FALCONSTOR SOFTWARE INC
Form 10-K
March 12, 2010

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, 2009.

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. ý

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 Filer ¨	Accelerated Filer ý
Non-Accelerated Filer ¨	Smaller Reporting Company ¨

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

The aggregate market value of Common Stock held by non-affiliates of the Registrant as of June 30, 2009 was $165,268,631 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 26, 2010 was 52,521,836 and 44,516,601, 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.

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FALCONSTOR SOFTWARE, INC. AND SUBSIDIARIES

2009 ANNUAL REPORT ON FORM 10-K

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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 TOTALLY 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 fast data recovery, Network Storage Server (NSS) for storage virtualization and provisioning, and File-interface Deduplication System (FDS) for capacity optimized storage solutions. All of our 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 storage virtualization and data protection 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 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 a TOTALLY 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 InfiniBand and Fibre Channel over Ethernet) 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-, Fibre Channel-, or InfiniBand-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 3COM, 3Par, Acer, Adaptec, Brocade, Bus-Tech, Cisco, Citrix, Compellent, Dell, Dynamic Solutions International, EMC, Hitachi Data Systems, HP, IBM, Intel, Lanchao, LSI Logic, Microsoft, NEC, Nexsan, Oracle, Pillar Data Systems, Promise, QLogic, SeaChange, Spectra Logic, Symantec, Violin Memory, Voltaire, VMware, and Xiotech.

Further validation of FalconStor solutions comes from the agreements FalconStor has with many Tier-1 original equipment manufacturers (OEMs) and others to integrate FalconStor technology with those companies' products. In the past year, OEM partners have released new solutions powered by FalconStor products and have pursued visible market presence with FalconStor, leveraging both brands for market presence.

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 and Massachusetts and throughout Europe, Asia and Australia.

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PRODUCTS AND TECHNOLOGY

FalconStor's products and solutions are built on the IPStor common network infrastructure 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 recover data in minutes, anytime, anywhere, with 100% data integrity. FalconStor offers the following core products: VTL with deduplication, CDP, NSS and FDS. All FalconStor 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.

One independent, TOTALLY Open data protection platform - FalconStor solutions provide complete independence to choose any storage or connectivity, delivering comprehensive data protection across the enterprise, and scaling from the data center to the remote office or single user desktop.

Integrated - FalconStor solutions are built on a common storage virtualization platform, eliminating the compatibility and integration issues typically found with "bolted together" solutions created from disparate products with different development histories. In addition, FalconStor solutions are built to seamlessly integrate within customers' environments to provide a high level of data services and protection to business applications.

Optimized - FalconStor solutions are designed to optimize performance and capacity utilization, making use of the latest advances in storage networking speed and technologies such as thin provisioning and deduplication. Application-specific tools optimize protection of key enterprise applications. Protection is enhanced even as costs are reduced.

Available - FalconStor solutions are built to provide the best in data protection, recovery, and persistent data accessibility. FalconStor delivers data protection with complete transactional integrity for fast and reliable recovery. FalconStor solutions are deployed in high availability models, with built-in failover capabilities.

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. Customers today are facing massive data growth. Gartner analyst David Cappuccio estimates enterprise data growth over the next 5 years to be 650% and that 80% of this will be unstructured data. Backup windows have not only shrunk; for many organizations they have disappeared altogether. Traditional backup has also 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 they 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 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 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:

- Storage Virtualization, Provisioning, and Management – FalconStor NSS
- Tape Backup Optimization – FalconStor VTL

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- Unified Backup and Disaster Recovery – FalconStor CDP
- Storage Capacity Optimization – FalconStor FDS

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, allowing FalconStor solutions 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)

FalconStor® Network Storage Server (NSS) 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)

FalconStor® Virtual Tape Library (VTL) 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 what it believes are 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.

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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 software 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)

FalconStor® File-interface Deduplication System (FDS) 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.

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.

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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.

BUSINESS STRATEGY

FalconStor intends to maintain its position as the provider of TOTALLY 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 TOTALLY 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 2009, FalconStor continued aggressively to develop its product portfolio. In February, the Company introduced FalconStor® HyperTrac™ Backup Accelerator technology for VMware Consolidated Backup, a backup enhancement option for VMware Consolidated Backup (VCB). FalconStor HyperTrac technology for VMware environments integrates with FalconStor Network Storage Server (NSS), a feature-rich, open storage virtualization and provisioning platform that provides a full range of data protection and DR solutions for the VMware platform. The FalconStor HyperTrac technology for VMware Consolidated Backup (VCB) further extends FalconStor NSS services to VMware Infrastructure by optimizing VCB backups in order to minimize impact on virtual machines and the storage servicing those environments. The no-impact backups enabled by FalconStor HyperTrac technology for VCB provides high performance backup for virtual machines, eliminating the disruption of backup windows required by traditional backup solutions for physical environments.

In March 2009, FalconStor announced the general availability of the FalconStor File-interface Deduplication System (FDS). FalconStor FDS opened up a new market for FalconStor Software by offering block-level deduplication of backup data via a simple file interface. This gives customers a choice between a file interface or a VTL interface or both, depending on data center requirements. FalconStor FDS extends the company´s highly scalable data deduplication technology -- already widespread as part of the industry-leading FalconStor VTL solution – to LAN-based disk-to-disk backup environments. In August, 2009, FalconStor announced a strategic venture for FalconStor FDS with our partner Nexsan Technologies, to offer an integrated deduplication product for high-performance, power-efficient data storage.

In September 2009, FalconStor introduced new storage management and new disaster recovery (DR) extensions for VMware vCenter™ Server and VMware vCenter Site Recovery Manager that provide virtual machine storage provisioning as well as automated failback of remote virtual machines to the primary data center. Additionally, FalconStor packaged our FalconStor File-interface Deduplication System as a Virtual Appliance for easy-to-deploy data deduplication for VMware vSphere 4 environments. FalconStor's entire product portfolio is now available as virtual appliances.

In October 2009, FalconStor announced that our storage virtualization and data replication solutions for virtual servers were integrated and available for Oracle VM, bringing a high level of data protection, recoverability and continuous availability to Oracle virtual environments.

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Expand Corporate Visibility

Throughout 2009, FalconStor took significant steps to increase our market presence and awareness. First, we took additional steps to increase our online presence in the form of banner ads on key media and industry community sites. In addition, we added an updated look and feel, a more user-friendly navigation, and additional resources to our website to make information more readily available 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 TOTALLY Open data protection message. We have stepped up our participation in online social networking sites and social media outlets such as youtube.com and twitter, as well as online conversations both with our own FalconStor expert bloggers and by monitoring and commenting on other blogs.

In late 2009 a new Chief Strategist was hired along with additional staff for product marketing. 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:

- Long Island Business News recognized our CFO, James Weber, for his leadership in Business
- Business Solutions Magazine named FalconStor among the Best Channel Vendors for storage in 2009
- FalconStor was Certified by United Business Media's Everything Channel as a 5-Star Overall Winner in its 2009 Partner Program Guide
- Our Chairman and CEO, ReiJane Huai was an Ernst & Young Entrepreneur Of The Year 2009 Award Finalist in Metro New York Region
- Our Vice President of North American Sales, Wendy Petty was recognized by Everything Channel's CRN Magazine as One of the Top 100 Women in the Channel
- FalconStor was selected by Everything Channel’s CRN as the 2009 Tech Innovator of the Year for FalconStor FDS

We anticipate that this positive recognition will continue throughout 2010, as we continue to innovate in our products and to refine our message to address new market conditions while delivering targeted marketing campaigns.

