

Edgar Filing: FALCONSTOR SOFTWARE INC - Form 10-K

FALCONSTOR SOFTWARE INC
Form 10-K
March 14, 2011

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-K

ý ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2010.

OR

¨ TRANSITION REPORT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from _____ to _____

Commission file number 0-23970

FALCONSTOR SOFTWARE, INC.
(Exact name of registrant as specified in its charter)

DELAWARE
(State or other jurisdiction of
incorporation or organization)

77-0216135
(I.R.S. Employer
Identification No.)

2 Huntington Quadrangle, Suite 2S01
Melville, New York
(Address of principal executive offices)

11747
(Zip code)

Registrant's telephone number, including area code: 631-777-5188

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on Which the Securities are Registered
Common Stock, \$.001 par value	NASDAQ Global Market

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ¨ No ý

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No ý

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ý No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required

to submit and post such files). Yes " No "

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. "

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of "large accelerated filer", "accelerated filer", and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated <input type="checkbox"/>	Accelerated filer <input checked="" type="checkbox"/>
Non-accelerated <input type="checkbox"/>	Smaller <input type="checkbox"/>
filer	Reporting <input type="checkbox"/>
	Company <input type="checkbox"/>

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ☐ No ☒

The aggregate market value of Common Stock held by non-affiliates of the Registrant as of June 30, 2010 was \$79,452,405 which value, solely for the purposes of this calculation excludes shares held by Registrant's officers and directors. Such exclusion should not be deemed a determination by Registrant that all such individuals are, in fact, affiliates of the Registrant. The number of shares of Common Stock issued and outstanding as of February 28, 2011 was 54,214,189 and 46,208,954, respectively.

Documents Incorporated by Reference:

The information required by Part III of Form 10-K will be incorporated by reference to certain portions of a definitive proxy statement which is expected to be filed by the Company pursuant to Regulation 14A within 120 days after the close of its fiscal year.

FALCONSTOR SOFTWARE, INC. AND SUBSIDIARIES
2010 ANNUAL REPORT ON FORM 10-K
TABLE OF CONTENTS

	Page
 <u>PART I.</u>	
<u>Item 1.</u>	<u>Business</u> 4
<u>Item 1A.</u>	<u>Risk Factors</u> 14
<u>Item 1B.</u>	<u>Unresolved Staff Comments</u> 28
<u>Item 2.</u>	<u>Properties</u> 28
<u>Item 3.</u>	<u>Legal Proceedings</u> 28
<u>Item 4.</u>	<u>Reserved</u> 29
 <u>PART II.</u>	
<u>Item 5.</u>	<u>Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u> 30
<u>Item 6.</u>	<u>Selected Financial Data</u> 32
<u>Item 7.</u>	<u>Management’s Discussion and Analysis of Financial Condition and Results of Operations</u> 34
<u>Item 7A.</u>	<u>Quantitative and Qualitative Disclosures About Market Risk</u> 50
<u>Item 8.</u>	<u>Financial Statements and Supplementary Data</u> 51
<u>Item 9.</u>	<u>Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u> 83
<u>Item 9A.</u>	<u>Controls and Procedures</u> 83
<u>Item 9B.</u>	<u>Other Information</u> 83
 <u>PART III.</u>	
<u>Item 10.</u>	<u>Directors, Executive Officers and Corporate Governance</u> 84
<u>Item 11.</u>	<u>Executive Compensation</u> 84
<u>Item 12.</u>	<u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u> 84
<u>Item 13.</u>	<u>Certain Relationships and Related Transactions, and Director Independence</u> 84
<u>Item 14.</u>	<u>Principal Accountant Fees and Services</u> 84
 <u>PART IV.</u>	
<u>Item 15.</u>	<u>Exhibits and Financial Statement Schedules</u> 85
 <u>SIGNATURES</u>	 87

PART I

Item 1. Business

OVERVIEW

FalconStor Software, Inc. (“FalconStor”, the “Company”, “we”, “our” or “us”) is the market leader in disk-based data protection. We deliver proven, comprehensive, data protection solutions that facilitate the continuous availability of business-critical data with speed, integrity, and simplicity. Our open data protection solutions, built upon the award-winning IPStor® virtualization platform, include the industry leading Virtual Tape Library (VTL) with data deduplication for backup optimization, Continuous Data Protector (CDP) for backup, replication, and fast data recovery, Network Storage Server (NSS) for storage virtualization and provisioning, File-interface Deduplication System (FDS) for capacity optimized storage, and the HyperFS® solution, a high-performance SAN-based file system to optimize storage performance for data intensive applications. All of our data protection solutions are enabled with WAN-optimized replication technology for cost-effective disaster recovery and remote office protection. From the Fortune 1000 to small and medium-size businesses, customers across a vast range of industries worldwide have implemented FalconStor solutions in their production IT environments in order to meet their recovery time objectives (RTO) and recovery point objectives (RPO), as well as to manage their storage infrastructures with minimal total cost of ownership (TCO) and with optimal return on investment (ROI).

The FalconStor data protection and storage virtualization solutions are designed to empower IT administrators and end users to recover data easily to any point in time in the event of hardware failure, data corruption, deletion, or catastrophic site-level disaster, allowing rollback or failover to a known, good, immediately useable state to ensure that businesses maintain reliable access to their vital applications, and to facilitate accurate data restoration while concurrently minimizing downtime. FalconStor solutions are engineered to integrate and to work seamlessly with database, email, and file systems, and with business applications. The application-level integration allows for maintaining space-efficient redundant sets of active data that are generated with complete transactional and point-in-time integrity. FalconStor solutions enhance business productivity by eliminating the need for the time-consuming consistency checks and data rebuilds that traditionally create long periods of downtime during a recovery process.

Designed to help contain escalating costs, FalconStor solutions enable companies to aggregate heterogeneous, distributed storage capacity and to centralize administration of both storage resources and business-critical data services such as backup, snapshot, replication, and data migration. Companies benefit from lower administrative overhead, elimination of storage over-provisioning, massive scalability, and the ability to make cost-effective storage allocation and purchasing decisions. Moreover, FalconStor’s commitment to an open software-based approach to storage networking entails any-to-any connectivity via native support for industry standards (including Fibre Channel, iSCSI, SCSI, SAS, SATA and emerging standards such as Fibre Channel over Ethernet (FCoE)), and delivers unified support for multiple storage architectures. As a result, FalconStor solutions provide companies of any size and complexity with the freedom to leverage IP/iSCSI- or Fibre Channel- based networks and to implement their choice of state-of-the-art equipment based on any standard protocol from any storage manufacturer, without rendering their existing or future investments obsolete.

Recognizing the value propositions of FalconStor’s proven, cutting-edge technology, multiple partners utilize FalconStor’s innovative software products – including CDP, FDS, NSS, and VTL to power their storage appliances and their bundled solutions. FalconStor’s products have been certified by such industry leaders as Acer, Brocade, Cisco, Citrix, Data Direct Networks, Dell, Dynamic Solutions International, EMC, Fujitsu, Hitachi Data Systems, HP, Huawei Symantec, IBM, Lanchao, LSI Logic, Microsoft, NEC, Nexsan, Oracle, Pillar Data Systems, Promise, QLogic, Rorke Data, an Avnet Company, SeaChange, Spectra Logic, Symantec, Violin Memory, VMware, and

Xiotech.

FalconStor was incorporated in Delaware as Network Peripherals, Inc., in 1994. Pursuant to a merger with FalconStor Inc., in 2001, the former business of Network Peripherals, Inc., was discontinued, and newly re-named FalconStor Software, Inc., continued the storage software business started in 2000 by FalconStor, Inc. FalconStor's headquarters are located at 2 Huntington Quadrangle, Suite 2S01, Melville, NY 11747. The Company also maintains offices in California, Canada, and Massachusetts and throughout Europe, Asia and Australia.

PRODUCTS AND TECHNOLOGY

FalconStor's products and solutions are built on the IPStor software platform that provides the most reliable and complete disk-based data protection and storage virtualization solutions. FalconStor data protection solutions accelerate or eliminate the backup window, which allows users to operate 24x7 without any disruption to their business applications or services and to recover any service in minutes, anytime, anywhere, with 100% data integrity. FalconStor offers the following core data protection products: VTL with deduplication, CDP, NSS, and FDS. In addition FalconStor provides a high-performance SAN-based file system, HyperFS, for data-intensive applications. All FalconStor data protection products are enabled with WAN-optimized replication technology for cost-effective disaster recovery and remote/branch office protection. FalconStor solutions share several key technologies that foster seamless integration and offer a competitive edge.

All FalconStor solutions are developed under the same requirements and framework defined as Available, Managed, Protected and Efficient Services (AMPES). The goal of this framework is to provide optimized service availability while reducing infrastructure acquisition and operating costs.

Available - FalconStor solutions employ a clustered architecture to ensure that there is no single point of failure and that all components are redundant for optimum availability. This architecture allows us to deliver a highly scalable infrastructure for both block and file data services.

Managed - FalconStor solutions are built on a common storage virtualization technology platform, allowing FalconStor to deliver comprehensive yet integrated storage and data protection solutions with a universal management paradigm and tools. A unified management console allows central management and enforcement of global policies across the IT infrastructure, which in turn translates into lower management costs, consistent and persistent processes and better visibility into the state of the infrastructure and the data through global and comprehensive reports.

Protected - Traditional backup processes are ill-equipped to protect exponentially growing data stores or highly efficient virtual server infrastructures. FalconStor solutions were built with those challenges in mind. By transforming the backup process from a daily patch job to a continuous process, FalconStor solutions not only eliminate the backup window and reduce recourse overhead to virtually zero but also enable very aggressive recovery-point and recovery-time objectives that converge to near-zero recovery time and zero data loss. FalconStor solutions offer the latest in data protection technologies including, snapshots, mirroring, and replication, and they integrate with all major operating systems and business applications to deliver the most granular and rapid recovery possible.

Efficient - FalconStor's integrated data protection and recovery solutions are designed to deliver the highest resource efficiency to reduce costs and to improve performance. This includes space-efficient snapshots, WAN-optimized replication, dynamic read-write caching with solid-state memory or solid-state drives (SSD), and instant data and system recovery.

FalconStor's data protection solutions address the full spectrum of data protection business challenges, from the need to accelerate backup to the need to recover data after a disaster. One of the largest challenges customers are facing today is massive data growth. According to a survey published in November 2010 by Gartner, 47% of the respondents ranked data growth in their top three challenges with 62% of those respondents stating that they plan to expand hardware capacity at existing data centers by the end of 2011; while 30% plan to build entirely new data centers. Gartner research director, April Adams, states data capacity on average in enterprises is growing at 40% to 60% year over year due to a number of factors, including an explosion in unstructured data, such as e-mail and documents that have to be stored due to regulatory requirements that continue to evolve and change. Gartner Analyst, David Cappuccio estimates enterprise data growth to be 650% by 2015 and that 80% of this will be unstructured data.

Backup windows have not only shrunk, for many organizations they have disappeared altogether. Traditional backup also has been plagued with media and hardware failures. These are some of the issues addressed by FalconStor VTL or FalconStor FDS, depending on the customers' environments. In addition, the time to recover is also shrinking, so companies need more recovery points and times, rather than the once-a-day recovery point offered by daily backup. For this, customers turn to the FalconStor CDP solution to provide them with instant data availability and with many granular points of recovery. To improve the day-to-day management issues that arise from explosive storage growth, customers use the FalconStor NSS solution to virtualize, to provision, and to protect their data. And for protecting remote office data from disasters, FalconStor has built a highly efficient replication solution that integrates with all of its data protection product lines - VTL, CDP, NSS, and FDS. Because all of these solutions are built from a single technology platform, deployment is simplified and businesses benefit from the peace of mind of knowing that FalconStor solutions work together in an easily managed and a highly efficient fashion, with high data availability and rapid recovery always paramount.

Deployment options

FalconStor sells its solutions as standalone software, as software pre-installed on FalconStor-supplied hardware appliances, or as virtual appliances.

Solutions

FalconStor offers a wide range of data protection and storage virtualization solutions, as well as a massively scalable file system:

- Storage Virtualization, Provisioning, and Management – FalconStor NSS
 - Tape Backup Optimization – FalconStor VTL
 - Unified Backup and Disaster Recovery – FalconStor CDP
 - Storage Capacity Optimization – FalconStor FDS
 - High-Performance, Scalable File System – HyperFS

FalconStor provides data protection services at all levels – from operating systems and application software, to files, databases, and messaging data – across the entire organization. Our products are scalable in order to address the needs of small/medium businesses, large organizations, and global enterprises. Our solutions offer high availability (HA) through RAID, synchronous and asynchronous mirroring, HA failover, and clustering technologies.

Network Storage Server (NSS)

The FalconStor® Network Storage Server (NSS) solution integrates storage virtualization and provisioning across multiple disk arrays and connection protocols for an easy-to-use, scalable SAN solution. From a small iSCSI virtual server lab to an enterprise-class Fibre Channel SAN running Tier-1 database applications, FalconStor NSS is designed to meet all of the storage needs of any organization.

By virtualizing storage on any disk array, FalconStor NSS provides the ability to pool and tier disk assets, simplifying provisioning, reducing allocation errors, and maximizing resource utilization. This allows IT organizations to avoid over-provisioning of disk resources and to bring new servers and projects online quickly and efficiently. FalconStor NSS incorporates a full set of application-aware data protection services, including real-time synchronous mirroring, volume snapshots, and site-to-site WAN-optimized data replication, for disaster recovery.

Virtual server environments are well served by virtualized storage. FalconStor NSS is designed to make it easy to create a new disk resource to house virtual machine files, and disk resources are re-allocated to different servers or shared among servers to facilitate virtual machine high-availability operations that require shared disk. Specific integration tools allow FalconStor NSS to service virtual server environments in an optimal manner providing rapid and effective recovery processes of a virtual machine or entire virtual server farms.

In addition, FalconStor NSS enables and automates server-less backup processes. FalconStor backup server integration tools offload backup processes from the server to the FalconStor NSS repository, freeing up the application host server and completely eliminating the backup window.

The FalconStor NSS Virtual Appliance enables cost-effective server virtualization by converting internal or external server storage resources into shared storage resources to enable high availability options across virtual servers. The solution reduces infrastructure cost and complexity while maximizing customers' return on investment. The FalconStor NSS Virtual Appliance brings all the benefits and features of server and storage virtualization to the remote and branch offices to reduce costs and to enable effective data protection and recovery solutions across the enterprise.

Virtual Tape Library (VTL)

The FalconStor® Virtual Tape Library (VTL) solution is the industry's leading virtual tape solution, and we believe it is unmatched in terms of performance and scalability. With virtual tape, backups complete faster and more reliably, with little or no change needed to the backup environment. It enhances backup operations seamlessly without changing any backup processes or policies. Sophisticated physical tape integration and data security complete the solution. Designed from the start as an enterprise-class application, FalconStor VTL can achieve high backup speeds allowing users to solve the single biggest issue in backup: meeting the backup window.

Built-in data deduplication significantly reduces the amount of data needed to be stored on disk. By eliminating redundant backup data, the storage footprint can be reduced by 95% or more, allowing organizations to keep weeks or even months worth of data on disk, for fast, dependable restore, without any of the reliability concerns of a tape-based restore.

While deduplication can eliminate or greatly reduce the need for physical tapes, many organizations still require tape for long-term, off-site, or archival storage. FalconStor VTL has the industry's most sophisticated and the broadest integration with physical tape libraries, allowing companies to export data directly to physical tape, leveraging the speed of the FalconStor VTL without impacting the backup network.

FalconStor VTL also supports small and remote office environments through FalconStor VTL storage appliances and small footprint virtual appliances.

Continuous Data Protector (CDP)

FalconStor® Continuous Data Protector (CDP) technology reinvents the way data backup and recovery are implemented and performed. Moving far beyond failure-prone once-a-day tape backup models, FalconStor CDP combines local and remote protection into a cost-effective, unified, disk-based solution that allows organizations to recover data back to the most recent transaction. Combining application-aware snapshot agents and continuous journaling functions, FalconStor CDP enables customers to recover data to any point in time. The recovery point objective (RPO) shrinks to mere seconds.

In addition, FalconStor CDP delivers instant data availability and reliable recovery, bringing business applications back online in a matter of minutes after a failure. Using a wealth of sophisticated technologies — including application integration, physical-to-virtual recovery, and WAN-optimized replication — entire systems can be restored in under ten minutes. Lost files can be recovered in as little as two minutes. Data is protected in its native format and is instantly accessible. With FalconStor CDP, the recovery time objective (RTO) changes from hours to minutes, minimizing system downtime and economic impact.

In addition, FalconStor CDP enables and automates serverless backup processes. FalconStor backup server integration tools offload backup processes from the server to the FalconStor CDP repository, freeing up the application host server and completely eliminating the backup window.

The FalconStor CDP Virtual Appliance is a pre-configured, ready-to-run software application packaged for quick, easy deployment in virtual environments. The solution reduces infrastructure cost and complexity while maximizing customers' return on investment. The FalconStor CDP Virtual Appliance provides all the benefits and features of FalconStor CDP to the remote and branch office to enable comprehensive and effective data protection and recovery solutions across the enterprise.

File-interface Deduplication System (FDS)

The FalconStor® File-interface Deduplication System (FDS) offering extends FalconStor's deduplication technology to service a broader set of applications that goes beyond tape backup applications. FalconStor FDS allows companies to optimize storage capacity services for disk-to-disk backup and archiving applications.

FalconStor FDS presents network-attached storage (NAS) interface accessibility to a block-level deduplication repository through common LAN-based file-access protocols such as CIFS and NFS. Its deployment simplicity easily extends the FalconStor data deduplication technology across multiple applications. FalconStor FDS delivers global deduplication and is enabled with a WAN-optimized replication option for cost-effective DR implementations. Its high availability feature provides a value in the market to organizations that depend on the data deduplication infrastructure to support their backup and DR environments.

FalconStor FDS is also offered as a Virtual Appliance, providing remote and branch offices as well as small enterprises with an economical data deduplication solution. The Virtual Appliance deployment model can eliminate tape-based backup processes at the remote office and the costs and risks associated with physical tape shipments.

HyperFS

The HyperFS® solution is an innovative file system that simplifies the management and access of multiple types of large files. The HyperFS file system meets the challenges of today's demanding applications by offering remarkable performance and scalability. It supports up to 144PB of storage and tens of billions of files in a single file system together with hundreds of clients in a single global name space. Storage capacity can be added rapidly and dynamically.

The HyperFS solution can be integrated with leading third-party hardware. This solution takes full advantage of an enterprise's existing storage resources and provides low-cost, high-performance, cross-platform technology that is easily scalable and highly available.

The HyperFS solution can also be implemented with FalconStor® Network Storage Server (NSS) gateway software. This configuration works with any FalconStor NSS certified gateway server hardware and storage array, and enables comprehensive data protection, storage virtualization, and thin provisioning. When deployed in this manner, the HyperFS solution leverages all of the SAN and data protection benefits and features of FalconStor NSS, including built-in snapshots, WAN-optimized replication, and data migration for maximum data availability.

Application-Aware Snapshot Agents

FalconStor Snapshot Agents automate and minimize quiescence time during data replication, backup, and other snapshot-based operations to ensure transactional integrity and point-in-time consistency of Windows, Unix, Linux, and VMware systems, databases applications and messaging stores for fast time-to-recovery. Snapshot Agents are available for IBM® DB2® UDB, Informix®, Microsoft® SQL Server, Oracle®, Prevasive.SQL®, Sybase®, IBM Lotus Notes®/Domino, Microsoft® Exchange Server, Microsoft® Hyper-V, Microsoft® VSS, Novell® Groupwise®, VMware, and many file systems.

Application Specific Recovery Options

FalconStor recovery agents offer recovery solutions for database and messaging systems. For instance, FalconStor Message Recovery for Microsoft Exchange and Message Recovery for Lotus Notes/Domino expedite mailbox/message recovery by enabling IT administrators to recover individual mailboxes quickly from point-in-time snapshot images of their messaging server. In addition, FalconStor Database Recovery for Microsoft SQL Server expedites database recovery by enabling IT administrators to recover a database quickly from point-in-time snapshot images of their Microsoft SQL database.

Disaster Recovery Automation

The RecoverTrac™ disaster recovery (DR) automation tool is included as a standard feature of the FalconStor NSS and the FalconStor CDP solutions to automate complex, time-consuming and error-prone failover and failback operations of systems, applications, services, and entire datacenters. The RecoverTrac tool streamlines the implementation, testing and execution of DR operations; and it minimizes service failover time between sites and reduces DR costs by offering full recovery from physical to virtual server infrastructures.

BUSINESS STRATEGY

FalconStor intends to maintain its position as the leading provider of open disk-based data protection and storage virtualization solutions serving enterprises and SMBs worldwide. FalconStor intends to achieve this objective through the following strategies.

Disk-Based Data Protection Leadership

FalconStor intends to continue to leverage the protocol-independent, unified architecture, and robust open data protection technology of its solution to maintain a leadership position in the enterprise and SMB disk-based data protection software markets. FalconStor plans to continue its leadership in this market through its deep commitment to research and development and through continued rapid technology innovation. For information on our research and development expenditures, please see "Management's Discussion and Analysis of Financial Condition and Results of Operations" and our audited consolidated financial statements.

Expand Product Offerings

In 2010, FalconStor continued to develop its product portfolio aggressively. In February, the Company announced enhancements to the FalconStor® File-Interface Deduplication System (FDS) to deliver enterprise-class functionality and high-performance. In addition, Nexsan became the first FalconStor technology partner to incorporate the enhancements into its storage offering in the Nexsan DeDupe SG 2.0 family of deduplication appliances. Most notable enhancements to the FalconStor FDS included support for the Symantec OpenStorage (OST) option delivering 5.4 terabytes per hour of backup data throughput and ingest rates of 1.5 gigabytes per second over two 10 Gigabit Ethernet links for double the performance. The FalconStor FDS solution was selected in March 2010 by Government Computer News (GCN) as the top storage product and the best of show overall at FOSE, held in Washington, D.C. The GCN Best of FOSE Awards are bestowed on technology products that demonstrate outstanding and innovative approaches to critical issues facing government users. Calling FalconStor FDS "a file deduplication system that could represent the next wave in storage," and "a significant step in streamlining storage," GCN elevated the product to best of show over the 14 other category winners and the nearly 100 products introduced at FOSE by more than 65 technology companies.

In March 2010, FalconStor and Violin Memory announced the first flash-memory-based storage system that simultaneously accelerates reads and writes for mission-critical applications as well as general SAN performance. The FalconStor® NSS SAN Accelerator doubles SAN performance, delivering high-speed access to stored data with minimal latency at a fraction of the cost of conventional solutions. The solution combines the FalconStor® Network Storage Server (NSS) Gateway, a Violin 1010 Flash Memory Appliance, and FalconStor's storage management software to create a virtual SAN out of new or existing storage resources while introducing a solid-state memory array as a caching platform for all application data requiring the fastest input/output (I/O). The integrated solution uses an economical amount of solid-state storage as a caching platform. Lab tests of the FalconStor NSS SAN Accelerator conducted by FalconStor show that a solid-state layer of 1 percent of a SAN's total storage capacity will increase overall SAN performance greater than 100 percent. The FalconStor NSS SAN Accelerator was later named a 2010 Product of the Year finalist by Storage Magazine and SearchStorage.com.

In April 2010, at the National Association of Broadcasters (NAB) conference, FalconStor introduced the HyperFS file system, a high-performance, massively scalable solution for data-intensive applications that generate very large numbers of files. The HyperFS solution is an innovative file system that simplifies the management of large files, providing high-speed, low-latency file access to heterogeneous clients across a global repository. The solution scales to 144PB of data with support for billions of large files, to meet the demands of customers in industries such as media and entertainment (M&E).

In August 2010, FalconStor announced a solution to enhance the performance and protection of VMware virtual desktop environments. The FalconStor® Network Storage Server (NSS) SAN Accelerator for VMware View™ is an SSD-enhanced storage solution that increases the performance of VMware virtual desktop environments while delivering integrated, multi-tier data protection. The solution performs backup and recovery for the entire virtual desktop environment and for each virtual desktop, as well as enables integrated self-service file recovery for individual virtual desktop users.

Expand Corporate Visibility

Throughout 2010, FalconStor took significant steps to increase our market presence and awareness. First, we increased our online presence in the form of banner ads on key media and industry community sites, as well as advertisements in search engines such as Google. In addition, we updated the look and feel of the corporate website, provided a more user-friendly navigation, created greater search-engine optimization with enriched content, and added additional resources, streaming media, and downloads. The site is now being hosted by a leading web hosting company to ensure 24/7 global availability to our customers and partners.

Second, through the release of new products, strategic relationships, and customer wins, we continued to increase our engagement with the press, analyst, and blogging communities to create awareness of and credibility for our data protection message. We have stepped up our participation in online social networking sites and social media outlets such as YouTube, LinkedIn, Flickr, and Twitter, as well as online conversations both with our own FalconStor expert bloggers and by monitoring and commenting on other blogs.

We have heavily reinforced our outreach with the press and analyst community to bring our comprehensive disk-based data protection message to the market. Our focus has turned significantly to highlighting our success with our customers and partners throughout the world, as well as the value our solutions bring to solving their data protection challenges. This broad effort has led to several awards and accolades:

- FalconStor FDS earns Best of Show at FOSE 2010, recognized as the "Next Wave in Storage;"
- Everything Channel awards FalconStor Software 2010 Five-Star Partner Program Guide Certification;
- FalconStor customer Earth Rangers, is selected by Storage Networking World as a winner in the Spring 2010 "Best Practices" Awards Program in the category of green computing, energy efficiency and the data center;
- FalconStor customer LionBridge, is selected by Storage Networking World as a finalist in the Spring 2010 "Best Practices" Awards Program in the category of Virtualization and Cloud Computing;
- FalconStor NSS SAN Accelerator earns recognition at the Long Island Software Awards (LISA) as a top software product;
- Business Solutions magazine's VAR subscribers select FalconStor Continuous Data Protector as a Best Channel Product in both the Backup and the Data Protection categories;
- FalconStor customer Victoria College, is selected by Storage Networking World as a finalist for its Fall 2010 "Best Practices" Awards Program in the Best Practices in Storage Resiliency, Data Protection and Recovery category;
 - TechTarget China awards FalconStor CDP a Best Backup & DR Product Award for 2010;
- The FalconStor NSS SAN Accelerator solution was named a 2010 Product of the Year finalist by Storage Magazine and SearchStorage.com.

We anticipate that this positive recognition will continue throughout 2011, as we continue to innovate and as we refine our message to address new market conditions while delivering targeted marketing campaigns.

In addition, we increased our investment in our partners for joint marketing and field engagement. We have also expanded our channel by partnering with new distributors and direct market resellers (DMR) to further penetrate the mid-range market and to extend our channel and customer reach.

Scalable Packaging

All FalconStor solutions support variable deployment options offering greater flexibility to seamlessly fit within our customers' environments and to respond to their exact needs and requirements. The scalability of our solutions can support the smallest environments such as remote and branch offices (ROBO) with prepackaged virtual appliances or small hardware appliances, as well as the largest deployments supporting multi-petabyte environments in large

datacenters.

The different packaging options include virtual appliances for small and remote offices, storage appliances for small to medium enterprises, and clustered gateway appliances and software appliance kits for large enterprise deployments.

Expand Technologies and Capabilities through Strategic Acquisitions and Alliances

FalconStor believes that opportunities may exist to expand our technological capabilities, product offerings, and services, whether through acquisition of businesses or software technology, or through strategic alliances. FalconStor will focus on opportunities that enable us to acquire or to license:

- Important enabling technology;
- Complementary applications;
- Marketing, sales, customers and technological synergies; and/or
- Key personnel.

Expand Software and Hardware Strategic Alliances with Industry Leaders

In June 2010, FalconStor entered into a Limited Procurement Agreement with Hitachi Data Systems to resell the FalconStor Virtual Tape Library (VTL) with deduplication and the FalconStor File-interface Deduplication System (FDS), both integrated with the Hitachi Adaptable Modular Storage 2000 family. This arrangement enabled the combination of industry-leading high-performance storage arrays with the world's number one VTL/deduplication system and a high-performance LAN-based deduplication system.

Also in June 2010, FalconStor Japan and Fujitsu Software Technologies (FST) entered into a partnership in which FST will resell FalconStor's backup and disaster recovery (DR) solutions in the Japanese market and provide consulting services, system deployment and post-sales support to customers. FalconStor's suite of data protection solutions complements FST's low-end backup software and high-end array-based mission-critical offerings with a set midrange solutions that complete FST's backup and DR product lineup. As a result, the partnership is designed to accelerate sales of FalconStor's data protection solutions in Japan.

FalconStor entered into a managed services and reseller agreement with HP Enterprise Services. Under the terms of the agreement, effective October 1, 2010, FalconStor Network Storage Server (NSS) software will be used to create new disaster recovery (DR) and business continuity offerings for HP Business Continuity & Recovery Services (BCRS) customers. This agreement enables HP Enterprise Services to add new heterogeneous replication services to the comprehensive offerings of HP BCRS as well as the full data protection capabilities of the FalconStor NSS solution.

