DOT HILL SYSTEMS CORP
Form 10-Q
November 08, 2013
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the Quarterly Period Ended September 30, 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 (State or other jurisdiction of incorporation or organization)	13-3460176 (I.R.S. Employer Identification No.)
1351 S. Sunset Street, Longmont, CO (Address of principal executive offices)	80501 (Zip Code)

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer	o	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 registrant had 58,999,296 shares of common stock, $0.001 par value, outstanding as of October 31, 2013.

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Part I. Financial Information
Item 1. Financial Statements
DOT HILL SYSTEMS CORP.
UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS
AS OF DECEMBER 31, 2012 AND SEPTEMBER 30, 2013
(In thousands, except par value data)

	December 31, 2012	September 30, 2013
ASSETS		
Current Assets:		
Cash and cash equivalents	$40,315	$40,357
Accounts receivable, net	25,025	30,110
Inventories	5,037	6,426
Prepaid expenses and other assets	5,810	6,816
Total current assets	76,187	83,709
Property and equipment, net	7,147	7,792
Other assets	603	533
Total assets	$83,937	$92,034
LIABILITIES AND STOCKHOLDERS’ EQUITY		
Current Liabilities:		
Accounts payable	$22,659	$27,159
Accrued compensation	4,863	5,256
Accrued expenses	8,690	7,677
Deferred revenue	2,889	4,216
Credit facility borrowings	2,800	—
Total current liabilities	41,901	44,308
Other long-term liabilities	3,261	3,382
Total liabilities	45,162	47,690
Commitments and Contingencies (Note 9)		
Stockholders’ Equity:		
Preferred stock, $.001 par value, 10,000 shares authorized, no shares issued or outstanding at December 31, 2012 and September 30, 2013	—	—
Common stock, $.001 par value, 100,000 shares authorized, 58,265 and 58,978 shares issued and outstanding at December 31, 2012 and September 30, 2013, respectively	58	59
Additional paid-in capital	326,575	329,076
Accumulated other comprehensive loss	(3,533)	(3,318)
Accumulated deficit	(284,325)	(281,473)
Total stockholders’ equity	38,775	44,344
Total liabilities and stockholders’ equity	$83,937	$92,034

See accompanying notes to unaudited condensed consolidated financial statements.

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DOT HILL SYSTEMS CORP.
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (LOSS)
FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2012 AND 2013
(In thousands, except per share amounts)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2013	2012	2013
NET REVENUE	$48,223	$52,603	$150,529	$147,766
COST OF GOODS SOLD	35,955	35,730	110,035	99,446
GROSS PROFIT	12,268	16,873	40,494	48,320
OPERATING EXPENSES:				
Research and development	9,368	8,972	28,226	26,593
Sales and marketing	3,558	3,512	10,415	9,807
General and administrative	1,918	2,512	6,918	8,416
Total operating expenses	14,844	14,996	45,559	44,816
OPERATING INCOME (LOSS)	(2,576)	1,877	(5,065)	3,504
OTHER INCOME:				
Interest income (expense), net	(4)	(1)	(4)	(16)
Other income (expense), net	(1)	(1)	12	(1)
Total other income (expense), net	(5)	(2)	8	(17)
INCOME (LOSS) BEFORE INCOME TAXES AND DISCONTINUED OPERATIONS	(2,581)	1,875	(5,057)	3,487
INCOME TAX EXPENSE	153	100	462	183
INCOME (LOSS) FROM CONTINUING OPERATIONS	(2,734)	1,775	(5,519)	3,304
LOSS FROM DISCONTINUED OPERATIONS	(280)	(18)	(4,411)	(452)
NET INCOME (LOSS)	$(3,014)	$1,757	$(9,930)	$2,852
NET EARNINGS (LOSS) PER SHARE:				
Continuing operations:				
Basic and diluted income (loss) per share	$(0.05)	$0.03	$(0.10)	$0.06
Discontinued operations:				
Basic and diluted loss per share	$—	$—	$(0.08)	$(0.01)
Net income (loss):				
Basic and diluted income (loss) per share*	(0.05)	0.03	(0.17)	0.05
WEIGHTED AVERAGE SHARES USED TO CALCULATE NET INCOME (LOSS) PER SHARE:				
Basic	57,327	58,736	56,768	58,376
Diluted	57,327	60,062	56,768	58,879
COMPREHENSIVE INCOME (LOSS):				
Net income (loss)	$(3,014)	$1,757	$(9,930)	$2,852
Foreign currency translation adjustment	(49)	11	(10)	215
Comprehensive income (loss)	$(3,063)	$1,768	$(9,940)	$3,067

* Per share data may not always add to the total for the period because each figure is independently calculated.
See accompanying notes to unaudited condensed consolidated financial statements.

