FORM 10-Q

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

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

For the quarterly period ended **June 30, 2004**

☐ 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 0-23970

FALCONSTOR SOFTWARE, INC.

(Exact name of registrant as specified in its charter)

DELAWARE	**77-0216135**
(State of Incorporation)	(I.R.S. Employer Identification No.)

2 Huntington Quadrangle

Melville, New York	**11747**
(Address of principal executive offices)	(Zip code)

Registrant's telephone number, including area code: **631-777-5188**

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 √ No

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

The number of shares of Common Stock issued and outstanding as of July 31, 2004 was 46,984,172, which includes redeemable common shares.

FALCONSTOR SOFTWARE, INC. AND SUBSIDIARIES

FORM 10-Q

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PART I. FINANCIAL INFORMATION
ITEM 1. Consolidated Financial Statements

FALCONSTOR SOFTWARE, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

	June 30, 2004 (unaudited)	December 31, 2003
Assets		
Current assets:		
Cash and cash equivalents	$ 12,535,117	$ 8,486,144
Marketable securities	22,167,010	28,199,242
Accounts receivable, net of allowances of 2,185,078 and 1,837,934, respectively	7,960,190	7,109,922
Prepaid expenses and other current assets	1,323,158	1,273,125
Total current assets	43,985,475	45,068,433
Property and equipment, net	4,182,617	3,861,069
Goodwill	3,512,796	3,366,642
Other intangible assets, net	334,500	396,940
Other assets	3,039,982	3,799,949
Total assets	$ 55,055,370	$ 56,493,033
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$ 922,014	$ 562,305
Accrued expenses	3,519,753	2,777,391
Deferred revenue	3,057,476	2,202,179
Total current liabilities	7,499,243	5,541,875
Deferred revenue	877,952	395,609
Total liabilities	8,377,195	5,937,484
Commitments		
Stockholders' equity:		
Convertible preferred stock - $.001 par value, 2,000,000 shares authorized	-	-
Common stock - $.001 par value, 100,000,000 shares authorized, 47,241,036 and 46,745,330 shares issued, respectively	47,241	46,745
Additional paid-in capital	83,749,741	83,277,981
Deferred compensation	-	(7,969)
Accumulated deficit	(34,998,187)	(31,063,589)
Common stock held in treasury, at cost (277,100 and 235,000 shares, respectively)	(1,714,775)	(1,435,130)
Accumulated other comprehensive loss	(405,845)	(262,489)
Total stockholders' equity	46,678,175	50,555,549
Total liabilities and stockholders' equity	$ 55,055,370	$ 56,493,033

See accompanying notes to unaudited consolidated financial statements.

FALCONSTOR SOFTWARE, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	**2003**	**2004**	**2003**
Revenues:				
Software license revenue	$ 4,915,498	$ 3,023,920	$ 8,463,329	$ 5,710,738
Maintenance revenue	1,043,202	762,837	1,865,055	1,047,048
Software services and other revenue	524,437	304,120	1,413,551	1,011,998
	6,483,137	4,090,877	11,741,935	7,769,784
Operating expenses:				
Amortization of purchased and capitalized software	409,250	338,798	824,298	622,539
Cost of maintenance, software services and other revenue	989,955	591,655	1,967,960	1,183,656
Software development costs	2,178,927	1,671,490	4,340,843	3,283,754
Selling and marketing	3,401,078	2,637,991	6,714,616	5,186,921
General and administrative	1,397,409	698,499	2,208,052	1,390,819
	8,376,619	5,938,433	16,055,769	11,667,689
Operating loss	(1,893,482)	(1,847,556)	(4,313,834)	(3,897,905)
Interest and other income	188,852	279,528	391,777	597,839
Loss before income taxes	(1,704,630)	(1,568,028)	(3,922,057)	(3,300,066)
Provision for income taxes	8,461	10,897	12,541	17,712
Net loss	$ (1,713,091)	$ (1,578,925)	$ (3,934,598)	$ (3,317,778)
Basic and diluted net loss per share	$ (0.04)	$ (0.03)	$ (0.08)	$ (0.07)
Weighted average basic and diluted shares outstanding	46,859,326	45,848,994	46,750,352	45,675,392

See accompanying notes to unaudited consolidated financial statements.

FALCONSTOR SOFTWARE, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

	Six Months Ended June 30, 2004	Six Months Ended June 30, 2003
Cash flows from operating activities:		
Net loss	$ (3,934,598)	$ (3,317,778)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	1,853,942	1,320,135
Non-cash professional services expenses	21,092	34,325
Equity-based compensation expense	7,969	231,738
Changes in operating assets and liabilities:		
Accounts receivable, net	(850,268)	(326,936)
Prepaid expenses and other current assets	(57,914)	509,044
Other assets	(1,948)	(89,389)
Accounts payable	359,709	49,515
Accrued expenses	596,207	153,606
Deferred revenue	1,337,640	(125,208)
Net cash used in operating activities	(668,169)	(1,560,948)
Cash flows from investing activities:		
Sale of marketable securities	22,698,597	11,745,748
Purchase of marketable securities	(16,810,099)	(6,216,791)
Purchase of investment	-	(137,710)
Purchase of property and equipment	(1,245,281)	(1,121,864)
Purchase of software licenses	(50,000)	(1,171,000)
Purchase of intangible assets	(43,472)	(90,235)
Security deposits	(4,501)	-
Net cash provided by investing activities	4,545,244	3,008,148
Cash flows from financing activities:		
Proceeds from exercise of stock options	451,165	279,061
Payments to acquire treasury stock	(279,645)	-
Net cash provided by financing activities	171,520	279,061
Cash flows from discontinued operations:		
Payments of liabilities of discontinued operations	-	(3,012,527)
Effect of exchange rate changes on cash	378	(54,802)
Net increase (decrease) in cash and cash equivalents	4,048,973	(1,341,068)
Cash and cash equivalents, beginning of period	8,486,144	14,191,075
Cash and cash equivalents, end of period	$ 12,535,117	$ 12,850,007

The Company did not pay any interest expense or income taxes for the six months ended June 30, 2004 and 2003. See accompanying notes to unaudited consolidated financial statements.

(1) Summary of Significant Accounting Policies

(a) The Company and Nature of Operations

FalconStor Software, Inc., a Delaware Corporation (the "Company"), develops, manufactures and sells network storage infrastructure software solutions and provides the related maintenance, implementation and engineering services.

(b) Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation.

(c) Unaudited Interim Financial Information

The unaudited interim consolidated financial statements of the Company as of and for the three and six months ended June 30, 2004 and 2003, included herein have been prepared, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”). Certain information and note disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations relating to interim financial statements.

In the opinion of management, the accompanying unaudited interim condensed consolidated financial statements reflect all adjustments, consisting only of normal recurring adjustments, necessary to present fairly the financial position of the Company at June 30, 2004 and the results of its operations for the three months and six months ended June 30, 2004 and 2003.

(d) Cash Equivalents and Marketable Securities

The Company considers all highly liquid investments with a maturity of three months or less when purchased to be cash equivalents. Cash equivalents, consisting of money market funds and commercial paper, amounted to approximately $11.0 million at June 30, 2004. Marketable securities at June 30, 2004 amounted to $22.2 million and consisted of corporate bonds and government securities, which are classified as available for sale, and accordingly, unrealized gains and losses on marketable securities are reflected as a component of accumulated other comprehensive loss in stockholders’ equity.

(e) Revenue Recognition

The Company recognizes revenue from software licenses in accordance with Statement of Position (“SOP”) 97-2, *Software Revenue Recognition*. Accordingly, revenue for software licenses is recognized when persuasive evidence of an arrangement exists, the fee is fixed and determinable and the software is delivered and collection of the resulting receivable is deemed probable. Software delivered to a customer on a trial basis is not recognized as revenue until a permanent key is delivered to the customer. When a customer licenses software together with the purchase of maintenance, the Company allocates a portion of the fee to maintenance for its fair value based on the contractual maintenance renewal rate. Software maintenance fees are deferred and recognized as revenue ratably over the term of the contract. The cost of providing technical support is included in cost of revenues.

