

FalconStor Software, Inc. and Subsidiaries
CONDENSED CONSOLIDATED BALANCE SHEETS

	September 30, 2016	December 31, 2015
	(unaudited)	
Assets		
Current assets:		
Cash and cash equivalents	\$ 5,643,610	\$ 6,013,382
Marketable securities	500,040	7,420,042
Accounts receivable, net	3,253,257	6,635,262
Prepaid expenses and other current assets	1,357,254	1,742,668
Inventory	6,181	70,534
Deferred tax assets, net	533,589	205,816
Total current assets	11,293,931	22,087,704
Property and equipment, net	1,129,565	1,565,932
Deferred tax assets, net	128,990	110,060
Software development costs, net	636,799	1,116,816
Other assets, net	1,037,763	1,139,377
Goodwill	4,150,339	4,150,339
Other intangible assets, net	227,883	256,137
Total assets	\$ 18,605,270	\$ 30,426,365
Liabilities and Stockholders' Deficit		
Current liabilities:		
Accounts payable	\$ 716,709	\$ 1,005,944
Accrued expenses	5,069,086	6,783,514
Deferred tax liabilities, net	89,662	89,343
Deferred revenue, net	14,589,751	16,553,519
Total current liabilities	20,465,208	24,432,320
Other long-term liabilities	1,008,067	735,089
Deferred tax liabilities, net	46,938	27,069
Deferred revenue, net	8,887,015	9,122,289
Total liabilities	30,407,228	34,316,767
Commitments and contingencies		
Series A redeemable convertible preferred stock	8,331,823	7,818,554
Total stockholders' deficit	(20,133,781)	(11,708,956)
Total liabilities and stockholders' deficit	\$ 18,605,270	\$ 30,426,365

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Revenue:				
Product revenue	\$ 2,245,544	\$ 3,756,579	\$ 7,465,996	\$ 21,377,450
Support and services revenue	5,081,266	5,926,647	15,361,096	17,798,241
Total revenue	<u>7,326,810</u>	<u>9,683,226</u>	<u>22,827,092</u>	<u>39,175,691</u>
Cost of revenue:				
Product	145,986	510,861	710,233	1,619,142
Support and service	1,914,383	1,915,090	5,675,728	5,875,837
Total cost of revenue	<u>2,060,369</u>	<u>2,425,951</u>	<u>6,385,961</u>	<u>7,494,979</u>
Gross profit	\$ 5,266,441	\$ 7,257,275	\$ 16,441,131	\$ 31,680,712
Operating expenses:				
Research and development costs	2,514,822	3,454,128	9,475,678	9,727,727
Selling and marketing	2,991,901	4,128,814	11,385,051	13,805,689
General and administrative	1,561,335	2,132,665	5,100,739	7,209,499
Investigation, litigation, and settlement related costs	—	—	—	8,842
Restructuring costs	—	15,024	177,389	172,995
Total operating expenses	<u>7,068,058</u>	<u>9,730,631</u>	<u>26,138,857</u>	<u>30,924,752</u>
Operating (loss) income	<u>(1,801,617)</u>	<u>(2,473,356)</u>	<u>(9,697,726)</u>	<u>755,960</u>
Interest and other (loss) income, net	<u>(90,037)</u>	<u>25,697</u>	<u>265,397</u>	<u>(339,968)</u>
(Loss) income before income taxes	<u>(1,891,654)</u>	<u>(2,447,659)</u>	<u>(9,432,329)</u>	<u>415,992</u>
Provision for income taxes	84,519	134,280	375,338	403,736
Net (loss) income	<u>\$ (1,976,173)</u>	<u>\$ (2,581,939)</u>	<u>\$ (9,807,667)</u>	<u>\$ 12,256</u>
Less: Accrual of Series A redeemable convertible preferred stock dividends	194,012	190,786	581,986	568,476
Less: Accretion to redemption value of Series A redeemable convertible preferred stock	178,619	149,969	513,269	430,943
Net loss attributable to common stockholders	<u>\$ (2,348,804)</u>	<u>\$ (2,922,694)</u>	<u>\$ (10,902,922)</u>	<u>\$ (987,163)</u>
Basic net loss per share attributable to common stockholders	<u>\$ (0.05)</u>	<u>\$ (0.07)</u>	<u>\$ (0.25)</u>	<u>\$ (0.02)</u>
Diluted net loss per share attributable to common stockholders	<u>\$ (0.05)</u>	<u>\$ (0.07)</u>	<u>\$ (0.25)</u>	<u>\$ (0.02)</u>
Weighted average basic shares outstanding	<u>43,488,448</u>	<u>41,113,431</u>	<u>42,847,038</u>	<u>41,004,976</u>
Weighted average diluted shares outstanding	<u>43,488,448</u>	<u>41,113,431</u>	<u>42,847,038</u>	<u>41,004,976</u>