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DOT HILL SYSTEMS CORP.
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2012 AND 2013
(In thousands)

	Nine Months Ended September 30,	
	2012	2013
Cash Flows From Operating Activities:		
Net income (loss)	$(9,930)	$2,852
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	2,828	2,315
Stock-based compensation expense	2,973	1,917
Provision for bad debt expense	12	3
Write-off of intangible assets	1,647	—
Write-off of property and equipment	312	—
Changes in operating assets and liabilities:		
Accounts receivable	3,352	(5,161)
Inventories	(156)	(1,397)
Prepaid expenses and other assets	1,067	(991)
Accounts payable	(4,748)	4,705
Accrued compensation and other expenses	(3,428)	(358)
Deferred revenue	380	1,342
Other long-term liabilities	1,019	151
Net cash provided by (used in) operating activities	(4,672)	5,378
Cash Flows From Investing Activities:		
Purchases of property and equipment	(2,914)	(3,096)
Net cash used in investing activities	(2,914)	(3,096)
Cash Flows From Financing Activities:		
Principal payment of note payable	(71)	—
Payments on bank borrowings	—	(7,700)
Proceeds from bank borrowings	1,800	4,900
Shares withheld for tax purposes	(543)	(222)
Proceeds from sale of stock to employees	754	808
Net cash provided by (used in) financing activities	1,940	(2,214)
Effect of Exchange Rate Changes on Cash and Cash Equivalents	20	(26)
Net Increase (Decrease) in Cash and Cash Equivalents	(5,626)	42
Cash and Cash Equivalents, beginning of period	46,168	40,315
Cash and Cash Equivalents, end of period	$40,542	$40,357
Supplemental Disclosures of Non-Cash Investing and Financing Activities:		
Property and equipment acquired but not yet paid	$507	$340
Stock payment for employee bonus plan	$1,005	$—
Supplemental Cash Flow Data:		
Cash paid for income taxes	$84	$75

See accompanying notes to unaudited condensed consolidated financial statements.

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DOT HILL SYSTEMS CORP.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Summary of Significant Accounting Policies

Basis of Presentation

The financial statements of Dot Hill Systems Corp. (referred to herein as Dot Hill, we, our or us) contained herein are unaudited and in the opinion of management contain all adjustments (consisting of normal recurring adjustments) necessary for a fair presentation of financial position, results of operations and cash flows for the periods presented. The interim unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America, or GAAP, for interim financial information and with the instructions to Securities and Exchange Commission, or SEC, Form 10-Q and Article 10 of SEC Regulation S-X. They do not include all of the information and disclosures required by GAAP for complete financial statements. The unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2012. Operating results for the three and nine months ended September 30, 2013 are not necessarily indicative of the results that may be expected for future quarters or the year ending December 31, 2013.

Use of Accounting Estimates

The preparation of our unaudited condensed consolidated financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the dates of the financial statements and the reported amounts of net revenue and expenses in the reporting periods. The accounting estimates that require management's most significant and subjective judgments include revenue recognition, inventory valuation, recurring and specific issue warranty obligations, the valuation and recognition of stock-based compensation expense, and the valuation of long-lived assets, including intangible assets. In addition, we have other accounting policies that involve estimates such as the determination of useful lives of long-lived assets, accruals for restructuring, and 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 is integrated with our OEM customers' industry standard hardware, and is 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.

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.

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

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 Costs of Goods Sold. This resulted in an understatement of $0 million and $2.2 million of revenue and $0.3 million and $2.2 million of the costs for the three and nine months ended September 30, 2012, respectively.

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 each of the deliverables would be if they were sold regularly on a standalone basis.

