NETWORK 1 SECURITY SOLUTIONS INC
Form 10QSB
August 16, 2002

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U.S. SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-QSB

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2002

[_] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM ______ TO ______

COMMISSION FILE NUMBER 1-14896

NETWORK-1 SECURITY SOLUTIONS, INC.
(EXACT NAME OF SMALL BUSINESS ISSUER AS SPECIFIED IN ITS CHARTER)

DELAWARE	11-3027591
(STATE OR OTHER JURISDICTION OF INCORPORATION OR ORGANIZATION)	(IRS EMPLOYER IDENTIFICATION NO.)

1601 TRAPELO ROAD, RESERVOIR PLACE, WALTHAM, MASSACHUSETTS 02451
(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES)

781-522-3400
(ISSUER'S TELEPHONE NUMBER)

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 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 [X] No [_]

As of August 1, 2002 there were 7,701,264 shares of Common Stock, $.01 par value per share, 231,054 shares of Series D Convertible Preferred Stock, $.01 par value per share, and 2,790,105 shares of Series E Convertible Preferred Stock, $.01 par value per share, outstanding.

Transitional Small Business Disclosure Format (check one): Yes [_] No [X]

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NETWORK-1 SECURITY SOLUTIONS, INC.
CONDENSED BALANCE SHEETS

JUNE 30, 2002
(UNAUDITED)

ASSETS	
Current assets:	
Cash and cash equivalents	$ 4,156,000
Accounts receivable - net	71,000
Prepaid expenses and other current assets	63,000
Total current assets	4,290,000
Equipment and fixtures	327,000
Capitalized software costs - net	546,000
Security deposits	21,000
	$ 5,184,000
LIABILITIES	
Current liabilities:	
Accounts payable	$ 211,000
Accrued expenses and other current liabilities	865,000
Deferred revenue	258,000
Total current liabilities	1,334,000
Liability Settled with Equity Instrument	416,000
	1,750,000
Commitments and contingencies	
STOCKHOLDERS' EQUITY	
Preferred stock - $.01 par value; authorized 10,000,000 shares;	
Series D -231,054 and 231,054 shares issued and outstanding, respectively	2,000
Series E -2,790,105 and 3,191,037 shares issued and outstanding, respectively	28,000
Common stock - $.01 par value; authorized 50,000,000 shares; 7,701,264 and 6,781,374 shares issued and outstanding, respectively	77,000
Additional paid-in capital	41,402,000
Accumulated deficit	(38,075,000
	3,434,000
	$ 5,184,000

See notes to condensed financial statements

NETWORK-1 SECURITY SOLUTIONS, INC.
CONDENSED STATEMENTS OF OPERATIONS
(UNAUDITED)

	THREE MONTHS ENDED JUNE 30,		SI
	2002	2001	

Revenues:			
Licenses	$ 191,000	$ 251,000	$
Services	52,000	57,000	
Total revenues	243,000	308,000	
Cost of revenues:			
Amortization of software development costs	125,000	63,000	
Cost of licenses	7,000	8,000	
Cost of services	42,000	57,000	
	174,000	128,000	
Gross profit	69,000	180,000	
Operating expenses:			
Product development	397,000	673,000	
Selling and marketing	730,000	816,000	1
General and administrative	995,000	516,000	1
	2,122,000	2,005,000	3
Loss from continuing operations before interest	(2,053,000)	(1,825,000)	(3
Interest income - net	19,000	85,000	
Loss from continuing operations	(2,034,000)	(1,740,000)	$ (3
Income from discontinued operations	--	19,000	
Net loss	$ (2,034,000)	$ (1,721,000)	$ (3
Per common share information - basic and diluted			
Loss from continuing operations	$ (0.26)	$ (0.27)	$
Income from discontinued operations	--	0.00	
Net loss	$ (0.26)	$ (0.27)	$
Weighted average number of common shares outstanding	7,683,900	6,462,852	7

See notes to condensed financial statements

NETWORK-1 SECURITY SOLUTIONS, INC.
CONDENSED STATEMENTS OF CASH FLOWS
(UNAUDITED)

	SIX MONTHS ENDED JU
	2002

Cash flows from operating activities:		
Loss from continuing operations	$ (3,558,000)	$ (3
Adjustments to reconcile net loss from continuing operations to net cash used in operating activities:		
Issuance of common stock option and warrants for services rendered	416,000	
Provision for doubtful accounts	5,000	
Amortization of compensatory stock options and warrants	--	
Depreciation and amortization	304,000	
Changes in:		
Accounts receivable	(14,000)	
Prepaid expenses and other current assets	50,000	
Accounts payable, accrued expenses and other current liabilities	(4,000)	
Interest Payable	--	
Deferred revenue	13,000	
Net cash used in continuing operations	(2,788,000)	(2
Cash provided by (used in) discontinued operations	--	
Net cash used in operating activities	(2,788,000)	(2
Cash flows from investing activities:		
Acquisitions of equipment and fixtures	(117,000)	
Capitalized software costs	(180,000)	
Security deposit	(13,000)	
Net proceeds from sale of professional services group	--	
Net cash (used in) provided by investing activities	(310,000)	
Cash flows provided by financing activities:		
Proceeds from exercise of options and warrants	133,000	
Net decrease in cash and cash equivalents	(2,965,000)	(1
Cash and cash equivalents - beginning of period	7,121,000	4
Cash and cash equivalents - end of period	$ 4,156,000	$ 2
Supplemental disclosures of noncash investing and financing activity:		
Conversion of notes payable and accrued interest into 10,897 shares of common stock and 124,031 shares of preferred stock in 2001	$ --	$
Compensation charge for non qualified stock options related to employees of discontinued operations	$ --	$

