DOT HILL SYSTEMS CORP
Form 10-Q
November 09, 2005

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the Quarterly Period Ended September 30, 2005

OR

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

For the transition period from to

Commission file number 1-13317

DOT HILL SYSTEMS CORP.

(Exact name of registrant as specified in its charter)

Delaware	**13-3460176**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
6305 El Camino Real, Carlsbad, CA	**92009**
(Address of principal executive offices)	(Zip Code)

(760) 931-5500

(Registrant s telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by 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 ý No o

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

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

The registrant had 44,111,847 shares of common stock, $0.001 par value, outstanding as of November 7, 2005.

DOT HILL SYSTEMS CORP.

FORM 10-Q

For the Quarter Ended September 30, 2005

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Part I. Financial Information

Item 1. Financial Statements

DOT HILL SYSTEMS CORP. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(In Thousands Except Per Share Amounts)

(Unaudited)

	December 31, 2004		September 30, 2005	
ASSETS				
Current Assets:				
Cash and cash equivalents	$	67,496	$	90,001
Short-term investments		58,690		33,293
Accounts receivable, net of allowance of $491 and $1,241		40,788		35,488
Inventories		3,671		2,898
Prepaid expenses and other		2,273		3,898
Total current assets		172,918		165,578
Property and equipment, net		7,859		7,308
Goodwill		57,111		57,111
Other intangible assets, net		7,712		5,563
Other assets		967		394
Total assets	$	246,567	$	235,954
LIABILITIES AND STOCKHOLDERS EQUITY				
Current Liabilities:				
Accounts payable	$	40,512	$	24,068
Accrued compensation		3,338		3,738
Accrued expenses		3,309		3,149
Deferred revenue		779		1,449
Income taxes payable		532		289
Other liabilities		923		
Current portion of restructuring accrual		141		86
Total current liabilities		49,534		32,779
Restructuring accrual, net of current portion		37		
Other long-term liabilities		169		217
Total liabilities		49,740		32,996
Commitments and Contingencies (Note 13)				
Stockholders Equity:				
Preferred stock, $0.001 par value, 10,000 shares authorized, no shares issued or outstanding				

Common stock, $0.001 par value, 100,000 shares authorized, 43,656 and 44,107 shares issued and outstanding at December 31, 2004 and September 30, 2005, respectively		44		44
Additional paid-in capital		277,102		278,880
Deferred compensation		(8)		
Accumulated other comprehensive loss		(462)		(240)
Accumulated deficit		(79,849)		(75,726)
Total stockholders equity		196,827		202,958
Total liabilities and stockholders equity	$	246,567	$	235,954

See accompanying notes to condensed consolidated financial statements.

DOT HILL SYSTEMS CORP. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

AND COMPREHENSIVE INCOME (LOSS)

(In Thousands, Except Per Share Amounts)
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	**2005**	**2004**	**2005**
Net Revenue	$ 56,956	$ 53,616	$ 173,859	$ 177,524
Cost of Goods Sold	42,288	41,263	130,071	135,749
Gross Profit	14,668	12,353	43,788	41,775
Operating Expenses:				
Sales and marketing	3,994	5,180	12,274	14,920
Research and development	4,825	6,280	13,388	16,335
General and administrative	2,709	3,036	7,327	8,370
Restructuring, net	7		(384)	
In-process research and development			4,700	
Total operating expenses	11,535	14,496	37,305	39,625
Operating income (loss)	3,133	(2,143)	6,483	2,150
Other Income (Expense):				
Interest income	421	791	1,427	2,236
Interest expense	(69)		(355)	(47)
Gain (loss) on foreign currency transactions, net	98	(122)	252	(185)
Other income (expense), net	19	7	(1)	93
Total other income, net	469	676	1,323	2,097
Income (Loss) Before Income Taxes	3,602	(1,467)	7,806	4,247
Income Tax Benefit (Expense)	(151)	192	(243)	(124)
Net Income (Loss)	$ 3,451	$ (1,275)	$ 7,563	$ 4,123
Net Income (Loss) Per Share:				
Basic	$ 0.08	$ (0.03)	$ 0.17	$ 0.09
Diluted	$ 0.07	$ (0.03)	$ 0.16	$ 0.09
Weighted Average Shares Used to Calculate Net Income (Loss) Per Share:				
Basic	43,511	43,949	43,403	43,832
Diluted	46,188	43,949	46,489	45,613
Comprehensive Income (Loss):				
Net income (loss)	$ 3,451	$ (1,275)	$ 7,563	$ 4,123
Foreign currency translation adjustments	17	46	18	192
Net unrealized gain (loss) on short-term investments	94	51	(284)	30
Comprehensive income (loss)	$ 3,562	$ (1,178)	$ 7,297	$ 4,345

See accompanying notes to condensed consolidated financial statements.

DOT HILL SYSTEMS CORP. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In Thousands)
(Unaudited)

	Nine Months Ended September 30,	
	2004	**2005**
Cash Flows From Operating Activities:		
Net income	$ 7,563	$ 4,123
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	4,615	6,017
Write-off of in-process research and development	4,700	
Non-cash settlement of restructuring charges	(384)	
Loss on disposal of property and equipment		461
Provision for doubtful accounts	102	969
Stock-based compensation expense	15	8
Loss (gain) on sale of short-term investments	49	(5)
Changes in operating assets and liabilities (net of effects of Chaparral acquisition):		
Accounts receivable	(21,584)	4,331
Inventories	606	773
Prepaid expenses and other assets	(236)	(1,052)
Accounts payable	5,790	(17,214)
Accrued compensation and expenses	(1,058)	(683)
Deferred revenue	(450)	670
Income taxes payable	(78)	(243)
Restructuring accrual	(290)	(92)
Other long-term liabilities	821	48
Net cash provided by (used in) operating activities	181	(1,889)
Cash Flows From Investing Activities:		
Purchases of property and equipment	(5,253)	(3,008)
Sales of short-term investments	48,003	50,632
Purchases of short-term investments	(56,611)	(25,200)
Cash paid in Chaparral acquisition, net of cash acquired	(65,383)	
Net cash provided by (used in) investing activities	(79,244)	22,424
Cash Flows From Financing Activities:		
Proceeds from bank and other borrowings	13,662	
Payments on bank and other borrowings	(20,882)	
Proceeds from sale of stock to employees		1,040
Proceeds from exercise of stock options and warrants	1,092	738
Net cash provided by (used in) financing activities	(6,128)	1,778
Effect of Exchange Rate Changes on Cash	18	192
Net Increase (Decrease) in Cash and Cash Equivalents	(85,173)	22,505
Cash and Cash Equivalents, beginning of period	105,863	67,496
Cash and Cash Equivalents, end of period	$ 20,690	$ 90,001
Supplemental Disclosures of Cash Flow Information:		

Construction in progress costs incurred but not paid	$		$	770
Cash paid for interest	$	1,212	$	
Cash paid for income taxes	$	307	$	540

See accompanying notes to condensed consolidated financial statements.

DOT HILL SYSTEMS CORP. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared by Dot Hill Systems Corp. (referred to herein as Dot Hill, we, our or us) pursuant to the rules and regulations of the Securities and Exchange Commission, or SEC. Accordingly, they do not include all of the information and disclosures required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments and reclassifications considered necessary for a fair and comparable presentation have been included and are of a normal recurring nature. 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, 2004. Operating results for the three and nine months ended September 30, 2005 are not necessarily indicative of the results that may be expected for the year ending December 31, 2005.

The preparation of our financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Revenues are recognized pursuant to applicable accounting standards, including Securities and Exchange Commission Staff Accounting Bulletin No. 104, *Revenue Recognition* and Statement of Position No. 97-2, *Software Revenue Recognition* (SOP 97-2).

We recognize revenue for non-software product sales upon transfer of title to the customer. Reductions to revenue for estimated sales returns are also recorded at that time. These estimates are based on historical sales returns, changes in customer demand and other factors. If actual future returns and allowances differ from past experience, additional allowances may be required. Certain of our sales arrangements include multiple elements. Generally, these arrangements include delivery of the product, installation, training and product maintenance. Maintenance related to product sales entitles the customer to basic product support and significantly greater response time in resolving warranty related issues. We allocate revenue to each element of the arrangement based on its relative fair value. For maintenance contracts this is typically the price charged when such contracts are sold separately or renewed. Because professional services related to installation and training can be provided by other third party organizations, we allocate revenue related to professional services based on rates that are consistent with other like companies providing similar services, i.e., the market rate for such services. Revenue from product maintenance contracts is deferred and recognized ratably over the contract term, generally twelve months. Revenue from installation, training and consulting is recognized as the services are performed.

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

2. Stock-Based Compensation

As permitted by SFAS No. 123, *Accounting for Stock-Based Compensation,* we currently account for share-based payments to employees using APB Opinion No. 25 s intrinsic value method and, as such, generally recognize no compensation cost for employee stock options. Had compensation cost for our stock option awards been determined based upon the fair value at the date of grant in accordance with SFAS No. 123, our net income and basic and diluted net income per share would have been adjusted to the following amounts for the three and nine months ended September 30, 2004 and 2005 (in thousands, except per share information):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2005	2004	2005
Net income (loss)	$ 3,451	$ (1,275)	$ 7,563	$ 4,123
Stock-based employee compensation expense included in reported net income	5		15	8
Stock-based employee compensation expense determined under fair value based method	(1,262)	(1,343)	(3,084)	(3,783)
Pro forma net income (loss) available to common stockholders	$ 2,194	$ (2,618)	$ 4,494	$ 348
Basic net income (loss) per share:				
As reported	$ 0.08	$ (0.03)	$ 0.17	$ 0.09
Pro forma	$ 0.05	$ (0.06)	$ 0.10	$ 0.01
Diluted net income (loss) per share:				
As reported	$ 0.07	$ (0.03)	$ 0.16	$ 0.09
Pro forma	$ 0.05	$ (0.06)	$ 0.10	$ 0.01

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

	Nine Months Ended September 30,	
	2004	2005
Risk free interest rate	3.0%	3.8%
Expected dividend yield		
Expected life	4 years	4 years
Expected volatility	89%	78%

3. Acquisition

On February 23, 2004, we completed the acquisition of Chaparral Network Storage, Inc., or Chaparral, a privately held developer of specialized storage appliances as well as high-performance, midrange RAID controllers and data routers. The purchase price was $67.6 million of which $62 million was paid in cash. In addition, we agreed to pay approximately $4.1 million related to obligations due to certain employees covered by change in control agreements as a result of the acquisition, direct transaction costs of approximately $0.8 million and approximately $0.7 million in accrued integration costs consisting primarily of severance payments and amounts accrued related to Chaparral s leased facility were incurred. The acquisition of Chaparral is expected to enable us to increase the amount of proprietary technology within our storage systems, broaden our product line and diversify our customer base. The results of operations of Chaparral have been included in our results prospectively from February 23, 2004.

Goodwill recorded in connection with the acquisition of Chaparral totaled approximately $56.8 million. None of this goodwill will be deductible for tax purposes. Of the acquired assets, $4.7 million pertained to in-process research and development and was written off by our recognition of a charge to operations on the acquisition date. The remaining acquired intangible assets are being amortized using the straight-line method over their estimated useful lives as follows: developed and core technology, 2.5 to 4.5 years; customer relationships, 3.5 years; and backlog, 8 months. None of the other intangible assets will be deductible for tax purposes.