Revenues associated with software implementation and software engineering services are recognized as the services are performed. Costs of providing these services are included in cost of revenues.

The Company has entered into various distribution, licensing and joint promotion agreements with OEMs and distributors, whereby the Company has provided to the reseller a software license to install the Company’s software on certain hardware or to resell the Company’s software in exchange for payments based on the products distributed by the OEM or distributor. Nonrefundable advances and engineering fees received by the Company from an OEM are recorded

as deferred revenue and recognized as revenue when related software engineering services are complete, if any, and the software product master is delivered and accepted.

For the quarters ended June 30, 2004 and June 30, 2003, the Company had a limited number of transactions in which it purchased hardware and bundled this hardware with the Company's software and sold the bundled solution to its customer. Since the software is not essential for the functionality of the equipment included in the Company's bundled solutions, and both the hardware and software have stand alone value to the customer, a portion of the contractual fees is recognized as revenue when the software or hardware is delivered based on the relative fair value of the delivered element(s).

(f) Property and Equipment

Property and equipment are recorded at cost. Depreciation is recognized using the straight-line method over the estimated useful lives of the assets (3 to 7 years).

(g) Goodwill and Other Intangible Assets

Goodwill represents the excess of the purchase price over the estimated fair value of net tangible and identifiable intangible assets acquired in business combinations. Consistent with Statement of Financial Accounting Standards ("SFAS") 142, *Goodwill and Other Intangible Assets*, the Company has not amortized goodwill related to its acquisitions, but instead tested the balance for impairment. The Company's annual impairment assessment is performed as of December 31st of each year, and additionally if events or changes in circumstances indicate that it is more likely than not that the asset is impaired. Identifiable intangible assets are amortized over a three-year period using the straight-line method. Amortization expense was $54,169 and $34,940 for the three months ended June 30, 2004 and 2003, respectively, and $105,912 and $66,615 for the six months ended June 30, 2004 and 2003, respectively. The gross carrying amount and accumulated amortization of other intangible assets as of June 30, 2004 and December 31, 2003 are as follows:

	June 30, 2004	December 31, 2003
Customer relationships and purchased technology:		
Gross carrying amount	$ 216,850	$ 216,850
Accumulated amortization	(144,566)	(108,425)
Net carrying amount	$ 72,284	$ 108,425
Patents and trademarks:		
Gross carrying amount	$ 435,703	$ 392,231
Accumulated amortization	(173,487)	(103,716)
Net carrying amount	$ 262,216	$ 288,515

(h) Software Development Costs and Purchased Technology

Costs associated with the development of new software products and enhancements to existing software products are expensed as incurred until technological feasibility of the product has been established. Based on the Company's product development process, technological feasibility is established upon completion of a working model. The Company did not capitalize any software development costs until its initial product reached technological feasibility at the end of March 2001. Until such product was released, the Company capitalized $94,570 of software development costs, of which $7,881 was amortized for the three months ended June 30, 2003. Software development costs were fully amortized as of June 30, 2004. For the six months ended June 30, 2004 and 2003, $7,881 and $15,762 of software development costs were amortized, respectively. Amortization of software development costs is recorded at the greater of straight line over three years or the ratio of current revenue of the related products to total current and anticipated future revenue of these products.

Purchased software technology of $1,615,417 and $2,381,833, net of accumulated amortization of $3,295,583 and $2,479,167, is included in other assets in the balance sheets as of June 30, 2004 and December 31, 2003, respectively. Amortization expense was $409,250 and $330,917 for the three months ended June 30, 2004 and 2003, respectively, and $816,416 and $606,778 for the six months ended June 30, 2004 and 2003, respectively.

(i) Income Taxes

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be realized or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

(j) Long-Lived Assets

The Company reviews its long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of the asset may not be recoverable. If the sum of the expected future cash flows, undiscounted and without interest, is less than the carrying amount of the asset, an impairment loss is recognized as the amount by which the carrying amount of the asset exceeds its fair value.

(k) Accounting for Stock-Based Compensation

The Company applies the intrinsic-value based method of accounting prescribed by Accounting Principles Board ("APB") Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations including FASB Interpretation No. 44, *Accounting for Certain Transactions involving Stock Compensation*, *an interpretation of APB Opinion No. 25* to account for its fixed-plan stock options. Under this method, compensation expense is recorded only if on the date of grant only if the current market price of the underlying stock exceeded the exercise price. SFAS No. 123, *Accounting for Stock-Based Compensation*, established accounting and disclosure requirements using a fair-value-based method of accounting for stock-based employee compensation plans. As allowed by SFAS No. 123, the Company has elected to continue to apply the intrinsic-value-based method of accounting described above, and has adopted only the disclosure requirements of SFAS No. 123.

Had the Company determined stock-based compensation cost based upon the fair value method under SFAS No. 123, the Company's pro forma net loss and diluted net loss per share would have been adjusted to the pro forma amounts indicated below:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
Net loss as reported	$(1,713,091)	$(1,578,925)	$(3,934,598)	$(3,317,778)
Add stock-based employee compensation expense included in reported net income, net of tax	-	115,861	7,969	231,738
Deduct total stock-based employee compensation expense determined under fair-value-based method for all awards, net of tax	(2,035,104)	(1,688,785)	(3,718,235)	(3,005,827)
Net loss – pro forma	$(3,748,195)	$(3,151,849)	$(7,644,864)	$(6,091,867)
Basic net loss per common share-as reported	$ (.04)	$ (.03)	$ (.08)	$ (.07)
Basic net loss per common share-pro forma	$ (.08)	$ (.07)	$ (.16)	$ (.13)

The per share weighted average fair value of stock options granted was $5.18 and $3.20 for the three months ended June 30, 2004 and 2003, respectively, and $5.41 and $3.07 for the six months ended June 30, 2004 and 2003, respectively, on the date of grant using the Black-Scholes option pricing method with the following weighted average assumptions:

2004—expected dividend yield of 0%, risk free interest rate of 3%, expected stock volatility ranging from 116% to 160% and an expected option life of five years for options granted to employees of the Company, and an option life of ten years for options granted to non-employees;

2003—expected dividend yield of 0%, risk free interest rate of 3%, expected stock volatility ranging from 68% to 153% and an expected option life of five years for options granted to employees of the Company, and an option life of ten years for options granted to non-employees;

(l) Financial Instruments

As of June 30, 2004 and December 31, 2003, the fair value of the Company's financial instruments including cash and cash equivalents, accounts receivable, accounts payable and accrued expenses, approximates book value due to the short maturity of these instruments.

(m) Foreign Currency

Assets and liabilities of foreign operations are translated at rates of exchange at the end of the period, while results of operations are translated at average exchange rates in effect for the period. Unrealized gains and losses from the translation of foreign assets and liabilities are classified as a separate component of stockholders' equity. Realized gains and losses from foreign currency transactions are included in the statements of operations.

(n) Earnings Per Share (EPS)

Basic EPS is computed based on the weighted average number of shares of common stock outstanding. Diluted EPS is computed based on the weighted average number of common shares outstanding increased by dilutive common stock equivalents. Due to net losses for the periods presented, all common stock equivalents were excluded from diluted net loss per share. As of June 30, 2004, potentially dilutive common stock equivalents included 9,521,257 stock options outstanding and 750,000 warrants outstanding.

(o) Comprehensive Loss

Comprehensive loss amounted to $1,772,848 and $1,514,677 for the three months ended June 30, 2004 and 2003, respectively, and $4,077,954 and $3,384,196 for the six months ended June 30, 2004 and 2003, respectively. Comprehensive loss includes the Company's net loss and foreign currency translation adjustments of $(63,699) and $(49,365) for the three months ended June 30, 2004 and 2003, respectively, and $378 and $(54,802) for the six months ended June 30, 2004 and 2003, respectively. Additionally, comprehensive loss includes the Company's unrealized gains/(losses) on marketable securities of $3,942 and $113,613 for the three months ended June 30, 2004 and 2003, respectively, and $(143,734) and $(11,616) for the six months ended June 30, 2004 and 2003, respectively.