See notes to condensed financial statements

NETWORK-1 SECURITY SOLUTIONS, INC.
NOTES TO CONDENSED FINANCIAL STATEMENTS

1. FINANCIAL STATEMENT PRESENTATION

a. The condensed financial statements included herein have been prepared by the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission with respect to Form 10-QSB. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations, although the Company believes that the disclosures made herein are adequate to make the information contained herein not misleading. These interim financial statements and the notes thereto should be read in conjunction with the financial statements included in the Company's Form 10-KSB for the year ended December 31, 2001.

In the Company's opinion, all adjustments (consisting only of normal recurring adjustments) necessary for a fair presentation of the information shown have been included.

b. The results of operations for the six months ended June 30, 2002 presented herein are not necessarily indicative of the results of operations that may be expected for the year ending December 31, 2002.

c. The Company has suffered significant losses, has not generated positive cash flow from operations and has an accumulated deficit of $38,075,000 at June 30, 2002. Management believes it currently has cash to fund its operations until December 31, 2002, or earlier if the Company does not achieve certain plans and assumptions (see "Liquidity and Capital Resources" on page 11 of this report). The Company is involved in substantive discussions with a third party with respect to a strategic transaction, which would include financing. There is, however, no assurance that the Company will consummate such a strategic transaction or secure additional financing.

d. Basic loss per share is calculated by dividing the net loss by the weighted average number of outstanding common shares during the period. Diluted loss per share data includes the dilutive effects of options, warrants and convertible securities. As all potential common shares are anti-dilutive due to the loss from continuing operations, they are not included in the calculation of diluted loss per share.

e. On April 18, 2002, in consideration of additional consulting and financial advisory services, the Company issued to CMH Capital Management Corp. ("CMH") an option to purchase 750,000 shares of the Common Stock at an exercise price of $1.20 per share which was the market price of the Company's Common Stock on the date of issuance. Corey M. Horowitz, Chairman of the Board of Directors of the Company, is the sole owner and officer of CMH. The shares underlying the option shall vest over a three year period in equal amounts of 250,000 shares per year beginning April 18, 2003. In addition, the shares underlying the option shall vest in full in the event of a "change of control" or in the event that the closing price of the Company's common stock reaches a minimum of $3.50 per share for twenty (20) consecutive trading days. The options were valued utilizing the Black Scholes pricing model resulting in an estimated fair value of $416,000 which was charged to expense in the quarter ended June 30, 2002. The valuation of the option and accordingly, the expense recognized is subject to adjustment based on, among other factors, the market price of the option at the date of the valuation. The Company will extimate the value of the option at each reporting date until they have vested.

f. The Company paid CMH $94,000 in consulting fees and $36,000 in expenses under the agreement for the six months ended June 30, 2002 and had a payable due CMH of $14,000 at June 30, 2002. In addition, in January 2002 CMH was paid $23,000 for consulting fees and expenses incurred in 2001.

g. License Revenue includes $95,000 representing 49.7% and 36.7% of license revenues for the three and six months ended June 30, 2002, respectively, from a reseller located in Singapore and includes $46,000 representing 24.1% and 17.8% of license revenues for the three and six months ended June 30, 2002, respectively, from a major university.

2. SUBSEQUENT EVENTS

a. On July 2, 2002, the Company extended its Consulting Agreement with CMH until December 31, 2002. In accordance with the Consulting Agreement, CMH will continue to be paid $17,500 per month for consulting and financial advisory services and will receive reimbursement of expenses including rent for office space in New York City.

b. In the third quarter of 2002, the Company instituted measures to preserve capital which included the reduction of twenty-one (21) employees and the closing of its China development office and its Taiwan sales office. The reductions in personnel materially reduce the Company's sales and product development efforts.

Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

THIS QUARTERLY REPORT ON FORM 10-QSB CONTAINS FORWARD-LOOKING STATEMENTS WITHIN THE MEANING OF SECTION 27A OF THE SECURITIES ACT OF 1933, AS AMENDED (THE "SECURITIES ACT"), AND SECTION 21E OF THE SECURITIES EXCHANGE ACT OF 1934, AS AMENDED (THE "EXCHANGE ACT"). ACTUAL RESULTS, EVENTS AND CIRCUMSTANCES (INCLUDING FUTURE PERFORMANCE, RESULTS AND TRENDS) COULD DIFFER MATERIALLY FROM THOSE SET FORTH IN SUCH STATEMENTS DUE TO VARIOUS RISKS AND UNCERTAINTIES, INCLUDING, BUT NOT LIMITED TO, THOSE DISCUSSED BEGINNING ON PAGE 11 OF THIS REPORT.

