DOT HILL SYSTEMS CORP
Form 10-K
March 10, 2014

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

(Mark One)

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

For the Fiscal Year Ended December 31, 2013

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	13-3460176
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
1351 S. Sunset Street, Longmont, CO	80501
(Address of principal executive offices)	(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 if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No x

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 x No ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

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	o

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 aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold as of June 30, 2013 was $125,602,389.

The registrant had 59,882,431 shares of common stock, $0.001 par value, outstanding as of February 28, 2014.

Documents Incorporated by Reference

Portions of the registrant’s definitive proxy statement for its 2014 annual meeting of stockholders are incorporated by reference into Part III of this Form 10-K.

Table of Contents

DOT HILL SYSTEMS CORP.
FORM 10-K
For the Year Ended December 31, 2013
INDEX

Table of Contents

Forward-Looking Statements

Certain statements contained in this annual report on Form 10-K, including, but not limited to, 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, or the Securities Act, 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. Future filings with the Securities and Exchange Commission, or SEC, future press releases and future oral or written statements made by us or with our approval, which are not statements of historical fact, may also contain forward-looking statements. Because such statements include risks and uncertainties, many of which are beyond our control, actual results may differ materially from those expressed or implied by such forward-looking statements. Some of the factors that could cause actual results to differ materially from those expressed or implied by such forward-looking statements are set forth in the section entitled "Risk Factors" and in the section entitled "Management's Discussion and Analysis of Financial Condition and Results of Operations" and elsewhere throughout this annual report on Form 10-K. Readers are cautioned not to place undue reliance on these 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.

In this annual report on Form 10-K, "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.

Table of Contents

PART I
Item 1. Business

We design, manufacture and market a range of software and hardware storage systems for the entry and mid-range storage markets. We focus on selling through server-based original equipment manufacturers (OEMs), such as Hewlett-Packard, or HP, Dell Inc. or Dell, Lenovo Group Limited or Lenovo, Advanced Micro Devices, Inc. or AMD, and Stratus Technologies or Stratus; as well as into vertical markets through embedded solutions OEM's, such as Teradata Corporation or Teradata, CGG Veritas or CGG, Motorola, Inc. or Motorola, Tektronix Inc. or Tektronix, Samsung Electronics or Samsung, Concurrent Computer Corporation or Concurrent, Autodesk Inc. or Autodesk, Harris Broadcast Communications and Nokia Siemens Network or Nokia Siemens, which primarily include media and entertainment, telecommunications, high performance computing, digital image archive, big data and oil and gas. Our vertical market customers are OEMs, who embed our products into their solutions, as well as resellers.

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-based OEM's go into the IT infrastructure of companies and organizations to support a wide variety of internal applications, including email, Enterprise Resource and Planning, retail transactions and voicemail. 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 central office 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 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(TM) 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 U.S. government) compliant based on their ruggedness and reliability.

Our products span Price Bands 2 through 5 as defined by International Data Corporation. Our AssuredSAN 2000 and 3000 Series products address the entry level market (bands 2 and 3) and AssuredSAN 4000 and Pro 5000 Series address the mid-range market (bands 4 and 5). AssuredSAN Pro 5000 Series products include RealStorTM software that incorporates autonomic real-time data tiering via a virtualized back-end. With RealStor, businesses gain the advantage of using very high performance Solid State Drives (SSDs) to their maximum benefit, while storing less frequently accessed data on larger and much less expensive hard disk drives (HDDs).

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, 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-based OEMs, vertical markets partners that include embedded OEMs that integrate our products into their solutions, and value-added resellers, or VARs. Our storage system products' server-based OEM partners currently include, among others, HP, Lenovo and Stratus, who purchase our AssuredSAN products, and Dell and AMD, who purchase our AssuredVRA products. Our vertical markets partners include Teradata, CGG, Motorola, Tektronix, Samsung, Concurrent, Autodesk, Harris Broadcast Communications and Nokia Siemens. Although our products and services are sold worldwide, the majority of our net revenue is derived from our U.S. operations.

We began shipping products to HP in the fourth quarter of 2007. Our products are primarily sold as HP's MSA 2000/P2000 product family. The agreement with HP does not contain any minimum purchase commitments. In October 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 March 2008 to expire concurrently with the supply agreement in October 2016. Net revenue from HP

Table of Contents

approximated 59% of our total net revenue in 2013, down from 68% in 2012 and 74% in 2011. We expect sales to HP to continue to decline as a percentage of total revenue, but we still anticipate it to represent a substantial percentage of our total net revenue in 2014.

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 customers, in particular our OEM customers, as well as our ability to win new business;
- 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-based OEM customers and OEMs 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; and
- 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 in 2013 and prior periods may not necessarily be indicative of future net revenue and results of operations.

We were formed in 1999 by the combination of Box Hill Systems Corp., or Box Hill, and Artecon, Inc., or Artecon. We reincorporated in Delaware in 2001. Our website address is http://www.dothill.com. Information contained on our website does not constitute a part of this annual report on Form 10-K. Our annual reports on Form 10-K, our quarterly reports on Form 10-Q, our current reports on Form 8-K and all amendments to those reports that we file with the SEC are currently available free of charge to the general public through our website promptly after being filed with the SEC and are also accessible through the SEC’s website which may be found at http://www.sec.gov. In addition, you may read and copy the materials we file with the SEC at the SEC’s Public Reference Room at 100 F Street, N.E., Washington, DC 20549. You may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330.

Industry Background

Overall Storage Market

According to "Worldwide Enterprise Storage Systems 2013 - 2017 Forecast," published by International Data Corporation (IDC), the overall enterprise storage market is a $35.0 billion industry in 2012, of which over $26.3 billion is generated by external networked storage systems. IDC projects networked storage revenue's compound annual growth rate (CAGR) to be 4.9% through 2017. The market for networked storage is further divided into Direct Attach Storage (DAS) with $2.6 billion in revenue and Networked Storage, which includes Storage Area Network (SAN) products, with $16.6 billion in revenue and Network Attach Storage (NAS) with $6.1 billion in revenue. External storage systems have been growing faster than internal storage systems for 2012 - 2017, and have been growing faster since 2002. Storage capacity growth has increased at a much higher rate than revenue, as capacity per disk device continues to increase while component prices are declining.

External storage refers to storage systems not inside a server. The main components of a storage array system are HDDs, SSDs, one or two storage controllers, power supplies and an enclosure. The main advantage of networked storage, including SAN and NAS, is that it allows multiple servers to share the storage resources connected through a network interface such as Fibre Channel or iSCSI.

IDC tracks shipments of products from storage vendors and divides the market into ten specific price bands. Price bands most relevant to Dot Hill are bands 2 through 6, which represent a $14.2 billion projected total available market in 2014.

Table of Contents

Types of Data

Gartner, Inc. (Gartner), an information technology research and advisory company, classifies data types into four categories based on the format of how the data is stored. This differentiates data types across traditional relational, XML, messaging and multi-media formats. Examples of data types in the four categories include:

- Structured data. Structured data includes relational databases where full atomicity, consistency, isolation, and durability (ACID) features are supported.
- Semi-structured data. Semi-structured data is structured data that include metadata and are self-descripting. This also includes XML data.
- Quasi-structured data. Quasi-structured data includes web clickstream data that contains some inconsistencies in data values and format.
- Unstructured data. Unstructured data includes text documents, images, video and general file-based data.

Dot Hill storage products are suited to all data types.

Storage Systems by Market Segment

Traditionally, storage vendors have designed products for markets differentiated by capacity, performance, price and feature set. These storage markets are typically identified as:

- Entry-level. Entry-level storage products are designed for lower capacity, less complex data storage needs. OEMs and server companies address this market primarily through an indirect sales channel approach employing distributors, retailers and VARs that assist IT managers in identifying, purchasing and installing the product.
- Mid-range. Mid-range or departmental/workgroup storage products are designed for higher capacity and performance than entry-level products, but still feature ease of use and manageability, and are attached to a local server or a network of servers tailored to the needs of the local users. In this market, storage providers, OEMs and server companies primarily sell their products to local IT managers either directly or through distributors, VARs and regional system integrators (SIs).
- High-end. High-end or data center storage products are designed for use by larger organizations where data storage and management is critical. These organizations require large capacity storage systems that feature high-performance, automation, extreme reliability, continuous availability, operating systems interoperability and global service and support. In this market, storage providers, OEMs and server companies sell their products with a combination of a direct sales force and indirect channels, including OEMs, large SIs, VARs and managed services providers.

Dot Hill storage products address the entry-level (bands 2 and 3) and mid-range segments (bands 4 and 5).

Industry Trends

There are several disruptive trends in the storage industry that will continue to drive demand for increasing storage requirements in terms of capacity, performance, and price. These trends include the following:

- The explosion of personal data stored and shared on social networking sites and stored or accessed on various mobile devices;
- Consolidation of compute power and storage in a variety of centralized or cloud architectures;
- Big Data capture, storage and management of various unstructured and quasi-structured data formats;
- Business intelligence and analytics, often applied to Big Data stores that require additional storage resources during the map/reduce process;
- Data security and compliance requirements from government entities and customer privacy expectations; and
- Storage systems optimized for flash storage and storage class memory products to increase performance while optimizing cost.

We believe the storage industry is strong and growing and our unique product and company strengths will satisfy a growing set of customers in the years ahead.

Table of Contents

Our Strategy

Our primary objective is to sustain and grow profitability through our core business of selling entry and mid-level storage arrays through OEMs, including server-based OEMs and vertical markets OEMs focused on solutions for media and entertainment, telecommunications, Big Data, HPC Digital Image Archive and oil and gas, and also through channel based resellers focused primarily on the same vertical markets. We launched our first mid-range products on August 22, 2012, which include the AssuredSAN(TM) Pro 5000 Series, with RealStor(TM) software that incorporates autonomic real-time data tiering, and the AssuredSAN(TM) 4000 Series next-generation, high performance storage solution designed to deliver best-in-class price performance, 99.999 percent availability and exceptional streaming throughput. In addition, we will strive to create greater economies of scale and operating leverage in our entry level OEM storage array business, by focusing on new customer opportunities that may arise as a result of industry consolidation.

More specifically our strategy for the storage array business includes the following:

- Focus on embedding our storage products into solutions for media and entertainment, telecommunications, Big Data, HPC Digital Image Archive and oil and gas. Our AssuredSAN products are particularly well-suited for read and write workloads that are both random and sequential. A random workload implies that multiple users may wish to access the same data simultaneously. A sequential workload implies that users will need access to large files. The vertical markets we target all need storage with such performance characteristics. By addressing the needs of these markets through both OEMs that would embed our storage into their solutions and resellers that also sell into these segments, we can benefit from our channel partners’ knowledge of these vertical markets, extensive direct and indirect distribution networks, installed customer bases and greater sales, marketing and global service and support infrastructures. The costs associated with a direct worldwide sales force are extensive. By leveraging the sales networks of our partners, we can manage our sales and marketing costs to much lower levels. In addition, we encourage our partners to provide direct support and service to end-users.
- Focus on existing customers and develop new customer relationships. We have entered into OEM agreements with, HP, Tektronix, Lenovo, Dell, AMD, Motorola, Samsung, Stratus, Concurrent, Teradata, and CGG, among others. We intend to focus on expanding our relationships with our existing customers and to continue seeking additional OEM relationships with other industry leaders to sell current products and expand the number of products offered to these customers to enable them to address new markets.
- Grow and extend technology leadership. We view our core competencies as the research, design and engineering of modular open storage systems and data protection for enterprise servers. We believe that focused research and development on advanced, cost effective storage technologies is critical to our ongoing success. We intend to continue to develop and integrate high-end features into our products in order to offer more complete storage solutions and enhance our existing products to benefit our channel partners’ efforts to increase sales.
- Leverage our AssuredSAN architecture. We developed our AssuredSAN architecture as a foundational element of our AssuredSAN modular storage arrays. This modular architecture allows us to quickly develop and bring to market new products based on this foundation. We intend to focus and unify our development efforts on this approach, which we believe offers a competitive time to market advantage to us. In particular, we intend to utilize our AssuredSAN products to continually extend the feature sets of both our entry-level and mid-range solutions and build a comprehensive set of software-based features that offer our customers increased levels of value and differentiation.
- Quickly adopt new standards. We strive to introduce products that are first to market. For example, in November 2013 we introduced AssuredSAN 4004, the first entry-level storage array with flexible Fibre Channel and Fibre Channel / iSCSI interfaces that can be configured for 8Gb or 16Gb FIBRE Channel, or 1Gb or 10Gb iSCI host connectivity. This model series also offers a 12Gb SAS interface option. In August 2012, we introduced AssuredSAN(TM) Pro 5000 Series with RealStor(TM) software that incorporates autonomic real-time data tiering. With RealStor, businesses gain the advantage of very high performance SSDs, using them to their maximum benefit to store very frequently accessed or "hot" data, while storing less frequently accessed data on slower, but much less expensive, hard disk drives. This storage array technology delivers performance improvements within minutes for workloads as data being stored on the Series 5000 products are analyzed in real-time and migrated to faster but more expensive SSDs or to slower HDDs, based on frequency of use. On the same day, we also introduced our AssuredSAN(TM) 4000 Series

next-generation, high performance storage solution designed to deliver best-in-class price performance, 99.999 percent availability, and exceptional streaming throughput. The Series 4000 shares the same architecture as the Series 5000. In addition, our AssuredVRA enterprise RAID (redundant array of independent disks) stack for Windows and Linux servers allow us to quickly adopt and migrate to next generation Intel and AMD class server architectures due to its highly modular architecture and approach.

Table of Contents

- Pursue strategic alliances, partnerships and acquisitions. We plan to continue to evaluate and selectively pursue strategic acquisitions, alliances and partnerships and other strategic alternatives that are complementary to our business. We believe that growth of the network storage market will create additional opportunities to expand our business. In some cases, we believe the most efficient pursuit of these opportunities may be through partnerships and relationships that allow us to leverage our existing products, core competencies and channels while capitalizing on products, technologies and channels that may be available through potential strategic partners.

Our Products

Product Positioning and Highlights

We design, manufacture and market a range of enterprise storage solutions and virtual RAID adapters for the entry and mid-range storage markets. 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-based OEM's go into the IT infrastructure of companies and organizations to support a wide variety of internal applications, including email, Enterprise Resource and Planning, retail transactions and voicemail. 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 central office 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 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 AssuredSAN storage solutions are positioned in the market to lead in these areas:

- Proven value for network storage. Our storage arrays support raw capacities up to 288TB with 4TB disk drives, and offer High Availability with dual redundant controllers.
- Best-in-Class reliability and high availability. Based on over 650,000 total storage array systems shipped, and the large number of systems tracked in field service, the AssuredSAN product line has consistently demonstrated 99.999% availability. Our products have been validated by rigorous testing by multiple demanding OEM customers.
- Best-in-Class price/performance. With the introduction of the AssuredSAN 4004 models, we have established industry leading performance in terms of streaming read/write performance and transactions per second for this class of product. Our mid-range class products deliver more performance at a given price point than competing systems in the market. Since the initial launch in August 2012, multiple OEM customers have selected and qualified our mid-range products for their storage solutions.
- Most responsive storage with real-time tiering. Our AssuredSAN Pro 5000 series with RealStor™ software enables autonomic real-time tiering across disk technologies to achieve greater performance for dynamic workloads. With RealStor, businesses gain the advantage of deploying very high performance SSDs, using them to their maximum benefit to store very frequently accessed or “hot” data, while storing less frequently accessed data on slower, but much less expensive hard disk drives. This 8th generation storage array technology delivers performance improvements within minutes for workloads, as data being stored on the Series 5000 products are analyzed in real-time and migrated to faster but more expensive SSDs or to slower HDDs based on frequency of use.
- Disruptively simple interface for improved operational efficiency. In addition to the autonomic real-time tiering in the Assured SAN Pro 5000 series, the software interface has been designed for simplicity that eliminates all low level configuration tasks without complex policy settings.

AssuredSAN Product Line

We design our family of open systems storage hardware and software products with the reliability, flexibility and performance necessary to meet IT managers' needs for easily scalable cost-effective solutions. We currently offer storage systems in Fibre Channel, iSCSI, and SAS host interfaces which include HDD and SSD drive technologies. We also offer enterprise class RAID software for industry standard Windows and Linux servers, as well as storage management applications, which can manage any one or all of our storage system configurations. The AssuredSAN Pro 5000, RealStor™ software adds

Table of Contents

autonomic real-time tiering, thin provisioning, fast RAID rebuild and a disruptively simple user interface called Storage Management Console. In addition, performance-enhancing and Data Management Software is sold bundled with our storage systems or licensed separately to OEM customers, including AssuredSnap, AssuredCopy and AssuredRemote.

We also offer AssuredSAN Modular Storage Architecture products focused on the incorporation of SAS drive technology with a variety of front-end host interfaces. These products are focused on the general purpose market initially and introduce several technological advancements including EcoStor™ (elimination of batteries in a RAID cache management system) and SimulCache™ (high-speed mirrored cache coherency).

