible assets totaled $0.5 million, $0.3 million, $1.0 million and $0.7 million for the three and six months ended June 30, 2011 and 2012, respectively.

Estimated future amortization expense related to intangible assets as of June 30, 2012 is as follows (in thousands):

2012 (Remaining 3 months)	$245
Thereafter	—
Total	$245

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 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 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.

In October 2009, we discovered a quality issue associated with certain power supply devices provided by a long-term component supplier, which resulted in a higher than expected level of power supply failures to us and our customers. While we were able to promptly identify and resolve the cause of the failures, we are required to provide replacement products or make repairs to the affected power supply units that had been sold between March and October 2009. Through June 30, 2011, our component supplier had repaired all of the faulty power supplies at no cost to us, and reimbursed us for our out-of-pocket costs which has constituted a reimbursement to customers for certain out-of-pocket costs they incurred in connection with these power supply failures. The total amount reimbursed to us by our component supplier approximated $1.0 million through June 30, 2011.

In the second and third quarters of 2011, a material customer provided us with a framework estimating the potential claims precipitated by the power supply failures. As previously disclosed, the customer's preliminary framework of potential claims provided to us included additional costs related to the customer's internal overhead for other internal indirect costs, in addition to third-party direct costs. Based on preliminary discussions for settlement and our analysis of the framework provided by the customer, including future potential claims through the warranty period, we estimated that we had incurred a probable loss of approximately $2.8 million. Consequently, in addition to the $1.3 million previously recognized as of June 30, 2011, we recorded an estimated liability of $1.5 million as of September 30, 2011 within "Accrued expenses" on our condensed consolidated balance sheet.

Negotiations continued with our customer throughout the fourth quarter of 2011 into the first half of 2012. Based on the results of ongoing negotiations with the material customer, we increased our estimated liability at December 31, 2011 to $5.5 million, resulting in a charge of $2.7 million during the fourth quarter of 2011 within "Accrued expenses" on our condensed consolidated balance sheet, and are reported gross of any third-party recoveries.

A final settlement with this material customer was reached during the second quarter of 2012. The terms of the agreement required an immediate payment of $2.0 million, and an estimated remaining liability of approximately $3.5 million as of June 30, 2012 related to a combination of future price concessions and rebates to be paid quarterly based on sales volumes through December 31, 2012. While our estimated liability relating to failed power supply units is subject to some uncertainty until final settlement, based on our current expectation of sales volumes with this material customer, we do not believe the incurrence of an additional loss is either probable or reasonably possible at this time.

During the second quarter of 2011, based on the advice of legal counsel, we established that our component supplier is contractually obligated to reimburse us for fair and reasonable costs we incur with our customers associated with these power supply failures. Our component supplier had continued to re-work and distribute to our customer the affected population of power supplies at no cost to us. In addition, at the time, our collection experience with similar amounts already reimbursed to us by our supplier and our belief that our component supplier and its parent companies had the financial ability to continue to reimburse us for any additional costs we may incur, we recorded a current asset within "Prepaid expenses and other assets" on our consolidated balance sheet of $1.3 million as of June 30, 2011.

During the third quarter of 2011, as the claims from our customer became clearer, we commenced negotiations with our component supplier for fair and reasonable costs that we have and are likely to incur through the warranty period associated with this component failure. Originally we determined that the supplier was unlikely to make an up-front cash payment for the original settlement amount of $1.3 million, but it indicated a willingness to provide some form of reimbursement for costs incurred, in the form of cash and/or note receivable of $0.5 million plus future product rebates. Based on our judgment at the time, we reduced the previously recorded current asset of $1.3 million within "Prepaid expenses and other assets" to $0.5 million as of September 30, 2011. We continued to negotiate this settlement with our supplier and during the second quarter of 2012, the supplier signed a final settlement agreement providing for additional reimbursements above what was recognized as of September 30, 2011. Pursuant to the settlement, the supplier agreed to cash consideration of $1.2 million, of which we received $0.6 million upon the subsequent signing of the settlement agreement, with the remaining $0.6 million to be received in four quarterly installments commencing three months from the date of the signed settlement agreement. Additionally, our supplier committed to product rebates and/or price concessions on product orders for a period of 39 months from the execution of the settlement agreement, in return for our agreement to release our supplier from all obligations relating to the power supply failures known by us to date. This agreement is not subject to any required future purchases.