In addition we increased our investment in our partners, both OEM and channel, 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 extend our channel and customer reach.

Scalable Packaging

All FalconStor solutions support variable deployment options offering great flexibility to seamlessly fit within our customer’s environments and 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.

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Seek OEM Relationships with Industry Leaders

FalconStor intends to continue to enter into OEM agreements with strategic switch, storage, appliance, and operating system vendors. Besides accelerating overall market growth, the OEM relationships should continue to bolster FalconStor's product recognition, corporate credibility, and revenue stream.

Expand Software and Hardware Strategic Alliances

In August 2009, FalconStor formed a strategic alliance with Nexsan Technologies to deliver a data deduplication appliance to the market through Nexsan's channel community, combining the storage capacity optimization benefits of FalconStor FDS and the energy saving capabilities of the Nexsan AutoMAID technology. In 2010, FalconStor will seek to continue to form similar alliances to support the channel and to reach a broader market while continuing to raise the FalconStor brand awareness and recognition.

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 strongly positioned to take advantage of the rapid storage growth in China. Our OEM relationships with Acer, Inspur Group, and others, and the joint development/production agreement with The Chinese Academy of Science for enterprise-class storage, archiving and compliance solutions, will continue our growth in this market.

Current economic conditions suggest that there will be continued limited IT spending budgets into 2010. We anticipate that companies will be looking for innovative solutions to reduce their IT costs and to take full advantage of their current investments. FalconStor has been helping companies to reduce Capital Expenditures (CapEx), and to minimize Operating Expenditures (OpEx) through the deployment of cost-effective solutions that maximize the utilization rates for IT resources, consolidate management operations, and reduce storage capacity and networking bandwidth requirements.

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 2010. 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.

With a server virtualization market that is gaining 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 2009, we strengthened our relationships with vendors like VMware, Oracle, and Microsoft and we have developed more integration tools and solutions to support and enhance these environments. We expect that in 2010 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.

SALES, MARKETING AND CUSTOMER SERVICE

FalconStor plans to continue to sell our products primarily through original equipment manufacturers (OEMs), 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 increased 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 scalable solutions are also being deployed by Managed Service Providers (MSP) to deliver online data protection and recovery services across different vertical markets.

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Storage Appliances. FalconStor has agreements with strategic partners to adapt FalconStor products for use in the strategic partners' special-purpose storage appliances.

Direct Sales to End Users.   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 unified storage services or data protection, FalconStor believes it is the only software-based solution provider capable of delivering a high level of data protection services across the data center. 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 range of unified data protection storage service running on a standard Linux-, Windows-, or Solaris-based appliance. 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 storage 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 thirteen 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.

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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, 2009, we had two customers, EMC Corporation and Sun Microsystems, which accounted for 14% and 12%, respectively, of our total revenues. For the year ended December 31, 2008, EMC Corporation and Sun Microsystems, accounted for 20% and 13%, respectively, of our total revenues. For the year ended December 31, 2007, EMC Corporation and Sun Microsystems accounted for 26% and 12%, respectively, of our total revenues. As of December 31, 2009, there were no customers which accounted for more than 10% of our gross accounts receivable balance. As of December 31, 2008, EMC Corporation and H3C Technologies Co., Ltd.'s accounts receivable balance were each 11% of our gross accounts receivable balance.

EMPLOYEES

As of December 31, 2009, we had 542 full-time and part-time employees, consisting of 210 in research and development, 192 in sales and marketing, 109 in service, and 31 in general administration. We are not subject to any collective bargaining agreements and believe our employee relations are good.

INTERNET ADDRESS AND AVAILABILTY 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, 2009.

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 face a number of risks related to the recent financial crisis and severe tightening in the global credit markets.

The ongoing global financial crisis affecting the banking system and financial markets has resulted in a severe tightening in the credit markets, a low level of liquidity in many financial markets, and extreme volatility in credit and equity markets. This financial crisis has impacted us and could continue to impact our business in a number of ways, including:

Potential Deferment of Purchases and Orders by Customers: Uncertainty about current and future global economic conditions may cause end users, including businesses and governments, to defer purchases in response to tighter credit, decreased cash availability and declining consumer confidence. Accordingly, future demand for our products could differ materially from our current expectations.

Customers' Inability to Obtain Financing to Make Purchases from Us and/or Maintain Their Business: Some of our customers require financing in order to fund their operations and make purchases from us. The inability of these customers to obtain sufficient credit to finance purchases of our products and meet their payment obligations to us could adversely impact our financial results. In addition, if the financial crisis results in insolvencies for our customers, it could adversely impact our financial results.

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Negative Impact from Increased Financial Pressures on Third-Party OEMs and Resellers: Most of our software licenses are sold through third-party OEMs, solution providers and distributors. Although many of these third parties have significant operations and maintain access to available credit, others are smaller and more likely to be impacted by the significant decrease in available credit that has resulted from the current financial crisis. If credit pressures or other financial difficulties result in insolvency for these third parties and we are unable to successfully transition end users to purchase our products from other third parties, or from us directly, it could adversely impact our financial results.

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.

This is what happened in 2009. We had planned our expenses based on our revenue projections. Strategic transactions involving three of our OEM customers caused our revenues to fall below our projections which resulted in a net loss for the full year 2009.

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 and small office/home office markets.

We offer products for the small/medium business (SMB) and small office/home office (SOHO) markets. Our products may not be attractive to the SMB and the SOHO markets, or we may not be able to reach agreements with OEMs and resellers with significant presences in the SMB and SOHO markets. If we are unable to penetrate the SMB and SOHO markets, 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.

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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.

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

The vast majority of our sales come from sales to end users of our products by our OEM customers and by our resellers. These OEM customers and resellers have limited resources and sales forces and sell many different products, both in the network storage software market and in other markets. The OEM customers and resellers may choose to focus their sales efforts on other products in the network storage software market 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 software applications effectively could have a material adverse effect on our revenues and results of operations.

We rely significantly on our value-added resellers, systems integrators and corporate resellers, which we collectively refer to as resellers, for the marketing and distribution of our software applications and 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 software applications that are competitive with ours. These resellers may give a higher priority to other software applications, including those of our competitors, or may not continue to carry our software applications 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 our applications, 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.

We are dependent on certain key customers and a significant portion of our receivables is concentrated with two customers.

We tend to have one or more customers account for 10% or more of our revenues during each fiscal quarter and fiscal year. For the year ended December 31, 2009, we had two customers, EMC Corporation and Sun Microsystems which accounted for 14% and 12%, respectively of our total revenues. For the year ended December 31, 2008, we had two customers, EMC Corporation and Sun Microsystems, which accounted for 20% and 13%, respectively of our total revenues. For the year ended December 31, 2007, we had two customers, EMC Corporation and Sun Microsystems, which accounted for 26% and 12%, respectively of our total revenues. EMC purchased Data Domain, one of our competitors, in 2009. Sun Microsystems was recently purchased by Oracle Corporation. Oracle is continuing to sell the Sun products that incorporate our software, but there can be no assurance that these products will be actively marketed or sold in the future. While we believe that we will continue to receive revenue from these customers, our agreements do not have any minimum sales requirements and we cannot guarantee continued revenue. If our contract with any of these customers terminates, or if the volume of sales from any of these customers significantly declines, it would have a material adverse effect on our operating results.

As of December 31, 2009, there were no customers with accounts receivable balances greater than 10% of our gross accounts receivable. As of December 31, 2008, EMC Corporation's and H3C Technologies Co., Ltd.'s accounts receivable balance were each 11% of our gross accounts receivable.