- AssuredSAN 2000 Series. Our product line begins with the value priced storage arrays in the 2000 Series. The 2000 Series provides entry level SAN storage for business applications, with an easy to use management interface. The AssuredSAN model 2333 offers a 1Gb iSCSI interface and supports 1TB, 2TB, and 3TB HDDs with options to include SSD drives.
- AssuredSAN 3000 Series. The 3000 Series is ideal for demanding applications such as video post-production, surveillance, and virtual machine environments (VMware, Microsoft and Citrix). With the introduction of the 24 drive small form factor drive products (2U/24), we believe we were also the first to offer such systems with full embedded RAID and data protection capability. Our AssuredSAN 3000 Series includes a range of interface options including 8Gb Fibre Channel, 1Gb and 10Gb iSCSI, 6Gb SAS and a hybrid Fibre Channel / iSCSI option.
- AssuredSAN 4000 Series. Our AssuredSAN™ 4000 storage arrays which were announced on August 22, 2012 are the highest performing storage solutions in our portfolio with a traditional user interface for RAID storage systems. On November 6, 2013, we further enhanced the 4000 Series with the 4004 models based on the Company's ninth-generation RAID architecture. These products offer greater data security, faster throughput and substantial business benefits for markets that demand extremely high-bandwidth performance, such as cloud service providers, media & entertainment, oil & gas, telecommunications, big data analytics and digital image archiving. Host interface options include 12Gb SAS, 16Gb FC, 1Gb and 10Gb iSCI and the only hybrid 16Gb Gen 5 Fibre Channel/10Gb iSCI converged interface.
- AssuredSAN Pro 5000 Series. Also announced on August 22, 2012, our AssuredSAN Pro 5000 Series adds automated tiered storage capabilities to our smart, simple, SAN storage line-up. Using the Pro 5000 Series with integrated RealStor™ management software, IT managers can improve data responsiveness, remove provisioning and allocation guesswork, and simplify storage management and expansion. RealStor, our unique, patent pending software takes tiered storage to a more advanced level -beyond batch data migration to Real-Time automated tiered storage, that continuously responds to user data demands by moving 'hot' data to a high-speed SSD tier. RealStor software includes these key features:

RealTier™, Autonomic Tiered Storage software;
RealThin™, Thin provisioning solution;
RealPool™, automated pooling dramatically simplifies storage setup; and
RealQuick™, method for rapidly rebuilding sectors in record time.

Additional AssuredSAN Features

- High Availability. We believe that high availability is essential to our customers due to the critical nature of the data being stored. We have demonstrated 99.999% availability in our product lines and integrate the latest in technological advances to meet expanding market opportunities. We design redundancy, high reliability, high performance and ruggedness into our storage systems. Redundant components have the ability to be replaced while the system is on-line without interrupting network activity.
- Modular Scalability. Our products are designed using a single cohesive modular architecture that allows customers to size and configure storage systems to meet their specific requirements or storage network type. This modular architecture also allows customers to easily expand and, in some cases, reconfigure a system as their needs change, permitting them to extend the useful life of and better utilize their existing systems.
- Rugged Product Design. Our AssuredSAN products are designed to operate under extreme climatic and other harsh operating conditions without degradation in reliability or performance, as attested to with the NEBS, Level 3 and MIL-STD-810F compliance.

Table of Contents

- Open Systems, Multi-Platform Support. As an independent provider of storage products, we are well positioned to provide storage solutions on a variety of platforms and operating systems, including Linux, HP-UX, Solaris and Windows. Our product lines support access to data by multiple servers using different operating systems simultaneously. This multi-platform compatibility allows customers to standardize on a single storage system that can readily be reconfigured and redeployed at minimal cost as the customer's storage architecture changes.

Data Management Software (DMS) for AssuredSAN Products

Software features available with our AssuredSAN products include the following:

- AssuredSnap. AssuredSnap is our DMS software that introduces point in time snapshot technology into the AssuredSAN product family. AssuredSnap provides the ability to create point-in-time copies or backups of disk volumes with restoration of data to any captured point in time snapshot. Since AssuredSnap only copies changed data to disk, it can virtually eliminate backup windows. The AssuredSnap implementation is not only fast, but also reduces the size of snapshots by storing only a single instance of changed blocks. This technology allows IT managers increased backup efficiency and flexibility.
- AssuredCopy. AssuredCopy is our DMS software that introduces data cloning or volume copy services into the AssuredSAN product family. AssuredCopy leverages snapshot technology to create complete, physically independent copies of master or snapshot volumes. Once complete, volume copies can be mounted to any host system for read-only or read-write access. As both a data protection and a data management technology, AssuredCopy can be used to support applications such as backup and data recovery, data mining, decision support, data distribution and migration, application development and test. AssuredCopy protects against accidental or malicious loss or corruption of data, and provides additional protection against complete volume failure.
- AssuredRemote. AssuredRemote is our DMS software that introduces remote replication into the AssuredSAN product family. AssuredRemote leverages snapshot technology and then transfers them to a paired array over either Fiber Channel or Ethernet for enhanced data protection and disaster recovery.
- RAIDar. RAIDar is a web-based interface used for configuring, monitoring, error reporting and running diagnostics for certain of our RAID systems. This tool kit enables our OEM customers to private-label the user interface quickly and cost efficiently. RAIDar 2.0 adds greater end-user ease of use capability in the form of simple configuration wizards. RAIDar applies to the AssuredSAN 2000, 3000 and 4000 Series products.

AssuredVRA Product Line

AssuredVRA is a high-performance, feature rich, host based RAID stack for Windows and Linux based enterprise servers. Our OEM and SI customers typically integrate AssuredVRA as an ingredient of their entry-level Intel or AMD based server products. It has the ability to replace a dedicated hardware RAID adapter in many applications by utilizing the built-in disk I/O ports built into modern server hardware. In most instances, AssuredVRA is private labeled and branded with the OEM's own brand. The latest customer, Supermicro, was announced on January 13, 2014.

Dot Hill Market Access

Horizontal Markets

- Server Attach Storage. This is the traditional market for external network storage systems. SAN storage arrays connected through a network interface such as Fibre Channel or iSCSI and sold by one of the major system manufacturers. We currently sell to Hewlett-Packard, Lenovo, Stratus and other manufacturers that attach to server systems.
- Server Virtualization. Increasingly, servers are being virtualized through a hypervisor platform such as VMware, Microsoft Hyper-V, or Citrix and external network storage is connected through a network interface such as Fibre Channel or iSCSI to support these systems. Each physical server may handle multiple host applications. In this environment, we offer specialized features within the storage array to better integrate with the hypervisor platform. Examples are Microsoft VSS and VMware SRM.

Vertical Markets

- Telecommunications. We sell through multiple OEM's in the telecommunications space including Tektronix, Samsung, Motorola, and Nokia Siemens. Demand for storage in this market remains strong due to the proliferation of mobile devices and the build-out of 4G wireless networks.

Table of Contents

- Media & Entertainment. We have established success in various media and entertainment industries such as video post-production and broadcast systems. Our success in this segment spans both OEM and Indirect Channel partners. Current OEM customers include Autodesk, Concurrent, and Harris Broadcast Communications.
- Big Data / Data Analytics. Numerous business and technology trends are disrupting the traditional data management and processing landscape and perhaps none more than big data and data analytics. Many businesses now view the analysis of big data stores as a competitive advantage. This approach requires a new approach to the analysis of large unstructured data sources. We have engaged in this segment through OEM partners and expect this market will continue to expand with opportunities across all channels. Current OEM customers include Teradata.
- Oil & Gas. Energy exploration and delivery is significant part of the worldwide economy. In this industry advanced computing and storage technologies are used for acquisition, retrieval and analysis for seismic data as well as equipment monitoring and process optimization. Current OEM customers include CGG.
- Digital Image Archive. This segment includes the capture, storage and analysis of digital images from satellite, surveillance systems, medical images and many other applications.

OEM Partners for AssuredSAN platform

Our products and services are sold worldwide to facilitate server and SAN storage implementations, primarily through server-based OEMs and OEMs who focus on select vertical markets. Our storage system products' OEM partners currently include, among others, Autodesk, CGG, Concurrent, Harris Broadcast Communications, HP, Lenovo, Motorola, Quantum, Samsung, Stratus, Tektronix, and Teradata. Although our products and services are sold worldwide, the majority of our net revenue is derived from our U.S. operations.

We began shipping products to HP, our largest current customer, in the fourth quarter of 2007. In January 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 2000/P2000 product family. Sales to HP increased significantly during 2008 and increased again in 2009 primarily as a result of the successful launch and market acceptance of the HP MSA 2000 products. HP launched its third generation product line, now called the P2000 product line, in February 2010. Sales to HP increased again in 2010 as we began selling our next generation host interfaces across the HP P2000 product line. The agreement with HP does not contain any minimum purchase commitments. In October 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 March 2008 to expire concurrently with the supply agreement in October 2016. Net revenue from HP approximated 74% in 2011, 68% in 2012 and 59% in 2013, with 2011 reflecting discontinuance of our sales to NetApp. We expect sales to HP will continue to represent a substantial portion of our net revenue in 2014.

OEM Partners for AssuredVRA Platform

Virtual RAID Adapter (VRA) technology is a unique class of pure, host-based software RAID that combines key advantages of pure software RAID with many of the key advantages of hardware RAID adapters. As such it optimized for integration with server manufacturers. Our AssuredVRA OEM partners currently include, among others, Dell, AMD, and Supermicro.

Distribution Partners

Beginning in late 2009, we began placing more emphasis on selling higher gross margin products, which include appliance products and hardware products through indirect sales channels. This involves a two-tier distribution model whereby we sell directly to Distributors who then sell to Solutions Partners who sell a final solution to end customers. In 2013 we maintained distribution agreements in North America with Promark Technology, Inc., Pacific Alliance Capital, Inc., and Synnex among others, and in EMEA with Hammer PLC and CMS among others.

Business Overview

Sales and Marketing

Our hardware and software products and services are sold worldwide to facilitate network storage implementations in the entry level and mid-range market segments. Dot Hill branded products are sold primarily through distributors, VARs and resellers while “blackbox” and OEM-customized products are sold primarily through server-based OEMs, vertical markets OEMs and federal contractors. We utilize these channels to reach end-user customers that range in size from small businesses to government agencies and large multinational corporations. We maintain a sales and marketing organization operating out of our office in Longmont, Colorado, with regional offices in Germany, Japan, the United Kingdom and China as well as several

12

Table of Contents

smaller localized field sales offices throughout North America. Generally, our customers have no minimum purchase requirements and have certain rights to extend, delay or cancel shipment of their orders without penalty.

We support our indirect and OEM channels with a limited set of marketing programs designed to promote our products and technology leadership, attract additional channel partners and generate end-user demand. Our product marketing team focuses on marketing strategy, product launches, product messaging, demand assessment, competitive analysis, public relations, marketing communications and channel marketing. The marketing team ensures that all marketing activities occur on a well-managed, timely basis in coordination with our development, manufacturing and sales groups, as well as our sales channel partners. The groups work closely with our sales and research and development groups to align our product development road map to meet key customer and channel technology requirements.

Sales and marketing expenses consist primarily of salaries, marketing program related costs, lead generation, customer-related evaluation unit expenses, promotional costs and travel expenses.

Outsourced Manufacturing

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. The majority of our products sold in 2011, 2012, and 2013 were manufactured by Foxconn. We expect Foxconn to manufacture substantially all of our products in 2014.

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

Research and Development

Our research and development team has been focused on developing innovative storage products including hardware and software. Hardware platforms are highly leveraged across the product line to minimize investment and deliver products that meet needs in multiple target markets.

Our software capabilities were significantly expanded in 2012 with the introduction of RealStor software for the AssuredSAN Pro 5000. Our AssuredSAN Pro 5000 Series with RealStor technology overcomes the limitations of other tiered storage solutions to deliver a combination of industry-leading high performance and high availability on a scalable platform with advanced features that are easy to manage with minimal IT resources. Intelligent RealTier algorithms operate continuously, automatically and in real-time to deliver the best possible improvement in performance for today's rapidly-changing real-world workloads. And the low initial capital expenditure, combined with streamlined management, result in a surprisingly low total cost of ownership, while the performance gains yield a high return on investment.

We have a history of industry firsts, including the first successfully commercialized hot-swappable SCSI disk array and RAID storage system for the UNIX environment and the first NEBS Level 3 certified and MIL-STD-810F tested line of storage systems. We were first to market and have patented SimulCache, which increases the write performance in a dual controller array. We were first to market and have patented EcoStor into our AssuredSAN products, which eliminates batteries in the storage system, thereby decreasing service costs while ensuring permanent data integrity in the event of power failure. We also believe that we were one of the first in the industry to be able to reliably intermix SAS and SATA drives in the same storage system without caveat. This has enabled us to build products that can optimize capacity and performance applications within the same storage array. We launched the first external RAID products using both 24 small form factor drives and 12 large form factor drives in a two unit high chassis form factor for the media and entertainment industry where read and write bandwidth is of significant importance. Also, we believe we were first to market in February 2010 with entry level storage arrays that offered

8Gb Fibre Channel, 6Gb SAS and a hybrid Fibre Channel/iSCSI interface in our AssuredSAN 3000 product line.
We are focused on continuously developing products that meet changing customer needs and anticipating and proactively responding to highly evolving technology in a timely and cost-effective manner. We also generally design and develop our products to have a modular architecture that can be scaled to meet customer needs and modified to respond to technological developments in the open systems computing environment across product lines. We are actively working on next generation technologies in both storage hardware protocols and storage software applications. Research and development expenses consist primarily of project-related expenses, consulting charges and salaries for employees directly engaged in research and

Table of Contents

development. Our total research and development expenses were $31.2 million in 2011, $34.2 million in 2012 and $35.3 million in 2013.

Customer Service and Support

We recognize that providing comprehensive, proactive and responsive support is essential to maintaining and growing customer satisfaction, fostering customer loyalty and securing repeat business.

Our team of pre-sales sales engineers work in conjunction with their sales counterparts within our partners to train, scope opportunities and implement Dot Hill products in their customer environments when required. There are sales tools, try and buy and Beta evaluations, Partner Portal with all required sales information and competitive data. We offer partner boot camps in the Longmont, CO office for new product training, partner collaboration and feedback at various times throughout the year. This pre-sales support approach ensures our partners get whatever they require to be successful selling Dot Hill Products.

We provide comprehensive global customer service and support 24 hours a day, seven days a week, 365 days a year, either directly or through third-party service providers, aimed at simplifying installation, minimizing usage problems, maximizing system availability and streamlining administration. Through direct and third-party service providers, we maintain a global network of professional engineers and technicians who provide telephonic technical support in various languages from strategically located global response centers on a 24-hour, seven-day basis. In addition, we have the ability to provide four-hour on-site service response per contract on a global basis. We also offer all of our customers' access to SANsolve, our web-hosted interactive support knowledge base that gives our customers the ability to find answers to technical questions through our Customer Resource Center as well as initiate and track all support requests. Phone support is available via the web with a knowledge base and a Customer Resource Center with various information about our products and certification matrix.

Our new products also incorporate many diagnostic tools that will support the end user in self-servicing and diagnosing the issue easily. Industry standard SLA's are utilized but are also customizable by the partner if required.

We have also taken steps to better align our service and support structure with our indirect sales model, including the following:

- Collaborated with our OEM partners to provide support and service directly to end-users. For example, HP and other OEMs provide direct support to their end-user customers;
- Identified key areas for further development such as product certification/recertification training for our channel partners. In addition, we offered expanded array support services for a fee through our professional services offerings; and
- Established additional authorized service providers to provide localized service support in certain Asian and European locations.

We continue to capitalize on a growing population of product whose initial warranty expired by providing cost effective extended warranty and out-of-warranty repair services.

Intellectual Property

Our success depends significantly upon our proprietary technology. We have received registered trademark protection for the marks SANnet (R), SANpath (R), SANscape (R), Stratis (R), Dot Hill (R), Dot Hill Systems (R) and the Dot Hill logo. Other trademark registrations are in process including RealStor™, RealTier™, RealThin™, and RealQuick™, AssuredSAN™, SimulCache™, and EcoStor™. We have attempted to protect our intellectual property rights primarily through copyrights, trade secrets, employee and third party nondisclosure agreements and other measures. We have registered trademarks and will continue to evaluate the registration of additional trademarks as appropriate. We claim common law protection for, and may seek to register, other trademarks. In addition, we generally enter into confidentiality agreements with our employees and with key vendors and suppliers.

As of December 31, 2013, we had been awarded a total of 92 United States patents, 4 of which were awarded in 2013. 84 of these patents generally cover RAID controller and SAN-related technology. In addition, as of December 31, 2013 we had 25 filed United States patent applications pending approval. The patents covering our core technologies expire from 2014 to 2043. In addition, if we are unable to protect our intellectual property, or infringe intellectual property of a third party, our operating results could be harmed.

We also license certain technology from third parties and pay royalties on products shipped that incorporate such technology.

Table of Contents

OEM Sales Cycle

Our OEM sales cycle involves four distinct phases that characterize the pipeline of current and potential OEM customers. Although the time to bring on a new OEM customer can be significant, the revenue stream usually continues through one or more product cycles.

Phase 1 - Product Evaluation. During this phase, customers are investigating and evaluation products with regard to features, performance, and pricing. In addition, assessment of a vendor's capability for quality, support, processes, and flexibility is often as important as the product assessment. This phase typically takes one to six months and ends when the customer grants a verbal award to the selected vendor.

Phase 2 - Contract and SOW. This phase involves development of a formal agreement and sometimes a statement of work if there is any customization or feature enhancements required. During this time the business engagement is established. This phase typically takes one to six months and ends with a signed contract.

Phase 3 - Customize and Solution Integration. In Phase 3, any product customization is implemented as defined in a statement of work. The OEM customer will also test, integrate and develop their complete solution to be ready for market. This phase typically takes one to 12 months and ends with product availability.

Phase 4 - OEM Launch and Ramp. The final phase is launch and ramp of the product through the OEM customer's process. Revenue begins as product ships, and a ramp to full volume usually takes between three and 12 months. The timing and magnitude of revenue ramp for new customers is almost entirely dependent on their internal execution.

Administration

General and administrative (G&A) expenses consist primarily of compensation to officers and employees performing administrative functions, as well as expenditures for legal, accounting and other administrative services and fluctuations in currency valuations.

Other income (expense), net is comprised primarily of interest income earned on our cash and cash equivalents and other miscellaneous income and expense items.

Competition

The storage market is intensely competitive and is characterized by rapidly changing technology. For our AssuredSAN storage products sold to OEM's, we compete primarily against independent storage system suppliers including Fujitsu Technology Solutions GmbH or Fujitsu, NEC Corporation, Infortrend Technology or Infortrend, Promise Technology, Inc. or Promise, Nimble Storage, Inc. or Nimble, and NetApp as a result of its acquisition of LSI's Engenio Division in May 2011. For our AssuredSAN storage products sold through indirect channels, our competitors include EMC Corp., or EMC, Hitachi Data Systems Corp., or Hitachi, NetApp, Infortrend, and Promise. Our indirect channels also compete with traditional suppliers of computer systems and servers, including IBM, Oracle, Dell 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. As a result, they may have more advanced technology, larger distribution channels, stronger brand names, better customer service and access to more customers than we do. Other large companies with significant resources could become direct competitors, either through acquiring a competitor or through internal efforts. Additionally, a number of public and privately held companies are currently attempting to enter the storage market, some of which may become significant competitors in the future. We could conceivably 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 believe the principal competitive factors in the hardware storage systems and software storage solutions markets are:

- product performance, features, scalability and reliability;
- price;
- product breadth;
- timeliness of new product introductions;
- brand reputation;
- interoperability and ease of management; and

15

Table of Contents

• responsiveness to OEMs and customer support.

