

FalconStor Software, Inc. and Subsidiaries
CONDENSED CONSOLIDATED BALANCE SHEETS

	March 31, 2017	December 31, 2016
	(unaudited)	
Assets		
Current assets:		
Cash and cash equivalents	\$ 3,431,763	\$ 3,391,528
Accounts receivable, net	3,525,036	5,003,972
Prepaid expenses and other current assets	1,237,323	1,245,085
Inventory	6,181	6,181
Total current assets	<u>8,200,303</u>	<u>9,646,766</u>
Property and equipment, net	989,719	1,174,942
Deferred tax assets, net	580,419	577,735
Software development costs, net	458,317	547,558
Other assets, net	1,026,401	973,949
Goodwill	4,150,339	4,150,339
Other intangible assets, net	208,851	209,456
Total assets	<u>\$ 15,614,349</u>	<u>\$ 17,280,745</u>
Liabilities and Stockholders' Deficit		
Current liabilities:		
Accounts payable	\$ 860,397	\$ 419,877
Accrued expenses	3,651,703	4,471,010
Deferred revenue, net	15,809,374	15,236,123
Total current liabilities	<u>20,321,474</u>	<u>20,127,010</u>
Other long-term liabilities	1,159,992	1,170,844
Deferred tax liabilities, net	260,896	254,776
Deferred revenue, net	7,640,759	8,430,692
Total liabilities	<u>29,383,121</u>	<u>29,983,322</u>
Commitments and contingencies		
Series A redeemable convertible preferred stock	9,000,000	9,000,000
Total stockholders' deficit	<u>(22,768,772)</u>	<u>(21,702,577)</u>
Total liabilities and stockholders' deficit	<u>\$ 15,614,349</u>	<u>\$ 17,280,745</u>

FalconStor Software, Inc. and Subsidiaries
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

	Three Months Ended March 31,	
	2017	2016
Revenue:		
Product revenue	\$ 1,921,052	\$ 2,280,858
Support and services revenue	4,118,063	5,151,473
Total revenue	<u>6,039,115</u>	<u>7,432,331</u>
Cost of revenue:		
Product	198,715	244,273
Support and service	1,253,916	1,762,220
Total cost of revenue	<u>1,452,631</u>	<u>2,006,493</u>
Gross profit	\$ 4,586,484	\$ 5,425,838
Operating expenses:		
Research and development costs	2,294,863	3,656,777
Selling and marketing	2,050,542	4,268,800
General and administrative	1,621,551	1,705,925
Restructuring	(236,302)	83,984
Total operating expenses	<u>5,730,654</u>	<u>9,715,486</u>
Operating loss	<u>(1,144,170)</u>	<u>(4,289,648)</u>
Interest and other income, net	154,921	118,183
Loss before income taxes	(989,249)	(4,171,465)
Provision for income taxes	122,948	125,147
Net loss	<u>\$ (1,112,197)</u>	<u>\$ (4,296,612)</u>
Less: Accrual of Series A redeemable convertible preferred stock dividends	204,575	192,608
Less: Accretion to redemption value of Series A redeemable convertible preferred stock	—	163,669
Net loss attributable to common stockholders	<u>\$ (1,316,772)</u>	<u>\$ (4,652,889)</u>
Basic net loss per share attributable to common stockholders	<u>\$ (0.03)</u>	<u>\$ (0.11)</u>
Diluted net loss per share attributable to common stockholders	<u>\$ (0.03)</u>	<u>\$ (0.11)</u>
Weighted average basic shares outstanding	<u>44,088,352</u>	<u>41,882,232</u>
Weighted average diluted shares outstanding	<u>44,088,352</u>	<u>41,882,232</u>

FalconStor Software, Inc. and Subsidiaries
Reconciliation of GAAP to Non-GAAP Financial Measures
(Unaudited)

	Three Months Ended March 31,	
	2017	2016
GAAP loss from operations	\$ (1,144,170)	\$ (4,289,648)
Non-cash stock option expense (1)	\$ 445,414	\$ 990,610
Restructuring costs (3)	(236,302)	83,984
Non-GAAP loss from operations	<u>\$ (935,058)</u>	<u>\$ (3,215,054)</u>
GAAP net loss attributable to common stockholders	\$ (1,316,772)	\$ (4,652,889)
Non-cash stock option expense, net of income taxes (2)	445,414	990,610
Restructuring costs (3)	(236,302)	83,984
Effects of Series A redeemable convertible preferred stock (4)	204,575	356,277
Non-GAAP net loss	<u>\$ (903,085)</u>	<u>\$ (3,222,018)</u>
GAAP gross margin	76 %	73 %
Non-cash stock option expense (1)	1 %	0 %
Non-GAAP gross margin	<u>77 %</u>	<u>73 %</u>
GAAP gross margin - Product	90 %	89 %
Non-cash stock option expense (1)	0 %	0 %
Non-GAAP gross margin - Product	<u>90 %</u>	<u>89 %</u>
GAAP gross margin - Support and Service	70 %	66 %
Non-cash stock option expense (1)	1 %	0 %
Non-GAAP gross margin - Support and Service	<u>71 %</u>	<u>66 %</u>
GAAP operating margin	(19%)	(58%)
Non-cash stock option expense (1)	7%	13%
Restructuring costs (3)	(4%)	1%
Non-GAAP operating margin	<u>(15%)</u>	<u>(43%)</u>
GAAP Basic EPS	\$ (0.03)	\$ (0.11)
Non-cash stock option expense, net of income taxes (2)	0.01	0.02
Restructuring costs (3)	(0.01)	0.00
Effects of Series A redeemable convertible preferred stock (4)	0.00	0.01
Non-GAAP Basic EPS	<u>\$ (0.02)</u>	<u>\$ (0.08)</u>
GAAP Diluted EPS	\$ (0.03)	\$ (0.11)
Non-cash stock option expense, net of income taxes (2)	0.01	0.02
Restructuring costs (3)	(0.01)	0.00
Effects of Series A redeemable convertible preferred stock (4)	0.00	0.01
Non-GAAP Diluted EPS	<u>\$ (0.02)</u>	<u>\$ (0.08)</u>
Weighted average basic shares outstanding (GAAP and as adjusted)	44,088,352	41,882,232
Weighted average diluted shares outstanding (GAAP and as adjusted)	<u>44,088,352</u>	<u>41,882,232</u>

Footnotes:

(1) Represents non-cash, stock-based compensation charges as follows:

	Three Months Ended March 31,	
	2017	2016
Cost of revenue - Product	\$ —	\$ —
Cost of revenue - Support and Service	56,451	24,771
Research and development costs	129,715	746,162
Selling and marketing	56,540	67,730
General and administrative	202,708	151,947
Total non-cash stock based compensation expense	<u>\$ 445,414</u>	<u>\$ 990,610</u>

(2) Represents the effects of non-cash stock-based compensation expense recognized, net of related income tax effects. For the three months ended March 31, 2017 and 2016, the tax expense for both GAAP and Non-GAAP basis approximate the same amount. Included in share-based compensation expense for the three months ended March 31, 2016, was \$0.7 million, related to costs associated with our exclusive source code license and development agreement which were paid through the issuance of our common stock.

(3) Represents restructuring costs which were incurred during each respective period presented.

(4) Represents the effects of the accretion to redemption value of the Series A redeemable convertible preferred stock and accrual of Series A redeemable convertible preferred stock dividends.