

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-K



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

For the fiscal year ended December 31, 2012.

OR



TRANSITION REPORT 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
(State or other jurisdiction of
incorporation or organization)

77-0216135
(I.R.S. Employer
Identification No.)

2 Huntington Quadrangle, Suite 2S01
Melville, New York
(Address of principal executive offices)

11747
(Zip code)

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

Securities registered pursuant to Section 12(b) of the Act:

<u>Title of Each Class</u>	<u>Name of Each Exchange on Which the Securities are Registered</u>
Common Stock, \$.001 par value	NASDAQ Global Market

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ___ No

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

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 has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No ___

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

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

Large Accelerated Filer ___

Accelerated Filer

Non-Accelerated Filer ___

Smaller Reporting Company ___

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

The aggregate market value of Common Stock held by non-affiliates of the Registrant as of June 30, 2012 was \$108,165,786 which value, solely for the purposes of this calculation excludes shares held by Registrant's officers and directors. Such exclusion should not be deemed a determination by Registrant that all such individuals are, in fact, affiliates of the Registrant. The number of shares of Common Stock issued and outstanding as of February 28, 2013 was 55,920,972 and 47,915,737, respectively.

Documents Incorporated by Reference:

The information required by Part III of Form 10-K will be incorporated by reference to certain portions of a definitive proxy statement which is expected to be filed by the Company pursuant to Regulation 14A within 120 days after the close of its fiscal year.

FALCONSTOR SOFTWARE, INC. AND SUBSIDIARIES
2012 ANNUAL REPORT ON FORM 10-K
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PART I

Item 1. Business

OVERVIEW

FalconStor Software, Inc. (“FalconStor”, the “Company”, “we”, “our” or “us”) is a market leader in disk-based data protection. Our mission is to transform traditional backup and disaster recovery (DR) into next-generation service-oriented data protection. We deliver proven, comprehensive, data protection solutions that facilitate the continuous availability of business-critical data with speed, integrity, and simplicity. Our data protection solutions are built upon an award-winning platform that delivers storage virtualization, continuous data protection, WAN-optimized replication, and disaster recovery (DR) automation to meet the evolving needs of today’s data center. Our Business Continuity and Disaster Recovery products include Network Storage Server (NSS) and Continuous Data Protector (CDP). Our Backup Optimization with Deduplication products include the industry-leading Virtual Tape Library (VTL) and File-interface Deduplication System (FDS). From Fortune 100 enterprises to small and medium-size businesses, customers across a vast range of industries worldwide have implemented FalconStor solutions in their production IT environments in order to meet their recovery time objectives (RTO) and recovery point objectives (RPO), as well as to manage their storage infrastructures with minimal total cost of ownership (TCO) and with optimal return on investment (ROI).

FalconStor data protection and storage virtualization solutions are designed to empower IT administrators and end users to recover data easily to any point in time in the event of hardware failure, data corruption, deletion, or catastrophic site-level disaster, allowing rollback or failover to a known, good, immediately useable state to ensure that businesses maintain reliable access to their vital applications, and to facilitate accurate data recovery while minimizing downtime. FalconStor solutions are engineered to integrate and to work seamlessly with database, email, file systems, and business applications. Application-level integration allows for maintaining space-efficient copies of the data that are generated with complete transactional and point-in-time integrity. FalconStor solutions enhance business productivity by eliminating the need for the time-consuming restore and data rebuild processes, which traditionally create long periods of downtime during a recovery process.

Designed to help contain escalating costs, FalconStor solutions enable companies to aggregate heterogeneous, distributed storage capacity and to centralize administration of both storage resources and business-critical data services such as backup, snapshot, replication, and data migration. Companies benefit from lower administrative overhead, elimination of storage over-provisioning, massive scalability, and the ability to make cost-effective storage allocation and purchasing decisions. Moreover, FalconStor’s commitment to an open software-based approach to storage networking entails any-to-any connectivity via native support for industry standards (including Fibre Channel, iSCSI, SCSI, SAS, SATA and Fibre Channel over Ethernet [FCoE]), and delivers unified support for multiple storage architectures. As a result, FalconStor solutions provide companies of any size and complexity with the freedom to leverage IP/iSCSI- or Fibre Channel-based networks and to implement their choice of state-of-the-art equipment based on any standard protocol from any storage manufacturer, without rendering their existing or future investments obsolete.

Recognizing the value propositions of FalconStor’s proven, cutting-edge technology, multiple partners utilize FalconStor’s innovative software products – including CDP, FDS, NSS, and VTL – to power their storage appliances and their bundled solutions. FalconStor’s products have been certified by such industry leaders as Cisco, Citrix, Data Direct Networks, Dell, Dynamic Solutions International, Fujitsu, Hitachi Data Systems, HP, Huawei, IBM, Lanchao, Microsoft, QLogic, Rorke Data, an Avnet Company, Silicon Graphics, Symantec, Violin Memory, VMware, and XIO.

FalconStor was incorporated in Delaware as Network Peripherals, Inc., in 1994. Pursuant to a merger with FalconStor Inc., in 2001, the former business of Network Peripherals, Inc., was discontinued, and the newly re-named FalconStor Software, Inc., continued the storage software business started in 2000 by FalconStor, Inc. FalconStor’s headquarters are located at 2 Huntington Quadrangle, Suite 2S01, Melville, NY 11747. The Company also maintains offices throughout Europe and Asia Pacific.

PRODUCTS AND TECHNOLOGY

FalconStor's products and solutions are built on IPStor® technology, a common software platform that provides the most reliable and complete disk-based data protection and storage virtualization solutions. FalconStor solutions are built to seamlessly integrate within customers' environments to provide a high level of data services and protection to business applications. Not only are FalconStor solutions designed to optimize performance and capacity utilization, making use of the latest advances in storage networking speed and technologies such as deduplication, they also are designed to reduce or eliminate the backup window completely, which allows users to operate 24x7 without any disruption to their business applications or services and to recover any service in minutes, anytime, anywhere, with 100% data integrity. FalconStor offers the following core storage and data protection products: CDP, FDS, NSS, and VTL. All FalconStor products are enabled with WAN-optimized replication technology for cost-effective disaster recovery and remote/branch office protection. In addition, FalconStor solutions share several key technologies that foster seamless integration and offer a competitive edge.

FalconStor's solutions address the full spectrum of data protection business challenges, from the need to accelerate backup to the need to recover data quickly after a disaster. Backup windows not only have shrunk, but for many organizations they have disappeared altogether. Traditional tape backup has been plagued with media and hardware failures. These are some of the issues addressed by FalconStor VTL or FalconStor FDS, depending on the customers' environments. With the time to recover also shrinking, companies need more recovery points and times as well as automation of their recovery processes in order to meet service level agreements (SLAs). According to a survey published by IDG Research Services in July 2012, 59% of the enterprise IT executives and staff surveyed had a RTO for their most mission-critical applications/services of four hours or less. And 65% of those respondents stated that a significant portion of their DR processes are manual. For this reason, customers turn to the FalconStor CDP solution with RecoverTrac™ technology to provide them with instant data availability and automated disaster recovery. To improve the day-to-day management issues that arise from explosive storage growth, customers use the FalconStor NSS solution to virtualize, provision, achieve higher availability and to protect their data. Because all FalconStor solutions are built from a single technology platform, deployment is simplified and businesses benefit from the peace of mind of knowing that FalconStor solutions work in an easily managed and a highly efficient fashion, with high data availability and rapid recovery always paramount.

Deployment options

FalconStor sells its solutions as standalone software, as software pre-installed on FalconStor-supplied hardware appliances, or as virtual appliances.

Solutions

FalconStor offers a wide range of data protection and storage virtualization solutions:

- Data Migration and Storage Virtualization, Provisioning, and Management – FalconStor NSS
- Unified Backup and Disaster Recovery – FalconStor CDP
- Tape Backup Optimization – FalconStor VTL
- Storage Capacity Optimization – FalconStor FDS

FalconStor solutions provide data protection services at all levels – from operating systems and application software, to files, databases, and messaging data – across the entire organization. Our products are scalable in order to address the needs of small/medium businesses, large organizations, and global enterprises. Our solutions offer high availability (HA) through RAID, synchronous and asynchronous mirroring, HA failover, and clustering technologies.

Network Storage Server (NSS)

The FalconStor® Network Storage Server (NSS) solution is a scalable, highly available solution that enables storage virtualization and business continuity in heterogeneous environments. Supporting existing third-party disk arrays, FalconStor NSS eliminates storage boundaries and vendor lock-in, providing fast and easy data storage provisioning and migration. From a small iSCSI virtual server lab to an enterprise-class Fibre Channel SAN running Tier-1 database applications, FalconStor NSS is designed to meet all of the storage needs of any organization.

Moving data between different storage platforms can be complex, time consuming, and disruptive to business operations. FalconStor's core storage virtualization technology provides a non-disruptive and simple approach to data mobility across different SAN protocols and vendors. With FalconStor NSS, it becomes a simple operation to move data from older platforms to newer ones or to introduce new storage tiers. This allows organizations to respond to evolving performance and capacity requirements.

By virtualizing storage on any disk array, FalconStor NSS provides the ability to pool and tier disk assets, simplifying provisioning, reducing allocation errors, and maximizing resource utilization. This allows IT organizations to avoid overprovisioning of disk resources and to bring new servers and projects online quickly and efficiently. FalconStor NSS incorporates a full set of application-aware data protection services, including real-time synchronous mirroring, volume snapshots, and site-to-site WAN-optimized data replication, and leverages the RecoverTrac™ tool for automated disaster recovery.

When deployed in high availability (HA) clusters, FalconStor NSS offers HA functionality. FalconStor NSS can also be implemented as a highly available stretch cluster. A stretch cluster provides automatic failover of storage services between different physical locations or geographic sites within a metropolitan area. Stretch clusters typically are used to create "active/active" data centers in order to provide business continuity with bi-directional replication and dynamic workload balancing across sites. FalconStor NSS stretch clusters enable enterprise-level HA and uninterrupted service for organizations requiring the most stringent level of protection and automation for DR.

Virtual server environments are well served by virtualized storage. FalconStor NSS is designed to make it easy to create a new disk resource to house virtual machine files, and disk resources are re-allocated to different servers or shared among servers to facilitate virtual machine high-availability operations that require shared disk. Specific integration tools allow FalconStor NSS to service virtual server environments in an optimal manner providing rapid and effective recovery processes of a virtual machine or entire virtual server farms. Specifically, FalconStor NSS integrates with and enhances VMware technologies such as VMware vSphere, VMware vCenter, and VMware vCenter Site Recovery Manager. Support of VMware vStorage APIs for Array Integration (VAAI) extends VMware integration into any storage environment and optimizes VMware deployments with comprehensive, flexible storage virtualization and data protection functionality.

In addition, FalconStor NSS enables and automates server-less backup processes. FalconStor backup server integration tools offload backup processes from the server to the FalconStor NSS repository, freeing up the application host server and completely eliminating the backup window.

The FalconStor NSS Virtual Appliance enables cost-effective server virtualization by converting internal or external server storage resources into shared storage resources to enable high availability options across virtual servers. The solution reduces infrastructure cost and complexity while maximizing customers' return on investment. The FalconStor NSS Virtual Appliance brings all the benefits and features of server and storage virtualization to the remote and branch office to reduce costs and to enable effective data protection and recovery solutions across the enterprise.

Continuous Data Protector (CDP)

FalconStor® Continuous Data Protector (CDP) technology reinvents the way data backup and recovery are implemented and performed. Moving far beyond failure-prone once-a-day tape backup models, FalconStor CDP combines local and remote protection into a cost-effective, unified, disk-based solution that allows organizations to recover data back to the most recent transaction. Combining application-aware snapshot agents and continuous journaling functions, FalconStor CDP enables customers to recover data to any point in time.

In addition, FalconStor CDP delivers instant data availability and reliable recovery, bringing business applications back on line in a matter of minutes after a failure. FalconStor CDP protects application-specific data for Microsoft, Oracle, SAP, and other business applications, ensuring high performance and stability for even the most complex business environments. Using a wealth of sophisticated technologies – including application integration, physical-to-virtual recovery, WAN-optimized replication, and disaster recovery automation via the RecoverTrac tool – entire systems can be restored in under ten minutes. Lost files can be recovered in as little as two minutes. Data is protected in its native format and is instantly accessible. With FalconStor CDP, the RTO changes from hours to minutes, minimizing system downtime and economic impact.

In addition, FalconStor CDP enables and automates serverless backup processes. FalconStor's backup server integration tools offload backup processes from the server to the FalconStor CDP repository, freeing up the application host server and completely eliminating the backup window.

The FalconStor CDP Virtual Appliance is a pre-configured, ready-to-run software application packaged for quick, easy deployment in virtual environments. The solution reduces infrastructure cost and complexity while maximizing customers' return on investment. The FalconStor CDP Virtual Appliance provides all the benefits and features of FalconStor CDP to the remote and branch office to enable comprehensive and effective data protection and recovery solutions across the enterprise.

Virtual Tape Library (VTL)

The FalconStor® Virtual Tape Library (VTL) solution is one of the industry's leading virtual tape solution, and we believe it is unmatched in terms of performance and scalability. With virtual tape, backups complete faster and more reliably, with little or no change needed to the backup environment. It enhances backup operations seamlessly without changing any backup processes or policies. Sophisticated physical tape integration and data security complete the solution. Designed from the start as an enterprise-class application, FalconStor VTL can achieve high backup speeds of 20TB per hour per node. Up to eight nodes can combine into a single logical unit, scaling performance to a remarkable 160TB per hour, allowing users to solve the single biggest issue in backup: meeting the backup window.

Built-in data deduplication significantly reduces the amount of data needed to be stored on disk. Combined with the latest high-speed protocols, including 8Gb Fibre Channel (FC) and 10Gb Ethernet, we believe FalconStor VTL demonstrates the fastest sustained deduplication speeds in the industry: more than 28 terabytes per hour with inline deduplication and more than 40 terabytes per hour with post processing. Because not all data is alike, we believe FalconStor VTL is the only deduplication solution to offer flexible deduplication options, letting the customer choose from any combination of four deduplication methods (inline, post-process, concurrent, and no deduplication) to align deduplication processes with business goals and unique requirements. By eliminating redundant backup data, the storage footprint can be reduced by 95% or more, allowing organizations to keep weeks or even months worth of data on disk for fast, dependable restore without any of the reliability concerns of a tape-based restore.

In addition, FalconStor VTL provides a shared deduplication repository that spans multiple application sources, environments, and storage protocols, maximizing space savings. This allows for backup data from any node to be deduplicated against all data in the repository, for true global deduplication. This improves and accelerates data restores, making it easier to meet or exceed service level agreements.

While deduplication can eliminate or greatly reduce the need for physical tapes, many organizations still require tape for long-term, offsite, or archival storage. FalconStor VTL has the industry's broadest and most sophisticated integration with physical tape libraries, allowing companies to export data directly to physical tape, leveraging the speed of the FalconStor VTL without impacting the backup network.

FalconStor VTL also supports small and remote office environments through FalconStor VTL storage appliances and small footprint virtual appliances.

File-interface Deduplication System (FDS)

The FalconStor® File-interface Deduplication System (FDS) offering extends FalconStor's deduplication technology to service a broader set of applications that goes beyond tape backup applications. FalconStor FDS allows companies to optimize storage capacity services for disk-to-disk backup and archiving applications. FalconStor FDS is ideal for small-to-medium businesses (SMB) and remote office/branch office (ROBO) environments that are looking at eliminating or reducing tape infrastructure.

This data deduplication solution reduces storage capacity by as much as 95% and is certified with leading backup and archiving applications. FalconStor FDS presents network-attached storage (NAS) interface accessibility to a block-level deduplication repository through common LAN-based file-access protocols such as CIFS and NFS. Its deployment simplicity easily extends the FalconStor data deduplication technology across multiple applications. FalconStor FDS also delivers a scalable, highly available architecture for the enterprise by sharing a global deduplication repository with the FalconStor VTL. FalconStor FDS provides multi-application data protection and

deduplication at the remote office, and WAN-optimized replication to a scalable, shared deduplication repository at the data center.

FalconStor FDS is also offered as a Virtual Appliance, providing remote and branch offices as well as small enterprises with an economical data deduplication solution. The Virtual Appliance deployment model can eliminate tape-based backup processes at the remote office and the costs and risks associated with physical tape shipments.

Application-Aware Snapshot Agents

FalconStor Snapshot Agents automate and minimize quiescence time during data replication, backup, and other snapshot-based operations to ensure transactional integrity and point-in-time consistency of Windows, Unix, Linux, and VMware systems, databases applications and messaging stores for fast time-to-recovery. Snapshot Agents are available for IBM® DB2® UDB, Informix®, Microsoft® SQL Server, Oracle®, Sybase®, IBM Lotus Notes®/Domino, Microsoft® Exchange Server, Microsoft® Hyper-V, Microsoft® VSS, VMware, and many file systems.

Application-Specific Recovery Options

FalconStor recovery agents offer recovery solutions for database and messaging systems. For instance, FalconStor Message Recovery for Microsoft Exchange expedites mailbox/message recovery by enabling IT administrators to recover individual mailboxes quickly from point-in-time snapshot images of their messaging server. In addition, FalconStor Database Recovery for Microsoft SQL Server expedites database recovery by enabling IT administrators to recover a database quickly from point-in-time snapshot images of their Microsoft SQL database.

Disaster Recovery Automation

The RecoverTrac disaster recovery (DR) automation tool is included as a standard feature of the FalconStor NSS and the FalconStor CDP solutions to automate complex, time-consuming and error-prone failover and failback operations of systems, applications, services, and entire data centers. The RecoverTrac tool streamlines the implementation, testing and execution of DR operations. It minimizes service failover time between sites and reduces DR costs by offering full recovery from physical-to-physical, virtual-to-virtual, and physical-to-virtual server infrastructures.

BUSINESS STRATEGY

FalconStor intends to maintain its position as a leading provider of disk-based data protection and storage virtualization solutions serving enterprises and SMEs worldwide. FalconStor intends to achieve this objective through the following strategies.

Disk-Based Data Protection Leadership

FalconStor intends to continue to leverage the protocol-independent, unified architecture, and robust open data protection technology of its solution to maintain a leadership position in the enterprise and SME disk-based data protection software markets. FalconStor plans to continue its leadership in this market through its deep commitment to research and development and through continued rapid technology innovation. For information on our research and development expenditures, please see “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and our audited consolidated financial statements.

Expand Product Offerings

In 2012, FalconStor continued to develop its product portfolio. In April 2012, the Company announced the latest release of its VTL solution. FalconStor VTL 7.5 provides customers the flexibility to optimize backup for speed and efficiency by tailoring deduplication processes to the needs of their environment. With this release customers can choose from an array of deduplication options – including inline, concurrent, post-processing or no deduplication – and the flexibility to deploy them in multiple configurations to match types of data and available storage. In addition, FalconStor VTL 7.5 is able to attain one of the fastest sustained deduplication speeds in the industry: more than 28 terabytes per hour with inline deduplication and more than 40 terabytes per hour with post processing.

This release also offers improvements in scalability and security. For instance, the solution can scale by either adding nodes or adding storage, an option not available from other vendors, helping customers reduce upfront storage spending and improve efficiency. In addition, this release contains advanced security options with extended support of Advanced Encryption Standard (AES), tape-shredding functionality, full replication encryption, and the addition of Federal Information Processing Standards (FIPS) support for government agencies.

In August 2012, FalconStor released the RecoverTrac 2.5 DR automation tool. The RecoverTrac tool is a standard feature of FalconStor CDP and FalconStor NSS and is the first DR automation solution to bring service-oriented recovery to both physical and virtual server infrastructures, automating the complex, time-consuming and error-prone failover and failback execution of the DR plan. The RecoverTrac 2.5 technology is optimized to meet the needs of today's heterogeneous data centers. Key performance enhancements include the ability to recover multiple machines simultaneously; increased integration with VMware and Hyper-V; the ability to failover and failback between any combination of physical and virtual servers and between dissimilar hardware; greater VMware support, including support for VMware vSphere 5 and VMware cluster support for load balancing and high-availability configurations; and automated DR rehearsal, which allows busy IT managers to test and refine recovery processes on a regular basis without disrupting business operations.

Expand Corporate Visibility

Throughout 2012, FalconStor took significant steps to increase our market presence and awareness. We continued our effort to increase our online presence in the form of advertisements and editorial on key media and industry community sites, as well as advertisements in search engines such as Google. In addition, we refreshed the look and feel of the corporate website; upgraded the website's platform to provide easier access to content and tools; created greater search-engine optimization with enriched content; and added additional resources, streaming media, and downloads.

Through the press releases regarding new products, strategic relationships, and customer wins, we continued to increase our engagement with the press, analyst, and blogging communities to create awareness of and credibility for our data protection message. We have stepped up our participation in online social networking sites and social media outlets such as YouTube, Vimeo, LinkedIn, Flickr, Google+, and Twitter, as well as online conversations both with FalconStor's own expert bloggers and by monitoring and commenting on other blogs.

We have participated in several industry events and speaking engagements and heavily reinforced our outreach with the press and analyst community to bring our comprehensive disk-based data protection message to the market. Our focus aims to highlight our success with our customers and partners throughout the world as well as the value our solutions bring to solving their data protection challenges. This broad effort has led to several awards and accolades:

- Everything Channel awarded FalconStor Software the 2012 Five-Star Partner Program Guide Certification.
- FalconStor was recognized as a 2012 Long Island Software Award (LISA) recipient for FalconStor CDP 7.0.
- FalconStor Software was named to Everything Channel's CRN Virtualization 100 List.
- The FalconStor VTL solution was selected for the Network World Asia Information Management Award within the Backup & Recovery Solution category.
- RecoverTrac technology was selected as a "Best of VMworld 2012" award gold winner in the Business Continuity and Data Protection category.
- The FalconStor NSS VS Series HA Appliance was named as a silver medal winner of the "2012 Editors' Best Awards" in the Best Hardware Appliance category by Penton Media's Windows IT Pro.
- RecoverTrac technology was named a 2012 Product of the Year finalist within the backup and disaster recovery software and services category by Storage Magazine and SearchStorage.com.

We anticipate that this positive recognition will continue throughout 2013, as we continue to innovate and refine our message to address new market conditions while delivering targeted marketing campaigns.

We continue to promote strong relationships with our channel partners. In 2012, we increased our investment in our partners with joint marketing and field engagement, completing focused multi-pronged demand generation and nurturing programs to jointly build our businesses.

Scalable Delivery

All FalconStor solutions support variable deployment options offering greater flexibility to seamlessly fit within our customers' environments and to respond to their exact needs and requirements. The scalability of our solutions can support the smallest environments such as remote and branch offices with prepackaged virtual appliances or small hardware appliances, as well as the largest deployments supporting multi-petabyte environments in large datacenters.

The different delivery options include virtual appliances for small and remote offices, storage appliances for small to medium enterprises, and clustered gateways and software appliance kits for large enterprise deployments.

Expand Software and Hardware Strategic Alliances with Industry Leaders

In March 2012, FalconStor announced that it had entered into a worldwide agreement with Dell Services to deploy FalconStor NSS technology to enable a data migration service. This technology sharing agreement enables Dell to meet their customers' need to efficiently expand and upgrade legacy storage installations without disrupting operations.

Identify and Nurture New Growth Drivers

FalconStor has made key investments in several areas from which we expect growth in the coming years. We believe we are strongly positioned to continue to take advantage of the rapid storage growth in China and Japan. Our strategic relationships with Dell, Fujitsu, Hitachi Data Systems, HP, and Huawei should enable growth across our main geographies in Asia Pacific, Europe Middle-East and Africa, and North America.

We also see opportunity in emerging regions. According to a 2012 DatacenterDynamics Industry Census, the global investment in data centers grew by 22.1% to \$105 billion in 2012 and is expected to grow by another 14.5% to \$120 billion in 2013. Much of this growth is being driven by the Asia Pacific and Latin America regions.

As the amount of data continues to increase, we believe companies will look to alternatives to simply adding more storage to their infrastructure and will leverage technologies such as storage virtualization, thin provisioning, and data deduplication to reduce data storage requirements. We believe that FalconStor, as a leading developer of storage virtualization and disk-based data protection solutions, will see a growing demand for its products and solutions.

As the server virtualization market continues to gain rapid adoption, we anticipate a growing need for integrated storage and server virtualization solutions for maximizing IT productivity and business continuity. This combination of solutions should improve data center resource management by increasing utilization of existing physical resources, while optimizing virtual infrastructure performance through real-time data migration, to deliver more cost-effective and reliable high-availability and disaster recovery. In 2012, we developed more integration tools and solutions to support and enhance VMware and Microsoft environments. We expect that in 2013 our relationships with virtualization vendors and our joint technology solutions will continue to grow and will put FalconStor in a strong position to service customers that are looking at deploying these solutions.

SALES, MARKETING AND CUSTOMER SERVICE

FalconStor plans to continue to sell our products primarily through strategic alliances, value-added resellers (VARs) or solution providers, large system integrators, Direct Market Resellers (DMRs), distributors, and original equipment manufacturers (OEMs).

VAR and Distributor Relationships. FalconStor has entered into VAR and distributor agreements to help sell our products in various geographic areas. We have revamped our sales and marketing infrastructure to further support and expand our network of VARs worldwide. FalconStor's VARs and distributors market various FalconStor products and receive a discount off of the list price on products sold. FalconStor's scalable solutions are also being deployed by Managed Service Providers (MSP) to deliver online data protection and recovery services across different vertical markets. We have reduced the number of VARs with whom we do business. Our focus is on the VARs who are willing to commit to FalconStor.

Strategic Alliances. FalconStor has agreements with strategic partners to utilize FalconStor products for use in the strategic partners' special-purpose storage appliances.

OEM Relationships. OEMs collaborate with FalconStor to integrate FalconStor technology into their own product offerings or to resell FalconStor technology under their own label.

FalconStor has relationships with three of the largest and most influential storage vendors in the industry, Dell, Hewlett Packard, and Hitachi Data Systems.

In a limited number of circumstances, FalconStor has entered into software license agreements directly with end users.

FalconStor's marketing efforts focus on building brand recognition among customers, partners, analysts, and the media and on developing qualified leads for the sales force and our partners.

FalconStor's Professional Services personnel are also available to assist customers and partners throughout the lifecycle of FalconStor solution deployments. The Professional Services team includes experienced Storage Architects (expert field engineers) who can assist in the assessment, planning/design, deployment, and test phases of the deployment project, and a Technical Support Group for post-deployment assistance and ongoing support.

COMPETITION

As the demand grows for data protection and network-based storage products and services, so does the demand for services and integration with emerging technologies. This growing demand combined with increases in services for cloud computing and Big Data, will cause more competitors to enter this high-growth market segment. Although there are several companies attempting to offer data protection for specific environments, FalconStor believes it is the only software-based solution provider capable of delivering a high level of data protection services across the data center, crossing the infrastructure boundaries between virtual and physical server environments. FalconStor holds multiple patents on key technologies that enable and optimize our snapshots, data protection, and data reduction platform. We believe that our integrated services and products based on our common storage virtualization platform – including CDP, FDS, NSS, VTL, WAN-optimized replication for remote offices and data centers, and disaster recovery automation – are unique to the industry.

Although some of FalconStor's products provide capabilities that put them in competition with products from a number of companies, FalconStor is not aware of any other software company providing the same level of data protection and recovery capabilities for both physical and virtual infrastructures in a common solution. FalconStor believes that the principal competitive factors enhancing its marketability include product features such as scalability, high availability, price, reliability, hardware/platform neutrality, and customer service and support.

As FalconStor continues its move into the non-enterprise market, the products and services offered by its partners may compete with existing or new products and services offered by current and new entrants to the market.

FalconStor's future and existing competitors could conceivably introduce products with superior features, scalability, and functionality at lower prices than FalconStor's products. They could also bundle existing or new products with other more established products to compete with FalconStor. Increased competition could result in price reductions and reduced gross margins, which in turn could impact FalconStor's business. FalconStor's success will depend largely on its ability to generate market demand and awareness of its products and to enhance or develop new products and services in a timely manner. The Company's success also will depend on its ability to convince potential partners of the benefits of licensing FalconStor's software rather than competing technologies.

INTELLECTUAL PROPERTY

FalconStor's success is dependent in part upon its proprietary technology. The IPStor platform forms the core of this proprietary technology. FalconStor currently has nineteen patents and numerous pending patent applications. The Company has multiple registered trademarks – including "FalconStor Software" and "IPStor" – as well as pending trademark applications related to FalconStor and its products.

FalconStor seeks to protect its proprietary rights and other intellectual property through a combination of copyright, patents, trademark, and trade secret protection, as well as through contractual protections such as proprietary information agreements and nondisclosure agreements. The technological and creative skills of its personnel, new product developments, frequent product enhancements, and reliable product maintenance are essential to establishing and maintaining a technology leader position.