We believe that we compete favorably in several of these categories. To remain competitive, we believe we must invest significant resources in developing new products, enhancing our current products and maintaining high quality standards and customer satisfaction.

Dot Hill Operating Leverage

We believe we have several unique points of operating leverage that will create value for the business As such, we are focused on improving our business strength in these areas.

Gross margin levers will improve the overall margin of the business. For example, our supply chain costs are relatively fixed and as volume increases, the average cost per unit declines, which will improve margins. The primary drivers of gross margin are the mix of customers (server OEM vs. vertical markets), the size of the customer (large vs. small), the products purchased by our customers (entry level vs. mid-range) and engagement model (drive-full vs. drive-less).

Operating expense levers enable us to significantly leverage a relatively fixed engineering investment across multiple customers with similar product needs. Within the OEM sales team, the effort is largely centered on design wins and not on-going demand generation. Also, G&A costs are relatively fixed and as volume increases, the incremental expense to support the increased volume is disproportionately smaller than the increased volume, which will improve operating margins.

Balance sheet and cash leverage is gained with working capital and line of credit that are sufficient to satisfy customers and suppliers. This enables investment in adding new customers to the pipeline. If needed, we have the cash to invest in customer inventory.

Employees

As of December 31, 2013, we had 326 full-time employees, of whom 169 were engaged in research and development, 52 in sales and marketing, 52 in manufacturing, 38 in general management and administration and 15 in customer service and support. We have not had a work stoppage among our employees and none of our employees are represented under collective bargaining agreements. We consider our relations with our employees to be good.

Named Executive Officers of the Registrant

Name	Age	Position	Officer or Key Employee Since
Dana W. Kammersgard	58	Chief Executive Officer and President	August 1984(1)
Hanif I. Jamal	53	Senior Vice President, Chief Financial Officer, Treasurer and Corporate Secretary	July 2006

(1) In 1999, Artecon and Box Hill merged to form Dot Hill. Artecon was founded in 1984 and Mr. Kammersgard was an officer of Artecon from its inception until the merger, and has been an officer of Dot Hill since that date.

All officers are elected by our Board of Directors and serve at the pleasure of our Board of Directors as provided in our bylaws.

Dana W. Kammersgard has served as our President since August 2004. In March 2006, Mr. Kammersgard was appointed as our Chief Executive Officer and President. From August 1999 to August 2004, Mr. Kammersgard served as our Chief Technical Officer. Mr. Kammersgard was a founder of Artecon and served as a director from its inception in 1984 until the merger of Box Hill and Artecon in August 1999. At Artecon, Mr. Kammersgard served in various positions since 1984, including Secretary and Senior Vice President of Engineering from March 1998 until August 1999 and as Vice President of Sales and Marketing from March 1997 until March 1998. Prior to co-founding Artecon, Mr. Kammersgard was the director of software development at CALMA, a division of General Electric Company. Mr. Kammersgard holds a B.A. in Chemistry from the University of California, San Diego.

Hanif I. Jamal has served as our Senior Vice President, Chief Financial Officer, Treasurer and Corporate Secretary since July 2006. Prior to joining Dot Hill, Mr. Jamal served as Vice President and Corporate Treasurer for Gateway Inc. from 2004 to 2006. Prior to joining Gateway in 2002, Mr. Jamal served in a number of leadership positions over 17 years within Hewlett- Packard Company in the customer financing division, HP Technology Finance. Mr. Jamal led HP’s customer financing operations in North America, Latin America and Europe and was also Vice President and General Manager for HP’s Commercial and Consumer Financing Division. In 1998, he established Hewlett-Packard International Bank in Dublin, Ireland,

Table of Contents

and served as Managing Director through 2000. Mr. Jamal holds an MBA from Stanford Graduate School of Business and a Bachelor of Science degree, with Honors, in Management Sciences from the University of Manchester Institute of Science and Technology in the United Kingdom.

Item 1A. Risk Factors

The following sets forth risk factors that may affect our future results. Our business, results of operations and financial condition may be materially and adversely affected due to any of the following risks. We face risks described but not limited to those detailed below. Additional risks we are not presently aware of or that we currently believe are immaterial may also impair our business operations. The trading price of our common stock could decline due to any of these risks. In assessing these risks, you should also refer to the other information contained or incorporated by reference in this annual report on Form 10-K, including our financial statements and related notes.

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. For example, sales to HP accounted for 74% of our net revenue for the year ended December 31, 2011, 68% of our net revenue for the year ended December 31, 2012 and 59% of our net revenue for the year ended December 31, 2013. If our relationships with HP or certain of our other 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 HP or our other customers will expand or not otherwise be disrupted.

Going forward, we expect to generate additional revenue from our vertical markets partners and from potential new server-based 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; and
- the ability of our customers to effectively deliver, market and increase sales of their own solutions based on our products.

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.

Our products may contain undetected errors, or failures that become epidemic failures, 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 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 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,

Table of Contents

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. The last significant quality issue was discovered in 2009, and was due to a problem with one of our power supply vendors. Refer to Note 6 of the financial statements 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. The acquisition and ongoing integration of new businesses into our business may adversely affect our operations or profitability.

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

We have recently expanded our indirect sales model to access end-user markets primarily through our distributors, VARs and OSPs and are investing significant monetary and human resources in order to grow this indirect sales channel. If we cannot successfully identify, manage, develop, and generate sufficient net revenue through our indirect sales channel, our business could be harmed. In addition, even if we are able to grow our indirect sales channel, managing the interaction of our OEMs', distributors', VARs' and OSPs' efforts to reach various potential customer segments for our products and services is a complex process. Moreover, since each channel method has distinct risks and gross margins, our failure to implement the most advantageous balance in the delivery model for our products and services could adversely affect our net revenue and gross margin and our 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.

Table of Contents

Our contracts with our customers do not include minimum purchase requirements and are not exclusive, and we cannot assure you that our relationship with these customers will not be terminated or will generate significant sales.
None of our contracts with our existing customers, including HP, 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 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 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;

19

Table of Contents

- 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; and
- the ability of our customers to ramp sales of our products including the desire of customer's to purchase legacy products.

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 assure you that our sales will not decline in future periods.

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. 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 HP and thus do not need to make substantial incremental investments in sales and marketing to generate demand for our products to our largest customer. 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.

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 Corp., or EMC, Hitachi Data Systems Corp., or Hitachi, Infortrend, Promise Technology, Inc., or Promise, NEC and NetApp as a result of its acquisition of LSI's Engenio Division in May 2011. We also compete with traditional suppliers of computer systems, including IBM, Oracle, Dell and HP, which market storage systems as well as other computer products.

Table of Contents

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 assure you that we will be able to successfully incorporate these factors into our products and compete against current or future competitors or that competitive pressures we face will not harm our business. If we are unable to 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. 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.

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.

Table of Contents

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 relations.

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. If our agreement with Foxconn is terminated, or 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 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 our agreement with Foxconn terminates, 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,

22

Table of Contents

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 continue to 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, 2012, and 2011, we incurred income (loss) from continuing operations of $5.5 million, $(10.4) million, and $(8.5) million, respectively. We expect our business to remain volatile as we are often unable to reliably predict net revenue from HP and our other 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 2014. Consequently, we cannot assure you 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 HP and other 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;
- 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.

Table of Contents

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.

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.

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

Table of Contents

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.

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 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.

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. A substantial portion 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 U.S. dollars and in foreign currencies. An increase in the value of the U.S. 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 U.S.-based revenues. A decrease in the value of the U.S. dollar relative to foreign currencies could increase operating expenses in foreign markets. Prices for our products are substantially U.S. 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 U.S. 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.

Table of Contents

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 U.S. 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 U.S. 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 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 U.S. registrants prepare financial statements in accordance with International Financial Reporting Standards (IFRS), 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.

Table of Contents

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 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.

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. 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.

Table of Contents

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. Despite our security measures, 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.

Item 1B. Unresolved Staff Comments

None.

Item 2. Properties

Our corporate headquarters currently occupy approximately 88,000 square feet that includes office and laboratory space in two buildings located in Longmont, Colorado. These facilities include research and development, administration, sales and marketing and operations functions. The lease for these buildings expires in May 2018.

We lease approximately 7,300 square feet of office space located in Plymouth, Minnesota, under a lease that expires October 2015. We use this office space as a research and development facility for our AssuredVRA software.

In addition, we lease other international office space in Germany, Japan, China, Singapore and the United Kingdom, primarily for supply-based management and sales and marketing functions.

Our existing leased facilities are appropriate for our current needs. We do not own any real estate.

Item 3. Legal Proceedings

The information required by this Item is incorporated by reference from Note 12, Commitments and Contingencies, of the financial statements beginning on page F-1 of this annual report on Form 10-K.

Item 4. Mine Safety Disclosures

None.

PART II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Our common stock is currently included for quotation on the NASDAQ Global Market and is currently traded under the symbol "HILL."

The following table sets forth for the periods indicated the per share range of the high and low sales prices of our common stock as reported on the NASDAQ Global Market.

Table of Contents

	Low	High
Year Ended December 31, 2012		
First Quarter	$1.22	$1.65
Second Quarter	1.05	1.60
Third Quarter	0.98	1.25
Fourth Quarter	0.72	1.09
Year Ended December 31, 2013		
First Quarter	$0.88	$1.39
Second Quarter	1.10	2.31
Third Quarter	2.04	2.97
Fourth Quarter	2.13	3.41

On February 28, 2014 the last reported sale price for our common stock on the NASDAQ Global Market was $5.33 per share. As of February 28, 2014 there were 59,882,431 shares of our common stock outstanding held by approximately 98 holders of record. We have never paid any cash dividends on our common stock, and currently intend to retain future earnings, if any, to the extent possible to fund the development and growth of our business. We do not anticipate paying any cash dividends on our common stock in the foreseeable future.

The information required to be disclosed by item 201(d) of Regulation S-K, "Securities Authorized for Issuance Under Equity Compensation Plans," is included under Item 12 of Part III of this annual report on Form 10-K.

PERFORMANCE MEASUREMENT COMPARISON

The following graph compares the cumulative 5-year total return provided stockholders on our common stock relative to the cumulative total returns of the S&P 500 Index, the NASDAQ Composite Index and the NASDAQ Computer Index. An investment of $100 (with reinvestment of all dividends) is assumed to have been made in our common stock and in each index on December 31, 2008 and its relative performance is tracked through December 31, 2013.

Table of Contents

Item 6. Selected Financial Data

We derived the selected consolidated financial data presented below from our audited consolidated financial statements for the years ended December 31, 2011, 2012 and 2013, which are included elsewhere in this annual report on Form 10-K. Statement of operations data for the years ended December 31, 2009 and 2010 and balance sheet data as of December 31, 2009, 2010 and 2011 have been derived from our audited consolidated financial statements not included herein. All data are in thousands except per share data. You should read the selected consolidated financial data together with our consolidated financial statements and related disclosures thereto and with "Management's Discussion and Analysis of Financial Condition and Results of Operations" included elsewhere in this annual report on Form 10-K.

	2009	2010	2011	2012	2013
Statement of Operations Data:					
Net Revenue	$234,383	$251,838	$195,827	$194,548	$206,565
Cost of goods sold	196,556	207,653	150,544	146,177	140,495
Gross profit	37,827	44,185	45,283	48,371	66,070
Operating expenses:					
Research and development	28,120	28,113	31,196	34,199	35,332
Sales and marketing	10,970	11,837	13,225	14,133	13,450
General and administrative	12,569	11,251	9,174	9,695	11,658
Operating income (loss)	(13,832)	(7,016)	(8,312)	(9,656)	5,630
Other income (loss), net	167	(3)	(23)	3	(39)
Income tax (benefit) expense	(40)	213	129	749	51
Gain (loss) from continuing operations	(13,625)	(7,232)	(8,464)	(10,402)	5,540
Loss from discontinued operations (2)	—	(6,019)	(13,560)	(4,548)	(476)
Net income (loss)	$(13,625)	$(13,251)	$(22,024)	$(14,950)	$5,064
Net income (loss) per share (1):					
Income (loss) from continuing operations	$(0.29)	$(0.14)	$(0.15)	$(0.18)	$0.09
Loss from discontinued operations	$—	$(0.11)	$(0.25)	$(0.08)	$(0.01)
Basic and diluted	$(0.29)	$(0.25)	$(0.40)	$(0.26)	$0.09
Balance Sheet Data:					
Cash, cash equivalents and short-term investments	$57,574	$45,732	$46,168	$40,315	$40,406
Working capital	62,010	49,879	41,387	34,286	43,794
Total assets	108,280	107,502	98,879	83,937	105,384
Total long-term debt	346	71	—	—	—
Total stockholders' equity	66,351	64,378	48,702	38,775	47,647

(1) See Note 2 of Notes to Consolidated Financial Statements for an explanation of the calculation of net income (loss) per share.

(2) During September 2011, we performed an impairment analysis over our long-lived and intangible assets. The impairment analysis identified $4.1 million of impaired goodwill, $2.8 million of impaired acquired software and $0.1 million of impaired acquired trade name, all related to our acquisition of Cloverleaf, Inc. As of December 31, 2011, the goodwill impairment charge, long-lived asset impairment charge and the acquired software impairment charge were recorded as components of discontinued operations. See further discussion of our long-lived asset impairment in Note 5 of Notes to Consolidated Financial Statements.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Cautionary Statement for Forward-Looking Information

Certain statements contained in this annual report on Form 10-K, 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 I, Item 1A, “Risk Factors” and elsewhere in this annual report on Form 10-K. Readers are cautioned not to place undue reliance on forward-looking statements. The forward-looking statements speak only as of the date on which they are made, and we undertake no obligation to update such statements to reflect events that occur or circumstances that exist after the date on which they are made.
The following discussion of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and notes thereto included elsewhere in this annual report on Form 10-K.

Overview

We design, manufacture and market a range of software and hardware storage systems for the entry and mid-range storage markets. We focus on selling through server-based original equipment manufacturers (OEMs), such as Hewlett-Packard, or HP, Dell Inc. or Dell, Lenovo Group Limited or Lenovo, Advanced Micro Devices, Inc. or AMD, and Stratus Technologies or Stratus; as well as into vertical markets through embedded solutions OEM's, such as Teradata Corporation or Teradata, CGG Veritas or CGG, Motorola, Inc. or Motorola, Tektronix Inc. or Tektronix, Samsung Electronics or Samsung, Concurrent Computer Corporation or Concurrent, Autodesk Inc. or Autodesk, Harris Broadcast Communications and Nokia Siemens Network or Nokia Siemens, which primarily include media and entertainment, telecommunications, high performance computing, digital image archive, big data and oil and gas. Our vertical market customers are OEMs, who embed our products into their solutions, as well as resellers.

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-based OEM's go into the IT infrastructure of companies and organizations to support a wide variety of internal applications, including email, Enterprise Resource and Planning, retail transactions and voicemail. 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 central office 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 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(TM) 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 U.S. government) compliant based on their ruggedness and reliability.

Our products span Price Bands 2 through 5 as defined by International Data Corporation. Our AssuredSAN 2000 and 3000 Series products address the entry level market (bands 2 and 3) and AssuredSAN 4000 and Pro 5000 Series address the mid-range market (bands 4 and 5). AssuredSAN Pro 5000 Series products include RealStorTM software that incorporates autonomic real-time data tiering via a virtualized back-end. With RealStor, businesses gain the advantage of using very high performance Solid State Drives (SSDs) to their maximum benefit, while storing less frequently accessed data on larger and much less expensive hard disk drives (HDDs).

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, our ability to reduce product cost, our product lead time, our ability to meet delivery schedules required by our customers and the economic environment.

Table of Contents

Our products and services are sold worldwide to facilitate server and SAN storage implementations, primarily through server-based OEMs, vertical markets partners that include embedded OEMs that integrate our products into their solutions, and value-added resellers, or VARs. Our storage system products' server-based OEM partners currently include, among others, HP, Lenovo and Stratus, who purchase our AssuredSAN products, and Dell and AMD, who purchase our AssuredVRA products. Our vertical markets partners include Teradata, CGG, Motorola, Tektronix, Samsung, Concurrent, Autodesk, Harris Broadcast Communications and Nokia Siemens. Although our products and services are sold worldwide, the majority of our net revenue is derived from our U.S. operations.

We began shipping products to HP in the fourth quarter of 2007. Our products are primarily sold as HP’s MSA 2000/P2000 product family. The agreement with HP does not contain any minimum purchase commitments. In October 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 March 2008 to expire concurrently with the supply agreement in October 2016. Net revenue from HP approximated 59% of our total net revenue in 2013, down from 68% in 2012 and 74% in 2011. We expect sales to HP to continue to decline as a percentage of total revenue, but we still anticipate it to represent a substantial percentage of our total net revenue in 2014.

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 customers, in particular our OEM customers, as well as our ability to win new business;
- 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-based OEM customers and OEMs 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; and
- 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 in 2013 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 our payment terms. The majority of our products sold in 2011, 2012, and 2013 were manufactured by Foxconn. We expect Foxconn to manufacture substantially all of our products in 2014.

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

Research and development expenses consist primarily of project-related expenses, consulting charges and salaries for employees directly engaged in research and development.

Table of Contents

Sales and marketing expenses consist primarily of salaries and commissions, marketing related costs, advertising, customer-related evaluation unit expenses, promotional costs and travel expenses.

General and administrative expenses consist primarily of compensation to officers and employees performing administrative functions, as well as expenditures for legal, accounting and other administrative services and fluctuations in currency valuations. Restructuring charges are aggregated in the general and administrative expenses line item.