In addition, we have commenced discussions with our General Liability and Errors and Omissions Insurance and underwriters and will continue to pursue our rights to cover any damages we incur and that are not reimbursed by our supplier. The insurance company has issued a reservation of rights letter to us and at this time, it is not possible to estimate to what extent the residual amounts, if any, we will be covered by our carrier. As of June 30, 2012 we have not assumed or recorded any insurance reimbursement.

To the extent our settlement agreements with our customer and our component supplier are not on mutually beneficial terms, or our component supplier does not continue to reimburse us for the expenses incurred by us or our customers, and we are unsuccessful in recovering such expenses from our insurance provider, we could incur additional expenses which could potentially have a material effect on our financial statements and liquidity.

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Our warranty accrual and cost activity is as follows as of and for the three and six months ended June 30, (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2012	2011	2012
Balance, beginning of period	$881	$6,930	$982	$6,871
Charges to operations	1,781	48	2,265	416
Deductions for costs incurred	(506)	(2,199)	(1,091)	(2,508)
Balance, end of period	$2,156	$4,779	$2,156	$4,779

The table above includes $5.5 million of charges recorded to cost of sales in the second, third and fourth quarters of 2011 related to the liability established for certain third-party material and service costs incurred by our customer related to replacing failed power supplies. The table above does not include the corresponding $1.2 million benefit recorded within cost of sales in 2011 related to the current asset established for the recovery of such costs incurred by our customer which are to be reimbursed to us by our component supplier. There were no additional charges recorded during the first or second quarters of 2012 related to the liability established for certain third-party material and service costs incurred by our customer related to replacing failed power supplies. We paid $2.0 million to our material customer as part of the settlement agreement entered into during the second quarter of 2012.

6. Restructuring

2008 Plan

In December 2008, our management approved, committed to, and initiated a restructuring plan, or the 2008 Plan, to improve efficiencies in our operations, which was largely driven by our plan to consolidate our facility in Carlsbad, California into the Longmont, Colorado facility. As a result of this relocation, we terminated approximately 70 California employees whose positions have been relocated to Colorado and incurred approximately $1.5 million in severance-related costs, all of which was recognized and paid as of December 31, 2010.

As part of the 2008 Plan, we also incurred contract termination costs of $3.8 million since the inception of the 2008 Plan through September 30, 2011. We record charges for contract termination and other associated costs as restructuring expense, which is presented as a separate component within operating expenses. Accrued contract termination and other associated costs are recorded in the restructuring accrual line on our consolidated balance sheets. We expect to pay these contract lease termination costs over the remainder of the lease term ending in April 2013. Based on our estimates, we do not expect to receive any material amounts of sublease income through the remainder of the lease term.

All of the 2008 Plan activity relates to our storage systems operating segment.

The following table summarizes our 2008 Plan activities (in thousands):

	Contract Termination and Other Associated Costs
Accrued restructuring balance, beginning of period	$1,212
Restructuring plan expense	29

Adjustments to restructuring plan	(73)
Cash payments	(400)
Accrued restructuring balance, end of period	$768

The adjustment to the 2008 Plan resulted from certain credits received in the first quarter 2012 for previously paid common area maintenance (CAM) charges relating to our lease of the Carlsbad, California facility. We recorded this benefit as a reduction of restructuring expense, which is presented as a separate component within operating expenses.

During July 2012, we signed an amendment to our lease of the Carlsbad facility abating approximately $0.2 million in rent and other operating expenses in lieu of allowing the landlord to use the facility for the remainder of the lease term.