Overview

The Company develops, markets, licenses and supports a suite of

security software products designed to prevent unauthorized access to critical information residing on networked servers, desktops and laptops. In January 1999, the Company introduced its CYBERWALLPLUS family of network security products. The Company has made only limited sales of its CYBERWALLPLUS product, upon which an evaluation of its prospects and future performance can be made. Such prospects must be considered in light of the risks, expenses and difficulties frequently encountered in the introduction of new products and the shift from research and product development to commercialization of products based on rapidly changing technologies in a highly specialized and emerging market. The Company will be required to significantly expand its product and development capabilities, introduce new products, introduce enhanced features to existing products, expand its in-house sales force, establish and maintain distribution channels through third-party vendors, increase marketing expenditures, and attract additional qualified personnel. In addition, the Company must adapt to the demands of an emerging and rapidly changing computer network security market, intense competition and rapidly changing technology and industry standards. The Company may not be able to successfully address such risks, and the failure to do so would have a material adverse effect on the Company's business, results of operations and financial condition.

To date, the Company has incurred significant losses and, at June 30, 2002, had an accumulated deficit of $38,075,000. In addition, since June 30, 2002, the Company has continued to incur significant operating losses. Management believes it currently has cash to fund its operations until December 31, 2002 (or earlier if the Company does not achieve certain plans and assumptions) (See "Liquidity and Capital Resources" on page 11 of this report). The Company is actively engaged in substantive discussions with a third party with respect to a strategic transaction which would include financing. There is, however, no assurance that the Company will consummate such strategic transaction or secure additional financing. The inability of the Company to consummate a strategic transaction or secure additional financing would have a material adverse effect on the Company requiring it to curtail or possibly cease operations. In the third quarter of 2002, the Company instituted measures to preserve capital which included the reduction of twenty-one (21) employees and the closing of its China development office and its Taiwan sales office. The reductions in personnel materially reduce the Company's sales and product development efforts.

On October 2, 2001, the Company completed a $6.765 million private offering of Series E Preferred Stock and Warrants pursuant to a Securities Purchase Agreement with investors (the "Financing"). In accordance with the Securities Purchase Agreement, an aggregate of 3,191,037 shares of Series E Preferred Stock were sold to investors at a price of $2.12 per share together with warrants to purchase 6,882,074 shares of Common Stock at an exercise price of $1.27 per share. Each share of Series E Preferred Stock is convertible into two (2) shares of Common Stock, subject to adjustment. As the largest investor ($2,300,000) in the Financing, FalconStor Software, Inc. ("FalconStor"), a storage networking infrastructure software company, received an additional warrant to purchase 500,000 shares of the Company's Common Stock (the "Additional Warrant"). The shares underlying the Series E Preferred Stock and the warrants (including the Additional Warrant) issued in the Financing were registered pursuant to a Form S-3 Registration Statement which was declared effective by the SEC on February 12, 2002. Simultaneously with the closing of the Financing, the Company and FalconStor entered into a ten year Distribution and License Agreement pursuant to which FalconStor has the right to distribute the Company's product offerings in its indirect and OEM channels. As part of the Distribution and License Agreement, FalconStor paid the Company a non-refundable advance of $500,000 against future royalty payments of which, in accordance with accounting principles generally accepted in the United States of America, $350,000 has been accounted for as the purchase price of the Additional Warrant and this resulted in total proceeds allocated to the Financing of $7,115,000. The remaining $150,000 has been recorded as deferred revenue and will be

recognized as revenue when licensed to the customer.

On March 11, 2002, the Company hired Richard Kosinski as Chief Executive Officer and President pursuant to a two (2) year Employment Agreement in which Mr. Kosinski receives an annual base salary of $200,000 per year and is eligible to receive bonus compensation of up to $150,000 per year. In addition, Mr. Kosinski was issued options to purchase 1,200,000 shares of the Company's Common Stock, at an exercise price of $1.65 per share (the market price on the date of grant) which vest over a four (4) year period.

The Company's software products have not yet achieved market acceptance. The future success of the Company is largely dependent upon market acceptance of its CYBERWALLPLUS family of software products. While the Company believes that its family of software products offer advantages over competing products for network security, license revenue from network security software products since the introduction of FireWall/Plus (September 1995), a predecessor product line, through June 30, 2002 has only been $4,968,000. From January 1999 through June 30, 2002, license revenue from CYBERWALLPLUS has only been $2,236,000. CYBERWALLPLUS may not achieve significant market acceptance. Revenue from such commercial products depend on a number of factors, including the influence of market competition, technological changes in the network security market, the Company's ability to design, develop and introduce enhancements on a timely basis, and the ability of the Company to successfully establish and maintain distribution channels. The failure of CYBERWALLPLUS to achieve significant market acceptance as a result of competition, technological change or other factors, would have a material adverse effect on the Company's business, operating results and financial condition.

The Company has committed significant product and development resources to its CYBERWALLPLUS family of products. The Company's anticipated levels of expenditures for product development are based on its plans for product enhancements and new product development. The Company capitalizes and amortizes software development costs in accordance with Statement of Financial Accounting Standards No. 86. These costs consist of salaries, consulting fees and applicable overhead.