FalconStor generally enters into confidentiality or license agreements with employees, consultants, and corporate partners and generally controls access to and distribution of its software, documentation, and other proprietary information. Despite the Company's efforts to protect its proprietary rights, unauthorized parties may attempt to copy or otherwise obtain and use FalconStor's products or technology. Monitoring unauthorized use of FalconStor's products is difficult, and there can be no assurance that the steps FalconStor has taken will prevent misappropriation of its technology, particularly in foreign countries where laws may not protect its proprietary rights as fully as do the laws of the United States.

MAJOR CUSTOMERS

For the year ended December 31, 2012, we had one customer, Hitachi Data Systems, which accounted for 11% of our total revenues. For the year ended December 31, 2011, we had no customers that accounted for 10% or more of our total revenues. For the year ended December 31, 2010, we had one customer, EMC Corporation, which accounted for 10% of our total revenues. As of December 31, 2012 and December 31, 2011, Hitachi Data Systems' accounts receivable balance was 20% and 11%, respectively, of our gross accounts receivable balance.

EMPLOYEES

As of December 31, 2012, we had 427 full-time and part-time employees, consisting of 171 in research & development, 135 in sales & marketing, 82 in service, and 39 in general administration. We are not subject to any collective bargaining agreements and we believe that our employee relations are good.

INTERNET ADDRESS AND AVAILABILITY OF FILINGS

Our internet address is www.falconstor.com. The Company makes available free of charge, on or through its Internet website, the Company's Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, current Reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Sections 13(a) or (15)(d) of the Securities Exchange Act of 1934, as amended, as soon as reasonably practicable after the Company electronically files such material with, or furnishes it to, the Securities and Exchange Commission. The Company complied with this policy for every Securities Exchange Act of 1934, as amended, report filed during the year ended December 31, 2012.

Item 1A. Risk Factors

We are affected by risks specific to us as well as factors that affect all businesses operating in a global market. The significant factors known to us that could materially adversely affect our business, financial condition, or operating results are set forth below.

We are operating under a Deferred Prosecution Agreement with the United States Attorney's Office. If we violate its terms, we could be subject to criminal prosecution, which would have a negative impact on the Company.

On June 27, 2012, we entered into a Deferred Prosecution Agreement ("DPA") with the United States Attorney's Office for the Eastern District of New York ("USAO"). In conjunction with the DPA, a Criminal Complaint was filed against the Company. The USAO agreed, as part of the DPA, to defer prosecution of that complaint for eighteen months. If we comply fully with the DPA, the charges will be dismissed at the conclusion of the eighteen month period. Among other things, the DPA requires us to continue to comply with various control changes we had made in response to the discovery that improper payments had been made to one customer by three former employees. The DPA also mandates that we do not commit any criminal acts. If we fail to comply with the DPA, the USAO has the right to prosecute the complaint and to file additional charges if we have committed any new criminal acts. While we expect to be in compliance with the DPA, a prosecution of the Company would have a severe negative impact on the long term viability of the Company.

We are among the defendants in a class action lawsuit by stockholders. While a proposed settlement has been filed with the court, we cannot predict the timing or the outcome of these actions, or whether we have adequate insurance to cover our costs and any damages.

We are defendants in a class action lawsuit brought by Company shareholders (the “Class Action”). The other defendants are James Weber, our former CFO and Vice President for Operations, and the estate of ReiJane Huai. Mr. Huai was our former Chairman, President and CEO.

The Class Action complaint alleges that the defendants defrauded shareholders by falsely certifying in our SEC filings that they had disclosed any fraud, whether or not material, that involved management or other employees who had a significant role in the registrant’s internal control over financial reporting. The Class Action complaint alleges that the defendants were in fact aware of fraud.

In January, 2013, the parties to the Class Action reached an agreement in principle to settle the Class Action. Pursuant to a Memorandum of Understanding signed by counsel for the class plaintiffs and by counsel for all defendants, the Company will pay \$5.0 million to settle the Class Action. This amount includes damages, plaintiffs’ attorneys’ fees, and costs of administration of the settlement. The Company expects to pay this settlement with a combination of cash on hand and insurance proceeds. In accordance with the Memorandum of Understanding, a stipulation of settlement and a joint motion for preliminary approval of the settlement will be submitted to the court for its approval. Final settlement of the Class Action is subject to certain conditions and to approval by the court. We cannot predict if or when the court might approve the settlement.

Certain of the defendants may be entitled to indemnification by the Company under the laws of Delaware and/or our by-laws.

While we have insurance policies that we believe cover us for the allegations of the Class Action, we have already reached an agreement with one insurance carrier that gave us less than the face amount of the insurance. There can be no assurance that the recovery we make on the remainder of our insurance will be adequate to cover the costs of our defense or settlement of the Class Action, or any damages that might ultimately be awarded against us or anyone to whom we might owe indemnification if the settlement is not approved by the court. Our insurers may deny coverage under the policies. If our insurance recovery is not adequate to cover the costs of defense, settlement, damages and/or indemnification, or our insurers deny coverage, the amounts to be paid by the Company could have a significant negative impact on our financial results, our cash flows and our cash balances.

The Deferred Prosecution Agreement and the facts detailed therein could damage our reputation and harm our ability to compete for customers.

The market for network storage solutions is highly competitive. The fact that we are operating under a Deferred Prosecution Agreement, the facts detailed therein regarding improper payments to one customer by three former employees, and the filing of a criminal complaint have damaged our reputation and harmed our ability to compete for customers. We are aware that some of our competitors have used these facts in attempts to dissuade potential customers from doing business with us and we believe some of our competitors will continue to do so in the future. When potential customers choose not to buy our products or services, or not to license our software, it has a negative impact on our business.

We have engaged Wells Fargo Securities LLC to advise us with regard to potential strategic alternatives to enhance stockholder value. There can be no guarantee that we will enter into a strategic transaction or that any such transaction will enhance stockholder value.

The Company has retained the investment banking firm Wells Fargo Securities, LLC as its exclusive financial advisor to assist the Company in exploring and evaluating strategic alternatives to maximize stockholder value. There can be no guarantee that the Company or its advisor will be able to identify or to complete any transaction or that any such transaction will enhance stockholder value.

We have had significant turnover in our senior management.

Since September 29, 2010, we have accepted the resignations of our CEO; two CFO’s; our CTO; two VP’s of Sales for North America; our VP of Sales and General Manager for Europe, the Middle East and Africa; our VP of Sales and General Manager of Asia-Pacific; our VP of Global Support; and our VP of Marketing.

We have filled these positions with highly qualified individuals with extensive storage and software company experience. However, there can be no guarantee that the new senior management will be able to get up to speed and successfully manage the Company. In addition, with the exception of James P. McNiel, we have no employment agreements with any of our senior management and there can be no assurance that we will be able to retain any or all of the members of the senior management team.

Our revenues from certain key customers have been declining and there is no guarantee that we will be able to replace it.

From 2005 to 2010, revenue from EMC accounted for 10% or more of our annual revenue. For 2012 and 2011, revenue from EMC was less than 10% of our annual revenues and we do not expect that revenue from EMC will be 10% or more of our total revenue at any point in the future.

We are attempting to replace the revenue we formerly received from EMC with revenue from other partners and from our FalconStor-branded solutions, but there is no guarantee that we will be successful in these attempts.

A significant portion of our receivables is concentrated with one customer.

As of December 31, 2012 and December 31, 2011, Hitachi Data Systems' accounts receivable balance was 20% and 11%, respectively, of our gross accounts receivable balance. We currently have no reason to expect that Hitachi Data Systems will fail to pay the amounts invoiced, nor do we have any history of non-payment with Hitachi Data Systems, but the concentration of this receivable means that any failure by Hitachi Data Systems to pay us all or a significant portion of this receivable would have a material impact on us.

Our increased emphasis on sales of turn-key appliances may not be successful and exposes us to supply, inventory and support risks.

We now emphasize sales of turn-key appliances. These appliances consist of our branded software loaded onto industry standard hardware. The hardware, while purchased from third parties, is FalconStor branded. There can be no guarantee that we will be more successful selling these appliances than we have been selling software-only solutions.

In addition, the increased emphasis on appliances creates the following additional risks:

- **Supply.** We are dependent on third parties for the supply of the hardware. If we cannot obtain adequate supplies of the hardware, we could lose sales and revenues. If our hardware suppliers discontinue certain models, our sales could be disrupted while we find and certify replacement models. If customer orders exceed our expectations, we may not be able to deliver all of the appliances to meet those orders in a particular quarter.
- **Inventory.** In order to mitigate supply issues, we maintain an inventory of appliances. We spend money on this inventory in advance of customer orders. This is money that could have been used for other purposes or that could have been invested. If the inventory is inadequate, we may lose sales or not be able to fulfill orders in a particular quarter. If the inventory is excessive, we could end up with obsolete hardware for which we have paid and for which we are unable to find buyers, leaving us with a loss.
- **Support.** While our suppliers are responsible for providing us with support for their hardware, our customers look to us for support of the entire appliance. We are responsible for coordinating all support for the appliance, whether the problem relates to the software or to the hardware. This increases the burden on our support group and may require us to hire additional support personnel.

We are highly dependent on one third party for the supply of hardware. Changes made by this third party could impact our ability to sell our bundled solutions.

We install our software on industry-standard hardware. We purchase nearly all of that hardware from Dell. We test our software with the Dell hardware to make sure that the software runs smoothly. From time to time, Dell makes modifications to the hardware or stops offering certain hardware models. In those instances, we need to recertify that our software operates properly on the revised or new hardware. This testing takes time. If it is discovered that we need to modify our software to operate properly with the revised or new hardware, we need time

to make the changes and to certify that the software runs smoothly. These delays can impact our ability to ship our products in a timely manner and could negatively impact our results.

We are highly dependent on one third party for the supply of hardware and this third party may be dependent on others for components. Any disruption in the supply chain could impact our ability to ship our products.

We install our software on industry-standard hardware. We purchase nearly all of that hardware from Dell. The Dell hardware contains many components. Should Dell experience disruption in its supply chain, Dell might not be able to provide us with enough hardware to meet our needs. For example, in 2011, flooding in Thailand caused significant disruptions in the worldwide supply of hard disk drives. We were warned by Dell that this could result in the rationing of Dell hardware. Fortunately, Dell was able to meet all of our requirements. But there can be no guarantee that a similar disruption in the supply chain will not impact our ability to source all of the hardware we require. If we are unable to acquire the necessary hardware, our revenues will be impacted negatively.

Our margins have been and will continue to be impacted by our emphasis on FalconStor branded appliances and the decrease in our OEM sales.

The shift in emphasis from sales of software licenses to sales of turn-key appliances has hurt our profit margins.

Once software is developed, the cost of licensing each individual copy of the software is lower than the cost of selling an appliance. In addition to the costs associated with licensing software, with sales of turn-key appliances we incur the cost of the hardware itself. Margins on hardware sales are typically quite small, so the overall margin on the sale of an appliance is lower than the sale of a license to stand-alone software.

Software license sales to OEMs typically have the highest margins, because no salespeople are compensated, support costs are typically lower, and marketing expenses are minimal. Sales of FalconStor-branded appliances and software require us to compensate salespeople, to provide customer support and to market the products, all of which reduce our profit margins.

We had losses for fiscal years 2012, 2011, 2010 and 2009 and we cannot guarantee that we will return to profitability.

We have operated at a loss for each of the past four years. We are, and have been, attempting to increase revenues and to decrease costs, but there can be no guarantee that we will be profitable again. If our losses continue, we will deplete our available cash and we may not be able to continue to fund effective sales and marketing or the research and development activities on which we are dependent.

Due to the uncertain and shifting development of the data protection and network storage software markets and our reliance on our partners, we may have difficulty accurately predicting revenue for future periods and appropriately budgeting for expenses.

The rapidly evolving nature of the data protection and network storage software markets in which we sell our products, the degrees of effort and success of our partners' sales and marketing efforts, and other factors that are beyond our control, reduce our ability to accurately forecast our quarterly and annual revenue. However, we must 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.

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

The data protection and the network storage software markets continue 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 data protection or network storage software market segments and emerging technologies to remain competitive in the data storage software industry. We are uncertain whether we will successfully qualify new data protection or network storage software products with our customers by meeting customer performance and quality specifications. Any failure to address additional market segments could harm our business, financial condition and operating results.

Our next generation products have been delayed, and there can be no guarantee that we will be able to release them in a timely manner.

We now intend to release our next generation products in stages over the next two years. It is possible that the development schedule could be delayed again or that we will not be able to develop certain features. Because our customers expect continuous improvements and innovations, any additional delays in the release of new products could have a material negative impact on our 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 storage 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 products may have errors or defects that could result in reduced demand for our products or costly litigation.

Our solutions are complex and are 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 infrastructures. 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 could result in damage to our customers. These problems could cause us to incur significant service and engineering 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.

Our other products may also contain errors or defects. If we are unable to fix the errors or other problems that may be discovered, 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 to integrate smoothly with end user systems could impact demand for the appliances.

We offer our software on a stand-alone basis and as part of an appliance in which we install our software onto third party hardware. In addition, we have entered into agreements with resellers and OEM partners to develop storage appliances that combine VTL, CDP, NSS or FDS 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 suffer.

Issues with the hardware on which our software products are installed could increase our support costs and result in lower sales of our products.

We deliver some of our products, both through our resellers and directly to end-users, installed on third party hardware. If the hardware does not function properly, our support costs will go up. We will have to arrange or pay for the repair or replacement of the broken hardware and we may have to increase the size of our support operations. Hardware reliability issues could also cause resellers and end-users to refuse to make purchases from us, even if our software products function properly.

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

The vast majority of our sales come from sales to end users of our products by our resellers and by our OEM customers. These resellers and OEM customers have limited resources and sales forces and sell many different

products, both in the data protection and the network storage software markets and in other markets. The resellers and OEM customers may choose to focus their sales efforts on other products in the data protection and the network storage software markets 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.

The failure of our resellers to sell our products effectively could have a material adverse effect on our revenues and results of operations.

We rely significantly on our value-added resellers, direct market resellers, systems integrators and corporate resellers, which we collectively refer to as resellers, for the marketing and distribution of our software products and our services. However, our agreements with resellers are generally not exclusive, are generally renewable annually and in many cases may be terminated by either party without cause. Many of our resellers carry products that are competitive with ours. These resellers may give a higher priority to other products, including those of our competitors, or may not continue to carry our products at all. If a number of resellers were to discontinue or reduce the sales of our products, or were to promote our competitors' products in lieu of ours, it would have a material adverse effect on our future revenues. Events or occurrences of this nature could seriously harm our sales and results of operations. In addition, we expect that a significant portion of our sales growth will depend upon our ability to identify and attract new reseller partners. The use of resellers is an integral part of our distribution network. We believe that our competitors also use reseller arrangements. Our competitors may be more successful in attracting reseller partners and could enter into exclusive relationships with resellers that make it difficult to expand our reseller network. Any failure on our part to expand our network of resellers could impair our ability to grow revenues in the future.

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. If our software was to be replaced in an OEM solution by competing software, or if our software is not selected by OEMs for future solutions, it would likely result in lower revenues to us and would impede our ability to grow our business.

We rely on channel partners to sell our solutions, and disruptions to, or our failure to develop and manage our channel partners would harm our business.

Our future success is partially dependent upon establishing and maintaining successful relationships with the right channel partners. A majority of our revenue is generated by sales through our channel partners, and we expect channel sales to continue to make up the majority of our total revenue in the future. Accordingly, our revenues are largely dependent on the effective sales and lead generation activities of these channel partners.

Recruiting and retaining qualified channel partners and training them in our technology and product offerings requires significant time and resources. In order to develop and expand our distribution channel, we must continue to scale and improve our processes and procedures that support our channel, including investment in systems and training. Those processes and procedures may become increasingly complex and difficult to manage as we grow our organization. We have no minimum purchase commitments from any of our channel partners, and our contracts with these channel partners do not prohibit them from offering products or services that compete with ours. Our competitors may provide incentives to existing and potential channel partners to favor their products or to prevent or reduce sales of our solutions. Our channel partners may choose not to offer our solutions exclusively or at all. Establishing relationships with channel partners who have a history of selling our competitors' products may also prove to be difficult. In addition, some of our channel partners are also competitors. Our failure to establish and maintain successful relationships with channel partners would harm our business and operating results.

The data protection and network storage software markets are highly competitive and intense competition could negatively impact our business.

The data protection and network storage software markets are 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 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 ability to sell our products is highly dependent on the quality of our services offerings, and our failure to offer high quality support and professional services would have a material adverse affect on our sales of our products and results of operations.

Our services include the assessment and design of solutions to meet our customers' data protection and storage management requirements and the efficient installation and deployment of our products based on specified business objectives. Further, once our products are deployed, our customers depend on us to resolve issues relating to our products. A high level of service is critical for the successful marketing and sale of our software. If our partners or we do not effectively install or deploy our applications, or succeed in helping our customers quickly resolve post-deployment issues, it would adversely affect our ability to sell software products to existing customers and could harm our reputation with potential customers. As a result, our failure to maintain high quality support and professional services would have a material adverse effect on our sales of our products and results of operations.

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.

Our revenues depend in part on spending by corporate customers.

The operating results of our business depend in part on the overall demand for data protection and network storage software. Because the market for our software is primarily major corporate customers, any softness in demand for data protection or network storage software may result in decreased revenues.

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

Our previous results are not necessarily indicative of our future performance and our future quarterly results may fluctuate significantly.

Our future performance will depend on many factors, including:

- compliance with the Deferred Prosecution Agreement with the United States Attorney's Office and Court approval of the class action lawsuit;
- fluctuations in the economy;
- the timing of securing software license contracts and the delivery of software and related revenue recognition;
- the seasonality of information technology, including network storage products, spending;
- 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;
- our ability to release new and innovative products;
- 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 December 31, 2012, the closing market price of our common stock as quoted on the NASDAQ Global Market fluctuated between \$1.73 and \$3.80. The market price of our common stock may be significantly affected by the following factors:

- actual or anticipated fluctuations in our operating results;
- the impact of the Deferred Prosecution Agreement and whether we comply with the Deferred Prosecution Agreement;
- the status of the class action and derivative lawsuits;
- failure to meet financial estimates;
- changes in market valuations of other technology companies, particularly those in the network storage software market;
- the announcement of any strategic alternatives;
- announcements by us or our competitors of significant technical innovations, acquisitions, strategic partnerships, strategic alternatives, joint ventures or capital commitments;
- loss of one or more key 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.

Our ability to forecast earnings is limited by the impact of certain accounting requirements.

The Financial Accounting Standards Board requires companies to recognize the fair value of stock options and other share-based payment compensation to employees as compensation expense in the statement of operations. However, this expense, which we estimate based on the “Black-Scholes” model, is subject to factors beyond our control. These factors include the market price of our stock on a particular day and stock price “volatility.” These unknowns make it difficult for us to forecast accurately what the amount of share-based compensation expense will be in the future. Because of these factors, our ability to make accurate forecasts of future earnings is compromised.

Our marketable securities portfolio could experience a decline in market value which could materially and adversely affect our financial results.

As of December 31, 2012, we held short-term marketable securities aggregating \$10.5 million. We invest in a mixture of corporate bonds, government securities and marketable debt securities, the majority of which are high investment grade, and we limit the amount of credit exposure through diversification and investment in highly rated securities. However, investing in highly rated securities does not entirely mitigate the risk of potential declines in market value. A further deterioration in the economy, including further tightening of credit markets or significant volatility in interest rates, could cause our marketable securities to decline in value or could impact the liquidity of the portfolio. If market conditions deteriorate significantly, our results of operations or financial condition could be materially and adversely affected.

The ability to predict our future effective tax rates could impact our ability to accurately forecast future earnings.

We are subject to income taxes in both the United States and the various foreign jurisdictions in which we operate. Judgment is required in determining our provision for income taxes and there are many transactions and calculations where the tax determination may be uncertain. Our future effective tax rates could be affected by changes in our (i) earnings or losses; (ii) changes in the valuation of our deferred tax assets; (iii) changes in tax laws; and (iv) other factors. Our ability to correctly predict our future effective tax rates based upon these possible changes could significantly impact our forecasted earnings.

The likelihood of a change of control in our company could be impacted by the fact that we have a significant amount of authorized but unissued preferred stock, a staggered Board of Directors and change of control agreements as well as certain provisions under Delaware law.

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. Further, we have a staggered Board of Directors and have entered into change of control agreements through either employment agreements, our 2005 Key Executive Severance Protection Plan with certain executives, or certain incentives provided to certain employees which may also have the effect of delaying, deterring or preventing a change in control.

We have a significant number of outstanding options, the exercise of which would dilute the then-existing stockholders’ percentage ownership of our common stock, and a smaller number of restricted shares of stock, the vesting of which will also dilute the then-existing stockholders’ percentage ownership of our common stock.

As of December 31, 2012, we had outstanding options to purchase 11,360,842 shares of our common stock, and we had an aggregate of 171,190 outstanding restricted shares and restricted stock units. If all of these outstanding options were exercised, and all of the outstanding restricted stock and restricted stock units vested, the proceeds to the Company would average \$4.59 per share. We also had 2,526,036 shares of our common stock reserved for issuance under our stock plans with respect to options (or restricted stock or restricted stock units) that have not been granted. In addition, if, on July 1st of any calendar year in which our 2006 Incentive Stock Plan, as amended (the “2006 Plan”), is in effect, the number of shares of stock to which options, restricted shares and

restricted stock units may be granted is less than five percent (5%) of the number of outstanding shares of stock, then the number of shares of stock available for issuance under the 2006 Plan shall be increased so that the number equals five percent (5%) of the shares of stock outstanding. In no event shall the number of shares of stock subject to the 2006 Plan in the aggregate exceed twenty million shares, subject to adjustment as provided in the 2006 Plan. See Note (2) *Share-Based Payment Arrangements* to our consolidated financial statements.

The exercise of all of the outstanding options and/or the vesting of all outstanding restricted shares and restricted stock units and/or the grant and exercise of additional options and/or the grant and vesting of restricted stock and restricted stock units 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.

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

While our headquarters facilities contain redundant power supplies and generators, our domestic and foreign 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.

In 2011, our supply of hardware components was impacted by floods in Thailand. We continually look for alternatives to help mitigate any supply chain disruptions due to natural disasters, terrorist acts or other catastrophic events. However, our failure to mitigate these supply chain disruptions could impact our ability to procure and deliver products to our customers, which could adversely impact our overall financial condition.

We are dependent on a variety of IT and telecommunications systems, and any failure of these systems could adversely impact our business and operating results.

We depend on IT and telecommunications systems for our operations. These systems support a variety of functions including order processing, shipping, shipment tracking, billing, support center and internal information exchange.

Failures or significant downtime of our IT or telecommunications systems could prevent us from taking customer orders, shipping products, billing customers, handling support calls, or communication among our offices. The Internet and individual websites have experienced a number of disruptions and slowdowns, some of which were caused by organized attacks. In addition, some websites have experienced security breakdowns. If we were to experience a security breakdown, disruption or breach that compromised sensitive information, it could harm our relationship with our customers. Our support centers are dependent upon telephone and data services provided by third party telecommunications service vendors and our IT and telecommunications system. Any significant increase in our IT and telecommunications costs or temporary or permanent loss of our IT or telecommunications systems could harm our relationships with our customers. The occurrence of any of these events could have an adverse effect on our operations and financial results.

United States Government export restrictions could impede our ability to sell our software to certain end users.

Certain of our products include the ability for the end user to encrypt data. The United States, through the Bureau of Industry Security, places restrictions on the export of certain encryption technology. These restrictions may include: the requirement to have a license to export the technology; the requirement to have software licenses approved before export is allowed; and outright bans on the licensing of certain encryption technology to particular end users or to all end users in a particular country. Certain of our products are subject to various levels of export restrictions. These export restrictions could negatively impact our business.

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.

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 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.

Foreign currency fluctuations may impact our revenues.

Our licenses and services in Japan are sold in Yen. Many of our licenses and services in the Republic of Korea, Australia, Canada, and in Europe, the Middle East and Africa (“EMEA”) are sold in Won, Canadian dollars, Australian dollars, and European Monetary Units (“Euros”), respectively.

Changes in economic or political conditions globally and in any of the countries in which we operate could result in exchange rate movements, new currency or exchange controls or other restrictions being imposed on our operations.

Fluctuations in the value of the U.S. dollar may adversely affect our results of operations. Because our consolidated financial results are reported in U.S. dollars, translation of sales or earnings generated in other currencies into U.S. dollars can result in a significant increase or decrease in the reported amount of those sales or earnings. Significant changes in the value of these foreign currencies relative to the U.S. dollar could have a material adverse effect on our financial condition or results of operations.

Fluctuations in currencies relative to currencies in which our earnings are generated make it more difficult to perform period-to-period comparisons of our reported results of operations. For purposes of accounting, the assets and liabilities of our foreign operations, where the local currency is the functional currency, are translated using period-end exchange rates, and the revenues, expenses and cash flows of our foreign operations are translated using average exchange rates during each period.

In addition to currency translation risks, we incur currency transaction risk whenever we enter into either a purchase or a sales transaction using a currency other than the local currency of the transacting entity. Given the volatility of exchange rates, we cannot be assured we will be able to effectively manage our currency transaction and/or translation risks. Volatility in currency exchange rates may have a material effect on our financial condition or results of operations. Currency exchange rate fluctuations have not, in the past, resulted in a material impact on earnings. However, we may experience at times in the future an impact on earnings as a result of foreign currency exchange rate fluctuations.

Since 2009, we have utilized a program to hedge some of our foreign currency risks from time to time. The hedging program will not remove all downside risk and limits the gains we might otherwise receive from currency fluctuations. There can be no assurance that we will be able to enter into future currency hedges on terms acceptable to us (see Note (11) *Derivative Financial Instruments* to our consolidated financial statements).

Because we conduct operations in China, risks associated with economic, political and social events in China could negatively affect our business and operating results.

China is becoming a significant market for our products and we are increasing our operations in China. In addition to a joint venture with the Chinese Academy of Science, we have OEM agreements with several Chinese companies. We also have research and development and sales offices in China employing a total of 46 people as of December 31, 2012. Our operations in China are subject to a number of risks relating to China’s economic and political systems, including:

- government controlled foreign exchange rate and limitations on the convertibility of the Chinese Renminbi;
- extensive government regulation;
- changing governmental policies relating to tax benefits available to foreign-owned businesses;

- the telecommunications infrastructure;
- relatively uncertain legal system; and
- uncertainties related to continued economic and social reform.

Any significant interruption in our China operations, whether resulting from any of the above uncertainties, natural disasters or otherwise, could result in delays or disruptions in our revenue and our research development operations, either of which could cause our business and operating results to suffer.

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

Our success is dependent upon our proprietary technology. We have 21 patents issued, and we have multiple pending patent applications, numerous trademarks registered and multiple pending trademark applications related to our products. 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 were already subject to one action, which alleged that our technology infringed on patents held by a third party. While we settled this litigation, the fees and expenses of the litigation as well as the litigation settlement were expensive and the litigation diverted management's time and attention. In addition, as part of our ongoing litigation with Avazpour Networking Services, Inc., we have filed counterclaims for copyright infringement. Any additional litigation, regardless of its outcome, would likely be time consuming and expensive to resolve and would divert management's time and attention and might subject us to significant liability for damages or invalidate our intellectual property rights. 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.

Developments limiting the availability of Open Source software could impact our ability to deliver products and could subject us to costly litigation.

Many of our products are designed to include software or other intellectual property licensed from third parties, including "Open Source" software. At least one intellectual property rights holder has alleged that it holds the rights to software traditionally viewed as Open Source. In addition, United States courts have not interpreted the terms of many open source licenses, and there is a risk that such licenses could be construed in a manner that could impose unanticipated conditions or restrictions on our ability to commercialize our appliances. We could be required to seek licenses from third parties in order to continue offering our software, to re-engineer our software, to discontinue the sale of our software in the event re-engineering cannot be accomplished on a timely basis or to litigate any disputes relating to our use of open source software, any of which could harm our business. There can be no assurance that the necessary licenses would be available on acceptable terms, if at all. The inability to obtain certain licenses or other rights or to obtain such licenses or rights on favorable terms, or the need to engage in litigation regarding these matters, could have a material adverse effect on our business, operating results, and financial condition. Moreover,

the inclusion in our products of software or other intellectual property licensed from third parties on a nonexclusive basis could limit our ability to protect our proprietary rights in our products.

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 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 though we have no agreements, commitments or understanding with respect to any acquisition. 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 accounting 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 Report on Form 10-K describes the significant accounting policies and estimates 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 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.

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 1B. Unresolved Staff Comments

None

Item 2. Properties

The Company's headquarters are located in an approximately 59,000 square foot facility in Melville, New York. Offices are also leased for development, support, and sales and marketing personnel, which total an aggregate of approximately 66,000 square feet in Le Chesnay and Toulouse, France; Reading, UK; Munich, Germany; Madrid, Spain; Taipei and Taichung, Taiwan; Tokyo, Japan; Beijing, Shenzhen, Shanghai, and Hong Kong, China; Seoul,

Korea; Kuala Lumpur, Malaysia; North Sydney, Australia; and Singapore. Initial lease terms range from one to six years, with multiple renewal options.