Certain of our employees are former Chaparral employees who were party to agreements with Chaparral providing for payment in the event of a change in control of Chaparral, 50% of which was payable immediately and 50% of which is payable after 18 months of service following the acquisition date. As a result of our acquisition of Chaparral, these employees were paid approximately $3.1 million in March 2004 and $1.0 million during 2005. Our obligations under these agreements were completely satisfied as of September 30, 2005. During the three and nine months ended September 30, 2005, we recorded compensation expense of approximately $23,000 and $91,000, respectively, relating to these agreements.

The following unaudited pro forma results of operations present the impact on our results of operations for the three and nine months ended September 30, 2004 as if the acquisition of Chaparral had been completed as of the beginning of the period reported on. The charge of $4.7 million related to the write-off of in-process research and development has been excluded from the pro forma results of operations as it is nonrecurring in nature.

	(In Thousands, Except Per Share Amounts)			
	Three Months Ended September 30, 2004		Nine Months Ended September 30, 2004	
	Historical	Pro Forma	Historical	Pro Forma
Net revenue	$ 56,956	56,956	$ 173,859	$ 175,615
Net income available to common stockholders	$ 3,451	3,066	$ 7,563	$ 9,923
Basic net income per share	$ 0.08	0.07	$ 0.17	$ 0.23
Diluted net income per share	$ 0.07	0.07	$ 0.16	$ 0.21

4. Net Income Per Share

Basic net income per share is calculated by dividing net income by the weighted average number of common shares outstanding during the period.

Diluted net income per share reflects the potential dilution of securities by including common stock equivalents, such as stock options and stock warrants in the weighted average number of common shares outstanding for a period, if dilutive.

The following table sets forth a reconciliation of the basic and diluted number of weighted average shares outstanding used in the calculation of net income per share (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2005	2004	2005
Shares used in computing basic net income per share	43,511	43,949	43,403	43,832
Dilutive effect of warrants and common stock equivalents	2,677		3,086	1,781
Shares used in computing diluted net income per share	46,188	43,949	46,489	45,613

For the three and nine months ended September 30, 2004, outstanding options to purchase 1,816,681 and 1,785,127 shares of common stock respectively, were not included in the calculation of diluted loss per share because their effect was antidilutive. For the three months ended September 30, 2005, all outstanding options and warrants to purchase 5,041,468 and 1,966,849 shares of common stock, respectively, were not included in the calculation of diluted income per share because their effect was antidilutive. For the nine months ended September 30, 2005, outstanding options to purchase 2,703,599 shares of common stock were not included in the calculation of diluted income per share because their effect was antidilutive.

5. Short-Term Investments

The following table summarizes our short-term investments as of September 30, 2005 (in thousands):

	Cost	Unrealized Losses	Unrealized Gains	Fair Value
U.S. Government securities	$ 31,418	$ (95)	$	$ 31,323
Municipal securities and corporate debt	1,974	(4)		1,970
	$ 33,392	$ (99)	$	$ 33,293

For the nine months ended September 30, 2005, gross realized gains on these investments was $5,000. There were no gross realized gains (losses) on these investments for the three months ended September 30, 2005.

6. Inventories

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

	December 31, 2004	September 30, 2005
Purchased parts and materials	$ 1,507	$ 1,201
Work-in-process	37	1
Finished goods	2,127	1,696
	$ 3,671	$ 2,898

7. Goodwill and Other Intangible Assets

Under the provisions of SFAS No. 142, goodwill and intangible assets with indefinite lives are not amortized, but instead are tested for impairment at least annually or more frequently if impairment indicators arise. All of our remaining intangible assets are considered to have finite lives and are being amortized in accordance with this statement.

Intangible assets that are subject to amortization under SFAS No. 142 consist of the following as of September 30, 2005 (in thousands):

	Gross	Accumulated Amortization	Net
Core technology	$ 5,000	$ (1,759)	$ 3,241
Developed technology	2,600	(1,647)	953
Customer relationships	2,500	(1,131)	1,369
Backlog	100	(100)	
Total other intangible assets	$ 10,200	$ (4,637)	$ 5,563

Estimated future amortization expense related to other intangible assets as of September 30, 2005 is as follows (in thousands):

Years ending December 31,	
2005 (remaining 3 months)	$ 717
2006	2,518
2007	1,588
2008	740
Total	$ 5,563

8. Product Warranties

We generally extend to our customers the warranties provided to us by our suppliers and, accordingly, the majority of our warranty obligations to customers are covered by supplier warranties. For warranty costs not covered by our suppliers, we provide for estimated warranty costs in the period the revenue is recognized. There can be no assurance that our suppliers will continue to provide such warranties to us in the future, which could have a material adverse effect on our operating results and financial condition. Product warranties are included in accrued expenses. The changes in our aggregate product warranty liability are as follows for the three and nine months ended September 30, 2005 (in thousands):

	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2005
Balance, beginning of period	$ 1,453	$ 1,104
Current period accrual	843	2,467
Amounts charged to accrual	(815)	(2,090)
Balance, end of period	$ 1,481	$ 1,481

9. Restructurings

Restructuring liabilities at September 30, 2005 were originally recorded in 2001 and 2002 and pertain to leases for former offices located in New York, Chicago and Carlsbad that extend through 2006. As of September 30, 2005, the remaining restructuring liability pertains to only the Chicago and Carlsbad offices.

The following is a summary of restructuring activity recorded during the nine months ended September 30, 2005 (in thousands):

March 2001 Restructuring

	Accrued Restructuring Expenses at December 31, 2004	Additional Restructuring Expenses	Current Amounts Utilized	Accrued Restructuring Expenses at September 30, 2005
Facility closures and related costs	$ 168	$ 17	$ (116)	$ 69

June 2001 Restructuring

	Accrued Restructuring Expenses at December 31, 2004	Additional Restructuring Expenses	Current Amounts Utilized	Accrued Restructuring Expenses at September 30, 2005
Facility closures and related costs	$ 10	$ 75	$ (68)	$ 17

We believe that there are no unresolved issues or additional liabilities that may result in a significant adjustment to restructuring expenses accrued as of September 30, 2005.

10. Income Taxes

We recorded an income tax expense (benefit) of $(0.2) and $0.1 million for the three and nine months ended September 30, 2005. Our effective income tax rate was (13.1)% and 2.9% for the three and nine months ended September 30, 2005. Our income tax expense for the nine months ended September 30, 2005 included the receipt by our European subsidiary of $0.2 million from European taxing authorities related to a 2002 loss that was carried back to the years 1998 through 2001. Excluding the impact of the loss carryback, our effective income tax rate was 7.0% for the nine months ended September 30, 2005.

We currently anticipate an effective income tax rate of approximately 4.3% for the year ended December 31, 2005. Our effective income tax rate is primarily attributable to federal and state minimum tax liabilities as well as local and foreign taxes and was significantly reduced through the use of net operating loss carryforwards for which a valuation allowance had previously been recorded.

As of December 31, 2004, we have federal and state net operating loss carryforwards of approximately $119.1 million and $79.9 million, which begin to expire in 2009 and 2005, respectively. In addition, we have federal tax credit carryforwards of approximately $3.1 million, of which $0.4 million can be carried forward indefinitely to offset future taxable income, and the remaining $2.7 million will begin to expire in 2008. We also have state tax credit carryforwards of $2.9 million, of which $2.7 million can be carried forward indefinitely to offset future taxable income, and the remaining $0.2 million will begin to expire in 2006. We have a full valuation allowance recorded on the net deferred tax asset which was approximately $50.9 million as of December 31, 2004, because we believe it is more likely than not that the amounts will not be realized.

In assessing the realizability of deferred tax assets, we consider whether it is more likely than not that the deferred tax assets will be realized. We consider projected future taxable income, the cumulative three year historical (income) losses, customer contract terms and customer concentrations in making this assessment. We reassess the realizability of deferred tax assets on a periodic basis. At such time as we determine that the recoverability of deferred tax assets is more likely than not, we will release the deferred tax valuation allowance, record an income tax benefit and subsequently record a provision for income taxes for financial statement purposes based on the amount of taxable net income. As of December 31, 2004, approximately $16.4 million of the valuation allowance is attributable to acquired deferred tax assets, which if recognized, will reduce goodwill related to the acquisition of Chaparral. Additionally, at December 31, 2004 approximately $4.6 million of the valuation allowance is attributed to the potential tax benefit of stock option transactions that will be credited directly to common stock, if realized.

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

As a result of our acquisition of Chaparral, an ownership change, within the meaning of Internal Revenue Code Section 382, occurred on February 23, 2004. As a result, annual use of the acquired 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.

11. Employee Benefit Plans

Our Employee Stock Purchase Plan (the Purchase Plan) was adopted in August 1997, and amended and restated in March 2000 and February 2004. The Purchase Plan qualifies under the provisions of Section 423 of the Internal Revenue Code and provides our eligible employees, as defined in the Purchase Plan with an opportunity to purchase shares of our common stock at 85% of fair market value, as defined. During the nine months ended September 30, 2005 199,438 shares were issued under the Purchase Plan.

12. Comprehensive Income

The components of comprehensive income are as follows (in thousands):

	Foreign Currency Items	Unrealized Gain (Loss) on Securities	Total
Balance, December 31, 2004	$ (333)	$ (129)	$ (462)
Quarterly change	16	(133)	(117)
Balance, March 31, 2005	(317)	(262)	(579)
Quarterly change	130	112	242
Balance, June 30, 2005	(187)	(150)	(337)
Quarterly change	46	51	97
Balance, September 30, 2005	$ (141)	$ (99)	$ (240)

13. Commitments and Contingencies

Crossroads Systems Litigation

On October 17, 2003, Crossroads Systems, or Crossroads, filed a lawsuit against us in the United States District Court in Austin, Texas alleging that our products infringe two United States patents assigned to Crossroads, Patent Numbers 5,941,972 and 6,425,035. We were served with the lawsuit on October 27, 2003. In March 2004, Chaparral was added as a party to the lawsuit. The patents involve storage routers and methods for providing virtual local storage. Patent Number 5,941,972 involves the interface of SCSI storage devices and the Fibre Channel protocol and Patent Number 6,425,035 involves the interface of any one-transport medium and a second transport medium. We believe that we have meritorious defenses to Crossroads claims and intend to vigorously defend against them. We have already incurred, and expect to continue to incur, significant legal expenses in connection with this litigation. These defense costs, and other expenses related to this litigation, will be expensed as incurred and will negatively affect our future operating results. If we are not successful in our defense of Crossroads claims, we may be required to pay significant amounts in the form of damages for past infringement. We also could be required to pay significant amounts in the form of licensing fees to allow us to continue to market certain products in the future, or Crossroads may deny us a license, which could lead to our inability to market certain products at all. Further, other third parties may assert additional infringement claims against us in the future, which would similarly require us to incur substantial license fees, legal fees and other expenses, and distract management from the operations of our business. The outcome is uncertain and no amounts have been accrued as of September 30, 2005.

Securities Class Action

In August 2004, a class action lawsuit was filed against, among others, Chaparral and a number of former officers and directors of Chaparral in the United States District Court for the Central District of California. The lawsuit, among other things, alleges violations of federal securities laws and purports to seek damages on behalf of a class of shareholders who held interests in limited liability companies that had purchased, among other securities, Chaparral stock during a defined period prior to our acquisition of Chaparral. In May 2005, the Second Amended Complaint was dismissed with leave to amend. Plaintiffs filed a Third Amended Complaint, which Chaparral and other defendants are again moving to dismiss. We believe that the claims against Chaparral and its former officers and directors are without merit and are in the process of vigorously defending against them. The outcome is uncertain and no amounts have been accrued as of September 30, 2005.

We are involved in certain other legal actions and claims arising in the ordinary course of business. Management believes that the outcome of such other litigation and claims are not likely to have a material adverse effect on our financial condition or operating results.