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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 portion of our revenue is generated by sales through our channel partners, and we expect channel sales to continue to make up a significant portion of our total revenue in the future. Accordingly, our revenue depends in part 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 had an impact on our revenues. If additional OEM 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.

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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 software applications 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 software applications 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 software applications based on specified business objectives. Further, once our software applications are deployed, our customers depend on us to resolve issues relating to our software applications. 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 software applications 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 2009, and we anticipate that our quarterly results for 2010 will show the effects of seasonality as well.

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Our future performance will depend on many factors, including:

- 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, 2009, the closing market price of our common stock as quoted on the NASDAQ Global Market fluctuated between $2.10 and $5.57 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.

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

As of December 31, 2009, we held short-term and long-term marketable securities aggregating $26.0 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, 2009, we had options to purchase 12,538,338 shares of our common stock outstanding, and we had an aggregate of 1,253,661 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 $5.01 per share. We also had 1,626,805 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 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.

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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.

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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 56 people as of December 31, 2009. 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.

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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 thirteen 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.

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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 67,000 square feet in Le Chesnay and Toulouse, France; Taipei and Taichung, Taiwan; Tokyo, Japan; Beijing, Shenzhen, Shanghai, Kunshan 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.

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Item 3. Legal Proceedings

We are 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, we believe that such matters will not have a material adverse effect on our financial condition, results of operations, 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:

	2009		2008	
	High	Low	High	Low
Fourth Quarter	$4.60	$3.31	$5.09	$2.09
Third Quarter	$5.57	$4.27	$7.80	$5.05
Second Quarter	$4.85	$2.41	$9.13	$6.99
First Quarter	$3.77	$2.10	$10.74	$6.85

Holders of Common Stock

We had approximately 139 holders of record of Common Stock as of February 26, 2010. 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.

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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 (1) (a)	Weighted - Average exercise Price of Outstanding Options, Warrants and Rights (1) (b)	Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in Column (a)(1) (c)
Equity compensation plans approved by security holders……..	13,791,999	$ 5.01	1,626,805

(1) As of December 31, 2009 we had 1,626,805 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.

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 Computer Software and Services companies, a peer group index, and b) the Russell 3000 Index, a broad equity market index.

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ASSUMES $100 INVESTED ON DEC. 31, 2004
ASSUMES DIVIDEND REINVESTED
FISCAL YEAR ENDING DECEMBER 31, 2009

	Fiscal Year Ending					
	2004	2005	2006	2007	2008	2009
FALCONSTOR SOFTWARE, INC.	$ 100.00	$ 77.22	$ 90.39	$ 117.66	$ 29.05	$ 42.42
PEER GROUP INDEX	$ 100.00	$ 99.75	$ 116.20	$ 136.90	$ 82.66	$ 125.16
RUSSELL 3000 INDEX	$ 100.00	$ 106.12	$ 122.80	$ 129.11	$ 80.94	$ 103.88

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 Purchase of Equity Securities

Shares of common stock repurchased during the quarter ended December 31, 2009:

	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plan	Maximum Number of Shares that May Yet Be Purchased Under the Plan at Month End
November 2009	350,845	$3.93	350,845	6,258,220
December 2009	263,455	$4.11	263,455	5,994,765
Total	614,300	$4.01	614,300	5,994,765

On February 4, 2009, the Company's Board of Directors increased its authorization to repurchase the Company's outstanding common stock from eight million shares to fourteen million shares in the aggregate. As of December 31, 2009, the Company had repurchased 8,005,235 shares since October 2001. The program has no expiration date. See Note (7) Stockholders' Equity to our consolidated financial statements for further information.

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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, 2009 (a)	Year Ended December 31, 2008 (a)	Year Ended December 31, 2007(a), (b)	Year Ended December 31, 2006(a)	Year Ended December 31, 2005
	(In thousands, except per share data)				
Revenues:					
Software license revenue	$58,155	$58,590	$53,154	$38,317	$29,544
Maintenance revenue	25,477	23,283	18,607	12,475	7,594
Software services and other revenue	5,827	5,152	5,639	4,274	3,826
	89,459	87,025	77,399	55,066	40,964
Operating expenses:					
Amortization of purchased and capitalized software	719	221	122	362	782
Cost of maintenance, software services and other revenue	16,197	13,653	11,091	9,048	6,114
Software development costs	26,761	25,296	22,405	20,022	12,039
Selling and marketing	42,255	38,097	29,656	23,713	16,109
General and administrative	9,875	8,746	8,024	5,828	4,213
Litigation settlement	--	--	--	799	--
	95,807	86,013	71,298	59,772	39,257
Operating (loss) income	(6,348)	1,012	6,101	(4,706)	1,707
Interest and other (loss) income	(128)	1,689	2,329	1,650	705
(Loss) income before income taxes	(6,476)	2,700	8,430	(3,056)	2,412
(Benefit) provision for income taxes	(3,383)	1,498	(4,312)	319	119
Net (loss) income	$(3,093)	$1,203	$12,742	$(3,375)	$2,293
Basic net (loss) income per share	$(0.07)	$0.03	$0.26	$(0.07)	$0.05
Diluted net (loss) income per share	$(0.07)	$0.02	$0.24	$(0.07)	$0.05
Basic weighted average common shares outstanding	44,782	47,859	49,421	48,045	47,662
	44,782	49,497	53,131	48,045	50,776

Diluted weighted average common shares outstanding

(a) We adopted the authoritative guidance issued by the Financial Accounting Standards Board ("FASB") on stock compensation, on January 1, 2006, and recorded \$8.8 million, \$9.1 million, \$7.9 million and \$9.4 million of compensation expenses in our consolidated statements of operations for the years ended December 31, 2009, 2008, 2007 and 2006, respectively. See Note (8) Share-Based Payment Arrangements 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. See Note (6) Income Taxes to our consolidated financial statements for further information.

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CONSOLIDATED BALANCE SHEET DATA:

	December 31, 2009	December 31, 2008	December 31, 2007	December 31, 2006	December 31, 2005
	(In thousands)				
Cash and cash equivalents and marketable securities	$ 41,783	$ 42,810	$ 62,904	$ 40,960	$ 36,631
Working capital	46,097	48,329	71,845	46,934	39,730
Total assets	99,002	96,364	115,182	78,231	63,974
Long-term obligations	6,254	6,192	5,070	3,783	2,316
Stockholders' equity	66,153	65,076	87,478	55,043	48,658

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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

Due to the continuing economic downturn, and as a result of unanticipated mergers and acquisition activity among three of our largest OEM partners, our revenue and net income fell short of our expectations for 2009.

Despite the economic downturn, we continued to make progress toward our goal of ramping up the sale of FalconStor-branded products to end users, what we call "non-OEM sales." We have made investments in our sales and our marketing functions, increasing headcount and spending on advertising, promotions and other public relations, to increase market awareness of the branded products. We also focused and increased our efforts in creating FalconStor-branded storage appliances.

We had previously put most of our non-OEM sales efforts behind FalconStor-branded software. But feedback we received from our resellers and the end users suggested that we could increase sales if we offered storage appliances with our software installed on hardware. To meet this demand, we have created FalconStor-branded gateway appliances and complete storage appliances with integrated disks.

These combined efforts led to a 15% increase in gross non-OEM software license revenue in 2009. We expect that the investment we made in these areas, combined with an improved macroeconomic environment, will cause our non-OEM sales to continue to increase in 2010.