Identify and Nurture New Growth Drivers

FalconStor has made key investments in several areas from which we expect growth in the coming years. We believe we are positioned to take advantage of the rapid storage growth in China and Japan. Our OEM relationships with Acer, Inspur Group, and others, new relationships with Hitachi Data Systems, Fujitsu, and HP, and the joint development/production agreement with The Chinese Academy of Science for enterprise-class storage, archiving and compliance solutions, should continue our growth in Asia.

According to a Gartner survey published in November 2010, 50% of respondents stated that the most significant driver for strategic change in the data center in 2011 will be the need for business continuity and availability. Cost containment initiatives ranked second with 37%, followed by the need to maintain or improve user service levels and satisfaction at 36%. In addition, 50% of respondents globally expect to expand the capacity of their existing data centers by the end of 2011, while 30% expect to build one or more new data centers, and 21% expect to consolidate some data centers down. Regarding cloud-based services, 41% of respondents worldwide plan to invest in cloud computing or cloud services by the end of 2011.

Industry analysts predict that technologies such as data deduplication, storage virtualization, and network bandwidth optimization are on the top of almost every IT project list for 2011. We believe that FalconStor will see a growing demand for its products and solutions, as a market leader of disk-based data protection solutions, and as a leading developer of technologies such as data deduplication, storage virtualization, and WAN-optimized replication.

As the server virtualization market continues to gain rapid adoption, we anticipate a growing need for integrated storage and server virtualization solutions for maximizing IT productivity and business continuity. This combination of solutions will improve data center resource management by increasing utilization of existing physical resources, while optimizing virtual infrastructure performance through real-time data migration, to deliver more cost-effective and reliable high-availability and disaster recovery. In 2010, we strengthened our relationships with vendors like VMware and Microsoft and we have developed more integration tools and solutions to support and enhance these environments. We expect that in 2011 these relationships and joint technology solutions will continue to grow and will put FalconStor in a strong position to service customers that are looking at deploying these solutions.

In a report published in August 2010 entitled “Best Practices for Addressing the Broken State of Backup,” Gartner confirms the widespread need in the IT industry to update traditional methods for backup and disaster recovery and to migrate to next-generation disk-based data protection technologies, which FalconStor solutions employ. FalconStor was positioned in the Visionaries quadrant of the Gartner “Magic Quadrant for Enterprise Disk-Based Backup/Recover,” published in January 2011, which recognized FalconStor for its process, quality, and customer focus in its mission to deliver service-oriented data protection with its disk-based backup and recovery solutions.

SALES, MARKETING AND CUSTOMER SERVICE

FalconStor plans to continue to sell our products primarily through original equipment manufacturers (OEMs), strategic alliances, value-added resellers (VARs) or solution providers, large system integrators, Direct Market Resellers (DMRs), and distributors.

OEM Relationships. OEMs collaborate with FalconStor to integrate FalconStor technology into their own product offerings or to resell FalconStor technology under their own label.

VAR, and Distributor Relationships. FalconStor has entered into VAR and distributor agreements to help sell our products in various geographic areas. We have revamped our sales and marketing infrastructure to further support and expand our network of VARs worldwide. FalconStor’s VARs and distributors market various FalconStor products and receive a discount off of the list price on products sold. FalconStor’s scalable solutions are also being deployed by Managed Service Providers (MSP) to deliver online data protection and recovery services across different vertical markets.

Strategic Alliances. FalconStor has agreements with strategic partners to adapt FalconStor products for use in the strategic partners’ special-purpose storage appliances.

In a limited number of circumstances, FalconStor has entered into software license agreements directly with end users.

FalconStor’s marketing efforts focus on building brand recognition among customers, partners, analysts, and the media, and developing qualified leads for the sales force.

FalconStor’s Professional Services personnel are also available to assist customers and partners throughout the lifecycle of FalconStor solution deployments. The Professional Services team includes experienced Storage Architects (expert field engineers) who can assist in the assessment, planning/design, deployment, and test phases of the deployment project, and a Technical Support Group for post-deployment assistance and ongoing support.

COMPETITION

As the demand for data protection and network-based storage products and services increases, more competitors will enter this high-growth market segment. Although there are several companies attempting to offer data protection for specific environments, FalconStor believes it is the only software-based solution provider capable of delivering a high level of data protection services across the data center, crossing the infrastructure boundaries between virtual and physical server environments. FalconStor holds multiple patents on key technologies that enable and optimize our data protection and data reduction platform. We believe that our integrated services and products based on our common storage virtualization platform – including NSS, VTL, CDP, FDS, and WAN-optimized replication for remote offices and data centers – are unique to the industry.

Although some of FalconStor’s products provide capabilities that put them in competition with products from a number of companies with substantially greater financial resources, FalconStor is not aware of any other software

company providing the same level of data protection and recovery speed and capabilities for both physical and virtual infrastructures. FalconStor believes that the principal competitive factors enhancing its marketability include product features such as scalability, data availability, ease of use, price, reliability, hardware/platform neutrality, and customer service and support.

As FalconStor continues its move into the non-enterprise market, the products and services offered by its partners may compete with existing or new products and services offered by current and new entrants to the market.

FalconStor's future and existing competitors could conceivably introduce products with superior features, scalability, and functionality at lower prices than FalconStor's products and could also bundle existing or new products with other more established products to compete with FalconStor products. Increased competition could result in price reductions and reduced gross margins, which could impact FalconStor's business. FalconStor's success will depend largely on its ability to generate market demand and awareness of its products and to develop additional or enhanced products in a timely manner. FalconStor's success will also depend on its ability to convince potential partners of the benefits of licensing its software rather than that of competing technologies.

INTELLECTUAL PROPERTY

FalconStor's success is dependent in part upon its proprietary technology. The IPStor platform forms the core of this proprietary technology. FalconStor currently has fourteen patents and numerous pending patent applications; and multiple registered trademarks – including “FalconStor Software” and “IPStor” – and pending trademark applications related to FalconStor and its products.

FalconStor seeks to protect its proprietary rights and other intellectual property through a combination of copyright, patents, trademark and trade secret protection, as well as through contractual protections such as proprietary information agreements and nondisclosure agreements. The technological and creative skills of its personnel, new product developments, frequent product enhancements and reliable product maintenance are essential to establishing and maintaining a technology leader position.

FalconStor generally enters into confidentiality or license agreements with employees, consultants, and corporate partners, and generally controls access to and distribution of its software, documentation, and other proprietary information. Despite FalconStor's efforts to protect its proprietary rights, unauthorized parties may attempt to copy or otherwise obtain and use its products or technology. Monitoring unauthorized use of its products is difficult, and there can be no assurance that the steps FalconStor has taken will prevent misappropriation of its technology, particularly in foreign countries where laws may not protect its proprietary rights as fully as do the laws of the United States.

MAJOR CUSTOMERS

For the year ended December 31, 2010, we had one customer, EMC Corporation, which accounted for 10% of our total revenues. For the year ended December 31, 2009, we had two customers, EMC Corporation, and Oracle USA (formerly Sun Microsystems), which accounted for 14% and 12%, respectively, of our total revenues. For the year ended December 31, 2008, EMC Corporation and Oracle USA, accounted for 20% and 13%, respectively, of our total revenues. As of December 31, 2010, Hitachi Data Systems accounts receivable balance was 13% of our gross accounts receivable balance. As of December 31, 2009, there were no customers that accounted for more than 10% of our gross accounts receivable balance.

EMPLOYEES

As of December 31, 2010, we had 501 full-time and part-time employees, consisting of 215 in research and development, 154 in sales and marketing, 98 in service, and 34 in general administration. We are not subject to any collective bargaining agreements and believe our employee relations are good.

INTERNET ADDRESS AND AVAILABILITY OF FILINGS

Our internet address is www.falconstor.com. The Company makes available free of charge, on or through its Internet website, the Company's Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, current Reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Sections 13(a) or (15)(d) of the Securities Exchange Act of 1934, as amended, as soon as reasonably practicable after the Company electronically files such material with, or furnishes it to, the Securities and Exchange Commission. The Company complied with this policy for every Securities Exchange Act of 1934, as amended, report filed during the year ended December 31, 2010.

Item 1A. Risk Factors

We are affected by risks specific to us as well as factors that affect all businesses operating in a global market. The significant factors known to us that could materially adversely affect our business, financial condition, or operating results are set forth below.

We are currently undergoing investigations by the United States Attorney's Office and by the Securities and Exchange Commission. We cannot predict the scope, timing or the outcomes of these investigations.

On September 29, 2010, the Company announced that it had accepted the resignation of ReiJane Huai, its President and Chief Executive Officer, and the Chairman of its Board of Directors, following his disclosure to the Company that certain improper payments allegedly were made in connection with the Company's licensing of software to one customer. At the same time, the Company announced that it was cooperating fully with law enforcement authorities with respect to an ongoing investigation into the matter, that it had formed a Special Committee of the Board to conduct a full internal investigation, and that the Special Committee had retained counsel to assist it in its investigation. In addition, the counsel to the Special Committee retained independent forensic accountants to review the Company's practices. On November 10, 2010, counsel retained to assist with the internal investigation presented its report to the Special Committee.

Initially, the New York County District Attorney's Office commenced an investigation but thereafter, for reasons unknown to the Company, ceased its investigation. Separately, the U.S. Attorney's Office for the Eastern District of New York ("USAO") and the U.S. Securities and Exchange Commission ("SEC") each commenced investigations.

In October 2010, in connection with the USAO investigation, the Company received a grand jury subpoena seeking all documents relating to the Company's September 29, 2010, disclosure of the improper payments. Since that time, the Company has received additional subpoenas and document requests from the USAO seeking, among other things, documents relating to certain of the Company's employees and other information about the Company.

Also in October 2010, the Company received a subpoena from the SEC seeking, among other things, documentation relating to the Company's dealings with the customer in connection with whose licensing of software improper payments were made and documentation relating to certain of the Company's accounting practices. Since that time, the Company has received additional subpoenas seeking among other things, information related to certain of the Company's employees, customers, policies and practices.

We are cooperating fully with the investigations of both the USAO and the SEC and have produced documents responsive to both subpoenas and the additional document request. We intend to produce more documentation, if and when requested by the USAO and the SEC and to continue to cooperate fully with both investigations.

We cannot predict the scope, timing, or outcomes of the USAO and SEC investigations, which may include the institution of administrative, civil injunctive, or criminal proceedings, the imposition of fines and penalties, which may be significant, suspensions or debarments from government contracts, and other remedies and sanctions, any of which could lead to an adverse impact on our credit ratings and ability to obtain financing, an adverse impact on our stock price, loss of additional senior management, the inability to attract or retain key employees, and the loss of customers. In addition, under the law, any illegal acts of our employees may be ascribed to us. We cannot predict what impact, if any, these matters may have on our business, financial condition, results of operations, and liquidity.

While these investigations are ongoing, we are spending substantial resources, both monetary and in human capital, dealing with and responding to the requests of the USAO and the SEC.

We are among the defendants in two purported class action lawsuits by stockholders. We cannot predict the timing or the outcome of these actions, or whether we have adequate insurance to cover our costs and any damages.

In October 2010, two purported securities class actions (the “Actions”) were filed in the United States District Court for the Eastern District of New York on behalf of purchasers of the common stock of the Company between February 5, 2009 and September 29, 2010. The two Actions contain substantially similar allegations and causes of actions. The complaint in each of the Actions name as defendants the Company and Mr. Huai, as well as Wayne Lam an officer of the Company and James Weber the Company’s Chief Financial Officer and interim Chief Operating Officer. The complaints in each of the actions allege that the defendants made a series of materially false and misleading statements related to the Company’s business and operations in violation of the Securities Exchange Act of 1934, as amended. The following adverse facts are alleged: (i) that FalconStor was experiencing weak demand for its products and services; (ii) that FalconStor was making improper payments to secure a contract with at least one of its customers; and (iii) as a result of the foregoing, the defendants lacked a reasonable basis for their positive statements about FalconStor and its prospects. The plaintiffs in each Action seek damages from the defendants. On November 1, 2010, the parties to one of the two Actions entered into a stipulation setting forth a schedule for an amended complaint and an answer or other response thereto. On November 3, 2010, the Actions were consolidated before Judge Edward R. Korman, and the Company anticipates that it will be receiving an amended complaint (the combined Actions are referred to as the “Class Action”).

Certain of the defendants may be entitled to indemnification by the Company under the laws of Delaware and/or our by-laws.

We cannot predict when the Class Action will be resolved or its outcome. While we have insurance policies that we believe cover us for the allegations of the Class Action, there can be no assurance that the amount of insurance will be adequate to cover the costs of our defense of the Class Action or any damages that might be awarded against us or any defendant(s) to whom we owe indemnification. Our insurers may deny coverage under the policies. If the plaintiffs are awarded damages and our insurance is not adequate to cover the amounts, or our insurers deny coverage, the amounts to be paid by the Company could have a significant negative impact on our financial results, our cash flow and our cash reserves.

We are among the defendants in a putative derivative action lawsuit. We cannot predict the timing or the outcome of this action, or whether we have adequate insurance to cover our costs and any damages.

In January 2011, a Company shareholder filed an action in the Suffolk County Division of the Supreme Court of the State of New York, putatively derivatively on behalf of the Company against the Company, each of the Company’s Directors, and Messrs. Huai, Lam and Weber (the “Derivative Action”). The Derivative Action alleges that the defendants breached their duties to the Company by: (1) causing or allowing the dissemination of false and misleading information; (2) failing to maintain internal controls; (3) failing to manage the Company properly; (4) unjustly enriching themselves; (5) abusing their control of the Company; and (6) wasting Company assets. The Derivative Action alleges that Messrs. Oxenhorn, Fischer, Kaufman, Lieber and Rubenstein breached their duties to the Company by allowing Mr. Huai to resign.

Certain of the defendants may be entitled to indemnification by the Company under the laws of Delaware and/or our by-laws.

We cannot predict when the Derivative Action will be resolved or its outcome. While we have insurance policies that we believe cover us for the allegations of the Derivative Action, there can be no assurance that the amount of insurance will be adequate to cover the costs of our defense of the Derivative Action or any damages that might be awarded against us or any defendant(s) to whom we owe indemnification. Our insurers may deny coverage under the

policies. If the plaintiffs are awarded damages and our insurance is not adequate to cover the amounts, or our insurers deny coverage, the amounts to be paid by the Company could have a significant negative impact on our financial results, our cash flow and our cash reserves.

Our announcement of improper payments, and the existence of the governmental investigations and the stockholder suits, could damage our reputation and harm our ability to compete for customers.

The market for network storage solutions is highly competitive. Our announcement of improper payments, and the existence of the governmental investigations and the stockholder suits could damage our reputation and harm our ability to compete for customers. We are aware that some of our competitors are already using these facts in attempts to dissuade potential customers from doing business with us. If potential customers choose not to buy our products or services, or not to license our software, it will have a negative impact on our business.

ReiJane Huai, the former CEO and President, and the former Chairman of our Board of Directors, resigned and there have been other changes in our senior management.

On September 29, 2010, ReiJane Huai, our CEO and President, and the Chairman of our Board of Directors resigned from each of those positions in connection with improper payments made to a customer. Mr. Huai had broad experience and was highly regarded in the network storage solutions industry. Jim McNiel, who had been our Chief Strategy Officer, replaced Mr. Huai on an interim basis. On January 11, 2011, Mr. McNiel was appointed CEO and President. While Mr. McNiel has been a successful software industry executive, and has a broad range of experience in other areas, there can be no guarantee that Mr. McNiel will be able to lead and to grow the Company effectively.

Wai Lam, our Chief Technology Officer resigned effective November 5, 2010. Mr. Lam was involved in the development of nearly all of our software products. While Mr. Lam remains a consultant to us for two years, he no longer remains involved on a day-to-day basis. We have replaced Mr. Lam with another highly skilled engineer, but there can be no guarantee that our product development will continue at the same pace or quality.

On January 12, 2011, we announced the appointment of John Turner as our Vice President for North American Sales. Mr. Turner replaced Mr. McNiel, who had been acting in the role since Wendy Petty, the former head of sales for North America, took a leave of absence at the end of October, 2010. Ms. Petty subsequently resigned from all roles with the Company. While Mr. Turner is a respected sales veteran in the software industry, the United States is our largest market and there is no guarantee the Mr. Turner will be able to recruit and manage an effective sales force.

Our revenues from certain key customers have been declining and there is no guarantee that we will be able to replace it.

Since 2004, revenue from EMC has accounted for 10% or more of our annual revenue. However, over the past two years, the amount of revenue we have received from EMC, on both absolute and percentage bases, has steadily declined. Although EMC provided 10% or more of our revenue in 2010, and while we believe that we will continue to receive revenue from EMC, we do not believe that EMC will provide 10% or more of our revenues in 2011 or beyond.

Revenue from Oracle USA (formerly Sun Microsystems), which for the past few years provided 10% or more of our annual revenue, has also declined and was not 10% or more of our revenue for 2010. While our contract with Sun has not been terminated by Oracle USA, we currently have no expectation of continued meaningful revenues from Oracle USA.

We are attempting to replace the revenue we formerly received from EMC and Oracle USA with revenue from other partners and from our FalconStor-branded solutions, but there is no guarantee that we will be successful in these attempts.

Our increased emphasis on sales of turn-key appliances may not be successful and exposes us to supply, inventory and support risks.

We have begun to emphasize sales of turn-key appliances. These appliances consist of our branded software loaded onto industry standard hardware. In some instances, the hardware, while purchased from third parties, is FalconStor branded. There can be no guarantee that we will be more successful selling these appliances than we have been selling software-only solutions.

In addition, the increased emphasis on appliances creates the following additional risks:

- **Supply.** We are dependent on third parties for the supply of the hardware. If we cannot obtain adequate supplies of the hardware, we could lose sales and revenues. If our hardware suppliers discontinue certain models, our sales could be disrupted while we find and certify replacement models. If customer orders exceed our expectations, we may not be able to deliver all of the appliances to meet those orders in a particular quarter.
- **Inventory.** In order to mitigate supply issues, we maintain an inventory of appliances. We spend money on this inventory in advance of customer orders. This is money that could have been used for other purposes or that could have been invested. If the inventory is inadequate, we may lose sales or not be able to fulfill orders in a particular quarter. If the inventory is excessive, we could end up with obsolete hardware for which we have paid and for which we are unable to find buyers, leaving us with a loss.
- **Support.** While our suppliers are responsible for providing us with support for their hardware, our customers look to us for support of the entire appliance. We are responsible for coordinating all support for the appliance, whether the problem relates to the software or to the hardware. This increases the burden on our support group and may require us to hire additional support personnel.

Our margins have been and will continue to be impacted by our emphasis on FalconStor branded appliances and the decrease in our OEM sales.

The shift in emphasis from sales of software licenses to sales of turn-key appliances has hurt our profit margins.

Once software is developed, the cost of licensing each individual copy of the software is lower than the cost of selling an appliance. In addition to the costs associated with licensing software, with sales of turn-key appliances we incur the cost of the hardware itself. Margins on hardware sales are typically quite small, so the overall margin on the sale of an appliance is lower than the sale of a license to stand-alone software.

Software license sales to OEMs typically have the highest margins, because no salespeople are compensated, support costs are typically lower, and marketing expenses are minimal. Sales of FalconStor-branded appliances and software require us to compensate salespeople, to provide customer support and to market the products, all of which reduce our profit margins.

We had losses for fiscal years 2010 and 2009 and we cannot guarantee that we will return to profitability.

We have operated at a loss for each of the past two years. We are, and have been, attempting to increase revenues and to decrease costs, but there can be no guarantee that we will be profitable again. If our losses continue, we will deplete our available cash and we may not be able to continue to fund effective sales and marketing or the research and development activities on which we are dependent.

Due to the uncertain and shifting development of the data protection and network storage software markets and our reliance on our partners, we may have difficulty accurately predicting revenue for future periods and appropriately budgeting for expenses.

The rapidly evolving nature of the data protection and network storage software markets in which we sell our products, the degrees of effort and success of our partners' sales and marketing efforts, and other factors that are beyond our control, reduce our ability to accurately forecast our quarterly and annual revenue. However, we must use our forecasted revenue to establish our expense budget. Most of our expenses are fixed in the short term or incurred in advance of anticipated revenue. As a result, we may not be able to decrease our expenses in a timely manner to offset

any shortfall in revenue.

The markets for many of our products are still maturing, and our business will suffer if they do not continue to develop as we expect.

The continued adoption of Storage Area Networks (IP/iSCSI-, Fibre Channel-, and InfiniBand-based)) and Network Attached Storage solutions, disk-based backup and disaster recovery solutions, storage virtualization solutions, deduplication solutions, and virtual environments is critical to our future success. The markets for these solutions are still maturing, making it difficult to predict their potential sizes or future growth rates. If these markets develop more slowly than we expect, our business, financial condition and results of operations would be adversely affected.

We may not be able to penetrate the small/medium business markets.

We offer products for the small/medium business (SMB) market. Our products may not be attractive to the SMB market, or we may not be able to reach agreements with OEMs and resellers with significant presences in the SMB market. If we are unable to penetrate the SMB market, we will not be able to recoup the expenses associated with our efforts in these markets and our ability to grow revenues could suffer.

If we are unable to develop and manufacture new products that achieve acceptance in the data protection and the network storage software markets, our operating results may suffer.

The data protection and the network storage software markets continue to evolve and as a result there is continuing demand for new products. Accordingly, we may need to develop and manufacture new products that address additional data protection or network storage software market segments and emerging technologies to remain competitive in the data storage software industry. We are uncertain whether we will successfully qualify new data protection or network storage software products with our customers by meeting customer performance and quality specifications. Any failure to address additional market segments could harm our business, financial condition and operating results.

Our products must conform to industry standards in order to be accepted by customers in our markets.

Our current products are only one part of a storage system. All components of these systems must comply with the same industry standards in order to operate together efficiently. We depend on companies that provide other components of these systems to conform to industry standards. Some industry standards may not be widely adopted or implemented uniformly, and competing standards may emerge that may be preferred by OEM customers or end users. If other providers of components do not support the same industry standards as we do, or if competing standards emerge, our products may not achieve market acceptance, which would adversely affect our business.

Our products may have errors or defects that could result in reduced demand for our products or costly litigation.

Our IPStor platform, the basic building block of all of our solutions, is complex and is designed to be deployed in large and complex networks. Many of our customers have unique infrastructures, which may require additional professional services in order for our software to work within their infrastructures. Because our products are critical to the networks of our customers, any significant interruption in their service as a result of defects in our product could result in damage to our customers. These problems could cause us to incur significant service and engineering costs, divert engineering personnel from product development efforts and significantly impair our ability to maintain existing customer relationships and attract new customers. In addition, a product liability claim, whether successful or not, would likely be time consuming and expensive to resolve and would divert management time and attention. Further, if we are unable to fix the errors or other problems that may be identified in full deployment, we would likely experience loss of or delay in revenues and loss of market share and our business and prospects would suffer.

Our other products may also contain errors or defects. If we are unable to fix the errors or other problems that may be discovered, we would likely experience loss of or delay in revenues and loss of market share and our business and prospects would suffer.

Failure of storage appliances to integrate smoothly with end user systems could impact demand for the appliances.

We offer our software on a stand-alone basis and as part of an appliance in which we install our software onto third party hardware. In addition, we have entered into agreements with resellers and OEM partners to develop storage appliances that combine VTL, CDP, NSS or FDS functionality with third party hardware to create single purpose

turnkey solutions that are designed to be easy to deploy. If the storage appliances are not easy to deploy or do not integrate smoothly with end user systems, the basic premise behind the appliances will not be met and sales would suffer.

Issues with the hardware on which our software products are installed could increase our support costs and result in lower sales of our products.

We deliver some of our products, both through our resellers and directly to end-users, installed on third party hardware. If the hardware does not function properly, our support costs will go up. We will have to arrange or pay for the repair or replacement of the broken hardware and we may have to increase the size of our support operations. Hardware reliability issues could also cause resellers and end-users to refuse to make purchases from us, even if our software products function properly.

Our OEM customers require our products to undergo a lengthy and expensive qualification process that does not assure product sales.

Prior to offering our products for sale, our OEM customers typically require that each of our products undergo an extensive qualification process, which involves interoperability testing of our product in the OEM's system as well as rigorous reliability testing. This qualification of a product by an OEM does not assure any sales of the product to the OEM. Despite this uncertainty, we devote substantial resources, including engineering, sales, marketing and management efforts, toward qualifying our products with OEMs in anticipation of sales to them. If we are unsuccessful or delayed in qualifying any products with an OEM, such failure or delay would preclude or delay sales of that product to the OEM, which may impede our ability to grow our business.

We rely on our resellers and our OEM customers for most of our sales.

The vast majority of our sales come from sales to end users of our products by our resellers and by our OEM customers. These resellers and OEM customers have limited resources and sales forces and sell many different products, both in the data protection and the network storage software markets and in other markets. The resellers and OEM customers may choose to focus their sales efforts on other products in the data protection and the network storage software markets or other markets. The OEM customers might also choose not to continue to develop or to market products which include our products. This would likely result in lower revenues to us and would impede our ability to grow our business.

Our OEM customers are not obligated to continue to sell our products.

We have no control over the shipping dates or volumes of systems incorporation of our product that our OEM customers ship and they have no obligation to ship systems incorporating our software applications. Our OEM customers also have no obligation to recommend or offer our software applications exclusively or at all, and they have no minimum sales requirements. These OEMs also could choose to develop their own data protection and network storage software internally, or to license software from our competitors, and incorporate those products into their systems instead of our software applications. The OEMs that we do business with also compete with one another. If one of our OEMs views our arrangement with another OEM as competing with its products, it may decide to stop doing business with us. Any material decrease in the volume of sales generated by OEMs with whom we do business, as a result of these factors or otherwise, would have a material adverse effect on our revenues and results of operations in future periods.

The failure of our resellers to sell our products effectively could have a material adverse effect on our revenues and results of operations.

We rely significantly on our value-added resellers, direct market resellers, systems integrators and corporate resellers, which we collectively refer to as resellers, for the marketing and distribution of our software products and our services. However, our agreements with resellers are generally not exclusive, are generally renewable annually and in

many cases may be terminated by either party without cause. Many of our resellers carry products that are competitive with ours. These resellers may give a higher priority to other products, including those of our competitors, or may not continue to carry our products at all. If a number of resellers were to discontinue or reduce the sales of our products, or were to promote our competitors' products in lieu of ours, it would have a material adverse effect on our future revenues. Events or occurrences of this nature could seriously harm our sales and results of operations. In addition, we expect that a significant portion of our sales growth will depend upon our ability to identify and attract new reseller partners. The use of resellers is an integral part of our distribution network. We believe that our competitors also use reseller arrangements. Our competitors may be more successful in attracting reseller partners and could enter into exclusive relationships with resellers that make it difficult to expand our reseller network. Any failure on our part to expand our network of resellers could impair our ability to grow revenues in the future.

A significant portion of our receivables is concentrated with one customer.

As of December 31, 2010, Hitachi Data Systems accounts receivable balance was 13% of our gross accounts receivable balance. We currently have no reason to expect that Hitachi Data Systems will fail to pay the amounts invoiced, but the concentration of this receivable means that any failure by Hitachi Data Systems to pay us would have a material impact on us.

We must maintain our existing relationships and develop new relationships with strategic industry partners.

Part of our strategy is to partner with major third-party software and hardware vendors who integrate our products into their offerings and/or market our products to others. These strategic partners often have customer or distribution networks to which we otherwise would not have access or the development of which would take up large amounts of our time and other resources. There is intense competition to establish relationships with these strategic partners. Some of our agreements with our OEM customers grant to the OEMs limited exclusivity rights to portions of our products for periods of time. This could result in lost sales opportunities for us with other customers or could cause other potential OEM partners to consider or select software from our competitors for their storage solutions. In addition, the desire for product differentiation could cause potential OEM partners to select software from our competitors. We cannot guarantee that our current strategic partners, or those companies with whom we may partner in the future, will continue to be our partners for any period of time. If our software was to be replaced in an OEM solution by competing software, or if our software is not selected by OEMs for future solutions, it would likely result in lower revenues to us and would impede our ability to grow our business.

We rely on channel partners to sell our solutions, and disruptions to, or our failure to develop and manage our channel partners would harm our business.

Our future success is partially dependent upon establishing and maintaining successful relationships with the right channel partners. A majority of our revenue is generated by sales through our channel partners, and we expect channel sales to continue to make up the majority of our total revenue in the future. Accordingly, our revenues are largely dependent on the effective sales and lead generation activities of these channel partners.