For multi-element arrangements that include both software and non-software related elements, we allocate and recognize a portion of the transaction price as revenue related to software deliverables based on the VSOE of fair value of the software related elements. We allocate and recognize the remainder of the transaction price to the non-software related elements based on their relative selling prices, using the hierarchy for determining the selling price outlined above. In circumstances when VSOE of fair value of undelivered software related elements is not available, the entire transaction price is deferred and recognized in accordance with the guidance outlined under the software heading above.

From time to time, we enter into arrangements with customers that include acceptance criteria. In such instances, we defer all revenue on the arrangement until customer acceptance is obtained or the acceptance clause lapses.

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.

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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.

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: Hewlett Packard, or HP, and Tektronix, Inc., or Tektronix. Our agreements with our original equipment manufacturers, or OEM, partners do not contain any minimum purchase commitments, do not obligate our OEM partners to purchase their storage solutions exclusively from us and may be terminated at any time upon notice from the applicable partner.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2013	2012	2013
HP	68 %	58 %	67 %	56 %
Tektronix	4 %	13 %	10 %	15 %
Other customers less than 10%	28 %	29 %	23 %	29 %
Total	100 %	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.

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. Our Product Purchase Agreement with HP, as amended, terminates on October 30, 2016. HP also holds warrants to purchase 1,602,489 shares of our common stock at an exercise price of $2.40 per share, expiring on October 30, 2016.

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.

Cash and Cash Equivalents

We classify investments as cash equivalents if they are readily convertible to cash and have original maturities of three months or less at the time of acquisition. Cash and cash equivalents consist primarily of money market mutual funds issued or managed in the United States. As of December 31, 2012 and September 30, 2013, the carrying value of cash and cash equivalents approximates fair value due to the short period of time to maturity.

As of September 30, 2013, $2.9 million of the $40.4 million of cash and cash equivalents was held by our foreign subsidiaries.

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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.

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

	September 30, 2012	September 30, 2013
Balance, beginning of the year	$203	$240
Additions to allowance	12	4
Write-offs	—	(212)
Recoveries	—	(1)
Balance, quarter ended	$215	$31

Long-lived Asset Impairment

We periodically review the recoverability of the carrying value of long-lived assets for impairment whenever events or changes in circumstances indicate that their carrying value may not be recoverable. An impairment in the carrying value of an asset group is recognized whenever anticipated future undiscounted cash flows from an asset group are estimated to be less than its carrying value. The amount of impairment recognized is the difference between the carrying value of the asset group and its fair value. Fair value estimates are based on assumptions concerning the amount and timing of estimated future cash flows and assumed discount rates, reflecting varying degrees of perceived risk. There were no impairment charges for the period ended September 30, 2013.

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.

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2. Earnings Per Share

Basic earnings per share, for both 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 net income (loss) per share, for both 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 in the three and nine months ended September 30, 2012 because we incurred net losses in the periods and the effect of inclusion would have been anti-dilutive.

The following is a reconciliation of weighted-average shares outstanding used in the calculation of basic and diluted earnings from continuing operations per share for the three and nine months ended September 30, 2012 and 2013 (in thousands, except per share data):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2013	2012	2013
Income (loss) from continuing operations	$(2,734)	$1,775	$(5,519)	$3,304
Basic weighted-average common shares outstanding	57,327	58,736	56,768	58,376
Assumed exercise of dilutive stock options, warrants and restricted stock	—	1,326	—	503
Diluted weighted-average common shares outstanding	57,327	60,062	56,768	58,879
Income (loss) from continuing operations:				
Basic earnings (loss) per share	$(0.05)	$0.03	$(0.10)	$0.06
Diluted earnings (loss) per share	$(0.05)	$0.03	$(0.10)	$0.06

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

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2012		2013		2012		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	Number of Potential Shares	Range of Exercise Prices
Stock options	10,724,690	$0.47 - $16.36	4,457,057	$1.74 - $16.36	10,724,690	$0.47 - $16.36	9,167,615	$1.26 - $16.36
Unvested stock awards	884,391	$ —	112,977	—	884,391	$ —	279,415	$—
Warrants	1,602,489	$ 2.40	—	—	1,602,489	$ 2.40	1,602,489	$2.40

