

FalconStor Software, Inc. and Subsidiaries
CONDENSED CONSOLIDATED BALANCE SHEETS

| | June 30, 2014 | December 31, |
|--|----------------------|---------------------|
| | (unaudited) | 2013 |
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 18,333,685 | \$ 19,288,340 |
| Restricted cash | 750,000 | 750,000 |
| Marketable securities | 9,694,304 | 8,073,108 |
| Accounts receivable, net | 7,566,015 | 11,150,323 |
| Prepaid expenses and other current assets | 1,669,715 | 1,636,891 |
| Inventory | 692,395 | 919,390 |
| Deferred tax assets, net | 358,092 | 358,092 |
| Total current assets | 39,064,206 | 42,176,144 |
| Property and equipment, net | 2,627,624 | 3,317,344 |
| Deferred tax assets, net | 62,534 | 49,651 |
| Software development costs, net | 1,571,951 | 1,796,075 |
| Other assets, net | 1,422,265 | 1,549,255 |
| Goodwill | 4,150,339 | 4,150,339 |
| Other intangible assets, net | 161,633 | 179,596 |
| Total assets | \$ 49,060,552 | \$ 53,218,404 |
| Liabilities and Stockholders' Equity | | |
| Current liabilities: | | |
| Accounts payable | \$ 1,388,317 | \$ 1,024,180 |
| Accrued expenses | 7,133,299 | 8,658,863 |
| Deferred tax liabilities, net | 18,005 | 18,005 |
| Deferred revenue, net | 18,618,744 | 18,148,268 |
| Total current liabilities | 27,158,365 | 27,849,316 |
| Other long-term liabilities | 637,229 | 617,300 |
| Deferred tax liabilities, net | 205,948 | 193,705 |
| Deferred revenue, net | 14,515,430 | 11,602,177 |
| Total liabilities | 42,516,972 | 40,262,498 |
| Commitments and contingencies | | |
| Series A redeemable convertible preferred stock | 6,973,485 | 6,737,578 |
| Total stockholders' (deficit) equity | (429,905) | 6,218,328 |
| Total liabilities and stockholders' (deficit) equity | \$ 49,060,552 | \$ 53,218,404 |