(p) Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and 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.

(q) New Accounting Pronouncements

In April 2003, the Financial Accounting Standards Board ("FASB") determined that stock-based compensation should be recognized as a cost in the financial statements and that such cost be measured according to the fair value of the stock options. The FASB plans to issue an accounting standard that would become effective in 2005. The Company will

continue to monitor communications on this subject from the FASB to determine the impact on the Company's consolidated financial statements.

(r) Reclassifications

Certain reclassifications have been made to prior year's consolidated financial statements to conform to the current year's presentation.

(2) Segment Reporting

The Company is organized in a single operating segment for purposes of making operating decisions and assessing performance. Revenues from the United States to customers in the following geographical areas for the three and six months ended June 30, 2004 and June 30, 2003 and the location of long-lived assets as of June 30, 2004 and December 31, 2003 are summarized as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
United States	$ 3,888,657	$ 2,179,226	$ 6,502,730	$ 4,480,792
Asia and other international	2,594,480	1,911,651	5,239,205	3,288,992
Total revenues	$ 6,483,137	$ 4,090,877	$11,741,935	$ 7,769,784

	June 30, 2004	December 31, 2003
Long-lived assets (includes all non-current assets):		
United States	$ 10,068,644	$ 10,329,876
Asia and other international	1,001,251	1,094,724
Total long-lived assets	$ 11,069,895	$ 11,424,600

(3) Stock Repurchase Program

On October 25, 2001, the Company announced that its Board of Directors authorized the repurchase of up to two million shares of the Company's outstanding common stock. The repurchases may be made from time to time in open market transactions in such amounts as determined at the discretion of the Company's management. The terms of the stock repurchases will be determined by management based on market conditions. During the quarter ended June 30, 2004, the Company purchased 42,100 shares of its common stock in open market purchases for a total cost of $279,645. As of June 30, 2004, the Company repurchased a total of 277,100 shares for $1,714,775.

(4) Contingencies

Dot Hill Systems Corporation ("Dot Hill") brought a third party action against the Company alleging a right to be indemnified for certain potential liabilities in a patent infringement action by Crossroad Systems (Texas), Inc. ("Crossroads") against Dot Hill in the United States District Court for the Western District of Texas. In the underlying

action, Crossroads alleges that multiple products sold by Dot Hill, including two that incorporate software licensed from the Company, infringe certain patents held by Crossroads (the "Crossroads Patents"). The Company subsequently brought an action against Crossroads claiming, among other things, that the FalconStor products licensed to Dot Hill and its subsidiary do not infringe the Crossroads patents, and that the Crossroads patents are invalid or unenforceable. Crossroads brought a counterclaim against the Company alleging that the Crossroads patents are valid and enforceable, and that certain FalconStor products infringe the Crossroads Patents. While the outcome of litigation can never be predicted with certainty, the Company believes that it has meritorious defenses to the claims asserted by Dot Hill and that the Company's positions regarding validity, unenforceability and non-infringement are correct. The Company intends to take any and all action necessary to vigorously defend the Company's products.

In addition to the action discussed above, the Company is subject to various legal proceedings and claims, asserted or unasserted, which arise in the ordinary course of business. While the outcome of any such matters cannot be predicted with certainty, the Company believes that such matters will not have a material adverse effect on the Company's financial condition or operating results.

(5) Stock Option Plan

On May 14, 2004, the Company's stockholders approved an amendment to the Company's 2000 Stock Option Plan to increase the number of shares of common stock reserved for issuance thereunder by 1,500,000 from 12,662,296 to 14,162,296. In addition, the Company's stockholders approved the 2004 Outside Director Stock Option Plan (the "2004 Plan"). A maximum of 300,000 of authorized but unissued or treasury shares of the common stock of the Company may be issued upon the exercise of the options granted under the 2004 Plan.

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

The following Management's Discussion and Analysis of Financial Condition and Results of Operations contains "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These forward-looking statements can be identified by the use of predictive, future-tense or forward-looking terminology, such as "believes," "anticipates," "expects," "estimates," "plans," "may," "intends," "will," or similar terms. Investors are cautioned that any forward-looking statements are not guarantees of future performance and involve significant risks and uncertainties, and that actual results may differ materially from those projected in the forward-looking statements. The following discussion should be read together with the consolidated financial statements and notes to those financial statements included elsewhere in this report.

OVERVIEW

The second quarter of 2004 was another quarter of growth for our Company. Our revenues increased 58% compared with the second quarter of 2003, and 23% compared with the first quarter of 2004. This ongoing growth reflects the continued success and acceptance of our products in the marketplace.

We saw increases in sales by both our resellers and our strategic OEM partners. As we expected would happen in the second quarter of 2004, and as we anticipate will be the case for several additional quarters, the percentage of revenues attributable to sales by our OEM partners as compared to our resellers increased. This increase in sales attributable to OEMs is one of the key factors we look to for the future growth of our business.

During the second quarter of 2004, we announced several OEM relationships, including an agreement with EMC Corporation. The EMC solution that incorporates portions of our technology began shipping in the second quarter.

Our deferred revenues also increased on both a second quarter 2004/second quarter 2003 and a second quarter 2004/first quarter 2004 comparison. We believe this is an indicator of the health of our business because it reflects, in part, maintenance renewals from satisfied customers.

Our expenses for the second quarter of 2004 increased by $2.4 million, or 41% compared with the second quarter of 2003. An increase in expenses was expected and is attributable primarily to: increases in our research and development, quality assurance, support and sales staffs; the higher cost of our new headquarters compared with our old office space; and the purchase of additional hardware and software to support and to develop our products. All of these increases were necessary to support the growth of our business. In addition, we incurred $0.6 million in expenses related to patent litigation which is discussed in Note 4 to our financial statements and in Part II, Item 1 of this Form 10-Q. We are unable to predict what our future expenses related to the patent litigation will be.

We try to contain the growth of our expenses by exercising prudent oversight of spending. To that end, expenses related to the growth and support of our business, and other recurring expenses, increased only $0.1 million from the first quarter of 2004. Overall, expenses increased $0.7 million from the first quarter of 2004. The additional $0.6 million in expenses were related to patent litigation. We anticipate that our overall expenses for the third quarter of 2004 will continue to increase. The cost of compliance with Section 404 of the Sarbanes-Oxley Act of 2002 will contribute to this overall increase.

RESULTS OF OPERATIONS – FOR THE THREE MONTHS ENDED JUNE 30, 2004 COMPARED TO THE THREE MONTHS ENDED JUNE 30, 2003.

Revenues for the three months ended June 30, 2004 increased 58% to $6.5 million compared with $4.1 million for the three months ended June 30, 2003. Our operating expenses increased 41% from $5.9 million for the three months ended June 30, 2003 to $8.4 million for the three months ended June 30, 2004. Net loss increased 8% from $1.6 million for the three months ended June 30, 2003 to $1.7 million for the three months ended June 30, 2004. The increase in revenues was mainly due to an increase in demand for our network storage solution software. Revenue contribution from our OEM partners increased to over 20% of our total revenue for the three months ended June 30, 2004, and the remaining revenue was derived from resellers and distributors. Expenses increased in all aspects of our business to support our growth. In

November, 2003 we moved our headquarters to a larger facility and for the three months ended June 30, 2004, we increased the number of employees and continued to invest in infrastructure by purchasing additional computers and equipment. We also increased the number of employees from 150 as of June 30, 2003 to 189 as of June 30, 2004. In addition, we incurred $0.6 million in expenses related to patent litigation.

Revenues

Software license revenue

Software license revenue is comprised of software licenses sold through our OEMs, value-added resellers and distributors to end users and, to a lesser extent, directly to end users. These revenues are recognized when, among other requirements, we receive a customer purchase order and the software and permanent key codes are delivered to the customer. We also receive nonrefundable royalty advances and engineering fees from some of our OEM partners. These arrangements are evidenced by a signed customer contract, and the revenue is recognized when the software product master is delivered and accepted, and the engineering services, if any, have been performed.