RESULTS OF OPERATIONS

SIX MONTHS ENDED JUNE 30, 2002 COMPARED TO SIX MONTHS ENDED JUNE 30, 2001

Revenues decreased by $404,000 or 53%, from $765,000 for the six months ended June 30, 2001 to $361,000 for the six months ended June 30, 2002, primarily as a result of a decrease in license revenues during the six months ended June 30, 2002. License revenues decreased by $388,000 or 60%, from $647,000 for the six months ended June 30, 2001 to $259,000 for the six months ended June 30, 2002. The Company's revenues for the first six months ended June 30, 2002 were negatively impacted by the lack of enterprise licenses as well as adverse economic conditions and reduced technology spending. Revenue for the six months ended June 30, 2001 included two large CyberwallPLUS server licenses issued to a major university and a major government sub-contractor totaling $199,000, and $118,000 in license revenue from a distributor in China. Revenue for the six months ended June 30, 2002 included a large CyberwallPLUS workstation license issued to an international reseller for $95,000 in Singapore and CyberwallPLUS server license to a major university for $46,000. Service revenues decreased by $16,000 or 14%, from $118,000 for the six months ended June 30, 2001 to $102,000 for the six months ended June 30, 2002 primarily due to a reduction in training revenue. The Company's revenues from customers in the United States represented 77% of its revenues during the six months ended June 30, 2001 and 65% of its revenues during the six months ended June 30, 2002,

respectively.

Cost of revenues consists of amortization of software development costs, cost of licenses and cost of services. Amortization of software development costs increased by $70,000 or 56%, from $125,000 for six months ended June 30, 2001 to $195,000 for the six months ended June 30, 2002, representing 19% and 75% of license revenues, respectively.

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Cost of licenses consists of software media (disks), documentation, product packaging, production costs and product royalties. Cost of licenses decreased by $12,000 or 55%, from $22,000 for the six months ended June 30, 2001 to $10,000 for the six months ended June 30, 2002, representing 3% and 4% of license revenues, respectively. Cost of licenses as a percentage of license revenues may fluctuate from period to period due to changes in product mix, changes in the number or size of transactions recorded in a given period or an increase or decrease in licenses of products which would require the Company to pay royalties to third parties.

Cost of services consists of salaries, benefits and overhead associated with the technical support of maintenance contracts. Cost of services decreased by $35,000 or 29%, from $119,000 for the six months ended June 30, 2001 to $84,000 for the six months ended June 30, 2002, representing 101% and 82% of service revenues, respectively. The decrease in cost of services in both dollar amount and as a percentage of service revenues resulted primarily from decreased personnel costs in the group as a result of the capital preservation programs implemented last year. Cost of services as a percentage of service revenues may fluctuate from period to period due to changes in support headcount and related benefit costs.

Gross profit was $499,000 for the six months ended June 30, 2001 compared to a gross profit of $72,000 for the six months ended June 30, 2002 , representing 65% and 20% of revenues, respectively. The decrease in gross profit was primarily due to the decrease in license revenue.

Product development consists of salaries, benefits, bonuses, travel and related costs of the Company's product development personnel, including consulting fees, the costs of computer equipment used in product and technology development. Product development expense decreased $449,000 or 35%, from $1,285,000 for six months ended June 30, 2001 to $836,000 for the six months ended June 30, 2002, representing 168% and 232% of revenues, respectively. Total product development costs, including capitalized costs of $235,000 for the six months ended June 30, 2001 and $180,000 for the six months ended June 30, 2002, were $1,520,000 and $1,016,000 for the six months ended June 30, 2001 and June 30, 2002, respectively. The decrease in total product development costs was due primarily to the reduction in the use of outside programmer's services of $442,000 and non-cash warrant compensation of $225,000. These costs reductions were partially offset by the establishment of a development team to service the Asia Pacific region during the six month period ended June 30, 2002 at a cost of $236,000. The Company closed its China development office in the third quarter of 2002.

Selling and marketing expenses consist primarily of salaries, including commissions, benefits, bonuses, travel, advertising, public relations, consultants and trade shows. Selling and marketing expenses decreased by $363,000 or 21%, from $1,712,000 for the six months ended June 30, 2001 to $1,349,000 for the six months ended June 30, 2002, representing 224% and 374% of revenues, respectively. The decrease in selling and marketing expenses was due primarily to a decrease of $355,000 in personnel costs, recruiting and travel expenditures related to the headcount reduction in 2001 to preserve capital, and a $48,000 reduction in advertising and direct mail spending. These costs

reductions were partially offset by the establishment of a sales team to service the Asia Pacific region for the six month period ended June 30, 2002 at a cost of $96,000. The Company closed its Taiwan sales office in the third quarter of 2002.

General and administrative expenses include employee costs, including salary, benefits, travel and other related expenses associated with management, finance and accounting operations, and legal and other professional services provided to the Company. General and administrative expenses increased by $480,000, from $1,010,000 for the six months ended June 30, 2001 to $1,490,000 for the six months ended June 30, 2002, representing 132% and 413% of revenues, respectively. Increases in non-cash charges of $309,000 attributable to the expense of the estimated fair value of stock options granted to an entity owned by the Company's Chairman of the Board of Directors of $416,000, increases in outside consultants of $241,000 of which $144,000 was to the Company's Chairman of the Board of Directors, professional fees increased by $55,000, which was offset by decreases in personnel related costs of $76,000, and investor relations expenses of $41,000.

The discontinued operations was sold on February 9, 2000 to Exodus Communications. The gain from discontinued operations in 2001 was attributed to the contingent payments and related contingent expenses pertaining to the sale received or paid in 2001.