Item 3. Legal Proceedings

In view of the inherent difficulty of predicting the outcome of litigation, particularly where the claimants seek very large or indeterminate damages, the Company generally cannot predict what the eventual outcome of the pending matters will be, what the timing of the ultimate resolution of these matters will be, or what the eventual loss, fines or penalties related to each pending matter may be.

In accordance with the authoritative guidance issued by the FASB on contingencies, the Company accrues anticipated costs of settlement, damages and losses for claims to the extent specific losses are probable and estimable. The Company records a receivable for insurance recoveries when such amounts are probable and collectable. In such cases, there may be an exposure to loss in excess of any amounts accrued. If, at the time of evaluation, the loss contingency related to a litigation is not both probable and estimable, the matter will continue to be monitored for further developments that would make such loss contingency both probable and estimable and, the Company will expense these costs as incurred. If the estimate of a probable loss is a range and no amount within the range is more likely, the Company will accrue the minimum amount of the range.

The Internal and Government Investigations

As previously disclosed, both the United States Attorney's Office for the Eastern District of New York ("USAO") and the Securities and Exchange Commission ("SEC") commenced investigations of the Company in October, 2010, in response to the Company's announcement that it had accepted the resignation of ReiJane Huai, its President and Chief Executive Officer, and the Chairman of its Board of Directors, following his disclosure to the Company that certain improper payments allegedly were made in connection with the Company's licensing of software to one customer.

The Company conducted its own investigation into the matter and cooperated with the USAO and SEC investigations.

On June 27, 2012, the Company announced that it had entered into settlements with the USAO and the SEC.

The Company entered into a Deferred Prosecution Agreement (DPA) with the USAO. Under the DPA, the USAO agreed that it will defer prosecution of the Company in connection with the matter, and ultimately not prosecute the Company if the Company satisfies its obligations during the 18 month term of the DPA. The DPA acknowledges the remedial actions taken by the Company in response to its discovery of the improper payments and does not require the Company to make any additional control or compliance changes. Under the DPA, the Company will forfeit \$2.9 million over eighteen months.

The Company agreed with the SEC to the entry of a Consent Judgment (CJ) to settle a civil action filed by the SEC. Pursuant to the CJ, the Company agreed not to violate the anti-fraud and registration provisions of Sections 17(a)(2), 5(a) and 5(c) of the Securities Act of 1933, and the books and records provisions of Sections 13(b)(2)(A) and 13(b)(2)(B) of the Securities Exchange Act of 1934. The Company further agreed to pay a civil penalty of \$2.9 million to the SEC.

As of December 31, 2012, the Company has paid a total of \$4.1 million of the total \$5.8 million, for which the Company had previously accrued. The balance of \$1.7 million is payable in December 2013.

Stockholder Litigation

The Company is a defendant in a class action lawsuit brought in United States District Court for the Eastern District of New York, by Company shareholders (the "Class Action"). The other defendants are James Weber, our former CFO and Vice President for Operations, and the estate of ReiJane Huai. Mr. Huai was the Company's former Chairman, President and CEO.

The Class Action complaint alleges that the defendants defrauded shareholders by falsely certifying in the Company's SEC filings that they had disclosed any fraud, whether or not material, that involved management or other employees who had a significant role in the registrant's internal control over financial reporting. The Class Action complaint alleges that the defendants were in fact aware of fraud.

In January, 2013, the parties to the Class Action reached an agreement in principle to settle the Class Action. Pursuant to a Memorandum of Understanding signed by counsel for the class plaintiffs and by counsel for all defendants, the Company will pay \$5.0 million to settle the Class Action. This amount includes damages, plaintiffs' attorneys' fees, and costs of administration of the settlement. The Company expects to pay this settlement with a combination of cash on hand and insurance proceeds. In accordance with the Memorandum of Understanding, a stipulation of settlement and a joint motion for preliminary approval of the settlement will be submitted to the court for its approval. Final settlement of the Class Action is subject to certain conditions and to approval by the court. We cannot predict if or when the court might approve the settlement. Certain of the defendants may be entitled to indemnification by the Company under the laws of Delaware and/or our by-laws.

While the Company has insurance policies that it believes will cover it for the allegations of the Class Action, the Company has already reached an agreement with one insurance carrier that gave it less than the face amount of the insurance. There can be no assurance that the recovery the Company makes on the remainder of its insurance will be adequate to cover the costs of its defense or settlement of the Class Action, or any damages that might ultimately be awarded against the Company or anyone to whom the Company might owe indemnification if the settlement is not approved by the court. The Company's insurers may deny coverage under the policies. If the Company's insurance recovery is not adequate to cover the costs of defense, settlement, damages and/or indemnification, or its insurers deny coverage, the amounts to be paid by the Company could have a significant negative impact on its financial results, its cash flows and its cash balances.

The Company's Directors and Officers ("D&O") Insurance, is composed of more than one layer, each layer written by a different insurance company. After the close of the third quarter, in connection with the Class Action, and in connection with the Derivative Action discussed below, the Company entered into an agreement with the carrier of the first \$5.0 million layer of the Company's D&O insurance. Pursuant to this agreement, the Company accepted a payment of \$3.9 million from the first layer insurance carrier in satisfaction of the carrier's obligations to the Company under the first layer D&O insurance policy. The combined costs of (i) defense of the Class Action and the Derivative Action, and (ii) the proposed \$5.0 million settlement of the Class Action exceeds \$3.9 million, and the Company is responsible for paying the next \$1.1 million of costs, settlement amounts or liability up to \$5.0 million, before the next layer of the Company's D&O insurance might cover the Company. This \$5.0 million payment, when and if made, will negatively impact its cash flows and its cash reserves when paid. In addition, as part of the October 2012 agreement with the carrier, the Company agreed to indemnify the carrier of the first layer of D&O insurance against potential claims by certain named insured persons under the first layer D&O insurance policy. The Company cannot predict the likelihood or the outcome of any such claims by the named insureds.

There can be no assurance that the amount of remaining D&O insurance will be adequate to cover the costs of the Company's defense of the Class Action or any damages that might be awarded against the Company or any defendant(s) to whom we owe indemnification. The Company's remaining insurers may deny coverage under the policies. If the plaintiffs are awarded damages and the Company's insurance is not adequate to cover the amounts, or its insurers deny coverage, the amounts to be paid by the Company could have a significant negative impact on our financial results, our cash flow and our cash reserves.

To date, the Company has recorded \$6.6 million of total costs associated with the Class Action and the Derivative Actions. The Company has recorded a liability in the amount of \$5.2 million in "accrued expenses" in the consolidated balance sheets as of December 31, 2012 which includes estimated costs of the proposed Class Action settlement and legal fees for both the Class Action and the Derivative Action to date. As a result of the agreement reached with the Company's D&O insurance carrier, the Company has recorded an insurance recovery of approximately \$3.9 million of legal expenses previously incurred related to the class action and derivative lawsuits as well as the potential settlement of the class action lawsuits. The \$3.9 million insurance recovery was reimbursed by the Company's insurance carrier during 2012. In connection with discussions with the insurer of the Company's next layer of D&O insurance regarding that insurer's obligations to the Company, the Company has recorded a \$1.0 million receivable in "prepaid expenses and other current assets" in the consolidated balance sheet as of December 31, 2012.

Company shareholders filed actions in the Suffolk County Division of the Supreme Court of the State of New York, putatively derivatively on behalf of the Company, against the Company, each of the Company's Directors, Mr. Weber, Wayne Lam, a former Vice President of the Company, the estate of Mr. Huai, and Jason Lin, a former employee of the Company (the "Derivative Action"). The consolidated amended Derivative Action complaint alleged that the defendants breached their duties to the Company by: (1) causing or allowing the dissemination of false and misleading information; (2) failing to maintain internal controls; (3) failing to manage the Company

properly; (4) unjustly enriching themselves; (5) abusing their control of the Company; and (6) wasting Company assets.

On March 5, 2013, the Suffolk County Division of the Supreme Court of the State of New York granted a motion made by all of the defendants in the Derivative Action, except Mr. Lin, and dismissed the Derivative Action as to all defendants other than Mr. Lin.

During 2012, we recorded a \$0.3 million reduction of investigation, litigation and settlement related costs. The reduction was comprised of (i) a \$1.7 million reduction in the accrual for certain costs associated with the resolution of the government investigations and (ii) a recovery of \$0.3 million of legal expenses previously incurred related to the class action and derivative lawsuits, partially offset by (i) \$1.5 million of legal expenses related to the class action and derivative lawsuits as well as for the potential settlement of the class action lawsuit that are not or may not be recoverable through insurance and (ii) \$0.2 million of legal fees incurred related to the resolution of the government investigations.

Avazpour Litigation

The Company is the defendant in an action brought by Avazpour Networking Services, Inc., and its former principals (collectively, “Avazpour”), pending in the United States District Court for the Eastern District of New York. Avazpour alleged that the Company gave grossly negligent advice in connection with an upgrade of Avazpour’s storage system resulting in damages to Avazpour and breached its contract with Avazpour. On March 13, 2013, the Court granted the Company’s motion to dismiss all of the claims except for the claim of breach of contract. The Company believes that limitation of liability clauses of the contract mean that Avazpour will not be able to collect any damages.

The Company cannot predict when the Avazpour action will be resolved or its outcome. While the Company has insurance policies that it believes covers the Company for the allegations of the Avazpour Action, there can be no assurance that the amount of insurance will be adequate to cover the costs of the Company’s defense of the Avazpour Action or any damages that might be awarded against it. If the plaintiffs are awarded damages and the Company’s insurance is not adequate to cover the amounts, or the Company’s insurers deny coverage, the amounts to be paid by the Company could have a significant negative impact on its financial results, cash flow and cash reserves.

Other Claims

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, such matters are not expected to have a material adverse effect on the Company’s financial condition or operating results.

The Company continues to assess certain litigation and claims to determine the amounts, if any, that the Company believes may be paid as a result of such claims and litigation and, therefore, additional losses may be accrued and paid in the future, which could materially adversely impact the Company’s financial results, its cash flows and its cash reserves.

Item 4. Mine Safety Disclosures

Not applicable

PART II

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

Market Information

Our Common Stock is listed on The Nasdaq Global Market (“Nasdaq”) under the symbol “FALC”. The following table sets forth the range of high and low closing sales prices of our Common Stock for the periods indicated as reported by Nasdaq:

	2012		2011	
	<u>High</u>	<u>Low</u>	<u>High</u>	<u>Low</u>
Fourth Quarter	\$ 2.48	\$ 2.01	\$ 3.55	\$ 2.49
Third Quarter	\$ 2.72	\$ 1.73	\$ 4.65	\$ 2.82
Second Quarter	\$ 3.80	\$ 2.46	\$ 4.55	\$ 3.66
First Quarter	\$ 3.77	\$ 2.42	\$ 4.91	\$ 3.22

Holders

We had approximately 123 holders of record of Common Stock as of February 28, 2013. This does not reflect persons or entities that hold Common Stock in nominee or “street” name through various brokerage firms.

Dividends

We have not paid any cash dividends on our common stock since inception. We expect to reinvest any future earnings to finance growth, and therefore do not intend to pay cash dividends in the foreseeable future. Our board of directors may determine to pay future cash dividends if it determines that dividends are an appropriate use of Company capital.

Equity Compensation Plan Information

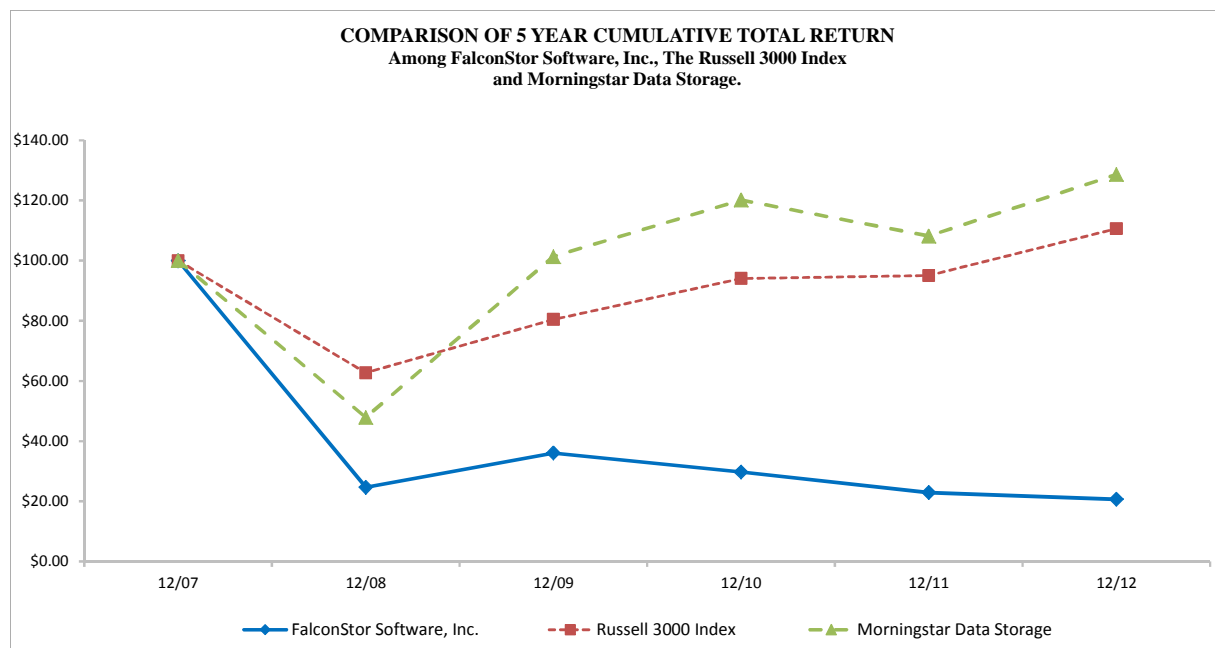
The Company currently does not have any equity compensation plans not approved by security holders.

Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants and rights (1) (a)	Weighted-average exercise price of outstanding options, warrants and rights (1) (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (1) (c)
Equity compensation plans approved by security holders	11,532,032	\$4.59	2,526,036

(1) As of December 31, 2012 we had 2,526,036 shares of our common stock reserved for issuance under our stock plans with respect to options (or restricted stock or restricted stock units) that have not been granted. In addition, if, on July 1st of any calendar year in which our 2006 Plan is in effect, the number of shares of stock to which options may be granted is less than five percent (5%) of the number of outstanding shares of stock, then the number of shares of stock available for issuance under the 2006 Plan shall be increased so that the number equals five percent (5%) of the shares of stock outstanding. See Note (8) *Share-Based Payment Arrangements* to our consolidated financial statements for further information.

Performance graph

The following graph compares, for each of the periods indicated, the percentage change in the Company's cumulative total stockholder return on the Company's common stock with the cumulative total return of a) Morningstar Data Storage companies, a peer group index and b) the Russell 3000 Index, a broad equity market index.



ASSUMES \$100 INVESTED ON JANUARY 1, 2008
ASSUMES DIVIDEND REINVESTED
FISCAL YEAR ENDING DECEMBER 31, 2012

	Fiscal Year Ending					
	12/31/2007	12/31/2008	12/31/2009	12/31/2010	12/31/2011	12/31/2012
FalconStor Software, Inc.	\$ 100.00	\$ 24.69	\$ 36.06	\$ 29.75	\$ 22.91	\$ 20.69
Russell 3000 Index	\$ 100.00	\$ 62.69	\$ 80.45	\$ 94.07	\$ 95.04	\$ 110.64
Morningstar Data Storage	\$ 100.00	\$ 47.87	\$ 101.33	\$ 120.15	\$ 108.18	\$ 128.58

There can be no assurance that the common stock's performance will continue with the same or similar trends depicted in the graph above.

Issuer Purchases of Equity Securities

None.

Item 6. Selected Financial Data

The selected financial data appearing below have been derived from our audited consolidated financial statements, and should be read in conjunction with these consolidated financial statements and the notes thereto and the information contained in Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations."

CONSOLIDATED STATEMENTS OF OPERATIONS DATA:

	Year Ended December 31, 2012	Year Ended December 31, 2011	Year Ended December 31, 2010 (a)	Year Ended December 31, 2009	Year Ended December 31, 2008
	(In thousands, except per share data)				
Revenues:					
Product revenues	\$ 41,359	\$ 49,470	\$ 51,905	\$ 61,234	\$ 61,566
Support and services revenues	34,052	33,400	30,939	28,225	25,459
Total revenues	<u>75,411</u>	<u>82,871</u>	<u>82,844</u>	<u>89,459</u>	<u>87,025</u>
Cost of revenues:					
Product	8,215	8,387	9,291	3,390	2,636
Support and service	12,447	13,130	12,148	13,677	11,384
Total cost of revenues	<u>20,662</u>	<u>21,517</u>	<u>21,439</u>	<u>17,067</u>	<u>14,020</u>
Gross profit	\$ 54,749	\$ 61,354	\$ 61,405	\$ 72,392	\$ 73,004
Operating expenses					
Research and development costs	18,636	21,200	26,906	26,610	25,150
Selling and marketing	36,009	39,598	40,845	42,255	38,097
General and administrative	13,334	11,697	9,626	9,875	8,746
Investigation, litigation, and settlement related costs	(326)	10,257	1,616	-	-
Restructuring costs	771	822	-	-	-
Total operating expenses	<u>68,424</u>	<u>83,574</u>	<u>78,993</u>	<u>78,740</u>	<u>71,993</u>
Operating (loss) income	<u>(13,675)</u>	<u>(22,220)</u>	<u>(17,589)</u>	<u>(6,348)</u>	<u>1,012</u>
Interest and other (loss) income, net	<u>(523)</u>	<u>60</u>	<u>(213)</u>	<u>(128)</u>	<u>1,689</u>
(Loss) income before income taxes	(14,198)	(22,160)	(17,802)	(6,476)	2,700
Provision (benefit) for income taxes	<u>786</u>	<u>1,208</u>	<u>17,574</u>	<u>(3,383)</u>	<u>1,498</u>
Net (loss) income	<u>\$ (14,984)</u>	<u>\$ (23,368)</u>	<u>\$ (35,376)</u>	<u>\$ (3,093)</u>	<u>\$ 1,203</u>
Basic net (loss) income per share	<u>\$ (0.32)</u>	<u>\$ (0.50)</u>	<u>\$ (0.78)</u>	<u>\$ (0.07)</u>	<u>\$ 0.03</u>
Diluted net (loss) income per share	<u>\$ (0.32)</u>	<u>\$ (0.50)</u>	<u>\$ (0.78)</u>	<u>\$ (0.07)</u>	<u>\$ 0.02</u>
Weighted average basic shares outstanding	<u>47,409</u>	<u>46,649</u>	<u>45,549</u>	<u>44,782</u>	<u>47,859</u>
Weighted average diluted shares outstanding	<u>47,409</u>	<u>46,649</u>	<u>45,549</u>	<u>44,782</u>	<u>49,497</u>

- (a) During 2010, we recorded a non-recurring tax provision of \$16.3 million (included in our net tax provision of \$17.6 million) as we concluded that we could no longer realize substantially all of our deferred tax assets on a more-likely-than-not basis, which resulted in an increase in a valuation allowance on our deferred tax assets previously recognized. See Note (6) *Income Taxes* to our consolidated financial statements for further information.

CONSOLIDATED BALANCE SHEET DATA:

	December 31, 2012	December 31, 2011	December 31, 2010	December 31, 2009	December 31, 2008
			(In thousands)		
Cash, cash equivalents, restricted cash and marketable securities	\$ 29,932	\$ 37,763	\$ 37,325	\$ 41,783	\$ 42,810
Working capital	10,613	20,382	35,475	46,097	48,329
Total assets	59,705	73,047	76,545	99,002	96,364
Long-term obligations	9,099	10,285	9,063	6,254	6,192
Stockholders' equity	13,253	22,817	39,939	66,153	65,076

ITEM 7. 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

In 2012, we continued to reposition the Company to put our past troubles behind us and to put in place the proper management, employees and plans for future success.

The most significant event of 2012 for the Company was our resolution of the investigations by the United States Attorney’s Office for the Eastern District of New York (“USAO”) and by the Securities and Exchange Commission.

In June, 2012, we entered into a Deferred Prosecution Agreement (“DPA”) with the USAO. In conjunction with the DPA, a Criminal Complaint was filed against the Company. The USAO agreed, as part of the DPA, to defer prosecution of that complaint for eighteen months. If we comply fully with the DPA, the charges will be dismissed at the conclusion of the eighteen month period. Among other things, the DPA requires us to continue to comply with various control changes we had made in response to the discovery that improper payments had been made to one customer by three former employees. The DPA also mandates that we do not commit any criminal acts. If we fail to comply with the DPA, the USAO has the right to prosecute the complaint and to file additional charges if we have committed any new criminal acts. In addition, we agreed to forfeit \$2.9 million. We paid \$1.2 million during the third quarter of 2012 and we will pay the remaining \$1.7 million in December, 2013.

We agreed with the SEC to the entry of a Consent Judgment (CJ) to settle a civil action filed by the SEC. Pursuant to the CJ, we agreed not to violate the anti-fraud and registration provisions of Sections 17(a)(2), 5(a) and 5(c) of the Securities Act of 1933, and the books and records provisions of Sections 13(b)(2)(A) and 13(b)(2)(B) of the Securities Exchange Act of 1934. We further agreed to pay a civil penalty of \$2.9 million to the SEC. This fine was paid in full during the second quarter of 2012.

The resolution of these investigations is a milestone for the Company. This should enable us to move on from the events of the past and concentrate on the Company’s future. We will no longer be distracted by the substantial time and effort it took to complete the investigations. We can now dedicate our resources – both capital and human – to efforts that we hope will positively impact our bottom line. In addition, it reduces the potential of our competitors to raise concerns about the Company’s business conduct and long-term viability. They will again have to compete based on the merits of their products compared to ours. This is a competition that we believe we are well-positioned to win.

With regard to the Company’s reputation following these unfortunate events, we are proud that neither the DPA nor the settlement with the SEC required us to institute any new controls. Rather, both the USAO and the SEC referenced the numerous new or enhanced controls that we previously implemented after the commencement of our internal investigation. We believe that this is a validation of the path taken by Company management.

The Company, along with our former CFO, Jim Weber, and the estate of ReiJane Huai, our former Chairman and CEO, also remains a defendant in a class action lawsuit brought by stockholders (the “Class Action”). In January, 2013, we reached an agreement in principle to settle the Class Action for \$5.0 million and a Stipulation and Agreement of Settlement was filed with the court on March 13, 2013. The Class Action is more fully described in *Part I, Item 3 – Legal Proceedings* of this annual report on Form 10-K. If the settlement is approved by the court, it should limit one more legacy distraction.

In connection with the Class Action and a derivative action lawsuit that was dismissed in March 2013, we have been involved with discussions with the companies that provide our Directors and Officers Insurance (“D&O Insurance”) coverage. The D&O Insurance in place at the time that the two actions were commenced was divided into \$5.0 million layers, each written by a different insurer. The D&O Insurance should provide us with recovery of

fees spent defending the two actions and the costs of settlement or damages. However, some of the insurers have raised questions with regard to the validity of the insurance agreements due to the presumed knowledge of wrongful acts by certain former Company officers at the time the insurance was purchased. In October 2012, we reached a settlement with the insurer of the first \$5.0 million layer of our D&O Insurance pursuant to which the insurer agreed to pay us \$3.9 million in full satisfaction of its obligations. There can be no assurance that we will be able to recover any additional funds from the additional insurance companies. Even if we are able to recover under the additional layers of our D&O Insurance, we will still be responsible for the \$1.1 million gap between the recovery from the first insurer and the attachment point of the next \$5.0 million layer.

With regard to our business operations, in 2012 we focused on having the correct management team in place and refining our goals for our products going forward. Since September, 2010, we have hired new leadership in the following roles: Chief Executive Officer; Chief Financial Officer; Chief Technical Officer; Vice President Sales & Marketing – North America; Vice President Sales & Marketing – EMEA; Vice President Sales & Marketing – APAC; and Vice President of Global Support.

With this team in place, we reviewed our personnel, our products and our expenses. Among other decisions, we undertook a global reduction in force in July, 2012, that eliminated thirty five positions from our then existing headcount to better align our expense structure with our anticipated revenues.

Our revenues are now primarily generated by our FalconStor-branded gateway appliances and complete turn-key appliances with integrated disks, and licenses of our stand-alone software products. The appliances integrate our software with standard hardware configurations. The integrated products were created in response to feedback we received from our resellers and the end users suggested that we could increase sales if we offered turn-key appliances. This has proven to be correct. We are pleased that we have been able to absorb a cumulative decrease in total revenues from OEMs over the past three years of approximately \$22.0 million (representing successive over 25% annual declines).

Overall, product revenues decreased 16% from \$49.5 million for the year ended December 31, 2011 to \$41.4 million for the year ended December 31, 2012. We attribute the decline in product revenues to four main factors. First, we did not launch any new products in 2012. Second, we had continued turnover in our sales force, particularly in North America, as our new sales leaders put their teams in place. Third, macroeconomic conditions around the world contributed to the overall softness in IT spend. Last, sales from our legacy OEMs continued to decline.

Our product revenues from FalconStor-branded solutions decreased 15% over 2011. Product revenues from OEMs declined 25% from 2011. We do not expect to exit the OEM business entirely. OEMs can be valuable partners for us in a number of ways. Among these are: allowing penetration of markets, both geographical and industry-sector, where we do not have sufficient resources or history; providing feedback on product development and quality; and providing distribution channels for products that we may be de-emphasizing in our FalconStor-branded product line. We expect that an OEM relationship in China will continue to be a source of revenue to the Company.

Support and services revenue increased 2% from \$33.4 million for the year ended December 31, 2011 to \$34.1 million for the same period in 2012. The increase in support and services was primarily attributable to an increase in maintenance and technical support services.

Net loss for the year ended December 31, 2012 was \$15.0 million, compared with a net loss of \$23.4 million for the year ended December 31, 2011. As discussed more fully below, included in our net loss for the year ended December 31, 2012 was an income tax provision of \$0.8 million compared with an income tax provision of \$1.2 million for the year ended December 31, 2011. We had stock-based compensation expense – which relates to stock options and restricted stock we grant to employees, officers and directors as part of our incentive compensation plan, and to some consultants as payment for services – of \$4.6 million in 2012 and \$ 5.5 million in 2011, which is reflected in the net results for each year.

Typically, we look to operating income as another measure of our progress. This number enables us to measure and to compare our results of operations from one year to the next. Operating loss for 2012 was \$13.7 million, compared with an operating loss of \$22.2 million in 2011. These numbers again include stock-based compensation expense. Included in the operating loss is a \$0.3 million reduction of investigation, litigation and settlement related costs in 2012 compared to costs of \$10.3 million in 2011 related to investigation, litigation and settlement related costs.

We continued to work to decrease our operating expenses in 2012. Besides watching our expenditures, we undertook a review of our workforce and made strategic reductions in our headcount that eliminated thirty five positions from our then existing headcount to better align our expense structure with our anticipated revenues. Overall our operating expenses decreased 18% or \$15.1 million to \$68.4 million in 2012 from \$83.6 million in 2011. Included in our operating results for both 2012 and 2011 was a reduction of \$0.3 million and costs of \$10.3 million, respectively, related to investigation, litigation and settlement related costs.

Our gross margins were 73% for 2012 as compared with 74% in 2011.

Operating margin is a measure of operating efficiency. We incur research and development expenses before the product is offered for licensing. These expenses consist primarily of personnel costs for engineering and testing, but also include other items such as the depreciation and amortization of hardware and software used in development. We also have expenses for software support, sales and marketing, and general and administrative functions. Our operating margin increased to (18%) in 2012 from (27%) in 2011. The impact of investigation, litigation and settlement related costs on operating margin in 2012 was 0% compared with (12%) in 2011.

The key factors we look to for our future business prospects are:

- our ability to establish and to expand relationships with resellers, and sales and re-orders by those resellers;
- growth in deferred revenue;
- the development and sales of our new products;
- re-orders from existing customers; and
- the growth of the overall market for data protection and storage solutions.

We anticipate that in 2013 product revenue by resellers and, to a lesser extent, direct licenses to end users, should grow. We expect to see the results of our investments in new leadership and in our sales force and our marketing teams. We also have instituted, and we will be instituting further, support, training and incentive programs intended to increase sales by resellers.

Many enterprises look to value added resellers or solution providers to assist them in making their information technology purchases. These resellers typically review an enterprise's needs and suggest a hardware, software, or combined hardware and software solution to fulfill the enterprise's requirements.

We continue to enhance our reseller program. Our "Business Partner" program for our resellers was rolled out in EMEA in 2012. We had previously instituted it in the Americas and APAC in 2011. This program provides enhanced sales collateral, training, and, in some cases, financial incentives, for our resellers.

As service providers to companies, resellers' reputations are dependent on satisfying their customers' needs efficiently and effectively. Resellers have wide choices in fulfilling their customers' needs. If resellers determine that a product they have been providing to their customers is not functioning as promised, or is not providing adequate return on investment, or if the customers are not satisfied with the level of support they are receiving from the suppliers, the resellers will move quickly to offer different solutions to their customers. Additional sales by resellers are therefore an important indicator of our business prospects.