Software license revenue increased 63% from $3.0 million for the three months ended June 30, 2003 to $4.9 million for the three months ended June 30, 2004. Increased market acceptance and demand for our product were the primary drivers of the increase in software license revenue. A continued increase in the number of our channel partners and OEMs also increased our revenues. We expect software license revenue to continue to grow and the percentage of software license revenue derived from OEM partners to increase.

Maintenance, software services and other revenue

Maintenance, software services and other revenues are comprised of software maintenance and technical support, professional services primarily related to the implementation of our software, engineering services, and sales of computer hardware. Revenue derived from maintenance and technical support contracts is deferred and recognized ratably over the contractual maintenance term. Professional services revenue is recognized in the period that the related services are performed. Revenue from engineering services is primarily related to customizing software product masters for some of our OEM partners. Revenue from engineering services is recognized in the period the services are completed. For the three months ended June 30, 2004, we had a limited number of transactions in which we purchased hardware and bundled this hardware with our software and sold the bundled solution to our customer. A portion of the contractual fees is recognized as revenue when the hardware or software is delivered to the customer based on the relative fair value of the delivered element(s). Through June 30, 2004, the software and hardware in bundled solutions have almost always been delivered to the customer in the same quarter. Maintenance, software services and other revenue increased 47% to $1.6 million for the three months ended June 30, 2004 from $1.1 million for the three months ended June 30, 2003.

The major factor behind the increase in maintenance, software services and other revenue was an increase in the number of maintenance and technical support contracts we sold. As we are in business longer, and as we license more software, we expect these revenues will continue to increase. The majority of our new customers purchase maintenance and support and most customers renew their maintenance and support after their initial contracts expire. Maintenance revenue increased from $0.8 million for the three months ended June 30, 2003 to $1.0 million for the three months ended June 30, 2004. Growth in our professional services sales, which increased by $0.3 million for the three months ended June 30, 2004 compared with the three months ended June 30, 2003, also contributed to the increase in software services and other revenues. This increase in professional services revenue was related to the increase in our software license customers that elected to purchase professional services. Additionally, our hardware sales decreased from approximately $0.3 million for the three months ended June 30, 2003 to approximately $0.2 million for the three months ended June 30, 2004. This decrease was the result of a decrease in demand from our customers for bundled solutions.

We expect maintenance, software services and other revenues to continue to increase.

Cost of Revenues

Amortization of purchased and capitalized software

To remain successful in the network storage solutions market, we must continually upgrade our software by enhancing the existing features of our products and by adding new features and products. We often evaluate whether to develop these new offerings in-house or whether we can achieve a greater return on investment by purchasing or licensing software from third parties. Based on our evaluations we have purchased or licensed various software for resale since 2001. Amortization of purchased and capitalized software increased from $0.3 million for the three months ended June 30, 2003 to $0.4 million for the three months ended June 30, 2004. The increase in amortization expense was due to our purchase of an additional $0.7 million of software licenses subsequent to the second quarter of 2003. As of June 30, 2004, we had $4.9 million of purchased software licenses that are being amortized over three years. For the three months ended June 30, 2004, we recorded $0.4 million of amortization related to these purchased software licenses. As of June 30, 2003, we had $4.2 million of purchased software licenses and recorded approximately $0.3 million of amortization for the three months ended June 30, 2003 related to these purchased software licenses. We will continue to evaluate third party software licenses and may make additional purchases, which would result in an increase in amortization expense.

The Company did not capitalize any software development costs until our initial product reached technological feasibility in March 2001. At that point, we capitalized $0.1 million of software development costs, which are being amortized at the greater of straight line over three years or the ratio of current revenue of the related products to total current and anticipated future revenue of these products. Amortization of capitalized software costs was $7,881 for the three months ended June 30, 2003. Capitalized software costs were fully amortized as of the end of the first quarter of 2004.

Cost of maintenance, software services and other revenue

Cost of maintenance, software services and other revenues consists primarily of personnel and other costs associated with providing software implementations, technical support under maintenance contracts, and training. Cost of maintenance, software services and other revenues also includes the cost of hardware purchased for resale. Cost of maintenance, software services and other revenues for the three months ended June 30, 2004 increased by 67% to $1.0 million compared to $0.6 million for the three months ended June 30, 2003. The increase in cost of maintenance, software services and other revenue was principally due to an increase in personnel. As a result of our increased sales of maintenance and support contracts and professional services, we required a higher number of employees to provide technical support and to implement our software. Our cost of maintenance, software services and other revenue will continue to grow in absolute dollars as our revenue increases.

Gross profit for the three months ended June 30, 2004 was $5.1 million or 78% of revenue compared to $3.2 million or 77% of revenue for the three months ended June 30, 2003. The increase in gross profit and gross margin was directly related to the increase in revenues.

Software Development Costs

Software development costs consist primarily of personnel costs for product development personnel and other related costs associated with the development of new products, enhancements to existing products, quality assurance and testing. Software development costs increased 30% to $2.2 million for the three months ended June 30, 2004 from $1.7 million for the three months ended June 30, 2003. The increase in software development costs was primarily due to an increase in employees required to enhance and test our core network storage software product, as well as to develop new innovative features and options. In addition, as we entered into agreements with new OEM partners, we required additional employees to test and customize our software with our OEM partners' products. In the fourth quarter of 2003, we opened a development office in China to assist in our development efforts which also contributed to the increase in software development costs. We intend to continue recruiting and hiring product development personnel to support our development process.

Selling and Marketing

Selling and marketing expenses consist primarily of sales and marketing personnel and related costs, travel, public relations expense, marketing literature and promotions, commissions, trade show expenses, and the costs associated with our foreign sales offices. Selling and marketing expenses increased 29% to $3.4 million for the three months ended June 30, 2004 from $2.6 million for the three months ended June 30, 2003. As a result of the increase in revenue, our commission expense increased. In addition, we continued to hire new sales and sales support personnel and expand our worldwide presence to accommodate our revenue growth. We believe that to continue to grow sales, our sales and marketing expenses will continue to increase.

General and Administrative

General and administrative expenses consist primarily of personnel costs of general and administrative functions, public company related costs, directors and officers insurance, legal and professional fees, and other general corporate overhead costs. General and administrative expenses increased 100% to $1.4 million for the three months ended June 30, 2004 from $0.7 million for the three months ended June 30, 2003. The increase in general and administrative expenses was primarily due to an $0.6 million increase in legal expense attributable to the patent litigation with Crossroads Systems, Inc. We are unable to predict what our future expenses related to the patent litigation will be. An increase in the number of employees also contributed to the increase in expenses.

Interest and Other Income

We invest our cash, cash equivalents and marketable securities in government securities and other low risk investments. Interest and other income decreased 32% to $0.2 million for the three months ended June 30, 2004 from $0.3 million for the three months ended June 30, 2003. This decrease in interest income was due to lower interest rates and lower average cash, cash equivalent and marketable securities balances.

Income Taxes

We did not record a tax benefit associated with the pre-tax loss incurred from the period from inception (February 10, 2000) through June 30, 2004, as we deemed that it was more likely than not that the deferred tax assets will not be realized based on our development and now early stage operations. Accordingly, we provided a full valuation allowance against our net deferred tax assets. Our income tax provision consists of tax liabilities related to our foreign subsidiaries.

RESULTS OF OPERATIONS – FOR THE SIX MONTHS ENDED JUNE 30, 2004 COMPARED TO THE SIX MONTHS ENDED JUNE 30, 2003.