Unfortunately, the gains we made in non-OEM sales in 2009 were offset by declines in our OEM sales. During 2009, three of our largest OEM customers – EMC, Sun Microsystems, and 3Com – 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 declined 31%. Total revenue from EMC on an annual basis was still 14% of our total revenue for 2009. While our agreement with EMC runs through 2013, there are no minimum revenue commitments from EMC. Due to the changes at EMC we cannot say whether EMC will account for 10% or more of our revenue in 2010.

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. While for the full year, software license revenues from Sun declined only 3%, we fully anticipated at the outset of 2009 that Sun's software license revenues would increase when compared with 2008. Oracle is continuing to sell the Sun products that incorporate our software, but we do not yet know the level of sales and marketing effort and support that Oracle will put into sales of these products.

In December of each of the past several years, 3Com, through a Chinese subsidiary, had placed a multi-million dollar order with us for licenses to our software. In December, 2009, Hewlett-Packard announced that it had reached an agreement to purchase 3Com. This agreement caused 3Com to vary from its historical licensing pattern and to place a substantially smaller order than previous years. The purchase of 3Com by HP has not yet been completed. We do not know when or if 3Com will continue to license our software.

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Collectively, these three merger and acquisition events were the major factor contributing to the twenty-four percent decrease in OEM software license revenue.

Overall, our revenues for the full year increased to $89.5 million from $87 million in 2008. This is a 3% year over year increase in revenues. We currently anticipate that revenue will increase in 2010.

Net loss for the year was $3.1 million compared with net income of $1.2 million in 2008. 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 $8.8 million in 2009 and $9.1 million in 2008, which is reflected in the net results for each year.

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 2009 was $6.3 million, compared with operating income of $1 million in 2008. These numbers again include stock-based compensation expense. We attribute the decline in operating income from 2008 to 2009 primarily to the shortfall in anticipated revenue from our OEM customers. We planned our expenses for 2009 based on our assumptions about revenue growth. When the OEM revenue fell short, the result was a loss from operations.

This same OEM revenue shortfall negatively impacted gross margin, another important measure of our business. Among other things, gross margin measures our ability to scale our business. Our gross margins tend to increase as our software license revenue increases. Our gross margin for 2009 was 81% compared with 84% for 2008. The impact of the equity-based compensation expense on gross margin was equivalent to 2% for each of 2009 and 2008. The decline of OEM revenue was particularly harmful to our gross margin because the cost of OEM revenues tends to be much lower than the cost of channel revenue.

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 2009 to (7%), compared with 1% in 2008. The impact of the equity-based compensation expense on operating margin in 2009 and 2008 was equivalent to 10% each year.

Our focus for 2010 will be to continue to manage our business with a view towards long-term success and growth. Our goal is to keep making the Company more profitable, but we do not manage the business to meet quarterly or annual earnings targets. Our continued ability to generate cash from operations allows us to put money back into the business to continue its growth.

We anticipate that our cost of maintenance, software services and other revenue, research and development, sales and marketing and general and administrative expenses will be higher in 2010 as compared with 2009, as a result of the investments we made throughout 2009, which will now have a full-year impact on 2010.

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;
- our ability to establish and to expand relationships with key industry OEMs, and sales by those OEMs;
- 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.

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We anticipate that in 2010 software license sales by resellers and, to a lesser extent, direct licenses to end users, or our non-OEM business, will continue to grow in both absolute dollars and as a percentage of sales. Software license revenue from our non-OEM business increased 15% in 2009. Increasing sales from our non-OEM business remains an area of focus for us and in 2009 we made significant investments in our sales force and in our marketing team to help grow these 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 2009, 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 2009. We will continue to enter into relationships with resellers and to discontinue relationships with resellers with whom we are not satisfied.

Despite the decline in OEM revenue, OEM relationships continue to be important to us for two main reasons:

First, sales by our OEM partners contribute to our revenues. Overall, total revenue from OEMs accounted for approximately 36% of our revenues in 2009, down from 45% in 2008. Accordingly, the loss of these customers would have a material adverse effect on our business.

Second, having our products selected by respected, established industry leaders signals to customers, resellers and other potential OEM partners that our products are quality products that add value to their enterprise. Before licensing software, OEM partners typically undertake broad reviews of many of the competing software solutions available. The choice of our products by major industry participants validates both the design and the capabilities of the products and our product roadmaps.

We do everything we can to assure that our products meet the needs of our OEM partners and their customers. However, as was shown in 2009 we are vulnerable to strategic and tactical decisions made by our OEM partners that can result in lower revenue for us. In addition to potential changes in ownership and the effects that can result, we cannot control decisions by our OEM partners to change their product or marketing mix in ways that impact sales of products licensed by the OEMs from us. Over our history, we have entered into OEM agreements with partners, only to see those OEM partners change their strategies and make significant reductions in their commitments to the products that incorporate our technology.

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 1% to $22.2 million as of December 31, 2009, compared with $22.1 million as of December 31, 2008. We expect deferred revenue to continue to grow in 2010.

As discussed above, consolidation in the data protection and network storage market continued in 2009. The consolidation significantly impacted our revenue.

Our expenses increased 11% in 2009 from $86 million in 2008 to $95.8 million in 2009. This is well below the increase from 2007 to 2008, which was 21%, and the increase from 2006 to 2007, which was 19%. However, the increase in expenses outpaced our increase in revenues. Most of the increase in expenses related to our successful efforts to continue to build our non-OEM business. We continue to believe that the investments we have made in our business will provide a pay off in the long run through increased sales and market share. Included in our operating expenses for the years ended December 31, 2009 and 2008 was $8.8 million and $9.1 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 2009, and we anticipate that our quarterly results for 2010 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 2009. 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, 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 operating expenses increased 11% from $86.0 million in 2008 to $95.8 million in 2009. Included in our operating expenses for the years ended December 31, 2009 and 2008 were $8.8 million and $9.1 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 both our maintenance and our software services revenues. This growth was offset by slight declines in our total software license revenues of 1% for the year ended December 31, 2009 as compared with the same period 2008. Although our software license revenue declined during 2009 compared with 2008, our gross software license revenues from non-OEM partners increased 15% during 2009 compared with 2008, while our gross software license revenues from OEM partners decreased by 24% during 2009 compared with 2008. The increase in our non-OEM partner gross software license revenues was primarily driven by our ongoing focus and investments on the FalconStor branded non-OEM channel business, which resulted in increases in software licenses for our network storage solution software from both new customers and our installed customer base. The decrease in our OEM partner gross software license revenues was primarily attributable to the merger and acquisition activity that adversely impacted some of our key OEM partners, specifically, EMC, Sun Microsystems and 3Com. As a result of the current macroeconomic environment, we continued to experience slowed revenue growth, particularly in software license revenues, as a result of 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, revenue from our maintenance agreements were not as significantly impacted as compared with our software license revenues. Overall, total revenue contribution from our OEM partners decreased in both absolute dollars and as a percentage of total revenues for the year ended December 31, 2009 as compared with 2008. Total revenue from non-OEM partners increased in both absolute dollars and as a percentage of total revenue for the year ended December 31, 2009 as compared with 2008.

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Expenses increased in all aspects of our business as we continued to invest in our future by increasing headcount both domestically and internationally. To support our expected growth, 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, our investments in our future through additional headcount, specifically in sales and marketing functions for our non-OEM channel, would result in lower operating profits and margins. However, we have already began to recognize returns on our investments from our non-OEM channel business as indicated by the 15% growth in our gross software license revenues from this part of our business. We anticipate that these investments will continue to provide positive returns and accelerated sales momentum into 2010, and that these investments are in line with our long-term outlook. Finally, we continue to invest in our infrastructure by continued capital expenditures, particularly with purchases of equipment in support of our existing and future product offerings.

