

FalconStor Software, Inc. and Subsidiaries
CONDENSED CONSOLIDATED BALANCE SHEETS

	December 31, 2016	December 31, 2015
	(unaudited)	
Assets		
Current assets:		
Cash and cash equivalents	\$ 3,391,528	\$ 6,013,382
Marketable securities	—	7,420,042
Accounts receivable, net	5,003,972	6,635,262
Prepaid expenses and other current assets	1,245,085	1,742,668
Inventory	6,181	70,534
Deferred tax assets, net	—	205,816
Total current assets	<u>9,646,766</u>	<u>22,087,704</u>
Property and equipment, net	1,174,942	1,565,932
Deferred tax assets, net	577,735	110,060
Software development costs, net	547,558	1,116,816
Other assets, net	973,949	1,139,377
Goodwill	4,150,339	4,150,339
Other intangible assets, net	209,456	256,137
Total assets	<u>\$ 17,280,745</u>	<u>\$ 30,426,365</u>
Liabilities and Stockholders' Deficit		
Current liabilities:		
Accounts payable	\$ 419,877	\$ 1,005,944
Accrued expenses	4,471,010	6,783,514
Deferred tax liabilities, net	—	89,343
Deferred revenue, net	15,236,123	16,553,519
Total current liabilities	<u>20,127,010</u>	<u>24,432,320</u>
Other long-term liabilities	1,170,844	735,089
Deferred tax liabilities, net	254,776	27,069
Deferred revenue, net	8,430,692	9,122,289
Total liabilities	<u>29,983,322</u>	<u>34,316,767</u>
Commitments and contingencies		
Series A redeemable convertible preferred stock	9,000,000	7,818,554
Total stockholders' deficit	(21,702,577)	(11,708,956)
Total liabilities and stockholders' deficit	<u>\$ 17,280,745</u>	<u>\$ 30,426,365</u>

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

	Three Months Ended December 31,		Twelve Months Ended December 31,	
	2016	2015	2016	2015
Revenue:				
Product revenue	\$ 2,650,901	\$ 3,470,274	\$ 10,116,897	\$ 24,847,724
Support and services revenue	4,785,353	5,925,026	20,146,449	23,723,267
Total revenue	<u>7,436,254</u>	<u>9,395,300</u>	<u>30,263,346</u>	<u>48,570,991</u>
Cost of revenue:				
Product	222,213	323,843	932,446	1,942,985
Support and service	1,676,129	1,863,312	7,351,857	7,739,149
Total cost of revenue	<u>1,898,342</u>	<u>2,187,155</u>	<u>8,284,303</u>	<u>9,682,134</u>
Gross profit	\$ 5,537,912	\$ 7,208,145	\$ 21,979,043	\$ 38,888,857
Operating expenses:				
Research and development costs	2,227,278	3,059,879	11,702,956	12,787,606
Selling and marketing	2,533,442	4,216,300	13,918,493	18,021,989
General and administrative	1,369,840	1,971,790	6,470,579	9,181,289
Investigation, litigation, and settlement related costs	—	—	—	8,842
Restructuring costs	—	—	177,389	172,995
Total operating expenses	<u>6,130,560</u>	<u>9,247,969</u>	<u>32,269,417</u>	<u>40,172,721</u>
Operating loss	<u>(592,648)</u>	<u>(2,039,824)</u>	<u>(10,290,374)</u>	<u>(1,283,864)</u>
Interest and other (loss) income, net	<u>(386,610)</u>	<u>70,014</u>	<u>(121,213)</u>	<u>(269,954)</u>
Loss before income taxes	<u>(979,258)</u>	<u>(1,969,810)</u>	<u>(10,411,587)</u>	<u>(1,553,818)</u>
Provision (benefit) for income taxes	<u>211,869</u>	<u>(28,193)</u>	<u>587,207</u>	<u>375,543</u>
Net loss	<u>\$ (1,191,127)</u>	<u>\$ (1,941,617)</u>	<u>\$ (10,998,794)</u>	<u>\$ (1,929,361)</u>
Less: Accrual of Series A redeemable convertible preferred stock dividends	195,904	196,727	777,890	765,203
Less: Accretion to redemption value of Series A redeemable convertible preferred stock	<u>668,177</u>	<u>156,670</u>	<u>1,181,446</u>	<u>587,613</u>
Net loss attributable to common stockholders	<u>\$ (2,055,208)</u>	<u>\$ (2,295,014)</u>	<u>\$ (12,958,130)</u>	<u>\$ (3,282,177)</u>
Basic net loss per share attributable to common stockholders	<u>\$ (0.05)</u>	<u>\$ (0.06)</u>	<u>\$ (0.30)</u>	<u>\$ (0.08)</u>
Diluted net loss per share attributable to common stockholders	<u>\$ (0.05)</u>	<u>\$ (0.06)</u>	<u>\$ (0.30)</u>	<u>\$ (0.08)</u>
Weighted average basic shares outstanding	<u>43,818,413</u>	<u>41,356,757</u>	<u>43,091,878</u>	<u>41,093,644</u>
Weighted average diluted shares outstanding	<u>43,818,413</u>	<u>41,356,757</u>	<u>43,091,878</u>	<u>41,093,644</u>