Other income (expense), net is comprised primarily of interest income earned on our cash and cash equivalents and other miscellaneous income and expense items.

Critical Accounting Policies and Estimates

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements 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. We base our estimates on current facts, historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities and the accrual of costs and expenses that are not readily apparent from other sources. We evaluate these estimates on an ongoing basis. Actual results may differ from these estimates under different assumptions or conditions. To the extent there are material differences between the estimates and the actual results, future results of operations will be affected.

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 financial statements. We have many accounting policies that require us to make estimates and assumptions; the determination of useful lives of long-lived assets, warranty reserves, accruals for estimated restructuring, tax and legal liabilities and valuation allowance for deferred tax assets. The items listed below are not inclusive of all of our accounting policies but is a listing, identified by management, of those policies which require the most significant judgments and estimates to be made in the preparation of the consolidated financial statements.

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 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 and in addition, upon installation for certain of our AssuredUVS appliance products. 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 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, additional 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.

Specific long term software contracts may contain multiple deliverables including software licenses, services, training and post-contract support (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.

Table of Contents

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 Cost of Goods Sold.

During the preparation of the Company's consolidated financial statements for the year ended December 31, 2012 and the accounting analysis for the renewal of a long-term software contract, the Company determined that it had applied an inappropriate revenue recognition methodology in 2011 to the contract. The Company recorded revenue as royalty payments were received on this contract and should have deferred all the revenue and direct and incremental costs until all the deliverables, except PCS, were delivered in 2012.

This resulted in an overstatement of $2.8 million of revenue and $1.9 million of costs in 2011. This was corrected in the fourth quarter of 2012, and the net out-of-period impact of these adjustments was $1.1 million, consisting of a reduction of revenue and research and development costs of $4.2 million and $3.1 million, respectively. Once all elements except PCS were delivered, the related deferred direct and incremental costs began to be recognized ratably over the contractual PCS support period, as a component of Cost of Goods Sold.

Service

Our service revenue primarily includes 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, undelivered elements that relate to the hardware product's essential software, 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 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 removed our product from the warehouse to incorporate into its end products.

Warranty and Related Obligations

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.

Valuation of Inventories

Inventories are comprised of finished goods and purchased parts and assemblies, which include direct labor 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, are subject to technological risks, price changes and inventory reduction programs by our customers, and as 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 reserved inventory, the new cost basis is charged to cost of sales. The largest factor affecting the accuracy of our provisions for excess inventories is the accuracy of our forecasts of end-customer demand. The accuracy of our estimates depends in part on the accuracy of the non-binding forecasts we get from our end customers, the accuracy of our own forecast of warranty requirements of our customers, the demand for storage systems in our market segments and the speed at which our products are designed in or out of our customers' products.

Share-based Compensation

We account for share-based compensation by measuring and recognizing share-based compensation expense for equity-based awards granted, including stock options, restricted stock awards, performance-based restricted stock awards and employee stock purchase plan shares, for which expense will be recognized over the service period of the equity-based award based on the fair value of the award, at the date of grant. The estimation of stock option and employee stock purchase plan fair value requires management to make complex estimates and judgments about, among other things, employee exercise behavior, forfeiture rates and the volatility of our common stock. These judgments directly affect the amount of compensation expense that will ultimately be recognized.

Compensation expense for restricted stock awards is measured based on the fair-value of the award on the grant date (fair-value is calculated based on the closing price of our common stock on the date of grant), multiplied by the number of shares granted, and is recognized as expense over the respective vesting period. Compensation expense for performance-based restricted stock awards is measured similarly to restricted stock; however, compensation expense is only recorded for awards that ultimately vest, which is contingent upon employees achieving various performance criteria.

We currently use the Black-Scholes pricing model to estimate the fair value of our stock options and employee stock purchase plan shares. The fair values generated by the Black-Scholes pricing model may not be indicative of the actual fair values of our stock options and employee stock purchase plan shares as it does not consider certain factors important to those awards to employees, such as continued employment and periodic vesting requirements as well as limited transferability. The determination of the fair value of share-based payment awards utilizing the Black-Scholes pricing model is affected by our stock price and a number of assumptions, including expected volatility, expected life, risk-free interest rate and expected dividends. We use historical volatility of our stock for the expected life of the grant as the expected volatility assumption required in the Black-Scholes pricing model. Our selection of the historical volatility approach is due to the limited availability of data regarding actively traded options on our stock. The expected life of the stock options is based on historical and other economic data trended into the future. The risk-free interest rate assumption is based on observed interest rates appropriate for the terms of our stock options and employee stock purchase plan shares. The dividend yield assumption is based on our history and expectation of dividend payouts. We evaluate the assumptions used to value stock options on a quarterly basis. If factors change and we employ different assumptions, share-based compensation expense may differ significantly from what we have recorded in the past. If there are any modifications or cancellations of the underlying unvested securities, we may be required to accelerate, increase or cancel any remaining unearned share-based compensation expense.

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 aggregate due to rounding):

	Years Ended December 31,		
	2011	2012	2013
Net revenue	100.0 %	100.0 %	100.0 %
Cost of goods sold	76.9	75.1	68.0
Gross profit	23.1	24.9	32.0
Operating expenses:			
Research and development	15.9	17.6	17.1
Sales and marketing	6.8	7.3	6.5
General and administrative	4.6	5.0	5.6
Total operating expenses	27.3	29.9	29.2
Operating income (loss)	(4.2)	(5.0)	2.8
Other income (expense), net	—	—	—
Income (loss) before income taxes and discontinued operations	(4.2)	(5.0)	2.8
Income tax expense	0.1	0.4	—
Income (loss) from continuing operations	(4.3)	(5.4)	2.8
Loss from discontinued operations	(6.9)	(2.3)	(0.2)
Net income (loss)	(11.2)%	(7.7)%	2.6 %

Year Ended December 31, 2012 Compared to the Year Ended December 31, 2013

Net Revenue

	Years Ended December 31,			
	2012	2013	Increase	% Change
	(in thousands, except percentages)			
Net Revenue	$194,548	$206,565	$12,017	6.2 %

Net revenues increased approximately $12.0 million from $194.5 million for the year ended December 31, 2012 to $206.6 million for the year ended December 31, 2013. The increase in net revenue was primarily due to a $6.9 million increase in sales to Tektronix, from $19.1 million for the year ended December 31, 2012 to $26.0 million for the year ended December 31, 2013, along with an increase of $12.2 million in sales to various other OEM and channel customers. Sales to Tektronix approximated 10% of our net revenue for the year ended December 31, 2012 compared to 13% of our net revenue for the year ended December 31, 2013. This increase in net revenue was partially offset by a decrease in net revenue from HP of $9.5 million, from $131.4 million for the year ended December 31, 2012 to $121.9 million for the year ended December 31, 2013. Sales to HP approximated 68% of our net revenue for the year ended December 31, 2012 compared to 59% of our net revenue for the year ended December 31, 2013. We expect sales to HP as a percentage of total revenue to continue to decline. We expect sales to HP and Tektronix to continue to represent a substantial portion of our net revenue during 2014. During the fourth quarter of 2013, as a result of amending our agreement with a large OEM customer, we granted them more favorable payment terms commencing in October 2013, and we plan to grant an additional but smaller increase in payment terms in June 2014. In return for this concession, the customer awarded the Company two additional product or feature development programs and committed to purchase products to approximately their forecasted levels for the fourth quarter of 2013 as at the time of the execution of the contract amendment. In the fourth quarter of 2013, sales to this customer were a little higher than their contractual commitments for the quarter.

During the preparation of the Company's consolidated financial statements for the year ended December 31, 2012 and the accounting analysis for the renewal of a long-term software contract, the Company determined that it had applied an inappropriate revenue recognition methodology in 2011 to the contract. The Company recorded revenue as royalty payments were received on this contract and should have deferred all the revenue and direct and incremental costs until all the deliverables, except PCS, were delivered in 2012.

Table of Contents

This resulted in an overstatement of $2.8 million of revenue and $1.9 million of costs in 2011. This was corrected in the fourth quarter of 2012, and the net out-of-period impact of these adjustments was $1.1 million, consisting of a reduction of revenue and research and development costs of $4.2 million and $3.1 million, respectively.

Cost of Goods Sold and Gross Profit

	2012		2013		Increase (Decrease)	% Change
	Amount	% of Net Revenue	Amount	% of Net Revenue		
	(in thousands, except percentages)					
Cost of Goods Sold	$146,177	75.1 %	$140,495	68.0 %	$(5,682)	(3.9)%
Gross Profit	$48,371	24.9 %	$66,070	32.0 %	$17,699	36.6 %

Cost of goods sold decreased approximately $5.7 million from $146.2 million for the year ended December 31, 2012 to $140.5 million for the year ended December 31, 2013, primarily as a result of a more favorable customer and product mix, as well as greater supply chain efficiencies and component cost reductions.

Gross profit margin increased from 24.9% for the year ended December 31, 2012 to 32.0% for the year ended December 31, 2013. Gross profit margin benefited from a more favorable customer and product mix, as well as greater supply chain efficiencies, component cost reductions, and decreased warranty related costs. The decrease in warranty related costs reflects our negotiation of more favorable rates with a third-party service provider during the first quarter of 2013. Accordingly, we adjusted our warranty accrual by $0.8 million to reflect this change.

Research and Development Expenses

	2012		2013		Increase	% Change
	Amount	% of Net Revenue	Amount	% of Net Revenue		
	(in thousands, except percentages)					
Research and Development Expenses	$34,199	17.6 %	$35,332	17.1 %	$1,133	3.3 %

Research and development expense increased $1.1 million from $34.2 million for the year ended December 31, 2012 to $35.3 million for the year ended December 31, 2013. The increase was primarily due to the fact that in 2012 the Company deferred $3.6 million in direct and incremental engineering costs related to a long-term customer software contract (see Note 1 to the financial statements). In addition, allocable costs increased $0.6 million. This increase was partially offset by a $1.5 million decrease in project materials, test equipment and tooling expense, a $0.7 million decrease in stock compensation expense, and a $0.6 million decrease to consultant fees.

The increase in allocated costs is due to increased headcount and equipment necessary to support the research and development function. The decrease in project materials, test equipment, and tooling expense resulted from the scheduling and timing of new product development. The decrease in stock compensation expense is due to an overall decline in the value of unvested options and awards, driven by a lower share price on grant date and increased use of options versus unvested stock awards.

We expect that the timing of our engineering material purchases and additional headcount requirements to support new product releases will affect the amount of research and development expenses in future periods.

Sales and Marketing Expenses

	2012	2013	Decrease	%

	Amount	% of Net Revenue	Amount	% of Net Revenue	Change	
	(in thousands, except percentages)					
Sales and Marketing Expenses	$14,133	7.3 %	$13,450	6.5 %	$(683)	(4.8)%

Sales and marketing expense decreased approximately $0.7 million from $14.1 million for the year ended December 31, 2012 to $13.5 million for the year ended December 31, 2013. This decrease was primarily due to a decrease in evaluation unit expenses of $0.7 million because 2012 was at a higher level as a result of the introduction of a new product.

Table of Contents

General and Administrative Expenses

	2012			2013				Increase	% Change	
	Amount	% of Net Revenue		Amount		% of Net Revenue				
	(in thousands, except percentages)									
General and Administrative Expenses	$9,695	5.0	%	$11,658		5.6	%	$1,963	20.2	%

General and administrative expenses increased approximately $2.0 million from $9.7 million for the year ended December 31, 2012 to $11.7 million for the year ended December 31, 2013. The increase was partially due to a $0.9 million increase in salaries and payroll related expenses for the hiring of key administrative personnel as well as increased bonus accruals. Professional fees also increased by $0.5 million as a result of an increase in special projects performed by one of our service providers. Bank charges increased by $0.3 million due to a realignment between expense categories in 2013.

Other Income (Expense), net

	2012			2013				Increase		% Change	
	Amount	% of Net Revenue		Amount		% of Net Revenue					
	(in thousands, except percentages)										
Other Income (Expense), net	$3	—	%	$(39	)	—	%	$(42	)	1,400.0	%

Other income (expense), net 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 an income tax provision of $0.7 million for the year ended December 31, 2012 and an income tax provision of $0.1 million for the year ended December 31, 2013. Our provision primarily relates to estimated liabilities relating to certain tax positions involving our foreign subsidiaries that have not been concluded with the relevant taxing authority. The decrease from the prior year is a result of expense related to unrecognized tax positions that did not recur in 2013.

Loss From Discontinued Operations

	2012				2013				Decrease	% Change	
	Amount		% of Net Revenue		Amount		% of Net Revenue				
	(in thousands, except percentages)										
Loss From Discontinued Operations	$(4,548	)	(2.3	)%	$(476	)	(0.2	)%	$4,072	(89.5	)%

Loss from discontinued operations decreased $4.1 million from $4.5 million for the year ended December 31, 2012 to $0.5 million for the year ended December 31, 2013. The decline in losses was primarily driven by the Company's decision in the first quarter of 2012 to close down our Israel Technology Center and exit our AssuredUVS business. See Note 3 of Notes to Consolidated Financial Statements for more details regarding our discontinued operations.
Year Ended December 31, 2011 Compared to the Year Ended December 31, 2012

Net Revenue

	Year Ended December 31,			
	2011	2012	Decrease	% Change
	(in thousands, except percentages)			
Net Revenue	$195,827	$194,548	$(1,279)	(0.7)%

Net revenues decreased approximately $1.3 million from $195.8 million for the year ended December 31, 2011 to $194.5 million for the year ended December 31, 2012. The change in net revenue was primarily due to a $16.4 million increase in sales to our vertical markets customers, which included a $7.9 million increase in sales to Tektronix, and a $8.5 million increase in sales to other vertical markets customers, which was more than offset by a $13.5 million decrease in revenue from HP from $144.9 million for the year ended December 31, 2011 to $131.4 million for the year ended December 31, 2012 and the revenue

Table of Contents

adjustment described below. Sales to HP approximated 74% of our net revenue for the year ended December 31, 2011 compared to 68% of our net revenue for the year ended December 31, 2012.

During the preparation of the Company's consolidated financial statements for the year ended December 31, 2012 and the accounting analysis for the renewal of a long-term software contract, the Company determined that it had applied an inappropriate revenue recognition methodology in 2011 to the contract. The Company recorded revenue as royalty payments were received on this contract and should have deferred all the revenue and direct and incremental costs until all the deliverables, except PCS, were delivered in 2012.
This resulted in an overstatement of $2.8 million of revenue and $1.9 million of costs in 2011. This was corrected in the fourth quarter of 2012, and the net out-of-period impact of these adjustments was $1.1 million, consisting of a reduction of revenue and research and development costs of $4.2 million and $3.1 million, respectively.

Cost of Goods Sold and Gross Profit

	2011		2012		Decrease	% Change
	Amount	% of Net Revenue	Amount	% of Net Revenue		
	(in thousands, except percentages)					
Cost of Goods Sold	$150,544	76.9 %	$146,177	75.1 %	$(4,367)	(2.9)%
Gross Profit	$45,283	23.1 %	$48,371	24.9 %	$3,088	6.8 %

Cost of goods sold decreased approximately $4.4 million from $150.5 million for the year ended December 31, 2011 to $146.2 million for the year ended December 31, 2012, primarily as a result of a more favorable mix of sales revenue and cost reductions, which were partially offset by increased payroll-related costs and the correction of the accounting for the long-term software contract as discussed in Note 1 to the financial statements.

Gross profit margin increased from 23.1% for the year ended December 31, 2011 to 24.9% for the year ended December 31, 2012. Gross profit margin benefited from a more favorable product and customer mix, in addition to a decrease in warranty related costs, due to a one-time charge in 2011 related to failed power supplies, and favorable pricing from our contract manufacturer and vendors as compared to 2011.
Research and Development Expenses

	2011		2012		Increase	% Change
	Amount	% of Net Revenue	Amount	% of Net Revenue		
	(in thousands, except percentages)					
Research and Development Expenses	$31,196	15.9 %	$34,199	17.6 %	$3,003	9.6 %

Research and development expense increased $3.0 million from $31.2 million for the year ended December 31, 2011 to $34.2 million for the year ended December 31, 2012. The increase was primarily due to a $3.5 million increase in salaries and payroll expense, a $1.2 million increase in project materials expense, a $0.6 million increase in consulting expenses, a $0.8 million increase in depreciation expense, and a $0.5 million increase in allocated costs. These cost increases were partially offset by deferring $3.6 million in direct and incremental engineering costs related to a long-term customer software contract (see Note 1 to the financial statements). The increase in salaries and payroll related expense is the result of the 2012 reinstatement of salary levels from the reductions which were in effect throughout 2011. The increase in salaries expense is also the result of increased headcount focused on customizations for newer OEM customers, the launch of the company's Series 4000 and 5000 mid-range products and next generation product development. The increase in project materials expense and depreciation expense is the result of an increase in capital assets and project supplies required to support new customer wins, the launch of our mid-range products, and the development of our next generation storage products released in 2013.

The increase in allocated costs is due to increased headcount and equipment necessary to support the research and development function. The increase in consulting expense is primarily the result of an increased reliance on domestic and foreign engineering consultants to assist certain engineering functions with strategic development projects.

We expect that the timing of our engineering material purchases and additional headcount requirements to support new product releases will affect the amount of research and development expenses in future periods.

Table of Contents

Sales and Marketing Expenses

	2011		2012		Increase	% Change
	Amount	% of Net Revenue	Amount	% of Net Revenue		
	(in thousands, except percentages)					
Sales and Marketing Expenses	$13,225	6.8 %	$14,133	7.3 %	$908	6.9 %

Sales and marketing expense increased approximately $0.9 million from $13.2 million for the year ended December 31, 2011 to $14.1 million for the year ended December 31, 2012. This increase was primarily due to an increase in evaluation unit expenses of $0.7 million due to the promotion of our new products and to encourage sales opportunities with new OEMs. Other expenses increased $0.2 million.