Revenues

	Year Ended December 31,			
	2009		2008	
Revenues:				
Software license revenue	$ 58,154,948		$ 58,590,246	
Maintenance revenue	25,476,989		23,283,094	
Software services and other revenue	5,827,244		5,151,520	
Total Revenues	$ 89,459,181		$ 87,024,860	
Year-over-year Percentage Growth				
Software license revenue	-1	%	10	%
Maintenance revenue	9	%	25	%
Software services and other revenue	13	%	-9	%
Total percentage growth	3	%	12	%

Software license revenue

Software license revenue is comprised of software licenses sold through our OEMs, and through (i) value-added resellers, and (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 software licenses sold and the software and permanent key codes are delivered to the customer.

Software license revenue decreased 1% from $58.6 million for the year ended December 31, 2008 to $58.2 million for the year ended December 31, 2009. Software license revenue represented 65% and 67% of our total revenues for the years ended December 31, 2009 and 2008, respectively. The decrease in software license revenues was primarily attributable to a decline of 24% in gross software license 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 15% in gross software license revenues from our non-OEM partners during the year ended December 31, 2009, as compared with the same period in 2008.

Over the past several years, we have experienced broader market acceptance of our software applications and we have continued to offer new product solutions, which has resulted in increased demand for our software solutions. Additionally, during 2009 we focused our investments on the FalconStor branded non-OEM channel business as we feel this is in line with our long-term outlook. However, overall software license revenues continued to be impacted by the downturn in information technology spending as a result of the current macroeconomic environment, which commenced during the second half of 2008, and continued throughout 2009. While we anticipate this trend to continue into 2010, we also anticipate that our investments in the FalconStor branded business will result in our non-OEM generated software license revenue to grow at a greater rate in future years as compared with our OEM generated software license revenue.

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Maintenance revenue

Maintenance revenue is comprised of software maintenance and technical support services. Revenues derived from maintenance and technical support contracts are deferred and recognized ratably over the contractual maintenance term. Maintenance revenues increased 9% from $23.3 million for the year ended December 31, 2008 to $25.5 million for the year ended December 31, 2009.

The major factor behind the increase in maintenance revenue was an increase in the number of maintenance and technical support contracts we sold. As we are in business longer, and as we license more software 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. While we expect our maintenance revenue to continue to grow primarily because (i) the majority of our new customers purchase maintenance and support contracts, and (ii) the majority of our growing existing customer base renewed their maintenance and support contracts after their initial contracts expire, the slowed growth in software license revenues we have experienced since the second half of 2008 and throughout 2009, as discussed above, has impacted the typical maintenance revenue growth levels we have experienced historically year over year.

Software services and other revenue

Software services and other revenues are comprised of professional services primarily related to the implementation of our software, engineering services, and sales of computer hardware. 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. We have transactions in which we purchase hardware and bundled this hardware with our software and sell this bundled solution to our customer base. Our software is not essential to the functionality of the bundled hardware. The amount of revenue allocated to the software and hardware bundle is recognized as revenue in the period delivered provided all other revenue recognition criteria have been met. We further separate the software sales revenue from the hardware revenue for purposes of classification in the consolidated statements of operations in a systematic and rational manner based on their deemed relative fair values. Software services and other revenue increased 13% from $5.2 million for the year ended December 31, 2008 to $5.8 million for the year ended December 31, 2009.

The increase in software services and other revenue was primarily due to increases in both (i) computer hardware sales, which increased from $3.0 million for the year ended December 31, 2008 to $3.1 million for the same period in 2009, and (ii) our professional 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 software license contracts sold during the year, (ii) the number of our software license customers who elected to purchase professional services, and (iii) the number of professional services contracts that were completed during the year. 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 our software licenses. We expect the hardware revenue will continue to vary from year to year based upon the number of customers who wish to have us bundle hardware with our software for one complete solution.

Cost of Revenues

	Year ended December 31,	
	2009	2008
Total Revenues:	$ 89,459,181	$ 87,024,860
Cost of maintenance, software services		

and other revenue (including amortization of purchased and capitalized software)	$	16,915,407	$	13,874,238
Gross Profit	$	72,543,774	$	73,150,622
Gross Margin		81 %		84 %

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Cost of maintenance, software services and other revenue

Cost of maintenance, software services and other revenues consists primarily of personnel and other costs associated with providing software implementations, technical support under maintenance contracts, training, amortization of purchased and capitalized software and share-based compensation expense. Cost of maintenance, software services and other revenues also includes the cost of hardware purchased that was resold. Cost of maintenance, software services and other revenues for the year ended December 31, 2009 increased $3.0 million, or 22% to $16.9 million compared with $13.9 million for the same period in 2008. The increase in cost of maintenance, software services and other revenue for the year ended December 31, 2009 as compared with the same period in 2008 was primarily due to (i) an increase in personnel and related costs, (ii) increased hardware costs associated with the transactions in which we bundled purchased hardware with our software and sold the bundled solution, and (iii) an increase in amortization related to purchased and capitalized software, specifically related to the acquisition of World Venture Limited on July 1, 2008 (see Note (9) Acquisitions to our consolidated financial statements for additional information). As a result of our increased sales of maintenance and support contracts, we continued to hire additional employees to provide technical support services. Our cost of maintenance, software services and other revenue will continue to grow in absolute dollars as our revenues from these services also increase.

Gross profit decreased $0.6 million, or 1%, from $73.1 million for the year ended December 31, 2008 to $72.5 million for the year ended December 31, 2009. Gross margins decreased to 81% for the year ended December 31, 2009 from 84% in 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 our investment in 2009 in additional headcount to support our anticipated revenue growth for both the short and the long-term. These investments in 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 maintenance, software services and other revenue increased to $1.5 million from $1.4 million for the year ended December 31, 2009 and December 31, 2008, respectively. Share-based compensation expense was equal to 2% of revenue for each of the years ended December 31, 2009 and December 31, 2008.

Software Development Costs

Software 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. Software development costs increased $1.5 million, or 6% to $26.8 million for the year ended December 31, 2009 from $25.3 million in the same period in 2008. The major contributing factors to the increase in software development costs were higher salary and personnel related costs as a result of increased headcount to enhance and to test our core network storage software product and the development of new innovative products, features and options. Share-based compensation expense included in software development costs decreased to $3.1 million from $3.2 million for the years ended December 31, 2009 and 2008, respectively. Share-based compensation expense included in software development costs was equal to 3% of revenue for the year ended December 31, 2009 and 4% for the year ended December 31, 2008.

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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 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 our ongoing 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 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 $1.1 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

We invest our cash primarily in money market funds, commercial paper, government securities, and corporate bonds. 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, as a result of the continued suppressed interest rates on average cash balances invested 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.

As of January 1, 2008, we had approximately $5.1 million of federal net operating loss carryforwards available to offset future taxable income. These net operating loss carryforwards related to excess compensation deductions from previous years' exercises of stock options. During 2008, we utilized all of our net loss carryforwards, the benefits of which were credited to additional-paid-in-capital. As of December 31, 2009 and December 31, 2008, our deferred tax assets, net of a deferred tax liabilities and valuation allowance, were $14.0 million and $10.0 million, respectively.