Recruiting and retaining qualified channel partners and training them in our technology and product offerings requires significant time and resources. In order to develop and expand our distribution channel, we must continue to scale and improve our processes and procedures that support our channel, including investment in systems and training. Those processes and procedures may become increasingly complex and difficult to manage as we grow our organization. We have no minimum purchase commitments from any of our channel partners, and our contracts with these channel partners do not prohibit them from offering products or services that compete with ours. Our competitors may provide incentives to existing and potential channel partners to favor their products or to prevent or reduce sales of our solutions. Our channel partners may choose not to offer our solutions exclusively or at all. Establishing relationships with channel partners who have a history of selling our competitors' products may also prove to be difficult. In addition, some of our channel partners are also competitors. Our failure to establish and maintain successful relationships with channel partners would harm our business and operating results.

Consolidation in the data protection or the network storage industries could hurt our strategic relationships.

In the past, companies with whom we have OEM relationships have been acquired by other companies. In 2009, Oracle announced it was acquiring Sun and Hewlett Packard announced it was acquiring 3Com, the parent of our Chinese OEM. These acquisitions caused disruptions in the sales and marketing of our products and have negatively impacted our revenues. If additional key customers are acquired, the acquiring entity might choose to stop offering solutions containing our software. Even if the solutions continued to be offered, there might be a loss of focus and

sales momentum as the companies are integrated.

The data protection and network storage software markets are highly competitive and intense competition could negatively impact our business.

The data protection and network storage software markets are intensely competitive even during periods when demand is stable. Some of our current and potential competitors have longer operating histories, significantly greater resources, broader name recognition and a larger installed base of customers than we have. Those competitors and other potential competitors may be able to establish or to expand network storage software offerings more quickly, adapt to new technologies and customer requirements faster, and take advantage of acquisition and other opportunities more readily.

Our competitors also may:

- consolidate or establish strategic relationships among themselves to lower their product costs or to otherwise compete more effectively against us; or
- bundle their products with other products to increase demand for their products.

In addition, some OEMs with whom we do business, or hope to do business, may enter the market directly and rapidly capture market share. If we fail to compete successfully against current or future competitors, our business, financial condition and operating results may suffer.

Our ability to sell our products is highly dependent on the quality of our services offerings, and our failure to offer high quality support and professional services would have a material adverse affect on our sales of our products and results of operations.

Our services include the assessment and design of solutions to meet our customers' data protection and storage management requirements and the efficient installation and deployment of our products based on specified business objectives. Further, once our products are deployed, our customers depend on us to resolve issues relating to our products. A high level of service is critical for the successful marketing and sale of our software. If our partners or we do not effectively install or deploy our applications, or succeed in helping our customers quickly resolve post-deployment issues, it would adversely affect our ability to sell software products to existing customers and could harm our reputation with potential customers. As a result, our failure to maintain high quality support and professional services would have a material adverse effect on our sales of our products and results of operations.

Failure to achieve anticipated growth could harm our business and operating results.

Achieving our anticipated growth will depend on a number of factors, some of which include:

- retention of key management, marketing and technical personnel;
- our ability to increase our customer base and to increase the sales of our products; and
- competitive conditions in the network storage infrastructure software market.

We cannot assure you that the anticipated growth will be achieved. The failure to achieve anticipated growth could harm our business, financial condition and operating results.

Our revenues depend in part on spending by corporate customers.

The operating results of our business depend in part on the overall demand for data protection and network storage software. Because the market for our software is primarily major corporate customers, any softness in demand for data protection or network storage software may result in decreased revenues.

Our future quarterly results may fluctuate significantly, which could cause our stock price to decline.

Our previous results are not necessarily indicative of our future performance and our future quarterly results may fluctuate significantly.

Historically, information technology spending has been higher in the fourth and second quarters of each calendar year and somewhat slower in the other quarters, particularly the first quarter. Our quarterly results reflected this seasonality in 2010, and we anticipate that our quarterly results for 2011 will show the effects of seasonality as well.

Our future performance will depend on many factors, including:

- developments arising from the investigations by the United States Attorney's Office and the Securities and Exchange Commission, the two purported class action law suits and the derivative action lawsuit;
- fluctuations in the economy;
- the timing of securing software license contracts and the delivery of software and related revenue recognition;
- the seasonality of information technology, including network storage products, spending;
- the average unit selling price of our products;
- existing or new competitors introducing better products at competitive prices before we do;
- our ability to manage successfully the complex and difficult process of qualifying our products with our customers;
- new products or enhancements from us or our competitors;
- import or export restrictions on our proprietary technology; and
- personnel changes.

Many of our expenses are relatively fixed and difficult to reduce or modify. As a result, the fixed nature of our expenses will magnify any adverse effect of a decrease in revenue on our operating results.

Our stock price may be volatile.

The market price of our common stock has been volatile in the past and may be volatile in the future. For example, during the past twelve months ended December 31, 2010, the closing market price of our common stock as quoted on the NASDAQ Global Market fluctuated between \$2.39 and \$4.65 per share, and subsequent to December 31, 2010, the closing price has been as high as \$4.91 per share. The market price of our common stock may be significantly affected by the following factors:

- actual or anticipated fluctuations in our operating results;
- failure to meet financial estimates;
- changes in market valuations of other technology companies, particularly those in the network storage software market;
- announcements by us or our competitors of significant technical innovations, acquisitions, strategic partnerships, joint ventures or capital commitments;
- loss of one or more key OEM customers; and

- departures of key personnel.

The stock market has experienced extreme volatility that often has been unrelated to the performance of particular companies. These market fluctuations may cause our stock price to fall regardless of our performance.

Our ability to forecast earnings is limited by the impact of certain accounting requirements.

The Financial Accounting Standards Board requires companies to recognize the fair value of stock options and other share-based payment compensation to employees as compensation expense in the statement of operations. However, this expense, which we estimate based on the “Black-Scholes” model, is subject to factors beyond our control. These factors include the market price of our stock on a particular day and stock price “volatility.” These unknowns make it difficult for us to forecast accurately what the amount of share-based compensation expense will be in the future. Because of these factors, our ability to make accurate forecasts of future earnings is compromised.

Our marketable securities portfolio could experience a decline in market value which could materially and adversely affect our financial results.

As of December 31, 2010, we held short-term and long-term marketable securities aggregating \$19.5 million. We invest in a mixture of corporate bonds, government securities and marketable debt securities, the majority of which are high investment grade, and we limit the amount of credit exposure through diversification and investment in highly rated securities. However, investing in highly rated securities does not entirely mitigate the risk of potential declines in market value. A further deterioration in the economy, including further tightening of credit markets or significant volatility in interest rates, could cause our marketable securities to decline in value or could impact the liquidity of the portfolio. If market conditions deteriorate significantly, our results of operations or financial condition could be materially and adversely affected.

The ability to predict our future effective tax rates could impact our ability to accurately forecast future earnings.

We are subject to income taxes in both the United States and the various foreign jurisdictions in which we operate. Judgment is required in determining our provision for income taxes and there are many transactions and calculations where the tax determination may be uncertain. Our future effective tax rates could be affected by changes in our (i) earnings or losses; (ii) changes in the valuation of our deferred tax assets; (iii) changes in tax laws; and (iv) other factors. Our ability to correctly predict our future effective tax rates based upon these possible changes could significantly impact our forecasted earnings.

The likelihood of a change of control in our company could be impacted by the fact that we have a significant amount of authorized but unissued preferred stock, a staggered Board of Directors, change of control agreements with certain executives as well as certain provisions under Delaware law.

Our Board of Directors has the authority, without further action by the stockholders, to issue up to 2,000,000 shares of preferred stock on such terms and with such rights, preferences and designations, including, without limitation restricting dividends on our common stock, dilution of the voting power of our common stock and impairing the liquidation rights of the holders of our common stock, as the Board may determine without any vote of the stockholders. Issuance of such preferred stock, depending upon the rights, preferences and designations thereof may have the effect of delaying, deterring or preventing a change in control. In addition, certain “anti-takeover” provisions of the Delaware General Corporation Law, among other things, may restrict the ability of our stockholders to authorize a merger, business combination or change of control. Further, we have a staggered Board of Directors and have entered into change of control agreements with certain executives, which may also have the effect of delaying, deterring or preventing a change in control.

We have a significant number of outstanding options, the exercise of which would dilute the then-existing stockholders’ percentage ownership of our common stock, and a smaller number of restricted shares of stock, the vesting of which will also dilute the then-existing stockholders’ percentage ownership of our common stock.

As of December 31, 2010, we had options to purchase 12,192,884 shares of our common stock outstanding, and we had an aggregate of 839,422 outstanding restricted shares and restricted stock units. If all of these outstanding options were exercised, and all of the outstanding restricted stock and restricted stock units vested, the proceeds to the Company would average \$5.22 per share. We also had 2,232,882 shares of our common stock reserved for issuance under our stock plans with respect to options (or restricted stock or restricted stock units) that have not been granted. Subsequent to December 31, 2010, we issued 1,520,000 stock options, of which 1,220,000 are subject to shareholder approval, and 90,000 shares of restricted stock to James P. McNiel, President and Chief Executive Officer. In addition, if, on July 1st of any calendar year in which our 2006 Incentive Stock Plan, as amended (the "2006 Plan"), is in effect, the number of shares of stock to which options, restricted shares and restricted stock units may be granted is less than five percent (5%) of the number of outstanding shares of stock, then the number of shares of stock available for issuance under the 2006 Plan shall be increased so that the number equals five percent (5%) of the shares of stock outstanding. In no event shall the number of shares of stock subject to the 2006 Plan in the aggregate exceed twenty million shares, subject to adjustment as provided in the 2006 Plan. See Note (8) Share-Based Payment Arrangements to our consolidated financial statements.

The exercise of all of the outstanding options and/or the vesting of all outstanding restricted shares and restricted stock units and/or the grant and exercise of additional options and/or the grant and vesting of restricted stock and restricted stock units would dilute the then-existing stockholders' percentage ownership of common stock, and any sales in the public market of the common stock issuable upon such exercise could adversely affect prevailing market prices for the common stock. Moreover, the terms upon which we would be able to obtain additional equity capital could be adversely affected because the holders of such securities can be expected to exercise or convert them at a time when we would, in all likelihood, be able to obtain any needed capital on terms more favorable than those provided by such securities.

Our business could be materially affected as a result of a natural disaster, terrorist acts, or other catastrophic events.

While our headquarters facilities contain redundant power supplies and generators, our domestic and foreign operations, and the operations of our industry partners, remain susceptible to fire, floods, power loss, power shortages, telecommunications failures, break-ins and similar events.

Terrorist actions domestically or abroad could lead to business disruptions or to cancellations of customer orders or a general decrease in corporate spending on information technology, or could have direct impact on our marketing, administrative or financial functions and our financial condition could suffer.

We are dependent on a variety of IT and telecommunications systems, and any failure of these systems could adversely impact our business and operating results.

We depend on IT and telecommunications systems for our operations. These systems support a variety of functions including order processing, shipping, shipment tracking, billing, support center and internal information exchange.

Failures or significant downtime of our IT or telecommunications systems could prevent us from taking customer orders, shipping products, billing customers, handling support calls, or communication among our offices. The Internet and individual websites have experienced a number of disruptions and slowdowns, some of which were caused by organized attacks. In addition, some websites have experienced security breakdowns. If we were to experience a security breakdown, disruption or breach that compromised sensitive information, it could harm our relationship with our customers. Our support centers are dependent upon telephone and data services provided by third party telecommunications service vendors and our IT and telecommunications system. Any significant increase in our IT and telecommunications costs or temporary or permanent loss of our IT or telecommunications systems could harm our relationships with our customers. The occurrence of any of these events could have an adverse effect on our operations and financial results.

United States Government export restrictions could impede our ability to sell our software to certain end users.

Certain of our products include the ability for the end user to encrypt data. The United States, through the Bureau of Industry Security, places restrictions on the export of certain encryption technology. These restrictions may include: the requirement to have a license to export the technology; the requirement to have software licenses approved before export is allowed; and outright bans on the licensing of certain encryption technology to particular end users or to all end users in a particular country. Certain of our products are subject to various levels of export restrictions. These export restrictions could negatively impact our business.

The international nature of our business could have an adverse affect on our operating results.

We sell our products worldwide. Accordingly, our operating results could be materially adversely affected by various factors including regulatory, political, or economic conditions in a specific country or region, trade protection measures and other regulatory requirements, and acts of terrorism and international conflicts.

Additional risks inherent in our international business activities generally include, among others, longer accounts receivable payment cycles, difficulties in managing international operations, decreased flexibility in matching workforce needs as compared with the U.S., and potentially adverse tax consequences. Such factors could materially adversely affect our future international sales and, consequently, our operating results.

Foreign currency fluctuations may impact our revenues.

Our licenses and services in Japan are sold in Yen. Our licenses and services in the Republic of Korea are sold in Won. Many of the sales of our licenses and services in Europe, the Middle East and Africa, are made in European Monetary Units ("Euros").

Changes in economic or political conditions globally and in any of the countries in which we operate could result in exchange rate movements, new currency or exchange controls or other restrictions being imposed on our operations.

Fluctuations in the value of the U.S. dollar may adversely affect our results of operations. Because our consolidated financial results are reported in U.S. dollars, translation of sales or earnings generated in other currencies into U.S. dollars can result in a significant increase or decrease in the reported amount of those sales or earnings. Significant changes in the value of these foreign currencies relative to the U.S. dollar could have a material adverse effect on our financial condition or results of operations.

Fluctuations in currencies relative to currencies in which our earnings are generated make it more difficult to perform period-to-period comparisons of our reported results of operations. For purposes of accounting, the assets and liabilities of our foreign operations, where the local currency is the functional currency, are translated using period-end exchange rates, and the revenues, expenses and cash flows of our foreign operations are translated using average exchange rates during each period.

In addition to currency translation risks, we incur currency transaction risk whenever we enter into either a purchase or a sales transaction using a currency other than the local currency of the transacting entity. Given the volatility of exchange rates, we cannot be assured we will be able to effectively manage our currency transaction and/or translation risks. Volatility in currency exchange rates may have a material effect on our financial condition or results of operations. Currency exchange rate fluctuations have not, in the past, resulted in a material impact on earnings. However, we may experience at times in the future an impact on earnings as a result of foreign currency exchange rate fluctuations.

In April 2009, we began a program to hedge some of our foreign currency risks. The hedging program will not remove all downside risk and limits the gains we might otherwise receive from currency fluctuations. There can be no assurance that we will be able to enter into future currency hedges on terms acceptable to us (see Note (11) Derivative Financial Instruments to our consolidated financial statements).

Because we conduct operations in China, risks associated with economic, political and social events in China could negatively affect our business and operating results.

China is becoming a significant market for our products and we are increasing our operations in China. In addition to two joint ventures with the Chinese Academy of Science, we have OEM agreements with several Chinese companies. We also have research and development and sales offices in China employing a total of 57 people as of December 31, 2010. Our operations in China are subject to a number of risks relating to China's economic and political systems, including:

- government controlled foreign exchange rate and limitations on the convertibility of the Chinese Renminbi;
- extensive government regulation;

- changing governmental policies relating to tax benefits available to foreign-owned businesses;
- the telecommunications infrastructure;
- relatively uncertain legal system; and
- uncertainties related to continued economic and social reform.

Any significant interruption in our China operations, whether resulting from any of the above uncertainties, natural disasters or otherwise, could result in delays or disruptions in our revenue and our research development operations, either of which could cause our business and operating results to suffer.

If we are unable to protect our intellectual property, our business will suffer.

Our success is dependent upon our proprietary technology. Currently, the IPStor software suite is the core of our proprietary technology. We have fourteen patents issued, and we have multiple pending patent applications, numerous trademarks registered and multiple pending trademark applications related to our products. We cannot predict whether we will receive patents for our pending or future patent applications, and any patents that we own or that are issued to us may be invalidated, circumvented or challenged. In addition, the laws of certain countries in which we sell and manufacture our products, including various countries in Asia, may not protect our products and intellectual property rights to the same extent as the laws of the United States.

We also rely on trade secret, copyright and trademark laws, as well as the confidentiality and other restrictions contained in our respective sales contracts and confidentiality agreements to protect our proprietary rights. These legal protections afford only limited protection.

Our efforts to protect our intellectual property may cause us to become involved in costly and lengthy litigation, which could seriously harm our business.

In recent years, there has been significant litigation in the United States involving patents, trademarks and other intellectual property rights.

We were already subject to one action, which alleged that our technology infringed on patents held by a third party. While we settled this litigation, the fees and expenses of the litigation as well as the litigation settlement were expensive and the litigation diverted management's time and attention. Any additional litigation, regardless of its outcome, would likely be time consuming and expensive to resolve and would divert management's time and attention and might subject us to significant liability for damages or invalidate our intellectual property rights. Any potential intellectual property litigation against us could force us to take specific actions, including:

- cease selling our products that use the challenged intellectual property;
- obtain from the owner of the infringed intellectual property right a license to sell or use the relevant technology or trademark, which license may not be available on reasonable terms, or at all; or
- redesign those products that use infringing intellectual property or cease to use an infringing product or trademark.

Developments limiting the availability of Open Source software could impact our ability to deliver products and could subject us to costly litigation.

Many of our products are designed to include software or other intellectual property licensed from third parties, including “Open Source” software. At least one intellectual property rights holder has alleged that it holds the rights to software traditionally viewed as Open Source. In addition, United States courts have not interpreted the terms of many open source licenses, and there is a risk that such licenses could be construed in a manner that could impose unanticipated conditions or restrictions on our ability to commercialize our appliances. We could be required to seek licenses from third parties in order to continue offering our software, to re-engineer our software, to discontinue the sale of our software in the event re-engineering cannot be accomplished on a timely basis or to litigate any disputes relating to our use of open source software, any of which could harm our business. There can be no assurance that the necessary licenses would be available on acceptable terms, if at all. The inability to obtain certain licenses or other rights or to obtain such licenses or rights on favorable terms, or the need to engage in litigation regarding these matters, could have a material adverse effect on our business, operating results, and financial condition. Moreover, the inclusion in our products of software or other intellectual property licensed from third parties on a nonexclusive basis could limit our ability to protect our proprietary rights in our products.

The loss of any of our key personnel could harm our business.

Our success depends upon the continued contributions of our key employees, many of whom would be extremely difficult to replace. We do not have key person life insurance on any of our personnel. Worldwide competition for skilled employees in the network storage software industry is extremely intense. If we are unable to retain existing employees or to hire and integrate new employees, our business, financial condition and operating results could suffer. In addition, companies whose employees accept positions with competitors often claim that the competitors have engaged in unfair hiring practices. We may be the subject of such claims in the future as we seek to hire qualified personnel and could incur substantial costs defending ourselves against those claims.

We may not successfully integrate the products, technologies or businesses from, or realize the intended benefits of acquisitions.

We have made, and may continue to make, acquisitions of other companies or their assets. Integration of the acquired products, technologies and businesses, could divert management’s time and resources. Further, we may not be able to properly integrate the acquired products, technologies or businesses, with our existing products and operations, train, retain and motivate personnel from the acquired businesses, or combine potentially different corporate cultures. If we are unable to fully integrate the acquired products, technologies or businesses, or train, retain and motivate personnel from the acquired businesses, we may not receive the intended benefits of the acquisitions, which could harm our business, operating results and financial condition.

If actual results or events differ materially from our estimates and assumptions, our reported financial condition and results of operations for future periods could be materially affected.

The preparation of consolidated financial statements and related disclosure in accordance with generally accepted accounting principles requires management to establish policies that contain estimates and assumptions that affect the amounts reported in the consolidated financial statements and the accompanying notes. Note 1 to the Consolidated Financial Statements in this Report on Form 10-K describes the significant accounting policies and estimates essential to preparing our financial statements. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosures. We base our estimates on historical experience and assumptions that we believe to be reasonable under the circumstances. Actual future results may differ materially from these estimates. We evaluate, on an ongoing basis, our estimates and

assumptions.

Long Term Character of Investments

Our present and future equity investments may never appreciate in value, and are subject to normal risks associated with equity investments in businesses. These investments may involve technology risks as well as commercialization risks and market risks. As a result, we may be required to write down some or all of these investments in the future.

Unknown Factors

Additional risks and uncertainties of which we are unaware or which currently we deem immaterial also may become important factors that affect us.

Item 1B. Unresolved Staff Comments

None

Item 2. Properties

The Company's headquarters are located in an approximately 45,000 square foot facility in Melville, New York. Offices are also leased for development, sales and marketing personnel, which total an aggregate of approximately 66,000 square feet in Le Chesnay and Toulouse, France; Taipei and Taichung, Taiwan; Tokyo, Japan; Beijing, Shenzhen, Shanghai, and Hong Kong, China; Munich, Germany; Seoul, Korea; Kuala Lumpur, Malaysia; North Sydney, Australia; London, UK; Singapore; Newport Beach and Fremont, California; and Acton, Massachusetts. Initial lease terms range from one to eight years, with multiple renewal options.

Item 3. Legal Proceedings

The Internal and Government Investigations

On September 29, 2010, the Company announced that it had accepted the resignation of ReiJane Huai, its President and Chief Executive Officer, and the Chairman of its Board of Directors, following his disclosure to the Company that certain improper payments allegedly were made in connection with the Company's licensing of software to one customer. At the same time, the Company announced that it was cooperating fully with law enforcement authorities with respect to an ongoing investigation into the matter, that it had formed a Special Committee of the Board to conduct a full internal investigation, and that the Special Committee had retained counsel to assist it in its investigation. In addition, the counsel to the Special Committee retained independent forensic accountants to review the Company's practices. On November 10, 2010, counsel retained to assist with the internal investigation presented its report to the Special Committee.

Initially, the New York County District Attorney's Office commenced an investigation but thereafter, for reasons unknown to the Company, ceased its investigation. Separately, the U.S. Attorney's Office for the Eastern District of New York ("USAO") and the U.S. Securities and Exchange Commission ("SEC") each commenced investigations.

In October 2010, in connection with the USAO investigation, the Company received a grand jury subpoena seeking all documents relating to the Company's September 29, 2010, disclosure of the improper payments. Since that time, the Company has received additional subpoenas and document requests from the USAO seeking, among other things, documents relating to certain of the Company's employees and other information about the Company.

Also in October 2010, the Company received a subpoena from the SEC seeking, among other things, documentation relating to the Company's dealings with the customer in connection with whose licensing of software improper payments were made and documentation relating to certain of the Company's accounting practices. Since that time, the Company has received additional subpoenas seeking among other things, information related to certain of the Company's employees, customers, policies and practices.

The Company is cooperating fully with the investigations of both the USAO and the SEC and has produced documents responsive to all subpoenas and document requests. The Company intends to produce more documentation, if and when requested by the USAO and the SEC and to continue to cooperate fully with both investigations.

The Company cannot predict the scope, timing, or outcome of the USAO and SEC investigations and other matters referred to herein, which may include the institution of administrative, civil injunctive, or criminal proceedings, the

imposition of fines and penalties, which may be significant, suspensions or debarments from government contracts, and other remedies and sanctions, any of which could lead to an adverse impact on our credit ratings and ability to obtain financing, an adverse impact on the Company's stock price, loss of additional senior management, the inability to attract or to retain key employees, and the loss of customers. In addition, under the law, any illegal acts of the Company's employees may be ascribed to the Company. The Company cannot predict what impact, if any, these matters may have on its business, financial condition, results of operations, and liquidity.

Stockholder Litigation

In October 2010, two purported securities class actions (the “Actions”) were filed in the United States District Court for the Eastern District of New York on behalf of purchasers of the common stock of the Company between February 5, 2009 and September 29, 2010. The two Actions contain substantially similar allegations and causes of actions. The complaint in each of the Actions name as defendants the Company and Mr. Huai, as well as Wayne Lam an officer of the Company and James Weber the Company’s Chief Financial Officer and interim Chief Operating Officer. The complaints in each of the actions allege that the defendants made a series of materially false and misleading statements related to the Company’s business and operations in violation of the Securities Exchange Act of 1934. The following adverse facts are alleged: (i) that FalconStor was experiencing weak demand for its products and services; (ii) that FalconStor was making improper payments to secure a contract with at least one of its customers; and (iii) as a result of the foregoing, the defendants lacked a reasonable basis for their positive statements about FalconStor and its prospects. The plaintiffs in each Action seek damages from the defendants. On November 1, 2010, the parties to one of the two Actions entered into a stipulation setting forth a schedule for an amended complaint and an answer or other response thereto. On November 3, 2010, the Actions were consolidated before Judge Edward R. Korman, and the Company anticipates that it will be receiving an amended complaint (the combined Actions are referred to as the “Class Action”).

The Company is thus unable to determine what claims will ultimately be asserted in the Class Action. In addition key issues such as whether a class will be certified and, if so, who the members of the class will be and what time period the class will cover, have not yet been determined. The Company believes it has meritorious defenses to some or all of the claims of the Actions as filed and intends to file a motion to dismiss. The Company is therefore unable to estimate reasonably its exposure for the Class Action.

In January 2011, a Company shareholder filed an action in the Suffolk County Division of the Supreme Court of the State of New York, putatively derivatively on behalf of the Company against the Company, each of the Company’s Directors, and Messrs. Huai, Lam and Weber (the “Derivative Action”). The Derivative Action alleges that the defendants breached their duties to the Company by: (1) causing or allowing the dissemination of false and misleading information; (2) failing to maintain internal controls; (3) failing to manage the Company properly; (4) unjustly enriching themselves; (5) abusing their control of the Company; and (6) wasting Company assets. The Derivative Action alleges that Messrs. Oxenhorn, Fischer, Kaufman, Lieber and Rubenstein breached their duties to the Company by allowing Mr. Huai to resign.

The Company believes that the shareholder failed to make, and was not excused from making, a demand on the Company’s Board to redress these grievances and the Company intends to file a motion to dismiss. The Company further believes that it has meritorious defenses to some or all of the claims of the Derivative Action as filed, and intends to file a motion to dismiss based on these grounds.

Counsel for the nominal Plaintiff has indicated that it expects to file an amended complaint. The Company is thus unable to reasonably estimate its exposure for the Derivative Action.

The Company is subject to various legal proceedings and claims, asserted or unasserted, which arise in the ordinary course of business. While the outcome of any such matters cannot be predicted with certainty, such matters are not expected to have a material adverse effect on the Company’s financial condition or operating results, cash flows or liquidity.

Item 4. Reserved

PART II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Market Information

Our Common Stock is listed on The Nasdaq Global Market ("Nasdaq") under the symbol "FALC". The following table sets forth the range of high and low closing sales prices of our Common Stock for the periods indicated as reported by Nasdaq:

	2010		2009	
	High	Low	High	Low
Fourth Quarter	\$ 3.37	\$ 2.39	\$ 4.60	\$ 3.31
Third Quarter	\$ 4.06	\$ 2.62	\$ 5.57	\$ 4.27
Second Quarter	\$ 3.50	\$ 2.58	\$ 4.85	\$ 2.41
First Quarter	\$ 4.65	\$ 3.06	\$ 3.77	\$ 2.10

Holders of Common Stock

We had approximately 134 holders of record of Common Stock as of February 28, 2011. This does not reflect persons or entities that hold Common Stock in nominee or "street" name through various brokerage firms.

Dividends

We have not paid any cash dividends on our common stock since inception. We expect to reinvest any future earnings to finance growth, and therefore do not intend to pay cash dividends in the foreseeable future. Our board of directors may determine to pay future cash dividends if it determines that dividends are an appropriate use of Company capital.

Equity Compensation Plan Information

The Company currently does not have any equity compensation plans not approved by security holders.

Plan Category	Number of Securities to be Issued upon Exercise of Outstanding Options, Warrants and Rights	Weighted - Average exercise Price of Outstanding Options, Warrants and Rights	Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in Column (a))		
			(1) (2)		
			(a)		
			(b)		
Equity compensation plans approved by security holders	13,032,306	\$5.22	2,232,882		

(1)

As of December 31, 2010 we had 2,232,882 shares of our common stock reserved for issuance under our stock plans with respect to options (or restricted stock or restricted stock units) that have not been granted. In addition, if, on July 1st of any calendar year in which our 2006 Plan is in effect, the number of shares of stock to which options may be granted is less than five percent (5%) of the number of outstanding shares of stock, then the number of shares of stock available for issuance under the 2006 Plan shall be increased so that the number equals five percent (5%) of the shares of stock outstanding. See Note (8) Share-Based Payment Arrangements to our consolidated financial statements for further information.

(2) Does not include options to purchase 1,520,000 shares of our common stock, of which 1,220,000 are subject to shareholder approval, and 90,000 restricted shares of our common stock awarded to James P. McNiel on January 11, 2011.

Common Stock Performance: The following graph compares, for each of the periods indicated, the percentage change in the Company's cumulative total stockholder return on the Company's Common Stock with the cumulative total return of a) an index consisting of Hemscott Computer Software and Services companies, a peer group index, b) Morningstar Data Storage companies, a peer group index and c) the Russell 3000 Index, a broad equity market index. The graph includes an extra line for the Morningstar Data Storage industry group index. The reason for this addition is that as a result of the acquisition by Morningstar of Hemscott, the Hemscott Computer Software and Services index is being discontinued so going forward the Company will utilize the Morningstar Data Storage companies index as its industry peer group.