Lease Obligations

During September 2005, we entered into a lease agreement to occupy approximately 58,500 square feet of office space that will serve as a replacement for our current headquarters. The 88 month lease term will commence in January 2006. Upon the expiration of the initial term, we are entitled to two five-year renewal options.

Future minimum lease payments due under all noncancelable operating leases as of September 30, 2005 are as follows (in thousands):

Years ended December 31,		
2005 (remaining 3 months)	$	473
2006		1,760
2007		1,653
2008		1,111
2009		1,076
2010		1,025
Thereafter		2,502
Total minimum lease payments	$	9,600

The above minimum lease payments include minimum rental commitments totaling $0.2 million that have been included in the restructuring accrual as of September 30, 2005. Minimum payments for operating leases have not been reduced by minimum sublease rentals of $0.9 million due in the future under non-cancelable subleases.

The lease associated with our current headquarters will expire December 31, 2005. We plan on relocating to our new corporate headquarters during the first quarter of 2006. The minimum lease payment table above reflects all remaining payments due under our current corporate headquarter lease.

Other

In the fourth quarter of 2004, the Company made a payment of approximately $0.4 million to the State of New York to settle amounts related to a field audit of the Company s Franchise Tax Return. During the quarter ended March 31, 2005 we submitted tax returns to the City of New York and made a payment as an offer to settle in an amount similar to that accepted by the State of New York as described above. New York City is currently reviewing the returns, and the Company is waiting for a reply as to whether or not they have accepted the revised liability and payment as submitted. Amounts related to this matter have been previously accrued for.

Effective July 1, 2004, we entered into a credit agreement with Wells Fargo Bank, National Association, or Wells Fargo, which allows us to borrow up to $30.0 million under a revolving line of credit that expires July 1, 2006. Amounts loaned under the credit agreement bear interest at our option at a fluctuating rate per annum equal to the Prime Rate in effect from time to time, or at a fixed rate per annum determined by Wells Fargo to be 0.65% above LIBOR in effect on the first day of the applicable fixed rate term. In connection with the credit agreement, to the extent we have outstanding borrowings, we have granted Wells Fargo a security interest in our investment management account maintained with Wells Capital Management Incorporated. As of December 31, 2004 and September 30, 2005, there was no balance outstanding under this line of credit. The credit agreement limits any new borrowings, loans or advances outside of the credit agreement to an amount less than $1.0 million.

14. Segments and Geographic Information

Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by our chief operating decision-maker, or decision making group, in deciding how to allocate resources and in assessing performance. Our chief operating decision-maker is the Chief Executive Officer. Our operating segments are managed separately because each segment represents a strategic business unit that offers different products or services.

Our operating segments are organized on the basis of products and services. We have identified operating segments that consist of our SANnet family of systems, legacy and other systems, and services. We currently evaluate performance based on stand-alone segment revenue and gross margin. Because we do not currently maintain information regarding operating income at the operating segment level, such information is not presented.

Sales to our largest channel partner accounted for approximately 88% and 86% of our net revenue during the three months ended September 30, 2004 and 2005, respectively, and 88% and 86% for the nine months ended September 30, 2004 and 2005, respectively.

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

	SANnet Family	Legacy and Other	Services	Total
Three months ended:				
September 30, 2005:				
Net revenue	$ 51,496	$ 1,391	$ 729	$ 53,616
Gross profit	$ 11,446	$ 380	$ 527	$ 12,353
September 30, 2004:				
Net revenue	$ 52,977	$ 3,336	$ 643	$ 56,956
Gross profit (loss)	$ 15,604	$ (1,111)	$ 175	$ 14,668
Nine months ended:				
September 30, 2005:				
Net revenue	$ 170,882	$ 4,406	$ 2,236	$ 177,524
Gross profit	$ 39,153	$ 1,058	$ 1,564	$ 41,775
September 30, 2004:				
Net revenue	$ 163,587	$ 5,311	$ 4,961	$ 173,859
Gross profit (loss)	$ 47,933	$ (4,351)	$ 206	$ 43,788

Information concerning operating assets by product and service, derived by specific identification for assets related to specific segments and an allocation based on segment volume for assets related to multiple segments, is as follows (in thousands):

	SANnet Family	Legacy and Other	Services	Total
As of:				

September 30, 2005	$	225,348	$	7,692	$	2,914	$	235,954
December 31, 2004	$	235,969	$	7,285	$	3,313	$	246,567

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

	Three Months Ended September 30,				Nine Months Ended September 30,			
		2004		**2005**		**2004**		**2005**
Net revenue:								
United States	$	53,065	$	49,307	$	163,587	$	165,440
Europe		1,973		2,851		5,311		8,256
Asia		1,918		1,458		4,961		3,828
	$	56,956	$	53,616	$	173,859	$	177,524
Operating income (loss):								
United States	$	2,747	$	(2,506)	$	6,037	$	3,390
Europe		(33)		216		(349)		(1,068)
Asia		419		147		795		(172)
	$	3,133	$	(2,143)	$	6,483	$	2,150

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

15. Recent Accounting Pronouncements

In March 2004, the Financial Accounting Standards Board, or FASB, issued EITF Issue No. 03-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments,* which provides new guidance for assessing impairment losses on debt and equity investments. Additionally, EITF Issue No. 03-1 includes new disclosure requirements for investments that are deemed to be temporarily impaired. In September 2004, the FASB delayed the accounting provisions of EITF Issue No. 03-1; however, the disclosure requirements remain effective and have been adopted for our year ended December 31, 2004. We will evaluate the effect, if any, of EITF 03-1 when final guidance is released.

On November 24, 2004, the FASB issued Statement No. 151, *Inventory Costs*, an Amendment of ARB No. 43, Chapter 4, to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material. This Statement is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. We have not completed the process of evaluating the impact that the adoption of Statement 151 will have on our financial position or results of operations.

In December 2004, the FASB issued SFAS No. 123 (revised 2004), *Share-Based Payment* (SFAS No. 123(R)), which amends SFAS No. 123, *Accounting for Stock-Based Compensation*, supercedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and amends SFAS No. 95, *Statement of Cash Flows*. SFAS No. 123(R) requires companies to measure all employee stock-based compensation awards using a fair value method and record such expense in its consolidated financial statements. In addition, the adoption of SFAS No. 123(R) requires additional accounting and disclosure related to the income tax and cash flow effects resulting from share-based payment arrangements. SFAS No. 123(R) is effective beginning as of the first annual reporting period beginning after June 15, 2005. As permitted by SFAS No. 123, the Company currently accounts for share-based payments to employees using APB Opinion No. 25 s intrinsic value method and, as such, generally recognizes no compensation cost for employee stock options. Accordingly, the adoption of SFAS No. 123(R) s fair value method will have a significant impact on our results of operations, although it will have no impact on our overall financial position. The impact of adoption of SFAS 123(R) cannot be predicted at this time because it will depend on levels of share-based payments granted in the future. Statement 123(R) also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as required under current literature. This requirement will reduce net operating cash flows and increase net financing cash flows in periods after adoption.

In December 2004, the FASB issued Statement No. 153, *Exchanges of Nonmonetary Assets*, which eliminates the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. Statement No. 153 will be effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. We do not believe the adoption of Statement No. 153 will have material impact on our results of operations or financial condition.

In May 2005, the FASB issued Statement No. 154, *Accounting Changes and Error Corrections,* which requires retrospective application to prior periods financial statements of a voluntary change in accounting principle and that a change in method of depreciation, amortization, or depletion for long-lived, nonfinancial assets be accounted for as a change in accounting estimate that is effected by a change in accounting principle. Statement No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005.

16. Subsequent Events

On October 20, 2005, we entered into a Product Supplement/Award Letter with Sun Microsystems, Inc. and Sun Microsystems International B.V., collectively, Sun, pursuant to our Product Purchase Agreement with Sun, as amended, or the PPA. This Product Supplement/Award Letter adds certain next generation disk array controller and chassis storage products to the PPA under the product family name SE-3320, which are intended to be successor products to certain disk array and chassis storage products currently available to Sun under the PPA. These new next generation disk array controller and chassis storage products will be designed to be compliant with European Union Directive 2002/95/EC with regard to the restriction on the use of hazardous substances in electrical and electronic equipment.

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

Cautionary Statement for Forward-Looking Information

Certain statements contained in this report, including, statements regarding the development, growth and expansion of our business, our intent, belief or current expectations, primarily with respect to our future operating performance and the products we expect to offer, and other statements regarding matters that are not historical facts, are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, and are subject to the safe harbor created by these sections. 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 can be found under the caption Certain Risk Factors Related to Dot Hill s Business, and elsewhere in this quarterly report on Form 10-Q. Readers are cautioned not to place undue reliance on forward-looking statements. The forward-looking statements speak only as of the date on which they are made, and we undertake no obligation to update such statements to reflect events that occur or circumstances that exist after the date on which they are made.

The following discussion of our financial condition and results of operations should be read in conjunction with our condensed consolidated financial statements and notes thereto included elsewhere in this quarterly report on Form 10-Q and our consolidated financial statements and notes thereto included in our annual report on Form 10-K for the year ended December 31, 2004.

Overview

We are a provider of storage systems for organizations requiring high reliability, high performance networked storage and data management solutions in an open systems architecture. Our storage solutions consist of integrated hardware and software products employing a modular system that allows end-users to add capacity as needed. Our broad range of products, from medium capacity stand-alone storage units to complete turn-key, multi-terabyte storage area networks, provides end-users with a cost-effective means of addressing increasing storage demands without sacrificing performance.

Our products and services are sold worldwide to end-users primarily through our channel partners, including original equipment manufacturers, or OEMs, systems integrators, or SIs, and value added resellers, or VARs. In May 2002, we entered into a product purchase agreement with Sun Microsystems, or Sun, to provide our storage hardware and software products for private label sales by Sun. That agreement has since been extended so that it expires on January 1, 2011 and now provides for automatic renewals for additional one-year periods unless either party notifies the other of its intent not to renew within a certain period of time. We have been shipping our products to Sun for resale to Sun s customers since October 2002. Since the start of the relationship, we have continued to develop new products for resale by Sun and others. Our agreement with Sun was most recently amended in September 2005 to provide for discounts for prompt payment by Sun of amounts due to us and an extended repair warranty for repaired or replacement products that we deliver to Sun. Because of the significance of our relationship with Sun, we are subject to seasonality associated with Sun s business. Typically, sales in the second quarter of our fiscal year reflect the positive impact associated with Sun s fiscal year-end. Conversely, sales in the third quarter of our fiscal year typically reflect the impact of lower Sun first quarter sales compared to the historically stronger sales of Sun s June year-end quarter.

On July 26, 2005, we entered into a Development and OEM Supply Agreement with Network Appliance, Inc. and Network Appliance B.V., collectively, NetApp. Under the Agreement, we will design and develop general purpose disk arrays for a variety of products to be developed for sale to NetApp. We believe that once sales under this agreement increase, which is expected to occur over the next several quarters, our revenue dependence upon Sun will be significantly reduced.

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

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

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

Sales and marketing expenses consist primarily of salaries and commissions, advertising and promotional costs and travel expenses. Research and development expenses consist primarily of project-related expenses and salaries for employees directly engaged in research and development. General and administrative expenses consist primarily of compensation to officers and employees performing administrative functions and expenditures for administrative facilities. Restructuring expenses consist primarily of employee severance, lease termination costs and other office closure expenses related to the consolidation of excess facilities.

Other income is comprised primarily of interest income earned on our cash, cash equivalents, and short-term investments and other miscellaneous income and expense items.