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

	Three Months Ended December 31,		Twelve Months Ended December 31,	
	2016	2015	2016	2015
GAAP loss from operations	\$ (592,648)	\$ (2,039,824)	\$(10,290,374)	\$ (1,283,864)
Non-cash stock option expense (1)	(63,944)	756,430	2,328,218	1,929,377
Legal related costs (3)	—	—	—	8,842
Restructuring costs (4)	—	—	177,389	172,995
Non-GAAP (loss) income from operations	<u>\$ (656,592)</u>	<u>\$ (1,283,394)</u>	<u>\$ (7,784,767)</u>	<u>\$ 827,350</u>
GAAP net loss attributable to common stockholders	\$ (2,055,208)	\$ (2,295,014)	\$(12,958,130)	\$ (3,282,177)
Non-cash stock option expense, net of income taxes (2)	(63,944)	756,430	2,328,218	1,929,377
Legal related costs (3)	—	—	—	8,842
Restructuring costs (4)	—	—	177,389	172,995
Effects of Series A redeemable convertible preferred stock (5)	864,081	353,397	1,959,336	1,352,816
Non-GAAP net (loss) income	<u>\$ (1,255,071)</u>	<u>\$ (1,185,187)</u>	<u>\$ (8,493,187)</u>	<u>\$ 181,853</u>
GAAP gross margin	74 %	77 %	73 %	80 %
Non-cash stock option expense (1)	0 %	0 %	0 %	0 %
Non-GAAP gross margin	<u>74 %</u>	<u>77 %</u>	<u>73 %</u>	<u>80 %</u>
GAAP gross margin - Product	92 %	91 %	91 %	92 %
Non-cash stock option expense (1)	0 %	0 %	0 %	0 %
Non-GAAP gross margin - Product	<u>92 %</u>	<u>91 %</u>	<u>91 %</u>	<u>92 %</u>
GAAP gross margin - Support and Service	65 %	69 %	64 %	67 %
Non-cash stock option expense (1)	0 %	0 %	0 %	0 %
Non-GAAP gross margin - Support and Service	<u>65 %</u>	<u>69 %</u>	<u>64 %</u>	<u>68 %</u>
GAAP operating margin	(8%)	(22%)	(34%)	(3%)
Non-cash stock option expense (1)	(1%)	8%	8%	4%
Legal related (benefits) costs (3)	0%	0%	0%	0%
Restructuring costs (4)	0%	0%	1%	0%
Non-GAAP operating margin	<u>(9%)</u>	<u>(14%)</u>	<u>(26%)</u>	<u>2%</u>
GAAP Basic EPS	\$ (0.05)	\$ (0.06)	\$ (0.30)	\$ (0.08)
Non-cash stock option expense, net of income taxes (2)	0.00	0.02	0.05	0.05
Legal related (benefits) 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)	0.02	0.01	0.05	0.03
Non-GAAP Basic EPS	<u>\$ (0.03)</u>	<u>\$ (0.03)</u>	<u>\$ (0.20)</u>	<u>\$ 0.00</u>

GAAP Diluted EPS	\$ (0.05)	\$ (0.06)	\$ (0.30)	\$ (0.08)
Non-cash stock option expense, net of income taxes (2)	0.00	0.02	0.05	0.04
Legal related (benefits) 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)	0.02	0.01	0.05	0.03
Non-GAAP Diluted EPS	\$ (0.03)	\$ (0.03)	\$ (0.20)	\$ 0.00
Weighted average basic shares outstanding (GAAP and as adjusted)	43,818,413	41,356,757	43,091,878	41,093,644
Weighted average diluted shares outstanding (GAAP)	43,818,413	41,356,757	43,091,878	41,093,644
Weighted average diluted shares outstanding (as adjusted)	43,818,413	41,356,757	43,091,878	42,906,072

Footnotes:

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

	Three Months Ended December 31,		Twelve Months Ended December 31,	
	2016	2015	2016	2015
Cost of revenues - Product	\$ —	\$ —	\$ —	\$ —
Cost of revenues - Support and Service	(4,618)	18,419	80,903	98,776
Research and development costs	1,229	577,355	1,653,336	806,348
Selling and marketing	9,502	60,632	241,481	285,787
General and administrative	(70,057)	100,024	352,498	738,466
Total non-cash stock based compensation expense	\$ (63,944)	\$ 756,430	\$ 2,328,218	\$ 1,929,377

(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 twelve months ended December 31, 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 twelve months ended December 31, 2016 and 2015 was \$1.5 million and \$0.5 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/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 Series A redeemable convertible preferred stock dividends.