ASSUMES \$100 INVESTED ON JANUARY 1, 2005
 ASSUMES DIVIDEND REINVESTED
 FISCAL YEAR ENDING DECEMBER 31, 2010

	Fiscal Year Ending					
	12/31/2005	12/31/2006	12/31/2007	12/31/2008	12/31/2009	12/31/2010
FalconStor Software, Inc.	\$100.00	\$117.05	\$152.37	\$37.62	\$54.94	\$45.33
Russell 3000 Index	\$100.00	\$115.72	\$121.66	\$76.27	\$97.89	\$114.46
Morningstar Data Storage	\$100.00	\$117.57	\$122.77	\$58.75	\$123.17	\$159.38
Hemscott Computer Software & Services	\$100.00	\$113.79	\$121.53	\$74.50	\$116.24	\$129.09

There can be no assurance that the Common Stock's performance will continue with the same or similar trends depicted in the graph above.

Issuer Purchases of Equity Securities

None.

Item 6. Selected Financial Data

The selected financial data appearing below have been derived from our audited consolidated financial statements, and should be read in conjunction with these consolidated financial statements and the notes thereto and the information contained in Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations."

CONSOLIDATED STATEMENTS OF OPERATIONS DATA:

	Year Ended December 31, 2010 (a)	Year Ended December 31, 2009	Year Ended December 31, 2008	Year Ended December 31, 2007 (b)	Year Ended December 31, 2006
(In thousands, except per share data)					
Revenues:					
Product revenues	\$ 51,905	\$ 61,234	\$ 61,566	\$ 56,535	\$ 40,922
Support and services revenues	30,939	28,225	25,459	20,864	14,144
Total revenueus	82,844	89,459	87,025	77,399	55,066
Cost of revenues:					
Product	\$ 9,291	\$ 3,390	\$ 2,636	\$ 2,470	\$ 2,135
Support and service	13,204	13,677	11,384	8,744	7,275
Total cost of revenues	22,495	17,067	14,020	11,214	9,411
Gross profit	\$ 60,348	\$ 72,392	\$ 73,004	\$ 66,185	\$ 45,656
Operating expenses:					
Research and development costs	25,849	26,610	25,150	22,405	20,022
Selling and marketing	40,845	42,255	38,097	29,656	23,713
General and administrative	11,243	9,875	8,746	8,024	5,828
Litigation settlement	--	--	--	--	799
Total operating expenses	77,937	78,740	71,993	60,085	50,362
Operating (loss) income	(17,589)	(6,348)	1,012	6,101	(4,706)
Interest and other (loss) income	(213)	(128)	1,689	2,329	1,650
(Loss) income before income taxes	(17,802)	(6,476)	2,700	8,430	(3,056)
Provision (benefit) for income taxes	17,574	(3,383)	1,498	(4,312)	319
Net (loss) income	\$ (35,376)	\$ (3,093)	\$ 1,203	\$ 12,742	\$ (3,375)

Basic net (loss) income per share	\$ (0.78)	\$ (0.07)	\$ 0.03	\$ 0.26	\$ (0.07)
Diluted net (loss) income per share	\$ (0.78)	\$ (0.07)	\$ 0.02	\$ 0.24	\$ (0.07)
Basic weighted average common shares outstanding	45,549	44,782	47,859	49,421	48,045
Diluted weighted average common shares outstanding	45,549	44,782	49,497	53,131	48,045

- (a) During 2010, we recorded a non-recurring tax provision of \$16.3 million (included in our net tax provision of \$17.6 million) as we concluded that we could no longer realize substantially all of our deferred tax assets on a more-likely-than-not basis, which resulted in an increase in a valuation allowance on our deferred tax assets previously recognized. See Note (6) Income Taxes to our consolidated financial statements for further information.
- (b) During 2007, we recorded a non-recurring tax benefit of \$8.9 million (included within our net tax benefit of \$4.3 million) primarily due to our recognition of a significant portion of our deferred tax assets through a reduction in our deferred tax asset valuation allowance.

CONSOLIDATED BALANCE SHEET DATA:

	December 31, 2010	December 31, 2009	December 31, 2008 (In thousands)	December 31, 2007	December 31, 2006
Cash, cash equivalents and marketable securities	\$ 37,325	\$ 41,783	\$ 42,810	\$ 62,904	\$ 40,960
Working capital	35,475	46,097	48,329	71,845	46,934
Total assets	76,545	99,002	96,364	115,182	78,231
Long-term obligations	9,063	6,254	6,192	5,070	3,783
Stockholders' equity	39,939	66,153	65,076	87,478	55,043

ITEM 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following Management's Discussion and Analysis of Financial Condition and Results of Operations contains "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These forward-looking statements can be identified by the use of predictive, future-tense or forward-looking terminology, such as "believes," "anticipates," "expects," "estimates," "plans," "may," "in," "will," or similar terms. Investors are cautioned that any forward-looking statements are not guarantees of future performance and involve significant risks and uncertainties, and that actual results may differ materially from those projected in the forward-looking statements. The following discussion should be read together with the consolidated financial statements and notes to those financial statements included elsewhere in this report.

OVERVIEW

Our results of operations for 2010 were overshadowed by our discovery, in September, 2010, that improper payments had been made in connection with a customer's licensing of software from us. Following the discovery of the improper payments, ReiJane Huai, our President and Chief Executive Officer, and the Chairman of our Board of Directors, resigned from all positions with the Company. We conducted an internal investigation of the issue and we are being investigated by the United States Attorney's Office for the Eastern District of New York and by the Securities and Exchange Commission. In addition, stockholder lawsuits have been filed against the Company. The investigations and the lawsuits are more fully described in Part 1, Item 3 – Legal Proceedings of this annual report on Form 10-K.

In response to these events, we made several changes to our management. In September 2010, James McNiel, previously a Vice President and our Chief Strategy Officer, was initially appointed interim Chief Executive Officer and interim President. James Weber, a Vice President and our Chief Financial Officer, was given the additional title and responsibilities of interim Chief Operating Officer. Eli Oxenhorn, one of our Directors, was named non-executive Chairman of the Board of Directors. Together, Messrs. McNiel, Weber and Oxenhorn conducted a thorough review of our operations and began to implement changes.

Some of these changes are as follows: In January 2011, Mr. McNiel was appointed Chief Executive Officer and President. Also in January 2011, John Turner was named Vice President of Sales for North America. Additional changes were made in the leadership of our engineering and support organizations.

The discovery of the improper payments and the ongoing investigations and civil lawsuits distracted us from, and continue to cause distraction to, our efforts to promote, market and sell our goods and services. In addition, these events could negatively impact the perception that customers or potential customers have of our Company which could reduce our potential revenues. We cannot predict how long the external investigations or the stockholder lawsuits will last or what the outcomes will be. We have also incurred, and will continue to incur, significant expenses, primarily for legal counsel and legal services providers, due to the internal and external investigations. At December 31, 2010, our cash, cash equivalents and marketable securities totaled approximately \$37.3 million, compared with \$41.8 million at December 31, 2009. We anticipate a further decrease in our cash, cash equivalents and marketable securities due to the costs resulting from the internal and external investigations.

With regard to our business operations, on a year over year basis we continued to see benefits from our renewed sales efforts for FalconStor-branded products. We also continued to reduce costs from our operations. Despite a 48% year over year decline in our OEM product revenues, our overall total revenues declined only 7%.

The year 2010 saw the full rollout of FalconStor-branded gateway appliances and complete turn-key appliances with integrated disks. These products integrate our software with standard hardware configurations. The integrated

products were created in response to feedback we received from our resellers and the end users suggested that we could increase sales if we offered turn-key appliances.

We believe that the introduction of the turn-key appliances had a significant impact on our revenues in 2010. While our non-OEM (Channel and direct) product revenues only increased 1% compared with 2009, our 2009 non-OEM product revenues included one order by a customer which represented 12% of our total non-OEM product revenues in 2009. This shows that the non-OEM product revenues of our branded appliances increased dramatically in 2010 compared with 2009.

We are continuing to invest in our FalconStor-branded products and in our channel development and marketing activities. We expect that these investments will result in further increases in non-OEM product revenue in 2011.

As we expected, our OEM product revenues continued to decline in 2010. During 2009, two of our largest OEM customers – EMC, and Sun Microsystems– became involved in transactions that had substantial negative effects on our revenues.

In July 2009, EMC acquired Data Domain, Inc. This acquisition resulted in changes to EMC's product lines and sales and marketing focus. As result, sales of the EMC products that incorporate our software continued to decline. Total revenue from EMC on an annual basis was still more than 10% of our total revenue for 2010, but a substantial portion of that revenue was attributable to maintenance and support fees for existing deployments, rather than for sales of new EMC products that incorporate our software. Our agreement with EMC runs through 2013, but there are no minimum revenue commitments from EMC. We do not expect that EMC will account for 10% or more of our revenue in any future period.

In June 2009, Oracle Corporation announced that it had reached an agreement to buy Sun Microsystems. Before completing the acquisition, Oracle was required to get approval for the purchase from various jurisdictions worldwide. This approval process took several months, and at various points the statements of the regulators cast doubt on whether the transaction would be approved. Ultimately, the purchase of Sun was not completed until January 2010. During this period of delay and uncertainty, Sun suffered a substantial decline in its sales, including sales of the Sun products that incorporate our software. Oracle has since discontinued the Sun product line that incorporated our software. We will continue to receive revenue for a period of time for support and maintenance of the existing installed Sun customer base, but the revenue will continue to decline.

Collectively, these two merger and acquisition events continued to cause a decline in our OEM product revenues. OEM product revenues declined 48% in 2010 from 2009.

Overall, our total revenues for the full year decreased to \$82.8 million from \$89.5 million in 2009. This is a 7% year over year decrease in total revenues. We currently anticipate that revenue will increase in 2011 compared with 2010.

Net loss for the year was \$35.4 million compared with a net loss of \$3.1 million in 2009. As discussed more fully below, included in our net loss for the year ended December 31, 2010 was an income tax provision of \$17.6 million, compared with an income tax benefit of \$3.4 million for the same period in 2009. We had stock-based compensation expense – which relates to stock options and restricted stock we grant to employees, officers and directors as part of our incentive compensation plan, and to some consultants as payment for services – of \$8.7 million in 2010 and \$ 8.8 million in 2009, which is reflected in the net results for each year.

Typically, we look to operating income as another measure of our progress. This number enables us to measure and to compare our results of operations from one year to the next. Operating loss for 2010 was \$17.6 million, compared with operating loss of \$6.3 million in 2009. These numbers again include stock-based compensation expense. We attribute the decline in operating income from 2009 to 2010 primarily to the decrease in our OEM product revenues (as discussed above) and expenditures related to the governmental investigations.

As we expected, our gross margin showed a decline in 2010 from 2009. Sales of FalconStor-branded turn-key appliances require us to purchase hardware from third-party vendors. Our margins on the resale of the hardware as part of an appliance are significantly lower than our margins on sales of software-only solutions, particularly sales to OEMs. Because sales of appliances have become the core of our business plan, our margins were bound to decrease.

Operating margin is a measure of operating efficiency. We incur research and development expenses before the product is offered for licensing. These expenses consist primarily of personnel costs for engineering and testing, but also include other items such as the depreciation and amortization of hardware and software used in development. We also have expenses for software support, sales and marketing, and general and administrative functions. Our operating margin decreased in 2010 to (21%), compared with (7%) in 2009. The impact of the equity-based compensation expense on operating margin in 2010 and 2009 was equivalent to 9% and 8%, respectively.

The key factors we look to for our future business prospects are:

- our ability to establish and to expand relationships with resellers, and sales and re-orders by those resellers;
- growth in deferred revenue;
- the development and sales of our new products;
- re-orders from existing customers; and
- the growth of the overall market for data protection and storage solutions.

We anticipate that in 2011 product revenue by resellers and, to a lesser extent, direct licenses to end users, will continue to grow in both absolute dollars and as a percentage of sales. Increasing sales from our non-OEM business remains an area of focus for us and we have installed new leadership and made significant investments in our sales force and in our marketing team to help grow these sales. We expect these investments to take time to increase our sales. We also have instituted, and we will be instituting further, support, training and incentive programs intended to increase sales by resellers.

We continue to enhance our reseller program. Many enterprises look to value added resellers or solution providers to assist them in making their information technology purchases. These resellers typically review an enterprise's needs and suggest a hardware, software, or combined hardware and software solution to fulfill the enterprise's requirements.

As service providers to companies, resellers' reputations are dependent on satisfying their customers' needs efficiently and effectively. Resellers have wide choices in fulfilling their customers' needs. If resellers determine that a product they have been providing to their customers is not functioning as promised, or is not providing adequate return on investment, or if the customers are not satisfied with the level of support they are receiving from the suppliers, the resellers will move quickly to offer different solutions to their customers. Additional sales by resellers are therefore an important indicator of our business prospects.

In 2010, we signed agreements with new resellers worldwide. The type of resellers with whom we are signing agreements has continued to evolve. While we still sign agreements with strong local and regional resellers, we have also entered into reseller agreements with national and multi-national resellers who have their own distribution networks. The enhanced distribution and marketing networks offered by these larger resellers should help us to continue to grow our sales.

We also terminated relationships with resellers who we believed were not properly selling our products in 2010. We will continue to enter into relationships with resellers and to discontinue relationships with resellers with whom we are not satisfied.

Our deferred revenues consist primarily of amounts attributable to future support and maintenance of our products. The level of deferred revenue is an important indicator of our success. Maintenance and support for our products is sold for fixed periods of time. Maintenance and support agreements are typically for one year, although some agreements are for terms in excess of one year. If we do not deliver the support needed by end users of our products or by our OEM partners and resellers, then they will not renew their maintenance and support agreements. If end users stop using our products, they also will not renew their maintenance and support agreements. An increase in deferred revenues thus indicates growth in our installed base and end user and OEM satisfaction with our products and our maintenance and support services. Our deferred revenue increased 6% to \$23.5 million as of December 31, 2010, compared with \$22.2 million as of December 31, 2009. We expect deferred revenue to continue to grow in 2011.

At the start of 2010, we instituted cost controls and new restrictions on hiring in an effort to better align our cost structure with our anticipated revenues. These efforts paid off as our operating expenses decreased 1% in 2010 from \$78.7 million in 2009 to \$77.9 million in 2010. By way of comparison, our operating expenses increased by 9% from 2008 to 2009 and by 20% from 2007 to 2008. We did anticipate even greater savings in 2010, however the costs of our internal investigation of the misconduct that came to light, the government investigations, and the stockholder lawsuits negated some of our anticipated improvement in cost containment. These costs, primarily related to professional fees and fees for service providers, amounted to over \$1.6 million. We expect costs related to the governmental investigations and the stockholder suits to continue to impact our expenses in 2011. Included in our operating expenses for the years ended December 31, 2010 and 2009 was \$7.5 million and \$7.3 million, respectively, of share-based compensation expense.

We expect to continue to be affected by seasonality of the information technology business on a quarterly basis. Historically, information technology spending has been higher in the fourth and second quarters of each calendar year, and somewhat slower in the other quarters, particularly the first quarter. While our results were skewed by the impact of the strategic transactions affecting our OEM customers, our quarterly results reflected this seasonality in 2010, and we anticipate that our quarterly results for 2011 will show the effects of seasonality as well.

Accounting rules relating to share-based compensation expense continued to have a negative impact on our earnings in 2010. On an on-going basis we weigh the impact of the expense on our consolidated financial statements against the impact of discontinuing the grant of equity-based compensation to our worldwide workforce. It continues to be our view that the opportunity to participate in the growth of our Company is an important motivating factor for our current employees and a valuable recruiting tool for new employees. We will thus continue to apply the criteria and the methodology we have used in the past to determine grants of stock options or other equity-based compensation to our employees. For the management of our business and the review of our progress, we will continue to look to our results before share-based compensation expense. We will use these non-GAAP financial measures in making operating decisions because they measure the results of our day-to-day operations and because they provide a more consistent basis for evaluating and comparing our results across different periods.

RESULTS OF OPERATIONS – FOR THE YEAR ENDED DECEMBER 31, 2010 COMPARED WITH THE YEAR ENDED DECEMBER 31, 2009

During 2010, we shifted our focus to selling turn-key solutions, whereby our software is integrated with industry standard hardware and sold as one complete integrated solution. As a result, commencing in the second quarter of 2010, we reclassified our revenue into two categories: (i) product revenue, and (ii) support and services revenue. Product revenue consists of both integrated solutions and stand-alone software revenues. Support and services revenues consists of both maintenance revenues and professional services revenues. As a result of the reclassification, we have a corresponding cost of revenues for each revenue category.

Revenues for the year ended December 31, 2010 decreased 7% to \$82.8 million compared with \$89.5 million for the year ended December 31, 2009. Our cost of revenues increased 32% from \$17.1 million for the year ended December 31, 2009 to \$22.5 million for the year ended December 31, 2010. Included in our cost of revenues for the years ended December 31, 2010 and 2009 were \$1.1 million and \$1.6 million, respectively, of share-based compensation expense. Our operating expenses decreased 1% from \$78.7 million for the year ended December 31, 2009 to \$77.9 million for the year ended December 31, 2010. Included in our operating expenses for the years ended December 31, 2010 and 2009 were \$7.5 million and \$7.3 million, respectively, of share-based compensation expense. In addition, we incurred approximately \$1.6 million of legal and professional fees resulting from the internal and external investigations that commenced during the third quarter of 2010 and from stockholder lawsuits that were filed in the fourth quarter of 2010. Net loss for the year ended December 31, 2010 was \$35.4 million compared with a net loss of \$3.1 million for the year ended December 31, 2009. Included in our net loss for the year ended December 31, 2010 was an income tax provision of \$17.6 million, compared with an income tax benefit of \$3.4 million for the same period in 2009. During 2010, as part of our income tax provision, we recorded \$16.3 million in connection with a valuation allowance on substantially all of our existing deferred tax assets due to our determination during the year that we would not utilize our deferred tax assets on a more-likely-than-not basis in future periods. The \$3.4 million income tax benefit recorded during the year ended December 31, 2009, was primarily attributable to (i) a benefit of \$1.4 million related to research and development credits we recognized during 2009, and (ii) the impact of our full year effective tax rate on our pre-tax losses for 2009.

Our overall 7% decline in revenues was primarily due to a significant decrease in our product revenue. This decline was partially offset by increases in our support and services revenues for the year ended December 31, 2010, compared with the same period in 2009. Our product revenues from our non-OEM partners increased 1%, while our

product revenues from our OEM partners decreased 48%, for the year ended December 31, 2010, compared with the same period in 2009. Although, we had one transaction that accounted for 12% of the total non-OEM product revenue for the year ended December 31, 2009, our non-OEM product revenue still increased in 2010 as a result of our ongoing focus on the FalconStor-branded business for the year ended December 31, 2010. The decrease in our OEM product revenues continues to result primarily from the merger and acquisition activity that commenced during 2009 that affected some of our key OEM partners, specifically, EMC and Oracle USA (formerly Sun Microsystems). Historically, both EMC and Sun Microsystems each represented over 10% of our annual revenues. As we have stated over the past several quarters, we do not anticipate that revenues from either OEM partner will return to their historical peaks, which has resulted in our continued and ongoing focus of the non-OEM FalconStor-branded business. However, because of our well-established installed customer base, support and services revenues continued to grow and have not been as significantly impacted by the disruptions in our OEM channel.

Our operating expenses have decreased. Commencing in the second quarter of 2010, we implemented expense controls and put new restrictions on new hires. We have begun to recognize the benefits of these cost savings initiatives, but the full impact of these initiatives have yet to be recognized on a full year basis. We will continue to evaluate the appropriate headcount levels to properly align requirements with our current and long-term outlook. Our worldwide headcount was 501 employees as of December 31, 2010, compared with 542 employees as of December 31, 2009.

Revenues

	Year Ended December 31,				
	2010		2009		
Revenues:					
Product revenue	\$	51,905,096	\$	61,234,075	
Support and services revenue		30,938,650		28,225,106	
Total Revenues	\$	82,843,746	\$	89,459,181	
Year-over-year percentage growth					
Product revenue		-15	%	-1	%
Support and services revenue		10	%	11	%
Total percentage growth		-7	%	3	%

Product revenue

Product revenue is comprised of sales of our software integrated with industry standard hardware creating a turn-key solution or integrated solution, and our stand-alone software applications. The products are sold through our OEMs, and through (i) value-added resellers, (ii) distributors, and/or (iii) directly to end-users (collectively “non-OEMs”). These revenues are recognized when, among other requirements, we receive a customer purchase order or a royalty report summarizing stand-alone software applications sold, or integrated solutions are sold and/or permanent key codes are delivered to the customer.

Product revenue decreased 15% from \$61.2 million for the year ended December 31, 2009 to \$51.9 million for the year ended December 31, 2010. Product revenue represented 63% and 68% of our total revenues for the years ended December 31, 2010 and 2009, respectively. The decrease in product revenue was primarily attributable to a decline of 48% in product revenue from our OEM partners for the year ended December 31, 2010, compared with the same period in 2009. This decrease was offset partially by an increase in our non-OEM product revenues of 1% for the year ended December 31, 2010, compared with the same period in 2009. We had one transaction that accounted for 12% of the total non-OEM product revenue for the year ended December 31, 2009. While this one transaction was not repeated in 2010, the absence of this revenue was offset in 2010 by increases in our non-OEM product revenues as a result of our ongoing focus on the FalconStor-branded business. The decrease in our OEM partner product revenue was primarily attributable to the impact of merger and acquisition activity involving some of our key OEM partners that commenced during 2009. We do not anticipate that revenues from these OEM partners will return to their historical peaks. Product revenue from our non-OEM partners represented 80% and 67% of our total product revenue for the years ended December 31, 2010 and 2009, respectively. Product revenue from our OEM partners represented 20% and 33% of our total product revenue for the years ended December 31, 2010 and 2009, respectively.

We continue to focus our investments on the FalconStor-branded non-OEM channel business as we feel this is in line with our long-term outlook. We anticipate that our investments in the FalconStor-branded business will result in our non-OEM generated product revenue growing at a greater rate in future years when compared to our OEM generated product revenue.

Support and services revenue

Support and services revenue is comprised of (i) maintenance and technical support services, (ii) professional services primarily related to the implementation of our software, and (iii) engineering services. Revenues derived from maintenance and technical support contracts are deferred and recognized ratably over the contractual maintenance term. Professional services revenue is recognized in the period that the related services are performed. Revenue from engineering services is primarily related to customizing software product masters for some of our OEM partners. Revenue from engineering services is recognized in the period in which the services are completed. Support and services revenue increased 10% from \$28.2 million for the year ended December 31, 2009 to \$30.9 million for the year ended December 31, 2010.

The increase in support and services revenue was attributable to maintenance and technical support services, which increased from \$25.5 million for the year ended December 31, 2009 to \$27.6 million for the same period in 2010. As we are in business longer, and as we license more integrated solutions and stand-alone software applications to new customers and grow our installed customer base, we expect the amount of maintenance and technical support contracts we have to grow as well. The anticipated growth in our maintenance and technical support service revenue is expected to result primarily from (i) the purchase of maintenance and support contracts by our customers, and (ii) the renewal of maintenance and support contracts by our existing and new customers after their initial contracts expire.

Professional services revenues also contributed to the increase in our support and services revenue, which increased from \$2.7 million for the year ended December 31, 2009 to \$3.3 million for the same period in 2010. The professional services revenue varies from year to year based upon (i) the number of integrated solutions sold during the existing and previous periods, (ii) the number of our customers who elect to purchase professional services, and (iii) the number of professional services contracts that were completed during the period. We expect professional services revenues to continue to vary from year to year based upon the number of customers who elect to utilize our professional services upon purchasing any of our integrated solutions.

Cost of Revenues

	Year Ended December 31,				
	2010		2009		
Cost of revenues:					
Product	\$	9,291,236	\$	3,390,065	
Support and service		13,204,089		13,676,740	
Total cost of revenues	\$	22,495,325	\$	17,066,805	
Total Gross Profit	\$	60,348,421	\$	72,392,376	
Gross Margin:					
Product		82	%	94	%
Support and service		57	%	52	%
Total gross margin		73	%	81	%

Cost of revenues, gross profit and gross margin

Cost of product revenue consists primarily of industry standard hardware we purchase and integrate with our software for a turn-key integrated solution, personnel costs, amortization of purchased and capitalized software, shipping and logistics costs, and share-based compensation expense. Cost of support and service consists primarily of personnel and other costs associated with providing software implementations, technical support under maintenance contracts, training, and share-based compensation expense. Cost of product revenue for the year ended December 31, 2010 increased \$5.9 million, or 174%, to \$9.3 million compared with \$3.4 million for the same period in 2009. The increase in cost of product revenue was primarily due to the increased hardware costs associated with our new focus in 2010 on selling FalconStor-branded integrated turn-key solutions. Our cost of support and service revenues for the year ended December 31, 2010 decreased \$0.5 million, or 3%, to \$13.2 million compared with \$13.7 million for the same period in 2009. The decrease in cost of support and service revenue is primarily related to our cost savings controls and new restrictions on new hires that were implemented during the second quarter of 2010.

Total gross profit decreased \$12.0 million, or 17%, from \$72.4 million for the year ended December 31, 2009, to \$60.3 million for the year ended December 31, 2010. Total gross margin decreased to 73% for the year ended December 31, 2010 from 81% for the same period in 2009. The decrease in both our total gross profit and total gross margins for the year ended December 31, 2010, compared with the same period in 2009, was primarily due to (i) a 7% decline in our total revenue, and (ii) increased hardware costs associated with our new focus in 2010 of selling FalconStor-branded turn-key integrated solutions. Generally, our total gross profits and total gross margins may fluctuate based on several factors, including (i) revenue growth levels, (ii) changes in personnel headcount and related costs, and (iii) our product offerings and service mix of sales.

Share-based compensation expense included in the cost of product revenue was less than 1% of revenue for both the years ended December 31, 2010 and December 31, 2009. Share-based compensation expense included in the cost of support and service revenue decreased to \$1.1 million from \$1.5 million for the years ended December 31, 2010 and December 31, 2009, respectively. Share-based compensation expense related to cost of support and service revenue was equal to 1% and 2% of total revenue for the years ended December 31, 2010 and 2009, respectively.

Operating Expenses

Research and Development Costs

Research and development costs consist primarily of personnel costs for product development personnel, share-based compensation expense, and other related costs associated with the development of new products, enhancements to existing products, quality assurance and testing. Research and development costs decreased \$0.8 million, or 3%, to \$25.8 million for the year ended December 31, 2010 from \$26.6 million in the same period in 2009. The decrease in research and development costs was primarily the result of our cost savings controls and new restrictions on new hires that were implemented during the second quarter of 2010. While implementing our cost savings initiatives, we believe we continued to provide the highest levels of resources in support of our research and development activities to continue to enhance and to test our core products and in the development of new innovative products, features and options. Share-based compensation expense included in research and development costs totaled \$3.0 million for both the years ended December 31, 2010 and December 31, 2009. Share-based compensation expense included in research and development costs was equal to 4% of revenue for the years ended December 31, 2010 and 3% for the same period in 2009.

Selling and Marketing

Selling and marketing expenses consist primarily of sales and marketing personnel and related costs, share-based compensation expense, travel, public relations expense, marketing literature and promotions, commissions, trade show expenses, and the costs associated with our foreign sales offices. Selling and marketing expenses decreased \$1.4 million, or 3%, to \$40.8 million for the year ended December 31, 2010, from \$42.3 million for the same period in 2009. The decrease in selling and marketing expenses was primarily due to (i) lower commissions paid as a result of our 7% decline in total revenue, and (ii) lower salary and personnel related costs as a result of the decline in total sales and marketing personnel. Share-based compensation expense included in selling and marketing expenses increased to \$3.4 million from \$3.1 million for the years ended December 31, 2010 and December 31, 2009, respectively. Share-based compensation expense included in selling and marketing expenses was equal to 4% of revenue for the years ended December 31, 2010 and 3% for the same period in 2009.

General and Administrative

General and administrative expenses consist primarily of personnel costs of general and administrative functions, share-based compensation expense, public company related costs, directors and officers insurance, legal and

professional fees, and other general corporate overhead costs. General and administrative expenses increased \$1.4 million, or 14%, to \$11.2 million for the year ended December 31, 2010 from \$9.9 million for the same period in 2009. The increase in general and administrative expenses was primarily related to \$1.6 million of legal and professional fees resulting from the internal and external investigations which commenced during the third quarter of 2010 and from stockholder lawsuits that were filed in fourth quarter of 2010. The increase in general and administrative expenses was offset in part by our cost savings controls and new restrictions on new hires that were implemented during the second quarter of 2010. Share-based compensation expense included in general and administrative expenses increased to \$1.2 million from \$1.1 million for the years ended December 31, 2010 and December 31, 2009, respectively. Share-based compensation expense included in general and administrative expenses was equal to 1% of revenue for both the years ended December 31, 2010 and December 31, 2009. We expect our general and administrative expenses will continue to be adversely impacted in 2011 due to professional fees and service provider fees resulting from the ongoing external investigations and stockholder lawsuits.