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

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

Critical Accounting Policies and Estimates

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and use judgment that may impact the reported amounts of assets, liabilities, revenues, expenses and related disclosure of contingent assets and liabilities. As a part of our on-going internal processes, we evaluate our estimates, including those related to inventory write-downs, warranty cost accruals, revenue recognition, bad debt allowances, long-lived assets valuation, goodwill and intangible assets valuation, income taxes, including deferred income tax asset valuation, litigation and contingencies. We base these estimates upon both historical information and other assumptions that we believe are valid and reasonable under the circumstances. These assumptions form the basis for making judgments and determining the carrying values of assets and liabilities that are not apparent from other sources. Actual results could vary from those estimates under different assumptions and conditions.

We believe that the policies set forth below may involve a higher degree of judgment and complexity in their application than our other accounting policies and represent the critical accounting policies used in the preparation of our financial statements.

Revenue Recognition

Revenues are recognized pursuant to applicable accounting standards, including Securities and Exchange Commission Staff Accounting Bulletin No. 104, *Revenue Recognition* and Statement of Position No. 97-2, *Software Revenue Recognition* (SOP 97-2).

We recognize revenue for non-software product sales upon transfer of title to the customer. Reductions to revenue for estimated sales returns are also recorded at that time. These estimates are based on historical sales returns, changes in customer demand and other factors. If actual future returns and allowances differ from past experience, additional allowances may be required. Certain of our sales arrangements include multiple elements. Generally, these arrangements include delivery of the product, installation, training and product maintenance. Maintenance related to product sales entitles the customer to basic product support and significantly greater response time in resolving warranty related issues. We allocate revenue to each element of the arrangement based on its relative fair value. For maintenance contracts this is typically the price charged when such contracts are sold separately or renewed. Because professional services related to installation and training can be

provided by other third party organizations, we allocate revenue related to professional services based on rates that are consistent with other like companies providing similar services, i.e., the market rate for such services. Revenue from product maintenance contracts is deferred and recognized ratably over the contract term, generally twelve months. Revenue from installation, training and consulting is recognized as the services are performed.

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

Valuation of Inventories

Inventories are comprised of purchased parts and assemblies, which include direct labor and overhead. We record inventories at the lower of cost or market value, with cost generally determined on a first-in, first-out basis. We perform periodic valuation assessments based on projected sales forecasts and analyzing upcoming changes in future configurations of our products and record inventory write-downs for excess and obsolete inventory. Although we strive to ensure the accuracy of our forecasts, we periodically are faced with uncertainties. The outcomes of these uncertainties are not within our control, and may not be known for prolonged periods of time. Any significant unanticipated changes in demand or technological developments could have a significant impact on the value of our inventories and commitments, and consequently, on our operating results. If actual market conditions become less favorable than those forecasted, additional inventory write-downs might be required, adversely affecting operating results.

Valuation of Goodwill

We review goodwill for impairment annually and whenever events or changes in circumstances indicate the carrying value of an asset may not be recoverable in accordance with SFAS No. 142. The provisions of SFAS No. 142 require that a two-step impairment test be performed on goodwill. In the first step, we compare the fair value of each reporting unit to its carrying value. Our reporting units are consistent with the segments identified in the notes to our consolidated financial statements. We determine the fair value of our reporting units using the income approach. Under the income approach, we calculate the fair value of a reporting unit based on the present value of estimated future cash flows. If the fair value of the reporting unit exceeds the carrying value of the net assets assigned to that unit, goodwill is not impaired and we are not required to perform further testing. If the carrying value of the net assets assigned to the reporting unit exceeds the fair value of the reporting unit, then we must perform the second step in order to determine the implied fair value of the reporting unit s goodwill and compare it to the carrying value of the reporting unit s goodwill. If the carrying value of a reporting unit s goodwill exceeds its implied fair value, then we must record an impairment loss equal to the difference.

The income approach is dependent on a number of factors including estimates of future market growth and trends, forecasted revenue and costs, expected periods the assets will be utilized, appropriate discount rates and other variables. We base our fair value estimates on assumptions we believe to be reasonable, but which are unpredictable and inherently uncertain. Actual future results may differ from those estimates.

Deferred Income Taxes

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. We maintain a full valuation allowance against the deferred tax asset due to uncertainty regarding the future realization based on historical taxable income, projected future taxable income and the expected timing of the reversals of existing temporary differences. If we continue to generate taxable income and ultimately determine that it is more likely than not that all of the remaining deferred tax assets will be utilized to offset future taxable income, the valuation allowance or a portion thereof would be eliminated.

At December 31, 2004, our net deferred tax asset is approximately $50.9 million (including approximately $16.4 million net deferred tax asset acquired in the Chaparral transaction), and we have provided for a valuation allowance against the entire net deferred tax asset. An elimination of the valuation allowance as of December 31, 2004 would have resulted in a decrease to goodwill to the extent of our acquired net deferred tax asset, an increase to equity for net operating losses arising from stock option deductions, with the remaining deferred tax asset decreasing income tax expense, resulting in a one-time, non-cash increase in earnings.

In assessing the realizability of deferred tax assets, we consider whether it is more likely than not that the deferred tax assets will be realized. We consider projected future taxable income, the cumulative three year historical (income) losses, customer contract terms and customer concentrations in making this assessment. We reassess the realizability of deferred tax assets on a periodic basis. At such time as we determine that the recoverability of deferred tax assets is more likely than not, we will release the deferred tax valuation allowance, record an income tax benefit and subsequently record a provision for income taxes for financial statement purposes based on the amount of taxable net income. Although we would experience a substantial temporary decrease to our effective tax rate in the period in which we remove the valuation allowance, our effective tax rate in subsequent periods is likely to more closely resemble the applicable federal and state statutory tax rates.

Results of Operations

The following table sets forth certain items from our statements of operations as a percentage of net revenue for the periods indicated:

	Three Months Ended September 30,		**Nine Months Ended September 30,**	
	2004	**2005**	**2004**	**2005**
Net revenue:	100.0%	100.0%	100.0%	100.0%
Cost of goods sold	74.2	77.0	74.8	76.5
Gross profit	25.8	23.0	25.2	23.5
Operating expenses:				
Sales and marketing	7.0	9.6	7.1	8.4
Research and development	8.5	11.7	7.7	9.2
General and administrative	4.8	5.7	4.2	4.7
Restructuring, net			(0.2)	
In-process research and development			2.7	
Total operating expenses	20.3	27.0	21.5	22.3
Operating income (loss)	5.5	(4.0)	3.7	1.2
Net income (loss)	6.1%	(2.4)%	4.4%	2.3%

Three Months Ended September 30, 2005 Compared to Three Months Ended September 30, 2004

Net Revenue

Net revenue decreased $3.4 million, or 6.0%, to $53.6 million for the three months ended September 30, 2005 from $57.0 million for the three months ended September 30, 2004. The decrease in net revenue was attributable to decreased orders for our products from our channel partner, Sun, which accounted for 86% of our net revenue for the three months ended September 30, 2005. Total Fibre Channel units shipped were 2,522 for the three months ended September 30, 2005 compared to 2,334 units shipped for the three months ended September 30, 2004. Small computer systems interface, or SCSI, units shipped were 2,952 for the three months ended September 30, 2005 compared to 3,489 units for the three months ended September 30, 2004. An offsetting increase in revenue reflects approximately $3.9 million from the sale of our SATA product which began shipping in the second quarter of 2004. SATA units shipped were 728 for the three months ended September 30, 2005 compared to 332 units for the three months ended September 30, 2004. Non-Sun revenue was $7.7 million for the three months ended September 30, 2005 compared to $8.2 million for the three months ended September 30, 2004.

Cost of Goods Sold

Cost of goods sold decreased $1.0 million, or 2.4%, to $41.3 million for the three months ended September 30, 2005 from $42.3 million for the three months ended September 30, 2004. As a percentage of net revenue, cost of goods sold increased to 77.0% for the three months ended September 30, 2005 from 74.2% for the three months ended September 30, 2004. The decrease in the dollar amount of cost of goods sold was attributable to a lower volume of product sales during the quarter ended September 30, 2005 compared to the quarter ended September 30, 2004 offset by incremental cost of goods sold attributable to sales of our SATA product in the third quarter of 2005 and a $0.2 million increase in inventory reserves associated with excess and obsolete inventory. The increase in cost of goods sold, as a percentage of our net revenue is primarily attributable to higher depreciation expense related to the installation of tooling and test equipment at locations in Asia, and an increase of inventory reserves associated with excess and obsolete inventory.

Gross Profit

Gross profit decreased $2.3 million, or 15.6%, to $12.4 million for the three months ended September 30, 2005 from $14.7 million for the three months ended September 30, 2004. As a percentage of net revenue, gross profit decreased to 23.0% for the three months ended September 30, 2005 from 25.8% for the three months ended September 30, 2004. The decrease in the dollar amount of gross profit is attributable to a lower volume of product sales during the three months ended September 30, 2005 compared to the three months ended September 30, 2004. The decrease in gross profit as a percentage of our net revenue for the three months ended September 30, 2005 when compared to the three months ended September 30, 2004 can be attributed, in part, to continued pricing pressures on our mature products, to changes in customers and product mix, and to a lower volume of product sales. Our gross profit margin was also negatively impacted for the three months ended September 30, 2005 by sales of our SATA product that presently has a significantly lower gross profit margin than either our Fibre Channel or SCSI products. We have transitioned the high labor content of our SATA product to locales in Asia and are working to complete the hard tooling of the chassis. We started to realize the benefits of these cost reduction efforts during the second quarter of 2005 and continued to see improvements during the third quarter.

Sales and Marketing Expenses

Sales and marketing expenses increased $1.2 million, or 30.0%, to $5.2 million for the three months ended September 30, 2005 from $4.0 million for the three months ended September 30, 2004. As a percentage of net revenue, sales and marketing expenses increased to 9.6% for the three months ended September 30, 2005 from 7.0% for the three months ended September 30, 2004. The increase in the dollar amount of sales and marketing related expenses is attributable to increased selling expenses associated with developing our domestic OEM and channel customer base. Our increased sales and marketing expenses further reflect the additional sales activities incurred by our European subsidiary as we continue to pursue an increased market share in Europe. The increase in sales and marketing expenses as a percentage of net revenue reflects decreased 2005 revenue. We will continue our efforts to grow our non-OEM commercial sales during 2005. Accordingly, we expect sales and marketing expenses for the year ending December 31, 2005 to exceed spending levels incurred during 2004.

Research and Development Expenses

Research and development expenses increased $1.5 million, or 31.3%, to $6.3 million for the three months ended September 30, 2005 from $4.8 million for the three months ended September 30, 2004. As a percentage of net revenue, research and development expenses increased to 11.7% for the three months ended September 30, 2005 from 8.5% for the three months ended September 30, 2004. The dollar increase in research and development expenses primarily reflects an increase in contract labor, evaluation unit expenses, and the cost of on-going research of approximately $1.4 million for product development related to future product offerings, as well as an increase of $0.1 million for the development of our new controller technology. The percentage increase in research and development expenses reflects the decrease in revenue for the three months ended September 30, 2005. We expect that 2005 research and development expense will exceed amounts incurred during 2004 due to our planned efforts to complete the integration of the technology acquired from Chaparral into our products and research and development activities related to other future product offerings for existing and newly announced customers.