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RESULTS OF OPERATIONS – FOR THE YEAR ENDED DECEMBER 31, 2008 COMPARED WITH THE YEAR ENDED DECEMBER 31, 2007

Revenues for the year ended December 31, 2008 increased 12% to $87.0 million compared with $77.4 million for the year ended December 31, 2007. Our operating expenses increased 21% from $71.3 million in 2007 to $86.0 million in 2008. Included in our operating expenses for the years ended December 31, 2008 and 2007 were $9.1 million and $7.9 million, respectively, of share-based compensation expense. Net income for the years ended December 31, 2008 and 2007 was $1.2 million and $12.7 million, respectively. Included in our net income for the year ended December 31, 2008 was a tax provision of $1.5 million compared with the year ended December 31, 2007 which included an income tax benefit of $4.3 million, that primarily consisted of a reversal of certain deferred tax asset valuation allowances as a result of our continuing positive operating results and financial projections. Our 12% revenue growth for the year ended December 31, 2008 as compared with the same period in 2007 was due to growth in both our software license revenue and maintenance revenues. This growth in revenues was primarily driven by increases in (i) demand for our data protection and network storage solution software, and (ii) maintenance revenue from new and existing customers. However, during the second half of 2008, our revenue growth slowed, particularly software license revenues, as a result of the difficult economic conditions encountered as a result of the disruptions in the global financial markets, specifically in North America, when compared with the same period in 2007. Because of our well-established installed customer base and growing number of software licenses sold, our revenue from maintenance agreements were not significantly impacted as compared with our software license revenues as a result of the downturn in information technology spending experienced during the second half of 2008. Revenue contribution from our OEM partners increased in absolute dollars for the year ended December 31, 2008 as compared with the same period in 2007. Revenue from our non-OEM partners increased in both absolute dollars and as a percentage of total revenue for the year ended December 31, 2008 as compared with the same period in 2007. Expenses increased in all aspects primarily as a result of increased worldwide headcount to 505 employees as of December 31, 2008, as compared with 414 employees as of December 31, 2007.

Revenues

	Year Ended December 31,			
	2008		2007	
Revenues:				
Software license revenue	$	58,590,246	$	53,153,980
Maintenance revenue		23,283,094		18,606,591
Software services and other revenue		5,151,520		5,638,651
Total Revenues	$	87,024,860	$	77,399,222
Year-over-year Percentage Growth				
Software license revenue	10	%	39	%
Maintenance revenue	25	%	49	%
Software services and other revenue	-9	%	32	%
Total percentage growth	12	%	41	%

Software license revenue

Software license revenue increased 10% from $53.2 million for the year ended December 31, 2007 to $58.6 million for the year ended December 31, 2008. Software license revenue represented 67% and 69% of our total revenues for the years ended December 31, 2008 and 2007, respectively. As a result of broader market acceptance of our software applications, new product offerings and increased demand for our products from our expanding base of customers, we continued to experience increased software license revenues. However, during the second half of 2008, as a result of the difficult economic conditions encountered as a result of the disruptions in the global financial markets, specifically in North America, our software license revenue growth slowed when compared with the same period in 2007. Overall, during the year ended December 31, 2008, gross software license revenue from our OEM partners decreased 7%, while gross software license revenues from our non-OEM partners increased 22% when compared to the same period in 2007.

Maintenance revenue

Maintenance revenues increased 25% from $18.6 million for the year ended December 31, 2007 to $23.3 million for the year ended December 31, 2008. The major factor behind the increase in maintenance revenue was an increase in the number of maintenance and technical support contracts we sold.

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Software services and other revenue

Software services and other revenue decreased 9% from $5.6 million for the year ended December 31, 2007 to $5.2 million for the year ended December 31, 2008. The decrease in software services and other revenue was primarily due to a decrease in computer hardware sales, which declined from $3.4 million for the year ended December 31, 2007 to $3.0 million for the year ended December 31, 2008. Our professional services revenue decreased $0.1 million to $2.2 million for the year ended December 31, 2008 from $2.3 million in the same period in 2007. We expect professional services revenues to vary from year to year based upon the number of customers who elect to utilize our professional services upon purchasing our software licenses. The hardware revenue will vary from year to year based upon the number of customers who wish to have us bundle hardware with our software for one complete solution.

Cost of Revenues

	Year ended December 31,	
	2008	2007
Total Revenues:	$ 87,024,860	$ 77,399,222
Cost of maintenance, software services and other revenue (including amortization of purchased and capitalized software)	$ 13,874,238	$ 11,213,935
Gross Profit	$ 73,150,622	$ 66,185,287
Gross Margin	84 %	86 %

Cost of maintenance, software services and other revenue

Cost of maintenance, software services and other revenues increased $2.7 million or 24% to $13.9 million for the year ended December 31, 2008, from $11.2 million for the same period in 2007. The increase in cost of maintenance, software services and other revenue was primarily due to the increase in personnel and related costs. As a result of our increased sales from maintenance and support contracts, we continued to hire additional employees to provide technical support services.

Gross profit increased $7.0 million or 11% to $73.2 million for the year ended December 31, 2008, from $66.2 million for the same period in 2007. Gross margins decreased from 86% for the year ended December 31, 2007, to 84% for the year ended December 31, 2008. Even though we had an increase in our gross profit, our gross margins decreased. Generally, our gross margins may fluctuate based on several factors, including (i) revenue growth levels, (ii) timing of changes in personnel headcount and related costs, (iii) our mix of product offerings and services, and (iv) costs related to the procurement of hardware for our bundled solutions. Share-based compensation expense included in the cost of maintenance, software services and other revenue increased to $1.4 million from $1.0 million for the years ended December 31, 2008 and 2007, respectively. Share-based compensation expense was equal to 2% and 1% of revenue for the years ended December 31, 2008 and 2007, respectively.

Software Development Costs

Software development costs increased 13% to $25.3 million for the year ended December 31, 2008, from $22.4 million in the same period in 2007. The major contributing factors to the increase in software development costs were higher salary and personnel related costs as a result of increased headcount to enhance and test our core network storage software product and the development of new innovative features and options. Share-based compensation expense included in software development costs decreased to $3.2 million from $3.3 million for the years ended

December 31, 2008 and 2007, respectively. Share-based compensation expense included in software development costs was equal to 4% of revenue for each of the years ended December 31, 2008 and 2007, respectively.

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Selling and Marketing

Selling and marketing expenses increased 28% to $38.1 million for the year ended December 31, 2008, from $29.7 million for the same period in 2007. 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, and (ii) higher advertising and marketing related expenses as a result of trade and industry shows, new product offerings/enhancements, new product branding and related advertising and marketing of such initiatives. Share-based compensation expense included in selling and marketing increased to $3.5 million from $2.6 million for the years ended December 31, 2008 and 2007, respectively. Share-based compensation expense included in selling and marketing expenses was equal to 4% and 3% for the years ended December 31, 2008 and 2007, respectively.

General and Administrative

General and administrative expenses increased 9% to $8.7 million for the year ended December 31, 2008 from $8.0 million for the same period in 2007. Increased compensation and personnel related costs as a result of increased headcount to support our general and administrative needs was offset by decreases in professional fees and various administrative expenses during the year ended December 31, 2008, as compared with the same period in 2007. Share-based compensation expense included in general and administrative expenses decreased to $0.9 million from $1.0 million for the years ended December 31, 2008 and 2007, 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, 2008 and 2007, respectively.