General and Administrative Expenses

	2011		2012		Decrease	% Change
	Amount	% of Net Revenue	Amount	% of Net Revenue		
	(in thousands, except percentages)					
General and Administrative Expenses	$9,174	4.6 %	$9,695	5.0 %	$521	5.7 %

General and administrative expenses increased approximately $0.5 million from $9.2 million for the year ended December 31, 2011 to $9.7 million for the year ended December 31, 2012. The increase was partially due to a $0.7 million increase in salaries and payroll related expenses for the hiring of key administrative personnel. Additionally, consulting and recruiting fees increased $0.3 million from the prior year. Professional fees also increased by $0.1 million as a result of an increase in special projects performed by one of our service providers, offset partially by a decrease in investor relations expenses, due to a one-time charge in 2011 for a media segment created to target new investors, along with bundling of certain investor relations services during 2012 to reduce costs. Realized and unrealized currency gains and losses were unfavorable during 2012 and favorable in 2011, causing an unfavorable change from year to year of $0.8 million. These increases to general and administrative expenses were partially offset by a decrease in stock compensation expense of $0.5 million, mostly due to the expense incurred related to the stock bonus plan during 2011, with no corresponding expense in 2012. Included in this change is a decrease of restructuring charges (recoveries) of $0.9 million from an expense of $0.7 million for the year ended December 31, 2011 to a recovery of $0.2 million for the year ended December 31, 2012. These expenses relate to our 2008 and 2010 Restructuring Plans, for which there are no significant expenses remaining to be incurred.

Other Income (Expense), net

	2011		2012		Decrease	% Change
	Amount	% of Net Revenue	Amount	% of Net Revenue		
	(in thousands, except percentages)					
Other Income (Expense), net	$(23)	— %	$3	— %	$26	113.0 %

Other income (expense), net 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 an income tax provision of $0.1 million for the year ended December 31, 2011 and an income tax provision of $0.7 million for the year ended December 31, 2012. Our provision primarily relates to estimated liabilities relating to certain tax positions involving our foreign subsidiaries that have not been concluded with the relevant taxing authority. The increase from the prior year is due to an increase in our unrecognized tax positions related to our foreign entities, due to changes in transfer pricing policies and other regulations in the countries in which we operate.

Table of Contents

Loss From Discontinued Operations

	2011		2012		Increase	% Change
	Amount	% of Net Revenue	Amount	% of Net Revenue		
	(in thousands, except percentages)					
Loss From Discontinued Operations	$(13,560)	(6.9)%	$(4,548)	(2.3)%	$9,012	(66.5)%

Loss from discontinued operations decreased $9.0 million from $13.6 million for the year ended December 31, 2012 to $4.5 million for the year ended December 31, 2012. The decline in losses was primarily driven by the Company's decision in the first quarter of 2012 to close down our Israel Technology Center and exit out of our AssuredUVS business.

This decrease was primarily due to a decline in operating expenses from discontinued operations of $7.5 million. The categories comprising these decreases primarily consisted of a reduction in research and development expense of $3.6 million, a decrease in sales and marketing expense of $0.6 million, and an impairment of goodwill of $4.1 million recorded in 2011, partially offset by an increase in restructuring charges of $0.9 million. Total operating expenses from discontinued operations decreased primarily due to a $3.1 million decrease in salaries and payroll related expenses, a $0.4 million decrease in depreciation expense, a $0.3 million decrease in stock-based compensation expense and an impairment of goodwill of $4.1 million recorded in 2011. These decreases were partially offset by an increase in professional service fees of $0.4 million.

In addition, we realized a benefit due to an increase in gross profit of $1.5 million, primarily driven by a decrease of $1.3 million in revenue and a decrease of $2.8 million cost of goods sold. The decrease in cost of goods sold was primarily a result of a $2.9 million intangible impairment charge in 2011.

All of the above are a result of activity related to our plan to exit our AssuredUVS business and close down our Israel Technology Development Center. See Note 3 of Notes to Consolidated Financial Statements for more details regarding our discontinued operations.

Liquidity and Capital Resources

The primary drivers affecting cash and liquidity are net income, 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. We typically bill customers on an open account basis subject to our standard credit quality and payment terms ranging between net 30 and net 55 days. 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. During the fourth quarter of 2013, we increased payment terms to a large OEM customer. We plan to grant an additional but smaller increase in payment terms to the same OEM customer commencing in the second quarter of 2014. While this will likely delay collection of our accounts receivable and correspondingly reduce cash, our net working capital will not be impacted. Our accounts payable also increase or decrease in connection with changes in volumes as well as our cash conservation strategies.

As of December 31, 2013, we had $40.4 million of cash and cash equivalents and $43.8 million of working capital compared to $40.3 million of cash and cash equivalents and $34.3 million of working capital as of December 31, 2012. The increase in cash and cash equivalents is further described below.

Cash equivalents include highly liquid investments purchased with a weighted average maturity of 90 days or less and consist principally of short-term money market mutual funds. As of December 31, 2013, $3.6 million of the $40.4 million of cash, cash equivalents, and marketable securities was held by our foreign subsidiaries. We currently intend to repatriate approximately $2.1 million of our cash and cash equivalents held by our foreign subsidiaries during 2014. We obtained a favorable ruling from one of the foreign jurisdictions and will not be charged foreign taxes on the repatriation and we expect net operating loss carryforwards and foreign tax credits to offset any remaining cash tax liability. We anticipate that future foreign earnings will be deemed to 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 U.S. income taxes to the extent a tax liability results after utilization of net operating loss carryforwards and available tax credits.
Operating Activities
Net cash provided by operating activities for the year ended December 31, 2013 was $4.1 million compared to net cash used in operating activities of $2.4 million for the year ended December 31, 2012. The operating activities that affected cash consisted of a net income (loss), which totaled $5.1 million and $(15.0) million for the years ended December 31, 2013 and 2012, respectively, in addition to the factors discussed below.

Table of Contents

The adjustments to reconcile net income to net cash provided by operating activities of continuing operations for the year ended December 31, 2013 for items that did not affect cash consisted of depreciation and amortization of $3.1 million and stock-based compensation expense of $2.7 million.

Cash flows from operations reflect a positive impact of $11.1 million, which reflects an increase in accounts payable due to higher inventory purchases driven by increased sales. This resulted in our days payable outstanding increasing from 62 days at December 31, 2012 to 74 days at December 31, 2013. Accrued compensation and other expenses positively impacted the cash from operations by $0.6 million due primarily to an increase in overall payroll accruals, an increase to the excess and obsolete liability at a contract manufacturer due to end of life products, and increases to accrued taxes payable, offset by payments on a settlement with a material customer related to failed power supply units. Deferred revenue had a $1.3 million positive impact to cash from operations due to an increase in prepaid maintenance agreements sold through our Channel partners, and the deferral of revenue for a certain software contract, to be recognized over the contract term. Cash flows from operations also reflect the positive impact of $1.2 million related to an overall increase in other long-term liabilities, primarily due to an increase in long-term deferred revenue. Cash flows from operations reflects the negative impact of $17.9 million related to an increase in accounts receivable, which was primarily due to an increase in sales in the fourth quarter of 2013 as compared to the fourth quarter of 2012. Our days sales outstanding increased from 50 days at December 31, 2012 to 67 days at December 31, 2013, primarily due to extending payment terms to a large OEM customer. Cash flows from operations also reflects the negative impact of $1.6 million related to an overall increase in prepaid expenses and other assets at December 31, 2013, which was primarily due to increases in non-trade accounts receivable and certain other annual prepaid contracts. Additionally, there was an increase to overall inventory balances that resulted in a negative impact to cash flows of $1.5 million primarily related to the increase in sales.

Investing Activities

Cash used in investing activities for the year ended December 31, 2013 was approximately $3.6 million compared to $6.1 million for the year ended December 31, 2012. Cash used in investing activities for the year ended December 31, 2013 was due to purchases of property and equipment primarily associated with test and other equipment used by our contract manufacturing partners in the production of our products and for equipment used in our Longmont, Colorado engineering laboratories.

Financing Activities

Cash provided by financing activities for the year ended December 31, 2013 was approximately $0.0 million compared to $2.9 million for the year ended December 31, 2012. Cash provided by financing activities for the year ended December 31, 2013 was primarily due to the sale of stock to employees under our employee stock plans of approximately $1.1 million, which was offset by $0.8 million of net repayments under the Silicon Valley Bank line of credit and tax liability payments of $0.2 million made by Dot Hill associated with employee equity awards.

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, 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 timing and extent of net revenue and 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, growth in operations 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 shorten our payment terms with them, or if HP were to further lengthen their payment terms with us, our financial condition could be harmed.

We maintain a credit facility with Silicon Valley Bank for cash advances and letters of credit of up to an aggregate of $30 million based upon an advance rate dependent on certain concentration limits within eligible accounts receivable. These limitations 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 bank's prime rate, which was 4% at December 31, 2013, 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, 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 December 31, 2013, 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 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 million (measured on a rolling three-month basis), the interest rate will increase to the bank's prime rate plus 1% and additional restrictions will apply. The maturity date of the credit facility is July 21, 2015.

As of December 31, 2013 we had no outstanding letters of credit and there was $2 million outstanding under the Silicon Valley Bank line of credit. There was $28.0 million available for borrowing under the agreement as of December 31, 2013.

Contractual Obligations

The following table summarizes our contractual obligations as of December 31, 2013 (in thousands).

	Total	2014	2015	2016	2017	2018	Thereafter
Operating lease obligations	$5,229	$1,232	$1,224	$1,130	$1,155	$488	$—
Inventory-related purchase obligations	$34,623	$34,623	$—	$—	$—	$—	$—
Credit facility borrowings	$2,000	$2,000	$—	$—	$—	$—	$—
Total	$41,852	$37,855	$1,224	$1,130	$1,155	$488	$488

We lease office space, equipment and automobiles under non-cancelable operating leases, which expire at various dates through May 2018. For purposes of the table above, the operating lease obligations exclude common area maintenance, real estate taxes and insurance expenses.

Inventory related purchase obligations represent contractual purchase commitments to our suppliers for certain components in order to ensure supply of select key components at the most favorable pricing.

In addition to the amounts shown in the table above, $0.8 million of unrecognized tax benefits have been recorded as liabilities, and we are uncertain as to if or when such amounts may be settled.

Off — Balance Sheet Arrangements

At December 31, 2013, 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.

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

Please see Note 1 of the Notes to Consolidated Financial Statements.

Item 7A. 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 significantly impact our December 31, 2013 financial statements.

We have a line of credit agreement, which accrues interest on any outstanding balances at the bank's prime rate. As of December 31, 2013, there was $2 million 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 U.S. dollar, the currency in which our consolidated financial statements are reported. The most significant foreign currencies that subjected us to foreign currency exchange rate risk for the year ended December 31, 2013 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 U.S. dollar. 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. Although foreign currency transaction gains and losses have not historically been significant, we incurred $0.5 million in foreign currency losses during the year ended December 31, 2013, primarily resulting from the re-measurement process of certain of our foreign subsidiaries that maintain their books of record in a currency other than the functional currency. Future changes in foreign currency rates could adversely impact our financial statements. A 10% unfavorable change in exchange rates would result in foreign currency losses of approximately $0.1 million.

Item 8. Financial Statements and Supplementary Data

The information required by this Item is incorporated by reference from the financial statements beginning on page F-1 of this annual report on Form 10-K.

Item 9. Changes In and Disagreements With Accountants on Accounting and Financial Disclosure

None.

Item 9A. 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)), are 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 report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Management’s Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) to provide reasonable assurance regarding the reliability of our financial reporting and the preparation of consolidated financial statements for external purposes in accordance with U.S. generally accepted accounting principles.

Management assessed our internal control over financial reporting as of December 31, 2013, the end of our fiscal year. Management based its assessment on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission in 1992. Management’s assessment included evaluation of elements such as the design and operating effectiveness of key financial reporting controls, process documentation, accounting policies, and our overall control environment.

Based on our assessment, management has concluded that our internal control over financial reporting was effective as of the end of the fiscal year to provide reasonable assurance regarding the reliability of financial reporting and the preparation of consolidated financial statements for external reporting purposes in accordance with U.S. generally accepted accounting principles.

Our independent registered public accounting firm, Deloitte and Touche LLP, independently assessed the effectiveness of the company's internal control over financial reporting, as stated in their attestation report, which is included at the end of Part II of this Form 10-K.

Table of Contents

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of
Dot Hill Systems Corp. and Subsidiaries
Longmont, Colorado

We have audited the internal control over financial reporting of Dot Hill Systems Corp. and Subsidiaries (the "Company") as of December 31, 2013, based on criteria established in Internal Control - Integrated Framework (1992) issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying "Management's Report on Internal Control Over Financial Reporting". Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2013, based on the criteria established in Internal Control - Integrated Framework (1992) issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements as of and for the year ended December 31, 2013 of the Company and our report dated March 10, 2014 expressed an unqualified opinion on those financial statements and included an explanatory paragraph regarding the presentation of discontinued operations.

/s/ Deloitte & Touche LLP

Denver, Colorado
March 10, 2014

Table of Contents

Item 9B. Other Information

None.

Part III

Item 10. Directors, Executive Officers and Corporate Governance

Some of the information required by this item is incorporated by reference to our Definitive Proxy Statement to be filed with the SEC pursuant to Regulation 14A in connection with our 2014 annual meeting of stockholders under the headings “Election of Directors” and “Section 16(a) Beneficial Ownership Reporting Compliance.” Other information required by this item is incorporated by reference to Item 1 of Part I of this annual report on Form 10-K under the heading “Named Executive Officers and Key Employees of the Registrant.”

We have adopted a code of ethics that applies to our principal executive officer and principal financial officer, who is also our principal accounting officer. This code of ethics is incorporated in our code of business conduct and ethics that applies to all of our officers, directors and employees. A copy of our code of business conduct and ethics is available on our web site at www.dothill.com. We intend to satisfy the SEC’s disclosure requirements regarding amendments to, or waivers of, the code of business conduct and ethics by posting such information on our web site. A paper copy of our code of business conduct and ethics may be obtained free of charge by writing to our Investor Relations Department at our principal executive office.

Item 11. Executive Compensation

The information required by this item is incorporated by reference to our Definitive Proxy Statement to be filed with the SEC pursuant to Regulation 14A in connection with our 2014 annual meeting of stockholders under the headings “Executive Compensation,” “Compensation Committee Report” and “Compensation Committee Interlocks and Insider Participation.”

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

The information under the heading “Security Ownership of Certain Beneficial Owners and Management” in our Definitive Proxy Statement to be filed with the SEC pursuant to Regulation 14A in connection with our 2014 annual meeting of stockholders is incorporated by reference.

Securities Authorized for Issuance Under Equity Compensation Plans

The following table sets forth our equity securities authorized for issuance under equity compensation plans as of December 31, 2013.

Stock Plan	Number of Securities to be Issued Upon Exercise of Outstanding Options and Rights	Weighted Average Exercise Price of Outstanding Options and Rights	Number of Securities Remaining Available for Future Issuance
2000 EIP	3,174,089	$4.26	—
2009 EIP	6,076,409	$1.73	2,684,232
2000 ESPP	Not Applicable	Not Applicable	—
2000 NEDSOP	600,000	$2.37	293,124
Total	9,850,498	$—	2,977,356

All of our equity compensation plans have been approved by our stockholders.

Item 13. Certain Relationships and Related Transactions, and Director Independence

The information required by this item is incorporated by reference to our Definitive Proxy Statement to be filed with the SEC pursuant to Regulation 14A in connection with our 2014 annual meeting of stockholders under the headings “Election of Director(s),” “Transactions with Related Persons” and “Policies and Procedures with Respect to Related Party Transactions.”

Item 14. Principal Accounting Fees and Services

The information required by this item is incorporated by reference to our Definitive Proxy Statement to be filed with the SEC pursuant to Regulation 14A in connection with our 2014 annual meeting of stockholders under the heading “Ratification of Selection of Independent Auditors.”

Table of Contents

Item 15. Exhibits, Financial Statement Schedules

The following documents are filed as part of this report:

(1) Financial statements:

The consolidated balance sheets as of December 31, 2012 and 2013, and the consolidated statements of operations and comprehensive loss, stockholders’ equity and cash flows for the years ended December 31, 2011, 2012 and 2013, together with notes thereto included elsewhere in this annual report on Form 10-K are incorporated herein by reference.

(2) All other schedules have been omitted from this annual report on Form 10-K because they are not applicable or because the information required by any applicable schedule is included in the consolidated financial statements or the notes thereto.