Revenues

Revenues for the six months ended June 30, 2004 increased 51% to $11.7 million compared with $7.8 million for the six months ended June 30, 2003. Our operating expenses increased 38% from $11.7 million for the six months ended June 30, 2003 to $16.1 million for the six months ended June 30, 2004. Net loss increased 19% from $3.3 million for the six months ended June 30, 2003 to $3.9 million for the six months ended June 30, 2004. The increase in revenues was mainly due to an increase in demand for our network storage solution software. Revenue contribution from our OEM partners increased to over 20% of our total revenue for the six months ended June 30, 2004, and the remaining revenue was derived from resellers and distributors. Expenses increased in all aspects of our business to support our growth. In November, 2003 we moved our headquarters to a larger facility and, for the six months ended June 30, 2004, we increased the number of employees and continued to invest in infrastructure by purchasing additional computers and equipment. We also increased the number of employees from 150 as of June 30, 2003 to 189 as of June 30, 2004. In addition, we incurred $0.6 million in expenses related to patent litigation.

Software license revenue

Software license revenue increased 48% from $5.7 million for the six months ended June 30, 2003 to $8.5 million for the six months ended June 30, 2004. Increased market acceptance and demand for our product were the primary drivers of the increase in software license revenue. A continued increase in the number of our channel partners and OEMs also contributed to the increase in our revenues. We expect software license revenue to continue to grow and the percentage of software license revenue derived from OEM partners to increase.

Maintenance, software services and other revenue

Maintenance, software services and other revenue increased 59% to $3.3 million for the six months ended June 30, 2004 compared with $2.1 million for the six months ended June 30, 2003. The primary reason for the increase in maintenance, software services and other revenue was an increase in the number of our maintenance and technical support contracts. As we are in business longer, and as we license more software, we expect these revenues will continue to increase. The majority of our new customers purchase maintenance and support and most customers renew their maintenance and support after their initial contracts expire. Maintenance revenue increased from $1.0 million for the six months ended June 30, 2003 to $1.9 million for the six months ended June 30, 2004. Growth in our professional service sales, which increased from $0.3 million for the six months ended June 30, 2003 to $0.7 million for the six months ended June 30, 2004, also contributed to the increase in software services and other revenues. This increase in professional services revenue was related to the increase in our software license customers that elected to purchase professional services.

Cost of Revenues

Amortization of purchased and capitalized software

Amortization of purchased and capitalized software increased from $0.6 million for the six months ended June 30, 2003 to $0.8 million for the six months ended June 30, 2004. The increase in amortization expense was due to our purchase of an additional $0.7 million of software licenses subsequent to the second quarter of 2003. As of June 30, 2004, we had $4.9 million of purchased software licenses that are being amortized over three years. For the six months ended June 30, 2004, we recorded $0.8 million of amortization related to these purchased software licenses. As of June 30, 2003, we had $4.2 million of purchased software licenses and recorded approximately $0.6 million of amortization for the six months ended June 30, 2003 related to these purchased software licenses. Amortization of capitalized software was $7,881 and $15,762 for the six months ended June 30, 2004 and June 30, 2003, respectively.

Cost of maintenance, software services and other revenue

Cost of maintenance, software services and other revenues for the six months ended June 30, 2004 increased by 66% to $2.0 million compared to $1.2 million for the six months ended June 30, 2003. The increase in cost of maintenance,

software services and other revenues was principally due to an increase in personnel. As a result of our increased sales of maintenance and support contracts and professional services, we required a higher number of employees to provide technical support and to implement our software. Our cost of maintenance, software services and other revenue will continue to grow in absolute dollars as our revenue increases.

Gross profit for the six months ended June 30, 2004 was $8.9 million or 76% of revenues compared with $6.0 million or 77% of revenues for the six months ended June 30, 2003. The increase in gross profit was directly related to the increase in revenues. The decrease in gross margins was primarily due to the increase in amortization of purchased software licenses.

Software Development Costs

Software development costs increased 32% to $4.3 million for the six months ended June 30, 2004 compared with $3.3 million for the six months ended June 30, 2003. The increase in software development costs was mainly due to an increase in employees required to enhance and test our core network storage software product, as well as to develop new innovative features and options. In addition, as we entered into agreements with new OEM partners, we required additional employees to test and customize our software with our OEM partners' products.

Selling and Marketing

Selling and marketing expenses increased 29% to $6.7 million for the six months ended June 30, 2004 from $5.2 million for the six months ended June 30, 2003. This increase in selling and marketing expenses was partially due to increased commission expense, which is directly related to our increase in revenues. Additionally, salary related expenses increased as we increased our headcount to support our revenue growth.

General and Administrative

General and administrative expenses increased 59% to $2.2 million for the six months ended June 30, 2004 from $1.4 million for the six months ended June 30, 2003. The increase in general and administrative expenses was primarily due to a $0.6 million increase in legal expense attributable to the patent litigation with Crossroads Systems, Inc. We are unable to predict what our future expenses related to the patent litigation will be. An increase in the number of employees also contributed to the increase in expenses.

Interest and Other Income

Interest and other income decreased 34% to $0.4 million for the six months ended June 30, 2004 from $0.6 million for the six months ended June 30, 2003. This decrease in interest income was due to lower interest rates and lower average cash, cash equivalent and marketable securities balances.

Income Taxes

We did not record a tax benefit associated with the pre-tax loss incurred from the period from inception (February 10, 2000) through June 30, 2004, as we deemed that it was more likely than not that the deferred tax assets will not be realized based on our development and now early stage operations. Accordingly, we provided a full valuation allowance against our net deferred tax assets. Our income tax provision consists of tax liabilities related to our foreign subsidiaries.

LIQUIDITY AND CAPITAL RESOURCES

Our cash and cash equivalents totaled $12.5 million and marketable securities totaled $22.2 million at June 30, 2004. As of June 30, 2003, we had approximately $12.9 million in cash and cash equivalents and $31.4 million in marketable securities. The reasons for this decrease in cash and cash equivalents and marketable securities are discussed below. Because we have not yet been profitable, our cash has been used primarily to fund operations. Until we reach profitability, we will continue to use our cash to fund operations.

In November, 2003 we moved our headquarters to a larger facility. We continued to invest in our infrastructure to support our long-term growth during the six months ended June 30, 2004. We made investments in property and equipment and we increased the number of employees during the second quarter of 2004.

We currently do not have any debt and our only material commitments are related to our office leases.

In connection with our acquisition of IP Metrics in July 2002, we must make cash payments to the former shareholders of IP Metrics, which are contingent on the level of revenues from IP Metrics products for a period of twenty-four months subsequent to the acquisition. In 2003, we made payments to the former shareholders of IP Metrics totaling $287,130. As of June 30, 2004, we accrued $0.2 million of additional purchase consideration related to sales of IP Metrics products, which will be paid in the third quarter of 2004.

In October 2001, our Board of Directors authorized the repurchase of up to two million shares of our outstanding common stock, of which 277,100 shares were repurchased through June 30, 2004, at an aggregate purchase price of $1.7 million. During the quarter ended June 30, 2004, the Company purchased 42,100 shares of its common stock in open market purchases for a total cost of $279,645.

Net cash used in operating activities totaled $0.7 million for the six months ended June 30, 2004. This was primarily a result of our net loss of $3.9 million, and increases in accounts receivable and prepaid expenses. These amounts were partially offset by non-cash charges of $1.9 million consisting of depreciation and amortization, non-cash professional services expenses, and equity-based compensation. Additional offsetting amounts include increases in accounts payable, accrued expenses and deferred revenue of $2.3 million in the aggregate. Net cash used in operating activities for the six months ended June 30, 2003 was $1.6 million. The cash used in operating activities for the six months ended June 30, 2003 was mainly comprised of the Company's net loss of $3.3 million, an increase in accounts receivable and other assets and a decrease in deferred revenue. These amounts were partially offset by non-cash expenses of $1.6 million, as well as decreases in prepaid expenses and other assets and increases in accounts payable and accrued expenses.

Net cash provided by investing activities was $4.5 million for the six months ended June 30, 2004, due primarily to net sales of marketable securities of $5.9 million. This amount was partially offset by purchases of property and equipment of $1.2 million and purchases of software licenses and intangible assets of $0.1 million. Net cash provided by investing activities was $3.0 million for the six months ended June 30, 2003, primarily due to $5.5 million in net sales of marketable securities. This amount was partially offset by $1.1 million in purchases of property and equipment, and $1.2 million in purchases of software licenses.