General and Administrative Expenses

General and administrative expenses increased $0.3 million, or 11.1%, to $3.0 million for the three months ended September 30, 2005 from $2.7 million for the three months ended September 30, 2004. As a percentage of revenue, general and administrative expenses increased to 5.7% for the three months ended September 30, 2005 from 4.8% for the three months ended September 30, 2004. The increase in dollar amount of

general and administrative expenses during the three months ended September 30, 2005 compared to the three months ended September 30, 2004 reflects an increase in bad debt expense of $0.5 million which relates to our subsidiaries in Europe, an increase in professional services of $0.1 million associated with our compliance with the Sarbanes-Oxley Act of 2002, and the inclusion of compensation paid to our president, formerly our Chief Technology Officer, that had been classified as research and development expense in the comparable prior period. The increases in general and administrative expenses were partially offset by a decrease to legal expenses of $0.4 million attributable to expected cash receipts from insurance proceeds arising from legal matters described elsewhere in this document, and a decrease in insurance expense of $0.1 million. The percentage increase in general and administrative expenses reflects the decrease in revenue for the three months ended September 30, 2005. We expect general and administrative expenses to increase in 2005 compared to 2004 due to the continuing cost of complying with various corporate governance regulations and the cost of corrective actions we intend to take as a result of such regulations, such as the implementation of a new enterprise resource planning, or ERP, software package.

Other Income (Expense)

Other income (expense) increased by $0.2 million to $0.7 million for the three months ended September 30, 2005 from $0.5 million for the three months ended September 30, 2004. The increase was primarily attributable to an increase in interest income of $0.4 million due to rising interest rates and a decrease in interest expense of approximately $0.1 million as a result of the payoff in August 2004 of a $6 million note payable that was assumed in connection with the acquisition of Chaparral and the repayment and termination of our Japanese credit facilities in the fourth quarter of 2004. The increases in other income were offset by a loss of $0.2 million on foreign currency transactions resulting from a strengthening dollar.

Income Taxes

We recorded an income tax benefit of $0.2 million for the three months ended September 30, 2005. Our effective income tax rate was (13.1)% for the quarter ended September 30, 2005. We currently anticipate an effective income tax rate of approximately 4.3% for the year ended December 31, 2005. Our effective income tax rate is primarily attributable to federal and state minimum tax liabilities as well as local and foreign taxes and was significantly reduced through the use of net operating loss carryforwards for which a valuation allowance had previously been recorded.

As of December 31, 2004, we have federal and state net operating loss carryforwards of approximately $119.1 million and $79.9 million, which begin to expire in 2009 and 2005, respectively. In addition, we have federal tax credit carryforwards of approximately $3.1 million, of which $0.4 million can be carried forward indefinitely to offset future taxable income, and the remaining $2.7 million will begin to expire in 2008. We also have state tax credit carryforwards of $2.9 million, of which $2.7 million can be carried forward indefinitely to offset future taxable income, and the remaining $0.2 million will begin to expire in 2006. We have a full valuation allowance recorded on the net deferred tax asset which was approximately $50.9 million as of December 31, 2004.

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

As a result of our acquisition of Chaparral, an ownership change, within the meaning of IRC Section 382, occurred on February 23, 2004. As a result, annual use of the acquired 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.

Nine Months Ended September 30, 2005 Compared to Nine Months Ended September 30, 2004

Net Revenue

Net revenue increased $3.6 million, or 2.1%, to $177.5 million for the nine months ended September 30, 2005 from $173.9 million for the nine months ended September 30, 2004. The increase in net revenue was attributable to increased orders for our products from our channel partner, Sun, which accounted for 86% of our net revenue for the nine months ended September 30, 2005. Total Fibre Channel units shipped were 8,028 for the nine months ended September 30, 2005 compared to 7,903 units for the nine months ended September 30, 2004. SCSI units shipped were 10,445 for the nine months ended September 30, 2005 compared to 10,426 units for the nine months ended September 30, 2004. The increase in revenue also reflects approximately $12.7 million from the sale of our SATA product which began shipping in the second quarter of 2004. Non-Sun revenue was $24.5 million for the nine months ended September 30, 2005 compared to $24.4 million for the nine months ended September 30, 2004.

Cost of Goods Sold

Cost of goods sold increased $5.6 million, or 4.3%, to $135.7 million for the nine months ended September 30, 2005 from $130.1 million for the nine months ended September 30, 2004. As a percentage of net revenue, cost of goods sold increased to 76.5% for the nine months ended September 30, 2005 from 74.8% for the nine months ended September 30, 2004. The increase in cost of goods sold was attributable to greater volume of product sales during the nine months ended September 30, 2005 compared to the nine months ended September 30, 2004 including

the incremental cost of goods sold attributable to sales of our SATA product for the full nine months of 2005 and a $1.0 million increase in inventory reserves associated with excess and obsolete inventory. The increase in cost of goods sold, as a percentage of our net revenue is primarily attributable to lower than anticipated cost reductions achieved during the nine months ended September 30, 2005 based on the failure to obtain the usual disk drive price reductions due to the industry-wide shortage of disk drives.

Gross Profit

Gross profit decreased $2.0 million, or 4.6%, to $41.8 million for the nine months ended September 30, 2005 from $43.8 million for the nine months ended September 30, 2004. As a percentage of net revenue, gross profit decreased to 23.5% for the nine months ended September 30, 2005 from 25.2% for the nine months ended September 30, 2004. The decrease in the dollar amount of gross profit is attributable to increased costs related to ramping up certain Asian facilities and an increase of inventory reserves associated with excess and obsolete inventory during the nine months ended September 30, 2005 compared to the nine months ended September 30, 2004. The decrease in gross profit as a percentage of our net revenue for the nine months ended September 30, 2005 when compared to the nine months ended September 30, 2004 can be attributed, in part, to continued pricing pressures on our mature products, to changes in customer and product mix, to lower than anticipated sales volume and the failure to obtain the usual disk drive price reductions due to the industry-wide shortage of disk drives. Our gross profit margin was also negatively impacted for the nine months ended September 30, 2005 by sales of our SATA product that presently have a significantly lower gross profit margin than either our Fibre Channel or SCSI products. We have transitioned the high labor content of our SATA product to locales in Asia and are working to complete the hard tooling of the chassis. We started to realize the benefits of these cost reduction efforts during the second quarter. Gross profit margin was also negatively impacted by a full nine months of amortization of finite lived intangible assets acquired in the Chaparral transaction. Amortization of finite lived intangible assets acquired in the Chaparral transaction was $1.6 million for the nine months ended September 30, 2005 compared to $1.4 million for the nine months ended September 30, 2004. The first three quarters of 2004 reflects only seven months of amortization because Chaparral was acquired in late February 2004.

Sales and Marketing Expenses

Sales and marketing expenses increased $2.6 million, or 21.1%, to $14.9 million for the nine months ended September 30, 2005 from $12.3 million for the nine months ended September 30, 2004. As a percentage of net revenue, sales and marketing expenses increased to 8.4% for the nine months ended September 30, 2005 from 7.1% for the nine months ended September 30, 2004. The increase in the dollar amount of sales and marketing expenses is partially attributable to a full nine months of salaries and related expenses for those employees added in connection with our acquisition of Chaparral in late February 2004 compared to seven months for the comparable period of 2004 and the additional sales activities incurred by our European subsidiary as we continue to pursue an increased market share in Europe. Amortization of our customer relationship intangible asset acquired in connection with the acquisition of Chaparral was $0.5 for the nine months ended September 30, 2005 compared to $0.4 million for the nine months ended September 30, 2004. The increase in sales and marketing expenses as a percentage of net revenue is primarily due to our continued efforts to grow our non-OEM commercial sales during 2005. Accordingly, we expect sales and marketing expenses for the year ending December 31, 2005 will exceed spending levels incurred during 2004.

Research and Development Expenses

Research and development expenses increased $2.9 million, or 21.6%, to $16.3 million for the nine months ended September 30, 2005 from $13.4 million for the nine months ended September 30, 2004. As a percentage of net revenue, research and development expenses increased to 9.2% for the nine months ended September 30, 2005 from 7.7% for the nine months ended September 30, 2004. The dollar increase in research and development expenses primarily reflects an increase in salaries, the cost of on-going research and development projects, facility related expenses, and all other expenses associated with our Longmont Technology Center acquired in late February 2004. Costs associated with research and development of new product offerings for the nine months ended September 30, 2005 were $2.6 million as compared to $0.4 million for the nine months ended September 30, 2004. This increase was partially offset by a reduction in costs related to our SATA product of $1.1 million, which was released for sale early in the second quarter of 2004. Total costs attributable to our Longmont Technology Center for the nine months ended September 30, 2005 were approximately $4.2 million compared to approximately $2.8 million for the nine months ended September 30, 2004. This increase reflects a full nine months of activity in the current period compared to seven months in the prior comparable period. The percentage increase in research and development expenses was primarily due to our continued commitment to developing other future product offerings. We expect that 2005 research and development expense will exceed amounts incurred during 2004 due to our planned efforts to complete the integration of the technology acquired from Chaparral into our products for existing and newly announced customers.

General and Administrative Expenses

General and administrative expenses increased $1.1 million, or 15.1%, to $8.4 million for the nine months ended September 30, 2005 from $7.3 million for the nine months ended September 30, 2004. As a percentage of net revenue, general and administrative expenses increased to 4.7% for the nine months ended September 30, 2005 from 4.2% for the nine months ended September 30, 2004. The increase in dollar amount is partially attributable to a full nine months of salaries and related expenses for those employees added in connection with our acquisition of Chaparral in late February 2004 compared to seven months for the nine months ended September 30, 2004, and increase in bad debt expense of $1.1 million which relates to our subsidiaries in Europe, and the inclusion in the first nine months of 2005 of compensation paid to our president, formerly our Chief Technology Officer, that had been classified as research and development expense in the comparable prior period. Additionally, we paid approximately $0.1 million to the former managing director of our Japanese subsidiary upon his retirement in March 2005. We also incurred $0.5 million in increased expenses related to the cost of our compliance with the Sarbanes-Oxley Act of 2002 for the nine months ended September 30, 2005 compared to the nine months ended September 30, 2004. The increases in general and administrative expense were partially offset by a decrease of $0.2 million in lower insurance expense and a decrease in legal expenses of $0.8 million. The percentage increase in general and administrative expenses was primarily due to the charges mentioned above. We expect general and administrative expenses to increase in 2005 compared to 2004 due to the continuing cost of complying with various corporate governance regulations and the cost of corrective actions we intend to take as a result of such regulations, such as the implementation of a new ERP software package.

Restructuring Expenses

In June 2004, we negotiated an exit from our lease of the 10th floor of our former New York City office thereby eliminating our related rent exposure. Accordingly, during the three months ended June 30, 2004, we recorded a reduction of approximately $0.5 million to our restructuring reserve previously established in connection with the closure of our New York City office. Additionally, we evaluated certain factors pertaining to our remaining sublease tenant; accordingly, during the three months ended June 30, 2004, we recorded an additional restructuring accrual of approximately $0.1 million. There were no similar charges for the nine months ended September 30, 2005.

In-Process Research and Development Charges

Projects that qualify as in-process research and development represent those that have not yet reached technological feasibility and for which no future alternative uses exist. Technological feasibility is defined as being equivalent to a beta-phase working prototype in which there is no remaining risk relating to the development. For the nine months ended September 30, 2004 we recorded an IPR&D charge of $4.7 million, in connection with the acquisition of Chaparral. There were no similar charges for the nine months ended September 30, 2005.

Other Income (Expense)

Other income (expense) increased by $0.8 million to $2.1 million for the nine months ended September 30, 2005 from $1.3 million for the nine months ended September 30, 2004. The increase was primarily attributable to an increase in interest income of $0.8 million due to rising interest rates and a decrease in interest expense of approximately $0.3 million as a result of the payoff in August 2004 of a $6 million note payable that was assumed in connection with the acquisition of Chaparral and the repayment and termination of our Japanese credit facilities in the fourth quarter of 2004. The increases in other income were offset by a loss of $0.4 million on foreign currency transactions resulting from a strengthening dollar.