(3) Exhibits:

Exhibit Number	Description
2.1	Agreement and Plan of Merger dated as of February 23, 2004, by and among Dot Hill Systems Corp., DHSA Corp., Chaparral Network Storage, Inc., and C. Timothy Smoot, as Stockholders' Representative.(1)
2.2	Amended and Restated Asset Purchase and Technology License Agreement dated September 17, 2008 by and between Dot Hill Systems Corp. and Ciprico Inc.(2)
3.1	Certificate of Incorporation of Dot Hill Systems Corp.(3)
3.2	Amended and Restated By-laws of Dot Hill Systems Corp.(4)
4.1	Certificate of Incorporation Dot Hill Systems Corp.(3)
4.2	Amended and Restated By-laws of Dot Hill Systems Corp.(4)
4.3	Form of Common Stock Certificate.(5)
4.4	Certificate of Designation of Series A Junior Participating Preferred Stock, as filed with the Secretary of State of Delaware on May 19, 2003.(6)
4.5	Form of Rights Certificate.(6)
4.6	Warrant to Purchase Shares of Common Stock dated January 4, 2008.(8)
10.1	Rights Agreement dated as of May 19, 2003 by and between Dot Hill Systems Corp. and American Stock Transfer and Trust Company.(6)
10.2	2000 Amended and Restated Equity Incentive Plan.(9)†
10.3	2009 Equity Incentive Plan, as amended.(29)†
10.4	Form of Stock Option Agreement (Incentive and Non-statutory Stock Options) used in connection with the 2000 Amended and Restated Equity Incentive Plan.(9)†
10.5	Form of Stock Option Grant Notice used in connection with the 2000 Amended and Restated Equity Incentive Plan.(9)†
10.6	Amended and Restated 2000 Employee Stock Purchase Plan.(10)†
10.7	Amended and Restated 2000 Non-Employee Directors' Stock Option Plan.(11)†
10.8	Form of Stock Option Agreement used in connection with the 2000 Non-Employee Directors' Stock Option Plan.(12)†
10.9	Amended and Restated Employment Agreement between Dot Hill Systems Corp. and Dana Kammersgard, effective as of December 18, 2008.(13)†
10.10	Amended and Restated Employment Agreement between Dot Hill Systems Corp. and Hanif I. Jamal, effective as of March 16, 2009.(27)†
10.11	Description of 2008 Executive Compensation Plan.(14)†
10.12	Description of Amended and Restated Policy for Director Compensation.(15)†
10.13	Form of Indemnity Agreement.(16)
10.14	Lease Agreement by and between Dot Hill Systems Corp. and Equastone 2200 Faraday, LLC effective as of September 1, 2005 and dated as of September 16, 2005.(17)
10.15	

	Lease Agreement by and between Dot Hill Systems Corp. and Circle Capital Longmont LLC as of April 12, 2007.(18)
10.16	Loan and Security Agreement dated August 1, 2008 by and between Dot Hill Systems Corp. and Silicon Valley Bank.(19)

49

10.17	Manufacturing Agreement between Dot Hill Systems Corp. and Flextronics Corporation dated May 20, 2002.(20)*
10.18	Amendment to Manufacturing Agreement between Dot Hill Systems Corp. and Solectron Corporation dated April 5, 2005.(21)*
10.19	Second Amendment to Manufacturing Agreement dated September 16, 2005 between Dot Hill Systems Corp. and Solectron Corporation.(22)*
10.20	Second Award Letter dated September 16, 2005 between Dot Hill Systems Corp. and Solectron Corporation.(22)*
10.21	Manufacturing Agreement by and among Dot Hill Systems Corp., MiTAC International Corporation and SYNNEX Corporation dated February 20, 2007.(23)*
10.22	Manufacturing and Purchase Agreement dated September 24, 2008 by and between Dot Hill Systems Corp. and Hon Hai Precision Industry LTD.(2)*
10.23	Amended and Restated Technology License Agreement, dated as of October 29, 2010 among NetApp, Inc., NetApp Holding and Manufacturing B.V. and Dot Hill Systems Corp.(28)*
10.24	Product Purchase Agreement dated September 10, 2007 by and between Dot Hill Systems Corp. and Hewlett-Packard Company.(25)*
10.25	Amendment One to Product Purchase Agreement dated January 4, 2008, by and between Dot Hill Systems Corp. and Hewlett-Packard Company.(25)*
10.26	Amendment Eight to Product Purchase Agreement dated September 30, 2008 by and between Dot Hill Systems Corp. and Hewlett Packard Company.(2)*
10.27	Patent Cross License dated December 29, 2005 between Dot Hill Systems Corp. and International Business Machines Corporation.(24)*
10.28	Amended Settlement and License Agreement dated October 5, 2006 by and between Dot Hill Systems Corp. and Crossroads, Inc.(26)*
10.29	Amendment to Lease Agreement by and between Dot Hill Systems Corp. and Circle Capital Longmont LLC as of April 12, 2007. (30)
10.30	Amendment Twelve to Product Purchase Agreement dated September 10, 2007 by and between Dot Hill Systems Corp. and Hewlett-Packard Company. (30)*
10.31	Third Amendment to Loan and Security Agreement dated June 22, 2012 by and between Dot Hill Systems Corp. and Silicon Valley Bank. (31)
10.32	First Amendment to Lease Agreement by and between Dot Hill Systems Corp. and DL Faraday L.P. as of July 24, 2012.(32)
10.33	Amendment Fourteen to Product Purchase Agreement dated September 10, 2007 by and between Dot Hill Systems Corp. and Hewlett-Packard Company.*
21.1	Subsidiaries of Dot Hill Systems Corp.(7)
23.1	Consent of Deloitte & Touche LLP
24.1	Power of Attorney. Reference is made to the signature page hereto.
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
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document

† Indicates management or compensatory plan or arrangement.
* Confidential treatment has been granted by, or requested from, the SEC.
Dot Hill's Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q and Current Reports on Form 8-K have a Commission File Number of 001-13317.

(1) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on February 24, 2004 and incorporated herein by reference.
(2) Filed as an exhibit to our Quarterly Report on Form 10-Q for the quarter ended September 30, 2008 and incorporated herein by reference.
(3) 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.
(4) 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.
(5) 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.
(6) 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.
(7) Filed as an exhibit to our Annual Report on Form 10-K for the year ended December 31, 2002 and incorporated herein by reference.
(8) 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.
(9) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on August 23, 2000 and incorporated herein by reference.
(10) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on June 19, 2009 and incorporated herein by reference.
(11) Filed as an exhibit to our Quarterly Report on Form 10-Q for the quarter ended June 30, 2009 and incorporated herein by reference.
(12) Filed as an exhibit to our Registration Statement on Form S-8 (No. 333-43834) and incorporated herein by reference.
(13) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on December 24, 2008 and incorporated herein by reference.
(14) Filed as item 5.02(e) of our Current Report on Form 8-K filed with the SEC on April 3, 2008 and incorporated herein by reference.
(15) Incorporated herein by reference to the description contained in our Current Report on Form 8-K filed with the SEC on July 29, 2005.
(16) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on December 13, 2005 and incorporated herein by reference.
(17) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on September 21, 2005 and incorporated herein by reference.
(18) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on April 16, 2007 and incorporated herein by reference.
(19) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on August 5, 2008 and incorporated herein by reference.
(20) Filed as an exhibit to our Quarterly Report on Form 10-Q for the quarter ended June 30, 2002 and incorporated herein by reference.
(21) Filed as an exhibit to our Quarterly Report on Form 10-Q for the quarter ended June 30, 2005 and incorporated herein by reference.
(22) Filed as an exhibit to our Quarterly Report on Form 10-Q for the quarter ended September 30, 2005 and incorporated herein by reference.
(23)

Filed as an exhibit to our Quarterly Report on Form 10-Q for the quarter ended March 31, 2007 and incorporated herein by reference.

(24) Filed as an exhibit to our Annual Report on Form 10-K for the year ended December 31, 2005 and incorporated herein by reference.

(25) Filed as an exhibit to our Quarterly Report on Form 10-Q for the quarter ended March 31, 2008 and incorporated herein by reference.

(26) Filed as an exhibit to our Quarterly Report on Form 10-Q for the quarter ended June 30, 2006 and incorporated herein by reference.

(27) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on March 20, 2009 and incorporated herein by reference.

(28) Filed as an exhibit to our Annual Report on Form 10-K for the year ended December 31, 2010 and incorporated herein by reference.

(29) Filed as an exhibit to our Quarterly Report on Form 10-Q for the quarter ended March 31, 2012 and incorporated herein by reference.

(30) Filed as an exhibit to our Quarterly Report on Form 10-Q for the quarter ended June 30, 2012 and incorporated herein by reference.

(31) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on June 27, 2012 and incorporated herein by reference.

(32) Filed as an exhibit to our Quarterly Report on Form 10-Q for the quarter ended September 30, 2012 and incorporated herein by reference.

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: March 10, 2014

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

Date: March 10, 2014

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

KNOW ALL PERSONS BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints Dana W. Kammersgard and Hanif I. Jamal, and each of them, as his true and lawful attorneys-in-fact and agents, with full power of substitution and resubstitution, for him and in his name, place, and stead, in any and all capacities, to sign any and all amendments to this Report, and to file the same, with all exhibits thereto, and other documents in connection therewith, with the Securities and Exchange Commission, granting unto said attorneys-in-fact and agents, and each of them, full power and authority to do and perform each and every act and thing requisite and necessary to be done in connection therewith, as fully to all intents and purposes as he might or could do in person, hereby ratifying and confirming that all said attorneys-in-fact and agents, or any of them or their or his substitute or substituted, may lawfully do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, as amended, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Name	Title	Date
/S/ DANA W. KAMMERSGARD Dana W. Kammersgard	Chief Executive Officer, President and Director (Principal Executive Officer)	March 10, 2014
/S/ HANIF I. JAMAL Hanif I. Jamal	Chief Financial Officer, and Treasurer (Principal Financial and Accounting Officer)	March 10, 2014
/S/ CHARLES CHRIST Charles Christ	Chairman of the Board of Directors	March 10, 2014
/S/ TOM MARMEN Tom Marmen	Director	March 10, 2014
/S/ RICHARD MEJIA JR Richard Mejia, Jr.	Director	March 10, 2014
/S/ BARRY RUDOLPH Barry Rudolph	Director	March 10, 2014
/S/ RODERICK M. SHERWOOD III Roderick M. Sherwood III	Director	March 10, 2014
/S/ DEBBIE TIBEY Debbie Tibey	Director	March 10, 2014

INDEX TO FINANCIAL STATEMENTS

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of
Dot Hill Systems Corp. and Subsidiaries
Longmont, Colorado

We have audited the accompanying consolidated balance sheets of Dot Hill Systems Corp. and Subsidiaries (the "Company") as of December 31, 2012 and 2013, and the related consolidated statements of operations and comprehensive income (loss), stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2013. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Dot Hill Systems Corp. and Subsidiaries as of December 31, 2012 and 2013, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2013, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 1 to the consolidated financial statements, the accompanying 2011 financial statements have been retrospectively adjusted for discontinued operations.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of December 31, 2013, based on the criteria established in Internal Control - Integrated Framework (1992) issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 10, 2014 expressed an unqualified opinion on the Company's internal control over financial reporting.

/s/ Deloitte & Touche LLP

Denver, Colorado
March 10, 2014

F-1

DOT HILL SYSTEMS CORP.
CONSOLIDATED BALANCE SHEETS
AS OF DECEMBER 31, 2012 AND 2013
(In thousands, except par value data)

	December 31, 2012	2013
ASSETS		
Current Assets:		
Cash and cash equivalents	$40,315	$40,406
Accounts receivable, net	25,025	42,907
Inventories	5,037	6,539
Prepaid expenses and other assets	5,810	7,265
Total current assets	76,187	97,117
Property and equipment, net	7,147	7,565
Other assets	603	702
Total assets	$83,937	$105,384
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	$22,659	$33,255
Accrued compensation	4,863	4,922
Accrued expenses	8,690	8,935
Deferred revenue	2,889	4,211
Credit facility borrowings	2,800	2,000
Total current liabilities	41,901	53,323
Other long-term liabilities	3,261	4,414
Total liabilities	45,162	57,737
Commitments and Contingencies (Note 12)		
Stockholders' Equity:		
Preferred stock, $.001 par value, 10,000 shares authorized, zero shares issued and outstanding at December 31, 2012 and 2013	—	—
Common stock, $.001 par value, 100,000 shares authorized, 58,265 and 59,138 shares issued and outstanding at December 31, 2012 and 2013, respectively	58	59
Additional paid-in capital	326,575	330,103
Accumulated other comprehensive loss	(3,533)	(3,254)
Accumulated deficit	(284,325)	(279,261)
Total stockholders' equity	38,775	47,647
Total liabilities and stockholders' equity	$83,937	$105,384

See accompanying notes to consolidated financial statements.

F-2

DOT HILL SYSTEMS CORP.
CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (LOSS)
FOR THE YEARS ENDED DECEMBER 31, 2011, 2012 AND 2013
(In thousands, except per share amounts)

	Year ended December 31,		
	2011	2012	2013
NET REVENUE	$195,827	$194,548	$206,565
COST OF GOODS SOLD	150,544	146,177	140,495
GROSS PROFIT	45,283	48,371	66,070
OPERATING EXPENSES:			
Research and development	31,196	34,199	35,332
Sales and marketing	13,225	14,133	13,450
General and administrative	9,174	9,695	11,658
Total operating expenses	53,595	58,027	60,440
OPERATING INCOME (LOSS)	(8,312)	(9,656)	5,630
OTHER INCOME:			
Interest income (expense), net	16	(8)	(16)
Other income (expense), net	(39)	11	(23)
Total other income (expense), net	(23)	3	(39)
INCOME (LOSS) BEFORE INCOME TAXES AND DISCONTINUED OPERATIONS	(8,335)	(9,653)	5,591
INCOME TAX EXPENSE	129	749	51
INCOME (LOSS) FROM CONTINUING OPERATIONS	(8,464)	(10,402)	5,540
LOSS FROM DISCONTINUED OPERATIONS	(13,560)	(4,548)	(476)
NET INCOME (LOSS)	$(22,024)	$(14,950)	$5,064
NET INCOME (LOSS) PER SHARE:			
Income (Loss) from continuing operations	$(0.15)	$(0.18)	$0.09
Loss from discontinued operations	$(0.25)	$(0.08)	$(0.01)
Basic and Diluted	$(0.40)	$(0.26)	$0.09
WEIGHTED AVERAGE SHARES USED TO CALCULATE NET LOSS PER SHARE:			
Basic	54,908	56,954	58,521
Diluted	54,908	56,954	59,247
COMPREHENSIVE INCOME (LOSS):			
Net income (loss)	$(22,024)	$(14,950)	$5,064
Foreign currency translation adjustment	(78)	129	279
Comprehensive income (loss)	$(22,102)	$(14,821)	$5,343

See accompanying notes to consolidated financial statements.

Table of Contents

DOT HILL SYSTEMS CORP.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
FOR THE YEARS ENDED DECEMBER 31, 2011, 2012 AND 2013
(In thousands, except per share amounts)

	Common Stock					
	Shares	Amount	Additional Paid-In Capital	Accumulated Other Comprehensive Loss	Accumulated Deficit	Total Stockholders' Equity
Balance, January 1, 2011	55,953	$56	$315,257	$(3,584)	$(247,351)	$64,378
Issuance of warrant to customer			1,007			1,007
Common stock issued under stock plans, net	1,746	2	1,026			1,028
Share-based compensation expense			4,379			4,379
Excess tax benefit			12			12
Foreign currency translation adjustment				(78)		(78)
Net loss					(22,024)	(22,024)
Balance, December 31, 2011	57,699	$58	$321,681	$(3,662)	$(269,375)	$48,702
Common stock issued (canceled) under stock plans, net	(253)	—	166			166
Common stock issued under bonus plan	819	—	1,005			1,005
Share-based compensation expense			3,723			3,723
Foreign currency translation adjustment				129		129
Net loss					(14,950)	(14,950)
Balance, December 31, 2012	58,265	$58	$326,575	$(3,533)	$(284,325)	$38,775
Common stock issued under stock plans, net	873	1	838			839
Share-based compensation expense			2,690			2,690
Foreign currency translation adjustment				279		279
Net income					5,064	5,064
Balance, December 31, 2013	59,138	$59	$330,103	$(3,254)	$(279,261)	$47,647

See accompanying notes to consolidated financial statements.

DOT HILL SYSTEMS CORP.
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 2011, 2012 AND 2013
(In thousands)

	2011	2012	2013
Cash Flows From Operating Activities:			
Net income (loss)	$(22,024)	$(14,950)	$5,064
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:			
Depreciation and amortization	4,755	3,527	3,125
Provision of bad debt expense	203	25	2
Stock-based compensation expense	5,385	3,723	2,690
Issuance of warrant to customer	1,007	—	—
Long-lived assets impairment charge	2,928	1,647	—
Goodwill impairment charge	4,140	—	—
Loss on write-off of fixed assets	—	244	23
Changes in operating assets and liabilities:			
Accounts receivable	3,309	6,621	(17,931)
Inventories	2,091	213	(1,503)
Prepaid expenses and other assets	(4,263)	1,740	(1,618)
Accounts payable	(92)	(7,474)	11,100
Accrued compensation and other expenses	5,833	(2,505)	614
Deferred revenue	(501)	2,017	1,340
Other long-term liabilities	(571)	2,726	1,182
Net cash provided by (used in) operating activities	2,200	(2,446)	4,088
Cash Flows From Investing Activities:			
Purchases of property and equipment	(2,548)	(6,152)	(3,644)
Proceeds from sale of property and equipment	—	74	—
Net cash used in investing activities	(2,548)	(6,078)	(3,644)
Cash Flows From Financing Activities:			
Principal payment of note payable	(398)	(71)	—
Payments on bank borrowings	—	(1,800)	(7,700)
Proceeds from bank borrowings	—	4,600	6,900
Shares withheld for tax purposes	(422)	(590)	(223)
Proceeds from sale of stock to employees	1,450	756	1,062
Net cash provided by financing activities	630	2,895	39
Effect of Exchange Rate Changes on Cash and Cash Equivalents	154	(224)	(392)
Net Increase (Decrease) in Cash and Cash Equivalents	436	(5,853)	91
Cash and Cash Equivalents, beginning of period	45,732	46,168	40,315
Cash and Cash Equivalents, end of period	$46,168	$40,315	$40,406
Supplemental Disclosures of Non-Cash Investing and Financing Activities:			
Property and equipment acquired but not yet paid	$1,540	$477	$398
Stock payment for employee bonus plan	—	1,005	—
Supplemental Cash Flow Data:			
Cash paid for income taxes	$235	116	72

See accompanying notes to consolidated financial statements.

F-5

DOT HILL SYSTEMS CORP.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
FOR THE YEARS ENDED DECEMBER 31, 2011, 2012 AND 2013

1. Summary of Significant Accounting Policies

Description of Business

Dot Hill Systems Corp (referred to herein as Dot Hill, we, our or us) is a provider of software and hardware storage systems for the entry and mid-range storage markets for organizations requiring high reliability, high performance networked storage and data management solutions in an open systems architecture. Our storage solutions consist of integrated hardware, firmware and software products employing a modular system that allows end-users to add various capacity or data protection schemes as needed. Our broad range of products, from medium capacity standalone storage units to complete multi-terabyte storage area networks, or SANs, provide end-users with a cost-effective means of addressing increasing storage demands without sacrificing performance.

Basis of Presentation

The accompanying consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America, or GAAP.

2011 amounts in our consolidated financial statements have been retrospectively adjusted for discontinued operations. See Note 3.