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|--|-----------------------|--------------------------------------|-----------------------|
| | 2014 | 2013 | 2014 | 2013 |
| Revenues: | | | | |
| Product revenues | \$ 4,252,486 | \$ 6,542,429 | \$ 9,215,545 | \$ 14,301,885 |
| Support and services revenues | 7,050,181 | 7,431,710 | 14,088,621 | 14,957,071 |
| Total revenues | <u>11,302,667</u> | <u>13,974,139</u> | <u>23,304,166</u> | <u>29,258,956</u> |
| Cost of revenues: | | | | |
| Product | 698,222 | 963,102 | 1,273,346 | 2,262,756 |
| Support and service | 2,009,441 | 2,861,992 | 4,108,692 | 5,870,395 |
| Total cost of revenues | <u>2,707,663</u> | <u>3,825,094</u> | <u>5,382,038</u> | <u>8,133,151</u> |
| Gross profit | \$ 8,595,004 | \$ 10,149,045 | \$ 17,922,128 | \$ 21,125,805 |
| Operating expenses: | | | | |
| Research and development costs | 3,143,224 | 4,395,823 | 6,492,019 | 9,044,432 |
| Selling and marketing | 6,351,947 | 6,879,315 | 12,240,413 | 13,719,886 |
| General and administrative | 2,364,380 | 3,361,881 | 4,755,790 | 6,608,948 |
| Investigation, litigation, and settlement related costs | (5,275,920) | 62,392 | (5,164,209) | 176,458 |
| Restructuring costs | 562,913 | — | 786,486 | — |
| Total operating expenses | <u>7,146,544</u> | <u>14,699,411</u> | <u>19,110,499</u> | <u>29,549,724</u> |
| Operating income (loss) | <u>1,448,460</u> | <u>(4,550,366)</u> | <u>(1,188,371)</u> | <u>(8,423,919)</u> |
| Interest and other (loss) income, net | <u>(30,982)</u> | <u>(487,176)</u> | <u>19,126</u> | <u>(817,966)</u> |
| Income (loss) before income taxes | 1,417,478 | (5,037,542) | (1,169,245) | (9,241,885) |
| Provision for income taxes | 86,531 | 169,751 | 301,606 | 345,853 |
| Net income (loss) | <u>\$ 1,330,947</u> | <u>\$ (5,207,293)</u> | <u>\$ (1,470,851)</u> | <u>\$ (9,587,738)</u> |
| Less: Accrual of Preferred stock dividends | 186,904 | — | 373,808 | — |
| Less: Accretion to redemption value of Series A preferred stock | 120,531 | — | 235,907 | — |
| Net income (loss) attributable to common stockholders | <u>\$ 1,023,512</u> | <u>\$ (5,207,293)</u> | <u>\$ (2,080,566)</u> | <u>\$ (9,587,738)</u> |
| Basic net income (loss) per share attributable to common stockholders | <u>\$ 0.02</u> | <u>\$ (0.11)</u> | <u>\$ (0.04)</u> | <u>\$ (0.20)</u> |
| Diluted net income (loss) per share attributable to common stockholders | <u>\$ 0.02</u> | <u>\$ (0.11)</u> | <u>\$ (0.04)</u> | <u>\$ (0.20)</u> |
| Weighted average basic shares outstanding | <u>47,919,318</u> | <u>47,996,027</u> | <u>47,975,217</u> | <u>47,929,799</u> |
| Weighted average diluted shares outstanding | <u>48,780,606</u> | <u>47,996,027</u> | <u>47,975,217</u> | <u>47,929,799</u> |