Income Taxes

We recorded an income tax expense of $0.1 million for the nine months ended September 30, 2005 which includes the receipt by our European subsidiary of $0.2 million from European taxing authorities related to a 2002 loss that was carried back to the years 1998 through 2001. Excluding the impact of the loss carryback, our effective income tax rate was 7.0% for the nine months ended September 30, 2005 and is primarily attributable to federal and state minimum tax liabilities as well as local and foreign taxes. Our effective income tax rate for the nine months ended September 30, 2005 was significantly reduced through the use of net operating loss carryforwards for which a valuation allowance had previously been recorded.

As of December 31, 2004, we have federal and state net operating loss carryforwards of approximately $119.1 million and $79.9 million, which begin to expire in 2009 and 2005, respectively. In addition, we have federal tax credit carryforwards of approximately $3.1 million, of which $0.4 million can be carried forward indefinitely to offset future taxable income, and the remaining $2.7 million will begin to expire in 2008. We also have state tax credit carryforwards of $2.9 million, of which $2.7 million can be carried forward indefinitely to offset future taxable income, and the remaining $0.2 million will begin to expire in 2006. We have a full valuation allowance recorded on the net deferred tax asset which was approximately $50.9 million as of December 31, 2004.

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 Systems Corp. immediately before the ownership change multiplied by (ii) the long-term tax-exempt rate (within the meaning of IRC Section 382 (f)) in effect at that time. The annual limitation is cumulative and, therefore, if not fully utilized in a year, can be utilized in future years in addition to the Section 382 limitation for those years.

As a result of our acquisition of Chaparral, an ownership change, within the meaning of IRC Section 382, occurred on February 23, 2004. As a result, annual use of the acquired 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.

Liquidity and Capital Resources

As of September 30, 2005, we had $123.3 million of cash, cash equivalents and short-term investments. We had $132.8 million of working capital as of September 30, 2005.

For the nine months ended September 30, 2005, cash used in operating activities was $1.9 million compared to cash provided by operating activities of $0.2 million for the same period in 2004. The net cash used in operating activities for the nine months ended September 30, 2005 is primarily attributable to net income of $4.1 million, depreciation and amortization of $6.0 million, a $0.5 million loss on disposal of property and equipment, a decrease in inventory of approximately $0.8 million that reflects our efforts to better manage the materials portion of our business, an increase to our provision for doubtful accounts of $1.0 million which is primarily attributable to our subsidiaries in Europe, and a decrease in accounts receivable of $4.3 million, directly resulting from a decrease in sales volume from Sun during September 2005 compared to September 2004. These amounts were offset by a decrease in accounts payable of $17.2 million that reflects the implementation of our new payment terms with Solectron, an increase in prepaids and other assets of $1.1 million primarily attributed to a $0.5 million increase in vendor rebates and a $0.4 million increase in insurance receivables, an increase in deferred revenue of $0.7 million which reflects product shipments to customers where all the conditions for revenue recognition have not been met and a decrease in accrued compensation and expenses of $0.7 million primarily related to the payment of management bonuses. In April 2005, we amended our manufacturing agreement with Solectron to provide for a change to the original payment terms. The new payment terms establish a payment due date for a given validly submitted invoice based on the delivery date of the product in relationship to an established series of reconciliation dates. Under the new terms, the due date for a given payment will always fall on the next reconciliation date which can range from five days to approximately ninety days after the date of the applicable invoice. We expect that the average payment term with our third party manufacturer will now closely resemble the payment terms we have established with our largest customer.

Cash provided by investing activities for the nine months ended September 30, 2005 was $22.4 million compared to cash used in investing activities of $79.2 million for the same period in 2004. This fluctuation is primarily the result of our acquisition of Chaparral that was completed in February 2004. During the nine months ended September 30, 2005, certain of our short term investments matured resulting in the sale of these instruments of $50.6 million, offset by the reinvested proceeds of $25.2 million. We also made capital expenditures of $3.0 million during the nine months ended September 30, 2005 primarily to support new product development.

Cash provided by financing activities for the nine months ended September 30, 2005 was $1.8 million compared to cash used in financing activities of $6.1 million for the nine months ended September 30, 2004. The cash provided by financing activities is attributable to exercises of stock options under our 2000 Stock Incentive Plan of $0.7 million and proceeds from the sale of common stock to employees under our employee stock purchase plan of approximately $1.0 million. We did not incur any borrowings under our line of credit and do not anticipate the

need for such borrowing in the foreseeable future.

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

During September 2005, we entered into a lease agreement to occupy approximately 58,500 square feet of office space that will serve as a replacement for our current headquarters. The 88 month lease term will commence in January 2006. Upon the expiration of the initial term, we are entitled to two five-year renewal options.

Future minimum lease payments due under all noncancelable operating leases as of September 30, 2005 are as follows (in thousands):

Years ended December 31,		
2005 (remaining 3 months)	$	473
2006		1,760
2007		1,653
2008		1,111
2009		1,076
2010		1,025
Thereafter		2,502
Total minimum lease payments	$	9,600

The above minimum lease payments include minimum rental commitments totaling $0.2 million that have been included in the restructuring accrual as of September 30, 2005. Minimum payments for operating leases have not been reduced by minimum sublease rentals of $0.9 million due in the future under non-cancelable subleases.

The lease associated with our current headquarters will expire December 31, 2005. We plan on relocating to our new corporate headquarters during the first quarter of 2006. The minimum lease payment table above reflects all remaining payments due under our current corporate headquarter lease.

Recent Accounting Pronouncements

In March 2004, the Financial Accounting Standards Board, or FASB, issued EITF Issue No. 03-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments,* which provides new guidance for assessing impairment losses on debt and equity investments. Additionally, EITF Issue No. 03-1 includes new disclosure requirements for investments that are deemed to be temporarily impaired. In September 2004, the FASB delayed the accounting provisions of EITF Issue No. 03-1; however, the disclosure requirements remain effective and have been adopted for our year ended December 31, 2004. We will evaluate the effect, if any, of EITF 03-1 when final guidance is released.

On November 24, 2004, the FASB issued Statement No. 151, *Inventory Costs*, an Amendment of ARB No. 43, Chapter 4, to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material. This Statement is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. We have not completed the process of evaluating the impact that the adoption of Statement 151 will have on our financial position or results of operations.

In December 2004, FASB issued SFAS No. 123 (revised 2004), *Share-Based Payment* (SFAS No. 123(R)), which amends SFAS No. 123, *Accounting for Stock-Based Compensation*, supercedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and amends SFAS

No. 95, *Statement of Cash Flows*. SFAS No. 123(R) requires companies to measure all employee stock-based compensation awards using a fair value method and record such expense in its consolidated financial statements. In addition, the adoption of SFAS No. 123(R) requires additional accounting and disclosure related to the income tax and cash flow effects resulting from share-based payment arrangements. SFAS No. 123(R) is effective beginning as of the first annual reporting period beginning after June 15, 2005. As permitted by SFAS No. 123, the Company currently accounts for share-based payments to employees using APB Opinion No. 25 s intrinsic value method and, as such, generally recognizes no compensation cost for employee stock options. Accordingly, the adoption of SFAS No. 123(R) s fair value method will have a significant impact on our result of operations, although it will have no impact on our overall financial position. The impact of adoption of SFAS 123(R) cannot be predicted at this time because it will depend on levels of share-based payments granted in the future. SFAS 123(R) also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as required under current literature. This requirement will reduce net operating cash flows and increase net financing cash flows in periods after adoption.

In December 2004, the FASB issued Statement No. 153, *Exchanges of Nonmonetary Assets*, which eliminates the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. Statement No. 153 will be effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. We do not believe the adoption of Statement No. 153 will have material impact on our results of operations or financial condition.

In May 2005, the FASB issued Statement No. 154, *Accounting Changes and Error Corrections,* which requires retrospective application to prior periods financial statements of a voluntary change in accounting principle and that a change in method of depreciation, amortization, or depletion for long-lived, nonfinancial assets be accounted for as a change in accounting estimate that is effected by a change in accounting principle. Statement No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005.

Certain Risk Factors Related to Dot Hill s Business

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

Under our OEM agreements with Sun, NetApp and others, our customers are not required to make minimum purchases or purchase exclusively from us, and we cannot assure you that our relationship with these key customers will not be terminated or will generate significant sales.

Our business is highly dependent on our relationship with Sun, and we believe will be dependent, in the future, on our relationship with NetApp once sales to that customer begin to increase. Sales to Sun accounted for 86.3% and 86.2% of our net revenue for the year ended December 31, 2004, and the nine months ended September 30, 2005, respectively. There are no minimum purchase requirements or guarantees in our agreement with Sun or NetApp, the agreements do not obligate those customers to purchase storage solutions exclusively from us on a continual basis and either customer may cancel purchase orders submitted under the agreement at any time. Further, either customer may terminate the entire contract prior to the contract expiration date upon the occurrence of certain events that are not remedied within a specified cure period. The decision by these customers to terminate their respective contracts, to cease making purchases or to cancel purchase orders would cause our revenues to decline substantially. We cannot be certain if, when or to what extent any customer might cancel purchase orders, cease making purchases or elect not to renew the applicable contract upon the expiration of the current term. We expect to receive a substantial majority of our projected net revenue for the year ended December 31, 2005 from sales of our products to Sun, and a substantial majority of our projected net revenue for the year 2006 from a combination of sales to Sun and NetApp. We cannot assure you that we will achieve these expected sales levels. If we do not achieve the sales levels we expect to receive from these customers, our business and result of operations will be significantly harmed.

Any decline in Sun s or NetApp s sales could harm our business.

A substantial majority of our revenues are generated by sales to Sun, and we expect a substantial majority of our future revenue to be generated by a combination of sales to Sun and NetApp. If Sun s or NetApp s storage-related sales decline, our revenues will also decline and our business could be materially harmed. In addition, Sun s quarterly operating results typically fluctuate downward in the first quarter of their fiscal year

when compared with the immediately preceding fourth quarter. Further, in June 2005, Sun acquired Storage Technologies, Inc., or StorageTek, which is a fellow provider of storage systems. While we do not currently believe that Engenio s relationship with Sun or Sun s acquisition of StorageTek will impact our sales or our relationship with Sun, we cannot predict with certainty the impact that these circumstances will have, if any, on our future sales to Sun.

In addition, it is likely that NetApp s sales of any storage products supplied to it by us will fluctuate on a quarterly or seasonal basis, which fluctuations will effect our financial results. Due to the infancy of the relationship, we can not be certain of what affect these fluctuations will have on our quarterly results, if any.

Lower than anticipated sales to NetApp could harm our business and render our expectations inaccurate, which could lead to a decrease in our stock price.

During the third quarter of 2005, we entered into a Development and OEM Supply Agreement with NetApp by which we will design and develop general purpose disk arrays for a variety of products to be developed for sale to NetApp. We expect that sales to NetApp will increase, and have predicted that in the future, sales to NetApp will reduce our dependence upon Sun significantly and increase our revenue substantially. There are no guarantees that our relationship with NetApp will be successful, or that we will achieve the expected volume of sales to NetApp. Our agreement with NetApp does not provide for minimum purchase quantities, and allows for NetApp to terminate the contract or stop purchasing from us. If our sales to NetApp are not as expected, our results will fall substantially short of our predictions and, to the extent that our current stock price reflects anticipated increases in our revenue or profits based on sales to NetApp, our stock price likely will fall.