Net cash provided by financing activities was $0.2 million for the six months ended June 30, 2004. This amount was primarily related to proceeds from the exercise of stock options of $0.5 million partially offset by payments to acquire treasury stock of $0.3 million. Net cash provided by financing activities was $0.3 million for the six months ended June 30, 2003 which was related to the proceeds from the exercise of stock options.

Our only material contractual obligations relate to our operating leases. We have an operating lease covering our primary office facility that expires in February, 2012. We also have several operating leases related to a second domestic office and offices in foreign countries. The expiration dates for these leases range from 2004 through 2012.

For the six months ended June 30, 2003, we paid $3.0 million related to liabilities of discontinued operations. As of December 31, 2003, all significant liabilities related to our discontinued operations had been paid.

We believe that our current balance of cash, cash equivalents and marketable securities, and expected cash flows from operations will be sufficient to meet our cash requirements for at least the next twelve months.

Impact of Recently Issued Accounting Pronouncements

In April 2003, the Financial Accounting Standards Board ("FASB") determined that stock-based compensation should be recognized as a cost in the financial statements and that such cost should be measured according to the fair value

of the stock options. The FASB plans to issue an accounting standard that would become effective in 2005. We will continue to monitor communications on this subject from the FASB to determine the impact on our consolidated financial statements.

RISK FACTORS

We have had limited revenues and a history of losses, and we may not achieve or maintain profitability.

We have had limited revenues and a history of losses. For the year ended December 31, 2003 and the six months ended June 30, 2004, we had revenues of $16.9 million and $11.7 million, respectively. For the period from inception (February 10, 2000) through June 30, 2004 and for the six months ended June 30, 2004, we had a net loss of $35.0 million and $3.9 million, respectively. We have signed contracts with resellers and original equipment manufacturers, or OEMs, and believe that as a result of these contracts, our revenues should increase in the future, although we are unable to predict whether we will be profitable. Our business model depends upon signing agreements with additional OEM customers, further developing our reseller sales channel, and expanding our sales force. Any difficulty in obtaining these OEM and reseller customers or in attracting qualified sales personnel will hinder our ability to generate additional revenues and achieve or maintain profitability.

Failure to achieve anticipated growth could harm our business and operating results.

Achieving our anticipated growth will depend on a number of factors, some of which include:

- retention of key management, marketing and technical personnel;
- our ability to increase our customer base and to increase the sales of our products; and
- competitive conditions in the network storage infrastructure software market.

We cannot assure you that the anticipated growth will be achieved. The failure to achieve anticipated growth could harm our business, financial condition and operating results.

We have significant lease commitments that could impact our profitability.

During the third quarter of 2003, we signed a lease for new office space that commenced on November 1, 2003 and continues through February, 2012. This commitment could impact our ability to achieve or to maintain profitability.

Due to the uncertain and shifting development of the network storage infrastructure software market, we may have difficulty accurately predicting revenue for future periods and appropriately budgeting for expenses.

The rapidly evolving nature of the network storage infrastructure software market in which we sell our products, and other factors that are beyond our control, reduces our ability to accurately forecast our quarterly and annual revenue. However, we use our forecasted revenue to establish our expense budget. Most of our expenses are fixed in the short term or incurred in advance of anticipated revenue. As a result, we may not be able to decrease our expenses in a timely manner to offset any shortfall in revenue.

Our revenues depend in part on spending by corporate customers.

The operating results of our business depend in part on the overall demand for network storage infrastructure software. Because our sales are primarily to major corporate customers, any softness in demand for network storage infrastructure software may result in decreased revenues.

The markets for Storage Area Networks and Network Attached Storage are new and uncertain, and our business will suffer if they do not develop as we expect.

The rapid adoption of Storage Area Networks (SAN) and Network Attached Storage (NAS) solutions is critical to our future success. The markets for SAN and NAS solutions are still unproven, making it difficult to predict their potential sizes or future growth rates. Most potential customers have made substantial investments in their current storage networking infrastructure, and they may elect to remain with current network architectures or to adopt new architecture, in limited stages or over extended periods of time. We are uncertain whether a viable market for our products will develop or be sustainable. If these markets fail to develop, or develop more slowly than we expect, our business, financial condition and results of operations would be adversely affected.

If we are unable to develop and manufacture new products that achieve acceptance in the network storage infrastructure software market, our operating results may suffer.

The network storage infrastructure software market continues to evolve and as a result there is continuing demand for new products. Accordingly, we may need to develop and manufacture new products that address additional network storage infrastructure software market segments and emerging technologies to remain competitive in the data storage software industry. We are uncertain whether we will successfully qualify new network storage infrastructure software products with our customers by meeting customer performance and quality specifications or quickly achieve high volume production of storage networking infrastructure software products. Any failure to address additional market segments could harm our business, financial condition and operating results.

Our products must conform to industry standards in order to be accepted by customers in our markets.

Our current products are only one part of a SAN or NAS system. All components of these systems must comply with the same industry standards in order to operate together efficiently. We depend on companies that provide other components of these systems to conform to industry standards. Some industry standards may not be widely adopted or implemented uniformly, and competing standards may emerge that may be preferred by OEM customers or end users. If other providers of components do not support the same industry standards as we do, or if competing standards emerge, our products may not achieve market acceptance, which would adversely affect our business.

Our complex products may have errors or defects that could result in reduced demand for our products or costly litigation.

Our IPStor platform is complex and is designed to be deployed in large and complex networks. Many of our customers have unique infrastructures, which may require additional professional services in order for our software to work within their infrastructure. Because our products are critical to the networks of our customers, any significant interruption in their service as a result of defects in our product within our customers' networks could result in lost profits or damage to our customers. These problems could cause us to incur significant service and warranty costs, divert engineering personnel from product development efforts and significantly impair our ability to maintain existing customer relationships and attract new customers. In addition, a product liability claim, whether successful or not, would likely be time consuming and expensive to resolve and would divert management time and attention. Further, if we are unable to fix the errors or other problems that may be identified in full deployment, we would likely experience loss of or delay in revenues and loss of market share and our business and prospects would suffer.

Failure of storage appliances powered by IPStor to integrate smoothly with end user systems could impact demand for the appliances.

We have entered into agreements with our resellers and OEM partners to develop storage appliances that combine certain aspects of IPStor functionality with third party hardware to create single purpose turnkey solutions that are designed to be easy to deploy. If the storage appliances are not easy to deploy or do not integrate smoothly with end user systems, the basic premise behind the appliances will not be met and sales would be impacted negatively.

Our OEM customers require our products to undergo a lengthy and expensive qualification process that does not assure product sales.

Prior to offering our products for sale, our OEM customers require that each of our products undergo an extensive qualification process, which involves interoperability testing of our product in the OEM's system as well as rigorous reliability testing. This qualification of a product by an OEM does not assure any sales of the product to the OEM. Despite this uncertainty, we devote substantial resources, including sales, marketing and management efforts, toward qualifying our products with OEMs in anticipation of sales to them. If we are unsuccessful or delayed in qualifying any products with an OEM, such failure or delay would preclude or delay sales of that product to the OEM, which may impede our ability to grow our business.

We rely on our OEM customers and resellers for most of our sales.

Almost all of our sales come from sales to end users of our products by our OEM customers and by our resellers. These OEM customers and resellers have limited resources and sales forces and sell many different products, both in the network storage infrastructure software market and in other markets. The OEM customers and resellers may choose to focus their sales efforts on other products in the network storage infrastructure software market or other markets. The OEM customers might also choose not to continue to develop or to market products which include our products. This would likely result in lower revenues to us and would impede our ability to grow our business.

Issues with the hardware sold by our partners could result in lower sales of our products.

As part of our sales channel, we license our software to OEMs and other partners who install our software on their own hardware or on the hardware of other third parties. If the hardware does not function properly or causes damage to customers' systems, we could lose sales to future customers, even though our software functions properly. Problems with our partners' hardware could negatively impact our business.