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
GAAP (loss) income from operations	\$ (1,801,617)	\$ (2,473,356)	\$ (9,697,726)	\$ 755,960
Non-cash stock option expense (1)	274,206	372,173	2,392,162	1,172,947
Legal related costs (3)	—	—	—	8,842
Restructuring costs (4)	—	15,024	177,389	172,995
Non-GAAP (loss) income from operations	<u>\$ (1,527,411)</u>	<u>\$ (2,086,159)</u>	<u>\$ (7,128,175)</u>	<u>\$ 2,110,744</u>
GAAP net (loss) income attributable to common stockholders	\$ (2,348,804)	\$ (2,922,694)	\$ (10,902,922)	\$ (987,163)
Non-cash stock option expense, net of income taxes (2)	274,206	372,173	2,392,162	1,172,947
Legal related costs (3)	—	—	—	8,842
Restructuring costs (4)	—	15,024	177,389	172,995
Effects of Series A redeemable convertible preferred stock (5)	372,631	340,755	1,095,255	999,419
Non-GAAP net (loss) income	<u>\$ (1,701,967)</u>	<u>\$ (2,194,742)</u>	<u>\$ (7,238,116)</u>	<u>\$ 1,367,040</u>
GAAP gross margin	72 %	75 %	72 %	81%
Non-cash stock option expense (1)	0 %	0 %	0 %	0%
Non-GAAP gross margin	<u>72 %</u>	<u>75 %</u>	<u>72 %</u>	<u>81%</u>
GAAP gross margin - Product	93 %	86 %	90 %	92%
Non-cash stock option expense (1)	0 %	0 %	0 %	0%
Non-GAAP gross margin - Product	<u>93 %</u>	<u>86 %</u>	<u>90 %</u>	<u>92%</u>
GAAP gross margin - Support and Service	62 %	68 %	63 %	67%
Non-cash stock option expense (1)	0 %	0 %	1 %	0%
Non-GAAP gross margin - Support and Service	<u>63 %</u>	<u>68 %</u>	<u>64 %</u>	<u>67%</u>
GAAP operating margin	(25%)	(26%)	(42%)	2%
Non-cash stock option expense (1)	4%	4%	10%	3%
Legal related costs (3)	0%	0%	0%	0%
Restructuring costs (4)	0%	0%	1%	0%
Non-GAAP operating margin	<u>(21%)</u>	<u>(22%)</u>	<u>(31%)</u>	<u>5%</u>
GAAP Basic EPS	\$ (0.05)	\$ (0.07)	\$ (0.25)	\$ (0.02)
Non-cash stock option expense, net of income taxes (2)	0.01	0.01	0.06	0.03
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	0.03	0.02
Non-GAAP Basic EPS	<u>\$ (0.04)</u>	<u>\$ (0.05)</u>	<u>\$ (0.17)</u>	<u>\$ 0.03</u>

GAAP Diluted EPS	\$ (0.05)	\$ (0.07)	\$ (0.25)	\$ (0.02)
Non-cash stock option expense, net of income taxes (2)	0.01	0.01	0.06	0.03
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	0.03	0.02
Non-GAAP Diluted EPS	\$ (0.04)	\$ (0.05)	\$ (0.17)	\$ 0.03
Weighted average basic shares outstanding (GAAP and as adjusted)	43,488,448	41,113,431	42,847,038	41,004,976
Weighted average diluted shares outstanding (GAAP)	43,488,448	41,113,431	42,847,038	41,004,976
Weighted average diluted shares outstanding (as adjusted)	43,488,448	41,113,431	42,847,038	42,637,654

Footnotes:

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Cost of revenue - Product	\$ —	\$ —	\$ —	\$ —
Cost of revenue - Support and Service	16,684	26,653	85,521	80,357
Research and development costs	80,310	57,478	1,652,107	228,993
Selling and marketing	88,907	73,575	231,979	225,155
General and administrative	88,305	214,467	422,555	638,442
Total non-cash stock based compensation expense	\$ 274,206	\$ 372,173	\$ 2,392,162	\$ 1,172,947

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