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Shares issued

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

	Nine Months Ended September 30, 2012	Nine Months Ended September 30, 2013
Shares issued:		
Options exercised	27	50
Restricted stock awards granted	844	30
Shares purchased under stock plan	675	809
Share decreases:		
Shares repurchased for tax purposes	431	151
Restricted stock awards canceled	447	25

3. Discontinued Operations

During 2011, 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. In February 2012, our Board of Directors approved a plan to exit our AssuredUVS business and close down our Israel Technology Development Center. 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 during the three months ended June 30, 2012. The AssuredUVS business is now recorded in discontinued operations since we ceased all significant ongoing operational activities as of September 30, 2012.

The following is a summary of the components of loss from discontinued operations for the three and nine months ended September 30, 2012 and 2013 (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2013	2012	2013
Net revenue	$26	$18	$232	$40
Cost of goods sold	70	—	2,373	142
Gross loss	(44)	18	(2,141)	(102)
Operating expenses:				
Research and development	(20)	—	741	—
Sales and marketing	—	—	56	—
General and administrative	204	36	700	350
Restructuring charge	53	—	772	—
Total operating expenses	237	36	2,269	350
Operating loss	(281)	(18)	(4,410)	(452)
Other expense, net	1	—	(1)	—
Loss from discontinued operations	$(280)	$(18)	$(4,411)	$(452)

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.

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4. Inventories

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

	December 31, 2012	September 30, 2013
Purchased parts and materials	$3,051	$3,528
Finished goods	1,986	2,898
Total inventory	$5,037	$6,426

Inventories are valued at the lower of cost (first-in, first-out method) or market value. The valuation of production inventory requires us to estimate excess or obsolete inventory. The determination of excess or obsolete inventory requires us to estimate the future demand for our products. Our markets are volatile, subject to technological risks and price changes and inventory reduction programs by our customers. In addition, we are required to make last time buys of certain components on occasion. These factors result in a risk that we will forecast incorrectly and purchase excess inventories of particular products or have commitments to purchase excess inventory components from our suppliers. As a result, actual demand will differ from forecasts, and such a difference has in the past and may in the future have a material effect on our financial statements. Any write downs to inventory due to the existence of excess quantities, physical obsolescence, changes in pricing, damage, or other causes establish a new cost basis for the inventory. When we sell or dispose of reserved inventory the new cost basis is charged to cost of sales. Service inventory is amortized ratably over the estimated life of the related product series.

5. Intangible Assets

Identifiable intangible assets are as follows (in thousands), as of December 31, 2012 and September 30, 2013:

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

Amortization expense related to intangible assets totaled $0.2 million and $1.0 million for the three and nine months ended September 30, 2012, respectively, including $0.0 million and $0.2 million, respectively, included in discontinued operations. There was no amortization expense related to intangible assets during the three and nine months ended September 30, 2013.

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 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. For warranty costs not covered by our suppliers, we provide for estimated warranty costs in the period the revenue is recognized. Estimated liabilities for product warranties are included in accrued expenses.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2013	2012	2013
Balance, beginning of period	$4,779	$2,683	$6,871	$4,455
Charges to operations	1,274	320	1,691	1,025
Deductions for payments made	(969)	(142)	(3,478)	(1,308)
Changes in estimates	—	(5)	—	(1,316)
Balance, end of period	$5,084	$2,856	$5,084	$2,856

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.

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7. Credit Facilities

We maintain a credit facility with Silicon Valley Bank for cash advances of up to an aggregate of $30 million based upon an advance rate dependent on certain concentration limits within eligible accounts receivable. These limits exclude certain eligible customer receivables if an individual customer account balance exceeds 25, 50 or 70 percent of the total eligible accounts receivable, depending on the customer, as defined by our Loan and Security Agreement with Silicon Valley Bank. Borrowings under the credit facility bear interest at the Silicon Valley Bank's prime rate, which was 4.0% as of September 30, 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 September 30, 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 prime plus 1% and additional restrictions will apply. The maturity date of the credit facility is July 21, 2015. As of September 30, 2013, the Company had no borrowings outstanding under the Silicon Valley Bank line of credit. There was $24.1 million available for borrowing under the agreement as of September 30, 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	$—	$—	$—

		Fair Value Measurements Using			
Description	September 30, 2013	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	$40,357	$40,357	$—	$—	$—

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Fair Value of Financial Instruments

The Company's financial instruments consist of cash and cash equivalents, and credit facility borrowings. The following disclosure relates to financial instruments for which the ending balances at December 31, 2012, which are not carried at fair value in their entirety on the Unaudited Condensed Consolidated Balance Sheet. This table presents the carrying value and fair value, by fair value hierarchy, of our financial instruments, excluding cash and cash equivalents at December 31, 2012 (in thousands).