We must maintain our existing relationships and develop new relationships with strategic industry partners.

Part of our strategy is to partner with major third-party software and hardware vendors who integrate our products into their offerings and/or market our products to others. These strategic partners often have customer or distribution networks to which we otherwise would not have access or the development of which would take up large amounts of our time and other resources. There is intense competition to establish relationships with these strategic partners. We cannot guarantee that our current strategic partners, or those companies with whom we may partner in the future, will continue to be our partners for any period of time.

The network storage infrastructure software market is highly competitive and intense competition could negatively impact our business.

The network storage infrastructure software market is intensely competitive even during periods when demand is stable. Some of our current and potential competitors have longer operating histories, significantly greater resources, broader name recognition and a larger installed base of customers than we have. Those competitors and other potential competitors may be able to establish or to expand network storage infrastructure software offerings more quickly, adapt to new technologies and customer requirements faster, and take advantage of acquisition and other opportunities more readily.

Our competitors also may:

- consolidate or establish strategic relationships among themselves to lower their product costs or to otherwise compete more effectively against us; or

- bundle their products with other products to increase demand for their products.

In addition, some OEMs with whom we do business, or hope to do business, may enter the market directly and rapidly capture market share. If we fail to compete successfully against current or future competitors, our business, financial condition and operating results may suffer.

Our future quarterly results may fluctuate significantly, which could cause our stock price to decline.

Our future performance will depend on many factors, including:

- the timing of securing software license contracts and the delivery of software and related revenue recognition;
- the average unit selling price of our products;
- existing or new competitors introducing better products at competitive prices before we do;
- our ability to manage successfully the complex and difficult process of qualifying our products with our customers;
- new products or enhancements from us or our competitors;
- import or export restrictions on our proprietary technology; and
- personnel changes.

Many of our expenses are relatively fixed and difficult to reduce or modify. As a result, the fixed nature of our expenses will magnify any adverse effect of a decrease in revenue on our operating results.

Our stock price may be volatile

The market price of our common stock has been volatile in the past and may be volatile in the future. For example, during the past twelve months ended June 30, 2004, the market price of our common stock as quoted on the NASDAQ National Market System fluctuated between $4.54 and $10.32. The market price of our common stock may be significantly affected by the following factors:

- actual or anticipated fluctuations in our operating results;
- failure to meet financial estimates;
- changes in market valuations of other technology companies, particularly those in the storage networking infrastructure software market;
- announcements by us or our competitors of significant technical innovations, acquisitions, strategic partnerships, joint ventures or capital commitments;
- loss of one or more key OEM customers; and
- departures of key personnel.

The stock market has experienced extreme volatility that often has been unrelated to the performance of particular companies. These market fluctuations may cause our stock price to fall regardless of our performance.

We have a significant amount of authorized but unissued preferred stock, which may affect the likelihood of a change of control in our company.

Our Board of Directors has the authority, without further action by the stockholders, to issue up to 2,000,000 shares of preferred stock on such terms and with such rights, preferences and designations, including, without limitation restricting dividends on our common stock, dilution of the voting power of our common stock and impairing the liquidation rights of the holders of our common stock, as the Board may determine without any vote of the stockholders. Issuance of such preferred stock, depending upon the rights, preferences and designations thereof may have the effect of delaying, deterring or preventing a change in control. In addition, certain “anti-takeover” provisions of the Delaware General Corporation Law, among other things, may restrict the ability of our stockholders to authorize a merger, business combination or change of control. Finally, we have entered into change of control agreements with certain executives.

We have a significant number of outstanding options and warrants, the exercise of which would dilute the then-existing stockholders' percentage ownership of our common stock.

As of June 30, 2004, we had outstanding options and warrants to purchase an aggregate of 9,521,257 shares of our common stock at a weighted average exercise price of $4.53 per share. We also have 2,904,733 shares reserved for issuance under our stock option plans with respect to options that have not been granted.

The exercise of all of the outstanding options would dilute the then-existing stockholders' percentage ownership of common stock, and any sales in the public market of the common stock issuable upon such exercise could adversely affect prevailing market prices for the common stock. Moreover, the terms upon which we would be able to obtain additional equity capital could be adversely affected because the holders of such securities can be expected to exercise or convert them at a time when we would, in all likelihood, be able to obtain any needed capital on terms more favorable than those provided by such securities.

If we are required to recognize the fair value of stock options granted as an expense, our results of operations will be impacted negatively.

The Financial Accounting Standards Board ("FASB") has formally proposed to require companies to recognize the fair value of stock options and other stock-based compensation to employees as compensation expense in the statement of operations for the 2005 reporting periods. If the FASB proposal is adopted, there will be a negative impact on our results of operations.

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

In August, 2003, our business was interrupted due to a large scale blackout in the northeastern United States. While the headquarters facilities we moved in to in November, 2003 contain redundant power supplies and generators, our operations, and the operations of our industry partners, remain susceptible to fire, floods, power loss, power shortages, telecommunications failures, break-ins and similar events.

Terrorist actions domestically or abroad could lead to business disruptions or to cancellations of customer orders or a general decrease in corporate spending on information technology, or could have direct impact on our marketing, administrative or financial functions and our financial condition could suffer.

The international nature of our business could have an adverse affect on our operating results.

We sell our products worldwide. Accordingly, our operating results could be materially adversely affected by various factors including regulatory, political, or economic conditions in a specific country or region, trade protection measures and other regulatory requirements, and acts of terrorism and international conflicts.

Our international sales are denominated primarily in U.S. dollars. An increase in the value of the U.S. dollar relative to foreign currencies could make our products more expensive and, therefore, potentially less competitive in foreign markets.

Additional risks inherent in our international business activities generally include, among others, longer accounts receivable payment cycles, difficulties in managing international operations, decreased flexibility in matching workforce to needs as compared with the U.S., and potentially adverse tax consequences. Such factors could materially adversely affect our future international sales and, consequently, our operating results.

If we are unable to protect our intellectual property, our business will suffer.

Our success is dependent upon our proprietary technology. Currently, the IPStor software suite is the core of our proprietary technology. We have one patent issued, multiple pending patent applications, numerous trademarks registered and multiple pending trademark applications related to our IPStor product. We cannot predict whether we will receive patents for our pending or future patent applications, and any patents that we own or that are issued to us may be invalidated, circumvented or challenged. In addition, the laws of certain countries in which we sell and manufacture our

products, including various countries in Asia, may not protect our products and intellectual property rights to the same extent as the laws of the United States.

We also rely on trade secret, copyright and trademark laws, as well as the confidentiality and other restrictions contained in our respective sales contracts and confidentiality agreements to protect our proprietary rights. These legal protections afford only limited protection.

Our efforts to protect our intellectual property may cause us to become involved in costly and lengthy litigation, which could seriously harm our business.

In recent years, there has been significant litigation in the United States involving patents, trademarks and other intellectual property rights.

We have already been subject to one action alleging that our technology infringes patents held by a third party. This and other legal proceedings could subject us to significant liability for damages or invalidate our intellectual property rights. The litigation has been expensive and has diverted management's time and attention. Any additional litigation, regardless of its outcome, would likely be time consuming and expensive to resolve and would divert management's time and attention. Any potential intellectual property litigation against us could force us to take specific actions, including:

- cease selling our products that use the challenged intellectual property;
- obtain from the owner of the infringed intellectual property right a license to sell or use the relevant technology or trademark, which license may not be available on reasonable terms, or at all; or
- redesign those products that use infringing intellectual property or cease to use an infringing product or trademark.

The loss of any of our key personnel could harm our business.

Our success depends upon the continued contributions of our key employees, many of whom would be extremely difficult to replace. We do not have key person life insurance on any of our personnel. Worldwide competition for skilled employees in the network storage infrastructure software industry is extremely intense. If we are unable to retain existing employees or to hire and integrate new employees, our business, financial condition and operating results could suffer. In addition, companies whose employees accept positions with competitors often claim that the competitors have engaged in unfair hiring practices. We may be the subject of such claims in the future as we seek to hire qualified personnel and could incur substantial costs defending ourselves against those claims.