In 2012, we signed agreements with new resellers worldwide. The type of resellers with whom we are signing agreements has continued to evolve. While we still sign agreements with strong local and regional resellers, we have also entered into reseller agreements with national and multi-national resellers who have their own distribution networks. The enhanced distribution and marketing networks offered by these larger resellers should help us to continue to grow our sales.

We also terminated relationships with resellers who we believed were not selling our products at the levels we expected in 2012. We will continue to enter into relationships with resellers and to discontinue relationships with resellers with whom we are not satisfied.

Our deferred revenues consist primarily of amounts attributable to future support and maintenance of our products. The level of deferred revenue is an important indicator of our success. Maintenance and support for our products is sold for fixed periods of time. Maintenance and support agreements are typically for one year, although some agreements are for terms in excess of one year. If we do not deliver the support needed by end users of our products or by our OEM partners and resellers, then they will not renew their maintenance and support agreements. If end users stop using our products, they also will not renew their maintenance and support agreements. Our deferred revenue decreased 11% from 2011 to \$24.1 million in 2012. The main reason for the decline was a result of the phasing out of our products by our legacy OEMs over the past few years. In addition, since our product sales declined as a result of the global economic conditions, we sold fewer new maintenance and support contracts.

We expect to continue to be affected by seasonality of the information technology business on a quarterly basis. Historically, information technology spending has been higher in the fourth and second quarters of each calendar year, and somewhat slower in the other quarters, particularly the first quarter. We did not experience this typical seasonality in 2012. We believe that this was an aberration based on global economic conditions and the internal revamping our sales force. We anticipate that our quarterly results for 2013 will show the effects of historical seasonality.

Share-based compensation expense continued to have a negative impact on our earnings in 2012. On an ongoing basis we weigh the impact of the expense on our consolidated financial statements against the impact of discontinuing the grant of equity-based compensation to our worldwide workforce. It continues to be our view that the opportunity to participate in the growth of our Company is an important motivating factor for our current employees and a valuable recruiting tool for new employees. We will thus continue to apply the criteria and the methodology we have used in the past to determine grants of stock options or other equity-based compensation to our employees. For the management of our business and the review of our progress, we will continue to look to our results excluding share-based compensation expense. We will use these non-GAAP financial measures in making operating decisions because they measure the results of our day-to-day operations and because they provide a more consistent basis for evaluating and comparing our results across different periods.

The primary risks to our success come from product development. For more information on the risks we face, please see *Part I, Item 1A, Risk Factors*, of this filing.

We need to provide a continuing series of new products and improvements to existing products. Innovation in the data protection market is key to survival. Customers expect that data protection software will become both more capable and easier to manage over time. If we are unable to deliver new, innovative products in a reasonable time frame, we will fall behind our competitors. Innovation requires adequate resources and the right people. If we do not have enough resources or the right people, we will fall behind.

RESULTS OF OPERATIONS – FOR THE YEAR ENDED DECEMBER 31, 2012 COMPARED WITH THE YEAR ENDED DECEMBER 31, 2011

Total revenues for the year ended December 31, 2012 decreased 9% to \$75.4 million, compared with \$82.9 million for the year ended December 31, 2011. During 2012, we completed a restructuring which was composed of a workforce reduction of approximately 35 positions worldwide from various departments. The restructuring charges related to the 2012 reduction totaled approximately \$0.8 million. During 2011, we completed a restructuring which was composed of a workforce reduction of approximately 25 positions worldwide from various departments and the closing of a satellite facility. The restructuring charges related to the 2011 reduction totaled approximately \$0.8 million. The restructuring charges for both 2012 and 2011 have been segregated from each of the respective expense line items and are included within “restructuring costs” in our consolidated statement of operations. Our cost of revenues decreased 4% to \$20.7 million for the year ended December 31, 2012, compared with \$21.5 million for the year ended December 31, 2011. Included in our cost of revenues for the years ended December 31, 2012 and 2011 were \$0.2 million and \$0.5 million, respectively, of share-based compensation expense. Our operating expenses decreased 18% from \$83.6 million for the year ended December 31, 2011 to \$68.4 million for the year ended December 31, 2012. Included in the operating results for the year ended December 31, 2012, was a net reduction of \$0.3 million of investigation, litigation and settlement costs and \$0.8 million of restructuring costs. Included in the operating results for the year ended December 31, 2011 was \$10.3 million of investigation, litigation, and settlement related costs and \$0.8 million of restructuring costs. The \$10.3 million was comprised of \$2.8 million of legal fees and an accrual of \$7.5 million for certain costs associated with the then outstanding resolution of the investigations. In addition, included in our operating expenses for the years ended December 31, 2012 and 2011 were \$4.4 million and \$5.1 million, respectively, of share-based compensation expense. Net loss for the year ended December 31, 2012 was \$15.0 million, compared with a net loss of \$23.4 million for the year ended December 31, 2011. Included

in our net loss for the year ended December 31, 2012 was an income tax provision of \$0.8 million compared with an income tax provision of \$1.2 million for the year ended December 31, 2011. The income tax provision of \$0.8 million and \$1.2 million were primarily attributable to the impact of our effective tax rate on our pre-tax losses for the years ended December 31, 2012 and 2011, respectively. No tax benefits were recognized during either period for our domestic losses due to the full valuation allowance over our domestic deferred tax assets.

The overall 9% decrease in total revenues was primarily due to a 16% decrease in product revenue for the year ended December 31, 2012, compared with the same period in 2011. This was partially offset by a 2% increase in support and services revenue for the year ended December 31, 2012, compared with the same period in 2011. Product revenues from OEM partners decreased 25%, while product revenues from non-OEM partners decreased 15% for the year ended December 31, 2012, compared with the same period in 2011. As we have previously reported over the past several years, product revenues from our legacy OEM partners continued to decline due to consolidation within the industry and end-of-life programs implemented by these legacy OEM partners. We do not anticipate that any of our legacy OEM partners will contribute over 10% of our annual revenues for the foreseeable future. During 2012, we continued our focus and emphasis on the FalconStor-branded business. As a result of overall macroeconomic conditions, we experienced significant competitive pricing practices from our competitors, customers delaying or postponing IT spending and the overall uncertainty in the marketplace. These factors have all contributed to the overall decrease in our non-OEM product revenues. In addition, the recently concluded government investigation also contributed to the challenges and disruptions we faced in our business.

Overall, our total operating expenses have decreased, primarily due to a decline in (i) our overall salary and personnel costs as part of our continued cost savings initiatives and our focus on improved operational efficiencies, and (ii) a \$10.6 million decrease in costs associated with the government investigations, litigation, and settlement related costs incurred during the year ended December 31, 2012, compared with the same period in 2011. We will continue to evaluate the appropriate headcount levels to properly align our resources with our current and long-term outlook.

Revenues

	Year ended December 31,	
	2012	2011
<i>Revenues:</i>		
Product revenue	\$ 41,358,621	\$ 49,470,139
Support and services revenue	34,052,348	33,400,463
<i>Total Revenues</i>	<u>\$ 75,410,969</u>	<u>\$ 82,870,602</u>
<i>Year-over-year percentage growth</i>		
Product revenue	-16%	-5%
Support and services revenue	2%	8%
<i>Total percentage growth</i>	<u>-9%</u>	<u>0%</u>

Product revenue

Product revenue is comprised of sales of licenses for our software integrated on industry standard hardware creating an integrated solution, and for our stand-alone software applications. The products are sold through our OEMs, and through (i) value-added resellers, (ii) distributors, and/or (iii) directly to end-users (collectively “non-OEMs”). These revenues are recognized when all the applicable criteria under Generally Accepted Accounting Principles in the United States are met.

Product revenue decreased 16% from \$49.5 million for the year ended December 31, 2011 to \$41.4 million for the year ended December 31, 2012. These amounts are net of a benefit of \$0.7 million recognized during the years ended December 31, 2012 and 2011, respectively, resulting from the impact of our collection efforts of previously reserved accounts receivable. Product revenues from OEM partners decreased 25%, while product revenues from non-OEM partners decreased 15% for the year ended December 31, 2012, compared with the same period in 2011. As we have previously reported over the past several years, product revenues from our legacy OEM partners continued to decline due to consolidation within the industry and end-of-life programs implemented by these legacy OEM partners. We do not anticipate that any of our legacy OEM partners will contribute over 10% of our annual revenues for the foreseeable future. During 2012, we continued our focus and emphasis on the

FalconStor-branded business. As a result of overall macroeconomic conditions, we experienced significant competitive pricing practices from our competitors, customers delaying or postponing IT spending and the overall uncertainty in the marketplace. These factors have all contributed to the overall decrease in our non-OEM product revenues. In addition, we believe the recently concluded government investigation also contributed to the challenges and disruptions we faced in our business. Product revenue from our non-OEM partners represented 88% and 87% of our total product revenue for the years ended December 31, 2012 and 2011, respectively. Product revenue from our OEM partners represented 12% and 13% of our total product revenue for the years ended December 31, 2012 and 2011, respectively.

We continue to focus our investments on the FalconStor-branded non-OEM channel business as we feel this is in line with our long-term outlook.

Support and services revenue

Support and services revenue is comprised of (i) maintenance and technical support services, (ii) professional services primarily related to the implementation of our software, and (iii) engineering services. Revenues derived from maintenance and technical support contracts are deferred and recognized ratably over the contractual maintenance term. Professional services revenue is recognized in the period that the related services are performed. Support and services revenue increased 2% from \$33.4 million for the year ended December 31, 2011 to \$34.1 million for the same period in 2012. The increase in support and services was primarily attributable to an increase in maintenance and technical support services.

Maintenance and technical support services increased from \$30.3 million for the year ended December 31, 2011 to \$31.0 million for the same period in 2012. As we are in business longer, and as we license more integrated solutions and stand-alone software applications to new customers and grow our installed customer base, we expect the amount of maintenance and technical support contracts we have to grow as well. The anticipated growth in our maintenance and technical support service revenue is expected to result primarily from (i) the purchase of maintenance and support contracts by our customers, and (ii) the renewal of maintenance and support contracts by our existing and new customers after their initial contracts expire. During the year ended December 31, 2012, the growth in maintenance revenue in the non-OEM channel business was primarily offset by (i) a decline in maintenance revenue from certain legacy OEM customers due to consolidation in the industry, (ii) the decrease from non-OEM product revenues during the current year, which are generally sold with maintenance, and (iii) deeper discounts provided on product in the current economic and competitive environment.

Professional services revenues remained consistent at \$3.1 million for the years ended December 31, 2012 and December 31, 2011. The professional services revenue varies from period to period based upon (i) the number of solutions sold during the existing and previous periods, (ii) the number of our customers who elect to purchase professional services, and (iii) the number of professional services contracts that are performed during the period. We expect professional services revenues to continue to vary from period to period based upon the number of customers who elect to utilize our professional services upon purchasing any of our solutions.

Cost of Revenues

	Year ended December 31,	
	2012	2011
<i>Cost of revenues:</i>		
Product	\$ 8,215,152	\$ 8,386,864
Support and service	12,446,921	13,130,045
Total cost of revenues	<u>\$ 20,662,073</u>	<u>\$ 21,516,909</u>
 <i>Total Gross Profit</i>	 \$ 54,748,896	 \$ 61,353,693
 <i>Gross Margin:</i>		
Product	80%	83%
Support and service	63%	61%
Total gross margin	<u>73%</u>	<u>74%</u>

Cost of revenues, gross profit and gross margin

Cost of product revenue consists primarily of industry standard hardware we purchase and integrate with our software for turn-key integrated solutions, personnel costs, amortization of purchased and capitalized software, shipping and logistics costs, and share-based compensation expense. Cost of support and service consists primarily of personnel and other costs associated with providing software implementations, technical support under maintenance contracts, training, and share-based compensation expense. Cost of product revenue for the year ended December 31, 2012 decreased \$0.2 million, or 2%, to \$8.2 million, compared with \$8.4 million for the same period in 2011. The overall decrease in cost of product revenue was attributable to a decrease in hardware costs as a result of fewer appliance units being sold, compared with the same period in 2011. Our cost of support and service revenues for the year ended December 31, 2012 decreased \$0.7 million, or 5%, to \$12.4 million, compared with \$13.1 million for the same period in 2011. The decrease in cost of support and service revenue was primarily related to a decrease in compensation costs due to the overall change in the mix of our headcount within support and services as compared to the same period in 2011 and a decrease in share-based compensation expenses which decreased to \$0.2 million for the year ended December 31, 2012, compared with \$0.5 million for the year ended December 31, 2011.

Total gross profit decreased \$6.6 million, or 11%, from \$61.4 million for the year ended December 31, 2011, to \$54.7 million for the year ended December 31, 2012. Total gross margin decreased slightly to 73% for the year ended December 31, 2012, compared with 74% for the year ended December 31, 2011. The decrease in our total gross profit for the year ended December 31, 2012, compared with the same period in 2011, was primarily due to a 9% decrease in our total revenues. Generally, our total gross profits and total gross margins may fluctuate based on several factors, including (i) revenue growth levels, (ii) changes in personnel headcount and related costs, and (iii) our product offerings and service mix of sales.

Share-based compensation expense included in the cost of product revenue was less than 1% of total revenue for each of the years ended December 31, 2012 and 2011. Share-based compensation expense included in the cost of support and service revenue decreased to \$0.2 million from \$0.5 million for the years ended December 31, 2012 and December 31, 2011, respectively. Share-based compensation expense related to cost of support and service revenue was less than 1% for the year ended December 31, 2012 and 1% for the year ended December 31, 2011.

Operating Expenses

Research and Development Costs

Research and development costs consist primarily of personnel costs for product development personnel, share-based compensation expense, and other related costs associated with the development of new products, enhancements to existing products, quality assurance and testing. Research and development costs decreased \$2.6 million, or 12%, to \$18.6 million for the year ended December 31, 2012, from \$21.2 million in the same period in 2011. The decrease in research and development costs was primarily the result of a decline in salary and personnel costs as the result of lower research and development headcount. We believe we continue to provide adequate levels of resources in support of our research and development activities to continue to enhance and to test our core products and in the development of new innovative products, features and options. Share-based compensation expense included in research and development costs decreased to \$0.7 million from \$1.3 million for the years ended December 31, 2012 and December 31, 2011, respectively. Share-based compensation expense included in research and development costs was equal to 1% and 2% of total revenue for the years ended December 31, 2012 and 2011, respectively.

Selling and Marketing

Selling and marketing expenses consist primarily of sales and marketing personnel and related costs, share-based compensation expense, 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 decreased \$3.6 million, or 9%, to \$36.0 million for the year ended December 31, 2012, from \$39.6 million for the year ended December 31, 2011. The decrease in selling and marketing expenses was primarily attributable to (i) a decrease in commissions due to the 16% decline in product revenue compared with the same period in 2011, (ii) a decrease in salary and personnel costs, including share-based compensation expenses, as a result of lower sales and marketing headcount, and (iii) a decrease in costs associated with the recruitment and hiring of additional sales personnel in 2011. Share-based compensation expense included in selling and marketing was \$1.7 million for the year ended December 31, 2012 and \$2.0 million for the year ended December 31, 2011. Share-based compensation

expense included in selling and marketing expenses was equal to 2% of total revenue for the years ended December 31, 2012 and 2011, respectively.

General and Administrative

General and administrative expenses consist primarily of personnel costs of general and administrative functions, share-based compensation expense, public company related costs, directors and officers insurance, legal and professional fees, and other general corporate overhead costs. General and administrative expenses increased \$1.6 million, or 14%, to \$13.3 million for the year ended December 31, 2012, from \$11.7 million for the same period in 2011. The overall increase within general and administrative expenses related to increases in (i) personnel related costs including share-based compensation expense, (ii) bad debt expense, (iii) professional fees, and (iv) various administrative costs. Share-based compensation expense included in general and administrative expenses was \$2.0 million for the year ended December 31, 2012, compared with \$1.7 million for the year ended December 31, 2011. Share-based compensation expense included in general and administrative expenses was equal to 3% of total revenue for the year ended December 31, 2012 and to 2% of total revenue for the year ended December 31, 2011.

Investigation, Litigation and Settlement Related Costs

During 2012, we recorded a \$0.3 million reduction of investigation, litigation and settlement related costs. The reduction was comprised of (i) a \$1.7 million reduction in the accrual for certain costs associated with the resolution of the government investigations and (ii) a recovery of \$0.3 million of legal expenses previously incurred related to the class action and derivative lawsuits, partially offset by (i) \$1.5 million of legal expenses related to the class action and derivative lawsuits as well as for the potential settlement of the class action lawsuit that are not or may not be recoverable through insurance and (ii) \$0.2 million of legal fees incurred related to the resolution of the government investigations. Investigation costs for the year ended December 31, 2011, totaled \$10.3 million, which consisted of \$2.8 million of legal and professional fees and an accrual of \$7.5 million for certain costs associated with the possible resolution of the government investigations. See *Part I, Item 3 – Legal Proceedings* of this annual report on Form 10-K, for a more detailed description of the investigations.

We expect our operating expenses will continue to be adversely impacted during 2013 due to professional and service provider fees, and other costs, resulting from the ongoing stockholder lawsuits.

Restructuring costs

During 2012, we completed a restructuring which was composed of a workforce reduction of approximately 35 positions worldwide from various departments. These actions were intended to better align our cost structure with the skills and resources required to more effectively execute our long-term growth strategy, to drive operational efficiencies and to support the anticipated revenue levels we expect to achieve on a go forward basis. The total amount incurred with respect to severance under the 2012 Plan was \$0.8 million. Actions under the 2012 Plan were substantially completed by the end of the third quarter of 2012. During 2011, we completed a restructuring which was composed of a workforce reduction of approximately 25 positions worldwide from various departments and the closing of a satellite facility. The total amounts incurred with respect to severance and facilities abandonment under the 2011 Plan were \$0.8 million and less than \$0.1 million, respectively. Actions under the 2011 Plan were substantially completed by the end of the third quarter of 2011. For further information, refer to Note (13) *Restructuring Costs*, to our consolidated financial statements.

Interest and Other Income (Loss)

We invest our cash primarily in money market funds, commercial paper, government securities, and corporate bonds. As of December 31, 2012, our cash, cash equivalents, and marketable securities totaled \$29.9 million, compared with \$37.8 million as of December 31, 2011. Interest and other income (loss) decreased \$0.6 million to a loss of (\$0.5) million for the year ended December 31, 2012, compared with \$0.1 million of income for the same period in 2011. The decrease in interest and other income was primarily due to foreign currency losses of (\$0.6) million and interest income of \$0.1 million during the year ended December 31, 2012, compared with \$0.1 million of interest income partially offset by \$0.1 million of foreign currency losses.

Income Taxes

Our provision for income taxes consists of federal, state and local, and foreign taxes. For the year ended December 31, 2012, we recorded an income tax provision of \$0.8 million on our pre-tax loss of \$14.2 million, consisting primarily of state and local and foreign taxes. For the year ended December 31, 2011, we recorded an income tax provision of \$1.2 million on our pre-tax loss of \$22.2 million, consisting of primarily state and local and foreign taxes. During 2010, we concluded that our domestic deferred tax assets were no longer realizable on a more-likely-than-not basis and, therefore, we recorded a full valuation allowance against our domestic deferred tax assets. During the years ended December 31, 2012 and 2011, our conclusion did not change with respect to our domestic deferred tax assets and therefore, we have not recorded any benefit for our net domestic deferred tax assets for the full years of 2012 and 2011.

RESULTS OF OPERATIONS – FOR THE YEAR ENDED DECEMBER 31, 2011 COMPARED WITH THE YEAR ENDED DECEMBER 31, 2010

Total revenues for the year ended December 31, 2011 increased less than 1% to \$82.9 million, compared with \$82.8 million for the year ended December 31, 2010. During 2011, we completed a restructuring which was composed of a workforce reduction of approximately 25 positions worldwide from various departments and the closing of a satellite facility. The restructuring charges totaled approximately \$0.8 million and have been segregated from each of the respective expense line items and are included within “restructuring costs” in our consolidated statement of operations. Our cost of revenues remained relatively consistent at \$21.5 million for the years ended December 31, 2011 as compared with \$21.4 million for the year ended December 31, 2010. Included in our cost of revenues for the years ended December 31, 2011 and 2010 was \$0.5 million and \$1.1 million, respectively, of share-based compensation expense. Our operating expenses increased 6% from \$79.0 million for the year ended December 31, 2010 to \$83.6 million for the year ended December 31, 2011. Included in the operating results for the year ended December 31, 2011 were (i) \$0.8 million of restructuring costs, and (ii) \$10.3 million of costs associated with the then outstanding government investigations that commenced during the second half of 2010. The \$10.3 million was comprised of \$2.8 million of legal fees, and an accrual of \$7.5 million for certain costs associated with the then outstanding government investigations. Included in the operating results for the year ended December 31, 2010 was \$1.6 million of costs associated with the then outstanding government investigations. The \$1.6 million was comprised completely of legal fees. In addition, included in our operating expenses for the years ended December 31, 2011 and 2010 were \$5.1 million and \$7.5 million, respectively, of share-based compensation expense. Net loss for the year ended December 31, 2011 was \$23.4 million, compared with a net loss of \$35.4 million for the year ended December 31, 2010. Included in our net loss for the year ended December 31, 2011 was an income tax provision of \$1.2 million, compared with an income tax provision of \$17.6 million for the year ended December 31, 2010. The income tax provision of \$1.2 million was primarily attributable to the impact of our effective tax rate on our pre-tax losses for the year ended December 31, 2011. The income tax provision of \$17.6 million recorded during the year ended December 31, 2010, was the result of a full valuation allowance recorded on substantially all of our existing domestic deferred tax assets as a result of our inability to utilize our domestic deferred tax assets on a more-likely-than-not basis in future periods.

Overall, the increase in total revenues was primarily due to an increase in support and service revenues for the year ended December 31, 2011, compared with the same period in 2010. In total, our product revenues decreased 5%. Product revenues from our non-OEM partners increased 6%, while product revenues from our OEM partners decreased 42% for the year ended December 31, 2011, compared with the same period in 2010. The overall increase in our non-OEM product revenues was primarily attributable to the continued focus and emphasis on our FalconStor-branded business. However, throughout 2011, the Company experienced several disruptions which adversely impacted our non-OEM product revenue growth. First, during the first half of 2011, our North American sales organization was in a period of transition. We recruited substantially an entire new sales team which led to lower than anticipated product revenues from North America during this period due to the time required to develop and train a new sales force. Second, during mid-2011, our European operations were impacted as a result of the ongoing uncertainties and disruptions in the overall European economy, and changes in senior management of the European operations. Finally, the then outstanding government investigations and uncertainties surrounding the potential outcome of these investigations all adversely impacted our overall non-OEM product revenue growth. In addition, as anticipated, our OEM product revenues continued to decline, as a result of merger and acquisition activity involving some of our historically major OEM partners that began in 2009 and which we have previously reported.

Overall, our total operating expenses increased \$4.6 million, or 6% to \$83.6 million for the year ended December 31, 2011, as compared with \$79.0 million for the same period in 2010. This increase was primarily due to

additional costs of (i) \$8.6 million associated with the then outstanding government investigations, and (ii) \$0.8 million of restructuring costs incurred during the year ended December 31, 2011 as compared with the same period in 2010.

Revenues

	Year Ended December 31,	
	2011	2010
<i>Revenues:</i>		
Product revenue	\$ 49,470,139	\$ 51,905,096
Support and services revenue	33,400,463	30,938,650
<i>Total Revenues</i>	\$ 82,870,602	\$ 82,843,746
<i>Year-over-year percentage growth</i>		
Product revenue	-5%	-15%
Support and services revenue	8%	10%
<i>Total percentage growth</i>	0%	-7%

Product revenue

Product revenue decreased 5% from \$51.9 million for the year ended December 31, 2010 to \$49.5 million for the year ended December 31, 2011. These amounts are net of a benefit of \$0.7 million recognized during the year ended December 31, 2011, compared with an expense of \$0.7 million in the same period in 2010, resulting from the impact of our collections of previously reserved accounts receivable. Product revenue represented 60% and 63% of our total revenues for the years ended December 31, 2011 and 2010, respectively. Product revenues from our non-OEM partners increased 6%, while product revenues from our OEM partners decreased 42% for the year ended December 31, 2011, compared with the same period in 2010. The overall increase in our non-OEM product revenues was primarily attributable to the continued focus and emphasis on our FalconStor-branded business. However, throughout 2011, the Company experienced several disruptions which adversely impacted our non-OEM product revenue growth. First, during the first half of 2011, our North American sales organization was in a period of transition. We recruited substantially an entire new sales team which led to lower than anticipated product revenues from North America during this period due to the time required to develop and train a new sales force. Second, during mid-2011, our European operations were impacted as a result of the ongoing uncertainties and disruptions in the overall European economy. Finally, the then outstanding government investigations and the uncertainties surrounding the potential outcome of these investigations all adversely impacted our overall non-OEM product revenue growth. Additionally, as anticipated, our OEM product revenues continued to decline, as a result of merger and acquisition activity involving some of our historically major OEM partners that began in 2009 and which we have previously reported. Product revenue from our non-OEM partners represented 87% and 78% of our total product revenue for the years ended December 31, 2011 and 2010, respectively. Product revenue from our OEM partners represented 13% and 22% of our total product revenue for the years ended December 31, 2011 and 2010, respectively.

Support and services revenue

The increase in support and services revenue was primarily attributable to maintenance and technical support services, which increased from \$27.6 million for the year ended December 31, 2010 to \$30.3 million for the same period in 2011.

Professional services revenues decreased from \$3.3 million for the year ended December 31, 2010 to \$3.1 million for the same period in 2011. The professional services revenue varies from period to period based upon (i) the number of integrated solutions sold during the existing and previous periods, (ii) the number of our customers who elect to purchase professional services, and (iii) the number of professional services contracts that were completed during the period.

Cost of Revenues

	Year Ended December 31,	
	2011	2010
<i>Cost of revenues:</i>		
Product	\$ 8,386,864	\$ 9,291,236
Support and service	13,130,045	12,147,715
Total cost of revenues	<u>\$ 21,516,909</u>	<u>\$ 21,438,951</u>
<i>Total Gross Profit</i>	\$ 61,353,693	\$ 61,404,795
<i>Gross Margin:</i>		
Product	83%	82%
Support and service	61%	61%
Total gross margin	<u>74%</u>	<u>74%</u>

Cost of revenues, gross profit and gross margin

Cost of product revenue for the year ended December 31, 2011 decreased \$0.9 million, or 10%, to \$8.4 million, compared with \$9.3 million for the same period in 2010. The decrease in cost of product revenue was primarily attributable to (i) decreased hardware and shipping costs as the result of the 5% decline in product revenues, and (ii) decreased amortization of purchased software costs during the year ended December 31, 2011 compared with the same period in 2010. Our cost of support and service revenues for the year ended December 31, 2011 increased \$1.0 million, or 8%, to \$13.1 million compared with \$12.1 million for the same period in 2010. The increase in cost of support and service revenue is primarily related to costs associated with the hiring of management for both our support and services divisions, as well as an overall change in the mix of our headcount within support and services as compared with the same period in 2011.

Total gross profit remained consistent at approximately \$61.4 million for each of the years ended December 31, 2011 and 2010. Total gross margin also remained consistent at 74% for each of the years ended December 31, 2011 and 2010. Generally, our total gross profits and total gross margins may fluctuate based on several factors, including (i) revenue growth levels, (ii) changes in personnel headcount and related costs, and (iii) our product offerings and service mix of sales.

Share-based compensation expense included in the cost of product revenue was less than 1% of revenue for each of the years ended December 31, 2011 and December 31, 2010. Share-based compensation expense included in the cost of support and service revenue decreased to \$0.5 million from \$1.1 million for the years ended December 31, 2011 and December 31, 2010, respectively. Share-based compensation expense related to cost of support and service revenue was equal to 1% for both the years ended December 31, 2011 and 2010, respectively.

Operating Expenses

Research and Development Costs

Research and development costs decreased \$5.7 million, or 21%, to \$21.2 million for the year ended December 31, 2011 from \$26.9 million in the same period in 2010. The decrease in research and development costs was primarily the result of (i) a decline in salary and personnel costs, including share-based compensation expenses, as a result of lower research and development headcount, and (ii) an increase of approximately \$0.9 million related to the capitalization of costs associated with software development. Share-based compensation expense included in research and development costs decreased to \$1.3 million from \$3.0 million for the years ended December 31, 2011 and December 31, 2010, respectively. Share-based compensation expense included in research and development costs was equal to 2% and 4% of total revenue for the years ended December 31, 2011 and 2010, respectively.

Selling and Marketing

Selling and marketing expenses decreased \$1.2 million, or 3%, to \$39.6 million for the year ended December 31, 2011, from \$40.8 million for the same period in 2010. The decrease in selling and marketing expenses was primarily due to lower headcounts, specifically within North America, during the first half of 2011, as the result of a transition within the North American sales force. These decreases were offset in part by the costs associated with the recruitment and hiring of (i) additional sales management in all of our regions, and (ii) costs related to the

increased sales and sales support personnel within North America. Share-based compensation expense included in selling and marketing decreased to \$2.0 million from \$3.4 million for the years ended December 31, 2011 and 2010, respectively. Share-based compensation expense included in selling and marketing expenses was equal to 2% and 4% of total revenue for the years ended December 31, 2011 and 2010, respectively.