		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)
Credit facility borrowings	$2,800	$—	$2,800	$—	$—

The Company had no outstanding borrowings on the credit facility as of September 30, 2013.

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 the identical liability, since quoted prices for the Company's debt instrument are not available.

9. Commitments and Contingencies

We are involved in certain legal actions and claims from time to time arising in the ordinary course of business. Management believes that the outcome of such litigation and claims would not have a material effect on our financial statements. Historically, the outcome of such litigation and claims has not had a material adverse effect on our financial condition or results of operations.

10. Segment Information

Operating segments, as defined in Accounting Standard Codification, or ASC, 280 Segment Reporting, are components of an enterprise for which separate financial information is available and is evaluated regularly by the Chief Operating Decision Maker, or CODM, in deciding how to allocate resources and in assessing performance. 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 the design, manufacture and marketing of a range of software and hardware storage systems for the entry and midrange storage markets.

Geographic Revenues

Net revenue is recorded in the geographic area in which the sale originated. Information concerning principal geographic areas in which we operate is as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2013	2012	2013
Net revenue:				
United States	$47,737	$51,717	$149,169	$146,400
Europe, Middle East and Africa	3	—	12	2
Asia	483	886	1,348	1,364
Total net revenue	$48,223	$52,603	$150,529	$147,766

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

Cautionary Statement for Forward-Looking Information

Certain statements contained in this quarterly report on Form 10-Q, including statements regarding the development, growth and expansion of our business, our intent, belief or current expectations, primarily with respect to our future operating

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performance and the products we expect to offer, and other statements regarding matters that are not historical facts, are "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, or the Exchange Act, and are subject to the "safe harbor" created by these sections. Because such forward-looking statements are subject to risks and uncertainties, many of which are beyond our control, actual results may differ materially from those expressed or implied by such forward-looking statements. Some of the factors that could cause actual results to differ materially from those expressed or implied by such forward-looking statements can be found in Part II, Item 1A, "Risk Factors" and in our reports filed with the Securities and Exchange Commission, or SEC, including our Annual Report on Form 10-K for the year ended December 31, 2012. 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 unaudited condensed consolidated financial statements and notes thereto included in the preceding pages in this quarterly report on Form 10-Q and our consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2012.

Overview

We design, manufacture and market a range of software and hardware storage systems for the entry and midrange 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, which primarily include media and entertainment, telecommunications, HPC, 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. 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™ 2000 and 3000 series of entry-level 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. In February 2010, we launched the latest AssuredSAN™ 4004 models of storage arrays that provide high speed interface options including 8 and 16 gigabit, or Gb, Fibre Channel, 1Gb and 10Gb iSCSI over Ethernet and 12Gb SAS connectivity.

On August 22, 2012, we introduced AssuredSAN™ Pro 5000 Series with RealStor™ software that incorporates autonomic real-time data tiering via a virtualized back-end. With RealStor™, businesses gain the advantage of very high performance SSDs, using them to their maximum benefit, while storing less frequently accessed data on slower, but much less expensive hard disk drives. On the same day, we also introduced our AssuredSAN™ 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 hardware architecture as the Pro 5000 Series. Our Series 2000 and 3000 products are characterized by International Data Corporation (IDC) as Band 2 and Band 3 products. With the announcement of our Series 4000 and 5000 products, we now have products

characterized within IDC Price Bands 4 and 5, which increases our total available market, as measured by end-user sales price, from $4.0 billion to $10.6 billion.

Our agreements with our customers do not contain any minimum purchase commitments and may be terminated at any time upon notice from the customer. Our ability to achieve and maintain profitability will depend on, among other things, the level and mix of orders we receive from such customers, the amounts we spend on marketing support, the 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.