Interest and Other Income

We invest our cash primarily in money market funds, commercial paper, government securities, and corporate bonds. As of December 31, 2008, our cash, cash equivalents, and marketable securities totaled $42.8 million, compared with $62.9 million as of December 31, 2007. Interest and other income decreased to $1.7 million for the year ended December 31, 2008, compared with $2.3 million for the same period in 2007. The decrease in interest income was primarily related to (i) a decrease in our cash, cash equivalents and marketable securities balances as a result of our repurchase of 5.6 million shares of our common stock at a total cost of $33.9 million during 2008, and (ii) lower interest rates on average cash balance invested during the year ended December 31, 2008, particularly during the second half of 2008, as a result of the U.S. banking liquidity crisis, as compared with the same period in 2007. The interest income in both 2008 and 2007 was impacted partially by other non-operating income and expenses, particularly, foreign currency gains of $0.2 million and $22,000, respectively.

Income Taxes

For the year ended December 31, 2008, our provision for income taxes was $1.5 million which consisted primarily of U.S., state, local and foreign taxes. For the year ended December 31, 2007, our benefit from income taxes was $4.3 million, which primarily related to a substantial reversal of our deferred income tax valuation allowance. During the year ended December 31, 2007, we determined that based upon a number of factors, including our then cumulative taxable income over the prior three years and expected profitability in future years, certain of our deferred tax assets were “more likely than not” realizable through future earnings. Accordingly, we recognized a significant portion of our deferred tax assets through a reduction in our deferred tax asset valuation allowance of approximately $8.9 million. As of December 31, 2008 and December 31, 2007, our deferred tax assets, net of a deferred tax liabilities and valuation allowance, were $10 million and $9.8 million, respectively.

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LIQUIDITY AND CAPITAL RESOURCES

Cash flow information is as follows:

	Years Ended December 31,		
	2009	2008	2007
Cash provided by (used in):			
Operating activities	$8,806,491	$18,231,609	$16,588,539
Investing activities	(11,019,560)	3,335,856	(12,357,286)
Financing activities	(3,826,699)	(30,998,308)	11,803,544
Effect of exchange rate changes	(571,939)	(424,271)	79,543
Net (decrease) increase in cash and cash equivalents	$(6,611,707)	$(9,855,114)	$16,114,340

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, 2009 totaled $41.8 million, as compared with $42.8 million as of December 31, 2008. Cash and cash equivalents totaled $15.8 million and marketable securities totaled $26.0 million at December 31, 2009. As of December 31, 2008, we had $22.4 million in cash and cash equivalents and $20.4 million in marketable securities.

In 2009, we continued making investments in our infrastructure in anticipation of our current and long-term outlook. As we continue to grow, we will continue to make investments in capital expenditures and we will continue to evaluate the need to increase our headcount. 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. In 2008, we purchased certain assets of World Venture Limited for an aggregate purchase price of $1.7 million including transaction and closing costs (see Note (9) Acquisitions to our consolidated financial statements). As of the date of this filing, we have no other agreements, commitments or understandings with respect to any such acquisitions.

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. 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. During 2007, we repurchased 318,900 shares of our common stock in open market purchases at an aggregate purchase price of $3.3 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, 2009, 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 provided by operating activities totaled $8.8 million for the year ended December 31, 2009, compared with net cash provided by operating activities of $18.2 million and $16.6 million for the years ended December 31, 2008 and 2007, respectively. The decrease in net cash provided by operating activities for the year ended December 31, 2009, as compared with the same periods in 2008 and 2007, respectively, was the result of recording a net loss of $3.1 million in 2009 compared with net income of $1.2 million and $12.7 million in 2008 and 2007, respectively, adjusted for: (i) the impact of non-cash charges, particularly relating to deferred income taxes and tax benefits from stock-based awards; and (ii) adjustments for net changes in operating assets and liabilities, primarily changes in our accounts payable, accrued expenses and deferred revenues. In addition, net cash provided by operating activities was impacted by the tax benefits recognized as a result of excess stock-based compensation deductions and exercises of stock options, particularly in 2008 and 2007. Based upon the authoritative guidance issued by the FASB on stock compensation, tax benefits relating to excess stock-based compensation deductions are to be presented as cash outflows from operating activities. We recognized tax benefits related to stock-based compensation deductions of $0.1 million, $2.1 million and $5.1 million for the years ended December 31, 2009, 2008, and 2007, respectively.

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Net cash used in investing activities was $11.0 million for the year ended December 31, 2009, compared with net cash provided by investing activities of $3.3 million for the year ended December 31, 2008 and net cash used in investing activities of $12.4 million for the year ended December 31, 2007. 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 ($5.6) million, $9.9 million and ($5.7) million for the years ended December 31, 2009, 2008 and 2007, 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 $4.3 million, $4.5 million and $5.5 million for the years ended December 31, 2009, 2008 and 2007, respectively. In addition, as discussed above and further in Note (9) Acquisitions to our consolidated financial statements, 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 2009 or 2007. 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, 2008 and 2007. 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 invest in our infrastructure to support our ongoing growth and expansion both domestically and internationally.

Net cash used in financing activities was $3.8 million for the year ended December 31, 2009, compared with net cash used in financing activities of $31.0 million for the year ended December 31, 2008 and net cash provided by financing activities of $11.8 million for the year ended December 31, 2007. Cash outflows from financing activities resulted from the repurchase of our outstanding 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. During 2007, we repurchased 0.3 million shares of our common stock at an aggregate purchase price of $3.3 million. 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 $35,000, $0.8 million and $10.0 million in 2009, 2008, and 2007, respectively. 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. Based upon the authoritative guidance issued by the FASB on stock compensation, tax benefits relating to excess stock-based compensation deductions are to be presented as cash inflows from financing activities. We recognized tax benefits related to stock-based compensation deductions of $0.1 million, $2.1 million and $5.1 million for the years ended December 31, 2009, 2008 and 2007, respectively.

As discussed in Note (4) Fair Value Measurements to our consolidated financial statements, on January 1, 2008, we adopted the authoritative guidance issued by the FASB on fair value measurements and disclosures. We utilize unobservable (Level 3) inputs in determining the fair value of auction rate securities we hold.

As of December 31, 2009 and 2008, $1.4 million and $1.5 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. During the first quarter of 2008, we began experiencing failed auctions on 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, 2009 and 2008.

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. However, due to events in the credit markets beginning in the second half of 2008, and continuing throughout 2009, 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 as of both December 31, 2009 and 2008. 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. Due to these events, we reclassified these instruments as Level 3 commencing in 2008 and we continued to do so in 2009.

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As of December 31, 2009, we have recorded $40,000 cumulatively in other-than-temporary impairment and a cumulative temporary decline in fair value of approximately $282,534 in accumulated other comprehensive loss. As of December 31, 2008, the losses related to our auction rate securities recorded in accumulated other comprehensive loss totaled $333,055. During the first quarter of 2009, we determined that a decline in the fair value of one of our particular investments was the result of a downgrade in the credit rating of certain underlying subordinate securities within the auction rate security. As a result, we determined a portion of the overall decline in fair value of the auction rate security to be other-than-temporary due to the creditworthiness of the underlying securities, and accordingly recorded $40,000 in other-than-temporary impairments on this auction rate security. Accordingly, any future fluctuation in the fair value related to any of the auction rate securities that we deem to be temporary, including any recoveries of previous write-downs, would be recorded to accumulated other comprehensive loss, net of tax. In addition, during the fourth quarter of 2009, $100,000 of our auction rate securities were called by the issuer at par value. Finally, with the exception of the creditworthiness of one of our auction rate securities, we believe that the remaining temporary declines in fair value are primarily due to liquidity concerns and not 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 that we determine 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 3% of our cash equivalents, and marketable securities balance as of each December 31, 2009 and 2008, 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 2010 through 2012. The following is a schedule of future minimum lease payments for all operating leases as of December 31, 2009:

Year ending December 31,		
2010		2,541,207
2011		1,875,376
2012		522,353
	$	4,938,936

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, 2009 and 2008, we had no off-balance sheet arrangements.

