

FalconStor Software, Inc. and Subsidiaries
CONDENSED CONSOLIDATED BALANCE SHEETS

	June 30, 2016	December 31,
	(unaudited)	2015
Assets		
Current assets:		
Cash and cash equivalents	\$ 7,925,334	\$ 6,013,382
Marketable securities	1,500,235	7,420,042
Accounts receivable, net	4,641,500	6,635,262
Prepaid expenses and other current assets	1,396,389	1,742,668
Inventory	6,181	70,534
Deferred tax assets, net	526,391	205,816
Total current assets	15,996,030	22,087,704
Property and equipment, net	1,257,917	1,565,932
Deferred tax assets, net	127,015	110,060
Software development costs, net	736,453	1,116,816
Other assets, net	1,045,956	1,139,377
Goodwill	4,150,339	4,150,339
Other intangible assets, net	235,408	256,137
Total assets	\$ 23,549,118	\$ 30,426,365
Liabilities and Stockholders' Deficit		
Current liabilities:		
Accounts payable	\$ 973,739	\$ 1,005,944
Accrued expenses	6,186,181	6,783,514
Deferred tax liabilities, net	89,474	89,343
Deferred revenue, net	15,969,741	16,553,519
Total current liabilities	23,219,135	24,432,320
Other long-term liabilities	991,781	735,089
Deferred tax liabilities, net	40,637	27,069
Deferred revenue, net	9,462,032	9,122,289
Total liabilities	33,713,585	34,316,767
Commitments and contingencies		
Series A redeemable convertible preferred stock	8,153,204	7,818,554
Total stockholders' deficit	(18,317,671)	(11,708,956)
Total liabilities and stockholders' deficit	\$ 23,549,118	\$ 30,426,365