General and Administrative

General and administrative expenses increased \$2.1 million, or 22%, to \$11.7 million for the year ended December 31, 2011 from \$9.6 million for the same period in 2010. The overall increase within general and administrative expenses related to increases in (i) personnel related costs, and (ii) various administrative costs. Share-based compensation expense included in general and administrative expenses increased to \$1.7 million from \$1.2 million for the years ended December 31, 2011 and 2010, respectively. Share-based compensation expense included in general and administrative expenses was equal to 2% and 1% of total revenue for the years ended December 31, 2011 and 2010, respectively.

Investigation costs

Investigation costs for the year ended December 31, 2011, totaled \$10.3 million, which consisted of \$2.8 million of legal and professional fees, and an accrual of \$7.5 million for certain costs associated with the then outstanding resolution of the government investigations. Investigation costs for the year ended December 31, 2010, totaled \$1.6 million, which related to legal and professional fees. See *Part I, Item 3 – Legal Proceedings* of this annual report on Form 10-K, for a more detailed description of the investigations.

Restructuring costs

During 2011, we completed a restructuring which was composed of a workforce reduction of approximately 25 global positions from various departments and the closing of a satellite facility (the “2011 Plan”). These actions were intended to better align our cost structure with the skills and resources required to more effectively execute our long-term growth strategy and drive operational efficiencies. The total amounts incurred with respect to severance and facilities abandonment under the 2011 Plan were \$0.8 million and less than \$0.1 million, respectively. Actions under the 2011 Plan were substantially completed by the end of the third quarter of 2011. For further information, refer to Note (13) *Restructuring Costs*, to our consolidated financial statements.

Interest and other income (loss)

As of December 31, 2011, our cash, cash equivalents, and marketable securities totaled \$37.8 million, compared with \$37.3 million as of December 31, 2010. Interest and other income (loss) increased \$0.3 million to \$0.1 million for the year ended December 31, 2011, compared with (\$0.2) million for the same period in 2010. The increase in interest and other income (loss) was primarily due to foreign currency losses of \$0.1 million incurred during the year ended December 31, 2011 compared with foreign currency losses of \$0.3 million for the same period in 2010.

Income Taxes

For the year ended December 31, 2011, we recorded an income tax provision of \$1.2 million on our pre-tax loss of \$22.2 million, consisting of primarily state and local and foreign taxes. For the year ended December 31, 2010, we recorded an income tax provision of \$17.6 million. During 2010, we concluded that our domestic deferred tax assets were no longer realizable on a more-likely-than-not basis, therefore, we recorded a discrete item of approximately \$16.3 million related to an increase in a valuation allowance on our domestic deferred tax assets previously recognized. During the year ended December 31, 2011, our conclusion did not change with respect to our domestic deferred tax assets and therefore, we have not recorded any benefit for our net domestic deferred tax assets for the full year 2011.

LIQUIDITY AND CAPITAL RESOURCES

Cash flow information is as follows:

	Years Ended December 31,		
	2012	2011	2010
<i>Cash provided by (used in):</i>			
Operating activities	(\$5,268,470)	\$3,138,766	(\$1,728,504)
Investing activities	7,235,301	(5,400,465)	3,634,373
Financing activities	738,184	920,106	409,889
Effect of exchange rate changes	(311,241)	(243,268)	(225,731)
<i>Net increase (decrease) in cash and cash equivalents</i>	\$2,393,774	(\$1,584,861)	\$2,090,027

Our principal sources of liquidity are cash flows generated from operations and our cash, cash equivalents, and marketable securities balances. Our cash and cash equivalents and marketable securities balance as of December 31, 2012 totaled \$29.9 million, compared with \$37.8 million as of December 31, 2011. Cash and cash equivalents totaled \$18.7 million, restricted cash totaled \$0.8 million, and marketable securities totaled \$10.5 million at December 31, 2012. As of December 31, 2011, we had \$16.3 million in cash and cash equivalents and \$21.5 million in marketable securities.

As of December 31, 2012, the Company had \$0.8 million of restricted cash. The restricted cash serves as collateral related to deposit service indebtedness with the Company's commercial bank.

Over the past two years, we have been in an ongoing period of transition, which included various senior management changes, new sales leadership in all of our regions, changes within our North American sales force structure, and restructurings. Most recently, during the third quarter 2012, we completed a restructuring which was composed of a workforce reduction of approximately 35 positions worldwide from various departments. These actions were intended to better align our cost structure with the skills and resources required to more effectively execute our long-term growth strategy, drive operational efficiencies and support the anticipated revenue level we expect to achieve on a go forward basis (see Note (13) *Restructuring Costs* to our consolidated financial statements for further information.) We continually evaluate the appropriate headcount levels to properly align all of our resources with our current and long-term outlook. We will continue to evaluate potential software license purchases and acquisitions, and if the right opportunity presents itself, we may use our cash for these purposes. As of the date of this filing, we have no agreements, commitments or understandings with respect to any such license purchases or acquisitions.

As discussed further in *Part I, Item 3 – Legal Proceedings* of this annual report on Form 10-K, in June 2012, we settled charges arising from investigations conducted by the United States Attorney's Office and the Securities and Exchange Commission for a total of \$5.8 million. During 2012, the Company paid \$4.1 million of the \$5.8 million investigation settlement, with the balance of \$1.7 million due in December 2013.

In addition, as discussed further in *Part I, Item 3 – Legal Proceedings* of this annual report on Form 10-K, we are among the defendants named in class action and derivative lawsuits. In accordance with our by-laws and Delaware law, we have been paying for the costs of defense of these actions for the other named defendants. If liability is ultimately assessed some of the other named defendants may be entitled to claim indemnification from us. We have incurred, and continue to incur significant expenses, primarily for legal counsel, due to the class action and derivative lawsuits. In January, 2013, the parties to the Class Action reached an agreement in principle to settle the Class Action. Pursuant to a Memorandum of Understanding signed by counsel for the class plaintiffs and by counsel for all defendants, the Company will pay \$5.0 million to settle the Class Action. This amount includes damages, plaintiffs' attorneys' fees, and costs of administration of the settlement. The Company expects to pay this settlement with a combination of cash on hand and insurance proceeds. In accordance with the Memorandum of Understanding, a stipulation of settlement and a joint motion for preliminary approval of the settlement will be submitted to the court for its approval. Final settlement of the Class Action is subject to certain conditions and to approval by the court. We cannot predict if or when the court might approve the settlement. Certain of the defendants may be entitled to indemnification by the Company under the laws of Delaware and/or our by-laws. In addition, we may be entitled to seek the recovery of certain costs and payments from certain former Company employees. On March 5, 2013, the Derivative Action was dismissed as to all defendants except for Jason Lin.

At various times from October 2001 through February 2009 our Board of Directors has authorized the repurchase of up to 14 million shares of our outstanding common stock in the aggregate. We did not repurchase any of our outstanding common stock during the years ended December 31, 2012, 2011 and 2010. Since October 2001, we have repurchased a total of 8,005,235 shares at an aggregate purchase price of \$46.9 million. As of December 31, 2012, we had the authority to repurchase 5,994,765 shares of our common stock based upon our judgment and market conditions. See Note (7) *Stockholders' Equity* to our consolidated financial statements for further information.

Net cash (used in) provided by operating activities totaled (\$5.3) million, \$3.1 million and (\$1.7) million for the years ended December 31, 2012, 2011 and 2010, respectively. The changes in net cash (used in) provided by operating activities for each of the years ended December 31, 2012, 2011 and 2010 is the result of recording a net loss of \$15.0 million, \$23.4 million and \$35.4 million, respectively, adjusted for: (i) the impact of non-cash charges, particularly relating to depreciation, amortization, stock-based compensation, provision for returns and doubtful accounts and deferred income taxes; and (ii) adjustments for net changes in operating assets and liabilities, primarily changes in our accounts receivable, prepaid expenses, inventory, accounts payable, accrued expenses and deferred revenues.

Net cash provided by (used in) investing activities totaled \$7.2 million, (\$5.4) million and \$3.6 million for the years ended December 31, 2012, 2011 and 2010, respectively. Included in investing activities for each year are the sales and purchases of our marketable securities, which include the sales, maturities and reinvestment of our marketable securities. The net cash provided by (used in) investing activities from the net sales of securities was \$11.1 million, (\$2.0) million and \$6.6 million for the years ended December 31, 2012, 2011 and 2010, respectively. These amounts will fluctuate from year to year depending on the maturity dates of our marketable securities. The cash used to purchase property and equipment was \$2.5 million, \$2.2 million and \$2.7 million for the years ended December 31, 2012, 2011 and 2010, respectively. The cash used in the capitalization of software development costs was \$0.5 million, \$1.0 million and \$0.1 million for the years ended December 31, 2012, 2011 and 2010, respectively. The cash used in changes of restricted cash was \$0.8 million for the year ended December 31, 2012. We continually evaluate potential software license purchases and acquisitions, and we may continue to make such investments if we find opportunities that would benefit our business. We anticipate continued capital expenditures, including capitalized software costs, as we continue to invest in our infrastructure and expand and enhance our product offerings.

Net cash provided by financing activities totaled \$0.7 million, \$0.9 million and \$0.4 million for the years ended December 31, 2012, 2011 and 2010, respectively, resulting from proceeds received from the exercise of stock options.

During the year ended December 31, 2012, the remaining \$0.7 million (at par value) of our auction rate securities were called by the issuer at par value. As of December 2011, \$0.7 million, (at par value) of our auction rate securities and were classified as long-term investments in our consolidated balance sheet at December 31, 2011.

We currently do not have any debt and our only significant commitments are related to our employment agreement with James P. McNiel, our President and Chief Executive Officer, the \$1.7 million remaining payment to the United States Attorney's Office, which is due in December 2013 and our office leases. In addition, on January 20, 2013, we announced we had reached a proposed settlement of the Class Action lawsuit between the Company and class plaintiffs for \$5.0 million which is pending approval by the court. On March 13, 2013, the parties to the Class Action submitted a Stipulation and Agreement of Settlement asking the court to approve a settlement of the Class Action agreed to by the parties. We cannot predict if or when the court might approve the settlement.

We have an operating lease covering our corporate office facility that we recently extended to February 2017. We also have several operating leases related to offices in the United States and foreign countries. The expiration dates for these leases range from 2013 through 2017. The following is a schedule of future minimum lease payments for all operating leases as of December 31, 2012:

Year ending December 31,	
2013	\$ 2,708,548
2014	2,329,788
2015	1,728,939
2016	1,639,594
2017	298,416
Thereafter	-
	<u>\$ 8,705,285</u>

In addition, as of December 31, 2012, our liability for uncertain tax positions totaled \$2.5 million. Due to the uncertainty relating to the timing of future payments, such amounts are not presented in the above schedule.

We believe that our current balance of cash, cash equivalents, restricted cash and marketable securities, and our expected cash flows from operations, will be sufficient to meet our cash requirements for at least the next twelve months. However, any projections of future cash needs and cash flows are subject to substantial uncertainty. See *Part I, Item 1A - Risk Factors*.

Off-Balance Sheet Arrangements

As of December 31, 2012 and 2011, we had no off-balance sheet arrangements.

Critical Accounting Policies and Estimates

Our critical accounting policies and estimates are those related to revenue recognition, accounts receivable allowances, deferred income taxes, accounting for share-based payments, goodwill and other intangible assets, software development costs, fair value measurements and litigation.

Revenue Recognition. As discussed further in Note (1) *Summary of Significant Accounting Policies*, to our consolidated financial statements, we recognize revenue in accordance with the authoritative guidance issued by the FASB on revenue recognition. Product revenue is recognized only when pervasive evidence of an arrangement exists and the fee is fixed and determinable, among other criteria. An arrangement is evidenced by a signed customer contract, a customer purchase order, and/or a royalty report summarizing software licenses sold for each software license resold by an OEM, distributor, or reseller to an end user. Product fees are fixed and determinable as our standard payment terms range from 30 to 90 days, depending on regional billing practices, and we have not provided any of our customers with extended payment terms. When a customer purchases our integrated solutions and/or licenses software together with the purchase of maintenance, we allocate a portion of the fee to maintenance based upon vendor-specific objective evidence (“VSOE”) of the fair value of the contractual optional maintenance renewal rate. If professional services are included in our multi-element software arrangements, we allocate a portion of the fee to these services based on its VSOE of fair value which is established using rates charged when sold on a stand-alone basis.

Accounts Receivable. We review accounts receivable to determine which receivables are doubtful of collection. In making the determination of the appropriate allowance for uncollectible accounts and returns, we consider (i) historical return rates, (ii) specific past due accounts, (iii) analysis of our accounts receivable aging, (iv) customer payment terms, (v) historical collections, write-offs and returns, (vi) changes in customer demand and relationships, (vii) actual cash collections on our accounts receivables and (viii) concentrations of credit risk and customer credit worthiness. When determining the appropriate allowance for uncollectible accounts and returns each period, the actual customer collections of outstanding account receivable balances impact the required allowance for returns. We recorded total provision expenses of approximately \$0.4 million, \$0.1 million and \$1.2 million for the years ended December 31, 2012, 2011 and 2010, respectively. These amounts are included within our consolidated statement of operations in each respective year. Changes in the product return rates, credit worthiness of customers, general economic conditions and other factors may impact the level of future write-offs, revenues and our general and administrative expenses.

Income Taxes. As discussed further in Note (6) *Income Taxes*, to our consolidated financial statements, in accordance with the authoritative guidance issued by the FASB on income taxes, we regularly evaluate our ability

to recover deferred tax assets, and report such deferred tax assets at the amount that is determined to be more-likely-than-not recoverable. Deferred tax assets and liabilities are recognized for 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. In determining the period in which related tax benefits are realized for financial reporting purposes, excess share-based compensation deductions included in net operating losses are realized after regular net operating losses are exhausted.

We account for uncertain tax positions in accordance with the authoritative guidance issued by the FASB on income taxes, which addresses the determination of whether tax benefits claimed or expected to be claimed on a tax return, should be recorded in the financial statements. Pursuant to the authoritative guidance, we may recognize the tax benefit from an uncertain tax position only if it meets the “more likely than not” threshold that the position will be sustained on examination by the taxing authority, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position should be measured based on the largest benefit that has a greater than fifty percent likelihood of being realized upon ultimate settlement. In addition, the authoritative guidance addresses de-recognition, classification, interest and penalties on income taxes, accounting in interim periods, and also requires increased disclosures.

Accounting for Share-Based Payments. As discussed further in Note (8) *Share-Based Payment Arrangements*, to our consolidated financial statements, we account for share-based awards in accordance with the authoritative guidance issued by the FASB on stock compensation.

We have used and expect to continue to use the Black-Scholes option-pricing model to compute the estimated fair value of share-based compensation expense. The Black-Scholes option-pricing model includes assumptions regarding dividend yields, expected volatility, expected option term and risk-free interest rates. The assumptions used in computing the fair value of share-based compensation expense reflect our best estimates, but involve uncertainties relating to market and other conditions, many of which are outside of our control. We estimate expected volatility based primarily on historical daily price changes of our stock and other factors. The expected option term is the number of years that we estimate that the stock options will be outstanding prior to exercise. The estimated expected term of the stock awards issued has been determined pursuant to SEC Staff Accounting Bulletin SAB No. 110. Additionally, we estimate forfeiture rates based primarily upon historical experience, adjusted when appropriate for known events or expected trends. We may adjust share-based compensation expense on a quarterly basis for changes to our estimate of expected equity award forfeitures based on our review of these events and trends and recognize the effect of adjusting the forfeiture rate for all expense amortization in the period in which we revised the forfeiture estimate. If other assumptions or estimates had been used, the share-based compensation expense that was recorded for the years ended December 31, 2012, 2011 and 2010 could have been materially different. Furthermore, if different assumptions or estimates are used in future periods, share-based compensation expense could be materially impacted in the future.

Goodwill and Other Intangible Assets. As discussed further in Note (1) *Summary of Significant Accounting Policies*, to our consolidated financial statements, we account for goodwill and other intangible assets in accordance with the authoritative guidance issued by the FASB on goodwill and other intangibles. The authoritative guidance requires an impairment-only approach to accounting for goodwill and other intangibles with an indefinite life. Absent any prior indicators of impairment, we perform an annual impairment analysis during the fourth quarter of each of our fiscal years.

As of each of December 31, 2012 and 2011, we had \$4.2 million of goodwill. As of each of December 31, 2012 and 2011, we had \$0.2 million (net of accumulated amortization), of other identifiable intangible assets. We do not amortize goodwill, but we assess for impairment at least annually and more often if a trigger event occurs. We amortize identifiable intangible assets over their estimated useful lives. We evaluate the recoverability of goodwill using a two-step process based on an evaluation of the reporting unit. The first step involves a comparison of a reporting unit’s fair value to its carrying value. In the second step, if the reporting unit’s carrying value exceeds its fair value, we compare the goodwill’s implied fair value and its carrying value. If the goodwill’s carrying value exceeds its implied fair value, we recognize an impairment loss in an amount equal to such excess. We evaluate the recoverability of other identifiable intangible assets whenever events or changes in circumstances indicate that its carrying value may not be recoverable. Such events include significant adverse changes in business climate, several periods of operating or cash flow losses, forecasted continuing losses or a current expectation that an asset or asset a

group will be disposed of before the end of its useful life. As of December 31, 2012 and 2011, we did not record any impairment charges on either our goodwill or other identifiable intangible assets.

Software Development Costs. As discussed further in Note (1) *Summary of Significant Accounting Policies*, to our consolidated financial statements, we account for software development costs in accordance with the authoritative guidance issued by the FASB on costs of software to be sold, leased or marketed.

As of December 31, 2012 and 2011, we had \$1.2 million and \$1.0 million, respectively, of software development costs, net of amortization. The authoritative guidance requires that the costs associated with the development of new software products and enhancements to existing software products be expensed as incurred until technological feasibility of the product has been established. Once technological feasibility is established, all software costs are capitalized until the product is available for general release to customers. Judgment is required in determining when technological feasibility of a product is established and assumptions are used that reflect our best estimates. If other assumptions had been used in the current period to estimate technological feasibility, the reported product development and enhancement expense could have been affected. Annual amortization of capitalized software costs is the greater of the amount computed using the ratio that current gross revenues for a product bear to the total of current and anticipated future gross revenues for that product or the straight-line method over the remaining estimated economic life of the software product, generally estimated to be five years from the date the product became available for general release to customers. Software development costs are reported at the lower of amortized cost or net realizable value. Net realizable value is computed as the estimated gross future revenues from each software solution less the amount of estimated future costs of completing and disposing of that product. Because the development of projected net future revenues related to our software solutions used in our net realizable value computation is based on estimates, a significant reduction in our future revenues could impact the recovery of our capitalized software development costs. We amortize software development costs using the straight-line method.

Fair Value Measurement. As discussed further in Note (4) *Fair Value Measurements*, to our consolidated financial statements, we determine fair value measurements of both financial and nonfinancial assets and liabilities in accordance with the authoritative guidance issued by the FASB on fair value measurements and disclosures.

In the current market environment, the assessment of the fair value of our marketable securities, specifically our debt instruments, can be difficult and subjective. The volume of trading activity of certain debt instruments has declined, and the rapid changes occurring in the current financial markets can lead to changes in the fair value of financial instruments in relatively short periods of time. The FASB authoritative guidance establishes three levels of inputs that may be used to measure fair value. Each level of input has different levels of subjectivity and difficulty involved in determining fair value.

Level 1 - instruments represent quoted prices in active markets. Therefore, determining fair value for Level 1 instruments does not require significant management judgment, and the estimation is not difficult.

Level 2 - instruments include observable inputs other than Level 1 prices, such as quoted prices for identical instruments in markets with insufficient volume or infrequent transactions (less active markets), issuer credit ratings, non-binding market consensus prices that can be corroborated with observable market data, model-derived valuations in which all significant inputs are observable or can be derived principally from or corroborated with observable market data for substantially the full term of the assets or liabilities, or quoted prices for similar assets or liabilities. These Level 2 instruments require more management judgment and subjectivity compared to Level 1 instruments.

Level 3 - instruments include unobservable inputs to the valuation methodology that are significant to the measurement of fair value of assets or liabilities. The determination of fair value for Level 3 instruments requires the most management judgment and subjectivity. All of our marketable debt instruments classified as Level 3 are valued using an undiscounted cash flow analysis, a non-binding market consensus price and/or a non-binding broker quote, all of which we corroborate with unobservable data. Non-binding market consensus prices are based on the proprietary valuation models of pricing providers or brokers. These valuation models incorporate a number of inputs, including non-binding and binding broker quotes; observable market prices for identical and/or similar securities; and the internal assumptions of pricing providers or brokers that use observable market inputs, and to a lesser degree non-observable market inputs. Adjustments to the fair value of instruments priced using non-binding market consensus prices and non-binding broker quotes, and classified as Level 3, were not significant as of December 31, 2011. There were no instruments classified as Level 3 as of December 31, 2012.

Other-Than-Temporary Impairment

After determining the fair value of our available-for-sale debt instruments, gains or losses on these investments are recorded to other comprehensive income, until either the investment is sold or we determine that the decline in value is other-than-temporary. Determining whether the decline in fair value is other-than-temporary requires management judgment based on the specific facts and circumstances of each investment. For investments in debt instruments, these judgments primarily consider the financial condition and liquidity of the issuer, the issuer's credit rating, and any specific events that may cause us to believe that the debt instrument will not mature and be paid in full; and our ability and intent to hold the investment to maturity. Given the current market conditions, these judgments could prove to be wrong, and companies with relatively high credit ratings and solid financial conditions may not be able to fulfill their obligations.

Litigation. As discussed further in Note (12) *Litigation*, to our consolidated financial statements, in accordance with the authoritative guidance issued by the FASB on contingencies, the Company accrues anticipated costs of settlement, damages and losses for claims to the extent specific losses are probable and estimable. The Company records a receivable for insurance recoveries when such amounts are probable and collectable. In such cases, there may be an exposure to loss in excess of any amounts accrued. If, at the time of evaluation, the loss contingency related to a litigation is not both probable and estimable, the matter will continue to be monitored for further developments that would make such loss contingency both probable and estimable and, the Company will expense these costs as incurred. If the estimate of a probable loss is a range and no amount within the range is more likely, the Company will accrue the minimum amount of the range.

Impact of Recently Issued Accounting Pronouncements

See Item 8 of Part II, Consolidated Financial Statements – Note (1) *Summary of Significant Accounting Policies – New Accounting Pronouncements*.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

Interest Rate Risks. Our cash, cash equivalents and marketable securities aggregated \$29.9 million as of December 31, 2012. Our exposure to market risk for changes in interest rates relates primarily to our investment portfolio. All of our cash equivalent and marketable securities are designated as available-for-sale and, accordingly, are presented at fair value on our consolidated balance sheets. We regularly assess these risks and have established policies and business practices to manage the market risk of our marketable securities. We generally invest our excess cash in investment grade short- to intermediate-term fixed income securities and AAA-rated money market funds. Fixed rate securities may have their fair market value adversely affected due to a rise in interest rates, and we may suffer losses in principal if forced to sell securities that have declined in market value due to changes in interest rates. Due to the short-term nature of the majority of our investments, the already severely suppressed interest rates we currently earn, and the fact that over 65% of our total cash, cash equivalents and marketable securities are comprised of money market funds and cash, we do not believe we are subject to any material interest rate risks on our investment balances levels at December 31, 2012.

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. For the years ended December 31, 2012, 2011 and 2010, approximately 60%, 56% and 45%, respectively, of our sales were from outside North America. Not all of these transactions were made in foreign currencies. Our primary exposure is to fluctuations in exchange rates for the U.S. Dollar versus the Euro, and the Japanese Yen, and to a lesser extent the Canadian Dollar, the Korean Won, the New Taiwanese Dollar and the Australian dollar. Changes in exchange rates in the functional currency for each geographic area's revenues are primarily offset by the related expenses associated with such revenues. However, changes in exchange rates of a particular currency could impact the re-measurement of such balances on our balance sheets.

If foreign currency exchange rates were to change adversely by 10% from the levels at December 31, 2012, the effect on our results before taxes from foreign currency fluctuations on our balance sheet would be approximately \$1.2 million. The above analysis disregards the possibility that rates for different foreign currencies can move in opposite directions and that losses from one currency may be offset by gains from another currency.

Item 8. Financial Statements and Supplementary Data

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Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders
FalconStor Software, Inc.:

We have audited the accompanying consolidated balance sheets of FalconStor Software, Inc. and subsidiaries as of December 31, 2012 and 2011, and the related consolidated statements of operations, stockholders' equity, comprehensive loss, and cash flows for each of the years in the three-year period ended December 31, 2012. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of FalconStor Software, Inc. and subsidiaries as of December 31, 2012 and 2011, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2012, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of FalconStor Software, Inc. and subsidiaries' internal control over financial reporting as of December 31, 2012, based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report, dated March 18, 2013, expressed an unqualified opinion on the effectiveness of internal control over financial reporting.

/s/ KPMG LLP

Melville, New York,
March 18, 2013

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders
FalconStor Software, Inc.:

We have audited FalconStor Software, Inc. and subsidiaries' internal control over financial reporting as of December 31, 2012, based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). FalconStor Software, Inc.'s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

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

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

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, FalconStor Software, Inc. and subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2012, based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission COSO.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of FalconStor Software, Inc. and subsidiaries as of December 31, 2012 and 2011, and the related consolidated statements of operations, stockholders' equity, comprehensive loss and cash flows for each of the years in the three-year period ended December 31, 2012, and our report dated March 18, 2013 expressed an unqualified opinion on those consolidated financial statements.

/s/ KPMG LLP

Melville, New York
March 18, 2013

FALCONSTOR SOFTWARE, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

	December 31,	
	2012	2011
Assets		
Current assets:		
Cash and cash equivalents	\$ 18,651,468	\$ 16,257,694
Restricted cash	750,000	-
Marketable securities	10,530,942	20,894,328
Accounts receivable, net of allowances of \$940,101 and \$1,723,679, respectively	14,130,302	19,314,789
Prepaid expenses and other current assets	2,796,665	1,912,831
Inventory	642,819	1,769,007
Deferred tax assets, net	464,031	177,798
Total current assets	47,966,227	60,326,447
Property and equipment, net of accumulated depreciation of \$16,131,570 and \$17,797,835, respectively	3,980,679	4,364,180
Long-term marketable securities	-	611,082
Deferred tax assets, net	86,465	217,771
Software development costs, net	1,161,822	1,001,530
Other assets, net	2,185,148	2,183,973
Goodwill	4,150,339	4,150,339
Other intangible assets, net	174,426	191,572
Total assets	\$ 59,705,106	\$ 73,046,894
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	\$ 2,801,372	\$ 2,883,844
Accrued expenses	16,720,582	17,609,766
Deferred revenue, net	17,831,653	19,450,966
Total current liabilities	37,353,607	39,944,576
Other long-term liabilities	2,618,818	2,587,327
Deferred tax liabilities, net	167,875	-
Deferred revenue, net	6,311,865	7,698,053
Total liabilities	46,452,165	50,229,956
Commitments and contingencies		
Stockholders' equity:		
Preferred stock - \$.001 par value, 2,000,000 shares authorized	-	-
Common stock - \$.001 par value, 100,000,000 shares authorized, 55,615,972 and 54,931,397 shares issued, respectively and 47,610,737 and 46,926,162 shares outstanding, respectively	55,616	54,931
Additional paid-in capital	162,673,833	157,321,564
Accumulated deficit	(100,910,119)	(85,925,798)
Common stock held in treasury, at cost (8,005,235 and 8,005,235 shares, respectively)	(46,916,339)	(46,916,339)
Accumulated other comprehensive loss, net	(1,650,050)	(1,717,420)
Total stockholders' equity	13,252,941	22,816,938
Total liabilities and stockholders' equity	\$ 59,705,106	\$ 73,046,894

See accompanying notes to consolidated financial statements.