No provision for or benefit from federal, state or foreign income taxes was recorded for six months ended June 30, 2001 or June 30, 2002 because the Company incurred net operating losses and fully reserved its deferred tax assets as their future realization could not be determined.

As a result of the foregoing, the Company had net loss of $2,733,000 for the six months ended June 30, 2001 compared with a net loss of $3,558,000 for the six months ended June 30, 2002.

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Liquidity and Capital Resources

The Company's capital requirements have been and will continue to be significant and its cash requirements continue to exceed its cash flow from operations. At June 30, 2002, the Company had $4,156,000 of cash and cash equivalents and working capital of $2,956,000. In October 2001, the Company completed a private offering of $6,765,000 of securities. The Company has financed its operations primarily through sales of equity and debt securities, and the sale of its professional services group. Net cash used in operating activities from continuing operations was $2,788,000 during the six months ended June 30, 2002, which was primarily attributable to the net loss of $3,558,000, partially offset by the non-cash expense of $416,000 attributable to the issuance of options and depreciation and amortization expense of $304,000.

The Company's operating activities during the six months ended June 30, 2002 were financed primarily with the funds raised in 2001. The Company does not currently have a line of credit from a commercial bank or other institution.

The Company anticipates, based on currently proposed plans and assumptions (including the timetable of, costs and expenses associated with, and success of, its marketing efforts), that its cash balance of approximately $4,156,000 as of June 30, 2002 will be sufficient to satisfy the Company's operations and capital requirements through December 31, 2002. There can be no assurance, however, that such funds will not be expended prior thereto. In the event the Company's plans change, or its assumptions change, or prove to be inaccurate (due to unanticipated expenses, difficulties, delays or otherwise), the Company may have insufficient funds to support its operations prior to

December 31, 2002. In the third quarter of 2002, the Company instituted certain measures to reduce its overhead including decreasing its headcount by twenty-one (21) employees and the closing of its China development office and its Taiwan sales office. The reductions in personnel materially reduce the Company's sales and product development efforts. The Company is actively engaged in substantive discussions with a third party with respect to a strategic transaction which would include financing. There is, however, no assurance that the Company will consummate such strategic transaction or secure additional financing. The inability of the Company to consummate a strategic transaction or additional financing would have a material adverse effect on the Company requiring it to curtail or possibly cease operations In addition, any additional equity financing or strategic transaction may involve substantial dilution to the interests of the Company's then existing stockholders.

Fluctuations in Operating Results

The Company anticipates significant quarterly fluctuations in its operating results in the future. The Company generally ships orders for commercial products as they are received and, as a result, does not have any material backlog. As a result, quarterly revenues and operating results depend on the volume and timing of orders received during the quarter, which are difficult to forecast. Operating results may fluctuate on a quarterly basis due to factors such as the demand for the Company's products, purchasing patterns and budgeting cycles of customers, the introduction of new products and product enhancements by the Company or its competitors, market acceptance of new products introduced by the Company or its competitors and the size, timing, cancellation or delay of customer orders, including cancellation or delay in anticipation of new product introduction or enhancement. Therefore, comparisons of quarterly operating results may not be meaningful and should not be relied upon, nor will they necessarily reflect the Company's future performance. Because of the foregoing factors, it is likely that in some future quarters the Company's operating results will be below the expectations of public market analysts and investors. In such event, the price of the Common Stock would likely be materially adversely affected.

The sales cycle for the Company's products can be lengthy and generally commences at the time a prospective customer demonstrates an interest in licensing a CYBERWALLPLUS solution which typically includes a 28-day free evaluation period and ends upon execution of a purchase order by the customer. The length of the sales cycle varies depending on the type and sophistication of the customer and the complexity of the operating environment.

RISK FACTORS THAT MAY AFFECT FUTURE RESULTS

THE COMPANY OPERATES IN A RAPIDLY CHANGING AND HIGHLY COMPETITIVE ENVIRONMENT THAT INVOLVES A NUMBER OF RISKS, SOME OF WHICH ARE BEYOND THE COMPANY'S CONTROL. THE FOLLOWING DISCUSSION HIGHLIGHTS THE MOST MATERIAL OF THE RISKS.

WE HAVE A HISTORY OF LOSSES AND IF WE DO NOT ACHIEVE PROFITABILITY, WE MAY NOT BE ABLE TO CONTINUE OUR BUSINESS IN THE FUTURE.

We have incurred substantial operating losses since our inception, which has resulted in an accumulated deficit of $ 38,075,000 as of June 30, 2002. For the year ended December 31, 2001 and the six months ended June 30, 2002, we incurred net losses of $5,872,000 and $3,558,000, respectively. Since June 30, 2002, we have continued to incur substantial operating losses. We have financed our operations primarily through the sales of equity and convertible

debt securities as well as the sale of our professional services business in February 2000. Our expense levels are high and our revenues are difficult to predict. We anticipate incurring additional losses until we increase our client base and revenues. We may never achieve or sustain significant revenues or profitability. If we are unable to achieve increased revenues, we will continue to have losses and may not be able to continue our operations.

WE COULD BE REQUIRED TO CUT BACK OR STOP OPERATIONS IF WE ARE UNABLE TO RAISE OR OBTAIN NEEDED FUNDING.