Principles of Consolidation

The accompanying consolidated financial statements include our accounts and the accounts of our wholly-owned subsidiaries. Intercompany transactions and balances have been eliminated in consolidation.

Foreign Currency Translation

For our foreign subsidiaries whose functional currency is the local currency, assets and liabilities are translated into United States dollars at period-end exchange rates. Revenues and expenses, and gains and losses, are translated at rates of exchange that approximate the rates in effect on the transaction date. Resulting translation gains and losses are recognized as a component of other comprehensive loss.

For our foreign subsidiaries that maintain their books of record in a currency other than the functional currency, the subsidiaries remeasure monetary assets and liabilities using current rates of exchange at the balance sheet date and remeasure non-monetary assets and liabilities using historical rates of exchange. Gains and losses from remeasurement for such subsidiaries are recognized currently in income as a component of general and administrative expenses.

Foreign currency translation adjustments comprise the entire amount of our accumulated other comprehensive loss at December 31, 2012 and 2013. We incurred foreign currency transaction losses of $0.3 million and $0.5 million for the years ended December 31, 2011 and 2013. We incurred foreign currency transaction gains of $0.5 million for the year ended December 31, 2012.

Use of Accounting Estimates

The preparation of our audited 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 6), the valuation and recognition of stock-based compensation expense, and the valuation of long-lived assets. In addition, we have other accounting policies that involve estimates such as the determination of useful lives of long-lived assets, the accruals for restructuring, and income taxes, including the valuation allowance for deferred tax assets. 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 OEM customers' industry standard hardware and which become essential to the integrated system product. We recognize

F-6

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 and in addition, upon installation for certain of our AssuredUVS appliance products. 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 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, additional 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.

Specific long term software contracts may contain multiple deliverables including software licenses, services, training and post-contract support (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 Cost of Goods Sold.

During the preparation of the Company's consolidated financial statements for the year ended December 31, 2012 and the accounting analysis for the renewal of a long-term software contract, the Company determined that it had applied an inappropriate revenue recognition methodology in 2011 to the contract. The Company recorded revenue as royalty payments were received on this contract and should have deferred all the revenue and direct and incremental costs until all the deliverables, except PCS, were delivered in 2012.

This resulted in an overstatement of $2.8 million of revenue and $1.9 million of costs in 2011. This was corrected in the fourth quarter of 2012, and the net out-of-period impact of these adjustments was $1.1 million, consisting of a reduction of revenue and research and development costs of $4.2 million and $3.1 million, respectively. Once all elements except PCS were delivered, the related deferred direct and incremental costs began to be recognized ratably over the contractual PCS support period, as a component of Cost of Goods Sold.

Service

Our service revenue primarily includes 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, undelivered elements that relate to the hardware product's essential software, 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 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 removed our product from the warehouse to incorporate into its end products.

Advertising Costs

We expense advertising costs in the period incurred. Advertising expense is included as a component of sales and marketing expense. Advertising expense was $1.2 million, $1.2 million and $1.6 million for the years ended December 31, 2011, 2012 and 2013, respectively.

Shipping and Handling

Cost related to the shipping and handling of our products is included in cost of goods sold for all periods presented.

Research and Development

Research and development costs are expensed as incurred. In conjunction with the development of our products, we incur certain software development costs. 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.

Stock-Based Compensation

Stock-based compensation expense for all share-based payment awards granted is determined based on the grant-date fair value. We recognize these compensation costs net of an estimated forfeiture rate, and recognize compensation cost only for those shares expected to vest on a straight-line basis over the requisite service period of the award, which is generally the vesting term of the share-based payment awards. We estimate forfeiture rates based on our historical experience.

Income Taxes

We recognize deferred tax assets and liabilities for the expected tax consequences 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.

Cash and Cash Equivalents

We classify investments as cash equivalents if they are readily convertible to cash and have average maturities of three months or less at the time of acquisition. Cash and cash equivalents consist primarily of mutual money market funds issued or managed in the United States. At December 31, 2012 and 2013, the carrying value of cash and cash equivalents approximates fair value due to the short period of time to maturity.

As of December 31, 2013, $3.6 million of the $40.4 million of cash, cash equivalents, and marketable securities was held by our foreign subsidiaries. We currently intend to repatriate approximately $2.1 million of our cash and cash equivalents held by our foreign subsidiaries during 2014. We obtained a favorable ruling from one of the foreign jurisdictions and will not be charged foreign taxes on the repatriation and we expect net operating loss carryforwards and foreign tax credits to offset any remaining cash tax liability. We anticipate that future foreign earnings will be deemed to be permanently reinvested, although we could elect to repatriate funds held in one or more foreign jurisdictions. If applicable, withholding taxes could reduce the

F-8

net amount repatriated, and we could be required to accrue and remit applicable U.S. income taxes to the extent a tax liability results after utilization of net operating loss carryforwards and available tax credits.

Property and Equipment

Property and equipment are recorded at cost less accumulated depreciation. Property and equipment are depreciated for financial reporting purposes using the straight-line method over the following estimated useful lives: machinery and equipment, furniture, fixtures and computer software, 3-5 years; leasehold improvements are amortized using the straight-line method over the shorter of the useful lives of the assets or the terms of the leases. Significant improvements to our property and equipment are capitalized while expenditures for maintenance and repairs are charged to expense in the period incurred.

The components of property and equipment consist of the following as of December 31, (in thousands):

	2012	2013
Machinery and equipment	14,810	16,628
Furniture, fixtures, and computer software	1,159	1,669
Leasehold improvements	1,926	2,578
Construction in progress	909	831
Total property and equipment, at cost	18,804	21,706
Less accumulated depreciation	(11,657)	(14,141)
Property and equipment, net	7,147	7,565

Depreciation expense was $2.2 million, $2.5 million and $3.1 million for the years ended December 31, 2011, 2012 and 2013, respectively.

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 account for more than 10% of our total net revenue: HP and 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):

	2011	2012	2013
HP	74%	68%	59%
Tektronix	6%	10%	13%
Other customers less than 10%	20%	22%	28%
Total	100%	100%	100%

If our relationship with HP or Tektronix 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, Tektronix, or our other customers will expand or not otherwise be disrupted.

At December 31, 2012, our accounts receivable from HP were $17.0 million comprising 68% of our total accounts receivable. At December 31, 2013, our accounts receivable from HP were $27.2 million comprising 63% of our total accounts receivable. The increase in accounts receivable from HP is due to increased revenue in the fourth quarter and the change in credit terms. We expect sales to HP to continue to decline as a percentage of total revenue. No other customer balance exceeded 10% of our total accounts receivable balance at December 31, 2012 or 2013.

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 the Product Purchase Agreement originally entered into with HP on September 10, 2007 (the Amendment). 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 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.

In September 2011, our primary AssuredUVS customer informed us that the AssuredUVS software would no longer be a component of its business strategy, resulting in significant declines in revenues for the Company. Our long-lived assets consisted of the intangible assets associated with our acquisition of certain identified Cloverleaf Communications, Inc., or Cloverleaf, assets acquired in January 2010. The impairment of these long-lived assets is now reported in discontinued operations (see Note 3), since we ceased all ongoing operational activities as of December 31, 2012.

Valuation of Goodwill

The changes in the carrying amount of goodwill are as follows during the years ended December 31, 2012 and 2013 (in thousands):

	Total
Balance as of January 1, 2012	
Goodwill	$44,840
Accumulated impairment losses	(44,840)
Balance as of December 31, 2012	
Goodwill	44,840
Accumulated impairment losses	(44,840)
	$—

	Total
Balance as of January 1, 2013	
Goodwill	$44,840
Accumulated impairment losses	(44,840)
Balance as of December 31, 2013	
Goodwill	44,840
Accumulated impairment losses	(44,840)
	$—

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 it was changing its strategy, which would result in a significant decline in revenue for the Company, and we determined that the reporting unit was less than its carrying value. The impairment of the goodwill related to the reporting unit is now reported in discontinued operations (see Note 3), since we ceased all ongoing operational activities as of December 31, 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 $0.2 million, $0.0 million and $0.0 million for the years ended December 31, 2011, 2012 and 2013, respectively, including $0.2 million, $0.0 million and $0.0 million in discontinued operations.

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

	December 31, 2012	December 31, 2013
Balance, beginning of the year	$203	$240
Write offs	—	(219)
Additions to allowance	37	2
Balance, end of the year	$240	$23

Recent Accounting Pronouncements

From time to time, new accounting pronouncements are issued that we adopt as of the specified effective date. We believe that 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 February 2013, the FASB issued Accounting Standards Update 2013-02, Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income ("ASU 2013-02"). This update requires presentation of reclassifications from accumulated other comprehensive income by component to net income either on the face of the income statement or in a single footnote, but does not require any new information to be disclosed. This update is effective for the interim and annual periods beginning after December 15, 2012. The Company has adopted ASU 2013-2 as of the Company's interim period ending March 31, 2013. The adoption of this update has not had any impact on the Company's financial statements as the Company has not had any reclassifications from accumulated other comprehensive income to net income. Other comprehensive income in each period is comprised solely of foreign currency translation adjustments.

In July 2013, the FASB issued Accounting Standards Update 2013-11, Income Taxes (Topic 740): Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists ("ASU 2013-11"). This update provides that an unrecognized tax benefit should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss or tax credit carryforward. To the extent that a net operating loss or tax credit carryforward is not available at the reporting date to settle any additional income taxes that would result from disallowance of a tax position, or the tax law does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such purpose, then the unrecognized tax benefit should be presented as a liability. This update is effective for the interim and annual periods beginning after December 15, 2013, with early adoption and retrospective application permitted. The Company elected to early adopt this update during the Company's interim period ending September 30, 2013. The adoption of this update has not had any impact on the Company's financial statements, since we were previously recording unrecognized tax benefits as a reduction of deferred tax assets to the extent available.

2. Earnings Per Share

Basic earnings per share, including continuing and discontinued operations, 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, including continuing and discontinued operations, 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. No such items were included in the computation of diluted loss per share for the year ended December 31, 2011 or 2012 because we incurred a net loss in each of these periods and the effect of inclusion would have been anti-dilutive.

	2011	2012	2013
Income (loss) from continuing operations	$(8,464)	$(10,402)	$5,540
Basic weighted-average common shares outstanding	54,908	56,954	58,521
Assumed exercise of dilutive stock options and restricted stock	—	—	726
Diluted weighted-average common shares outstanding	54,908	56,954	59,247
Income (loss) from continuing operations:			
Basic earnings (loss) per share	$(0.15)	$(0.18)	$0.09
Diluted earnings (loss) per share	$(0.15)	$(0.18)	$0.09

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

	December 31, 2011		December 31, 2012		December 31, 2013	
	Number of Potential Shares	Range of Exercise Prices	Number of Potential Shares	Range of Exercise Prices	Number of Potential Shares	Range of Exercise Prices
Stock options	7,314,039	$0.47 - $16.36	8,952,129	$0.47 - $16.36	5,879,842	$1.55 - $15.15
Unvested stock awards	2,221,205	$—	655,402	$—	92,811	$—
Warrants	1,602,489	$2.40	1,602,489	$2.40	1,602,489	$2.40

3. Discontinued Operations

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 consisted of the intangible assets associated with our acquisition in January 2010 of certain identified Cloverleaf assets, 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 consisted of 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 with a net book value of $4.9 million and a trade name with a net book value 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.

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 asset. 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.

We also evaluated goodwill for impairment and determined that the fair value of the reporting unit was less than its carrying value. Our valuation resulted in recognition of an impairment charge to goodwill of $4.1 million during 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, at which time it was determined 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. The AssuredUVS business is now recorded in discontinued operations, since we have ceased all ongoing operational activities as of December 31, 2013.

The following is a summary of the components of loss from discontinued operations for the years ended December 31, 2011, 2012 and 2013 (in thousands):

	2011	2012	2013
Net revenue	$1,634	$360	$50
Cost of goods sold	5,284	2,501	142
Gross profit	(3,650)	(2,141)	(92)
Operating expenses:			
Research and development	4,355	741	—
Sales and marketing	651	56	—
General and administrative	762	765	393
Restructuring charge (recovery)	—	844	(10)
Goodwill impairment charge	4,140	—	—
Total operating expenses	9,908	2,406	383
Operating loss	(13,558)	(4,547)	(475)
Other income (expense), net	(2)	(1)	(1)
Loss from discontinued operations	$(13,560)	$(4,548)	$(476)

The activity in 2013 is limited to the continued support of certain maintenance contracts entered into prior to shutting down the Israel Technology Development Center, as well as expenses related to the resolution of a dispute with the former primary AssuredUVS customer.

4. Inventories

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

	December 31,	
	2012	2013
Purchased parts and materials	$3,051	$2,911
Finished goods	1,986	3,628
Total inventory	$5,037	$6,539

Inventories are comprised of finished goods and purchased parts and assemblies, which include direct labor 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, are subject to technological risks, price changes and inventory reduction programs by our customers, and as 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 reserved inventory, the new cost basis is charged to cost of sales.

5. Intangible Assets
Identifiable intangible assets are as follows (in thousands):

	December 31, 2012			
	Estimated Useful Life	Gross	Accumulated Amortization	Net
RaidCore technology	4 years	$4,256	$(4,256)	$—
Total intangible assets		$4,256	$(4,256)	$—

	December 31, 2013			
	Estimated Useful Life	Gross	Accumulated Amortization	Net
RaidCore technology	4 years	$4,256	$(4,256)	$—
Total intangible assets		$4,256	$(4,256)	$—

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 3). 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 acquirer or, in the event a buyer could not be located, abandoned. Accordingly, the acquired software was temporarily idled, and no additional amortization expense was 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 are now reporting the underlying business as discontinued operations, since we have ceased all ongoing operational activities as of September 30, 2012. Amortization expense related to intangible assets totaled $1.1 million, $0.8 million and $0.0 million, for the years ended December 31, 2011, 2012 and 2013, respectively.

6. 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. 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. 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 future price concessions and rebates based on sales volumes. As of December 31, 2013, a $0.3 million liability related to this settlement remains outstanding.

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. 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, which was fully received as of December 31, 2013. 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.

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 December 31, 2013 we have not assumed or recorded any insurance reimbursement.

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

	December 31,		
	2011	2012	2013
Balance, beginning of year	$982	$6,871	$4,455
Charges to operations	8,244	2,116	1,350
Deductions for costs incurred	(2,355)	(4,532)	(2,840)
Balance, end of year	$6,871	$4,455	$2,965

During the first quarter of 2013, we were able to negotiate more favorable rates with a third-party service provider. Accordingly, we adjusted our warranty accrual by $0.8 million to reflect this change.

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 in 2012 or 2013 related to the liability established for certain third-party material and service costs incurred by our customer related to replacing failed power supplies.

7. 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 million based upon an advance rate dependent on certain concentration limits within eligible accounts receivable. These limitations 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 bank's prime rate, which was 4% at December 31, 2013, 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, 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 December 31, 2013, 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 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 million (measured on a rolling three-month basis), the interest rate will increase to the bank's prime rate plus 1% and additional restrictions will apply. The maturity date of the credit facility is July 21, 2015.

As of December 31, 2013 we had no outstanding letters of credit and there was $2.0 million outstanding under the Silicon Valley Bank line of credit. There was $28.0 million available for borrowing under the agreement as of December 31, 2013. We are currently in compliance with all covenant requirements.

8. 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. There were no transfers between Level I, II or III inputs for any of our assets measured at fair value during the reporting period.

Assets Measured at Fair Value on a Recurring Basis

		Fair Value Measurements Using			
Description	December 31, 2012	Quoted Prices for Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total (Losses)
	(in thousands)				

Cash and cash equivalents	$40,315	$40,315	$—	$—	$—

F-15

Description	December 31, 2013	Fair Value Measurements Using Quoted Prices for Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total (Losses)
	(in thousands)				
Cash and cash equivalents	$40,406	$40,406	$—	$—	$—

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 following disclosures relate to financial instruments for which the ending balances at December 31, 2012 and December 31, 2013, are not carried at fair value in their entirety on the consolidated balance sheets. These tables present the carrying value and fair value, by fair value hierarchy, of our financial instruments, excluding cash and cash equivalents, accounts receivable and accounts payable at December 31, 2012 and 2013, respectively (in thousands).

Description	December 31, 2012	Fair Value Measurements Using Quoted Prices for Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total (Losses)
Credit facility borrowings	$2,800	$—	$2,800	$—	$—

Description	December 31, 2013	Fair Value Measurements Using Quoted Prices for Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total (Losses)
Credit facility borrowings	$2,000	$—	$2,000	$—	$—

The fair value of the Company's debt was estimated using a market approach based on the amount at the measurement date that the Company would receive to enter into an identical liability, since quoted prices for the Company's debt instrument are not available.

9. Income Taxes

Components of income (loss) from continuing operations before taxes are as follows for the years ended December 31, (in thousands):

	2011	2012	2013
Income (loss) from continuing operations before taxes:			
U.S.	$(6,229)	$(7,211)	$9,051
Foreign	(2,106)	(2,442)	(3,460)
Total income (loss) from continuing operations before taxes	$(8,335)	$(9,653)	$5,591

Components of the income tax provision (benefit) are as follows for the years ended December 31, (in thousands):

	2011	2012	2013
Current:			
Federal	$—	$—	$(28)
State, local and foreign	129	749	184
	129	749	156
Deferred:			
Federal	—	—	—
State, local and foreign	—	—	(105)
	—	—	(105)
Total income tax provision	$129	$749	$51

The reconciliation of the income tax provision computed using the federal statutory income tax rate to the recognized income tax provision (benefit) is as follows for the years ended December 31, (in thousands):

	2011	2012	2013
Federal statutory rate	$(2,834)	$(3,282)	$1,901
State and local income taxes, net of federal benefit	(85)	(16)	65
State rate change and other adjustments	160	531	—
Adjustments to state deferred taxes	—	—	(590)
Increase (decrease) in valuation allowance	1,490	597	(1,672)
Foreign tax differential	816	915	24
Research and development credits	(49)	127	(365)
Share based compensation	402	518	491
Uncertain tax positions	(46)	767	(43)
Adjustments to federal deferred taxes	—	525	110
Other	275	67	130
Income tax provision	$129	$749	$51

The tax effect of temporary differences that give rise to deferred income taxes are as follows as of December 31, (in thousands):

	2012	2013
Deferred tax assets:		
Net operating loss and tax credit carry forwards	$93,547	$93,128
Inventory reserve and uniform capitalization	2,016	1,474
Stock options and warrants	2,330	2,440
In-process research and development	237	—
Allowance for bad debts	232	171
Vacation accrual	386	261
Deferred rent	429	143
Deferred revenue	376	380
Warranty accrual	937	958
Depreciation and amortization	1,012	1,358
Other accruals and reserves	701	362
Accrued Bonus	—	873
Acquired intangibles	1,336	1,195
Total deferred tax assets	103,539	102,743
Deferred tax liabilities:		
State taxes	(3,603)	(3,885)
Other	(205)	(548)
Total deferred income tax liabilities	(3,808)	(4,433)
Valuation allowance	(99,731)	(98,205)
Net deferred tax assets	$—	$105

As a result of certain realization requirements, the table of deferred tax assets and liabilities shown above does not include deferred tax assets for net operating losses as of December 31, 2013 that arose directly from tax deductions related to equity compensation in excess of compensation recognized for financial reporting. Equity will be increased by $1.1 million if and when such excess tax benefits are recognized through current taxes payable. The Company uses ASC 740 ordering when determining when excess tax benefits or shortfalls have been realized.