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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. Software license 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. The software license 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 extended payment terms. When a customer 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, and (vii) concentrations of credit risk and customer credit worthiness. 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 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, 2009, 2008, and 2007, 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.

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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. As discussed further in Note (9) Acquisitions to our consolidated financial statements, in 2008 we purchased certain assets of World Venture Limited for an aggregate purchase price of $1.7 million including transaction and closing costs, and recorded approximately $0.6 million of goodwill as a result of the related fair value appraisals performed.

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 our fiscal year.

As of each December 31, 2009 and 2008, we had $4.2 million of goodwill, respectively. As of each December 31, 2009 and 2008, we had $0.8 million and $1.4 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 a group will be disposed of before the end of its useful life. As discussed further in Note (9) Acquisitions, to our consolidated financial statements, in 2008 we purchased certain assets of World Venture Limited for an aggregate purchase price of $1.7 million including transaction and closing costs, and recorded approximately $0.6 million of goodwill as a result of the related fair value appraisals performed.

Throughout 2009, 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. A 20% decrease in the fair value of our reporting unit as of December 31, 2009 would have had no impact on the carrying value of our goodwill. As of both December 31, 2009 and 2008, 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, 2009 and 2008.

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, 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. As of December 31, 2008, our investments in marketable securities included $1.5 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.

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 $41.8 million as of December 31, 2009. 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 30% 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, 2009.

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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, 2009, 2008 and 2007, approximately 40%, 40% and 34%, 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, 2009, the effect on our results before taxes from foreign currency fluctuations on our balance sheet would be approximately $0.8 million. Commencing in the second quarter of 2009, we began entering into foreign currency hedges 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

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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, 2009 and 2008, 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, 2009. 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, 2009 and 2008, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2009, 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, 2009, 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 12, 2010, expressed an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

/s/ KPMG LLP

Melville, New York,
March 12, 2010

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, 2009, 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, 2009, 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, 2009 and 2008, 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, 2009, and our report dated March 12, 2010, expressed an unqualified opinion on those consolidated financial statements.

/s/ KPMG LLP

Melville, New York
March 12, 2010

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FALCONSTOR SOFTWARE, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

	December 31	
	2009	2008
Assets		
Current assets:		
Cash and cash equivalents	$15,752,528	$22,364,235
Marketable securities	24,952,966	19,279,010
Accounts receivable, net of allowances of $7,503,338 and $8,474,428, respectively	24,948,261	25,015,848
Prepaid expenses and other current assets	2,717,260	2,468,632
Deferred tax assets, net	4,320,773	4,296,297
Total current assets	72,691,788	73,424,022
Property and equipment, net of accumulated depreciation of $17,380,681 and $18,342,081 , respectively	7,601,727	7,963,019
Long-term marketable securities	1,077,466	1,166,945
Deferred tax assets, net	9,698,859	5,739,195
Other assets, net	2,958,229	2,544,545
Goodwill	4,150,339	4,150,339
Other intangible assets, net	823,416	1,375,695
Total assets	$99,001,824	$96,363,760
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$1,570,190	$738,140
Accrued expenses	8,454,743	8,288,732
Deferred revenue, net	16,570,076	16,068,370
Total current liabilities	26,595,009	25,095,242
Other long-term liabilities	608,907	199,323
Deferred revenue, net	5,644,994	5,992,843
Total liabilities	32,848,910	31,287,408
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, 52,389,028 and 51,970,442 shares issued, respectively and 44,383,793 and 45,146,392 shares outstanding, respectively	52,389	51,970
Additional paid-in capital	141,726,802	132,998,230
Accumulated deficit	(27,181,894)	(24,089,189)

Common stock held in treasury, at cost (8,005,235 and 6,824,050 shares, respectively)	(46,916,339)	(42,928,328)
Accumulated other comprehensive loss, net	(1,528,044)	(956,331)
Total stockholders' equity	66,152,914	65,076,352
Total liabilities and stockholders' equity	$99,001,824	$96,363,760

See accompanying notes to consolidated financial statements.

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FALCONSTOR SOFTWARE, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

	Years Ended December 31,		
	2009	2008	2007
Revenues:			
Software license revenue	$58,154,948	$58,590,246	$53,153,980
Maintenance revenue	25,476,989	23,283,094	18,606,591
Software services and other revenue	5,827,244	5,151,520	5,638,651
	89,459,181	87,024,860	77,399,222
Operating expenses:			
Amortization of purchased and capitalized software	718,448	221,344	122,560
Cost of maintenance, software services and other revenue	16,196,959	13,652,894	11,091,375
Software development costs	26,761,384	25,296,404	22,405,058
Selling and marketing	42,255,099	38,096,693	29,656,034
General and administrative	9,875,254	8,745,777	8,023,562
	95,807,144	86,013,112	71,298,589
Operating (loss) income	(6,347,963)	1,011,748	6,100,633
Interest and other (loss) income, net	(127,803)	1,688,699	2,329,187
(Loss) income before income taxes	(6,475,766)	2,700,447	8,429,820
(Benefit) provision for income taxes	(3,383,061)	1,497,635	(4,312,036)
Net (loss) income	$(3,092,705)	$1,202,812	$12,741,856
Basic net (loss) income per share	$(0.07)	$0.03	$0.26
Diluted net (loss) income per share	$(0.07)	$0.02	$0.24
Basic weighted average common shares outstanding	44,781,918	47,858,679	49,420,848
Diluted weighted average common shares outstanding	44,781,918	49,496,736	53,130,903

See accompanying notes to consolidated financial statements.

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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, 2006	$ 49,086	$ 99,282,308	$ (38,033,857)	$ (5,780,163)	$ (474,127)	$ 55,043,247	–
Exercise of stock awards	2,254	10,004,920	–	–	–	10,007,174	–
Net effects of tax benefits from stock-based award activity	–	5,070,031	–	–	–	5,070,031	–
Issuance of stock options to non-employees	–	209,218	–	–	–	209,218	–
Share-based compensation	–	7,728,305	–	–	–	7,728,305	
Net Income	–	–	12,741,856	–	–	12,741,856	12,741,856
Acquisition of treasury stock	–	–	–	(3,273,661)	–	(3,273,661)	–
Minimum pension liability adjustment, net (Note 12)	–	–	–	–	(115,925)	(115,925)	(115,925)
Change in unrealized gains / losses on marketable securities, net	–	–	–	–	66,975	66,975	66,975
Foreign currency translation adjustment	–	–	–	–	1,157	1,157	1,157
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	–
Issuance of stock options to non-employees	–	140,975	–	–	–	140,975	–
Share-based compensation	–	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 12)	–	–	–	–	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
Exercise of stock awards	419	35,101	–	–	–	35,520	–
Net effects of tax shortfalls from stock-based award activity	–	(133,970)	–	–	–	(133,970)	–
Issuance of stock options to non-employees	–	275,480	–	–	–	275,480	–
Share-based compensation	–	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 12)	–	–	–	–	(50,850)	(50,850)	(50,850)

Change in unrealized gains / losses on marketable securities, net	