Interest and Other Loss

We invest our cash primarily in money market funds, commercial paper, government securities, and corporate bonds. As of December 31, 2010, our cash, cash equivalents, and marketable securities totaled \$37.3 million, compared with \$41.8 million as of December 31, 2009. Interest and other loss increased \$0.1 million to (\$0.2) million for the year ended December 31, 2010, compared with (\$0.1) million for the same period in 2009. The increase in interest and other loss was due to (i) the decrease in interest income of \$0.3 million for the year ended December 31, 2010, as compared with the same period in 2009, and (ii) foreign currency losses of \$0.3 million incurred during the year ended December 31, 2010 as compared with a foreign currency losses of \$0.6 million for the same period in 2009.

Income Taxes

Our provision for income taxes consists of U.S., state and local, and foreign taxes in amounts necessary to align our year-to-date tax provision with the effective rate that we expect to achieve for the full year. For the year ended December 31, 2010, we recorded an income tax provision of \$17.6 million, compared with an income tax benefit of \$3.4 million for the same period in 2009. During 2010, we concluded that we could no longer realize substantially all of our deferred tax assets on a more-likely-than-not basis and recorded a discrete item of approximately \$16.3 million related to an increase in a valuation allowance on our deferred tax assets previously recognized. During 2009, we recorded an income tax benefit of \$3.4 million which was primarily attributable to (i) a benefit of \$1.4 million which resulted from previously unrecognized tax benefits in connection with our completion of a research and development study finalized during 2009, and (ii) the impact of our full year effective tax rate on our pre-tax losses for 2009.

RESULTS OF OPERATIONS – FOR THE YEAR ENDED DECEMBER 31, 2009 COMPARED WITH THE YEAR ENDED DECEMBER 31, 2008

Revenues for the year ended December 31, 2009 increased 3% to \$89.5 million compared with \$87.0 million for the year ended December 31, 2008. Our cost of revenues increased 22% from \$14.0 million for the year ended December 31, 2008 to \$17.1 million for the year ended December 31, 2009. Included in our cost of revenues for the years ended December 31, 2009 and 2008 were \$1.6 million and \$1.5 million, respectively, of share-based compensation expense. Our operating expenses increased 9% from \$72.0 million in 2008 to \$78.7 million in 2009. Included in our operating expenses for the years ended December 31, 2009 and 2008 were \$7.3 million and \$7.6 million, respectively, of share-based compensation expense. Net loss for the year ended December 31, 2009 was \$3.1 million compared with net income of \$1.2 million for the year ended December 31, 2008. Included in our net loss for the year ended December 31, 2009 was an income tax benefit of \$3.4 million compared with an income tax provision of \$1.5 million for the year ended December 31, 2008. The \$3.4 million income tax benefit was primarily attributable to (i) a benefit of \$1.4 million related to research and development credits we recognized during 2009, and (ii) the impact of our full year effective tax rate on our pre-tax losses for 2009.

Our 3% revenue growth in 2009 as compared with 2008 was primarily driven by increases in our support and services revenues. The overall increase was offset by slight declines in our product revenues of 1% for the year ended December 31, 2009 as compared with the same period 2008. Our product revenues from our non-OEM partners increased 17%, while our product revenues from our OEM partners decreased 23%, for the year ended December 31, 2009, compared with the same period in 2008. The increase in product revenues from our non-OEM partners was primarily driven by our ongoing focus and investments on the FalconStor branded non-OEM channel business. The decrease in our product revenues from our OEM partners was primarily attributable to the merger and acquisition activity that adversely impacted some of our key OEM partners, specifically, EMC, Oracle USA (formerly Sun Microsystems) and 3Com. Additionally, as a result of the macroeconomic environment during 2009, we continued to experience slowed revenue growth, particularly in product revenues, resulting from the downturn in information technology spending and disruptions in the global financial markets, which commenced during the third quarter of

2008 and continued throughout 2009. However, because of our well-established installed customer base, our support and services revenues were not as significantly impacted as compared with our product revenues.

Expenses increased in all aspects of our business as we increased headcount both domestically and internationally. We increased our worldwide headcount to 542 employees as of December 31, 2009, as compared with 505 employees as of December 31, 2008. As we stated throughout 2009, we invested in additional headcount, specifically in sales and marketing functions for our non-OEM channel, which would result in lower operating profits and margins.

Revenues

	Year Ended December 31,				
	2009		2008		
Revenues:					
Product revenue	\$	61,234,075	\$	61,565,673	
Support and services revenue		28,225,106		25,459,187	
Total Revenues	\$	89,459,181	\$	87,024,860	
Year-over-year percentage growth					
Product revenue		-1	%	9	%
Support and services revenue		11	%	22	%
Total percentage growth		3	%	12	%

Product revenue

Product revenue decreased 1% from \$61.6 million for the year ended December 31, 2008 to \$61.2 million for the year ended December 31, 2009. Product revenue represented 68% and 71% of our total revenues for the years ended December 31, 2009 and 2008, respectively. The decrease in product revenues was primarily attributable to a decline of 23% in product revenues from our OEM partners as a result of the merger and acquisition activity surrounding some of our key OEM partners during the year ended December 31, 2009, as compared with the same period in 2008. This decrease was offset by the growth of 17% in product revenues from our non-OEM partners during the year ended December 31, 2009, as compared with the same period in 2008. Product revenue from our non-OEM partners represented 67% and 57% of our total product revenue for the years ended December 31, 2009 and 2008, respectively. Product revenue from our OEM partners represented 33% and 43% of our total product revenue for the years ended December 31, 2009 and 2008, respectively.

Support and services revenue

Support and services revenue increased 11% from \$25.5 million for the year ended December 31, 2008 to \$28.2 million for the year ended December 31, 2009. The increase in support and services revenue was attributable to maintenance and technical support services, which increased from \$23.3 million for the year ended December 31, 2008 to \$25.5 million for the same period in 2009. As we are in business longer, and as we license more integrated solutions and stand-alone software applications to new customers and grow our installed customer base, the amount of maintenance and technical support contracts we have increase as well.

Professional services revenues also contributed to the increase in our support and services revenue, which increased from \$2.2 million for the year ended December 31, 2008 to \$2.7 million for the same period in 2009. The professional services revenue varies from year to year based upon (i) the number of integrated solutions sold during the existing and previous periods, (ii) the number of our customers who elect to purchase professional services, and (iii) the number of professional services contracts that were completed during the period.

Cost of Revenues

	Year Ended December 31,				
	2009		2008		
Cost of revenues:					
Product	\$	3,390,065	\$	2,636,042	
Support and service		13,676,740		11,384,457	
Total cost of revenues	\$	17,066,805	\$	14,020,499	
Total Gross Profit	\$	72,392,376	\$	73,004,361	
Gross Margin:					
Product		94	%	96	%
Support and service		52	%	55	%
Total gross margin		81	%	84	%

Cost of revenues, gross profit and gross margin

Cost of product revenue for the year ended December 31, 2009 increased \$0.8 million, or 29%, to \$3.4 million compared with \$2.6 million for the same period in 2008. The increase in cost of product revenue was primarily due to (i) increased hardware costs associated with transactions in which we bundled purchased hardware with our software and sold the bundled solution, and (ii) an increase in amortization related to purchased and capitalized software. Our cost of support and service revenues for the year ended December 31, 2009 increased \$2.3 million, or 20%, to \$13.7 million compared with \$11.4 million for the same period in 2008. The increase in cost of support and service revenue is primarily related to an increase in personnel and related costs.

Total gross profit decreased \$0.6 million, or 1%, from \$73.0 million for the year ended December 31, 2008, to \$72.4 million for the year ended December 31, 2009. Total gross margin decreased to 81% for the year ended December 31, 2009 from 84% for the same period in 2008. The decrease in both our gross profit and gross margins for the year ended December 31, 2009, as compared with the same period in 2008, was primarily due to additional headcount we added throughout 2008 and 2009. The additional headcount outpaced our actual revenue growth of 3% in 2009, and adversely impacted both our gross profit and gross margins. Generally, our gross profits and gross margins may fluctuate based on several factors, including (i) revenue growth levels, (ii) changes in personnel headcount and related costs, and (iii) our product offerings and service mix of sales.

Share-based compensation expense included in the cost of product revenue was less than 1% of revenue for both the years ended December 31, 2009 and December 31, 2008. Share-based compensation expense included in the cost of support and service revenue increased to \$1.5 million from \$1.4 million for the years ended December 31, 2009 and December 31, 2008, respectively. Share-based compensation expense related to cost of support and service revenue was equal to 2% of total revenue for each of the years ended December 31, 2009 and 2008, respectively.

Operating Expenses

Research and Development Costs

Research and development costs increased \$1.5 million, or 6% to \$26.6 million for the year ended December 31, 2009 from \$25.2 million in the same period in 2008. The major contributing factors to the increase in research and development costs were higher salary and personnel related costs as a result of increased headcount. Share-based compensation expense included in research and development costs decreased to \$3.0 million from \$3.2 million for the

years ended December 31, 2009 and 2008, respectively. Share-based compensation expense included in research and development costs was equal to 3% of revenue for the year ended December 31, 2009 and 4% for the year ended December 31, 2008.

Selling and Marketing

Selling and marketing expenses increased \$4.2 million, or 11% to \$42.3 million for the year ended December 31, 2009 from \$38.1 million for the same period in 2008. The increase in selling and marketing expenses was primarily due to (i) higher salary and personnel related costs as a result of increased sales and marketing headcount, specifically in support of our non-OEM channel business, (ii) higher commissions paid as a result of increase in our non-OEM channel business revenues, and (iii) higher marketing expenses related to product branding campaign of such initiatives. Share-based compensation expense included in selling and marketing decreased to \$3.1 million from \$3.5 million for the years ended December 31, 2009 and 2008, respectively. Share-based compensation expense included in selling and marketing expenses was equal to 3% and 4% for the years ended December 31, 2009 and 2008, respectively.

General and Administrative

General and administrative expenses increased \$1.1 million, or 13% to \$9.9 million for the year ended December 31, 2009 from \$8.7 million for the same period in 2008. The overall increase within general and administrative expenses related to increases in various administrative costs including (i) personnel related costs, (ii) general corporate insurances, and (iii) various professional fees. Share-based compensation expense included in general and administrative expenses increased to \$1.1 million from \$0.9 million for the years ended December 31, 2009 and 2008, respectively. Share-based compensation expense included in general and administrative expenses was equal to 1% of revenue for each of the years ended December 31, 2009 and 2008, respectively.

Interest and Other (Loss) Income

As of December 31, 2009, our cash, cash equivalents, and marketable securities totaled \$41.8 million, compared with \$42.8 million as of December 31, 2008. Interest and other (loss) income decreased \$1.8 million to (\$0.1) million for the year ended December 31, 2009, compared with \$1.7 million for the same period in 2008. The decrease in interest and other (loss) income was due to (i) the decrease in interest income of \$0.8 million for the year ended December 31, 2009, as compared with the same period in 2008, and (ii) foreign currency losses of \$0.6 million incurred during the year ended December 31, 2009 as compared with a foreign currency gain of \$0.2 million for the same period in 2008.

Income Taxes

For the year ended December 31, 2009, we recorded an income tax benefit of \$3.4 million, which was primarily attributable to (i) a benefit of \$1.4 million which resulted from previously unrecognized tax benefits in connection with our completion of a research and development study finalized during 2009, and (ii) the impact of our full year effective tax rate on our pre-tax losses for 2009. For the year ended December 31, 2008, our provision for income taxes was \$1.5 million and consisted primarily of U.S., state, local and foreign taxes.

LIQUIDITY AND CAPITAL RESOURCES

Cash flow information is as follows:

	Years Ended December 31,		
	2010	2009	2008
Cash provided by (used in):			
Operating activities	\$(1,728,504)	\$8,806,491	\$18,231,609
Investing activities	3,634,373	(11,019,560)	3,335,856
Financing activities	409,889	(3,826,699)	(30,998,308)

Edgar Filing: FALCONSTOR SOFTWARE INC - Form 10-K

Effect of exchange rate changes	(225,731)	(571,939)	(424,271)
Net increase (decrease) in cash and cash equivalents	\$2,090,027	\$(6,611,707)	\$(9,855,114)

Our principal sources of liquidity are cash flows generated from operations and our cash, cash equivalents, and marketable securities balances. Our cash and cash equivalents and marketable securities balance as of December 31, 2010 totaled \$37.3 million, as compared with \$41.8 million as of December 31, 2009. Cash and cash equivalents totaled \$17.8 million and marketable securities totaled \$19.5 million at December 31, 2010. As of December 31, 2009, we had \$15.8 million in cash and cash equivalents and \$26.0 million in marketable securities.

During the second quarter of 2010, we implemented cost savings initiatives and new restrictions on hiring in response to the operating losses we were incurring. Additionally, we continue to evaluate the appropriate headcount levels to properly align such requirements with our current and long-term outlook. We expect that these initiatives will help to bring our expense structure in line with our current revenue levels and provide a positive impact on our operating results. We will continue to make investments in capital expenditures. In the past, we have also used cash to purchase software licenses and to make acquisitions. We will continue to evaluate potential software license purchases and acquisitions, and if the right opportunity presents itself, we may continue to use our cash for these purposes. As of the date of this filing, we have no agreements, commitments or understandings with respect to any such acquisitions.

As discussed further in Part I, Item 3 – Legal Proceedings of this annual report on Form 10-K, we are currently under investigations by the United States Attorney’s Office and the Securities and Exchange Commission and are named in multiple lawsuits. We have incurred, and will continue to incur, significant expenses, primarily for legal counsel and legal services providers, due to the internal and external investigations. While these investigations will likely decrease our liquidity, we cannot predict the scope, timing, or outcome of such legal proceedings, nor can we predict what impact, if any, these matters may have on our business, financial condition, results of operations, and statement of cash flow.

We currently do not have any debt and our only significant commitments are related to our office leases.

At various times from October 2001 through February 2009 our Board of Directors has authorized the repurchase of up to 14 million shares of our outstanding common stock in the aggregate. We did not repurchase any of our outstanding common stock during the year ended December 31, 2010. During 2009, we repurchased 1,181,185 shares of our common stock in open market purchases at an aggregate purchase price of \$4.0 million. During 2008, we repurchased 5,639,950 shares of our common stock in open market purchases at an aggregate purchase price of \$33.9 million. Since October 2001, we have repurchased a total of 8,005,235 shares at an aggregate purchase price of \$46.9 million. As of December 31, 2010, we had the authority to repurchase an additional 5,994,765 shares of our common stock based upon our judgment and market conditions. See Note (7) Stockholders’ Equity to our consolidated financial statements for further information.

Net cash used in operating activities totaled \$1.7 million for the year ended December 31, 2010, compared with net cash provided by operating activities of \$8.8 million and \$18.2 million for the years ended December 31, 2009 and 2008, respectively. The decrease in net cash provided by operating activities for the year ended December 31, 2010, as compared with the same periods in 2009 and 2008, respectively, was the result of recording a net loss of \$35.4 million in 2010 compared with net loss of \$3.1 million and net income of \$1.2 million in 2009 and 2008, respectively, adjusted for: (i) the impact of non-cash charges, particularly relating to deferred income taxes and provision for returns and doubtful accounts; and (ii) adjustments for net changes in operating assets and liabilities, primarily changes in our accounts receivables, inventory, accounts payable, accrued expenses and deferred revenues. Cash outflows from operating activities were also impacted by the tax benefits recognized as a result of excess stock-based compensation deductions and exercises of stock options.

Net cash provided by investing activities was \$3.6 million for the year ended December 31, 2010, compared with net cash used in investing activities of \$11.0 million for the year ended December 31, 2009 and net cash provided by investing activities of \$3.3 million for the year ended December 31, 2008. Included in investing activities for each

year are the sales and purchases of our marketable securities. These represent the sales, maturities and reinvesting of our marketable securities. The net cash provided by investing activities from the net sales (purchases) of securities was \$6.6 million, (\$5.6) million and \$9.9 million for the years ended December 31, 2010, 2009 and 2008, respectively. These amounts will fluctuate from year to year depending on the maturity dates of our marketable securities. The cash used to purchase property and equipment was \$2.7 million, \$4.3 million and \$4.5 million for the years ended December 31, 2010, 2009 and 2008, respectively. In addition, during 2008 we used \$1.7 million for the acquisition of assets, while we did not have any acquisitions of assets in the same periods of 2010 or 2009. The cash used to purchase software licenses was \$1.0 million for the year ended December 31, 2009. We did not have any significant purchases of software licenses during the years ended December 31, 2010 and 2008. We continually evaluate potential software license purchases and acquisitions, and we may continue to make similar investments if we find opportunities that would benefit our business. We anticipate continued capital expenditures as we continue to invest in our infrastructure.

Net cash provided by financing activities was \$0.4 million for the year ended December 31, 2010, compared with net cash used in financing activities of \$3.8 million and \$31.0 million for the years ended December 31, 2009 and 2008, respectively. Cash inflows from financing activities primarily result from proceeds received from the exercise of stock options. We received proceeds from the exercise of stock options of \$0.4 million, \$35,000 and \$0.8 million in 2010, 2009, and 2008, respectively. Cash outflows from financing activities resulted from the repurchase of our outstanding common stock. During 2010, we did not repurchase any of our common stock. During 2009, we repurchased 1.2 million shares of our common stock at an aggregate purchase price of \$4.0 million. During 2008, we repurchased 5.6 million shares of our common stock at an aggregate purchase price of \$33.9 million. Cash inflows from financing activities were also impacted by the tax benefits recognized as a result of excess stock-based compensation deductions and exercises of stock options.

As discussed in Note (4) Fair Value Measurements to our consolidated financial statements, we utilize unobservable (Level 3) inputs in determining the fair value of auction rate securities we hold.

As of December 31, 2010 and December 31, 2009, \$0.7 million and \$1.4 million (at par value), respectively, of our investments was comprised of auction rate securities. Liquidity for these auction rate securities is typically provided by an auction process, which allows holders to sell their notes, and resets the applicable interest rate at pre-determined intervals. Over the past three years we have experienced failed auctions on our auction rate securities. An auction failure means that the parties wishing to sell their securities could not be matched with an adequate volume of buyers. In the event that there is a failed auction, the indenture governing the security requires the issuer to pay interest at a contractually defined rate that is generally above market rates for other types of similar short-term instruments. The securities for which auctions have failed will continue to accrue interest at the contractual rate and continue to reset the next auction date every 28 - 35 days until the auction succeeds, the issuer calls the securities, or they mature. Because there is no assurance that auctions for these securities will be successful in the near term and due to our ability and intent to hold these securities to maturity, the auction rate securities were classified as long-term investments in our consolidated balance sheet at both December 31, 2010 and 2009.

Our auction rate securities are classified as available-for-sale securities and are reflected at fair value. In prior periods during the auction process, quoted market prices were readily available, which would qualify as Level 1 under FASB authoritative guidance. Over the past three years, the auction events for most of these instruments failed and, therefore, we have determined the estimated fair values of these securities utilizing a discounted cash flow analysis or other type of valuation model. These analyses consider, among other items, the collateral underlying the security, the creditworthiness of the issuer, the timing of the expected future cash flows, including the final maturity, associated with the securities, and an assumption of when the next time the security is expected to have a successful auction. These securities were also compared, when possible, to other observable and relevant market data, which is limited at this time. As a result, we reclassified these instruments as Level 3 unobservable inputs within our consolidated financial statements.

As of December 31, 2010, we recorded a cumulative temporary decline in fair value of approximately \$121,357 in accumulated other comprehensive loss. As of December 31, 2009, we recorded \$40,000 cumulatively as an other-than-temporary impairment and a cumulative temporary decline in fair value of approximately \$282,534 in accumulated other comprehensive loss. During the fourth quarter of 2010, \$700,000 of our auction rate securities were called by the issuer at par value, including amounts previously recognized as an other-than-temporary impairment. We believe that the temporary declines in fair value are primarily due to liquidity concerns and are not due to the creditworthiness of the remaining underlying assets, because the majority of the underlying securities are almost entirely backed by the U.S. Government. However, if at any time in the future a determination that a valuation adjustment is other-than-temporary, we will record a charge to earnings in the period of determination.

Our holdings of auction rate securities (at par value) represented approximately 2% and 3% of our cash, cash equivalents, and marketable securities balance as of December 31, 2010 and December 31, 2009, respectively, which we believe allows us sufficient time for the securities to return to full value or to be refinanced by the issuer. Because we believe that the decline in fair value deemed to be temporary is primarily due to liquidity issues in the credit markets, any difference between our estimate and an estimate that would be arrived at by another party would have no impact on our earnings, since such difference would also be recorded to accumulated other comprehensive loss. We will continue to re-evaluate each of these factors as market conditions change in subsequent periods.

We currently do not have any debt and our only material cash commitments are related to our office leases. We have an operating lease covering our corporate office facility that expires in February 2012. We also have several operating leases related to offices in the United States and foreign countries. The expiration dates for these leases range from 2011 through 2013. The following is a schedule of future minimum lease payments for all operating leases as of December 31, 2010:

Year ending December 31,

2011	\$ 2,460,261
2012	949,625
2013	118,933
	\$ 3,528,819

We believe that our current balance of cash, cash equivalents and marketable securities, and our expected cash flows from operations, will be sufficient to meet our cash requirements for at least the next twelve months. However, any projections of future cash needs and cash flows are subject to substantial uncertainty. See Item 1A of Part I, “Risk Factors.”

Off-Balance Sheet Arrangements

As of December 31, 2010 and 2009, we had no off-balance sheet arrangements.

Critical Accounting Policies and Estimates

Our critical accounting policies and estimates are those related to revenue recognition, accounts receivable allowances, deferred income taxes, accounting for share-based payments, acquisitions, goodwill and other intangible assets, and fair value measurements.

Revenue Recognition. We recognize revenue in accordance with the authoritative guidance issued by the FASB on revenue recognition. Product revenue is recognized only when pervasive evidence of an arrangement exists and the fee is fixed and determinable, among other criteria. An arrangement is evidenced by a signed customer contract, a customer purchase order, and/or a royalty report summarizing software licenses sold for each software license resold by an OEM, distributor or solution provider to an end user. Product fees are fixed and determinable as our standard payment terms range from 30 to 90 days, depending on regional billing practices, and we have not provided any of our customers with extended payment terms. When a customer purchases our integrated solutions and/or licenses software together with the purchase of maintenance, we allocate a portion of the fee to maintenance for its fair value based on the contractual maintenance renewal rate.

Accounts Receivable. We review accounts receivable to determine which are doubtful of collection. In making the determination of the appropriate allowance for uncollectible accounts and returns, we consider (i) historical return rates, (ii) specific past due accounts, (iii) analysis of our accounts receivable aging, (iv) customer payment terms, (v) historical collections, write-offs and returns, (vi) changes in customer demand and relationships, (vii) actual cash collections on our accounts receivables and (viii) concentrations of credit risk and customer credit worthiness. As part of our determination of the appropriate allowance for uncollectible accounts each period, the actual customer collections of outstanding account receivable balances impact the required allowance for doubtful accounts. Historically, we have experienced a somewhat consistent level of write-offs and returns as a percentage of revenue due to our customer relationships, contract provisions and credit assessments. Changes in the product return rates, credit worthiness of customers, general economic conditions and other factors may impact the level of future write-offs, revenues and our general and administrative expenses.

Deferred Income Taxes. In accordance with the authoritative guidance issued by the FASB on income taxes, we regularly estimate our ability to recover deferred tax assets, and report such deferred tax assets at the amount that is determined to be more-likely-than-not recoverable. We also have to estimate our income taxes in each of the taxing jurisdictions in which we operate. This process involves estimating our current tax expense together with assessing any temporary differences resulting from the different treatment of certain items, such as the timing for recognizing revenue and expenses for tax and accounting purposes, as well as estimating foreign tax credits. These differences may result in deferred tax assets and liabilities, which are included in our condensed consolidated balance sheet. We are required to assess the likelihood that our deferred tax assets, which include temporary differences that are expected to be deductible in future years, will be recoverable from future taxable income or other tax planning strategies. If recovery is not likely, we have to provide a valuation allowance based on our estimates of future taxable income in the various taxing jurisdictions, and the amount of deferred taxes that are ultimately realizable. The provision for current and deferred taxes involves evaluations and judgments of uncertainties in the interpretation of complex tax regulations. This evaluation considers several factors, including an estimate of the likelihood of generating sufficient taxable income in future periods, the effect of temporary differences, the expected reversal of deferred tax liabilities, past and projected taxable income, and available tax planning strategies.

Accounting for Share-Based Payments. As discussed further in Note (8) Share-Based Payment Arrangements, to our consolidated financial statements, we account for stock-based awards in accordance with the authoritative guidance issued by the FASB on stock compensation.

We have used and expect to continue to use the Black-Scholes option-pricing model to compute the estimated fair value of share-based compensation expense. The Black-Scholes option-pricing model includes assumptions regarding dividend yields, expected volatility, expected option term and risk-free interest rates. The assumptions used in computing the fair value of share-based compensation expense reflect our best estimates, but involve uncertainties relating to market and other conditions, many of which are outside of our control. We estimate expected volatility based primarily on historical daily price changes of our stock and other factors. The expected option term is the number of years that we estimate that the stock options will be outstanding prior to exercise. The expected term of the awards issued prior to January 1, 2008, was determined using the “simplified method” prescribed in SEC Staff Accounting Bulletin (“SAB”) No. 107. The estimated expected term of the stock awards issued since January 1, 2008 has been determined pursuant to SAB No. 110. Additionally, we estimate forfeiture rates based primarily upon historical experiences, adjusted when appropriate for known events or expected trends. We may adjust share-based compensation expense on a quarterly basis for changes to our estimate of expected equity award forfeitures based on our review of these events and trends, and recognize the effect of adjusting the forfeiture rate for all expense amortization in the period in which we revised the forfeiture estimate. If other assumptions or estimates had been used, the share-based compensation expense that was recorded for the years ended December 31, 2010, 2009, and 2008, could have been materially different. Furthermore, if different assumptions or estimates are used in future periods, share-based compensation expense could be materially impacted in the future.

Acquisitions. We account for acquisitions in accordance with the authoritative guidance issued by the FASB on business combinations. Pursuant to the authoritative guidance, the acquiring company must allocate the purchase price of the assets acquired and liabilities assumed based on their estimated fair values at the date of acquisition, including intangible assets that can be identified. The purchase price in excess of the fair value of the net assets and liabilities is recorded as goodwill. Among other sources of relevant information, we use independent appraisals or other valuations to assist in determining the estimated and final recorded fair value of assets and liabilities acquired.

Goodwill and Other Intangible Assets. As discussed further in Note (1) Summary of Significant Accounting Policies, to our consolidated financial statements, we account for goodwill and other intangible assets in accordance with the authoritative guidance issued by the FASB on goodwill and other intangibles. The authoritative guidance requires an impairment-only approach to accounting for goodwill and other intangibles with an indefinite life. Absent any prior

indicators of impairment, we perform an annual impairment analysis during the fourth quarter of each of our fiscal year.

As of each December 31, 2010 and 2009, we had \$4.2 million of goodwill, respectively. As of each December 31, 2010 and 2009, we had \$0.4 million and \$0.8 million (net of amortization), respectively, of other identifiable intangible assets. We do not amortize goodwill, but we assess for impairment at least annually and more often if a trigger event occurs. We amortize identifiable intangible assets over their estimated useful lives, which typically is three years. We evaluate the recoverability of goodwill using a two-step process based on an evaluation of the reporting unit. The first step involves a comparison of a reporting unit's fair value to its carrying value. In the second step, if the reporting unit's carrying value exceeds its fair value, we compare the goodwill's implied fair value and its carrying value. If the goodwill's carrying value exceeds its implied fair value, we recognize an impairment loss in an amount equal to such excess. We evaluate the recoverability of other identifiable intangible assets whenever events or changes in circumstances indicate that its carrying value may not be recoverable. Such events include significant adverse changes in business climate, several periods of operating or cash flow losses, forecasted continuing losses or a current expectation that an asset or asset group will be disposed of before the end of its useful life.

Throughout 2010, we continually monitored the actual performance of the business relative to the fair value assumptions used during our annual goodwill impairment test. For the periods presented, we did not identify any triggering events which would require an update to our annual impairment test. As a measure of sensitivity, a 20% decrease in the fair value of our reporting unit as of December 31, 2010 would have had no impact on the carrying value of our goodwill. As of both December 31, 2010 and 2009, we did not record any impairment charges on either our goodwill or other identifiable intangible assets.

Fair Value Measurement. As discussed further in Note (4), Fair Value Measurements, to our consolidated financial statements, we determine fair value measurements of both financial and nonfinancial assets and liabilities in accordance with the authoritative guidance issued by the FASB on fair value measurements and disclosures.