We may not successfully integrate the products, technologies or businesses from, or realize the intended benefits of acquisitions.

We have made, and may continue to make, acquisitions of other companies or their assets. Integration of the acquired products, technologies and businesses, could divert management's time and resources. Further, we may not be able to properly integrate the acquired products, technologies or businesses, with our existing products and operations, train, retain and motivate personnel from the acquired businesses, or combine potentially different corporate cultures. If we are unable to fully integrate the acquired products, technologies or businesses, or train, retain and motivate personnel from the acquired businesses, we may not receive the intended benefits of the acquisitions, which could harm our business, operating results and financial condition.

If actual results or events differ materially from our estimates and assumptions, our reported financial condition and results of operations for future periods could be materially affected.

The preparation of consolidated financial statements and related disclosure in accordance with generally accepted account principles requires management to establish policies that contain estimates and assumptions that affect the amounts reported in the consolidated financial statements and the accompanying notes. Note 1 to the Consolidated Financial Statements in this Quarterly Report on Form 10-Q describes the significant accounting policies essential to preparing our financial statements. The preparation of these financial statements requires us to make estimates and judgments that affect

the reported amounts of assets, liabilities, revenues and expenses, and related disclosures. We base our estimates on historical experience and assumptions that we be believe to be reasonable under the circumstances. Actual future results may differ materially from these estimates. We evaluate, on an ongoing basis, our estimates and assumptions.

Long Term Character of Investments.

Our present and future equity investments may never appreciate in value, and are subject to normal risks associated with equity investments in businesses. These investments may involve technology risks as well as commercialization risks and market risks. As a result, we may be required to write down some or all of these investments in the future.

Unknown Factors

Additional risks and uncertainties of which we are unaware or which currently we deem immaterial also may become important factors that affect us.

Item 3. Qualitative and Quantitative Disclosures About Market Risk

Interest Rate Risks. Our return on our investments in cash, cash equivalents and marketable securities is subject to interest rate risks. We regularly assess these risks and have established policies and business practices to manage the market risk of our marketable securities.

Foreign Currency Risk. We have several offices outside the United States. Accordingly, we are subject to exposure from adverse movements in foreign currency exchange rates. The effect of foreign currency exchange rate fluctuations have not been material since our inception. We do not use derivative financial instruments to limit our foreign currency risk exposure.

Item 4. Controls and Procedures

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we have evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this report, and, based on their evaluation, our principal executive officer and principal financial officer have concluded that these controls and procedures are effective. No changes in the Company's internal controls over financial reporting occurred during the quarter ended June 30, 2004, that have materially affected, or are reasonably likely to materially affect, the Company's internal controls over financial reporting.

Disclosure controls and procedures are procedures that are designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by us in the reports that we file under the Exchange Act is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

Dot Hill Systems Corporation ("Dot Hill") brought a third party action against us alleging a right to be indemnified for certain potential liabilities in a patent infringement action by Crossroad Systems (Texas), Inc. ("Crossroads") against Dot Hill in the United States District Court for the Western District of Texas. In the underlying action, Crossroads alleges that multiple products sold by Dot Hill, including two that incorporate software licensed from us, infringe certain patents held by Crossroads (the "Crossroads Patents"). We subsequently brought an action against Crossroads claiming, among other things, that the FalconStor products licensed to Dot Hill and its subsidiary do not infringe the Crossroads patents, and that the Crossroads patents are invalid or unenforceable. Crossroads brought a counterclaim against us alleging that the

Crossroads patents are valid and enforceable, and that certain FalconStor products infringe the Crossroads Patents. While the outcome of litigation can never be predicted with certainty, we believe that we have meritorious defenses to the claims asserted by Dot Hill and that our positions regarding validity, unenforceability and non-infringement are correct. We intend to take any and all action necessary to vigorously defend our products.

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

Item 2. Changes in Securities and Use of Proceeds

	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plan	Maximum Number of Shares that May Yet Be Purchased Under the Plan
May, 2004	42,100	$ 6.60	42,100	1,722,900
Total	42,100	$ 6.60	42,100	1,722,900

The Company's Board of Directors approved a program, effective October 24, 2001, to repurchase up to two million shares of the Company's common stock. The program has no expiration date.

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

The Company held its annual meeting of stockholders on May 14, 2004. 41,996,151 shares of Common Stock, 90% of the outstanding shares, were represented in person or by proxy.

Lawrence S. Dolin was elected to serve as a director of the Company for a term expiring in 2007 with 41,270,122 shares voted in favor, 726,029 shares withheld and 0 broker non-votes.

ReiJane Huai was elected to serve as a director of the Company for a term expiring in 2007 with 41,270,727 shares voted in favor, 725,424 shares withheld and 0 broker non-votes.

The Company's 2004 Outside Directors Stock Option Plan was approved with 27,047,984 shares voted in favor, 1,265,380 shares voted against, 87,960 shares abstained, and 13,594,827 broker non-votes.

An amendment to the Company's 2000 Stock Option Plan was approved with 26,562,497 shares voted in favor, 1,731,336 shares voted against, 107,491 shares abstained and 12,594,827 broker non-votes.

The selection of KPMG LLP as independent accountants for the Company was ratified with 41,552,605 shares voted in favor, 171,461 shares voted against, 272,085 shares abstained and 0 broker non-votes.

Item 5. Other Information

On August 6, 2004, Steven Owings resigned as a Director of the Company due to personal health issues.

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

31.1 Certification of the Chief Executive Officer

31.2 Certification of the Chief Financial Officer

32.1 Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. § 1350)

32.2 Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. § 1350)

(b) Reports on Form 8-K

On April 28, 2004, we filed a Form 8-K under Items 7 and 12.

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.

FALCONSTOR SOFTWARE, INC.

/s/ James Weber
James Weber
Chief Financial Officer, Vice President and Treasurer
(Principal Accounting Officer)

August 9, 2004

Exhibit 31.1

I, ReiJane Huai, Chief Executive Officer of FalconStor Software, Inc., certify that:

1. I have reviewed this quarterly report on Form 10-Q of FalconStor Software, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and we have:
    a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
    b) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
    c) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
    a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to affect the registrants ability to record, process, summarize and report financial data and information; and
    b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 9, 2004

/s/ ReiJane Huai
ReiJane Huai
Chief Executive Officer

Exhibit 31.2

I, James Weber, Chief Financial Officer of FalconStor Software, Inc., certify that:

1. I have reviewed this quarterly report on Form 10-Q of FalconStor Software, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and we have:
    a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
    b) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
    c) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
    a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to affect the registrants ability to record, process, summarize and report financial data and information; and
    b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 9, 2004

/s/ James Weber_____
James Weber
Chief Financial Officer

Exhibit 32.1

CERTIFICATION OF CHIEF EXECUTIVE OFFICER

Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. § 1350)

Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. § 1350), the undersigned, ReiJane Huai, Chief Executive Officer of FalconStor Software, Inc., a Delaware Corporation (the "Company"), does hereby certify, to his knowledge, that:

The Quarterly Report on Form 10-Q for the quarter ended June 30, 2004 of the Company (the "Report") fully complies with the requirements of Sections 13(a) and 15(d) of the Securities Exchange Act of 1934, and the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ ReiJane Huai_____
ReiJane Huai
Chief Executive Officer
August 9, 2004

Exhibit 32.2

CERTIFICATION OF CHIEF FINANCIAL OFFICER

Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. § 1350)

Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. § 1350), the undersigned, James Weber, Chief Financial Officer of FalconStor Software, Inc., a Delaware Corporation (the "Company"), does hereby certify, to his knowledge, that:

The Quarterly Report on Form 10-Q for the quarter ended June 30, 2004 of the Company (the "Report") fully complies with the requirements of Sections 13(a) and 15(d) of the Securities Exchange Act of 1934, and the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ James Weber_____
James Weber
Chief Financial Officer
August 9, 2004