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
Revenue:				
Product revenue	\$ 2,939,594	\$ 3,650,504	\$ 5,220,452	\$ 17,620,871
Support and services revenue	5,128,357	5,902,085	10,279,830	11,871,594
Total revenue	<u>8,067,951</u>	<u>9,552,589</u>	<u>15,500,282</u>	<u>29,492,465</u>
Cost of revenue:				
Product	319,974	718,057	564,247	1,108,281
Support and service	1,999,125	1,940,729	3,761,345	3,960,747
Total cost of revenue	<u>2,319,099</u>	<u>2,658,786</u>	<u>4,325,592</u>	<u>5,069,028</u>
Gross profit	\$ 5,748,852	\$ 6,893,803	\$ 11,174,690	\$ 24,423,437
Operating expenses:				
Research and development costs	3,304,079	3,067,732	6,960,856	6,273,599
Selling and marketing	4,124,350	4,371,513	8,393,150	9,676,875
General and administrative	1,833,479	2,583,893	3,539,404	5,076,834
Investigation, litigation, and settlement related (benefits) costs	—	(8,186)	—	8,842
Restructuring costs	93,405	23,495	177,389	157,971
Total operating expenses	<u>9,355,313</u>	<u>10,038,447</u>	<u>19,070,799</u>	<u>21,194,121</u>
Operating (loss) income	<u>(3,606,461)</u>	<u>(3,144,644)</u>	<u>(7,896,109)</u>	<u>3,229,316</u>
Interest and other income (loss), net	237,251	98,411	355,434	(365,665)
(Loss) income before income taxes	(3,369,210)	(3,046,233)	(7,540,675)	2,863,651
Provision (benefit) for income taxes	165,672	(378,049)	290,819	269,456
Net (loss) income	<u>\$ (3,534,882)</u>	<u>\$ (2,668,184)</u>	<u>\$ (7,831,494)</u>	<u>\$ 2,594,195</u>
Less: Accrual of Series A redeemable convertible preferred stock dividends	195,366	186,904	387,974	377,690
Less: Accretion to redemption value of Series A redeemable convertible preferred stock	170,981	143,557	334,650	280,974
Net (loss) income attributable to common stockholders	<u>\$ (3,901,229)</u>	<u>\$ (2,998,645)</u>	<u>\$ (8,554,118)</u>	<u>\$ 1,935,531</u>
Basic net (loss) income per share attributable to common stockholders	<u>\$ (0.09)</u>	<u>\$ (0.07)</u>	<u>\$ (0.20)</u>	<u>\$ 0.05</u>
Diluted net (loss) income per share attributable to common stockholders	<u>\$ (0.09)</u>	<u>\$ (0.07)</u>	<u>\$ (0.20)</u>	<u>\$ 0.05</u>
Weighted average basic shares outstanding	<u>43,159,285</u>	<u>40,964,160</u>	<u>42,521,018</u>	<u>40,949,849</u>
Weighted average diluted shares outstanding	<u>43,159,285</u>	<u>40,964,160</u>	<u>42,521,018</u>	<u>42,492,677</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,	
	2016	2015	2016	2015
GAAP (loss) income from operations	\$ (3,606,461)	\$ (3,144,644)	\$ (7,896,109)	\$ 3,229,316
Non-cash stock option expense (1)	1,127,346	425,968	2,117,956	800,774
Legal related costs (3)	—	(8,186)	—	8,842
Restructuring costs (4)	93,405	23,495	177,389	157,971
Non-GAAP (loss) income from operations	<u>\$ (2,385,710)</u>	<u>\$ (2,703,367)</u>	<u>\$ (5,600,764)</u>	<u>\$ 4,196,903</u>
GAAP net (loss) income attributable to common stockholders	\$ (3,901,229)	\$ (2,998,645)	\$ (8,554,118)	\$ 1,935,531
Non-cash stock option expense, net of income taxes (2)	1,127,346	425,968	2,117,956	800,774
Legal related costs (3)	—	(8,186)	—	8,842
Restructuring costs (4)	93,405	23,495	177,389	157,971
Effects of Series A redeemable convertible preferred stock (5)	366,347	330,461	722,624	658,664
Non-GAAP net (loss) income	<u>\$ (2,314,131)</u>	<u>\$ (2,226,907)</u>	<u>\$ (5,536,149)</u>	<u>\$ 3,561,782</u>
GAAP gross margin	71 %	72 %	72 %	83%
Non-cash stock option expense (1)	1 %	0 %	0 %	0%
Non-GAAP gross margin	<u>72 %</u>	<u>73 %</u>	<u>73 %</u>	<u>83%</u>
GAAP gross margin - Product	89 %	80 %	89 %	94%
Non-cash stock option expense (1)	0 %	0 %	0 %	0%
Non-GAAP gross margin - Product	<u>89 %</u>	<u>80 %</u>	<u>89 %</u>	<u>94%</u>
GAAP gross margin - Support and Service	61 %	67 %	63 %	67%
Non-cash stock option expense (1)	1 %	1 %	1 %	0%
Non-GAAP gross margin - Support and Service	<u>62 %</u>	<u>68 %</u>	<u>64 %</u>	<u>67%</u>
GAAP operating margin	(45%)	(33%)	(51%)	11%
Non-cash stock option expense (1)	14%	4%	14%	3%
Legal related costs (3)	0%	0%	0%	0%
Restructuring costs (4)	1%	0%	1%	1%
Non-GAAP operating margin	<u>(30%)</u>	<u>(28%)</u>	<u>(36%)</u>	<u>14%</u>
GAAP Basic EPS	\$ (0.09)	\$ (0.07)	\$ (0.20)	\$ 0.05
Non-cash stock option expense, net of income taxes (2)	0.03	0.01	0.05	0.02
Legal related costs (3)	0.00	0.00	0.00	0.00
Restructuring costs (4)	0.00	0.00	0.00	0.00
Effects of Series A redeemable convertible preferred stock (5)	0.01	0.01	0.02	0.02
Non-GAAP Basic EPS	<u>\$ (0.05)</u>	<u>\$ (0.05)</u>	<u>\$ (0.13)</u>	<u>\$ 0.09</u>

GAAP Diluted EPS	\$ (0.09)	\$ (0.07)	\$ (0.20)	\$ 0.05
Non-cash stock option expense, net of income taxes (2)	0.03	0.01	0.05	0.02
Legal related costs (3)	0.00	0.00	0.00	0.00
Restructuring costs (4)	0.00	0.00	0.00	0.00
Effects of Series A redeemable convertible preferred stock (5)	0.01	0.01	0.02	0.02
Non-GAAP Diluted EPS	\$ (0.05)	\$ (0.05)	\$ (0.13)	\$ 0.08
Weighted average basic shares outstanding (GAAP and as adjusted)	43,159,285	40,964,160	42,521,018	40,949,849
Weighted average diluted shares outstanding (GAAP and as adjusted)	43,159,285	40,964,160	42,521,018	42,492,677

Footnotes:

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
Cost of revenue - Product	\$ —	\$ —	\$ —	\$ —
Cost of revenue - Support and Service	44,066	34,894	68,837	53,704
Research and development costs	825,635	98,495	1,571,797	171,515
Selling and marketing	75,342	63,510	143,072	151,580
General and administrative	182,303	229,069	334,250	423,975
Total non-cash stock based compensation expense	\$ 1,127,346	\$ 425,968	\$ 2,117,956	\$ 800,774

(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, 2016 and 2015, 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, respectively, related to costs associated with our exclusive source code license and development agreement which were paid through the issuance of our common stock.

(3) Legal related costs represent expenses 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 Series A redeemable convertible preferred stock dividends.