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|--------------------------------|-----------------------|------------------------------|-----------------------|
| | 2014 | 2013 | 2014 | 2013 |
| GAAP income (loss) from operations | \$ 1,448,460 | \$ (4,550,336) | \$ (1,188,371) | \$ (8,423,919) |
| Non-cash stock option expense (1) | 422,054 | 240,795 | 834,715 | 1,131,530 |
| Legal related costs (3) | (5,275,920) | 62,392 | (5,164,209) | 176,458 |
| Restructuring costs (4) | 562,913 | — | 786,486 | — |
| Non-GAAP loss from operations | <u>\$ (2,842,493)</u> | <u>\$ (4,247,149)</u> | <u>\$ (4,731,379)</u> | <u>\$ (7,115,931)</u> |
| GAAP net income (loss) attributable to common stockholders | \$ 1,023,512 | \$ (5,207,293) | \$ (2,080,566) | \$ (9,587,738) |
| Non-cash stock option expense, net of income taxes (2) | 422,054 | 240,795 | 834,715 | 1,131,530 |
| Legal related costs (3) | (5,275,920) | 62,392 | (5,164,209) | 176,458 |
| Restructuring costs (4) | 562,913 | — | 786,486 | — |
| Effects of preferred stock (5) | 307,435 | — | 609,715 | — |
| Non-GAAP net loss | <u>\$ (2,960,006)</u> | <u>\$ (4,904,106)</u> | <u>\$ (5,013,859)</u> | <u>\$ (8,279,750)</u> |
| GAAP gross margin | 76 % | 73 % | 77 % | 72 % |
| Non-cash stock option expense (1) | 0 % | 0 % | 0 % | 0 % |
| Non-GAAP gross margin | <u>76 %</u> | <u>73 %</u> | <u>77 %</u> | <u>72 %</u> |
| GAAP gross margin - Product | 84 % | 85 % | 86 % | 84 % |
| Non-cash stock option expense (1) | 0 % | 0 % | 0 % | 0 % |
| Non-GAAP gross margin - Product | <u>84 %</u> | <u>85 %</u> | <u>86 %</u> | <u>84 %</u> |
| GAAP gross margin - Support and Service | 71 % | 61 % | 71 % | 61 % |
| Non-cash stock option expense (1) | 0 % | 1 % | 0 % | 1 % |
| Non-GAAP gross margin - Support and Service | <u>72 %</u> | <u>62 %</u> | <u>71 %</u> | <u>61 %</u> |
| GAAP operating margin | 13% | (33%) | (5%) | (29%) |
| Non-cash stock option expense (1) | 4% | 2% | 4% | 4% |
| Legal related costs (3) | (47%) | 0% | (22%) | 1% |
| Restructuring costs (4) | 5% | 0% | 3% | 0% |
| Non-GAAP operating margin | <u>(25%)</u> | <u>(30%)</u> | <u>20%</u> | <u>(24%)</u> |
| GAAP Basic EPS | \$ 0.02 | \$ (0.11) | \$ (0.04) | \$ (0.20) |
| Non-cash stock option expense, net of income taxes (2) | 0.01 | 0.01 | 0.02 | 0.02 |
| Legal related costs (3) | (0.11) | 0.00 | (0.11) | 0.00 |
| Restructuring costs (4) | 0.01 | 0.00 | 0.02 | 0.00 |
| Effects of preferred stock (5) | 0.01 | 0.00 | 0.01 | 0.00 |
| Non-GAAP Basic EPS | <u>\$ (0.06)</u> | <u>\$ (0.10)</u> | <u>\$ (0.10)</u> | <u>\$ (0.17)</u> |
| GAAP Diluted EPS | \$ 0.02 | \$ (0.11) | \$ (0.04) | \$ (0.20) |
| Non-cash stock option expense, net of income taxes (2) | 0.01 | 0.01 | 0.02 | 0.02 |
| Legal related costs (3) | (0.11) | 0.00 | (0.11) | 0.00 |
| Restructuring costs (4) | 0.01 | 0.00 | 0.02 | 0.00 |
| Effects of preferred stock (5) | 0.01 | 0.00 | 0.01 | 0.00 |
| Non-GAAP Diluted EPS | <u>\$ (0.06)</u> | <u>\$ (0.10)</u> | <u>\$ (0.10)</u> | <u>\$ (0.17)</u> |
| Weighted average basic shares outstanding (GAAP and as adjusted) | <u>47,919,318</u> | <u>47,996,027</u> | <u>47,975,217</u> | <u>47,929,799</u> |
| Weighted average diluted shares outstanding (GAAP and as adjusted) | <u>48,780,606</u> | <u>47,996,027</u> | <u>47,975,217</u> | <u>47,929,799</u> |

Footnotes:

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|--------------------------------|------------|------------------------------|--------------|
| | 2014 | 2013 | 2014 | 2013 |
| Cost of revenues - Product | \$ — | \$ 50 | \$ — | \$ 99 |
| Cost of revenues - Support and Service | 32,454 | 53,936 | 54,337 | 104,192 |
| Research and development costs | 86,608 | 87,028 | 175,407 | 221,938 |
| Selling and marketing | 50,787 | (11,848) | 212,974 | 272,190 |
| General and administrative | 252,205 | 111,629 | 391,997 | 533,111 |
| Total non-cash stock based compensation expense | \$ 422,054 | \$ 240,795 | \$ 834,715 | \$ 1,131,530 |

- (2) Represents the effects of non-cash stock-based compensation expense recognized in accordance with the FASB Accounting Standards Codification, Topic 718, net of related income tax effects. For the three and six months ended June 30, 2014 and 2013, the tax expense for both GAAP and Non-GAAP basis approximate the same amount.
- (3) Legal related costs represent expenses/gains in connection with the Company's investigations, litigation and settlement related costs for each respective period presented.
- (4) Represents restructuring costs which were incurred during each respective period presented.
- (5) Represents the effects of the accretion to redemption value of the Series A redeemable convertible preferred stock and accrual of preferred stock dividends.