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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 Motorola, Inc., Tektronix, Samsung Electronics, Concurrent Computer Corporation, Autodesk Inc., Harris Broadcast Communications, Teradata Corporation, CGG and Nokia Siemens Network, among others. 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. In January 2008, we amended our agreement with HP to allow for sales of additional products to additional divisions within HP. HP launched the third generation product line based on our technology, called the MSA P2000, in February 2010. Sales to HP continued to increase with faster host interfaces across the HP P2000 product line. In May 2013, HP announced its fourth generation product based on our technology called the MSA 2040 which is now available to the HP customer base. 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 58% and 56% of our total net revenue for the three and nine months ended September 30, 2013, respectively. The agreement with HP does not contain any minimum purchase commitments; however, we expect sales to HP to continue to represent a substantial percentage of our total net revenue in 2013. If our relationship with HP were disrupted or declined significantly, we would lose a substantial portion of our anticipated net revenue and our business could be materially harmed. We cannot gaurantee that our relationship with HP will expand or not otherwise be disrupted. We expect to generate additional revenue from our indirect channel as well as new and potential new OEM customers.

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 for the three and nine months ended September 30, 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. 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 supplier not produce and deliver

inventory for us to sell on a timely basis, operating results may be adversely affected. 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 2012 and to date in 2013 were manufactured by Foxconn. We expect Foxconn to manufacture substantially all of our products throughout 2013.

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Cost of goods sold includes costs of materials, subcontractor costs, salary and related benefits for the production and service departments, depreciation of equipment 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.
Sales and marketing expenses consist primarily of salaries and commissions, marketing-related costs, channel programs, 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.
Other income (expense), net is comprised primarily of interest income earned on our cash and cash equivalents and other miscellaneous income and expense items.
In the first quarter of 2012, our management approved, committed to, and initiated a restructuring and cost reduction plan, or the 2012 Plan, that is associated with the closure of our Israel Technology Development Center. The 2012 Plan is designed to re-align our software investments to focus on accelerating the development of embedded software features, in order to launch a competitive set of mid-range storage array products in 2012, and to provide more differentiated entry-level products for both OEM and channel customers. Substantially all of our 2012 Plan workforce reductions were completed by July 31, 2012. The closure of our Israel Technology Development Center is now recorded in discontinued operations since we have ceased all ongoing operational activities as of September 30, 2012.

Critical Accounting Policies and Estimates

An accounting policy is deemed to be critical if it requires an accounting estimate to be made based on assumptions about matters that are highly uncertain at the time the estimate is made, if different estimates reasonably could have been used, or if changes in the estimate that are reasonably likely to occur could materially impact the unaudited condensed consolidated financial statements. Except as noted below, management believes that there have been no significant changes during the three and nine months ended September 30, 2013, to the items that we disclosed as our critical accounting policies and estimates in Management’s Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the fiscal year ended December 31, 2012.

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 is integrated with our OEM customers' industry standard hardware, and is 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.

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

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guidance for recognizing software revenue, we defer all revenue related to each deliverable until the only undelivered element is PCS. We then begin recognizing revenue ratably over the PCS period.

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

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 Costs of Goods Sold. This resulted in an understatement of $0 million and $2.2 million of revenue and $0.3 million and $2.2 million of the costs for the three and nine months ended September 30, 2012, respectively.

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 each of the deliverables would be if they were sold regularly on a standalone basis.

For multi-element arrangements that include both software and non-software related elements, we allocate and recognize a portion of the transaction price as revenue related to software deliverables based on the VSOE of fair value of the software related elements. We allocate and recognize the remainder of the transaction price to the non-software related elements based on their relative selling prices, using the hierarchy for determining the selling price outlined above. In circumstances when VSOE of fair value of undelivered software related elements is not available, the entire transaction price is deferred and recognized in accordance with the guidance outlined under the software heading above.

From time to time, we enter into arrangements with customers that include acceptance criteria. In such instances, we defer all revenue on the arrangement until customer acceptance is obtained or the acceptance clause lapses.

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.