We anticipate, based on our currently proposed plans and assumptions (including the timetable of, costs and expenses associated with, and success of, our marketing efforts), that our cash balance of approximately $4,156,000 as of June 30, 2002 will be sufficient to satisfy our operations and capital requirements through December 31, 2002. There can be no assurance, however, that such funds will not be expended prior thereto. In the event our plans change, or our assumptions change or prove to be inaccurate (due to unanticipated expenses, difficulties, delays or otherwise), we could have insufficient funds to support our operations prior to December 31, 2002. We are actively engaged in substantive discussions with a third party with respect to a strategic transaction which would include financing. There is, however, no assurance that we will consummate such strategic transaction or secure additional financing. Any inability to obtain additional financing or consummate a strategic transaction when needed would have a material adverse effect on our operations, requiring us to curtail and possibly cease operations.

WE HAVE NOT ACHIEVED SUBSTANTIAL REVENUE FROM SOFTWARE SALES.

We have had only limited sales of our products. Our total revenues for software licenses for the year ended December 31, 2001 and the six months ended June 30, 2002 were $809,000 and $259,000, respectively.

OUR REVENUES DEPEND ON SALES OF OUR CYBERWALLPLUS PRODUCTS AND WE ARE UNCERTAIN WHETHER THERE WILL BE BROAD MARKET ACCEPTANCE OF THESE PRODUCTS.

Our revenue growth for the foreseeable future is dependent upon increased sales of our CyberwallPLUS family of software products. Since the introduction of our CyberwallPLUS suite of products in January 1999 through June 30, 2002, license revenue from our CyberwallPLUS products was only $2,236,000. Our future financial performance will depend upon the successful introduction and customer acceptance of our CyberwallPLUS products as well as the development of new and enhanced versions of this product. Revenue from products such as CyberwallPLUS depend on a number of factors, including the influence of market competition, technological changes in the network security market, our ability to design, develop and introduce enhancements on a timely basis and our ability to successfully establish and maintain distribution channels. If we fail to achieve broad market acceptance of our CyberwallPLUS products, it would have a material adverse effect on our business, operating results and financial condition.

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WE NEED TO ATTRACT AND RETAIN HIGHLY QUALIFIED TECHNICAL, SALES, MARKETING, DEVELOPMENT AND MANAGEMENT PERSONNEL.

Our success depends on our ability to attract, train and retain highly qualified technical, sales, marketing, development and management personnel. There is considerable and often intense competition for the services of such personnel. We may not be able either to retain our existing personnel or acquire additional qualified personnel as and when needed. If we are unable to hire and

retain such personnel, our business, operating results and financial condition could be materially adversely affected.

CONTROL BY BARRY RUBENSTEIN, WHEATLEY AFFILIATES AND FALCONSTOR SOFTWARE, INC.

Barry Rubenstein, Wheatley Partners II, L.P. and other affiliated and related entities and parties (the "Wheatley Parties") currently own 32 % of our outstanding voting stock (exclusive of any securities owned by FalconStor). In addition, FalconStor currently owns 15.9% of our outstanding voting stock. Barry Rubenstein owns 15.4% of the outstanding voting securities of FalconStor and other Wheatley affiliates own an additional 6% of the outstanding voting securities of FalconStor. Accordingly, Barry Rubenstein and the Wheatley Parties together with FalconStor currently own 47.9 % of our outstanding voting securities (and beneficially own options and warrants to purchase an additional 28.2% of our outstanding voting securities) and as a result of their aggregate holdings would have the ability to control the outcome of all matters submitted to a vote of our stockholders including the election of directors, amendments to our Certificate of Incorporation and approval of mergers and a sale of substantially all of our assets. Such consolidation of voting power could also have the effect of delaying, deterring or preventing a change in control of our company that might be beneficial to other stockholders.

WE REQUIRE THE CONSENT OF THE HOLDERS OF SERIES E PREFERRED STOCK FOR CERTAIN CORPORATE ACTION.

In connection with our private offering of Series E Preferred Stock and warrants completed in October 2001, we agreed that so long as the holders of the outstanding shares of Series E Preferred Stock own at least 10% of our outstanding voting stock, we will not take certain actions without the consent of Wheatley Partners II, L.P., the designee of the holders of Series E Preferred Stock and one of our principal stockholders. Such actions requiring the consent of Wheatley Partners II, L.P. include, among others, (i) issuing securities other than securities to be issued under our stock option plan, (ii) incurring debt in excess of $250,000, (iii) entering into a merger, acquisition or sale of substantially all of our assets and (iv) taking any action to amend our Certificate of Incorporation or By-laws that could in any way adversely affect the rights of the holders of the Series E Preferred Stock. Accordingly, the holders of Series E Preferred Stock may not consent to certain actions that we may consider to be in our best interest and the best interest of the holders of Common Stock. For more information regarding the rights and preferences of the Series E Preferred Stock, see our Current Report on Form 8-K filed with the SEC on October 12, 2001.

WORLD INSTABILITY - TERRORISM.

The terrorist attacks on September 11, 2001 in the United States and the declaration of war by the United States against terrorism has created significant instability and uncertainty in the world which may continue to have a material adverse effect on world financial markets, including financial markets in the United States. In addition, such adverse political events may have an adverse impact on economic conditions in the United States. Unfavorable economic conditions in the United States may have an adverse effect on our financial operations including, but not limited to, our ability to expand the market for our products, obtain necessary financing, enter into strategic relationships and effectively compete in the network security market.

