

FalconStor Software, Inc. and Subsidiaries
CONDENSED CONSOLIDATED BALANCE SHEETS

	June 30, 2017	December 31,
	(unaudited)	2016
Assets		
Current assets:		
Cash and cash equivalents	\$ 1,647,695	\$ 3,391,528
Accounts receivable, net	2,986,927	5,003,972
Prepaid expenses and other current assets	875,598	1,245,085
Inventory	6,181	6,181
Total current assets	<u>5,516,401</u>	<u>9,646,766</u>
Property and equipment, net	858,978	1,174,942
Deferred tax assets, net	580,395	577,735
Software development costs, net	396,630	547,558
Other assets, net	1,010,247	973,949
Goodwill	4,150,339	4,150,339
Other intangible assets, net	174,200	209,456
Total assets	<u>\$ 12,687,190</u>	<u>\$ 17,280,745</u>
Liabilities and Stockholders' Deficit		
Current liabilities:		
Accounts payable	\$ 685,384	\$ 419,877
Accrued expenses	3,783,381	4,471,010
Deferred revenue, net	13,998,843	15,236,123
Total current liabilities	<u>18,467,608</u>	<u>20,127,010</u>
Other long-term liabilities	1,217,275	1,170,844
Deferred tax liabilities, net	267,174	254,776
Deferred revenue, net	7,272,609	8,430,692
Total liabilities	<u>27,224,666</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>(23,537,476)</u>	<u>(21,702,577)</u>
Total liabilities and stockholders' deficit	<u>\$ 12,687,190</u>	<u>\$ 17,280,745</u>

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Revenue:				
Product revenue	\$ 2,499,655	\$ 2,939,594	\$ 4,420,707	\$ 5,220,452
Support and services revenue	4,234,671	5,128,357	8,352,734	10,279,830
Total revenue	6,734,326	8,067,951	12,773,441	15,500,282
Cost of revenue:				
Product	351,969	319,974	550,684	564,247
Support and service	1,418,663	1,999,125	2,672,579	3,761,345
Total cost of revenue	1,770,632	2,319,099	3,223,263	4,325,592
Gross profit	\$ 4,963,694	\$ 5,748,852	\$ 9,550,178	\$ 11,174,690
Operating expenses:				
Research and development costs	2,025,132	3,304,079	4,319,995	6,960,856
Selling and marketing	2,109,599	4,124,350	4,160,141	8,393,150
General and administrative	1,345,343	1,833,479	2,966,894	3,539,404
Restructuring	—	93,405	(236,302)	177,389
Total operating expenses	5,480,074	9,355,313	11,210,728	19,070,799
Operating loss	(516,380)	(3,606,461)	(1,660,550)	(7,896,109)
Interest and other (loss) income, net	(29,121)	237,251	125,800	355,434
Loss before income taxes	(545,501)	(3,369,210)	(1,534,750)	(7,540,675)
Provision for income taxes	94,300	165,672	217,248	290,819
Net loss	\$ (639,801)	\$ (3,534,882)	\$ (1,751,998)	\$ (7,831,494)
Less: Accrual of Series A redeemable convertible preferred stock dividends	215,089	195,366	419,664	387,974
Less: Accretion to redemption value of Series A redeemable convertible preferred stock	—	170,981	—	334,650
Net loss attributable to common stockholders	\$ (854,890)	\$ (3,901,229)	\$ (2,171,662)	\$ (8,554,118)
Basic net loss per share attributable to common stockholders	\$ (0.02)	\$ (0.09)	\$ (0.05)	\$ (0.20)
Diluted net loss per share attributable to common stockholders	\$ (0.02)	\$ (0.09)	\$ (0.05)	\$ (0.20)
Weighted average basic shares outstanding	44,440,751	43,159,285	44,265,525	42,521,018
Weighted average diluted shares outstanding	44,440,751	43,159,285	44,265,525	42,521,018