In the current market environment, the assessment of the fair value of our marketable securities, specifically our debt instruments, can be difficult and subjective. The volume of trading activity of certain debt instruments has declined, and the rapid changes occurring in the current financial markets can lead to changes in the fair value of financial instruments in relatively short periods of time. The FASB authoritative guidance establishes three levels of inputs that may be used to measure fair value. Each level of input has different levels of subjectivity and difficulty involved in determining fair value.

Level 1 - instruments represent quoted prices in active markets. Therefore, determining fair value for Level 1 instruments does not require significant management judgment, and the estimation is not difficult.

Level 2 - instruments include observable inputs other than Level 1 prices, such as quoted prices for identical instruments in markets with insufficient volume or infrequent transactions (less active markets), issuer credit ratings, non-binding market consensus prices that can be corroborated with observable market data, model-derived valuations in which all significant inputs are observable or can be derived principally from or corroborated with observable market data for substantially the full term of the assets or liabilities, or quoted prices for similar assets or liabilities. These Level 2 instruments require more management judgment and subjectivity compared to Level 1 instruments.

Level 3 - instruments include unobservable inputs to the valuation methodology that are significant to the measurement of fair value of assets or liabilities. The determination of fair value for Level 3 instruments requires the most management judgment and subjectivity. All of our marketable debt instruments classified as Level 3 are valued using a undiscounted cash flow analysis, non-binding market consensus price and/or a non-binding broker quote, all of which we corroborate with unobservable data. Non-binding market consensus prices are based on the proprietary valuation models of pricing providers or brokers. These valuation models incorporate a number of inputs, including non-binding and binding broker quotes; observable market prices for identical and/or similar securities; and the internal assumptions of pricing providers or brokers that use observable market inputs, and to a lesser degree non-observable market inputs. Adjustments to the fair value of instruments priced using non-binding market consensus prices and non-binding broker quotes, and classified as Level 3, were not significant for each of the years ended December 31, 2010 and 2009.

Other-Than-Temporary Impairment

After determining the fair value of our available-for-sale debt instruments, gains or losses on these investments are recorded to other comprehensive income, until either the investment is sold or we determine that the decline in value is other-than-temporary. Determining whether the decline in fair value is other-than-temporary requires management judgment based on the specific facts and circumstances of each investment. For investments in debt instruments, these judgments primarily consider the financial condition and liquidity of the issuer, the issuer's credit rating, and any specific events that may cause us to believe that the debt instrument will not mature and be paid in full; and our ability and intent to hold the investment to maturity. Given the current market conditions, these judgments could prove to be

wrong, and companies with relatively high credit ratings and solid financial conditions may not be able to fulfill their obligations.

As of December 31, 2010, our investments in marketable securities included \$0.7 million (at par value) of available-for-sale auction rate securities, and we did not recognize any other-than-temporary impairments on our available-for-sale auction rate securities. As of December 31, 2009, our investments in marketable securities included \$1.4 million (at par value) of available-for-sale auction rate securities and recognized \$40,000 cumulatively in other-than-temporary impairments on our available-for-sale auction rate securities.

Impact of Recently Issued Accounting Pronouncements

See Item 8 of Part II, Consolidated Financial Statements – Note (1) Summary of Significant Accounting Policies – New Accounting Pronouncements.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

Interest Rate Risks. Our cash, cash equivalents and marketable securities aggregated \$37.3 million as of December 31, 2010. Our exposure to market risk for changes in interest rates relates primarily to our investment portfolio. All of our cash equivalent and marketable securities are designated as available-for-sale and, accordingly, are presented at fair value on our consolidated balance sheets. We regularly assess these risks and have established policies and business practices to manage the market risk of our marketable securities. We generally invest our excess cash in investment grade short- to intermediate-term fixed income securities and AAA-rated money market funds. Fixed rate securities may have their fair market value adversely affected due to a rise in interest rates, and we may suffer losses in principal if forced to sell securities that have declined in market value due to changes in interest rates. Due to the short-term nature of the majority of our investments, the already severely suppressed interest rates we currently earn, and the fact that over 35% of our total cash, cash equivalents and marketable securities are comprised of money market funds and cash, we do not believe we are subject to any material interest rate risks on our investment balances levels at December 31, 2010.

Foreign Currency Risk. We have several offices outside the United States. Accordingly, we are subject to exposure from adverse movements in foreign currency exchange rates. For the years ended December 31, 2010, 2009 and 2008, approximately 45%, 40% and 40%, respectively, of our sales were from outside the United States. Not all of these transactions were made in foreign currencies. Our primary exposure is to fluctuations in exchange rates for the U.S. dollar versus the Euro, Japanese yen, the New Taiwanese Dollar, Korean won, and to a lesser extent the Canadian dollar and the Australian dollar. Changes in exchange rates in the functional currency for each geographic area's revenues are primarily offset by the related expenses associated with such revenues. However, changes in exchange rates of a particular currency could impact the remeasurement of such balances on our balance sheets.

If foreign currency exchange rates were to change adversely by 10% from the levels at December 31, 2010, the effect on our results before taxes from foreign currency fluctuations on our balance sheet would be approximately \$1.0 million. Commencing in the second quarter of 2009, we began entering into foreign currency hedges, and from time to time will use such financial instruments to minimize our exposure to changes in certain foreign currency exchange rates on the balance sheet (see Note (11) Derivative Financial Instruments, to our consolidated financial statements). The above analysis disregards the possibility that rates for different foreign currencies can move in opposite directions and that losses from one currency may be offset by gains from another currency.

Item 8. Financial Statements and Supplementary Data

Index to Consolidated Financial Statements	Page
Reports of Independent Registered Public Accounting Firm	52
Consolidated Balance Sheets as of December 31, 2010 and 2009	54
Consolidated Statements of Operations for the years ended December 31, 2010, 2009 and 2008	55
Consolidated Statements of Stockholders' Equity and Comprehensive Income (Loss) for the years Ended December 31, 2010, 2009 and 2008	56
Consolidated Statements of Cash Flows for the years ended December 31, 2010, 2009 and 2008	57
Notes to Consolidated Financial Statements	59

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders
FalconStor Software, Inc.:

We have audited the accompanying consolidated balance sheets of FalconStor Software, Inc. and subsidiaries as of December 31, 2010 and 2009, and the related consolidated statements of operations, stockholders' equity and comprehensive income (loss), and cash flows for each of the years in the three-year period ended December 31, 2010. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of FalconStor Software, Inc. and subsidiaries as of December 31, 2010 and 2009, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2010, in conformity with U.S. generally accepted accounting principles.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of FalconStor Software, Inc. and subsidiaries' internal control over financial reporting as of December 31, 2010, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report, dated March 14, 2011, expressed an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

/s/ KPMG LLP

Melville, New York,
March 14, 2011

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders
FalconStor Software, Inc.:

We have audited FalconStor Software, Inc. and subsidiaries' internal control over financial reporting as of December 31, 2010, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). FalconStor Software, Inc.'s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, FalconStor Software, Inc. and subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2010, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of FalconStor Software, Inc. and subsidiaries as of December 31, 2010 and 2009, and the related consolidated statements of operations, stockholders' equity and comprehensive income (loss), and cash flows for each of the years in the three-year period ended December 31, 2010, and our report dated March 14, 2011, expressed an unqualified opinion on those consolidated financial statements.

/s/ KPMG LLP

Melville, New York
March 14, 2011

53

FALCONSTOR SOFTWARE, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

	December 31,	
	2010	2009
Assets		
Current assets:		
Cash and cash equivalents	\$17,842,555	\$15,752,528
Marketable securities	18,903,635	24,952,966
Accounts receivable, net of allowances of \$3,242,458 and \$7,503,338, respectively	23,286,660	24,948,261
Prepaid expenses and other current assets	1,190,531	1,556,787
Income tax receivable	385,682	830,816
Inventory	1,409,659	329,657
Deferred tax assets, net	-	4,320,773
Total current assets	\$63,018,722	\$72,691,788
Property and equipment, net of accumulated depreciation of \$19,468,420 and \$17,380,681, respectively	5,796,013	7,601,727
Long-term marketable securities	578,643	1,077,466
Deferred tax assets, net	235,197	9,698,859
Other assets, net	2,379,225	2,958,229
Goodwill	4,150,339	4,150,339
Other intangible assets, net	387,222	823,416
Total assets	\$76,545,361	\$99,001,824
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	\$1,455,013	\$1,570,190
Accrued expenses	9,109,424	8,454,743
Deferred revenue, net	16,979,455	16,570,076
Total current liabilities	27,543,892	26,595,009
Other long-term liabilities	2,507,169	608,907
Deferred revenue, net	6,555,437	5,644,994
Total liabilities	\$36,606,498	\$32,848,910
Commitments and Contingencies		
Stockholders' equity:		
Preferred stock - \$.001 par value, 2,000,000 shares authorized, none issued	--	--
Common stock - \$.001 par value, 100,000,000 shares authorized, 54,147,234 and 52,389,028 shares issued, respectively and 46,141,999 and 44,383,793 shares outstanding, respectively	54,147	52,389

Edgar Filing: FALCONSTOR SOFTWARE INC - Form 10-K

Additional paid-in capital	150,884,184	141,726,802
Accumulated deficit	(62,557,515)	(27,181,894)
Common stock held in treasury, at cost (8,005,235 and 8,005,235 shares, respectively)	(46,916,339)	(46,916,339)
Accumulated other comprehensive loss, net	(1,525,614)	(1,528,044)
Total stockholders' equity	39,938,863	66,152,914
Total liabilities and stockholders' equity	\$76,545,361	\$99,001,824

See accompanying notes to consolidated financial statements.

FALCONSTOR SOFTWARE, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

	Years Ended December 31,		
	2010	2009	2008
Revenues:			
Product revenues	\$51,905,096	\$61,234,075	\$61,565,673
Support and services revenues	30,938,650	28,225,106	25,459,187
Total revenues	82,843,746	89,459,181	87,024,860
Cost of revenues:			
Product	\$9,291,236	\$3,390,065	\$2,636,042
Support and service	13,204,089	13,676,740	11,384,457
Total cost of revenues	22,495,325	17,066,805	14,020,499
Gross profit	\$60,348,421	\$72,392,376	\$73,004,361
Operating expenses:			
Research and development costs	25,849,374	26,609,986	25,150,143
Selling and marketing	40,844,909	42,255,099	38,096,693
General and administrative	11,242,705	9,875,254	8,745,777
Total operating expenses	77,936,988	78,740,339	71,992,613
Operating (loss) income	(17,588,567)	(6,347,963)	1,011,748
Interest and other (loss) income, net	(213,079)	(127,803)	1,688,699
(Loss) income before income taxes	(17,801,646)	(6,475,766)	2,700,447
Provision (benefit) for income taxes	17,573,975	(3,383,061)	1,497,635
Net (loss) income	\$(35,375,621)	\$(3,092,705)	\$1,202,812
Basic net (loss) income per share	\$(0.78)	\$(0.07)	\$0.03
Diluted net (loss) income per share	\$(0.78)	\$(0.07)	\$0.02
Basic weighted average common shares outstanding	45,549,314	44,781,918	47,858,679
Diluted weighted average commonshares outstanding	45,549,314	44,781,918	49,496,736

See accompanying notes to consolidated financial statements.

FALCONSTOR SOFTWARE, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY AND COMPREHENSIVE INCOME (LOSS)

	Common stock	Additional paid-in capital	Accumulated deficit	Treasury stock	Accumulated other comprehensive (loss)	Total stockholders' equity	Comprehensive income (loss)
Balance, December 31, 2007	\$51,340	\$122,294,782	\$(25,292,001)	\$(9,053,824)	\$(521,920)	\$87,478,377	12,694,063
Exercise of stock awards	630	820,652	—	—	—	821,282	—
Net effects of tax benefits from stock-based award activity	—	798,280	—	—	—	798,280	—
Share-based compensation to non-employees	—	140,975	—	—	—	140,975	—
Share-based compensation to employees	—	8,943,541	—	—	—	8,943,541	—
Net Income	—	—	1,202,812	—	—	1,202,812	1,202,812
Acquisition of treasury stock	—	—	—	(33,874,504)	—	(33,874,504)	—
Minimum pension liability adjustment, net (Note 13)	—	—	—	—	61,454	61,454	61,454
Change in unrealized gains / losses on marketable securities, net	—	—	—	—	(224,299)	(224,299)	(224,299)
Foreign currency translation adjustment	—	—	—	—	(271,566)	(271,566)	(271,566)
Balance, December 31, 2008	\$51,970	\$132,998,230	\$(24,089,189)	\$(42,928,328)	\$(956,331)	\$65,076,352	\$768,401
	419	35,101	—	—	—	35,520	—

Exercise of stock awards							
Net effects of tax shortfalls from stock-based award activity	–	(133,970)	–	–	–	(133,970)	–
Share-based compensation to non-employees	–	275,480	–	–	–	275,480	–
Share-based compensation to employees	–	8,551,961	–	–	–	8,551,961	
Net Loss	–	–	(3,092,705)	–	–	(3,092,705)	(3,092,705)
Acquisition of treasury stock	–	–	–	(3,988,011)	–	(3,988,011)	–
Minimum pension liability adjustment, net (Note 13)	–	–	–	–	(50,850)	(50,850)	(50,850)
Change in unrealized gains / losses on marketable securities, net	–	–	–	–	24,031	24,031	24,031
Foreign currency translation adjustment	–	–	–	–	(544,894)	(544,894)	(544,894)
Balance, December 31, 2009	\$52,389	\$141,726,802	\$(27,181,894)	\$(46,916,339)	\$(1,528,044)	\$66,152,914	\$(3,664,418)

Exercise of stock awards	1,758	408,131	–	–	–	409,889	–
Net effects of tax shortfalls from stock-based award activity	–	63,682	–	–	–	63,682	–
Share-based compensation to non-employees	–	819,185	–	–	–	819,185	–
Share-based compensation to employees	–	7,866,384	–	–	–	7,866,384	
Net Loss	–	–	(35,375,621)	–	–	(35,375,621)	(35,375,621)

Minimum pension liability adjustment, net (Note 13)	—	—	—	—	(59,655)	(59,655)	(59,655)
Change in unrealized gains / losses on marketable securities, net	—	—	—	—	137,172	137,172	137,172
Foreign currency translation adjustment	—	—	—	—	(75,087)	(75,087)	(75,087)
Balance, December 31, 2010	\$54,147	\$150,884,184	\$(62,557,515)	\$(46,916,339)	\$(1,525,614)	\$39,938,863	\$(35,373,191)

See accompanying notes to consolidated financial statements.

FALCONSTOR SOFTWARE, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Years Ended December 31,		
	2010	2009	2008
Cash flows from operating activities:			
Net (loss) income	\$(35,375,621)	\$(3,092,705)	\$1,202,812
Adjustments to reconcile net (loss) income to net cash provided by operating activities:			
Depreciation and amortization	5,644,682	5,889,353	5,075,090
Share-based payment employee compensation	7,866,384	8,551,961	8,943,541
Non-cash professional services expenses	819,185	275,480	140,975
Realized loss (gain) on marketable securities	90,761	21,582	(7,403)
Impairment of cost method investments	--	57,068	65,424
Excess tax benefits from stock-based award activity	--	(125,792)	(2,054,914)
Provision for returns and doubtful accounts	1,211,838	3,163,697	4,088,575
Deferred income taxes	16,075,130	(4,112,205)	(1,125,867)
Changes in operating assets and liabilities:			
Accounts receivable	438,529	(3,111,342)	(2,968,069)
Prepaid expenses and other current assets	381,509	(58,479)	(125,558)
Income tax receivable	445,134	(110,659)	(720,157)
Inventory	(1,080,002)	(75,705)	(2,873)
Other assets	204,657	31,153	139,253
Accounts payable	(96,236)	839,210	(1,020,454)
Accrued expenses and other liabilities	324,726	507,140	3,503,772
Deferred revenue	1,320,820	156,734	3,097,462
Net cash (used in) provided by operating activities	(1,728,504)	8,806,491	18,231,609
Cash flows from investing activities:			
Purchase of marketable securities	(27,586,592)	(35,066,943)	(99,690,769)
Sale of marketable securities	34,148,774	29,499,217	109,569,524
Acquisition of assets	--	--	(1,696,000)
Purchase of property and equipment	(2,700,378)	(4,303,718)	(4,502,417)
Purchase of software licenses	--	(950,000)	--
Capitalized software development costs	(107,206)	(80,703)	--
Purchase of intangible assets	(129,306)	(83,973)	(340,482)
Security deposits	9,081	(33,440)	(4,000)
Net cash provided by (used in) investing activities	3,634,373	(11,019,560)	3,335,856

Cash flows from financing activities:

Proceeds from exercise of stock options	409,889	35,520	821,282
Payments to acquire treasury stock	--	(3,988,011)	(33,874,504)
Excess tax benefits from stock-based award activity	--	125,792	2,054,914
Net cash provided by (used in) financing activities	409,889	(3,826,699)	(30,998,308)
Effect of exchange rate changes	(225,731)	(571,939)	(424,271)
Net increase (decrease) in cash and cash equivalents	2,090,027	(6,611,707)	(9,855,114)
Cash and cash equivalents, beginning of year	15,752,528	22,364,235	32,219,349
Cash and cash equivalents, end of year	\$17,842,555	\$15,752,528	\$22,364,235
Cash paid for income taxes	\$721,159	\$130,125	\$1,125,415

The Company did not pay any interest for the three years ended December 31, 2010.

See accompanying notes to consolidated financial statements.

FALCONSTOR SOFTWARE, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

December 31, 2010

(1) Summary of Significant Accounting Policies

(a) The Company and Nature of Operations

FalconStor Software, Inc., a Delaware Corporation (the "Company"), develops, manufactures and sells network storage software solutions and provides the related maintenance, implementation and engineering services.

(b) Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation.

(c) Reclassifications

Certain prior years amounts have been reclassified to conform to the current year presentation. The Company no longer presents revenues classified as (i) "software licenses," (ii) "maintenance," and (iii) "software services and other" within the condensed consolidated statement of operations. The Company presents revenues derived from software solutions integrated with hardware and stand-alone software applications as "product revenue" and revenues derived from maintenance and professional services as "support and services revenue" within the condensed consolidated statement of operations. In addition, the Company presents the related cost of revenues from both "product revenue" and "support and services revenues" as separate line items within the condensed consolidated statement of operations. Certain costs, including personnel, shipping and logistics costs, and share-based compensation expense, from prior years have been reclassified from various operating expense line items to "cost of revenues – product." The Company believes the reclassifications provide a more meaningful representation of the Company's product and services offerings. The reclassifications had no effect on net earnings, total stockholders' equity, total assets or cash flows.

(d) Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. The Company's significant estimates include those related to revenue recognition, accounts receivable allowances, share-based payment compensation, cost-based investments, marketable securities and deferred income taxes. Actual results could differ from those estimates.

The financial market volatility, both in the U.S. and in many other countries where the Company operates, has impacted and may continue to impact the Company's business. Such conditions could have a material impact to the Company's significant accounting estimates discussed above, in particular those around accounts receivable allowances, cost-based investments, marketable securities and the recoverability of deferred tax assets.

(e) Cash Equivalents and Marketable Securities

The Company considers all highly liquid investments with maturities of three months or less when purchased to be cash equivalents. The Company records its cash equivalents and marketable securities at fair value in accordance with the authoritative guidance issued by the Financial Accounting Standards Board (“FASB”) on fair value measurements and disclosures. As of December 31, 2010 and December 31, 2009, the Company’s cash equivalents consisted of money market funds and government securities. At December 31, 2010 and December 31, 2009, the fair value of the Company’s cash equivalents amounted to approximately \$14.1 million and \$8.8 million, respectively. As of December 31, 2010 and December 31, 2009, the Company’s marketable securities consisted of corporate bonds, auction rate securities, and government securities. As of December 31, 2010 and December 31, 2009, the fair value of the Company’s current marketable securities was approximately \$18.9 million and \$25.0 million, respectively. In addition, at December 31, 2010 and December 31, 2009, the Company had an additional \$0.6 million and \$1.1 million, respectively, of long-term marketable securities that required a higher level of judgment to determine the fair value. All of the Company’s marketable securities are classified as available-for-sale, and accordingly, unrealized gains and losses on marketable securities, net of tax, are reflected as a component of accumulated other comprehensive loss in stockholders’ equity. Any other-than-temporary impairments are recorded in other income in the consolidated statement of operations. See Note (4) Fair Value Measurements for additional information.

(f) Fair Value of Financial Instruments

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. To increase the comparability of fair value measurements, a three-tier fair value hierarchy, which prioritizes the inputs used in the valuation methodologies, is as follows:

Level 1—Valuations based on quoted prices for identical assets and liabilities in active markets.

Level 2—Valuations based on observable inputs other than quoted prices included in Level 1, such as quoted prices for similar assets and liabilities in active markets, quoted prices for identical or similar assets and liabilities in markets that are not active, or other inputs that are observable or can be corroborated by observable market data.

Level 3—Valuations based on unobservable inputs reflecting our own assumptions, consistent with reasonably available assumptions made by other market participants. These valuations require significant judgment.

As of each December 31, 2010 and 2009, the fair value of the Company's financial instruments including cash and cash equivalents, accounts receivable, accounts payable and accrued expenses, approximates book value due to the short maturity of these instruments. See Note (4) Fair Value Measurements for additional information.

(g) Revenue Recognition

The Company derives its revenue from sales of its products and services. Product revenue consists of the Company's software integrated with industry standard hardware and sold as one complete turn-key integrated solution. Product revenue also consists of stand-alone software applications. Support and services revenue consists of both maintenance revenues and professional services revenues. Revenue is recorded net of applicable sales taxes.

In accordance with the authoritative guidance issued by the FASB on revenue recognition, the Company recognizes revenue from product sales when persuasive evidence of an arrangement exists, the fee is fixed and determinable, the product is delivered, and collection of the resulting receivable is deemed probable. Products delivered to a customer on a trial basis are not recognized as revenue until a permanent key code is delivered to the customer. Reseller customers typically send the Company a purchase order when they have an end user identified. For bundle arrangements that include either maintenance or both maintenance and professional services, the Company uses the residual method to determine the amount of product revenue to be recognized. Under the residual method, consideration is allocated to the undelivered elements based upon vendor-specific objective evidence ("VSOE") of the fair value of those elements, with the residual of the arrangement fee allocated to and recognized as product revenue. The long-term portion of deferred revenue relates to maintenance contracts with terms in excess of one year. The Company provides an allowance for product returns as a reduction of revenue, based upon historical experience and known or expected trends.

Revenues associated maintenance services are deferred and recognized as revenue ratably over the term of the contract. Revenues associated with software implementation and software engineering services are recognized when the services are performed. Costs of providing these services are included in cost of support and services revenue.

The Company has entered into various distribution, licensing and joint promotion agreements with OEMs and distributors, whereby the Company has provided to the reseller a non-exclusive software license to install the Company's software on certain hardware or to resell the Company's software in exchange for payments based on the products distributed by the OEM or distributor. Such payments from the OEM or distributor are recognized as revenue in the period reported by the OEM or distributor.

(h) Property and Equipment

Property and equipment are recorded at cost. Depreciation is recognized using the straight-line method over the estimated useful lives of the assets (3 to 7 years). Leasehold improvements are amortized on a straight-line basis over the terms of the respective leases or over their estimated useful lives, whichever is shorter.

(i) Goodwill and Other Intangible Assets

Goodwill represents the excess of the purchase price over the estimated fair value of net tangible and identifiable intangible assets acquired in business combinations. The Company has not amortized goodwill related to its acquisitions, but instead tests the balance for impairment. The Company's annual impairment assessment is performed during the fourth quarter of each year, and an assessment is made at other times if events or changes in circumstances indicate that it is more likely than not that the asset is impaired. Identifiable intangible assets, include (i) assets acquired through business combinations, which include customer contracts and intellectual property, and (ii) patents amortized over three years using the straight-line method.

Amortization expense was \$565,501, \$636,252 and \$464,495 for the years ended December 31, 2010, 2009 and 2008, respectively. The gross carrying amount and accumulated amortization of other intangible assets as of December 31, 2010 and December 31, 2009 are as follows:

	December 31, 2010	December 31, 2009
Goodwill:	\$ 4,150,339	\$ 4,150,339
Other intangible assets:		
Gross carrying amount	\$ 2,899,055	\$ 2,769,748
Accumulated amortization	(2,511,833)	(1,946,332)
Net carrying amount	\$ 387,222	\$ 823,416

As of December 31, 2010, amortization expense for existing identifiable intangible assets is expected to be \$303,258, \$61,343, and \$22,620 for the years ended December 31, 2011, 2012 and 2013, respectively. Such assets will be fully amortized at December 31, 2013.

(j) Software Development Costs and Purchased Software Technology

In accordance with the authoritative guidance issued by the FASB on costs of software to be sold, leased, or marketed, costs associated with the development of new software products and enhancements to existing software products are expensed as incurred until technological feasibility of the product has been established. Based on the Company's product development process, technological feasibility is established upon completion of a working model.

Amortization of software development costs is recorded at the greater of the straight-line basis over the products estimated life, or the ratio of current revenue of the related products to total current and anticipated future revenue of these products. During 2010 and 2009, the Company capitalized \$107,206 and \$80,703, respectively, related to software development projects. Amortization expense was \$26,901 and \$20,176 for the years ended December 31, 2010 and December 31, 2009, respectively.

Purchased software technology is included in "other assets" in the consolidated balance sheets. As of December 31, 2010, purchased software technology has been fully amortized. As of December 31, 2009, the net carrying value of purchased software technology totaled \$510,000, after accumulated amortization of \$5,817,431. Amortization expense was \$510,000, \$542,540 and \$143,477 for the years ended December 31, 2010, 2009 and 2008, respectively. Amortization of purchased software technology was recorded at the greater of the straight-line basis over the products

estimated remaining life or the ratio of current period revenue of the related products to total current and anticipated future revenue of these products.

As of December 31, 2010, amortization expense for software development costs is expected to be \$62,636, \$42,461 and \$35,735 for the years ended December 31, 2011, 2012 and 2013, respectively. Such assets will be fully amortized at December 31, 2013.

(k) Income Taxes

The Company records income taxes under the liability method. Deferred tax assets and liabilities are recognized for future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be realized or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. In determining the period in which related tax benefits are realized for book purposes, excess share-based compensation deductions included in net operating losses are realized after regular net operating losses are exhausted.

The Company accounts for uncertain tax positions in accordance with the authoritative guidance issued by the FASB on income taxes, which addresses the determination of whether tax benefits claimed or expected to be claimed on a tax return, should be recorded in the financial statements. Pursuant to the authoritative guidance, the Company may recognize the tax benefit from an uncertain tax position only if it meets the “more likely than not” threshold that the position will be sustained on examination by the taxing authority, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position should be measured based on the largest benefit that has a greater than fifty percent likelihood of being realized upon ultimate settlement. In addition, the authoritative guidance addresses de-recognition, classification, interest and penalties on income taxes, accounting in interim periods, and also requires increased disclosures. The Company includes interest and penalties related to its uncertain tax positions as part of income tax expense within its consolidated statement of operations. See Note (6) Income Taxes for additional information.

(l) Long-Lived Assets

The Company reviews its long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of the asset may not be recoverable. If the sum of the expected future cash flows, undiscounted and without interest is less than the carrying amount of the asset, an impairment loss is recognized as the amount by which the carrying amount of the asset exceeds its fair value.

(m) Share-Based Payments

The Company accounts for share-based payments in accordance with the authoritative guidance issued by the FASB on stock compensation, which establishes the accounting for transactions in which an entity exchanges its equity instruments for goods or services. Under the provisions of the authoritative guidance, share-based compensation expense is measured at the grant date, based on the fair value of the award, and is recognized as an expense over the requisite employee service period (generally the vesting period), net of estimated forfeitures. The Company estimates the fair value of share-based payments using the Black-Scholes option-pricing model. The estimation of share-based awards that will ultimately vest requires judgment, and to the extent actual results or updated estimates differ from the Company’s current estimates, such amounts will be recorded as a cumulative adjustment in the period estimates are revised. The Company considers many factors when estimating expected forfeitures, including types of awards, employee class and historical experience. Additionally, share-based awards to non-employees are expensed over the period in which the related services are rendered at their fair value. All share-based awards are expected to be fulfilled with new shares of common stock.

(n)

Foreign Currency

Assets and liabilities of foreign operations are translated at rates of exchange at the end of the period, while results of operations are translated at average exchange rates in effect for the period. Unrealized gains and losses from the translation of foreign assets and liabilities are classified as a separate component of stockholders' equity. Realized gains and losses from foreign currency transactions are included in the consolidated statements of operations within interest and other income, net. During the years ended December 31, 2010, 2009, and 2008, foreign currency realized gains (losses) totaled approximately (\$338,000), (\$626,000), and \$199,000, respectively. The aforementioned foreign currency transactional results are net of the foreign currency forward contracts utilized by the Company as part of the management program to reduce the volatility in earnings caused by exchange rate fluctuations. See Note (11) Derivative Financial Instruments for additional information.