U.S. income and withholding taxes have not been recognized on the excess of the amount for financial reporting over the tax basis of investments in foreign subsidiaries that are essentially permanent in duration.

The following table summarizes the activity related to our unrecognized tax benefits (in thousands):

	2011	2012	2013
Balance, January 1	$5,111	$5,025	$5,726
Increase related to prior period positions	—	583	341
Increase related to current year tax positions	124	241	380
Reductions for tax positions of prior years	(210)	(123)	(676)
Settlements	—	—	—
Balance, December 31	$5,025	$5,726	$5,771

At December 31, 2011, 2012, and 2013 we had cumulative unrecognized tax benefits of approximately $5.0 million, $5.7 million, and $5.8 million, respectively, of which approximately $0.2 million, $0.9 million, and $0.8 million, respectively, are included in other long term liabilities that, if recognized, would affect the effective tax rate. The remaining $4.8 million, $4.8 million and $5.0 million of unrecognized tax benefits will have no impact on the effective tax rate due to the existence of net operating loss carryforwards and a full valuation allowance. Consistent with previous periods, penalties and tax related interest expense are reported as a component of income tax expense. As of December 31, 2011, and 2012, the total amount of accrued income tax related interest and penalties included in the consolidated balance sheet was less than $0.1 million and $0.2 million, respectively. As of December 31, 2013, the total amount of accrued income tax related interest and penalties included in the consolidated balance sheet was approximately $0.4 million. We anticipate $0.3 million of our unrecognized tax positions will be settled or reversed within the next 12 months.

Due to net operating losses and other tax attributes going forward, we are currently open to audit under the statute of limitations by the Internal Revenue Service for the years ending March 31, 2000 through December 31, 2013. With few exceptions, our state income tax returns are open to audit for the years ended December 31, 2009 through 2013.

We periodically evaluate the likelihood of the realization of deferred tax assets, and adjust the carrying amount of the deferred tax assets by the valuation allowance to the extent the future realization of the deferred tax assets is not judged to be more likely than not. We consider many factors when assessing the likelihood of future realization of our deferred tax assets, including our recent cumulative earnings experience by taxing jurisdiction, expectations of future taxable income or loss, the carryforward periods available to us for tax reporting purposes, and other relevant factors. At December 31, 2013, based on the weight of available evidence, including cumulative losses in recent years and expectations regarding future taxable income, we determined that it was not more likely than not that our deferred tax assets would be realized and have a $98.2 million valuation allowance associated with our deferred tax assets.

As of December 31, 2013, we had federal and state net operating loss carryforwards of approximately $192.9 million and $106.5 million, respectively, which begin to expire in the tax years ending 2017 and 2013, respectively. We had foreign net operating loss carryforwards of $43.8 million, which have no expiration date. In addition, we had federal tax credit carryforwards of $4.7 million, of which approximately $0.5 million can be carried forward indefinitely to offset future tax liability, and the remaining $4.2 million begin to expire in the tax year ending 2018. We also had state tax credit carryforwards of $3.5 million, of which the entire $3.5 million has no expiration date.

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

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

As a result of our acquisition of Cloverleaf, a third ownership change, within the meaning of IRC Section 382, occurred on January 26, 2010. As a result, annual use of Cloverleaf’s federal net operating loss and credit carry forwards may be limited. The annual limitation is cumulative and, therefore, if not fully utilized in a year, can be utilized in future years in addition to the Section 382 limitation for those years.

10. Stockholders’ Equity, Equity Incentive Plans and Warrants

Stock Incentive Plans

2009 EIP. Our stockholders approved the 2009 Equity Incentive Plan, or the 2009 EIP, at our Annual Meeting of Stockholders held on June 15, 2009. The 2009 EIP authorizes the issuance or grant of incentive stock options, non-statutory stock options, restricted stock awards, restricted stock unit awards, stock appreciation rights, performance awards, performance cash awards and other stock awards to our employees, directors and consultants and is intended as the successor to and continuation of our 2000 EIP. Following the approval of the 2009 EIP by our stockholders, no additional stock awards may be granted under the 2000 Amended and Restated Equity Incentive

Plan, or the 2000 EIP. All outstanding stock awards granted under the 2000 EIP will remain subject to the terms of the 2000 EIP provided, however, that any shares subject to outstanding stock awards granted under the 2000 EIP that expire or terminate for any reason prior to exercise or settlement shall become available for issuance pursuant to awards granted under the 2009 EIP. Awards granted under the 2000 EIP expire 10 years from the date of grant. Awards granted under the 2009 EIP expire seven years from the date of grant. As of June 15, 2009, the total

Table of Contents

number of shares of our common stock reserved for issuance under the 2009 EIP consisted of 4,500,000 shares plus 7,112,217 shares that are subject to outstanding stock awards under the 2000 EIP that may become available for grant under the 2009 EIP if they expire or terminate for any reason prior to exercise or settlement under the 2000 EIP. On May 2, 2011 shareholders approved our Amended 2009 Equity Incentive Plan, primarily to increase the share reserve by 8,000,000 shares. Unless sooner terminated by our Board of Directors, the 2009 EIP shall automatically terminate on April 26, 2019, the day before the tenth anniversary of the date the 2009 EIP was adopted by the Board. The Board of Directors may also amend the 2009 EIP at any time subject to applicable laws and regulations, including the rules and regulations of The NASDAQ Stock Market LLC. In general, no amendment or termination of the 2009 EIP may adversely affect any rights under awards already granted to a participant unless agreed to by the affected participant. During 2011, 2012 and 2013, we granted restricted stock and options to purchase common stock with various vesting as approved by the Board upon each grant. As of December 31, 2013, 92,811 shares of restricted stock were outstanding under the 2009 EIP, of which none were performance-based restricted stock awards. Additionally, no shares of restricted stock were outstanding under the 2000 EIP. As of December 31, 2013, options to purchase 6,076,409 and 3,174,089 shares of common stock were outstanding under the 2009 EIP and 2000 EIP, respectively. 2,684,232 shares of common stock remained available for grant under the 2009 EIP.

2000 NEDSOP. Under our 2000 Non-Employee Directors Stock Option Plan, or 2000 NEDSOP, non-qualified stock options to purchase common stock are automatically granted to our non-employee directors upon appointment to our Board of Directors (initial grants) and upon each of our annual meeting of stockholders (annual grants). Options granted under the 2000 NEDSOP expire 10 years from the date of the grant. Initial grants vest over four years, with 25% of the shares subject to the option vesting one year from the date of grant and the remaining shares subject to the option vesting ratably thereafter on a monthly basis. Annual grants are fully vested on the date of grant. 1,000,000 shares of common stock are reserved for issuance under the 2000 NEDSOP. As of December 31, 2013, options to purchase 600,000 shares of common stock were outstanding under the 2000 NEDSOP and options to purchase 293,124 shares of common stock remained available for grant under the 2000 NEDSOP.

2000 ESPP. Our stockholders approved our Amended and Restated Employee Stock Purchase Plan, or 2000 ESPP, at our Annual Meeting of Stockholders held on June 15, 2009, primarily to increase the share reserve under the 2000 ESPP by 4,000,000 shares. The 2000 ESPP qualifies under the provisions of Section 423 of the Internal Revenue Code, or IRC, and provides our eligible employees, as defined in the 2000 ESPP, with an opportunity to purchase shares of our common stock at 85% of fair market value. There were 675,149 and 808,761 shares issued under the 2000 ESPP for the years ended December 31, 2012 and 2013, respectively. As of December 31, 2013, the 2000 ESPP had a total of 1,058,720 shares available for purchase.

As of December 31, 2013, total unrecognized share-based compensation cost related to unvested stock options, restricted stock awards, management stock incentive plan and our 2000 ESPP was $3.4 million, which is expected to be recognized over a weighted-average period of approximately 2.5 years. The following table summarizes share-based compensation expense for the years ended December 31, (in thousands):

	2011	2012	2013
Cost of goods sold	$828	$617	$334
Sales and marketing	540	419	274
Research and development	2,200	1,705	1,054
General and administrative	1,548	1,024	1,028
Share-based compensation expense before taxes	5,116	3,765	2,690
Related deferred income tax benefits	—	—	—
Share-based compensation expense	$5,116	$3,765	$2,690
Share-based compensation expense is derived from:			
Stock options	$1,434	$1,508	$1,924
Restricted stock awards	2,303	1,958	489
Stock bonus plan	1,005	—	—
2000 ESPP	374	299	277
Total	$5,116	$3,765	$2,690

F-20

Table of Contents

We estimate forfeitures at the time of grant and revise, if necessary, in subsequent periods if actual forfeitures differ from those estimates. We have historically and continue to estimate the fair value of share-based awards using the Black-Scholes pricing model.

A summary of stock option activity is as follows:

	Number of shares	Weighted average exercise price	Weighted average remaining contractual term (in years)	Aggregate intrinsic value
Outstanding at January 1, 2013	8,952,129	$2.93		
Granted	2,331,500	1.57		
Exercised	(210,551)	1.53		
Forfeited	(268,985)	1.47		
Expired	(953,595)	3.94		
Outstanding at December 31, 2013	9,850,498	$2.58	4.35	$12,056,111
Vested and expected to vest at December 31, 2013	9,511,564	$2.62	4.28	$11,423,719
Exercisable at December 31, 2013	6,155,904	$3.17	3.65	$5,528,671

A summary of restricted stock award activity for 2013 is as follows:

	Number of shares	Weighted average grant date fair value
Outstanding at January 1, 2013	655,402	$2.16
Granted	30,000	1.74
Vested	(567,268)	2.22
Forfeited	(25,323)	1.84
Outstanding and unvested at December 31, 2013	92,811	$1.73

The weighted average grant-date fair values of options granted during the years ended December 31, 2011, 2012 and 2013 were $1.78 per share, $0.89 per share, and $1.05 per share, respectively. The total intrinsic value of options exercised during the years ended December 31, 2011, 2012 and 2013 were $0.8 million, $0.0 million, and $0.2 million, respectively.

The weighted average grant-date fair values of restricted stock awards granted during the years ended December 31, 2011, 2012 and 2013 were $2.68, $1.23 and $1.74 per share, respectively. The fair value of restricted stock awards that vested during the years ended December 31, 2011, 2012 and 2013 was $1.4 million, $3.3 million and $1.3 million, respectively.

Cash generated from options exercised under all share-based compensation arrangements for the years ended December 31, 2011, 2012 and 2013 were $0.5 million, $0.0 million and $0.3 million, respectively. Cash generated from the purchase of shares through the 2000 ESPP for the years ended December 31, 2011, 2012 and 2013, was $0.9 million, $0.7 million, and $0.7 million respectively. We issue new shares from the respective plan share reserves upon exercise of options to purchase common stock and for purchases through the 2000 ESPP.

The aggregate intrinsic value in the stock option summary table above is based on our closing stock price of $3.37 per share as of the last business day of the fiscal year ended December 31, 2013, which value would have been realized by the optionees had all options been exercised on that date. The total fair value of options to purchase common stock that vested during the years ended December 31, 2011, 2012 and 2013 was $1.2 million, $2.1 million, and $2.2 million, respectively.

To estimate compensation expense for the years ended December 31, 2011, 2012, and 2013 we used the Black-Scholes pricing model with the following weighted-average assumptions for equity awards granted:

Table of Contents

	EIP and NEDSOP Years Ended December 31,						ESPP Years Ended December 31,					
	2011		2012		2013		2011		2012		2013	
Risk-free interest rate	1.84	%	1.19	%	1.07	%	0.17	%	0.12	%	0.09	%
Expected dividend yield	—	%	—	%	—	%	—	%	—	%	—	%
Volatility	85	%	81	%	82	%	70	%	64	%	63	%
Expected Term	5.4 years		5.2 years		5.3 years		0.5 years		0.5 years		0.5 years	
Forfeiture Rate	0%-12.25%		0%-10.62%		0%-9.45%		—	%	—	%	—	%

The risk-free interest rate is based on the implied yield available on United States Treasury issues with an equivalent remaining term. We have not paid dividends in the past and do not plan to pay any dividends in the future.

The expected volatility is based on historical volatility of our stock for the related vesting period. The expected life of the equity award is based on historical experience.

The forfeiture rate is estimated when awards are granted and updated if information becomes available indicating that actual forfeitures will differ.

Warrants

In January 2008, we amended our Product Purchase Agreement, or Agreement, originally entered into with HP in September 2007, to allow for sales to additional divisions within HP. In connection with the Agreement, we issued a warrant to HP to purchase 1,602,489 shares of our common stock (approximately 3.5% of our outstanding shares prior to the issuance of the warrant) at an exercise price of $2.40 per share.

On October 31, 2011, we amended again the Product Purchase Agreement originally entered into with HP on September 10, 2007. In part, this Amendment extends 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. The impact of this extension on our financial statements is a non-cash contra-revenue charge of approximately $1.0 million in Dot Hill’s 2011 statement of operations.

11. Employee Retirement Benefit Plans

Dot Hill Retirement Savings Plan

The Dot Hill Retirement Savings Plan, which qualifies under Section 401(k) of the IRC, is open to eligible employees over 21 years of age. Under the plan, participating United States employees may defer up to 100% of their pretax salary, but not more than statutory limits. At our discretion we may make contributions to this plan for plan participants. Our matching contributions vest to employees as a percentage based on years of employment from one to five years, and matching contributions are fully vested to employees after five years of employment. Our matching contributions to the retirement savings plan for the years ended December 31, 2011, 2012 and 2013 were $0.1 million, $0.3 million and $0.4 million, respectively.

12. Commitments and Contingencies

Operating Leases

We lease office space, equipment and automobiles under non-cancelable operating leases, which expire at various dates through May 2018. Rent expense for the years ended December 31, 2011, 2012 and 2013 was $1.0 million, $1.1 million and $1.2 million, respectively. We record rent expense on a straight–line basis based on contractual lease payments.

Future minimum lease payments due under all non-cancelable operating leases as of December 31, 2013 are as follows (in thousands):

2014	$1,232
2015	1,224
2016	1,130
2017	1,155
2018	488
Thereafter	—
Total minimum lease payments	$5,229

For purposes of the table above, the operating lease obligations exclude common area maintenance, real estate taxes and insurance expenses.

Unconditional Purchase Obligations

We have unconditional inventory related purchase obligations to certain suppliers for certain commodities in order to ensure supply of select key components at the most favorable pricing. Additionally, we have non-inventory related purchase obligations that represent purchase commitments made in the ordinary course of business. At December 31, 2013, we had approximately $34.6 million of unconditional purchase obligations, of which $1.1 million for excess purchase commitments was recorded in Accrued Expenses on the balance sheet.

Legal Proceedings

We are not party to any significant legal proceedings, 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.

13. 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 (CODM), in deciding how to allocate resources and in assessing performance. ASC 280 also requires disclosures about products and services, geographic areas and significant customers.

Our CODM operates our business in one reportable operating segment that includes design, manufacture, and marketing of a range of software and hardware storage systems for the entry and mid-range storage markets.

Geographic Information

Net revenue is recorded in the geographic area in which the sale is originated. Long-lived assets include property and equipment, net and other non-current assets. Information concerning principal geographic areas in which we operate is as follows (in thousands):

	Year ended December 31,		
	2011	2012	2013
Net revenue:			
United States	$193,755	$192,801	$204,764
Europe, Middle East and Africa	76	14	3
Asia	1,996	1,733	1,798
Total net revenue	$195,827	$194,548	$206,565
Long-lived assets:			
United States	$4,945	$7,682	$8,147
Europe, Middle East and Africa	2,922	68	15
Asia	—	—	—
Total long-lived assets	$7,867	$7,750	$8,162

F-23

Table of Contents

14. Quarterly Financial Information (Unaudited)

The information presented below reflects all adjustments, which, in the opinion of management, are of a normal and recurring nature necessary to present fairly the results of operations for the periods presented (in thousands, except per share amounts).

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Year Ended December 31, 2012:				
Net revenue	$54,598	$47,708	$48,223	$44,019
Gross profit	15,565	12,661	12,268	7,877
Income (loss) before income taxes and discontinued operations	69	(2,545)	(2,581)	(4,596)
Net income (loss) from continuing operations	160	(2,945)	(2,734)	(4,883)
Basic and diluted net income (loss) per share from continuing operations	$—	$(0.05)	$(0.05)	$(0.08)

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Year Ended December 31, 2013:				
Net revenue	$44,480	$50,683	$52,603	$58,799
Gross profit	14,440	17,007	16,873	17,750
Income (loss) before income taxes and discontinued operations	(526)	2,138	1,875	2,104
Net income (loss) from continuing operations	(560)	2,089	1,775	2,236
Basic and diluted net income (loss) per share from continuing operations	$(0.01)	$0.04	$0.03	$0.03