OUR INABILITY TO ENTER INTO STRATEGIC RELATIONSHIPS WITH INDIRECT CHANNEL PARTNERS COULD HAVE A MATERIAL ADVERSE EFFECT ON US.

As part of our sales and marketing efforts, we are seeking to develop strategic relationships with indirect channel partners, such as original equipment manufacturers and resellers. We have limited financial, personnel and other resources to undertake extensive marketing activities ourselves. Therefore, our prospects will depend on our ability to develop and maintain strategic marketing relationships with indirect channel partners and their ability to market and distribute our products. If we are unable to enter into and maintain such arrangements or if such arrangements do not result in the successful commercialization of our products, then this could have a material adverse effect on our business, operating results and financial condition.

WE MAY NOT BE ABLE TO SUCCESSFULLY COMPETE IN THE NETWORK SECURITY MARKET.

The network security market is characterized by intense competition and rapidly changing business conditions, customer requirements and technologies. The principal competitive factors affecting the market for network security products include security effectiveness, scope of product offerings, name recognition, product features, distribution channels, price, ease of use and customer service and support. Most of our current and potential competitors have longer operating histories, greater name recognition, larger installed customer bases and possess substantially greater financial, technical and marketing and other competitive resources than us. As a result, our competitors may be able to adapt more quickly to new or emerging technologies and changes in customer requirements or to devote greater resources to the promotion and sale of their products than we may. In addition, certain of our competitors may determine for strategic reasons to consolidate, to substantially lower the price of their network security products or to bundle their products with other products, such as hardware or other enterprise software products. Our current and potential competitors may develop products that may be more effective than our current or future products or that render our products obsolete or less marketable. Increased competition for network security products may result in price reductions and reduced gross margins and may adversely effect our ability to gain market share, any of which would adversely affect the Company's business, operating results and financial condition.

WE MAY NOT BE ABLE TO ADEQUATELY PROTECT OUR PROPRIETARY TECHNOLOGY, WHICH COULD RESULT IN LOWER REVENUES AND/OR PROFITS.

We do not hold any patents and rely on copyright and trade secret laws, non-disclosure agreements and contractual provisions to protect our proprietary technology. These methods afford only limited protection. Despite the precautions we take, unauthorized parties may attempt to copy or otherwise obtain and use our proprietary technologies, ideas, know-how and other proprietary information without authorization or may independently develop technologies similar or superior to our technologies. Policing unauthorized use of our products may be difficult and costly. Also, the laws of some foreign countries do not protect our proprietary rights as much as the laws of the United States. We are unable to predict whether our means of protecting our proprietary rights will be adequate.

We believe that our technologies have been developed independent of others. Nevertheless, third parties may assert infringement claims against us and our technologies may be determined to infringe on the intellectual property rights of others. We could become liable for damages, be required to modify our technologies or obtain a license if our technologies are determined to infringe

upon the intellectual property rights of others. We may not be able to modify our technologies or obtain a license in a timely manner, if required, or have the financial or other resources necessary to defend an infringement action. We would be materially adversely effected if we fail to do any of the foregoing.

WE CAN BE EXPOSED TO NUMEROUS POTENTIAL LIABILITY CLAIMS FOR DAMAGES AND, IF OUR INSURANCE DOESN'T ADEQUATELY COVER LOSSES, THIS COULD HAVE A MATERIAL ADVERSE EFFECT ON US.

Since our products are used to prevent unauthorized access to and attacks on critical enterprise information, we may be exposed to potential liability claims for damage caused as a result of an actual or alleged failure of an installed product. We cannot assure you that the provisions in our standard license agreements designed to limit our exposure will be enforceable. Our personnel often gain access to confidential and proprietary client information. Any unauthorized use or disclosure of such information could result in a claim for substantial damages. We can give no assurances that our insurance policies will be sufficient to cover potential claims or that adequate levels of coverage will be available in the future at a reasonable cost.

POSSIBLE DELISTING OF OUR SECURITIES FROM NASDAQ; RISKS RELATING TO LOW-PRICED STOCKS.

Our common stock is listed on The Nasdaq Stock Market's SmallCap Market under the symbol "NSSI." In order for our common stock to continue to be listed on Nasdaq, however, we must comply with certain maintenance standards (including, among others, a minimum bid price for our stock of $1.00 and stockholders equity of a minimum of $2.5 million). On July 9, 2002, the Company was notified by Nasdaq that its Common Stock failed to maintain a minimum bid price of $1.00 over the previous 30 trading days as required by The Nasdaq SmallCap Market Rules. In accordance with such rules, the Company has until January 6, 2003, for its Common Stock to trade at a closing bid price of at least $1.00 for 10 consecutive trading days or its securities will be subject to delisting from Nasdaq. In the event of a delisting, an investor could find it more difficult to dispose of or to obtain accurate quotations as to the market value of our common stock.