(o)

Earnings Per Share (EPS)

Basic EPS is computed based on the weighted average number of shares of common stock outstanding. Diluted EPS is computed based on the weighted average number of common shares outstanding increased by dilutive common stock equivalents, attributable to stock option awards, restricted stock awards and restricted stock unit awards outstanding. Due to the net loss for the years ended December 31, 2010 and December 31, 2009, all common stock equivalents of 13,032,306 and 13,791,999, respectively, were excluded from diluted net loss per share because they were anti-dilutive. As of December 31, 2008, potentially dilutive common stock equivalents totaled 10,163,985, of which, 8,525,928 were excluded from net income per share because they were anti-dilutive.

The following represents a reconciliation of the numerators and denominators of the basic and diluted earnings per share ("EPS") computation:

	Year Ended December 31, 2010			Year Ended December 31, 2009			Year Ended December 31, 2008		
	Net Loss	Shares	Per Share	Net Loss	Shares	Per Share	Net Income	Shares	Per Share
	(Numerator)	(Denominator)	Amount	(Numerator)	(Denominator)	Amount	(Numerator)	(Denominator)	Amount
Basic EPS	\$(35,375,621)	45,549,314	\$(0.78)	\$(3,092,705)	44,781,918	\$(0.07)	\$1,202,812	47,858,679	\$0.03
Effect of dilutive securities:									
Stock Options and Restricted Stock		-			-			1,638,057	
Diluted EPS	\$(35,375,621)	45,549,314	\$(0.78)	\$(3,092,705)	44,781,918	\$(0.07)	\$1,202,812	49,496,736	\$0.02

(o) Investments

As of both December 31, 2010 and 2009, the Company maintained certain cost-method investments aggregating \$973,965, which are included within "Other assets, net" in the accompanying consolidated balance sheets. During 2010, the Company did not recognize any impairment charges. During 2009 and 2008, the Company recognized impairment charges of \$57,068 and \$65,424, respectively, related to certain of its cost-method investments as a result of

other-than-temporary declines in market value related to certain of these investments. These charges are included within "Interest and other (loss) income, net" in the accompanying consolidated statements of operations.

(p) Treasury Stock

The Company accounts for treasury stock under the cost method and includes treasury stock as a component of stockholders' equity.

(q) New Accounting Pronouncements

In January 2010, the FASB issued authoritative guidance that requires reporting entities to make new disclosures about recurring or nonrecurring fair-value measurements including significant transfers into and out of Level 1 and Level 2 fair value measurements, and information on purchases, sales, issuances, and settlements on a gross basis in the reconciliation of Level 3 fair value measurements. The guidance was effective for the Company beginning with its first quarter of 2010, except for Level 3 reconciliation disclosures, which are effective for annual periods beginning after December 15, 2010. The adoption of this authoritative guidance did not have a significant impact on the Company's condensed consolidated financial statements.

In October 2009, the FASB issued authoritative guidance related to the recognition of revenue for multiple-deliverable arrangements. Under the authoritative guidance, revenue may be allocated to the different elements in an arrangement based on relative selling price using the best estimate of selling price if vendor-specific or other third-party evidence of value is not available. This authoritative guidance will be effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. The Company is still assessing the potential impact of adopting the new authoritative guidance.

In October 2009, the FASB issued authoritative guidance altering the scope of revenue recognition guidance for software deliverables to exclude items sold that include hardware with software that is essential to the hardware's functionality. This authoritative guidance will be effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. The Company is still assessing the potential impact of adopting the new authoritative guidance.

(2) Property and Equipment

Property and equipment consist of the following:

	December 31, 2010	December 31, 2009
Computer hardware and software	\$ 22,428,165	\$ 22,529,719
Furniture and equipment	728,727	626,909
Leasehold improvements	2,094,536	1,812,772
Automobile	13,008	13,008
	25,264,436	24,982,408
Less accumulated depreciation	(19,468,423)	(17,380,681)
	\$ 5,796,013	\$ 7,601,727

During the years ended December 31, 2010 and 2009, the Company wrote off approximately \$2.6 million and \$5.2 million, respectively of fully depreciated assets and related accumulated depreciation, for book purposes only. Depreciation expense was \$4,542,280, \$4,690,385, and \$4,467,118 in 2010, 2009, and 2008, respectively.

(3) Marketable Securities

The Company's marketable securities consist of available-for-sale securities, which are carried at fair value, with unrealized gains and losses reported as a separate component of stockholders' equity. Unrealized gains and losses are computed on the specific identification method. Realized gains, realized losses and declines in value judged to be other-than-temporary, are included in interest and other income, net. The cost of available-for-sale securities sold is based on the specific identification method and interest earned is included in interest and other income.

The cost and fair values of the Company's available-for-sale marketable securities as of December 31, 2010, were as follows:

	Aggregate Fair Value	Cost or Amortized Cost	Net Unrealized Gains / (loss)
Auction rate securities	\$578,643	\$700,000	\$(121,357)
Government securities	17,053,041	17,043,856	9,185
Corporate debt securities	1,850,594	1,842,413	8,181
	\$19,482,278	\$19,586,269	\$(103,991)

The cost and fair values of the Company's available-for-sale marketable securities as of December 31, 2009, were as follows:

	Aggregate Fair Value	Cost or Amortized Cost	Net Unrealized Gains / (loss)
Auction rate securities	\$1,077,466	\$1,360,000	\$(282,534)
Government securities	18,494,044	18,440,506	53,538
Corporate debt securities	6,458,922	6,438,616	20,306
	\$26,030,432	\$26,239,122	\$(208,690)

The cost basis and fair value of available-for-sale securities by contractual maturity as of December 31, 2010, were as follows:

	Fair Value	Cost
Due within one year	\$ 17,149,008	\$ 17,132,351
Due after one year	2,333,270	2,453,918
	\$ 19,482,278	\$ 19,586,269

(4) Fair Value Measurements

The Company measures its cash equivalents and marketable securities at fair value. Fair value is an exit price, representing the amount that would be received on the sale of an asset or that would be paid to transfer a liability in an orderly transaction between market participants. As a basis for considering such assumptions, the Company utilizes a three-tier fair value hierarchy, which prioritizes the inputs used in the valuation methodologies in measuring fair

value:

Fair Value Hierarchy

The methodology for measuring fair value specifies a hierarchy of valuation techniques based upon whether the inputs to those valuation techniques reflect assumptions other market participants would use based upon market data obtained from independent sources (observable inputs) or reflect the Company's own assumptions of market participant valuation (unobservable inputs). As a result, observable and unobservable inputs have created the following fair value hierarchy:

- Level 1 – Quoted prices in active markets that are unadjusted and accessible at the measurement date for identical, unrestricted assets or liabilities. The Level 1 category includes money market funds, which at December 31, 2010 and December 31, 2009 totaled \$13.7 million and \$6.4 million, respectively, which are included within cash and cash equivalents and marketable securities in the consolidated balance sheets.
- Level 2 – Quoted prices for identical assets and liabilities in markets that are not active, quoted prices for similar assets and liabilities in active markets or financial instruments for which significant inputs are observable, either directly or indirectly. The Level 2 category includes government securities and corporate debt securities, which at December 31, 2010 and December 31, 2009 totaled \$19.3 million and \$27.3 million, respectively, which are included within cash and cash equivalents and marketable securities in the consolidated balance sheets.
- Level 3 – Prices or valuations that require inputs that are both significant to the fair value measurement and unobservable. The Level 3 category includes auction rate securities, which at December 31, 2010 and December 31, 2009 totaled \$0.6 million and \$1.1 million, respectively, which are included within long-term marketable securities in the consolidated balance sheets.

Measurement of Fair Value

The Company measures fair value as an exit price using the procedures described below for all assets and liabilities measured at fair value. When available, the Company uses unadjusted quoted market prices to measure fair value and classifies such items within Level 1. If quoted market prices are not available, fair value is based upon financial models that use, when possible, current market-based or independently-sourced market parameters such as interest rates and currency rates. Items valued using financial generated models are classified according to the lowest level input or value driver that is significant to the valuation. Thus, an item may be classified in Level 3 even though there may be inputs that are readily observable. If quoted market prices are not available, the valuation model used generally depends on the specific asset or liability being valued. The determination of fair value considers various factors including interest rate yield curves and time value underlying the financial instruments.

As of each December 31, 2010 and 2009, the Company held certain assets that are required to be measured at fair value on a recurring basis. Included within the Company's marketable securities portfolio are investments in auction rate securities, which are classified as available-for-sale securities and are reflected at fair value. Over the past three years, the auction events for most of these instruments failed and, therefore, the Company has determined the estimated fair values of these securities utilizing a discounted cash flow analysis or other type of valuation model. These analyses consider, among other items, the collateral underlying the security, the creditworthiness of the issuer, the timing of the expected future cash flows, including the final maturity, and an assumption of when the next time the security is expected to have a successful auction. These securities were also compared, when possible, to other observable and relevant market data, which is limited at this time.

As of December 31, 2010, the Company recorded a cumulative temporary decline in fair value of approximately \$121,357 in accumulated other comprehensive loss. As of December 31, 2009, the Company recorded \$40,000 cumulatively as an other-than-temporary impairment and a cumulative temporary decline in fair value of approximately \$282,534 in accumulated other comprehensive loss. During the fourth quarter of 2010, \$700,000 of the Company's auction rate securities were called by the issuer at par value, including amounts previously recognized as an other-than-temporary impairment. The Company believes that the temporary declines in fair value are primarily due to liquidity concerns and are not due to the creditworthiness of the remaining underlying assets, because the majority of the underlying securities are almost entirely backed by the U.S. Government. However, if at any time in the future a determination that a valuation adjustment is other-than-temporary, the Company will record a charge to earnings in the period of determination.

Items Measured at Fair Value on a Recurring Basis

The following table presents the Company's assets that are measured at fair value on a recurring basis at December 31, 2010:

66

Fair Value Measurements at Reporting Date
Using

	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant other Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Cash equivalents:				
Money market funds	\$ 13,660,139	\$ 13,660,139	\$-	\$ -
Corporate debt and government securities	402,635	-	402,635	-
Total cash equivalents	14,062,774	13,660,139	402,635	-
Marketable securities:				
Corporate debt and government securities	18,903,635	-	18,903,635	-
Auction rate securities	578,643	-	-	578,643
Total marketable securities	19,482,278	-	18,903,635	578,643
Total assets measured at fair value	\$ 33,545,052	\$ 13,660,139	\$ 19,306,270	\$ 578,643

The following table presents the Company's assets that are measured at fair value on a recurring basis at December 31, 2009:

	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant other Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Cash equivalents:				
Money market funds	\$ 6,405,104	\$ 6,405,104	\$-	\$ -
Corporate debt and government securities	2,372,660	-	2,372,660	-
Total cash equivalents	8,777,764	6,405,104	2,372,660	-
Marketable securities:				
Corporate debt and government securities	24,952,966	-	24,952,966	-
Auction rate securities	1,077,466	-	-	1,077,466
Total marketable securities	26,030,432	-	24,952,966	1,077,466
Total assets measured at fair value	\$ 34,808,196	\$ 6,405,104	\$ 27,325,626	\$ 1,077,466

The Company's valuation methodology for auction rate securities includes a discounted cash flow analysis and other types of valuation models. The following table presents the Company's assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) as of each of the years ended December 31, 2010 and 2009:

Fair Value Measurements
Using
Significant Unobservable
Inputs
(Level 3)

Auction Rate Securities

	December 31, 2010	December 31, 2009
Beginning Balance	\$1,077,466	\$1,166,945
Total unrealized gains in accumulated other comprehensive loss	161,177	50,521
Total realized gains (losses) in other income	40,000	(40,000)
Securities called by issuer	(700,000)	(100,000)
Ending Balance	\$578,643	\$1,077,466

(5) Accrued Expenses

Accrued expenses are comprised of the following:

	December 31, 2010	December 31, 2009
Accrued compensation	\$3,192,749	\$2,920,802
Accrued consulting and professional fees	1,107,543	968,713
Accrued marketing and promotion	52,895	10,777
Other accrued expenses	1,451,555	1,704,500
Accrued income taxes	672,870	309,936
Accrued other taxes	882,292	1,515,654
Accrued hardware purchases	1,573,028	736,591
Accrued and deferred rent	176,492	287,770
	\$ 9,109,424	\$8,454,743

(6) Income Taxes

Information pertaining to the Company's (loss) income before income taxes and the applicable provision (benefit) for income taxes is as follows:

	2010	December 31, 2009	2008
(Loss) income before income taxes:			
Domestic (loss) income	\$(19,944,695)	\$(8,349,257)	\$1,238,431
Foreign income	2,143,049	1,873,491	1,462,016
Total (loss) income before income taxes:	\$(17,801,646)	\$(6,475,766)	\$2,700,447
Provision (benefit) for income taxes:			
Current:			
Federal	\$-	\$111,000	\$1,905,083
State and local	159,769	(13,988)	336,363
Foreign	1,339,076	778,129	382,056
	1,498,845	875,141	2,623,502
Deferred:			
Federal	\$15,310,413	\$(4,039,825)	\$(1,466,080)
State and local	980,137	(189,116)	77,941
Foreign	(215,420)	(29,261)	262,272
	16,075,130	(4,258,202)	(1,125,867)
Total provision (benefit) for income taxes:	\$17,573,975	\$(3,383,061)	\$1,497,635

During 2010, the Company recorded a tax provision of \$17,573,975 related to state and local and foreign taxes and a deferred provision related to an increase in valuation allowance as the Company concluded during the third quarter of 2010 that its domestic deferred tax assets were no longer realizable on a more-likely-than-not basis.

During 2009, the Company recorded a tax benefit of \$3,383,061 related to federal, state and local and foreign taxes. In addition, the Company recorded a deferred provision of \$14,302 as a component of other comprehensive income relating to unrealized gains on available-for-sale securities.

During 2008, the Company recorded a tax provision of \$1,497,635 related to federal, state and local and foreign taxes. In addition, the Company recorded a deferred tax benefit of \$135,198 as a component of other comprehensive income relating to unrealized losses on available-for-sale securities.

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and for income tax purposes. Significant components of the Company's deferred tax assets and liabilities are as follows:

	December 31,	
	2010	2009
Deferred Tax Assets and Liabilities:		
Allowance for receivables	\$1,209,716	\$2,799,390
Deferred revenue	2,251,437	2,177,914
Share-based compensation	7,525,267	5,505,648
Accrued expenses and other liabilities	489,798	526,219
Local net operating loss carryforwards	6,746,206	87,412
Foreign net operating loss carryforwards	503,186	630,223
Tax credit carryforwards	1,319,487	1,994,690
AMT tax credit carryforwards	485,817	503,798
Capital loss carryforwards	670,092	677,722
Fixed assets	933,586	267,847
Intangibles	3,798,046	473,292
Sub-total	25,932,638	15,644,155
Valuation allowance	(25,697,441)	(1,624,523)
Net Deferred Tax Asset	\$235,197	\$14,019,632

During the year ended December 31, 2010, the Company recorded a valuation allowance against all of its domestic deferred tax assets as the Company could no longer conclude that its domestic deferred tax assets were realizable on a more-likely-than-not basis. The reversal of the valuation allowance on deferred tax assets at December 31, 2010, would reduce income tax expense.

As of December 31, 2010, the Company had approximately \$1.8 million of various tax credit carryforwards, of which, approximately \$1.1 million related to research and development tax credit carryforwards. The research and development tax credits may be carried forward 20 years for federal tax purposes and are set to expire at various dates beginning in 2021 through 2030, if not utilized. The Company has recorded a full valuation allowance against all such carryforwards as of December 31, 2010.

As of December 31, 2009, the deferred tax asset valuation allowance of \$1.6 million related to: (i) capital loss carryforwards and write-down of investments of \$0.7 million; (ii) net operating losses related to excess share-based compensation expense deductions of \$0.1 million; (iii) foreign tax credits of \$0.2 million; and (iv) certain foreign net operating losses of \$0.6 million. If the remaining valuation allowance were to be reversed, approximately \$0.1 million would be allocated to additional paid-in-capital as such amounts are attributable to the tax effects of excess compensation deductions from exercises of employee and consultant stock options. The reversal of the remainder of the valuation allowance of approximately \$1.5 million would reduce income tax expense.

The Company has not provided for the United States income or the foreign withholding taxes on the undistributed earnings of its subsidiaries operating outside of the United States, with the exception of China. It is the Company's intention to reinvest those earnings permanently, and accordingly, it is not practicable to estimate the amount of tax that might be payable.

The effective tax rate before income taxes varies from the current statutory federal income tax rate as follows:

	2010	December 31, 2009	2008
Tax at Federal statutory rate	\$(6,230,576)	\$(2,266,518)	\$945,156
Increase (reduction) in income taxes resulting from:			
State and local taxes	159,769	(226,341)	119,963
Non-deductible expenses	(36,423)	92,856	(25,076)
Shared-based payment compensation	38,042	336,882	728,760
Net effect of foreign operations	619,953	145,310	(52,755)
Research and development credit	(515,324)	(1,413,087)	(446,033)
Change in tax rates	-	-	203,717
Change in valuation allowance	23,538,534	(52,163)	23,903
	\$17,573,975	\$(3,383,061)	\$1,497,635

A reconciliation of the beginning and ending amount of unrecognized tax benefits, excluding interest and penalties, is as follows:

	2010	2009
Balance at January 1,	\$ 4,667,404	\$ 4,985,445
Increases in tax positions for prior years	365,753	-
Decreases in tax positions for prior years	-	(436,196)
Increase in tax positions for current year	136,191	121,473
Settlements	-	(3,318)
Balance at December 31,	\$ 5,169,348	\$ 4,667,404

Of the amounts reflected in the table above at December 31, 2010, the entire amount if recognized would reduce the Company's annual effective tax rate. As of December 31, 2010, the Company had approximately \$113,557 of accrued interest and penalties. The Company does not expect its unrecognized tax benefits to change significantly over the next 12 months.

The Company files federal, state, and foreign income tax returns in jurisdictions with varying statutes of limitations. The 2007 through 2010 tax years generally remain subject to examination by federal and most state tax authorities. In addition to the U.S., the Company's major taxing jurisdictions include China, Taiwan, France, Germany and Korea.

(7) Stockholders' Equity

Stock Repurchase Activity

At various times from October 2001 through February 2009, the Company's Board of Directors has authorized the repurchase of up to 14 million shares of the Company's outstanding common stock in the aggregate. The repurchases may be made from time to time in open market transactions in such amounts as determined at the discretion of the Company's management. The terms of the stock repurchases are determined by management based on market

conditions.

71

During the year ended December 31, 2010, the Company did not repurchase any shares of its common stock. During the year ended December 31, 2009, the Company repurchased 1,181,185 shares of its common stock in open market purchases at an aggregate purchase price of \$3,988,011. Since October 2001, the Company has repurchased a total of 8,005,235 shares of its common stock at an aggregate purchase price of \$46,916,339. As of December 31, 2010, the Company had the authorization to repurchase an additional 5,994,765 shares of its common stock based upon its judgment and market conditions.

Preferred Stock

The Company is authorized to issue two million shares of \$0.001 par value Preferred Stock. No preferred stock has been issued or outstanding for any period presented.

(8) Share-Based Payment Arrangements

On May 17, 2006, the Company adopted the FalconStor Software, Inc., 2006 Incentive Stock Plan (the “2006 Plan”). The 2006 Plan was amended on May 8, 2007 and on May 8, 2008. The 2006 Plan is administered by the Board of Directors and provides for the grant of incentive and nonqualified stock options, shares of restricted stock, and restricted stock units to employees, officers, consultants and advisors of the Company. The number of shares available for grant or issuance under the 2006 Plan, as amended, is determined as follows: If, on July 1st of any calendar year in which the 2006 Plan is in effect, the number of shares of stock as to which options, restricted shares and restricted stock units may be granted under the 2006 Plan is less than five percent (5%) of the number of outstanding shares of stock, then the number of shares of stock available for issuance under the 2006 Plan is automatically increased so that the number equals five percent (5%) of the shares of stock outstanding. In no event shall the number of shares of stock subject to the 2006 Plan in the aggregate exceed twenty million shares, subject to adjustment as provided in the 2006 Plan. On July 1, 2010, the total number of outstanding shares of the Company’s common stock totaled 45,649,155. Pursuant to the 2006 Plan, as amended, the total shares available for issuance under the 2006 Plan thus increased by 1,808,729 shares to 2,282,458 shares available for issuance as of July 1, 2010. Exercise prices of the options must be equal to the fair market value of the common stock on the date of grant. Options granted have terms of not greater than ten years.

On May 6, 2010, the Company’s stockholders adopted the FalconStor Software, Inc., 2010 Outside Directors Equity Compensation Plan (the “2010 Plan”). The 2010 Plan is administered by the Board of Directors and provides for the issuance of up to 400,000 shares of Company common stock upon the vesting of options or upon the grant of shares with such restrictions as determined by the Board of Directors to the non-employee directors of the Company. Exercise prices of the options must be equal to the fair market value of the common stock on the date of grant. Options granted have terms of ten years. Shares of restricted stock have the terms and conditions set by the Board of Directors and are forfeitable until the terms of the grant have been satisfied.

The following table summarizes the plans under which the Company was able to grant equity compensation as of December 31, 2010:

Name of Plan	Shares Authorized	Shares Available for Grant	Shares Outstanding	Last Date for Grant of Shares
FalconStor Software, Inc., 2006 Incentive Stock Plan	9,928,114	1,852,882	6,567,739	May 17, 2016
	400,000	380,000	20,000	May 8, 2020

FalconStor Software, Inc., 2010 Outside
Directors Equity Compensation Plan

72

The following table summarizes the plans which have expired but still have equity awards outstanding as of December 31, 2010:

Name of Plan	Shares Available for Grant	Shares Outstanding
FalconStor Software, Inc., 2000 Stock Option Plan	--	5,853,667
1994 Outside Directors Stock Option Plan	--	125,500
2004 Outside Directors Stock Option Plan	--	250,000
FalconStor Software, Inc., 2007 Outside Directors Equity Compensation Plan	--	215,400

A summary of the Company's stock option activity for 2010 is as follows:

	Number of Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value
Options Outstanding at December 31, 2009	12,538,338	\$5.51		
Granted	1,892,000	\$3.42		
Exercised	(890,754)	\$0.46		
Canceled	(657,403)	\$6.19		
Forfeited	(689,297)	\$4.39		
Options Outstanding at December 31, 2010	12,192,884	\$5.58	6.09	\$2,762,852
Options Exercisable at December 31, 2010	8,059,899	\$6.65	4.73	\$1,031,289
Options Expected to Vest after December 31, 2010 (1)	3,251,116	\$3.45	8.73	\$-

(1) Options expected to vest after December 31, 2010 reflect an estimated forfeiture rate

Stock option exercises are fulfilled with new shares of common stock. The total cash received from stock option exercises for the years ended December 31, 2010, 2009 and 2008 was \$409,889, \$35,520 and \$821,282, respectively. The total intrinsic value of stock options exercised during the years ended December 31, 2010, 2009 and 2008 was \$2,881,294, \$358,495 and \$2,091,768, respectively.

The Company realized share-based compensation expense for all awards issued under the Company's stock plans in the following line items in the consolidated statement of operations:

	Years ended December 31,		
	2010	2009	2008
Cost of revenues - product	\$31,779	\$26,398	\$25,011
Cost of revenues - support and service	1,117,550	1,534,208	1,449,065
Research and development costs	2,987,146	3,030,747	3,215,700
Selling and marketing	3,379,518	3,107,877	3,531,375
General and administrative	1,169,576	1,128,211	863,365
	\$8,685,569	\$8,827,441	\$9,084,516

The Company did not recognize any tax benefits related to share-based compensation expense during the year ended December 31, 2010. During the years ended December 31, 2009 and 2008, the Company recognized approximately \$388,000 and \$506,000, respectively, of tax benefits related to share-based compensation expense.

The Company has the ability to issue both restricted stock and restricted stock units. The fair value of the restricted stock awards and restricted stock units are expensed at either (i) the fair value per share at date of grant (outside directors, officers and employees), or (ii) the fair value per share as of each reporting period (non-employee consultants). A summary of the total stock-based compensation expense related to restricted stock awards and restricted stock units, which is included in the Company's total share-based compensation expense for each respective year, is as follows:

	Years ended December 31,		
	2010	2009	2008
Outside directors, officers and employees	\$2,524,914	\$2,667,745	\$2,284,800
Non-employee consultants	760,661	123,249	177,824
	\$3,285,575	\$2,790,994	\$2,462,624

As of December 31, 2010, an aggregate of 2,658,872 shares of restricted stock have been issued, of which, 1,446,082 have vested and 417,485 have been forfeited. As of December 31, 2009, an aggregate of 2,178,854 shares of restricted stock have been issued, of which, 622,425 have vested and 393,180 have been forfeited. As of December 31, 2008, an aggregate of 1,140,000 shares of restricted stock have been issued, of which, 306,410 have vested and 390,500 have been forfeited.

As of December 31, 2010, an aggregate of 90,412 restricted stock units have been issued, of which, 43,975 have vested and 2,500 have been forfeited. As of December 31, 2009, an aggregate of 90,412 restricted stock units have been issued, of which none had vested or been forfeited. As of December 31, 2008, an aggregate of 45,750 restricted stock units have been issued, of which none had vested or been forfeited.

A summary of the Company's restricted stock activity for 2010 is as follows:

	Number of Restricted Stock Awards / Units
Non-Vested at December 31, 2009	1,253,661

Granted	480,018
Vested	(867,452)
Forfeited	(26,805)
Non-Vested at December 31, 2009	839,422

Restricted stock and restricted stock units are fulfilled with new shares of common stock. The total intrinsic value of restricted stock for which the restrictions lapsed during the years ended December 31, 2010, 2009 and 2008 was \$2,950,735, \$1,405,901, and \$1,542,308, respectively.

Options granted to non-employee consultants have exercise prices equal to the fair market value of the stock on the date of grant and a contractual term of ten years. Restricted stock awards granted to non-employee consultants have a contractual term equal to the lapse of restriction(s) of each specific award. Vesting periods for share-based awards granted to non-employee consultants range from immediate vesting to three years depending on service requirements. A summary of the total stock-based compensation expense related to share-based awards granted to non-employee consultants, which is included in the Company's total share-based compensation expense for each respective year, is as follows:

	Years ended December 31,		
	2010	2009	2008
Non-qualified stock options	\$58,524	\$152,231	\$(36,849)
Restricted stock awards	760,661	123,249	177,824
	\$819,185	\$275,480	\$140,975

During the first quarter of 2008, the Company issued restricted stock awards to certain executives and other officers, which vested over three-year terms dependent upon the Company achieving certain performance targets for the full-year 2008. During the first and second quarters of 2008, the Company recorded the related compensation costs associated with the performance awards. During the third quarter of 2008, the Company determined the performance criteria to be improbable of achievement and accordingly reversed compensation cost of approximately \$606,000 previously recognized within its consolidated statement of operations.

The Company estimates the fair value of share-based payments using the Black-Scholes option-pricing model. The Company believes that this valuation technique and the approach utilized to develop the underlying assumptions are appropriate in estimating the fair value of the Company's share-based payments granted during the years ended December 31, 2010, 2009, and 2008. Estimates of fair value are not intended to predict actual future events or the value ultimately realized by the employees who receive equity awards.

The per share weighted average fair value of share-based payments granted during the years ended December 31, 2010, 2009, and 2008 was \$1.95, \$1.77 and \$3.91, respectively. In addition, to the exercise and grant date prices of the awards, certain weighted average assumptions that were used to estimate the fair value of share-based payment grants in the respective periods are listed in the table below:

	Years ended December 31,					
	2010		2009		2008	
Expected dividend yield	0	%	0	%	0	%
Expected volatility	54 - 60	%	51 - 60	%	48 - 58	%
Risk-free interest rate	1.6 - 3.0	%	1.8 - 3.9	%	1.7 - 4.0	%
Expected term (years)	5.5		5.5		5.5	
Discount for post-vesting restrictions	N/A		N/A		N/A	

Options granted to officers, employees and directors during fiscal 2010, 2009, and 2008 have exercise prices equal to the fair market value of the stock on the date of grant, a contractual term of ten years, and a vesting period generally of three years. Based on each respective group's historical vesting experience and expected trends, the estimated forfeiture rate for officers, employees, and directors, as adjusted, was 11%, 24% and 9%, respectively.

The Company estimates expected volatility based primarily on historical daily volatility of the Company's stock and other factors, if applicable. The risk-free interest rate is based on the United States treasury yield curve in effect at the time of grant. The expected option term is the number of years that the Company estimates that options will be outstanding prior to exercise. The expected term of the awards issued since January 1, 2008, was determined based upon an estimate of the expected term of "plain vanilla" options as prescribed in SEC Staff Accounting Bulletin ("SAB") No. 110. The expected term of the awards issued prior to January 1, 2008, was determined using the "simplified method" prescribed in SAB No. 107.

As of December 31, 2010, there was approximately \$5,969,310 total unrecognized compensation cost related to the Company's unvested stock options, restricted stock and restricted stock unit awards granted under the Company's stock plans. The unrecognized compensation cost is expected to be recognized over a weighted-average period of 1.68 years.