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

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

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

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

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

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

Our business and operating results may suffer if we encounter significant product defects due to the introduction of our new, integrated systems.

We completed the integration of RAID controller technology we obtained in our acquisition of Chaparral into certain of our storage systems resulting in the introduction of new, integrated systems.

Our new, integrated systems, as well as our old products, may contain undetected errors or failures, which may be discovered after shipment, resulting in a loss of revenue or a loss or delay in market acceptance, which could harm our business. Even if the errors are detected before shipment, such errors could result in the halting of production, the delay of shipments, loss of good will, tarnishment of reputation or a substantial decrease in 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. Significant warranty costs, particularly those that exceed reserves, could adversely impact our business. In addition, defects in our products could result in our customers claiming property damages, consequential damages, personal injury or even death, which could also result in our loss of customers and goodwill. Any such claim could distract management s attention from operating our business and, if successful, result in damage claims against us that might not be covered by our insurance.

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

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

From time to time there is significant market demand for disk drives, RAID controllers and other components, and

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

Manufacturing disruptions could harm our business.

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

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

Any shortage of disk drives 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.

Demand for disk drives recently surpassed supply, forcing drive manufacturers, including those who supply the disk drives integrated into many of our storage products, to manage allocation of their inventory. If this shortage is prolonged, we may be forced to pay higher prices for disk drives or may be unable to purchase sufficient quantities of disk drives to meet our customers demand for our storage products in a timely manner or at all. Similar circumstances could occur with respect to other necessary components.

We may experience losses in the future.

In 2004 and 2003, we recorded net income of $11.6 million and $12.1 million respectively; however, for the third quarter of 2005, and for the years ended December 31, 2002 and 2001, we incurred net losses of $1.3 million, $34.3 million and $43.4 million respectively. Further, our latest forecast predicts that we will incur a loss during our fourth quarter of 2005, fueled, in part, by an increased investment in research and development related to our efforts to complete the integration of the technology acquired from Chaparral into our products, and the implementation of a new ERP software package. We cannot assure you that we will be profitable in any future period. Our future capital requirements will depend on, and could increase substantially as a result of, many factors, including:

- our plans to maintain and enhance our engineering, research, development and product testing programs;

the success of our manufacturing strategy;

the success of our sales and marketing efforts;

the extent and terms of any development, marketing or other arrangements;

changes in economic, regulatory or competitive conditions; and

costs of filing, prosecuting, defending and enforcing intellectual property rights.

Our available cash, cash equivalents and short-term investments as of September 30, 2005 totaled $123.3 million. We presently expect cash, cash equivalents, short-term investments and cash generated from operations to be sufficient to meet our operating and capital requirements through at least the next twelve months. However, unanticipated events, such as Sun s or NetApp s failure to meet its product purchase forecast or extraordinary expenses or operating expenses in excess of our projections, may require us to raise additional funds. We may not be able to raise additional funds on commercially reasonable terms or at all. Any sales of our debt or equity securities in the future may have a substantial dilutive effect on our existing stockholders. If we are able to borrow funds, we may be required to grant liens on our assets to the provider of any source of financing or enter into operating; debt service or working capital covenants with any provider of financing that could hinder our ability to operate our business in accordance with our plans. As a result, our ability to borrow money on a secured basis may be impaired, and we may not be able to issue secured debt on commercially reasonable terms or at all.

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

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

Quarter	Net Revenue	Net Income (Loss)
	(in millions)	
First Quarter 2001	$ 18.6	$ (28.7)
Second Quarter 2001	14.9	(5.7)
Third Quarter 2001	12.3	(3.3)
Fourth Quarter 2001	10.5	(5.7)
First Quarter 2002	10.9	(6.2)
Second Quarter 2002	11.2	(8.9)
Third Quarter 2002	8.6	(7.3)
Fourth Quarter 2002	16.3	(11.9)
First Quarter 2003	30.5	(1.5)
Second Quarter 2003	48.4	2.6
Third Quarter 2003	51.0	4.3
Fourth Quarter 2003	57.5	6.7
First Quarter 2004	47.9	(2.6)
Second Quarter 2004	69.0	6.7
Third Quarter 2004	57.0	3.5
Fourth Quarter 2004	65.5	4.0
First Quarter 2005	58.0	2.1
Second Quarter 2005	65.9	3.3
Third Quarter 2005	53.6	(1.3)

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

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

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

the size, timing, cancellation or rescheduling of significant orders;

the cost of litigation and settlements involving intellectual property and other issues;

product configuration, mix and quality issues;

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

manufacturing costs;

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

changes in pricing by us or our competitors;

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

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

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

the level of competition;

potential reductions in inventories held by channel partners;

slowing sales of the products of our channel partners;

technological changes in the open systems storage market;

levels of expenditures on research, engineering and product development;

changes in our business strategies;

personnel changes; and

general economic trends and other factors.

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

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

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

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

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

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

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

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

Pricing pressures exist in the data storage market and have harmed and may in the future continue to harm our net revenue and earnings. These pricing pressures are due, in part, to continuing decreases in component prices, such as those of disks and RAID controllers. Decreases in component prices are customarily passed on to customers by storage companies through a continuing decrease in price of storage hardware systems. In addition, because we expect to continue to make most of our sales to a small number of customers, we are subject to continued

pricing pressures from our customers, particularly our OEM customers. Pricing pressures are also due, in part, to the current difficult economic conditions, which have led many companies in our industry to pursue a strategy of decreasing prices in order to win sales, the narrowing of functional differences among competitors, which forces companies to compete on price as opposed to features of products, and the introduction of new technologies, which leaves older technology more vulnerable to pricing pressures. To the extent we are unable to offset those pressures with commensurate cost reductions from our suppliers or by providing new products and features, our margins will be harmed.

Our success depends significantly upon our ability to protect our intellectual property and to avoid infringing the intellectual property of third parties, which 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. For example, we have registered trademarks for SANnet, SANpath, SANscape, Stratis, Dot Hill and the Dot Hill logo. Despite our efforts to protect our intellectual property, unauthorized parties may attempt to copy aspects of our products or obtain and use information that we regard as proprietary. In addition, the laws of foreign countries may not adequately protect our intellectual property rights. Our efforts to protect our intellectual property from third party discovery and infringement may be insufficient and third parties may independently develop technologies similar to ours, duplicate our products or design around our patents.

On October 17, 2003, Crossroads Systems, or Crossroads, filed a lawsuit against us in the United States District Court in Austin, Texas alleging that our products infringe two United States patents assigned to Crossroads, Patent Numbers 5,941,972 and 6,425,035. We were served with the lawsuit on October 27, 2003. In March 2004, Chaparral was added as a party to the lawsuit. The patents involve storage routers and methods for providing virtual local storage. Patent Number 5,941,972 involves the interface of SCSI storage devices and the Fibre Channel protocol and Patent Number 6,425,035 involves the interface of any one-transport medium and a second transport medium. We believe that we have meritorious defenses to Crossroads claims and intend to vigorously defend against them. We have already incurred, and expect to continue to incur, significant legal expenses in connection with this litigation. These defense costs, and other expenses related to this litigation, will be expensed as incurred and will negatively affect our future operating results. If we are not successful in our defense of Crossroads claims, we may be required to pay significant amounts in the form of damages for past infringement. We also could be required to pay significant amounts in the form of licensing fees to allow us to continue to market certain products in the future, or Crossroads may deny us a license, which could lead to our inability to market certain products at all. Further, other third parties may assert additional infringement claims against us in the future, which would similarly require us to incur substantial license fees, legal fees and other expenses, and distract management from the operations of our business.

We expect that providers of storage products will increasingly be subject to infringement claims as the number of products and competitors increases. In addition to the formal claims brought against us by Crossroads, we receive, from time to time, letters from third parties suggesting that we may require a license from such third parties to manufacture or sell our products. We evaluate all such communications to assess whether to seek a license from the patent owner. We may 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 marketing products that incorporate the protected technology or incur substantial costs to redesign our products in a manner to avoid infringement of third party intellectual property rights.

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

The storage market is intensely competitive and is characterized by rapidly changing technology. We compete primarily against independent storage system suppliers, including EMC Corp., Hitachi Data Systems Corp., Engenio Information Technologies, Inc., Adaptec, Inc. and Xyratex Ltd.

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

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

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We also expect that competition will increase as a result of industry consolidation and the creation of companies with new, innovative product offerings. For example, on June 2, 2005, Sun purchased StorageTek. Current and potential competitors have established or may establish cooperative relationships among themselves or with third parties to increase the ability of their products to address the needs of our prospective customers. Accordingly, it is possible that new competitors or alliances among competitors may emerge and rapidly acquire significant market share. Increased competition is likely to result in price reductions, reduced operating margins and potential loss of market share, any of which could harm our business. We believe that the principal competitive factors affecting the storage systems market include:

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

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

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

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

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

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

if net revenue does not meet our projections, operating results may be negatively affected. We may experience shortfalls in net revenue for various reasons, including:

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

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

the reduction, rescheduling or cancellation of customer orders.

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

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

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

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

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

As of September 30, 2005, our executive officers, directors and their affiliates beneficially owned approximately 9.9% of our outstanding shares of common stock. These individual stockholders may be able to influence matters requiring approval by our stockholders, including the election of a majority of our directors. The voting power of these stockholders under certain circumstances could have the effect of delaying or preventing a change in control of us. This concentration of ownership may also make it more difficult or expensive for us to obtain financing. Further, any substantial sale of shares by these individuals could depress the market price of our common stock and impair our ability to raise capital in the future through the sale of our equity securities.

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

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

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

Dilution of the per share value of our common stock could result from the exercise of outstanding warrants. As of September 30, 2005 there were outstanding warrants to purchase 1,966,849 shares of our common stock. The warrants have exercise prices ranging from $2.97 to $4.50 per share and expire at various dates through March 14, 2008. When the exercise price of the warrants is less than the trading price of our common stock, exercise of the warrants would have a dilutive effect on our stockholders. The possibility of the issuance of shares of our common stock upon exercise of the warrants could cause the trading price of our common stock to decline.

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

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

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

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

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

minimizing the diversion of management attention from ongoing business concerns;

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

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

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

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

The trading price of our shares of common stock has been affected by the factors disclosed in this section as well as prevailing economic and financial trends and conditions in the public securities markets. Share prices of companies in technology-related industries, such as ours, tend to exhibit a high degree of volatility. The announcement of financial results that fall short of the results anticipated by the public markets could have an immediate and significant negative effect on the trading price of our shares in any given period. Such shortfalls may result from events that are beyond our immediate control, can be unpredictable and, since a significant proportion of our sales during each fiscal quarter tend to

occur in the latter stages of the quarter, may not be discernible until the end of a financial reporting period. These factors may contribute to the volatility of the trading value of our shares regardless of our long-term prospects. The trading price of our shares may also be affected by developments, including reported financial results and fluctuations in trading prices of the shares of other publicly held companies, in our industry generally and our business segment in particular, which may not have any direct relationship with our business or prospects.

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

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

A substantial number of shares of our common stock may become available for resale. If our stockholders sell substantial amounts of our common stock in the public market, the market price of our common stock could decline. These sales might also make it more difficult for us to sell equity securities in the future at times and prices that we deem appropriate. In addition, we are obligated to file a registration statement with respect to the resale of up to 1,394,269 shares of our common stock issuable upon exercise of warrants held by Sun.

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

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

Compliance with Sarbanes-Oxley Act of 2002.