FALCONSTOR SOFTWARE, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS

	Years Ended December 31,		
	2012	2011	2010
Revenues:			
Product revenues	\$ 41,358,621	\$ 49,470,139	\$ 51,905,096
Support and services revenues	34,052,348	33,400,463	30,938,650
Total revenues	<u>75,410,969</u>	<u>82,870,602</u>	<u>82,843,746</u>
Cost of revenues:			
Product	8,215,152	8,386,864	9,291,236
Support and service	12,446,921	13,130,045	12,147,715
Total cost of revenues	<u>20,662,073</u>	<u>21,516,909</u>	<u>21,438,951</u>
Gross profit	\$ 54,748,896	\$ 61,353,693	\$ 61,404,795
Operating expenses			
Research and development costs	18,636,328	21,199,816	26,905,748
Selling and marketing	36,008,655	39,597,590	40,844,909
General and administrative	13,334,475	11,696,512	9,626,464
Investigation, litigation, and settlement related costs	(326,408)	10,257,388	1,616,241
Restructuring costs	770,749	822,320	-
Total operating expenses	<u>68,423,799</u>	<u>83,573,626</u>	<u>78,993,362</u>
Operating loss	<u>(13,674,903)</u>	<u>(22,219,933)</u>	<u>(17,588,567)</u>
Interest and other (loss) income, net	<u>(523,011)</u>	<u>59,982</u>	<u>(213,079)</u>
Loss before income taxes	(14,197,914)	(22,159,951)	(17,801,646)
Provision for income taxes	<u>786,407</u>	<u>1,208,332</u>	<u>17,573,975</u>
Net loss	<u>\$ (14,984,321)</u>	<u>\$ (23,368,283)</u>	<u>\$ (35,375,621)</u>
Basic net loss per share	<u>\$ (0.32)</u>	<u>\$ (0.50)</u>	<u>\$ (0.78)</u>
Diluted net loss per share	<u>\$ (0.32)</u>	<u>\$ (0.50)</u>	<u>\$ (0.78)</u>
Weighted average basic shares outstanding	<u>47,408,995</u>	<u>46,648,928</u>	<u>45,549,314</u>
Weighted average diluted shares outstanding	<u>47,408,995</u>	<u>46,648,928</u>	<u>45,549,314</u>

See accompanying notes to consolidated financial statements.

FALCONSTOR SOFTWARE, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

	Years Ended December 31,		
	<u>2012</u>	<u>2011</u>	<u>2010</u>
Common stock, beginning of year	\$ 54,931	\$ 54,147	\$ 52,389
Exercise of stock awards	685	784	1,758
Common stock, end of year	<u>55,616</u>	<u>54,931</u>	<u>54,147</u>
Additional paid-in capital, beginning of year	157,321,564	150,884,184	141,726,802
Exercise of stock awards	737,500	919,322	408,131
Net effects of tax shortfalls from stock-based award activity	-	-	63,682
Share-based compensation to non-employees	27,487	24,369	819,185
Share-based compensation to employees	4,587,282	5,493,689	7,866,384
Additional paid-in capital, end of year	<u>162,673,833</u>	<u>157,321,564</u>	<u>150,884,184</u>
Accumulated deficit, beginning of year	(85,925,798)	(62,557,515)	(27,181,894)
Net loss	(14,984,321)	(23,368,283)	(35,375,621)
Accumulated deficit, end of year	<u>(100,910,119)</u>	<u>(85,925,798)</u>	<u>(62,557,515)</u>
Treasury stock, beginning and end of year	<u>(46,916,339)</u>	<u>(46,916,339)</u>	<u>(46,916,339)</u>
Accumulated other comprehensive loss, beginning of year	(1,717,420)	(1,525,614)	(1,528,044)
Other comprehensive income (loss)	67,370	(191,806)	2,430
Accumulated other comprehensive loss, end of year	<u>(1,650,050)</u>	<u>(1,717,420)</u>	<u>(1,525,614)</u>
Total stockholders' equity	<u>\$ 13,252,941</u>	<u>\$ 22,816,938</u>	<u>\$ 39,938,863</u>

See accompanying notes to consolidated financial statements.

FALCONSTOR SOFTWARE, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS

	Years Ended December 31,		
	2012	2011	2010
Net loss	\$ (14,984,321)	\$ (23,368,283)	\$ (35,375,621)
Other comprehensive income (loss):			
Foreign currency translation	(152,075)	(279,898)	(75,087)
Net unrealized gains on marketable securities	90,000	20,201	137,172
Net minimum pension liability	129,445	67,891	(59,655)
Total other comprehensive income (loss)	67,370	(191,806)	2,430
Total comprehensive loss	\$ (14,916,951)	\$ (23,560,089)	\$ (35,373,191)

See accompanying notes to consolidated financial statements.

FALCONSTOR SOFTWARE, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Years Ended December 31,		
	<u>2012</u>	<u>2011</u>	<u>2010</u>
Cash flows from operating activities:			
Net loss	\$ (14,984,321)	\$ (23,368,283)	\$ (35,375,621)
Adjustments to reconcile net loss to net cash from operating activities:			
Depreciation and amortization	3,314,360	4,107,761	5,644,682
Share-based payment compensation	4,587,282	5,493,689	7,866,384
Non-cash professional services expenses	27,487	24,369	819,185
Realized (gain) loss on marketable securities	(905)	-	90,761
Impairment of cost method investments	10,725	41,780	-
Provision for returns and doubtful accounts	357,301	120,992	1,211,838
Deferred income tax provision	(83,350)	(160,434)	16,075,130
Changes in operating assets and liabilities:			
Accounts receivable	4,849,209	3,830,769	438,529
Prepaid expenses and other current assets	(889,278)	(333,732)	826,643
Inventory	1,126,188	(359,348)	(1,080,002)
Other assets	31,837	48,135	204,657
Accounts payable	(101,784)	1,446,111	(96,236)
Accrued expenses and other liabilities	(660,428)	8,670,790	324,726
Deferred revenue	(2,852,793)	3,576,167	1,320,820
Net cash (used in) provided by operating activities	<u>(5,268,470)</u>	<u>3,138,766</u>	<u>(1,728,504)</u>
Cash flows from investing activities:			
Sales of marketable securities	32,332,954	22,098,206	34,148,774
Purchases of marketable securities	(21,267,582)	(24,101,138)	(27,586,592)
Transfer to restricted cash	(750,000)	-	-
Purchases of property and equipment	(2,487,128)	(2,220,380)	(2,700,378)
Capitalized software development costs	(461,555)	(1,001,025)	(107,206)
Security deposits	(29,746)	(48,238)	9,081
Purchase of intangible assets	(101,642)	(127,890)	(129,306)
Net cash provided by (used in) investing activities	<u>7,235,301</u>	<u>(5,400,465)</u>	<u>3,634,373</u>
Cash flows from financing activities:			
Proceeds from exercise of stock options	738,184	920,106	409,889
Net cash provided by financing activities	<u>738,184</u>	<u>920,106</u>	<u>409,889</u>
Effect of exchange rate changes on cash and cash equivalents	<u>(311,241)</u>	<u>(243,268)</u>	<u>(225,731)</u>
Net increase (decrease) in cash and cash equivalents	2,393,774	(1,584,861)	2,090,027
Cash and cash equivalents, beginning of period	16,257,694	17,842,555	15,752,528
Cash and cash equivalents, end of period	<u><u>\$ 18,651,468</u></u>	<u><u>\$ 16,257,694</u></u>	<u><u>\$ 17,842,555</u></u>
Cash paid for income taxes, net	<u><u>\$ 688,164</u></u>	<u><u>\$ 1,221,294</u></u>	<u><u>\$ 721,159</u></u>

The Company did not pay any interest for the three years ended December 31, 2012.

See accompanying notes to consolidated financial statements.

FALCONSTOR SOFTWARE, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

December 31, 2012

(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 data protection 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) *Reclassifications*

Certain prior year's amounts have been reclassified to conform to the current year presentation. Investigation costs recorded in 2010 are now presented separately from "general and administrative" expenses. Certain costs previously recorded within "cost of revenues – support and services" are now presented within "research and development costs" to better align these costs with functions performed.

(d) *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. The Company's significant estimates include those related to revenue recognition, accounts receivable allowances, share-based payment compensation, cost-based investments, marketable securities, software development costs, goodwill and other intangible assets and income taxes. Actual results could differ from those estimates.

The financial market volatility, both in the U.S. and in many other countries where the Company operates, has impacted and may continue to impact the Company's business. Such conditions could have a material impact to the Company's significant accounting estimates discussed above.

(e) *Cash Equivalents, Restricted Cash and Marketable Securities*

The Company considers all highly liquid investments with maturities of three months or less when purchased to be cash equivalents. The Company records its cash equivalents and marketable securities at fair value in accordance with the authoritative guidance issued by the Financial Accounting Standards Board ("FASB") on fair value measurements and disclosures. As of both December 31, 2012 and 2011, the Company's cash equivalents consisted of money market funds. At December 31, 2012 and 2011, the fair value of the Company's cash equivalents amounted to approximately \$4.3 million and \$8.1 million, respectively.

As of December 31, 2012, the Company had \$0.8 million of restricted cash. The restricted cash serves as collateral related to deposit service indebtedness with the Company's commercial bank. As of December 31, 2012, the Company did not have any deposit service indebtedness with the Company's bank.

As of December 31, 2012 and 2011, the Company's current portion of marketable securities consisted of corporate bonds and government securities. As of December 31, 2012 and 2011, the fair value of the Company's current marketable securities was approximately \$10.5 million and \$20.9 million, respectively. In addition, as of December 31, 2011, the Company had an additional \$0.6 million of long-term marketable securities that required a higher level of judgment to determine the fair value. During 2012, these auction rate securities were called by the issuer at par value. All of the Company's marketable securities are classified as available-for-sale, and accordingly,

unrealized gains and losses on marketable securities, net of tax, are reflected as a component of accumulated other comprehensive loss in stockholders' equity. Any other-than-temporary impairments are recorded within interest and other loss, net in the consolidated statement of operations. See Note (3) *Marketable Securities* for additional information.

(f) *Fair Value of Financial Instruments*

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. To increase the comparability of fair value measurements, a three-tier fair value hierarchy, which prioritizes the inputs used in the valuation methodologies, is as follows:

Level 1—Valuations based on quoted prices for identical assets and liabilities in active markets.

Level 2—Valuations based on observable inputs other than quoted prices included in Level 1, such as quoted prices for similar assets and liabilities in active markets, quoted prices for identical or similar assets and liabilities in markets that are not active, or other inputs that are observable or can be corroborated by observable market data.

Level 3—Valuations based on unobservable inputs reflecting our own assumptions, consistent with reasonably available assumptions made by other market participants. These valuations require significant judgment.

As of both December 31, 2012 and 2011, the fair value of the Company's financial instruments including cash and cash equivalents, accounts receivable, accounts payable, and accrued expenses, approximated carrying value due to the short maturity of these instruments. See Note (4) *Fair Value Measurements* for additional information.

(g) *Revenue Recognition*

The Company derives its revenue from sales of its products, support and services. Product revenue consists of the Company's software integrated with industry standard hardware and sold as complete turn-key integrated solutions. Product revenue also consists of stand-alone software applications. Support and services revenue consists of both maintenance revenues and professional services revenues. Revenue is recorded net of applicable sales taxes.

In accordance with the authoritative guidance issued by the FASB on revenue recognition, the Company recognizes revenue from product sales when persuasive evidence of an arrangement exists, the fee is fixed and determinable, the product is delivered, and collection of the resulting receivable is deemed probable. Products delivered to a customer on a trial basis are not recognized as revenue until a permanent key code is delivered to the customer. Reseller customers typically send the Company a purchase order when they have an end user identified. Distributor customers typically send the Company a purchase order when they have a reseller and end user identified. For bundled arrangements that include either maintenance or both maintenance and professional services, the Company uses the residual method to determine the amount of product revenue to be recognized. Under the residual method, consideration is allocated to the undelivered elements based upon vendor-specific objective evidence ("VSOE") of the fair value of those elements, with the residual of the arrangement fee allocated to and recognized as product revenue. The long-term portion of deferred revenue relates to maintenance contracts with terms in excess of one year. The Company provides an allowance for product returns as a reduction of revenue, based upon historical experience and known or expected trends.

Revenues associated with maintenance services are deferred and recognized as revenue ratably over the term of the contract. Revenues associated with professional services are recognized when the services are performed. Costs of providing these services are included in cost of support and services.

The Company has entered into various distribution, licensing and joint promotion agreements with OEMs, whereby the Company has provided to the OEM a non-exclusive 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 these OEMs. Such payments from the OEM or distributor are recognized as revenue in the period reported by the OEM.

(h) *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). Leasehold improvements are amortized on a straight-line basis over the terms of the respective leases or over their estimated useful lives, whichever is shorter.

(i) *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. The Company has not amortized goodwill related to its acquisitions, but instead tests the balance for impairment. The Company evaluates goodwill for impairment annually or more frequently when an event occurs or circumstances change that indicate that the carrying value may not be recoverable. The Company tests goodwill for impairment by first comparing the book value of net assets to the fair value of the reporting unit. If the fair value is determined to be less than the book value or qualitative factors indicate that it is more likely than not that goodwill is impaired, a second step is performed to compute the amount of impairment as the difference between the estimated fair value of goodwill and the carrying value.

The Company's annual impairment assessment is performed during the fourth quarter of each year, and the Company has determined there to be no impairment for any of the periods presented. Based on the Company's analysis, the fair value of its reporting unit substantially exceeds the carrying value of its goodwill balances as of December 31, 2012 and 2011. Identifiable intangible assets include (i) assets acquired through business combinations, which include customer contracts and intellectual property, and (ii) patents amortized over three years using the straight-line method.

For the years ended December 31, 2012, 2011 and 2010, amortization expense was \$118,789, \$323,540 and \$565,501, respectively. The gross carrying amount and accumulated amortization of other intangible assets as of December 31, 2012 and 2011 are as follows:

	<u>December 31,</u> <u>2012</u>	<u>December 31,</u> <u>2011</u>
Goodwill	<u>\$ 4,150,339</u>	<u>\$ 4,150,339</u>
Other intangible assets:		
Gross carrying amount	\$ 3,128,588	\$ 3,026,945
Accumulated amortization	<u>(2,954,162)</u>	<u>(2,835,373)</u>
Net carrying amount	<u>\$ 174,426</u>	<u>\$ 191,572</u>

As of December 31, 2012, amortization expense for existing identifiable intangible assets is expected to be \$99,131, \$57,215 and \$18,080 for the years ended December 31, 2013, 2014 and 2015, respectively. Such assets will be fully amortized at December 31, 2015.

(j) *Software Development Costs and Purchased Software Technology*

In accordance with the authoritative guidance issued by the FASB on costs of software to be sold, leased, or marketed, 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. Amortization of software development costs is recorded at the greater of the straight-line basis over the product's estimated life, or the ratio of current period revenue of the related products to total current and anticipated future revenue of these products. During 2012 and 2011, the Company capitalized approximately \$461,555 and \$1,001,025, respectively, of costs associated with software development projects. During the years ended December 31, 2012, 2011 and 2010, the Company recorded \$301,263, \$140,326 and \$26,901, respectively, of amortization expense related to capitalized software costs.

As of December 31, 2012, amortization expense for software development costs is expected to be \$328,251, \$292,516, \$292,516, \$214,826 and \$33,713 for the years ended December 31, 2013, 2014, 2015, 2016 and 2017, respectively. Such assets will be fully amortized at December 31, 2017.

Purchased software technology is carried at net value and is included within “other assets, net” in the consolidated balance sheets. Purchased software technology had been fully amortized since December 31, 2010. Amortization expense was \$510,000 for the year ended December 31, 2010. Amortization of purchased software technology was recorded at the greater of the straight-line basis over the products estimated remaining life or the ratio of current period revenue of the related products to total current and anticipated future revenue of these products.

(k) Income Taxes

The Company records income taxes under the liability method. Deferred tax assets and liabilities are recognized for 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. In determining the period in which related tax benefits are realized for financial reporting purposes, excess share-based compensation deductions included in net operating losses are realized after regular net operating losses are exhausted.

The Company accounts for uncertain tax positions in accordance with the authoritative guidance issued by the FASB on income taxes, which addresses the determination of whether tax benefits claimed or expected to be claimed on a tax return, should be recorded in the financial statements. Pursuant to the authoritative guidance, the Company may recognize the tax benefit from an uncertain tax position only if it meets the “more likely than not” threshold that the position will be sustained on examination by the taxing authority, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position should be measured based on the largest benefit that has a greater than fifty percent likelihood of being realized upon ultimate settlement. In addition, the authoritative guidance addresses de-recognition, classification, interest and penalties on income taxes, accounting in interim periods, and also requires increased disclosures. The Company includes interest and penalties related to its uncertain tax positions as part of income tax expense within its consolidated statement of operations. See Note (6) *Income Taxes* for additional information.

(l) 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.

(m) Share-Based Payments

The Company accounts for share-based payments in accordance with the authoritative guidance issued by the FASB on share-based compensation, which establishes the accounting for transactions in which an entity exchanges its equity instruments for goods or services. Under the provisions of the authoritative guidance, share-based compensation expense is measured at the grant date, based on the fair value of the award, and is recognized as an expense over the requisite employee service period (generally the vesting period), net of estimated forfeitures. The Company estimates the fair value of share-based payments using the Black-Scholes option-pricing model. The estimation of share-based awards that will ultimately vest requires judgment, and to the extent actual results or updated estimates differ from the Company’s current estimates, such amounts will be recorded as a cumulative adjustment in the period estimates are revised. The Company considers many factors when estimating expected forfeitures, including types of awards, employee class and historical experience. Additionally, share-based awards to non-employees are expensed over the period in which the related services are rendered at their fair value. All share-based awards are expected to be fulfilled with new shares of common stock. See Note (8) *Share-Based Payment Arrangements* for additional information.

(n) *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. Gains and losses from the translation of foreign assets and liabilities from the functional currency of the Company's subsidiaries into the U.S. dollar are classified as accumulated other comprehensive loss in stockholders' equity. Gains and losses from foreign currency transactions are included in the consolidated statements of operations within interest and other income (loss), net.

During the years ended December 31, 2012, 2011 and 2010, foreign currency transactional losses totaled approximately \$653,000, \$78,000 and \$338,000, respectively.

(o) *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, attributable to stock option awards, restricted stock awards and restricted stock unit awards outstanding. Due to the net loss for the years ended December 31, 2012, 2011 and 2010, all common stock equivalents, totaling 11,532,032, 14,982,611 and 13,032,306, respectively, were excluded from diluted net loss per share because they were anti-dilutive.

The following represents a reconciliation of the numerators and denominators of the basic and diluted EPS computation:

	Year Ended December 31, 2012			Year Ended December 31, 2011			Year Ended December 31, 2010		
	Net Loss (Numerator)	Shares (Denominator)	Per Share Amount	Net Loss (Numerator)	Shares (Denominator)	Per Share Amount	Net Loss (Numerator)	Shares (Denominator)	Per Share Amount
Basic EPS	\$ (14,984,321)	47,408,995	\$ (0.32)	\$ (23,368,283)	46,648,928	\$ (0.50)	\$ (35,375,621)	45,549,314	\$ (0.78)
Effect of dilutive securities: Stock options and restricted stock	-	-	-	-	-	-	-	-	-
Diluted EPS	\$ (14,984,321)	47,408,995	\$ (0.32)	\$ (23,368,283)	46,648,928	\$ (0.50)	\$ (35,375,621)	45,549,314	\$ (0.78)

(p) *Investments*

As of both December 31, 2012 and 2011, the Company maintained certain cost-method investments aggregating approximately \$0.9 million, which are included within "other assets, net" in the accompanying consolidated balance sheets. During 2012 and 2011, the Company recognized impairment charges of approximately \$11,000 and \$42,000, respectively, related to certain of its cost-method investments as a result of other-than-temporary declines in market value related to certain of these investments. These charges are included within "interest and other income (loss), net" in the accompanying consolidated statements of operations. During 2010, the Company did not recognize any impairment charges.

(q) *Treasury Stock*

The Company accounts for treasury stock under the cost method and includes treasury stock as a component of stockholders' equity.

(r) *New Accounting Pronouncements*

In February 2013, the FASB issued guidance on the reporting of amounts reclassified out of accumulated other comprehensive income. The guidance requires a company to report the effect of significant reclassifications out of accumulated other comprehensive income on the respective line items in net income if the amount being reclassified is required under U.S. generally accepted accounting principles to be reclassified in its entirety to net income. For other amounts that are not required under U.S. generally accepted accounting principles to be reclassified in their entirety to net income in the same reporting period, a company is required to cross-reference other disclosures required under U.S. generally accepted accounting principles that provide additional detail about those amounts. The guidance will be effective for the Company for all reporting periods ending after January 1, 2013. We do not expect the guidance to have a material impact on the Company's consolidated financial statements and disclosures.

In July 2012, the FASB issued guidance that permits an entity to first assess qualitative factors to determine whether it is more likely than not that an indefinite-lived intangible asset is impaired as a basis for determining whether it is necessary to perform a quantitative impairment test. An entity would continue to calculate the fair value of an indefinite-lived intangible asset if the asset fails the qualitative assessment, while no further analysis would be required if it passes. The guidance is effective for the Company for annual periods beginning after September 15, 2012. We do not expect the new guidance to have an impact on the 2013 impairment test results.

In September 2011, the FASB issued guidance for intangibles – goodwill and other, related to goodwill impairment guidance. The guidance gives an option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If after assessing all events and circumstances, an entity determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, the performance of the existing two-step impairment test is unnecessary. The guidance was effective for the Company for annual periods beginning after December 15, 2011. The implementation of the guidance did not have a material impact on the Company’s consolidated financial statements and disclosures.

In June 2011, the FASB issued guidance that modified how comprehensive income is presented in an entity’s financial statements. The guidance issued requires an entity to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements and eliminates the option to present the components of other comprehensive income as part of the statement of equity. The revised financial statement presentation for comprehensive income was effective for the Company for annual periods beginning after December 15, 2011. The Company has included an additional statement as a result of applying this guidance.

In May 2011, the FASB issued guidance for fair value measurements intended to achieve common fair value measurement and disclosure requirements. The amended guidance provides a consistent definition of fair value to ensure that the fair value measurement and disclosure requirements are similar between U.S. generally accepted accounting principles and International Financial Reporting Standards. The amended guidance changes certain fair value measurement principles and enhances the disclosure requirements, particularly for Level 3 fair value measurements. The amended guidance was effective for the Company for annual periods beginning after December 15, 2011. The implementation of the guidance did not have a material impact on the Company’s consolidated financial statements and disclosures.

(2) Property and Equipment

Property and equipment consist of the following:

	<u>December 31,</u> <u>2012</u>	<u>December 31,</u> <u>2011</u>
Computer hardware and software	\$ 16,626,381	\$ 19,080,877
Furniture and equipment	893,918	803,950
Leasehold improvements	2,578,942	2,264,180
Automobile	13,008	13,008
	<u>20,112,249</u>	<u>22,162,015</u>
Less accumulated depreciation	<u>(16,131,570)</u>	<u>(17,797,835)</u>
	<u>\$ 3,980,679</u>	<u>\$ 4,364,180</u>

During the years ended December 31, 2012 and 2011, the Company wrote off approximately \$4.6 million and \$5.3 million, respectively, of fully depreciated assets and related accumulated depreciation, for book purposes only. Depreciation expense was \$2.9 million, \$3.6 million and \$4.5 million in 2012, 2011 and 2010, respectively.

(3) Marketable Securities

The Company's marketable securities consist of available-for-sale securities, which are carried at fair value, with unrealized gains and losses reported as a separate component of stockholders' equity. Unrealized gains and losses are computed on the specific identification method. Realized gains, realized losses and declines in value judged to be other-than-temporary, are included in interest and other income, net. The cost of available-for-sale securities sold is based on the specific identification method and interest earned is included in interest and other income.

The cost and fair values of the Company's available-for-sale marketable securities as of December 31, 2012, were as follows:

	<u>Aggregate Fair Value</u>	<u>Cost or Amortized Cost</u>	<u>Net Unrealized Gains / (Loss)</u>
Government securities	\$ 8,328,392	\$ 8,324,372	\$ 4,020
Corporate debt securities	2,202,550	2,200,360	2,190
	<u>\$ 10,530,942</u>	<u>\$ 10,524,732</u>	<u>\$ 6,210</u>

The cost and fair values of the Company's available-for-sale marketable securities as of December 31, 2011, were as follows:

	<u>Aggregate Fair Value</u>	<u>Cost or Amortized Cost</u>	<u>Net Unrealized Gains / (Loss)</u>
Auction rate securities	\$ 611,082	\$ 700,000	\$ (88,918)
Government securities	17,303,207	17,286,598	16,609
Corporate debt securities	3,591,121	3,602,602	(11,481)
	<u>\$ 21,505,410</u>	<u>\$ 21,589,200</u>	<u>\$ (83,790)</u>

The cost basis and fair value of available-for-sale securities by contractual maturity as of December 31, 2012, were as follows:

	<u>Fair Value</u>	<u>Cost</u>
Due within one year	\$ 8,723,955	\$ 8,719,995
Due after one year	1,806,987	1,804,737
	<u>\$ 10,530,942</u>	<u>\$ 10,524,732</u>

(4) Fair Value Measurements

The Company measures its cash equivalents and marketable securities at fair value. Fair value is an exit price, representing the amount that would be received on the sale of an asset or that would be paid to transfer a liability in an orderly transaction between market participants. As a basis for considering such assumptions, the Company utilizes a three-tier fair value hierarchy, which prioritizes the inputs used in the valuation methodologies in measuring fair value:

Fair Value Hierarchy

The methodology for measuring fair value specifies a hierarchy of valuation techniques based upon whether the inputs to those valuation techniques reflect assumptions other market participants would use based upon market data obtained from independent sources (observable inputs) or reflect the Company's own assumptions of market participant valuation (unobservable inputs). As a result, observable and unobservable inputs have created the following fair value hierarchy:

- *Level 1* – Quoted prices in active markets that are unadjusted and accessible at the measurement date for identical, unrestricted assets or liabilities. The Level 1 category includes money market funds, which at December 31, 2012 and 2011 totaled \$4.3 million and \$8.1 million, respectively, which are included within “cash and cash equivalents” in the consolidated balance sheets.
- *Level 2* – Quoted prices for identical assets and liabilities in markets that are not active, quoted prices for similar assets and liabilities in active markets or financial instruments for which significant inputs are observable, either directly or indirectly. The Level 2 category includes government securities and corporate debt securities, which at December 31, 2012 and 2011 totaled \$10.5 million and \$20.9 million, respectively, which are included within “cash and cash equivalents” and “marketable securities” in the consolidated balance sheets.
- *Level 3* – Prices or valuations that require inputs that are both significant to the fair value measurement and unobservable. The Level 3 category includes auction rate securities, which at December 31, 2011 totaled \$0.6 million, which are included within “long-term marketable securities” in the consolidated balance sheets.

Measurement of Fair Value

The Company measures fair value as an exit price using the procedures described below for all assets and liabilities measured at fair value. When available, the Company uses unadjusted quoted market prices to measure fair value and classifies such items within Level 1. If quoted market prices are not available, fair value is based upon financial models that use, when possible, current market-based or independently-sourced market parameters such as interest rates and currency rates. Items valued using financial generated models are classified according to the lowest level input or value driver that is significant to the valuation. Thus, an item may be classified in Level 3 even though there may be inputs that are readily observable. If quoted market prices are not available, the valuation model used generally depends on the specific asset or liability being valued. The determination of fair value considers various factors including interest rate yield curves and time value underlying the financial instruments.

As of December 31, 2011, the Company held certain assets that were required to be measured at fair value on a recurring basis. Included within the Company’s marketable securities portfolio were investments in auction rate securities, which were classified as available-for-sale securities and were reflected at fair value. The Company determined the estimated fair values of those securities utilizing a discounted cash flow analysis or other type of valuation model. These analyses considered, among other items, the collateral underlying the security, the creditworthiness of the issuer, the timing of the expected future cash flows, including the final maturity, and an assumption of when the next time the security was expected to have a successful auction. These securities were also compared, when possible, to other observable and relevant market data, which is limited at this time. As of December 31, 2011, the fair value of our auction rate securities was approximately \$611,000, which is net of a cumulative temporary decline in fair value of approximately \$89,000, and was recorded in accumulated other comprehensive loss. During 2012, the remaining \$700,000 auction rate notes were called by the issuer at par value.