In addition, if our common stock were to become delisted from trading on Nasdaq and the trading price of our common stock were to then be below $5.00 per share, our common stock could be considered a penny stock. SEC regulations generally define a penny stock to be an equity security that is not listed on Nasdaq or a national securities exchange and that has a market value of less than $5.00 per share, subject to certain exceptions. The SEC regulations would require broker-dealers to deliver to a purchaser of our common stock a disclosure schedule explaining the penny stock market and the risks associated with it. Various sales practice requirements are also imposed on broker-dealers who sell penny stocks to persons other than established customers and accredited investors (generally institutions). Broker-dealers must also provide the customer with current bid and offer quotations for the penny stock, the compensation of the broker-dealer and monthly account statements disclosing recent price information for the penny stock held in the customer's account. If our common stock is no longer traded on Nasdaq and becomes subject to the regulations applicable to penny stocks, investors may find it more difficult to obtain timely and accurate quotes and execute trades in our common stock.

FAVORABLE LICENSE AND DISTRIBUTION AGREEMENT RECEIVED BY FALCONSTOR SOFTWARE, INC.

On October 2, 2001, we entered into a License and Distribution Agreement with FalconStor pursuant to which FalconStor has the right to distribute, on a non-exclusive basis, our product offerings in its indirect and OEM channels. Simultaneously and conditioned upon entering into the License and Distribution Agreement, FalconStor invested $2,300,000 in our private offering of $6,765,000 of preferred stock and warrants. (See "Management's Discussion and Analysis or Plan of Operation" at page 7). FalconStor currently owns 15.9% of our outstanding voting stock (27.4% assuming the exercise of currently exercisable warrants to purchase 2,169,870 shares of common stock). FalconStor, as the largest investor in the private offering, was able to negotiate terms (and may receive additional benefits in the future) with respect to the License and Distribution Agreement which would likely have not been available to other licensees and distributors who were not simultaneously making a significant investment in our securities.

OUR OPERATING RESULTS MAY FLUCTUATE QUARTERLY AND IF THEY WERE BELOW THE EXPECTATIONS OF INVESTORS AND ANALYSTS, THE PRICE OF OUR STOCK WOULD LIKELY BE ADVERSELY EFFECTED.

We anticipate significant quarterly fluctuations in our operations in the future, since our results are dependent on the volume and timing of orders, which are difficult to predict. Customers' purchasing patterns and budgeting cycles, as well as the introduction of new products, may also cause our operating results to fluctuate. Therefore, comparing quarterly operating results may not be meaningful and should not be relied on. Also, our operating results may be below analysts' and investors' expectations in some future quarters, which would likely have a material adverse effect on the price of our common stock.

THE SIGNIFICANT NUMBER OF OPTIONS, WARRANTS AND CONVERTIBLE SECURITIES OUTSTANDING MAY ADVERSELY AFFECT THE MARKET PRICE FOR OUR COMMON STOCK.

As of August 1, 2002, there are outstanding (i) options and warrants to purchase an aggregate of 13,552,564 shares of our common stock at exercise prices ranging from $.70 to $10.125, (ii) 3,021,159 shares of convertible preferred stock which are convertible at any time into 5,971,688 shares of our common stock and (iii) 700,176 additional shares of our common stock which may be issued in the future under our stock option plan. To the extent that outstanding options and warrants are exercised or preferred stock is converted, your percentage ownership will be diluted and any sales in the public market of the common stock underlying such options, warrants or convertible debt may adversely affect prevailing market prices for our common stock.

WE HAVE A SIGNIFICANT AMOUNT OF AUTHORIZED BUT UNISSUED PREFERRED STOCK, WHICH MAY AFFECT THE LIKELIHOOD OF A CHANGE OF CONTROL IN OUR COMPANY.

Our Board of Directors has the authority, without further action by the stockholders, to issue 10,000,000 shares of preferred stock (of which as of July 20, 2002 only 231,054 shares of Series D Preferred Stock are outstanding and 2,790,105 shares of Series E Preferred Stock are outstanding) on such terms and with such rights, preferences and designations as our Board of Directors may determine. Such terms may include restricting dividends on our common stock, dilution of the voting power of our common stock or impairing the liquidation rights of the holders of our common stock. Issuance of such preferred stock, depending on 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 in Delaware law may restrict the ability of

our stockholders to authorize a merger, business combination or change of control.

PART II. OTHER INFORMATION

Item 1. LEGAL PROCEEDINGS.

None.

Item 2. CHANGES IN SECURITIES AND USE OF PROCEEDS.

On April 18, 2002, the Company issued to CMH Capital Management Corp. a five (5) year option to purchase 750,000 shares of the Company's common stock at $1.20 per share. Such option was issued pursuant to the Company's Stock Option Plan.

Item 3. DEFAULTS UPON SENIOR SECURITIES.

None.

Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.

None.

Item 5. OTHER INFORMATION.

None.

Item 6. EXHIBITS AND REPORTS ON FORM 8-K.

a). Exhibits

The exhibits in the following table have been filed as part of this Quarterly Report on Form 10-QSB:

10.8 Extension of Consulting Agreement, dated July 2, 2002, between the Company and CMH Capital Management Corp.

99.1 Certification of Chief Executive Officer

99.2 Certification of Chief Financial Officer

b). Reports of Form 8-K.

None.

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SIGNATURES

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

NETWORK-1 SECURITY SOLUTIONS, INC.

By: /s/ Richard Kosinski

Richard Kosinski, President and
Chief Executive Officer
(Principal Executive Officer)

By: /s/ Murray P. Fish

Murray P. Fish
Chief Financial Officer
(Principal Financial and
Accounting Officer)

Date: August 16, 2002