We are exposed to significant costs and risks associated with complying with increasingly stringent and complex regulation of corporate governance and disclosure standards. Changing laws, regulations and standards relating to corporate governance and public disclosure, including the Sarbanes-Oxley Act of 2002, new SEC regulations and Nasdaq Stock Market rules require growing expenditure of management time and external resources. In particular, Section 404 of the Sarbanes-Oxley Act of 2002 requires management s annual review and evaluation of our internal controls, and attestations of the effectiveness of our internal controls by our independent auditors. This process has required us to hire additional personnel and outside advisory services and has resulted in significant accounting and legal expenses. We expect to continue to incur significant expense in future periods to comply with regulations pertaining to corporate governance as described above.

If we fail to maintain effective internal control over financial reporting, we may be required to make additional public disclosures related to our internal control deficiencies and our management may not be able to conclude that our internal control over financial reporting is effective for the year ending December 31, 2005.

We have documented and tested our internal control systems and procedures for the year ended December 31, 2004. Based on our evaluation we have identified internal control deficiencies that constitute material weaknesses relating to our financial closing process, inventory processing and processing related to fixed assets. Accordingly, management has concluded that our internal control over financial reporting was not effective as of December 31, 2004. If we encounter problems or delays in the implementation of improvements and corrective measures, we may be required to make further disclosures about internal control deficiencies and/or material weaknesses and investor perceptions of our company may be adversely affected, which could cause a decline in the market price of our stock.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Interest Rate and Credit Risk

Our exposure to market rate risk for changes in interest rates relates to our investment portfolio. Our primary investment strategy is to preserve the principal amounts invested, maximize investment yields, and maintain liquidity to meet projected cash requirements. Accordingly, we invest in instruments such as money market funds, certificates of deposit, U.S. Government/Agencies bonds, notes, bills and municipal bonds that meet high credit quality standards, as specified in our investment policy guidelines. Our investment policy also limits the amount of credit exposure to any one issue, issuer, and type of instrument. We do not currently use derivative financial instruments in our investment portfolio and we do not enter into market risk sensitive instruments for trading purposes. We do not expect to incur any material losses with respect to our investment portfolio.

The following table provides information about our investment portfolio at December 31, 2004 and September 30, 2005. For investment securities, the table presents carrying values at December 31, 2004 and September 30, 2005 and, as applicable, and related weighted average interest rates by expected maturity dates.

	December 31, 2004		September 30, 2005	
	(amounts in thousands)			
Cash equivalents	$	43,438	$	68,859
Average interest rate		2.3%		3.8%
Short-term investments	$	58,690	$	33,293
Average interest rate		2.2%		2.7%
Total portfolio	$	102,128	$	102,152
Average interest rate		2.2%		3.4%

We have a line of credit agreement, which accrues interest at a variable rate. As of September 30, 2005, we had no balance under this line. Were we to incur a balance under this line of credit, we would be exposed to interest rate risk on such debt.

Foreign Currency Exchange Rate Risk

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

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

We conducted an evaluation, under the supervision and with the participation of our chief executive officer and chief financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in the Securities Exchange Act of 1934 Rules 13a-15(e) and 15d-15(e)), as of September 30, 2005. Based upon that evaluation, the chief executive officer and the chief financial officer concluded that there were no significant changes in our disclosure controls and procedures as of the end of the period covered by this report (and therefore these disclosure controls and procedures were not effective since material weaknesses were discovered in our financial reporting controls as of December 31, 2004).

Internal Controls Over Financial Reporting

We have identified a material weakness related to the design and operating effectiveness of our period-end financial close and reporting process, resulting from (i) an inadequate number of accounting and finance personnel with sufficient technical expertise in the area of accounting principles generally accepted in the United States of America, or U.S. GAAP, and financial reporting, at both the corporate headquarters and foreign subsidiaries, (ii) our failure to sufficiently document our accounting policies, practices and procedures, and (iii) a lack of a sufficiently robust review of the period-end financial information to detect misstatements on a timely basis. These control deficiencies resulted in the restatement of previously issued interim financial statements to correct errors principally affecting sales, cost of goods sold, operating expenses and accounts receivable, as described further in the restated financial statements included in the amended Form 10-Qs for the quarters ending March 31, 2004, June 30, 2004 and September 30, 2004. Additionally, numerous adjustments that were not individually material to the financial statements, but which affected various financial statement line items, were necessary to present the annual financial statements for the year ended December 31, 2004 in accordance with U.S. GAAP. Due to the significance of the actual misstatements identified and the potential for further misstatement, and the significance of the financial closing and reporting process to the preparation of reliable financial statements, there is a more than remote likelihood that a material misstatement of the interim and annual financial statements would not have been prevented or detected.

We have identified a material weakness related to the ineffectiveness of internal controls over inventory and cost of goods sold. Various controls related to timely and accurate processing and recording of inventory-related transactions failed to operate effectively and as a result adjustments were recorded to inventory and cost of goods sold. Although these adjustments were not material to the interim and annual financial statements, the financial statements could have been materially misstated as a result of the control deficiencies. The deficiencies were concluded to be a material weakness based on the significance of the potential misstatement of the annual and interim financial statements, the significance of the controls over inventory to the preparation of reliable financial statements, and the absence of other mitigating controls to detect the adjustments.

We have identified a material weakness related to the operating effectiveness of internal controls over fixed assets related to the safeguarding and accounting for fixed assets which include (i) inadequate documentation within the fixed asset accounting system to assist in the identification and location of certain fixed assets, (ii) failure to apply identification tags to fixed assets located outside of the corporate headquarters and, (iii) failure to properly apply its accounting policies, practices and procedures pertaining to the categorization of certain expenditures as fixed assets. Based on the significance of the potential misstatement that could result due to the deficient controls over the safeguarding and accounting for fixed assets and the absence of other mitigating controls, there is a more than remote likelihood that a material misstatement of the interim and annual financial statements would not have been prevented or detected.

In order to address the material weaknesses identified above, we have undertaken the following corrective measures:

The sole certified public accountant on our finance department staff submitted his resignation, effective May 26, 2005. We have since hired a replacement who has been added to our senior managerial staff and added two additional certified public accountants to the finance department. We actively continue to strengthen our accounting and financial reporting functions and continue to recruit for additional certified public accountants with recent relevant experience. We have already hired a senior finance director for our subsidiary in Japan and added additional accounting resources to our subsidiary in the Netherlands. We also intend to hire additional clerical staff in the areas of accounts payable and general accounting and other staff in various areas of the company, including but not limited to, financial planning and analysis, order entry and materials management. We believe the addition of these individuals will allow us to perform and review the necessary internal control activities pertaining to our financial closing and reporting process on a timely basis and to complete the documentation of our accounting policies and procedures during 2005.

We are in the process of implementing a new ERP software package. We have hired consultants to assist management with various aspects of the implementation process. In April 2005, our Board of Directors approved and directed us to proceed with the project. Although there can be no assurances to timeframe and costs, we presently believe the new ERP system will be operational beginning January 2006. We believe the implementation of a new ERP system will improve our internal control over financial reporting by increasing the availability of data used in the financial closing process and through simplifying our current closing process by decreasing the amount of manual processes currently required by our current system. We believe our internal control over inventory processing will also be improved for the same reasons. Until the new ERP system is fully operational, we intend on increasing the management review processes related to our financial closing and inventory processes through the addition of the individuals described above.

We are in the process of initiating improvement in the controls over the processing of fixed assets. Such improvements consist of revised documentation and additional review of the authorization and accounting treatment related to the acquisition of fixed assets. We have also started the process of improving our ability to better identify and track our fixed assets by implementing controls over self constructed assets and we intend to assign asset identification tags to all of our assets located outside of our corporate headquarters.

Changes in Internal Controls

During the nine months ended September 30, 2005, we began the process of reviewing the gross margin related to each sales order for reasonableness. This review is performed by two independent members of our finance department. The purpose of this review is to identify unusual margins that might be the result an error in data input. Except as described above, there has been no change in our internal control over financial reporting that occurred during the quarter covered by this Periodic Report on Form 10-Q that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Part II. Other Information

Item 1. Legal Proceedings

Crossroads Systems On October 17, 2003, Crossroads Systems, or Crossroads, filed a lawsuit against us in the United States District Court in Austin, Texas alleging that our products infringe two United States patents assigned to Crossroads, Patent Numbers 5,941,972 and 6,425,035. We were served with the lawsuit on October 27, 2003. In March 2004, Chaparral was added as a party to the lawsuit. The patents involve storage routers and methods for providing virtual local storage. Patent Number 5,941,972 involves the interface of SCSI storage devices and the Fibre Channel protocol and Patent Number 6,425,035 involves the interface of any one-transport medium and a second transport medium. We believe that we have meritorious defenses to Crossroads claims and intend to vigorously defend against them. We have already incurred, and expect to continue to incur, significant legal expenses in connection with this litigation. These defense costs, and other expenses related to this litigation, will be expensed as incurred and will negatively affect our future operating results. If we are not successful in our defense of Crossroads claims, we may be required to pay significant amounts in the form of damages for past infringement. We also could be required to pay significant amounts in the form of licensing fees to allow us to continue to market certain products in the future, or Crossroads may deny us a license, which could lead to our inability to market certain products at all. Further, other third parties may assert additional infringement claims against us in the future, which would similarly require us to incur substantial license fees, legal fees and other expenses, and distract management from the operations of our business. The outcome is uncertain and no amounts have been accrued as of September 30, 2005.

Securities Class Action In August 2004, a class action lawsuit was filed against, among others, Chaparral and a number of former officers and directors of Chaparral in the United States District Court for the Central District of California. The lawsuit, among other things, alleges violations of federal securities laws and purports to seek damages on behalf of a class of shareholders who held interests in limited liability companies that had purchased, among other securities, Chaparral stock during a defined period prior to our acquisition of Chaparral. In May 2005, the Second Amended Complaint was dismissed with leave to amend. Plaintiffs filed a Third Amended Complaint, which Chaparral and other defendants are again moving to dismiss. We believe that the claims against Chaparral and its former officers and directors are without merit and are in the process of vigorously defending against them. The outcome is uncertain and no amounts have been accrued as of September 30, 2005.

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

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

None.

Item 3. Defaults Upon Senior Securities

None.

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

None.

Item 5. Other Information

None.

Item 6. Exhibits

a. List of Exhibits

Exhibit Number	Description
10.1	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 (filed as an exhibit to our Current Report on Form 8-K filed on September 21, 2005 and incorporated herein by reference).
10.2	Fourth Amendment to Product Purchase Agreement, dated as of September 26, 2005, by and among Sun Microsystems, Inc., Sun Microsystems International B.V., Dot Hill Systems Corp. and Dot Hill Systems B.V.*
10.3	Product Supplement/Award Letter, dated as of September 27, 2005, by and among Sun Microsystems, Inc., Sun Microsystems International B.V., Dot Hill Systems Corp. and Dot Hill Systems B.V.*
10.4	Second Amendment to Manufacturing Agreement, dated as of September 16, 2005 between Dot Hill Systems Corp. and Solectron Corporation.*
10.5	Second Award Letter, dated as of September 16, 2005 between Dot Hill Systems Corp. and Solectron Corporation.*
10.6	Development and OEM Supply Agreement, dated as of July 26, 2005 between Dot Hill Systems Corp., Dot Hill Systems B.V., Network Appliance, Inc. and Network Appliance B.V.*
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.

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* Confidential treatment requested.

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: November 9, 2005	By	/s/ JAMES L. LAMBERT James L. Lambert *Chief Executive Officer* *(Principal Executive Officer)*
Date: November 9, 2005	By	/s/ PRESTON S. ROMM Preston S. Romm *Chief Financial Officer and Treasurer* *(Principal Financial and Accounting Officer)*