The Company measures its cash equivalents and marketable securities at fair value. Fair value is an exit price, representing the amount that would be received on the sale of an asset or that would be paid to transfer a liability in an orderly transaction between market participants. As a basis for considering such assumptions, the Company utilizes a three-tier fair value hierarchy, which prioritizes the inputs used in the valuation methodologies in measuring fair value:

Items Measured at Fair Value on a Recurring Basis

The following table presents the Company’s assets that are measured at fair value on a recurring basis at December 31, 2012:

Fair Value Measurements at Reporting Date Using

	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant other Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Cash equivalents:				
<i>Money market funds</i>	\$ 4,285,309	\$ 4,285,309	\$ -	\$ -
Total cash equivalents	<u>4,285,309</u>	<u>4,285,309</u>	<u>-</u>	<u>-</u>
Marketable securities:				
<i>Corporate debt and government securities</i>	10,530,942	-	10,530,942	-
Total marketable securities	<u>10,530,942</u>	<u>-</u>	<u>10,530,942</u>	<u>-</u>
Total assets measured at fair value	<u>\$ 14,816,251</u>	<u>\$ 4,285,309</u>	<u>\$ 10,530,942</u>	<u>\$ -</u>

The following table presents the Company's assets that are measured at fair value on a recurring basis at December 31, 2011:

Fair Value Measurements at Reporting Date Using

	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant other Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Cash equivalents:				
<i>Money market funds</i>	\$ 8,129,960	\$ 8,129,960	\$ -	\$ -
Total cash equivalents	<u>8,129,960</u>	<u>8,129,960</u>	<u>-</u>	<u>-</u>
Marketable securities:				
<i>Corporate debt and government securities</i>	20,894,328	-	20,894,328	-
<i>Auction rate securities</i>	611,082	-	-	611,082
Total marketable securities	<u>21,505,410</u>	<u>-</u>	<u>20,894,328</u>	<u>611,082</u>
Total assets measured at fair value	<u>\$ 29,635,370</u>	<u>\$ 8,129,960</u>	<u>\$ 20,894,328</u>	<u>\$ 611,082</u>

The Company's valuation methodology for auction rate securities includes a discounted cash flow analysis. The following table presents the Company's assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) as of each of the years ended December 31, 2012 and 2011:

**Fair Value Measurements Using
Significant Unobservable Inputs
(Level 3)**

Auction Rate Securities

	December 31, 2012	December 31, 2011
Beginning Balance	\$ 611,082	\$ 578,643
Total unrealized gains in accumulated other comprehensive loss	88,918	32,439
Securities called by issuer	(700,000)	-
Ending Balance	<u>\$ -</u>	<u>\$ 611,082</u>

(5) Accrued Expenses

Accrued expenses are comprised of the following:

	<u>December 31,</u> <u>2012</u>	<u>December 31,</u> <u>2011</u>
Accrued compensation	\$ 4,052,253	\$ 3,853,405
Accrued consulting and professional fees	1,462,399	876,815
Accrued marketing and promotion	182,412	47,559
Other accrued expenses	1,270,598	1,539,242
Accrued income taxes	295,115	627,099
Accrued other taxes	1,172,007	1,144,700
Accrued hardware purchases	1,221,930	1,298,425
Accrued and deferred rent	76,069	33,652
Accrued restructuring costs	478	120,044
Accrued investigation, litigation, and settlement costs	6,987,321	8,068,825
	<u>\$ 16,720,582</u>	<u>\$ 17,609,766</u>

(6) Income Taxes

Information pertaining to the Company's loss before income taxes and the applicable provision for income taxes is as follows:

	<u>2012</u>	<u>December 31,</u> <u>2011</u>	<u>2010</u>
Loss before income taxes:			
Domestic loss	\$ (15,356,162)	\$ (24,181,349)	\$ (19,944,695)
Foreign income	1,158,248	2,021,398	2,143,049
Total loss before income taxes:	<u>(14,197,914)</u>	<u>(22,159,951)</u>	<u>(17,801,646)</u>
Provision (benefit) for income taxes:			
Current:			
Federal	\$ 105,198	\$ 94,974	\$ -
State and local	18,747	11,453	145,593
Foreign	745,812	1,262,339	1,353,252
	<u>869,757</u>	<u>1,368,766</u>	<u>1,498,845</u>
Deferred:			
Federal	\$ 14,876	\$ 14,876	\$ 15,310,413
State and local	981	981	980,137
Foreign	(99,207)	(176,291)	(215,420)
	<u>(83,350)</u>	<u>(160,434)</u>	<u>16,075,130</u>
Total provision for income taxes:	<u>\$ 786,407</u>	<u>\$ 1,208,332</u>	<u>\$ 17,573,975</u>

During 2012, the Company recorded a tax provision of \$786,407 related to state and local and foreign taxes, and interest related to federal uncertain tax positions. In computing the tax provision, expenses related to certain legal matters were determined to be non-deductible for US income tax purposes.

During 2011, the Company recorded a tax provision of \$1,208,332 related to state and local and foreign taxes. In computing the tax provision, expenses related to certain legal matters were determined to be non-deductible for US income tax purposes.

During 2010, the Company recorded a tax provision of \$17,573,975 related to state and local and foreign taxes and a deferred provision related to an increase in valuation allowance as the Company concluded during the third quarter of 2010 that its domestic deferred tax assets were no longer realizable on a more-likely-than-not basis.

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and for income tax purposes. Significant components of the Company's deferred tax assets and liabilities are as follows:

	December 31,	
	2012	2011
<i>Deferred Tax Assets:</i>		
Allowance for receivables	\$ 350,738	\$ 643,080
Deferred revenue	3,104,017	2,826,497
Share-based compensation	10,655,853	9,449,070
Accrued expenses and other liabilities	669,844	153,732
Domestic net operating loss carryforwards	16,526,224	11,559,661
Foreign net operating loss carryforwards	405,818	486,687
Tax credit carryforwards	654,966	728,902
AMT tax credit carryforwards	485,817	485,817
Capital loss carryforwards	80,055	77,240
Fixed assets	957,107	1,018,976
Intangibles	3,195,185	3,698,607
Sub-total	37,085,624	31,128,269
Valuation allowance	(36,606,643)	(30,732,700)
Net Deferred Tax Asset	<u>\$ 478,981</u>	<u>\$ 395,569</u>
<i>Deferred Tax Liabilities:</i>		
Foreign withholding taxes	\$ (96,360)	\$ -
Net Deferred Tax Liability	<u>\$ (96,360)</u>	<u>\$ -</u>
<i>Net Deferred Tax Assets</i>	<u>\$ 382,621</u>	<u>\$ 395,569</u>

During the year ended December 31, 2012, the Company's conclusion did not change with respect to its domestic deferred tax assets and, therefore, the Company has not recorded any benefit for its net domestic deferred tax assets for the full year 2012. The reversal of the valuation allowance on deferred tax assets at December 31, 2012, would reduce income tax expense. As of December 31, 2012, the Company had federal net operating loss carryforwards of approximately \$44.9 million which are set to expire at various dates beginning in 2030 through 2032, if not utilized.

During the year ended December 31, 2011, the Company's conclusion did not change with respect to its domestic deferred tax assets and, therefore, the Company did not record any benefit for its net domestic deferred tax assets for the full year 2011. The reversal of the valuation allowance on deferred tax assets at December 31, 2011, would reduce income tax expense. As of December 31, 2011, the Company had federal net operating loss carryforwards of approximately \$33.0 million which are set to expire in 2030 and 2031, if not utilized.

As of December 31, 2012, the Company had approximately \$1.1 million of various tax credit carryforwards, of which, approximately \$0.6 million related to research and development tax credit carryforwards. The research and development tax credits may be carried forward 20 years for federal tax purposes and are set to expire at various

dates beginning in 2021 through 2030, if not utilized. The Company has recorded a full valuation allowance against all such carryforwards as of December 31, 2012.

The Company has not provided for the United States income or the foreign withholding taxes on the undistributed earnings of its subsidiaries operating outside of the United States, with the exception of China. It is the Company's intention to reinvest those earnings permanently, and accordingly, it is not practicable to estimate the amount of tax that might be payable.

The effective tax rate before income taxes varies from the current statutory federal income tax rate as follows:

	<u>2012</u>	<u>December 31, 2011</u>	<u>2010</u>
Tax at Federal statutory rate	\$ (4,969,270)	\$ (7,755,983)	\$ (6,230,576)
Increase (reduction) in income taxes resulting from:			
State and local taxes	(3,130)	(59)	131,563
Non-deductible expenses	50,070	(25,071)	(36,423)
Settlement costs	(553,700)	2,625,000	-
Shared-based payment compensation	-	-	38,042
Net effect of foreign operations	259,592	530,630	619,953
Research and development credit	-	-	(515,324)
Uncertain tax positions	140,625	118,351	28,206
Change in valuation allowance	5,862,220	5,715,464	23,538,534
	<u>\$ 786,407</u>	<u>\$ 1,208,332</u>	<u>17,573,975</u>

A reconciliation of the beginning and ending amount of unrecognized tax benefits, excluding interest and penalties, is as follows:

	<u>2012</u>	<u>2011</u>
Balance at January 1,	\$ 5,062,124	\$ 5,169,348
Increases in tax positions for prior years	-	-
Decreases in tax positions for prior years	-	(128,831)
Increase in tax positions for current year	<u>3,572</u>	<u>21,607</u>
Balance at December 31,	<u>\$ 5,065,696</u>	<u>\$ 5,062,124</u>

At December 31, 2012, \$2.5 million including interest, if recognized, would reduce the Company's annual effective tax rate. As of December 31, 2012, the Company had approximately \$373,000 of accrued interest and penalties. The Company expects \$2.3 million of its unrecognized tax benefits to reverse within the next 12 months.

The Company files federal, state, and foreign income tax returns in jurisdictions with varying statutes of limitations. The 2009 through 2012 tax years generally remain subject to examination by federal and most state tax authorities. In addition to the U.S., the Company's major taxing jurisdictions include China, Taiwan, Japan, South Korea, France and Germany.

(7) Stockholders' Equity

Stock Repurchase Activity

At various times from October 2001 through February 2009, the Company's Board of Directors has authorized the repurchase of up to 14 million shares of the Company's outstanding common stock in the aggregate. 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 are determined by management based on market conditions.

During the years ended December 31, 2012 and 2011, the Company did not repurchase any shares of its common stock. Since October 2001, the Company has repurchased a total of 8,005,235 shares of its common stock at an aggregate purchase price of \$46,916,339. As of December 31, 2012, the Company had the authorization to repurchase 5,994,765 shares of its common stock based upon its judgment and market conditions.

Preferred Stock

The Company is authorized to issue two million shares of \$0.001 par value preferred stock. No preferred stock has been issued or outstanding for any period presented.

(8) Share-Based Payment Arrangements

The following table summarizes the plans under which the Company was able to grant equity compensation as of December 31, 2012:

Name of Plan	Shares Authorized	Shares Available for Grant	Shares Outstanding	Last Date for Grant of Shares
FalconStor Software, Inc., 2006 Incentive Stock Plan	12,224,133	2,246,036	7,388,945	May 17, 2016
FalconStor Software, Inc., 2010 Outside Directors Equity Compensation Plan	400,000	280,000	90,300	March 25, 2013

On July 1, 2012, the total shares available for issuance under the FalconStor Software, Inc., 2006 Incentive Stock Plan (the "2006 Plan") totaled 2,197,887. Pursuant to the 2006 Plan, as amended, if, on July 1st of any calendar year in which the 2006 Plan is in effect, the number of shares of stock as to which options, restricted shares and restricted stock units may be granted under the 2006 Plan is less than five percent (5%) of the number of outstanding shares of stock, then the number of shares of stock available for issuance under the 2006 Plan is automatically increased so that the number equals five percent (5%) of the shares of stock outstanding. In no event shall the number of shares of stock subject to the 2006 Plan in the aggregate exceed twenty million shares, subject to adjustment as provided in the 2006 Plan. On July 1, 2012, the total number of outstanding shares of the Company's common stock totaled 47,541,262. Pursuant to the 2006 Plan, as amended, the total shares available for issuance under the 2006 Plan thus increased by 179,176 shares from 2,197,887 to 2,377,063 shares available for issuance as of July 1, 2012.

The following table summarizes the Company's equity plans that have expired but that still have equity awards outstanding as of December 31, 2012:

Name of Plan	Shares Available for Grant	Shares Outstanding
FalconStor Software, Inc., 2000 Stock Option Plan	--	2,432,787
1994 Outside Directors Stock Option Plan	--	40,000
2004 Outside Directors Stock Option Plan	--	190,000
FalconStor Software, Inc., 2007 Outside Directors Equity Compensation Plan	--	170,000
Stand-Alone Stock Option Agreement between the Company and James P. McNiel	--	1,220,000

All outstanding options granted under the Company's equity plans have terms of ten years

A summary of the Company's stock option activity for 2012 is as follows:

	Number of Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value
Options Outstanding at December 31, 2011	<u>14,456,722</u>	<u>\$4.95</u>		
Granted	2,042,700	\$2.45		
Exercised	(321,260)	\$2.30		
Forfeited	(3,550,825)	\$4.79		
Expired	<u>(1,266,495)</u>	<u>\$4.62</u>		
Options Outstanding at December 31, 2012	<u>11,360,842</u>	<u>\$4.66</u>	<u>6.46</u>	<u>\$ 497,695</u>
Options Exercisable at December 31, 2012	<u>7,299,451</u>	<u>\$5.60</u>	<u>5.21</u>	<u>\$ 88,120</u>
Options Expected to Vest after December 31, 2012 ⁽¹⁾	<u>3,338,779</u>	<u>\$3.00</u>	<u>8.67</u>	<u>\$ 311,277</u>

⁽¹⁾ Options expected to vest after December 31, 2012 reflect an estimated forfeiture rate

Stock option exercises are fulfilled with new shares of common stock. The total cash received from stock option exercises for the years ended December 31, 2012, 2011 and 2010 was \$738,184, \$920,106 and \$409,889, respectively. The total intrinsic value of stock options exercised during the years ended December 31, 2012, 2011 and 2010 was \$273,935, \$422,136 and \$2,881,294, respectively.

The Company recognized share-based compensation expense for all awards issued under the Company's stock equity plans in the following line items in the consolidated statement of operations:

	Years ended December 31,		
	2012	2011	2010
Cost of revenues - Product	\$ 262	\$ 2,960	\$ 31,779
Cost of revenues - Support and Service	172,707	461,735	1,117,550
Research and development costs	727,826	1,302,129	2,987,146
Selling and marketing	1,677,469	2,023,370	3,379,518
General and administrative	2,036,505	1,727,864	1,169,576
	<u>\$ 4,614,769</u>	<u>\$ 5,518,058</u>	<u>\$ 8,685,569</u>

The Company did not recognize any tax benefits related to share-based compensation expense during the years ended December 31, 2012, 2011 and 2010.

The Company has the ability to issue both restricted stock and restricted stock units. The fair value of the restricted stock awards and restricted stock units are expensed at either (i) the fair value per share at date of grant (directors, officers and employees), or (ii) the fair value per share as of each reporting period (non-employee consultants). A summary of the total stock-based compensation expense related to restricted stock awards and restricted stock units, which is included in the Company's total share-based compensation expense for each respective year, is as follows:

	Years ended December 31,		
	2012	2011	2010
Directors, officers and employees	\$ 584,959	\$ 1,358,107	\$ 2,524,914
Non-employee consultants	13,488	21,882	760,661
	<u>\$ 598,447</u>	<u>\$ 1,379,989</u>	<u>\$ 3,285,575</u>

As of December 31, 2012, an aggregate of 2,876,068 shares of restricted stock had been issued, of which, 2,231,837 had vested and 473,041 had been forfeited. As of December 31, 2011, an aggregate of 2,821,054 shares of restricted stock had been issued, of which, 1,854,007 had vested and 446,990 had been forfeited. As of December 31, 2010, an aggregate of 2,658,872 shares of restricted stock had been issued, of which, 1,446,082 had vested and 417,485 had been forfeited.

As of December 31, 2012, an aggregate of 90,412 restricted stock units had been issued, of which, 79,065 had vested and 11,347 had been forfeited. As of December 31, 2011, an aggregate of 90,412 restricted stock units had been issued, of which, 73,580 had vested and 11,000 had been forfeited. As of December 31, 2010, an aggregate of 90,412 restricted stock units had been issued, of which, 43,975 had vested and 2,500 had been forfeited.

A summary of the Company's restricted stock activity for 2012 is as follows:

	Number of Restricted Stock Awards / Units
Non-Vested at December 31, 2011	<u>525,889</u>
Granted	55,014
Vested	(383,315)
Forfeited	<u>(26,398)</u>
Non-Vested at December 31, 2012	<u>171,190</u>

Restricted stock and restricted stock units are fulfilled with new shares of common stock. The total intrinsic value of restricted stock for which the restrictions lapsed during the years ended December 31, 2012, 2011 and 2010 was \$1,119,103, \$1,941,382 and \$2,950,735, respectively.

Options granted to non-employee consultants have exercise prices equal to the fair market value of the stock on the date of grant and a contractual term of ten years. Restricted stock awards granted to non-employee consultants have a contractual term equal to the lapse of restriction(s) of each specific award. Vesting periods for share-based awards granted to non-employee consultants range from immediate vesting to three years depending on service requirements. A summary of the total stock-based compensation expense/(benefit) related to share-based awards granted to non-employee consultants, which is included in the Company's total share-based compensation expense for each respective period, is as follows:

	Years ended December 31,		
	2012	2011	2010
Non-qualified stock options	\$ 13,999	\$ 2,487	\$ 58,524
Restricted stock awards	13,488	21,882	760,661
	<u>\$ 27,487</u>	<u>\$ 24,369</u>	<u>\$ 819,185</u>

The Company estimates the fair value of share-based payments using the Black-Scholes option-pricing model. The Company believes that this valuation technique and the approach utilized to develop the underlying assumptions are appropriate in estimating the fair value of the Company's share-based payments granted during the years ended December 31, 2012, 2011 and 2010. Estimates of fair value are not intended to predict actual future events or the value ultimately realized by the employees who receive equity awards.

The per share weighted average fair value of share-based payments granted during the years ended December 31, 2012, 2011 and 2010 was \$1.36, \$2.11 and \$1.95, respectively. In addition, to the exercise and grant date prices of the awards, certain weighted average assumptions that were used to estimate the fair value of share-based payment grants in the respective periods are listed in the table below:

	Years ended December 31,		
	2012	2011	2010
Expected dividend yield	0%	0%	0%
Expected volatility	60 - 61%	56 - 61%	54 - 60%
Risk-free interest rate	0.7 - 1.2%	1.0 - 2.5%	1.6 - 3.0%
Expected term (years)	5.5	5.5	5.5
Discount for post-vesting restrictions	N/A	N/A	N/A

Options granted to officers, employees and directors during fiscal 2012, 2011, and 2010 have exercise prices equal to the fair market value of the stock on the date of grant, a contractual term of ten years, and a vesting period generally of three years. Based on each respective group's historical vesting experience and expected trends, the estimated forfeiture rate for officers, employees, and directors, as adjusted, for both fiscal 2012 and 2011 was 11%, 24% and 0%, respectively. For fiscal year 2010, the estimated forfeiture rate for officers, employees, and directors, as adjusted, was 11%, 24% and 9%, respectively.

The Company estimates expected volatility based primarily on historical daily volatility of the Company's stock and other factors, if applicable. The risk-free interest rate is based on the United States treasury yield curve in effect at the time of grant. The expected option term is the number of years that the Company estimates that options will be outstanding prior to exercise. The expected term of the awards was determined based upon an estimate of the expected term of "plain vanilla" options as prescribed in SEC Staff Accounting Bulletin ("SAB") No. 110.

As of December 31, 2012, there was approximately \$5,476,063 total unrecognized compensation cost related to the Company's unvested stock options, restricted stock and restricted stock unit awards granted under the Company's stock plans. The unrecognized compensation cost is expected to be recognized over a weighted-average period of 1.76 years.

As of December 31, 2012, the Company had 14,058,068 shares of common stock reserved for issuance upon the exercise of stock options, restricted stock and restricted stock units.

(9) Inventories

Inventories consist of component materials and finished systems. Inventories are stated at the lower of cost (first-in, first-out) or market, not in excess of net realizable value. Component material consists of certain key replacement parts for the finished systems. Inventories are as follows:

	<u>December 31,</u> <u>2012</u>	<u>December 31,</u> <u>2011</u>
Component materials	\$ 18,989	\$ 63,179
Finished systems	<u>623,830</u>	<u>1,705,828</u>
<i>Total Inventory</i>	<u><u>\$ 642,819</u></u>	<u><u>\$ 1,769,007</u></u>

As of December 31, 2012 and 2011, the Company has not recorded any reserve for excess and/or obsolete inventories in arriving at estimated net realizable value of its inventory.

(10) Commitments and Contingencies

As of December 31, 2012, the Company has an operating lease covering its corporate office facility that expires in February 2017. The Company has the option to terminate the lease as of the last date of each month between August 31, 2013 and February 28, 2014, on nine month's prior written notice. The Company also has several operating leases related to offices in both the United States and foreign countries. The expiration dates for these leases range from 2013 through 2017. The following is a schedule of future minimum lease payments for all operating leases as of December 31, 2012:

Year ending December 31,	
2013	\$ 2,708,548
2014	2,329,788
2015	1,728,939
2016	1,639,594
2017	298,416
Thereafter	-
	<u><u>\$ 8,705,285</u></u>

These leases require the Company to pay its proportionate share of real estate taxes and other common charges. Total rent expense for operating leases was \$3,229,294, \$3,054,817 and \$2,840,796 for the years ended December 31, 2012, 2011 and 2010, respectively.

The Company typically provides its customers a warranty on its software products for a period of no more than 90 days. Such warranties are accounted for in accordance with the authoritative guidance issued by the FASB on contingencies. To date, the Company has not incurred any costs related to warranty obligations.

Under the terms of substantially all of its software license agreements, the Company has agreed to indemnify its customers for all costs and damages arising from claims against such customers based on, among other things, allegations that the Company's software infringes the intellectual property rights of a third party. In most cases, in the event of an infringement claim, the Company retains the right to (i) procure for the customer the right to continue using the software; (ii) replace or modify the software to eliminate the infringement while providing substantially equivalent functionality; or (iii) if neither (i) nor (ii) can be reasonably achieved, the Company may terminate the license agreement and refund to the customer a pro-rata portion of the license fee paid to the Company. Such indemnification provisions are accounted for in accordance with the authoritative guidance issued by the FASB on guarantees. As of December 31, 2012 and 2011, there were no claims outstanding under such indemnification provisions.

On January 11, 2011, the Company entered into an Employment Agreement ("McNiel Employment Agreement") with James P. McNiel. Pursuant to the McNiel Employment Agreement, the Company agreed to employ Mr. McNiel as President and Chief Executive Officer of the Company effective January 1, 2011 through

December 31, 2013, at an annual salary of \$400,000 per annum for calendar years 2011, 2012 and 2013. Pursuant to the McNiel Employment Agreement, Mr. McNiel's base salary is subject to review annually by the Board of Directors and may be increased but not decreased as determined by the Board of Directors based on job performance. The McNiel Employment Agreement also provides for the grant to Mr. McNiel of options to purchase up to 300,000 shares of the Company's common stock at an exercise price of \$3.22 per share, which vest over a three-year period commencing January 11, 2012 at 33%, 33% and 34% annually. In addition, the McNiel Employment Agreement provides for the grant of 90,000 restricted shares of the Company's common stock which will vest over a two-year period at 50% and 50% annually commencing January 11, 2012. Mr. McNiel is also entitled to certain other benefits set forth in the McNiel Employment Agreement. The options to purchase 300,000 shares of the Company's common stock and 90,000 restricted shares of the Company common stock were granted to Mr. McNiel by the Company's Compensation Committee on January 11, 2011.

On January 11, 2011, the Company entered into a Stand-Alone Stock Option Agreement ("McNiel Option Agreement") with James P. McNiel. The McNiel Option Agreement, which was approved by stockholders on May 9, 2011, provides for the grant to Mr. McNiel of options to purchase up to 1,220,000 shares of the Company's common stock at an exercise price of \$3.22 per share, which vest over a three-year period commencing January 11, 2012 at 33%, 33% and 34% annually.

On December 1, 2005, the Company adopted the 2005 FalconStor Software, Inc., Key Executive Severance Protection Plan, as amended ("Severance Plan"). Pursuant to the Severance Plan, the Company's Chief Executive Officer, Chief Financial Officer and certain other key personnel are entitled to receive certain contingent benefits, as set forth in the Severance Plan, including lump sum payments and acceleration of stock option vesting, each in certain circumstances.

As of December 31, 2012, the Company had a \$1.7 million payable outstanding relating to its settlement with the United States Attorney's Office, which is to be paid in December 2013. In addition, on January 20, 2013, the Company announced it had reached a proposed settlement of the Class Action lawsuit between the Company and class plaintiffs for \$5.0 million which is pending approval by the court.

(11) Derivative Financial Instruments

The Company from time to time will use derivative financial instruments, such as foreign currency forward contracts, as economic hedges to reduce exchange rate risks arising from the change in fair value of certain foreign currency denominated assets and liabilities (i.e., receivables and payables). The purpose of the Company's foreign currency risk management program is to reduce volatility in earnings caused by exchange rate fluctuations. In accordance with the authoritative guidance issued by the FASB on derivatives and hedging, companies are required to recognize all of the derivative financial instruments as either assets or liabilities at fair value in their balance sheets. The Company's derivative instruments do not meet the criteria for hedge accounting within the authoritative guidance. Therefore, the foreign currency forward contracts are recorded at fair value, with the gain or loss on these transactions recorded in the consolidated statements of operations within "interest and other income (loss), net" in the period in which they occur. The Company does not use derivative financial instruments for trading or speculative purposes.

As of both December 31, 2012 and 2011, the Company had no foreign currency forward contracts outstanding. The Company did not utilize foreign currency forward contracts during the years ended December 31, 2012 and 2011. During the year ended December 31, 2010, the Company recorded approximately \$0.1 million of gains related to its foreign currency forward contracts.

(12) Litigation

In view of the inherent difficulty of predicting the outcome of litigation, particularly where the claimants seek very large or indeterminate damages, the Company generally cannot predict what the eventual outcome of the pending matters will be, what the timing of the ultimate resolution of these matters will be, or what the eventual loss, fines or penalties related to each pending matter may be.

In accordance with the authoritative guidance issued by the FASB on contingencies, the Company accrues anticipated costs of settlement, damages and losses for claims to the extent specific losses are probable and estimable. The Company records a receivable for insurance recoveries when such amounts are probable and collectable. In such cases, there may be an exposure to loss in excess of any amounts accrued. If, at the time of evaluation, the loss contingency related to a litigation is not both probable and estimable, the matter will continue to

be monitored for further developments that would make such loss contingency both probable and estimable and, the Company will expense these costs as incurred. If the estimate of a probable loss is a range and no amount within the range is more likely, the Company will accrue the minimum amount of the range.

The Internal and Government Investigations

As previously disclosed, both the United States Attorney's Office for the Eastern District of New York ("USAO") and the Securities and Exchange Commission ("SEC") commenced investigations of the Company in October, 2010, in response to the Company's announcement that it had accepted the resignation of Reijane Huai, its President and Chief Executive Officer, and the Chairman of its Board of Directors, following his disclosure to the Company that certain improper payments allegedly were made in connection with the Company's licensing of software to one customer.

The Company conducted its own investigation into the matter and cooperated with the USAO and SEC investigations.

On June 27, 2012, the Company announced that it had entered into settlements with the USAO and the SEC.

The Company entered into a Deferred Prosecution Agreement (DPA) with the USAO. Under the DPA, the USAO agrees that it will defer prosecution of the Company in connection with the matter, and ultimately not prosecute the Company if the Company satisfies its obligations during the 18 month term of the DPA. The DPA acknowledges the remedial actions taken by the Company in response to its discovery of the improper payments and does not require the Company to make any additional control or compliance changes. Under the DPA, the Company will forfeit \$2.9 million over eighteen months.

The Company agreed with the SEC to the entry of a Consent Judgment (CJ) to settle a civil action filed by the SEC. Pursuant to the CJ, the Company agreed not to violate the anti-fraud and registration provisions of Sections 17(a)(2), 5(a) and 5(c) of the Securities Act of 1933, and the books and records provisions of Sections 13(b)(2)(A) and 13(b)(2)(B) of the Securities Exchange Act of 1934. The Company further agreed to pay a civil penalty of \$2.9 million to the SEC.

As of December 31, 2012, the Company has paid a total of \$4.1 million of the total \$5.8 million, for which the Company had previously accrued. The balance of \$1.7 million is payable in December 2013.

Stockholder Litigation

The Company is a defendant in a class action lawsuit brought in United States District Court for the Eastern District of New York, by Company shareholders (the "Class Action"). The other defendants are James Weber, our former CFO and Vice President for Operations, and the estate of Reijane Huai. Mr. Huai was the Company's former Chairman, President and CEO.

The Class Action complaint alleges that the defendants defrauded shareholders by falsely certifying in the Company's SEC filings that they had disclosed any fraud, whether or not material, that involved management or other employees who had a significant role in the registrant's internal control over financial reporting. The Class Action complaint alleges that the defendants were in fact aware of fraud.

In January, 2013, the parties to the Class Action reached an agreement in principle to settle the Class Action. Pursuant to a Memorandum of Understanding signed by counsel for the class plaintiffs and by counsel for all defendants, the Company will pay \$5.0 million to settle the Class Action. This amount includes damages, plaintiffs' attorneys' fees, and costs of administration of the settlement. The Company expects to pay this settlement with a combination of cash on hand and insurance proceeds. In accordance with the Memorandum of Understanding, a stipulation of settlement and a joint motion for preliminary approval of the settlement will be submitted to the court for its approval. Final settlement of the Class Action is subject to certain conditions and to approval by the court. We cannot predict if or when the court might approve the settlement. Certain of the defendants may be entitled to indemnification by the Company under the laws of Delaware and/or our by-laws.

While the Company has insurance policies that it believes will cover it for the allegations of the Class Action, the Company has already reached an agreement with one insurance carrier that gave it less than the face amount of the insurance. There can be no assurance that the recovery the Company makes on the remainder of its insurance will be adequate to cover the costs of its defense or settlement of the Class Action, or any damages that might

ultimately be awarded against the Company or anyone to whom the Company might owe indemnification if the settlement is not approved by the court. The Company's insurers may deny coverage under the policies. If the Company's insurance recovery is not adequate to cover the costs of defense, settlement, damages and/or indemnification, or its insurers deny coverage, the amounts to be paid by the Company could have a significant negative impact on its financial results, its cash flows and its cash balances.