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
GAAP loss from operations	\$ (516,380)	\$ (3,606,461)	\$ (1,660,550)	\$ (7,896,109)
Non-cash stock option expense (1)	97,155	1,127,346	\$ 542,569	\$ 2,117,956
Restructuring costs (3)	—	93,405	(236,302)	177,389
Non-GAAP loss from operations	<u>\$ (419,225)</u>	<u>\$ (2,385,710)</u>	<u>\$ (1,354,283)</u>	<u>\$ (5,600,764)</u>
GAAP net loss attributable to common stockholders	\$ (854,890)	\$ (3,901,229)	\$ (2,171,662)	\$ (8,554,118)
Non-cash stock option expense, net of income taxes (2)	97,155	1,127,346	542,569	2,117,956
Restructuring costs (3)	—	93,405	(236,302)	177,389
Effects of Series A redeemable convertible preferred stock (4)	215,089	366,347	419,664	722,624
Non-GAAP net loss	<u>\$ (542,646)</u>	<u>\$ (2,314,131)</u>	<u>\$ (1,445,731)</u>	<u>\$ (5,536,149)</u>
GAAP gross margin	74 %	71 %	75 %	72 %
Non-cash stock option expense (1)	0 %	1 %	1 %	0 %
Non-GAAP gross margin	<u>74 %</u>	<u>72 %</u>	<u>75 %</u>	<u>73 %</u>
GAAP gross margin - Product	86 %	89 %	88 %	89 %
Non-cash stock option expense (1)	0 %	0 %	0 %	0 %
Non-GAAP gross margin - Product	<u>86 %</u>	<u>89 %</u>	<u>88 %</u>	<u>89 %</u>
GAAP gross margin - Support and Service	66 %	61 %	68 %	63 %
Non-cash stock option expense (1)	0 %	1 %	1 %	1 %
Non-GAAP gross margin - Support and Service	<u>67 %</u>	<u>62 %</u>	<u>69 %</u>	<u>64 %</u>
GAAP operating margin	(8%)	(45%)	(13%)	(51%)
Non-cash stock option expense (1)	1%	14%	4%	14%
Restructuring costs (3)	0%	1%	(2%)	1%
Non-GAAP operating margin	<u>(6%)</u>	<u>(30%)</u>	<u>(11%)</u>	<u>(36%)</u>
GAAP Basic EPS	\$ (0.02)	\$ (0.09)	\$ (0.05)	\$ (0.20)
Non-cash stock option expense, net of income taxes (2)	0.00	0.03	0.01	0.05
Restructuring costs (3)	0.00	0.00	(0.01)	0.00
Effects of Series A redeemable convertible preferred stock (4)	0.00	0.01	0.01	0.02
Non-GAAP Basic EPS	<u>\$ (0.01)</u>	<u>\$ (0.05)</u>	<u>\$ (0.03)</u>	<u>\$ (0.13)</u>
GAAP Diluted EPS	\$ (0.02)	\$ (0.09)	\$ (0.05)	\$ (0.20)
Non-cash stock option expense, net of income taxes (2)	0.00	0.03	0.01	0.05
Restructuring costs (3)	0.00	0.00	(0.01)	0.00
Effects of Series A redeemable convertible preferred stock (4)	0.00	0.01	0.01	0.02
Non-GAAP Diluted EPS	<u>\$ (0.01)</u>	<u>\$ (0.05)</u>	<u>\$ (0.03)</u>	<u>\$ (0.13)</u>
Weighted average basic shares outstanding (GAAP and as adjusted)	<u>44,440,751</u>	<u>43,159,285</u>	<u>44,265,525</u>	<u>42,521,018</u>
Weighted average diluted shares outstanding (GAAP and as adjusted)	<u>44,440,751</u>	<u>43,159,285</u>	<u>44,265,525</u>	<u>42,521,018</u>

Footnotes:

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Cost of revenue - Product	\$ —	\$ —	\$ —	\$ —
Cost of revenue - Support and Service	8,834	44,066	65,285	68,837
Research and development costs	54,813	825,635	184,528	1,571,797
Selling and marketing	7,198	75,342	63,738	143,072
General and administrative	26,310	182,303	229,018	334,250
Total non-cash stock based compensation expense	<u>\$ 97,155</u>	<u>\$ 1,127,346</u>	<u>\$ 542,569</u>	<u>\$ 2,117,956</u>

(2) Represents the effects of non-cash stock-based compensation expense recognized, net of related income tax effects. For the three and six months ended June 30, 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 and six months ended June 30, 2016, was \$0.8 million and \$1.5 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.