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2010 Plan

In the second quarter of 2010, our management approved, committed to, and initiated a restructuring and cost reduction plan, or the 2010 Plan, to better align our resources in order to lower our breakeven point. The 2010 Plan includes severance and related costs for the reduction of approximately 10% of our workforce, and fees associated with the acceleration of the closure of our Carlsbad, California facility. As a result of these actions, we intend to terminate approximately 26 employees located in the United States, of which 25 have been terminated as of September 30, 2011. We expect to incur approximately $0.4 million in severance-related costs, all of which were recognized as of December 31, 2010. Accrued severance-related costs are recorded in the restructuring accrual line on our consolidated balance sheets. The remainder of the severance and related restructuring costs attributable to our 2010 Plan were paid out in the third quarter of 2011.

As part of the 2010 Plan, we also incurred contract termination costs of $0.3 million since the inception of the 2010 Plan through September 30, 2011 for facility lease and other associated costs that we continue to incur without economic benefit, as we exited the remaining portion of our Carlsbad, California facility. We record charges for contract termination costs and other associated costs as restructuring expense, which is presented as a separate component within operating expenses. Accrued contract termination and other associated costs are recorded in the restructuring accrual line on our consolidated balance sheets. We expect to pay these contract lease termination costs over the remainder of the lease term ending in April 2013. Based on our estimates, we do not expect to receive any material amounts of sublease income through the remainder of the lease term.

The majority of the 2010 Plan activity relates to our storage systems operating segment.

	Contract Termination and Other Associated Costs	
Accrued restructuring balance, beginning of period	$116	
Restructuring plan expense	3	
Adjustments to restructuring plan	(4	)
Cash payments	(41	)
Accrued restructuring balance, end of period	$74	

The adjustment to the 2010 Plan resulted from certain credits received in the first quarter 2012, for previously paid CAM charges relating to our lease of the Carlsbad, California facility. We recorded this benefit as a reduction of restructuring expense, which is presented as a separate component within operating expenses.

2012 Plan

In the first quarter 2012, our management approved, committed to, and initiated a restructuring and cost reduction plan, or the 2012 Plan, that is associated with the closure of our Israel Technology Development Center. The 2012 Plan is designed to re-align our software investments to focus on accelerating the development of embedded software features, in order to launch a competitive set of mid-range storage array products in 2012, and to provide more differentiated entry-level products for both OEM and channel customers. As a result of these actions, we intend to terminate approximately 32 employees located in our Israel Technology Development Center, of which 24 have been terminated as of June 30, 2012. As part of our efforts to attract a potential buyer of the UVS technology, we retained through July 2012 certain of our key Israeli employees with expertise on designing, building and maintaining the UVS technology. We expect to incur a total of approximately $0.4 million in severance-related costs. Accrued severance-related costs are recorded in the restructuring accrual line on our unaudited consolidated balance sheets. The majority of severance related restructuring costs attributable to our 2012 plan were paid out in the second quarter of 2012, with the remainder expected to be fully paid in the third quarter of 2012. Substantially all of our 2012 Plan workforce reductions were completed by July 31, 2012.

As part of the 2012 Plan, we also expect to incur approximately $0.4 million in contract termination costs for facility lease and other associated costs that we continue to incur without economic benefit, as we exited our Petah Tivka, Israel facility. We record charges for contract termination costs and other associated costs as restructuring expense, which is presented as a separate component within operating expenses. Accrued contract termination and other associated costs are recorded in the restructuring accrual line on our consolidated balance sheets. We expect to pay the majority of the contract lease termination costs over the remainder of the facility lease term ending in December 2012. Based on our estimates, we do not expect to

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receive any material amounts of sublease income through the remainder of the lease term. Approximately $0.1 million of our contractual commitments are expected to remain obligations of the Company through December 2013.

The majority of the activities comprising the 2012 Plan are expected to be completed by the end of 2012.

The following table summarizes our 2012 Plan activities (in thousands):

	Severance and Related Costs	Contract Termination and Other Associated Costs	Total
Accrued restructuring balance, beginning of period	$—	$—	$—
Restructuring plan charges	355	366	721
Reclass of customer deposits	—	150	150
Cash payments	(281		