The Company's Directors and Officers ("D&O") Insurance, is composed of more than one layer, each layer written by a different insurance company. After the close of the third quarter, in connection with the Class Action, and in connection with the Derivative Action discussed below, the Company entered into an agreement with the carrier of the first \$5.0 million layer of the Company's D&O insurance. Pursuant to this agreement, the Company accepted a payment of \$3.9 million from the first layer insurance carrier in satisfaction of the carrier's obligations to the Company under the first layer D&O insurance policy. The combined costs of (i) defense of the Class Action and the Derivative Action, and (ii) the proposed \$5.0 million settlement of the Class Action exceeds \$3.9 million, and the Company is responsible for paying the next \$1.1 million of costs, settlement amounts or liability up to \$5.0 million, before the next layer of the Company's D&O insurance might cover the Company. This \$5.0 million payment, when and if made, will negatively impact its cash flows and its cash reserves when paid. In addition, as part of the October 2012 agreement with the carrier, the Company agreed to indemnify the carrier of the first layer of D&O insurance against potential claims by certain named insured persons under the first layer D&O insurance policy. The Company cannot predict the likelihood or the outcome of any such claims by the named insureds.

There can be no assurance that the amount of remaining D&O insurance will be adequate to cover the costs of the Company's defense of the Class Action or any damages that might be awarded against the Company or any defendant(s) to whom we owe indemnification. The Company's remaining insurers may deny coverage under the policies. If the plaintiffs are awarded damages and the Company's insurance is not adequate to cover the amounts, or its insurers deny coverage, the amounts to be paid by the Company could have a significant negative impact on our financial results, our cash flow and our cash reserves.

To date, the Company has recorded \$6.6 million of total costs associated with the Class Action and the Derivative Actions. The Company has recorded a liability in the amount of \$5.2 million in "accrued expenses" in the consolidated balance sheets as of December 31, 2012 which includes estimated costs of resolutions and legal fees for both the Class Action and the Derivative Action to date. As a result of the agreement reached with the Company's D&O insurance carrier, the Company has recorded an insurance recovery of approximately \$3.9 million of legal expenses previously incurred related to the class action and derivative lawsuits as well as the potential settlement of the class action lawsuit. The \$3.9 million insurance recovery was reimbursed by the Company's insurance carrier during 2012. In connection with discussions with the insurer of the Company's next layer of D&O insurance regarding that insurer's obligations to the Company, the Company has recorded a \$1.0 million receivable in "prepaid expenses and other current assets" in the consolidated balance sheet as of December 31, 2012.

Company shareholders filed actions in the Suffolk County Division of the Supreme Court of the State of New York, putatively derivatively on behalf of the Company, against the Company, each of the Company's Directors, Mr. Weber, Wayne Lam, a former Vice president of the Company, the estate of Mr. Huai, and Jason Lin, a former employee of the Company (the "Derivative Action"). The consolidated amended Derivative Action complaint alleged that the defendants breached their duties to the Company by: (1) causing or allowing the dissemination of false and misleading information; (2) failing to maintain internal controls; (3) failing to manage the Company properly; (4) unjustly enriching themselves; (5) abusing their control of the Company; and (6) wasting Company assets.

On March 5, 2013, the Suffolk County Division of the Supreme Court of the State of New York granted a motion made by all of the defendants in the Derivative Action, except Mr. Lin, and dismissed the Derivative Action as to all defendants other than Mr. Lin.

During 2012, the Company recorded a \$0.3 million reduction of investigation, litigation and settlement related costs. The reduction was comprised of (i) a \$1.7 million reduction in the accrual for certain costs associated with the resolution of the government investigations and (ii) a recovery of \$0.3 million of legal expenses previously incurred related to the class action and derivative lawsuits, partially offset by (i) \$1.5 million of legal expenses related to the class action and derivative lawsuits as well as for the potential settlement of the class action lawsuit that are not or may not be recoverable through insurance and (ii) \$0.2 million of legal fees incurred related to the resolution of the government investigations.

Avazpour Litigation

The Company is the defendant in an action brought by Avazpour Networking Services, Inc., and its former principals (collectively, “Avazpour”), pending in the United States District Court for the Eastern District of New York. Avazpour alleged that the Company gave grossly negligent advice in connection with an upgrade of Avazpour’s storage system resulting in damages to Avazpour and breached its contract with Avazpour. On March 13, 2013, the Court granted the Company’s motion to dismiss all of the claims except for the claim of breach of contract. The Company believes that limitation of liability clauses of the contract mean that Avazpour will not be able to collect any damages.

The Company cannot predict when the Avazpour action will be resolved or its outcome. While the Company has insurance policies that it believes covers the Company for the allegations of the Avazpour Action, there can be no assurance that the amount of insurance will be adequate to cover the costs of the Company’s defense of the Avazpour Action or any damages that might be awarded against it. If the plaintiffs are awarded damages and the Company’s insurance is not adequate to cover the amounts, or the Company’s insurers deny coverage, the amounts to be paid by the Company could have a significant negative impact on its financial results, cash flow and cash reserves.

Other Claims

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, such matters are not expected to have a material adverse effect on the Company’s financial condition or operating results.

The Company continues to assess certain litigation and claims to determine the amounts, if any, that the Company believes may be paid as a result of such claims and litigation and, therefore, additional losses may be accrued and paid in the future, which could materially adversely impact the Company’s financial results, its cash flows and its cash reserves.

(13) Restructuring Costs

In July 2012, the Company undertook certain restructuring activities that included a workforce reduction of approximately 35 positions worldwide (the “2012 Plan”). These actions were intended to better align the Company’s cost structure with the skills and resources required to more effectively execute the Company’s long-term growth strategy and to support the anticipated revenue levels we expect to achieve on a go forward basis. The total amount incurred with respect to severance under the 2012 Plan was \$0.8 million. Actions under the 2012 Plan were substantially completed during the third quarter of 2012.

In July 2011, the Company undertook certain restructuring activities that included a workforce reduction of approximately 25 positions worldwide and the closing of a satellite facility (the “2011 Plan”). The total amounts incurred with respect to severance and facilities abandonment under the 2011 Plan were \$0.8 million and less than \$0.1 million, respectively. Actions under the 2011 Plan were substantially completed during the third quarter of 2011.

Accrued restructuring costs associated with the 2012 and 2011 Plans are as follows:

**Reconciliation of Aggregate Liability Recorded for
Restructuring Costs Under the 2012 Plan**

	<u>December 31, 2011</u>	<u>Provisions</u>	<u>Payments</u>	<u>December 31, 2012</u>
Severance related costs	\$ -	\$ 770,749	\$ 770,271	\$ 478

**Reconciliation of Aggregate Liability Recorded for
Restructuring Costs Under the 2011 Plan**

	<u>December 31, 2011</u>	<u>Provisions</u>	<u>Payments</u>	<u>December 31, 2012</u>
Severance related costs	\$ 94,844	\$ -	\$ 94,844	\$ -
Facility abandonment costs	25,200	-	25,200	-
Total Restructuring Costs	<u>\$ 120,044</u>	<u>\$ -</u>	<u>\$ 120,044</u>	<u>\$ -</u>

The severance related liabilities are included within “accrued expenses” in the accompanying consolidated balance sheets for both 2012 and 2011. The facility abandonment liabilities are included within “accrued expenses” in the accompanying consolidated balance sheets for 2011. The expenses under the 2012 Plan and the 2011 Plan are included within “restructuring costs” in the accompanying consolidated statements of operations. The remaining payment under the 2012 Plan was paid in January 2013. There were no remaining payments under the 2011 Plan as of December 31, 2012.

(14) Employee Benefit Plans

Defined Contribution Plan

Effective July 2002, the Company established a voluntary savings and defined contribution plan (the “Plan”) under Section 401(k) of the Internal Revenue Code. This Plan covers all U.S. employees meeting certain eligibility requirements and allows participants to contribute a portion of their annual compensation. Employees are 100% vested in their own contributions. For the years ended December 31, 2012, 2011 and 2010, the Company did not make any contributions to the Plan.

Effective July 1, 2007, the Company, in accordance with the labor pension system in Taiwan, contributes 6% of salaries to individual pension accounts managed by the Bureau of Labor Insurance. The plan covers all Taiwan employees that elect the new pension system and all employees hired after July 1, 2005. For the years ended December 31, 2012, 2011 and 2010, the Company contributed \$127,000, \$127,000 and \$148,000, respectively.

Defined Benefit Plan

The Company has a defined benefit plan covering employees in Taiwan. The Company accounts for its defined benefit plan in accordance with the authoritative guidance issued by the FASB on retirement benefits, which requires the Company to recognize the funded status of its defined benefit plan in the accompanying consolidated balance sheet, with the corresponding adjustment to accumulated other comprehensive income, net of tax.

At December 31, 2012 and 2011, \$55,122 and \$184,567, respectively, is included in accumulated other comprehensive income for amounts that have not yet been recognized in net periodic pension cost. These amounts include the following: unrecognized transition obligation of \$35,279 and \$39,359 at December 31, 2012 and 2011, respectively, and unrecognized actuarial losses of \$19,843 and \$145,208 at December 31, 2012 and 2011, respectively. During 2012, the total amount recorded in other comprehensive income related to the pension plan was

\$129,445 (net of tax), which consisted of an actuarial loss of \$125,365 and the recognition of \$4,080 of transition obligations recognized during 2012 as a component of net periodic pension cost. The transition obligation and actuarial loss included in accumulated other comprehensive loss and expected to be recognized in net periodic pension cost for the year ended December 31, 2012, is \$5,813 and \$5,346 respectively.

Pension information for the years ended December 31, 2012 and 2011, is as follows:

	<u>2012</u>	<u>2011</u>
Accumulated benefit obligation	<u>\$ 160,279</u>	<u>\$ 185,673</u>
Changes in projected benefit obligation:		
Projected benefit obligation at beginning of year	366,158	416,897
Interest cost	7,571	8,207
Actuarial (gain) loss	(126,282)	(45,170)
Benefits paid	-	-
Service cost	5,624	5,041
Currency translation and other	16,689	(18,817)
Projected benefit obligation at end of year	<u>\$ 269,760</u>	<u>\$ 366,158</u>
Changes in plan assets:		
Fair value of plan assets at beginning of year	\$ 92,651	\$ 83,591
Actual return on plan assets	792	741
Benefits paid	-	-
Employer contributions	9,911	12,737
Currency translation and other	4,860	(4,418)
Fair value of plan assets at end of year	<u>\$ 108,214</u>	<u>\$ 92,651</u>
Funded status	<u>\$ 161,546</u>	<u>\$ 273,507</u>
Components of net periodic pension cost:		
Interest cost	\$ 7,571	\$ 8,207
Expected return on plan assets	(1,916)	(1,646)
Amortization of net loss	11,159	13,477
Service cost	5,624	5,041
Net periodic pension cost	<u>\$ 22,438</u>	<u>\$ 25,079</u>

The Company makes contributions to the plan so that minimum contribution requirements, as determined by government regulations, are met. Company contributions of approximately \$10,000 are expected to be made during 2013. Benefit payments of approximately \$224,000 are expected to be paid in 2016 through 2022.

The Company utilized the following assumptions in computing the benefit obligation at December 31, 2012 and 2011 as follows:

	Years ended December 31,	
	<u>2012</u>	<u>2011</u>
Discount rate	1.75%	2.00%
Rate of increase in compensation levels	3.00%	3.30%
Expected long-term rate of return on plan assets	1.75%	2.00%

(15) Segment Reporting and Concentrations

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 years ended December 31, 2012, 2011 and 2010, and the location of long-lived assets as of December 31, 2012, 2011, and 2010, are summarized as follows:

Revenues:	Years ended December 31,		
	2012	2011	2010
America's	\$ 30,505,705	\$ 36,227,426	\$ 45,796,271
Asia Pacific	24,807,328	24,197,054	16,151,399
Europe, Middle East, Africa and Other	20,097,936	22,446,122	20,896,076
Total Revenues	\$ 75,410,969	\$ 82,870,602	\$ 82,843,746

Long-lived assets:	December 31,	
	2012	2011
America's	\$ 10,263,056	\$ 11,271,525
Asia Pacific	1,041,470	1,122,487
Europe, Middle East, Africa and Other	434,353	326,435
Total long-lived assets	\$ 11,738,879	\$ 12,720,447

For the year ended December 31, 2012, the Company had one customer that accounted for 11% of revenues. For the year ended December 31, 2011, the Company did not have any customers that accounted for 10% or more of total revenues. For the year ended December 31, 2010, the Company had one customer that accounted for 10% of total revenues. As of December 31, 2012, the Company had one customer that accounted for 20% of the gross accounts receivable balance. As of December 31, 2011, the Company had one customer that accounted for 11% of gross accounts receivable balances.

(16) Valuation and Qualifying Accounts – Allowance for Returns and Doubtful Accounts

Period Ended	Balance at Beginning of Period	Additions Charged to Expenses / Revenues	Deductions	Balance at End of Period
December 31, 2012	\$ 1,723,679	\$ 357,301	\$ 1,140,879	\$ 940,101
December 31, 2011	\$ 3,242,458	\$ 120,992	\$ 1,639,771	\$ 1,723,679
December 31, 2010	\$ 7,503,338	\$ 1,211,838	\$ 5,472,718	\$ 3,242,458

Note: Additions to the allowance for doubtful accounts are recorded within “general and administrative expenses” within the consolidated statements of operations. Additions to the return reserve for product and service are recorded within “revenues” within the consolidated statements of operations.

Due to cash collections of previously reserved accounts receivable balances, the Company recorded a benefit of approximately \$0.7 million during the years ended December 31, 2012 and 2011, respectively. During the year ended December 31, 2010, the Company recorded an expense of approximately \$0.7 million. These amounts are within “additions charged to expenses/revenues” above, and are included within revenues in each respective period in the accompanying consolidated statements of operations.

(17) Quarterly Financial Data (Unaudited)

The following is a summary of selected quarterly financial data for the years ended December 31, 2012 and 2011:

2012	Quarter			
	First	Second	Third	Fourth
Revenue (a)	\$ 19,368,072	\$ 16,466,201	\$ 17,089,013	\$ 22,487,683
Gross profit	14,186,230	11,587,960	12,208,096	16,766,610
Net loss	(2,449,408)	(6,620,586)	(3,568,051)	(2,346,276)
Basic net loss per share	(0.05)	(0.14)	(0.08)	(0.05)
Diluted net loss per share	(0.05)	(0.14)	(0.08)	(0.05)

2011	Quarter			
	First	Second	Third	Fourth
Revenue (b)	\$ 18,959,262	\$ 19,628,008	\$ 18,856,390	\$ 25,426,942
Gross profit	14,117,037	13,943,379	14,049,801	19,243,475
Net loss	(5,966,265)	(5,889,039)	(5,398,176)	(6,114,804)
Basic net loss per share	(0.13)	(0.13)	(0.12)	(0.13)
Diluted net loss per share	(0.13)	(0.13)	(0.12)	(0.13)

The sum of the quarterly net income (loss) per share amounts do not necessarily equal the annual amount reported, as per share amounts are computed independently for each quarter and the annual period based on the weighted average common shares outstanding in each period.

- (a) The Company recorded a benefit (expense) of approximately \$0.6 million, (\$0.3) million, \$0.2 million and \$0.2 million during the first, second, third and fourth quarters of 2012, respectively, representing the net impact from changes in accounts receivable allowances. These amounts are included within revenues in each respective period in the accompanying consolidated statements of operations.
- (b) The Company recorded a benefit (expense) of approximately \$0.9 million, (\$0.2) million, (\$0.4) million and \$0.4 million during the first, second, third and fourth quarters of 2011, respectively, representing the net impact from changes in accounts receivable allowances. These amounts are included within revenues in each respective period in the accompanying consolidated statements of operations.

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None.

Item 9A. Controls and Procedures

Disclosure Controls and Procedures

The Company maintains “disclosure controls and procedures,” as such term is defined in Rules 13a-15e and 15d-15e of the Securities and Exchange Act of 1934, as amended (the “Exchange Act”), that are designed to ensure that information required to be disclosed in its reports, pursuant to the Exchange Act, is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms, and that such information is accumulated and communicated to its management, including its Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding the required disclosures. In designing and evaluating the disclosure controls and procedures, management has recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurances of achieving the desired control objectives, and management necessarily is required to apply its judgment in evaluating the cost benefit relationship of possible controls and procedures.

The Company’s Chief Executive Officer (its principal executive officer) and Chief Financial Officer (its principal finance officer and principal accounting officer) have evaluated the effectiveness of its “disclosure controls and procedures” as of the end of the period covered by this Annual Report on Form 10-K. Based on their evaluation, the principal executive officer and principal financial officer concluded that its disclosure controls and procedures are effective at a reasonable assurance level at the end of the period covered by this report.

Internal Control Over Financial Reporting

Management’s Report on Internal Control Over Financial Reporting

The Company’s management is responsible for establishing and maintaining adequate internal control over financial reporting for the Company; as such term is defined in Rules 13a-15(f). To evaluate the effectiveness of the Company’s internal control over financial reporting, the Company’s management uses the Integrated Framework adopted by the Committee of Sponsoring Organizations of the Treadway Commission (“COSO”).

The Company’s management has assessed the effectiveness of the Company’s internal control over financial reporting as of December 31, 2012, using the COSO framework. The Company’s management has determined that the Company’s internal control over financial reporting is effective as of that date.

There were no changes in the Company’s internal controls over financial reporting during the Company’s last fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company’s internal control over financial reporting. As a result of the internal investigation arising from the revelation of the improper payments in connection with the licensing of software to a customer, our Board of Directors has accepted recommendations for changes and enhancements to the Company’s controls and procedures, and management has substantially completed the implementation of such changes and enhancements.

The registered public accounting firm that audited the financial statements included in this annual report has issued an attestation report on the Company’s internal control over financial reporting.

Item 9B. Other Information

On March 15, 2013, pursuant to the Company's 2012 Management Incentive Bonus Plan, the Company's Executive Officers received payments of the following amounts:

<u>Name</u>	<u>Title</u>	<u>Amount</u>
James P. McNiel	President & Chief Executive Officer	\$163,940
Seth R. Horowitz	Vice President, General Counsel & Secretary	\$38,742
Louis J. Petrucelly	Vice President & Chief Financial Officer	\$31,132
Bernard J. Wu	Vice President of Business Development	\$57,379

PART III

Item 10. Directors, Executive Officers and Corporate Governance

Information called for by Part III, Item 10, regarding the Registrant's directors will be included in our Proxy Statement relating to our annual meeting of stockholders scheduled to be held in May 2013, and is incorporated herein by reference. The information appears in the Proxy Statement under the captions "Election of Directors", "Management", "Executive Compensation", "Section 16 (a) Beneficial Ownership Reporting Compliance", and "Committees of the Board of Directors." The Proxy Statement will be filed within 120 days of December 31, 2012, our year-end.

Item 11. Executive Compensation

Information called for by Part III, Item 11, will be included in our Proxy Statement relating to our annual meeting of stockholders scheduled to be held in May 2013, and is incorporated herein by reference. The information appears in the Proxy Statement under the captions "Executive Compensation", "Director Compensation", "Compensation Committee Interlocks and Insider Participation", "Compensation Committee Report" and "Committees of the Board of Directors." The Proxy Statement will be filed within 120 days of December 31, 2012, our year-end.

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

Information regarding Securities Authorized for Issuance Under Equity Compensation Plans is included in Item 4 and is incorporated herein by reference. All other information called for by Part III, Item 12, will be included in our Proxy Statement relating to our annual meeting of stockholders scheduled to be held in May 2013, and is incorporated herein by reference. The information appears in the Proxy Statement under the caption "Beneficial Ownership of Shares." The Proxy Statement will be filed within 120 days of December 31, 2012, our year-end.

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

Information regarding our relationships and related transactions will be included in our Proxy Statement relating to our annual meeting of stockholders scheduled to be held in May 2013, and is incorporated by reference. The information appears in the Proxy Statement under the caption "Certain Relationships and Related Transactions." The Proxy Statement will be filed within 120 days of December 31, 2012, our year-end.

Item 14. Principal Accountant Fees and Services

Information called for by Part III, Item 14, will be included in our Proxy Statement relating to our annual meeting of stockholders scheduled to be held in May 2013, and is incorporated herein by reference. The information appears in the Proxy Statement under the caption "Principal Accountant Fees and Services." The Proxy Statement will be filed within 120 days of December 31, 2012, our year-end.

PART IV

Item 15. Exhibits and Financial Statement Schedules

The information required by subsections (a)(1) and (a)(2) of this item are included in the response to Item 8 of Part II of this annual report on Form 10-K.

(b) Exhibits

- 3.1 Restated Certificate of Incorporation, incorporated herein by reference to Exhibit 3.1 to the Registrant's registration statement on Form S-1 (File no. 33-79350), filed on April 28, 1994.
- 3.2 Amended and Restated By-Laws of FalconStor Software, Inc., incorporated herein by reference to Exhibit 3.2 to the Registrant's annual report on Form 10-K for the year ended December 31, 2010, filed on March 14, 2011.
- 3.3 Certificate of Amendment to the Restated Certificate of Incorporation, incorporated herein by reference to Exhibit 3.3 to the Registrant's annual report on Form 10-K for the year ended December 31, 1998, filed on March 22, 1999.
- 3.4 Certificate of Amendment to the Restated Certificate of Incorporation, incorporated herein by reference to Exhibit 3.4 to the Registrant's annual report on Form 10-K for the year ended December 31, 2001, filed on March 27, 2002.
- 4.1 2000 Stock Option Plan, incorporated herein by reference to Exhibit 4.1 of the Registrant's registration statement on Form S-8, filed on September 21, 2001.
- 4.2 2000 Stock Option Plan, as amended May 15, 2003, incorporated herein by reference to Exhibit 99 to the Registrant's quarterly report on Form 10-Q for the period ended June 30, 2003, filed on August 14, 2003.
- 4.3 2000 Stock Option Plan, as amended May 14, 2004, incorporated herein by reference to Exhibit 4.3 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2004, filed on March 16, 2005.
- 4.4 1994 Outside Directors Stock Plan, as amended May 17, 2002 incorporated herein by reference to Exhibit 4.2 to the Registrant's annual report on Form 10-K for the year ended December 31, 2002, filed on March 17, 2003.
- 4.5 2004 Outside Directors Stock Option Plan, incorporated herein by reference to Exhibit 4.5 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2004, filed on March 16, 2005.
- 4.6 Amended and Restated 2006 Incentive Stock Plan incorporated herein by reference to Exhibit 4.1 to the Registrant's quarterly report on Form 10-Q for the quarter ended March 31, 2007, filed on May 9, 2007.
- 4.7 2007 Outside Directors Equity Compensation Plan, as amended May 8, 2008, incorporated herein by reference to Exhibit 99.2 to the Registrant's quarterly report on Form 10-Q for the quarter ended June 30, 2008, filed on August 11, 2008.
- 4.8 Form of Restricted Stock Letter Agreement for Executive Officers, incorporated herein by reference to Exhibit 99.1 to the Registrant's quarterly report on Form 10-Q for the period ended March 31, 2008, filed May 9, 2008.
- 10.1 Agreement of lease between Huntington Quadrangle 2, LLC, and FalconStor Software, Inc.,

dated August 2003, incorporated herein by reference to Exhibit 99.1 to the Registrant's quarterly report on Form 10-Q for the period ended September 30, 2003, filed on November 14, 2003.

- 10.2 Employment Agreement dated January 11, 2011 between Registrant and James P. McNiel, incorporated herein by reference to Exhibit 10.1 to the Registrant's Current Report on Form 8-K, dated January 11, 2011.
- 10.3 Stand-Alone Stock Option Agreement dated January 11, 2011, by and between FalconStor Software, Inc., and James P. McNiel, incorporated herein by reference to Exhibit 10.2 to Registrant's Current Report on Form 8-K, dated January 11, 2011.
- 10.4 * FalconStor Software, Inc., 2005 Key Executive Severance Protection Plan, as amended January 4, 2013, attached hereto.
- 10.5 Amended and Restated FalconStor Software, Inc., 2005 Key Executive Severance Protection Plan, incorporated herein by reference to Exhibit 10.3 to Registrant's annual report on Form 10-K for the year ended December 31, 2005, filed on March 15, 2006.
- 10.6 FalconStor Software, Inc., Director Compensation Deferral Plan, effective January 1, 2011, incorporated herein by reference to Registrant's annual report on Form 10-K, for the year ended December 31, 2010, filed, on March 14, 2011.
- 21.1 Subsidiaries of Registrant – FalconStor, Inc., FalconStor AC, Inc., FalconStor Software (Korea), Inc.
- 23.1 *Consent of KPMG LLP
- 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)
- 101.1 The following financial statements from FalconStor Software, Inc's Annual Report on Form 10-K for the year ended December 31, 2012, formatted in XBRL (eXtensible Business Reporting Language):
 - (i) Consolidated Balance Sheets – December 31, 2012 and December 31, 2011.
 - (ii) Consolidated Statements of Operations – Years Ended December 31, 2012, 2011 and 2010.
 - (iii) Consolidated Statements of Stockholders' Equity – Years Ended December 31, 2012, 2011 and 2010.
 - (iv) Consolidated Statements of Comprehensive Loss – Years Ended December 31, 2012, 2011 and 2010.
 - (v) Consolidated Statements of Cash Flows – Years Ended December 31, 2012, 2011 and 2010.
 - (vi) Notes to Consolidated Financial Statements –December 31, 2012.

*- filed herewith.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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 in Melville, State of New York on March 18, 2013.

FALCONSTOR SOFTWARE, INC.

By: /s/ James P. McNiel Date: March 18, 2013
James P. McNiel, President and Chief Executive Officer of FalconStor Software, Inc.

POWER OF ATTORNEY

FalconStor Software, Inc. and each of the undersigned do hereby appoint James P. McNiel and Louis J. Petrucelly, and each of them severally, its or his true and lawful attorney to execute on behalf of FalconStor Software, Inc. and the undersigned any and all amendments to this Annual Report on Form 10-K and to file the same with all exhibits thereto and other documents in connection therewith, with the Securities and Exchange Commission; each of such attorneys shall have the power to act hereunder with or without the other.

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

By: /s/ James P. McNiel March 18, 2013
James P. McNiel, President and Chief Executive Officer (principal executive officer) Date

By: /s/ Louis J. Petrucelly March 18, 2013
Louis J. Petrucelly, Vice President, Chief Financial Officer and Treasurer (principal financial and accounting officer) Date

By: /s/ Steven R. Fischer March 18, 2013
Steven R. Fischer, Director Date

By: /s/ Alan W. Kaufman March 18, 2013
Alan W. Kaufman, Director Date

By: /s/ Irwin Lieber March 18, 2013
Irwin Lieber, Director Date

By: /s/ Eli Oxenhorn March 18, 2013
Eli Oxenhorn, Chairman of the Board Date

By: /s/ Barry Rubenstein March 18, 2013
Barry Rubenstein, Director Date

Consent of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders
FalconStor Software, Inc.:

We consent to the incorporation by reference in the registration statements (numbers 333-69834, 333-103925, 333-125126, 333-139032, and 333-145475) filed on Form S-8 and in the registration statement (number 333-69830) filed on Form S-3 of FalconStor Software, Inc. of our reports, dated March 18, 2013, with respect to the consolidated balance sheets of FalconStor Software, Inc. as of December 31, 2012 and 2011, and the related consolidated statements of operations, stockholders' equity, comprehensive loss, and cash flows for each of the years in the three-year period ended December 31, 2012, and the effectiveness of internal control over financial reporting as of December 31, 2012, which reports appear in the December 31, 2012 annual report on Form 10-K of FalconStor Software, Inc.

/s/ KPMG LLP

Melville, New York
March 18, 2013

I, James P. McNiel, certify that:

1. I have reviewed this annual report on Form 10-K 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 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)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) designed such disclosure control and procedures, or caused such disclosure control 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) designed such internal controls over financial reporting, or caused such internal controls over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) 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
 - d) 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 materially 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 the registrant's board of directors (or persons performing the equivalent functions):
 - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial 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: March 18, 2013

/s/ James P. McNiel
James P. McNiel
President and Chief Executive Officer
(principal executive officer)

I, Louis J. Petrucelly, certify that:

1. I have reviewed this annual report on Form 10-K 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 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)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and 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) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) 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
 - d) 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 materially 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 the registrant's board of directors (or persons performing the equivalent functions):
 - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial 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: March 18, 2013

/s/ Louis J. Petrucelly
Louis J. Petrucelly
Vice President, Chief Financial Officer and
Treasurer
(principal financial and accounting officer)

CERTIFICATION OF CHIEF EXECUTIVE OFFICER

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

The Annual Report on Form 10-K for the year ended December 31, 2012 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 P. McNiel
James P. McNiel
President and Chief Executive Officer
March 18, 2013

CERTIFICATION OF CHIEF FINANCIAL OFFICER

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

The Annual Report on Form 10-K for the year ended December 31, 2012 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/ Louis J. Petrucelly

Louis J. Petrucelly

Vice President, Chief Financial Officer and Treasurer

March 18, 2013