As of December 31, 2010, the Company had 15,265,188 shares of common stock reserved for issuance upon the exercise of stock options, restricted stock and restricted stock units.

(9) Inventories

Inventories consist of component materials and finished systems. Inventories are stated at the lower of cost (first-in, first-out) or market, not in excess of net realizable value. Component material consists of certain key replacement parts for the finished systems. Inventories are as follows:

	Years ended December 31,	
	2010	2009
Component materials	\$ 114,893	\$ 60,545
Finished systems	1,294,766	269,112
Total Inventory	\$ 1,409,659	\$ 329,657

As of December 31, 2010 and December 31, 2009, the Company had not recorded any reserve for excess and/or obsolete inventories in arriving at estimated net realizable value of its inventory.

(10) Commitments and Contingencies

The Company has an operating lease covering its primary office facility that expires in February 2012. The Company also has several operating leases related to offices in both the United States and foreign countries. The expiration dates for these leases range from 2011 through 2013. The following is a schedule of future minimum lease payments for all operating leases as of December 31, 2010:

Year ending December 31,	
2011	\$ 2,460,261
2012	949,625
2013	118,933
	\$ 3,528,819

These leases require the Company to pay its proportionate share of real estate taxes and other common charges. Total rent expense for operating leases was \$2,840,796, \$2,630,544, and \$2,512,346 for the years ended December 31, 2010, 2009 and 2008, respectively.

The Company typically provides its customers a warranty on its software products for a period of no more than 90 days. Such warranties are accounted for in accordance with the authoritative guidance issued by the FASB on contingencies. To date, the Company has not incurred any costs related to warranty obligations.

Under the terms of substantially all of its software license agreements, the Company has agreed to indemnify its customers for all costs and damages arising from claims against such customers based on, among other things, allegations that the Company's software infringes the intellectual property rights of a third party. In most cases, in the event of an infringement claim, the Company retains the right to (i) procure for the customer the right to continue using the software; (ii) replace or modify the software to eliminate the infringement while providing substantially equivalent functionality; or (iii) if neither (i) nor (ii) can be reasonably achieved, the Company may terminate the license agreement and refund to the customer a pro-rata portion of the license fee paid to the Company. Such indemnification provisions are accounted for in accordance with the authoritative guidance issued by the FASB on contingencies. As of December 31, 2010 and 2009, there were no claims outstanding under such indemnification provisions.

On January 11, 2011, the Company entered into an Employment Agreement (“Employment Agreement”) with James P. McNiel. Pursuant to the Employment Agreement, the Company agreed to employ Mr. McNiel as President and Chief Executive Officer of the Company effective January 1, 2011 through December 31, 2013, at an annual salary of \$400,000 per annum for calendar years 2011, 2012 and 2013. Pursuant to the Employment Agreement, Mr. McNiel’s base salary is subject to review annually by the Board of Directors and may be increased but not decreased as determined by the Board of Directors based on job performance. The Employment Agreement also provides for the grant to Mr. McNiel of options to purchase up to 300,000 shares of the Company’s common stock at an exercise price of \$3.22 per share, which vest over a three-year period at 33%, 33% and 34% annually. In addition, the Employment Agreement also provides for the grant of 90,000 restricted shares of the Company’s common stock which will vest over a two-year period at 50% and 50% annually. Mr. McNiel is also entitled to certain other benefits set forth in the Employment Agreement. The options to purchase 300,000 shares of the Company’s common stock and 90,000 restricted shares of the Company common stock were granted to Mr. McNiel by the Company’s Compensation Committee on January 11, 2011.

On January 11, 2011, the Company entered into a Stand-Alone Stock Option Agreement (“Stock Agreement”) with James P. McNiel. The Stock Agreement provides for the grant to Mr. McNiel of options to purchase up to 1,220,000 shares of the Company’s common stock at an exercise price of \$3.22 per share, subject to stockholder approval, which vest over a three-year period at 33%, 33% and 34% annually.

On December 1, 2005, the Company adopted the 2005 FalconStor Software, Inc., Key Executive Severance Protection Plan, as amended (“Severance Plan”). Pursuant to the Severance Plan, the Company’s Chief Executive Officer, Chief Financial Officer and certain other key personnel are entitled to receive certain contingent benefits, as set forth in the Severance Plan, including lump sum payments and acceleration of stock option vesting, each in certain circumstances.

(11) Derivative Financial Instruments

The Company commenced the use of derivative financial instruments during the second quarter of 2009 and from time to time will use such derivative financial instruments, such as foreign currency forward contracts, as economic hedges to reduce exchange rate risks arising from the change in fair value of certain foreign currency denominated assets and liabilities (i.e., receivables and payables). The purpose of the Company’s foreign currency risk management program is to reduce volatility in earnings caused by exchange rate fluctuations. In accordance with the authoritative guidance issued by the FASB on derivatives and hedging, companies are required to recognize all of the derivative financial instruments as either assets or liabilities at fair value in the consolidated balance sheets. The Company’s derivative instruments do not meet the criteria for hedge accounting within the authoritative guidance. Therefore, the foreign currency forward contracts are recorded at fair value, with the gain or loss on these transactions recorded in the consolidated statements of operations within “interest and other (loss) income, net” in the period in which they occur. The Company does not use derivative financial instruments for trading or speculative purposes.

As of both December 31, 2010 and 2009, the Company had no foreign currency forward contracts outstanding. During the year ended December 31, 2010, the Company recorded approximately \$0.1 million of gains related to its foreign currency forward contracts. During the year ended December 31, 2009, the Company recorded approximately \$0.8 million of losses related to its foreign currency forward contracts.

(12) Litigation

On September 29, 2010, the Company announced that it had accepted the resignation of ReiJane Huai, its President and Chief Executive Officer, and the Chairman of its Board of Directors, following his disclosure to the Company that certain improper payments allegedly were made in connection with the Company’s licensing of software to one customer. At the same time, the Company announced that it was cooperating fully with law enforcement authorities

with respect to an ongoing investigation into the matter, that it had formed a Special Committee of the Board to conduct a full internal investigation, and that the Special Committee had retained counsel to assist it in its investigation. In addition, the counsel to the Special Committee retained independent forensic accountants to review the Company's practices. On November 10, 2010, counsel retained to assist with the internal investigation presented its report to the Special Committee.

Initially, the New York County District Attorney's Office commenced an investigation but thereafter, for reasons unknown to the Company, ceased its investigation. Separately, the U.S. Attorney's Office for the Eastern District of New York ("USAO") and the U.S. Securities and Exchange Commission ("SEC") each commenced investigations.

In October 2010, in connection with the USAO investigation, the Company received a grand jury subpoena seeking all documents relating to the Company's September 29, 2010, disclosure of the improper payments. Since that time, the Company has received additional subpoenas and document requests from the USAO seeking, among other things, documents relating to certain of the Company's employees and other information about the Company.

Also in October 2010, the Company received a subpoena from the SEC seeking, among other things, documentation relating to the Company's dealings with the customer in connection with whose licensing of software improper payments were made and documentation relating to certain of the Company's accounting practices. Since that time, the Company has received additional subpoenas seeking among other things, information related to certain of the Company's employees, customers, policies and practices.

The Company is cooperating fully with the investigations of both the USAO and the SEC and has produced documents responsive to all subpoenas and document requests. The Company intends to produce more documentation and to cooperate fully with both investigations.

The Company cannot predict the scope, timing, or outcome of the USAO and SEC investigations and other matters referred to herein, which may include the institution of administrative, civil injunctive, or criminal proceedings, the imposition of fines and penalties, which may be significant, suspensions or debarments from government contracts, and other remedies and sanctions, any of which could lead to an adverse impact on our credit ratings and ability to obtain financing, an adverse impact on the Company's stock price, loss of additional senior management, the inability to attract or to retain key employees, and the loss of customers. In addition, under the law, any illegal acts of the Company's employees may be ascribed to the Company. The Company cannot predict what impact, if any, these matters may have on its business, financial condition, results of operations, and liquidity.

Stockholder Litigation

In October 2010, two purported securities class actions (the "Actions") were filed in the United States District Court for the Eastern District of New York on behalf of purchasers of the common stock of the Company between February 5, 2009 and September 29, 2010. The two Actions contain substantially similar allegations and causes of actions. The complaint in each of the Actions name as defendants the Company and Mr. Huai, as well as Wayne Lam an officer of the Company and James Weber the Company's Chief Financial Officer and interim Chief Operating Officer. The complaints in each of the actions allege that the defendants made a series of materially false and misleading statements related to the Company's business and operations in violation of the Securities Exchange Act of 1934. The following adverse facts are alleged: (i) that FalconStor was experiencing weak demand for its products and services; (ii) that FalconStor was making improper payments to secure a contract with at least one of its customers; and (iii) as a result of the foregoing, the defendants lacked a reasonable basis for their positive statements about FalconStor and its prospects. The plaintiffs in each Action seek damages from the defendants. On November 1, 2010, the parties to one of the two Actions entered into a stipulation setting forth a schedule for an amended complaint and an answer or other response thereto. On November 3, 2010, the Actions were consolidated before Judge Edward R. Korman, and the Company anticipates that it will be receiving an amended complaint (the combined Actions are referred to as the "Class Action").

The Company is thus unable to determine what claims will ultimately be asserted in the Class Action. In addition key issues such as whether a class will be certified and, if so, who the members of the class will be and what time period the class will cover, have not yet been determined. The Company believes it has meritorious defenses to some or all of

the claims of the Actions as filed and intends to file a motion to dismiss. The Company is therefore unable to estimate reasonably its exposure for the Class Action.

In January 2011, a Company shareholder filed an action in the Suffolk County Division of the Supreme Court of the State of New York, putatively derivatively on behalf of the Company against the Company, each of the Company's Directors, and Messrs. Huai, Lam and Weber (the "Derivative Action"). The Derivative Action alleges that the defendants breached their duties to the Company by: (1) causing or allowing the dissemination of false and misleading information; (2) failing to maintain internal controls; (3) failing to manage the Company properly; (4) unjustly enriching themselves; (5) abusing their control of the Company; and (6) wasting Company assets. The Derivative Action also alleges that Messrs. Oxenhorn, Fischer, Kaufman, Lieber and Rubenstein breached their duties to the Company by allowing Mr. Huai to resign.

The Company believes that the shareholder failed to make, and was not excused from making, a demand on the Company's Board to redress these grievances and the Company intends to file a motion to dismiss. The Company further believes that it has meritorious defenses to some or all of the claims of the Derivative Action as filed, and intends to file a motion to dismiss based on these grounds.

Counsel for the nominal Plaintiff has indicated that it expects to file an amended complaint. The Company is thus unable to reasonably estimate its exposure for the Derivative Action.

The Company is subject to various legal proceedings and claims, asserted or unasserted, which arise in the ordinary course of business. While the outcome of any such matters cannot be predicted with certainty, such matters are not expected to have a material adverse effect on the Company's financial condition or operating results.

(13) Employee Benefit Plans

Defined Contribution Plan

Effective July 2002, the Company established a voluntary savings and defined contribution plan (the "Plan") under Section 401(k) of the Internal Revenue Code. This Plan covers all U.S. employees meeting certain eligibility requirements and allows participants to contribute a portion of their annual compensation. Employees are 100% vested in their own contributions. For the years ended December 31, 2010, 2009, and 2008, the Company did not make any contributions to the Plan.

Effective July 1, 2007, the Company, in accordance with the labor pension system in Taiwan, contributes 6% of salaries to individual pension accounts managed by the Bureau of Labor Insurance. The Plan covers all Taiwan employees that elect the new pension system and all employees hired after July 1, 2005. For the years ended December 31, 2010, 2009, and 2008, the Company contributed \$148,000, \$127,000, and \$117,000, respectively.

Defined Benefit Plan

The Company has a defined benefit plan covering employees in Taiwan. The Company accounts for its defined benefit plan in accordance with the authoritative guidance issued by the FASB on retirement benefits, which requires the Company to recognize the funded status of its defined benefit plan in the accompanying consolidated balance sheet, with the corresponding adjustment to accumulated other comprehensive income, net of tax.

At December 31, 2010 and 2009, \$252,458, and \$192,803, respectively, is included in accumulated other comprehensive income for amounts that have not yet been recognized in net periodic pension cost. These amounts include the following: unrecognized transition obligation of \$47,231 and \$47,858 at December 31, 2010 and 2009, respectively, and unrecognized actuarial losses of \$205,227 and \$144,946 at December 31, 2010 and 2009, respectively. During 2010, the total amount recorded in other comprehensive income related to the pension plan was \$59,655 (net of tax), which consisted of an actuarial gain of \$60,281 and the recognition of \$626 of transition obligations recognized during 2010 as a component of net periodic pension cost. The transition obligation and actuarial loss included in accumulated other comprehensive loss and expected to be recognized in net periodic pension cost for the year ended December 31, 2011, is \$5,434 and \$7,168 respectively.

Pension information for the years ended December 31, 2010 and 2009, is as follows:

	2010	2009
Accumulated benefit obligation	\$226,051	\$170,312
Changes in projected benefit obligation:		
Projected benefit obligation at beginning of year	318,752	247,779
Interest cost	7,329	6,157
Actuarial loss	46,358	56,034
Benefits paid	-	-
Service cost	4,302	2,982
Currency translation and other	40,156	5,800
Projected benefit obligation at end of year	\$416,897	\$318,752
Changes in plan assets:		
Fair value of plan assets at beginning of year	\$62,414	\$48,456
Actual return on plan assets	934	930
Benefits paid	-	-
Employer contributions	12,225	11,854
Currency translation and other	8,018	1,174
Fair value of plan assets at end of year	\$83,591	\$62,414
Funded status	\$333,306	\$256,338
Components of net periodic pension cost:		
Interest cost	\$7,329	\$6,157
Expected return on plan assets	(1,435)	(1,205)
Amortization of net loss	11,516	8,988
Service cost	4,302	2,982
Net periodic pension cost	\$21,712	\$16,922

The Company makes contributions to the plan so that minimum contribution requirements, as determined by government regulations, are met. Company contributions of approximately \$12,000 are expected to be made during 2011. Benefit payments of approximately \$324,000 are expected to be paid in 2016 through 2020.

The Company utilized the following assumptions in computing the benefit obligation at December 31, 2010 and 2009 as follows:

	December 31, 2010		December 31, 2009	
Discount Rate	2.00	%	2.25	%
Rate of increase in compensation levels	3.00	%	3.00	%
Expected long-term rate of return on plan assets	2.00	%	2.25	%

(14) Segment Reporting and Concentrations

The Company is organized in a single operating segment for purposes of making operating decisions and assessing performance. Revenues from the United States to customers in the following geographical areas for the years ended

December 31, 2010, 2009 and 2008, and the location of long-lived assets as of December 31, 2010, 2009, and 2008, are summarized as follows:

80

	2010	2009	2008
Revenues:			
North America	\$45,796,271	\$53,306,365	\$52,540,234
Asia	16,151,399	15,140,444	14,143,622
Europe, Middle East, Africa and other	20,896,076	21,012,372	20,341,004
Total revenues	\$82,843,746	\$89,459,181	\$87,024,860
Long-lived assets (includes all non-current assets):			
North America	\$11,798,121	\$24,295,603	\$20,682,794
Asia	1,340,527	1,505,856	1,869,963
Europe, Middle East, Africa and other	387,991	508,577	386,981
Total long-lived assets	\$13,526,639	\$26,310,036	\$22,939,738

For the year ended December 31, 2010, the Company had one customer that accounted for 10% of total revenues. For the year ended December 31, 2009, the Company had two customers that together accounted for 26% of total revenues. For the year ended December 31, 2008, the Company had two customers that together accounted for a total of 33% of total revenues. As of December 31, 2010, the Company had one customer with accounts receivable balance greater than 10%, which totaled 13% of the gross accounts receivable balance. As of December 31, 2009, there were no customers with accounts receivables balances greater than 10% of the gross accounts receivable balance.

(15) Valuation and Qualifying Accounts – Allowance for Returns and Doubtful Accounts

Period Ended	Balance at Beginning of Period	Additions charged to Expenses / Revenues	Deductions	Balance at End of Period
December 31, 2010	\$ 7,503,338	\$ 1,211,838	\$ 5,472,718	\$ 3,242,458
December 31, 2009	\$ 8,474,428	\$ 3,163,697	\$ 4,134,787	\$ 7,503,338
December 31, 2008	\$ 8,780,880	\$ 4,088,575	\$ 4,395,027	\$ 8,474,428

Note: Additions to the allowance for doubtful accounts are recorded within general and administrative expenses. Additions to the reserve for product and service returns are recorded within net revenues.

(16) Quarterly Financial Data (Unaudited)

The following is a summary of selected quarterly financial data for the years ended December 31, 2010 and 2009:

	Fiscal Quarter			
	First	Second	Third	Fourth
2010				
Revenue (a)	\$ 17,119,656	\$ 20,270,709	\$ 18,975,832	\$ 26,477,550
Net loss	\$(5,530,066)	\$(3,375,498)	\$(26,416,827)	\$(53,229)
Basic net loss per share	\$(0.12)	\$(0.07)	\$(0.58)	\$(0.00)
Diluted net loss per share	\$(0.12)	\$(0.07)	\$(0.58)	\$(0.00)
Basic weighted average common shares outstanding	44,700,033	45,554,849	45,836,621	46,084,828
Diluted weighted average common shares outstanding	44,700,033	45,554,849	45,836,621	46,084,828
2009				
Revenue (a)	\$ 21,021,085	\$ 24,468,620	\$ 21,540,169	\$ 22,429,307
Net (loss) income	\$(850,961)	\$ 1,266,714	\$(2,031,405)	\$(1,477,053)
Basic net (loss) income per share	\$(0.02)	\$ 0.03	\$(0.05)	\$(0.03)
Diluted net (loss) income per share	\$(0.02)	\$ 0.03	\$(0.05)	\$(0.03)
Basic weighted average common shares outstanding	44,974,677	44,662,246	44,803,379	44,690,260
Diluted weighted average common shares outstanding	44,974,677	45,886,221	44,803,379	44,690,260

The sum of the quarterly net income (loss) per share amounts do not necessarily equal the annual amount reported, as per share amounts are computed independently for each quarter and the annual period based on the weighted average common shares outstanding in each period.

(a) Due to cash collections of previously reserved accounts receivable balances during the fourth quarter of 2010, the Company recorded a benefit of approximately \$1.2 million as compared with an expense of approximately \$0.9 million in the fourth quarter of 2009. These amounts are included in the Company's allowance for returns, and are therefore shown as part of net revenue in each respective period.

Item 6 Changes in and Disagreements with Accountants on Accounting and Financial Disclosure
9.

None.

Item 9A. Controls and Procedures

Disclosure Controls and Procedures

The Company maintains “disclosure controls and procedures,” as such term is defined in Rules 13a-15e and 15d-15e of the Securities and Exchange Act of 1934, as amended (the “Exchange Act”), that are designed to ensure that information required to be disclosed in its reports, pursuant to the Exchange Act, is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms, and that such information is accumulated and communicated to its management, including its Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding the required disclosures. In designing and evaluating the disclosure controls and procedures, management has recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurances of achieving the desired control objectives, and management necessarily is required to apply its judgment in evaluating the cost benefit relationship of possible controls and procedures.

The Company’s Chief Executive Officer (its principal executive officer) and Chief Financial Officer (its principal finance officer and principal accounting officer) have evaluated the effectiveness of its “disclosure controls and procedures” as of the end of the period covered by this Annual Report on Form 10-K. Based on their evaluation, the principal executive officer and principal financial officer concluded that its disclosure controls and procedures are effective at a reasonable assurance level at the end of the period covered by this report.

Internal Control Over Financial Reporting

Management’s Report on Internal Control Over Financial Reporting

The Company’s management is responsible for establishing and maintaining adequate internal control over financial reporting for the Company; as such term is defined in Rules 13a-15(f). To evaluate the effectiveness of the Company’s internal control over financial reporting, the Company’s management uses the Integrated Framework adopted by the Committee of Sponsoring Organizations of the Treadway Commission (“COSO”).

The Company’s management has assessed the effectiveness of the Company’s internal control over financial reporting as of December 31, 2010, using the COSO framework. The Company’s management has determined that the Company’s internal control over financial reporting is effective as of that date.

There were no changes in the Company’s internal controls over financial reporting during the Company’s last fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company’s internal control over financial reporting. As a result of the internal investigation arising from the revelation of the improper payments in connection with the licensing of software to a customer, our Board of Directors has accepted recommendations for changes and enhancements to the Company’s controls and procedures, and management has been working on the implementation of such changes and enhancements.

The registered public accounting firm that audited the financial statements included in this annual report has issued an attestation report on the Company’s internal control over financial reporting.

Other Information

Item
9B.

On March 10, 2011, Section 1.9 of the Company's By-Laws was amended by adding the following paragraph at the end of the Section:

"Broker non-votes and abstentions shall be considered for the purpose of establishing a quorum, but shall not be considered as votes cast for or against a proposal or a director nominee."

83

PART III

Item Directors, Executive Officers and Corporate Governance

10.

Information called for by Part III, Item 10, regarding the Registrant's directors will be included in our Proxy Statement relating to our annual meeting of stockholders scheduled to be held in May 2011, and is incorporated herein by reference. The information appears in the Proxy Statement under the captions "Election of Directors", "Management", "Executive Compensation", "Section 16 (a) Beneficial Ownership Reporting Compliance", and "Committees of the Board of Directors." The Proxy Statement will be filed within 120 days of December 31, 2010, our year-end.

Item Executive Compensation

11.

Information called for by Part III, Item 11, will be included in our Proxy Statement relating to our annual meeting of stockholders scheduled to be held in May 2011, and is incorporated herein by reference. The information appears in the Proxy Statement under the captions "Executive Compensation", "Director Compensation", "Compensation Committee Interlocks and Insider Participation", "Compensation Committee Report" and "Committees of the Board of Directors." The Proxy Statement will be filed within 120 days of December 31, 2010, our year-end.

Item Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

12.

Information regarding Securities Authorized for Issuance Under Equity Compensation Plans is included in Item 4 and is incorporated herein by reference. All other information called for by Part III, Item 12, will be included in our Proxy Statement relating to our annual meeting of stockholders scheduled to be held in May 2011, and is incorporated herein by reference. The information appears in the Proxy Statement under the caption "Beneficial Ownership of Shares." The Proxy Statement will be filed within 120 days of December 31, 2010, our year-end.

Item Certain Relationships and Related Transactions, and Director Independence

13.

Information regarding our relationships and related transactions will be included in our Proxy Statement relating to our annual meeting of stockholders scheduled to be held in May 2011, and is incorporated by reference. The information appears in the Proxy Statement under the caption "Certain Relationships and Related Transactions." The Proxy Statement will be filed within 120 days of December 31, 2010, our year-end.

Item Principal Accountant Fees and Services

14.

Information called for by Part III, Item 14, will be included in our Proxy Statement relating to our annual meeting of stockholders scheduled to be held in May 2011, and is incorporated herein by reference. The information appears in the Proxy Statement under the caption "Principal Accountant Fees and Services." The Proxy Statement will be filed within 120 days of December 31, 2010, our year-end.

PART IV

Item Exhibits and Financial Statement Schedules

15.

The information required by subsections (a)(1) and (a)(2) of this item are included in the response to Item 8 of Part II of this annual report on Form 10-K.

(b)

Exhibits

3.1 Restated Certificate of Incorporation, incorporated herein by reference to Exhibit 3.1 to the Registrant's registration statement on Form S-1 (File no. 33-79350), filed on April 28, 1994.

3.2

*Amended and Restated By-Laws of FalconStor Software, Inc.

3.3 Certificate of Amendment to the Certificate of Incorporation, incorporated herein by reference to Exhibit 3.3 to the Registrant's annual report on Form 10-K for the year ended December 31, 1998, filed on March 22, 1999.

3.4 Certificate of Amendment to the Certificate of Incorporation, incorporated herein by reference to Exhibit 3.4 to the Registrant's annual report on Form 10-K for the year ended December 31, 2001, filed on March 27, 2002.

4.1 2000 Stock Option Plan, incorporated herein by reference to Exhibit 4.1 of the Registrant's registration statement on Form S-8, filed on September 21, 2001.

4.2 2000 Stock Option Plan, as amended May 15, 2003, incorporated herein by reference to Exhibit 99 to the Registrant's quarterly report on Form 10-Q for the period ended June 30, 2003, filed on August 14, 2003.

4.3 2000 Stock Option Plan, as amended May 14, 2004, incorporated herein by reference to Exhibit 4.3 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2004, filed on March 16, 2005.

4.4 1994 Outside Directors Stock Plan, as amended May 17, 2002 incorporated herein by reference to Exhibit 4.2 to the Registrant's annual report on Form 10-K for the year ended December 31, 2002, filed on March 17, 2003.

4.5 2004 Outside Directors Stock Option Plan, incorporated herein by reference to Exhibit 4.5 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2004, filed on March 16, 2005.

4.6 Amended and Restated 2006 Incentive Stock Plan incorporated herein by reference to Exhibit 4.1 to the Registrant's quarterly report on Form 10-Q for the quarter ended March 31, 2007, filed on May 9, 2007.

4.7 2007 Outside Directors Equity Compensation Plan, as amended May 8, 2008, incorporated herein by reference to Exhibit 99.2 to the Registrant's quarterly report on Form 10-Q for the quarter ended June 30, 2008, filed on August 11, 2008.

4.8 Form of Restricted Stock Letter Agreement for Executive Officers, incorporated herein by reference to Exhibit 99.1 to the Registrant's quarterly report on Form 10-Q for the period ended March 31, 2008, filed May 9, 2008.

10.1 Agreement of lease between Huntington Quadrangle 2, LLC, and FalconStor Software, Inc., dated August 2003, incorporated herein by reference to Exhibit 99.1 to the Registrant's quarterly report on Form 10-Q for the period ended September 30, 2003, filed on November 14, 2003.

10.2 Employment Agreement dated January 11, 2011 between Registrant and James P. McNiel, incorporated herein by reference to Exhibit 10.1 to the Registrant's Current Report on Form 8-K, dated January 11, 2011.

10.3 Stand-Alone Stock Option Agreement dated January 11, 2011, by and between FalconStor Software, Inc., and James P. McNiel, incorporated herein by reference to Exhibit 10.2 to Registrant's Current Report on Form 8-K, dated January 11, 2011.

10.4 FalconStor Software, Inc., 2005 Key Executive Severance Protection Plan, as amended August 6, 2007, incorporated herein by reference to Exhibit 10.2 to Registrant's quarterly report on Form 10-Q for the period ended June 30, 2007, filed on August 8, 2007.

10.5 Amended and Restated FalconStor Software, Inc., 2005 Key Executive Severance Protection Plan, incorporated herein by reference to Exhibit 10.3 to Registrant's annual report on Form 10-K for the year ended December 31, 2005, filed on March 15, 2006.

10.6 *FalconStor Software, Inc., Director Compensation Deferral Plan, effective January 1, 2011

21.1 Subsidiaries of Registrant – FalconStor, Inc., FalconStor AC, Inc., FalconStor Software (Korea), Inc.

23.1

*Consent of KPMG LLP

31.1

*Certification of the Chief Executive Officer

31.2

*Certification of the Chief Financial Officer

32.1 *Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. § 1350)

32.2 *Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. § 1350)

*- filed herewith.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized in Melville, State of New York on March 14, 2011.

FALCONSTOR SOFTWARE, INC.

By:	/s/ James P. McNiel	Date: March 14, 2011
	James P. McNiel, President, Chief Executive Officer of FalconStor Software, Inc.	

POWER OF ATTORNEY

FalconStor Software, Inc. and each of the undersigned do hereby appoint James P. McNiel and James Weber, and each of them severally, its or his true and lawful attorney to execute on behalf of FalconStor Software, Inc. and the undersigned any and all amendments to this Annual Report on Form 10-K and to file the same with all exhibits thereto and other documents in connection therewith, with the Securities and Exchange Commission; each of such attorneys shall have the power to act hereunder with or without the other.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the date indicated.

By: /s/ James P. McNiel	March 14, 2011
James P. McNiel, President, Chief Executive Officer	Date
(Principal Executive Officer)	

By: /s/ James Weber	March 14, 2011
James Weber, Chief Financial Officer, Vice President, Interim Chief Operating Officer and Treasurer	Date
(Principal Financial Officer and Principal Accounting Officer)	

By: /s/ Steven R. Fischer	March 14, 2011
Steven R. Fischer, Director	Date

By: /s/ Alan W. Kaufman	March 14, 2011
Alan W. Kaufman, Director	Date

By: /s/ Irwin Lieber	March 14, 2011
Irwin Lieber, Director	Date

By: /s/ Eli Oxenhorn	March 14, 2011
Eli Oxenhorn, Chairman of the Board	Date

By: /s/ Barry Rubenstein	March 14, 2011
--------------------------	----------------

Barry Rubenstein, Director

Date