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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.
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):

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2012		2013		2012		2013	
NET REVENUE	100.0	%	100.0	%	100.0	%	100.0	%
COST OF GOODS SOLD	74.6		67.9		73.1		67.3	
GROSS PROFIT	25.4		32.1		26.9		32.7	
OPERATING EXPENSES:								
Research and development	19.4		17.1		18.8		18.0	
Sales and marketing	7.4		6.7		6.9		6.6	
General and administrative	4.0		4.8		4.5		5.7	
Total operating expenses	30.8		28.6		30.2		30.3	
OPERATING INCOME (LOSS)	(5.4	)	3.5		(3.3	)	2.4	
Other income (expense), net	—		—		—		—	
INCOME (LOSS) BEFORE INCOME TAXES AND DISCONTINUED OPERATIONS	(5.4	)	3.5		(3.3	)	2.4	
INCOME TAX EXPENSE	0.3		0.2		0.3		0.1	
INCOME (LOSS) FROM CONTINUING OPERATIONS	(5.7	)	3.3		(3.6	)	2.3	
LOSS FROM DISCONTINUED OPERATIONS	(0.6	)	—		(2.9	)	(0.3	)
NET INCOME (LOSS)	(6.3	)%	3.3	%	(6.5	)%	2.0	%

Three and Nine Months Ended September 30, 2012 Compared to the Three and Nine Months Ended September 30, 2013
Net Revenue

	Three Months Ended September 30,		Increase		% Change	
	2012	2013				
	(in thousands, except percentages)					
Net Revenue	$48,223	$52,603	$4,380		9.1	%

	Nine Months Ended September 30,		Decrease		% Change	
	2012	2013				
	(in thousands, except percentages)					
Net Revenue	$150,529	$147,766	$(2,763	)	(1.8	)%

Net revenue increased approximately $4.4 million from $48.2 million for the three months ended September 30, 2012 to $52.6 million for the three months ended September 30, 2013. The increase in net revenue was primarily due to an

increase in sales to Tektronix of $4.9 million, from $1.7 million for the three months ended September 30, 2012 to $6.6 million for the

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three months ended September 30, 2013, along with an increase of $1.8 million in sales to various other OEM and channel customers. The increase in net revenue was partially offset by a $2.4 million decrease in revenue from HP from $32.9 million for the three months ended September 30, 2012 to $30.5 million for the three months ended September 30, 2013.

Net revenue decreased approximately $2.8 million from $150.5 million for the nine months ended September 30, 2012 to $147.8 million for the nine months ended September 30, 2013. The decrease in net revenue was primarily due to a $17.1 million decrease in revenue from HP from $100.4 million for the nine months ended September 30, 2012 to $83.3 million for the nine months ended September 30, 2013. The decrease in net revenue from HP was partially offset by a $7.0 million increase in sales from Tektronix, from $15.3 million for the nine months ended September 30, 2012 to $22.3 million for the nine months ended September 30, 2013, along with an increase of $7.1 million in sales to various other OEM and channel customers. We expect sales to HP and Tektronix to continue to represent a substantial portion of our net revenue during 2013. Sales to HP approximated 67% of our net revenue for the nine months ended September 30, 2012 compared to 56% of our net revenue for the nine months ended September 30, 2013. Sales to Tektronix approximated 10% of our net revenue for the nine months ended September 30, 2012 compared to 15% of our net revenue for the nine months ended September 30, 2013.

In May 2013, HP announced its fourth generation product based on our technology called the MSA 2040 which is now available to the HP customer base.

Cost of Goods Sold and Gross Profit

	Three Months Ended September 30, 2012		Three Months Ended September 30, 2013		Increase/(Decrease)	% Change
	Amount	% of Net Revenue	Amount	% of Net Revenue		
	(in thousands, except percentages)					
Cost of Goods Sold	$35,955	74.6 %	$35,730	67.9 %	$ (225)	(0.6)%
Gross Profit	$12,268	25.4 %	$16,873	32.1 %	$ 4,605	37.5 %

	Nine Months Ended September 30, 2012		Nine Months Ended September 30, 2013		Increase/(Decrease)	% Change
	Amount	% of Net Revenue	Amount	% of Net Revenue		
	(in thousands, except percentages)					
Cost of Goods Sold	$110,035	73.1 %				