

Edgar Filing: STORAGE COMPUTER CORP - Form 10-Q

STORAGE COMPUTER CORP

Form 10-Q

November 22, 2004

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SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

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FORM 10-Q

(MARK ONE)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2004

OR

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 1-13616

-----

STORAGE COMPUTER CORPORATION

(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

DELAWARE

02-0450593

-----

(STATE OR OTHER JURISDICTION OF  
INCORPORATION OR ORGANIZATION)

-----

(I.R.S. EMPLOYER IDENTIFICATION NO.)

11 RIVERSIDE DRIVE, NASHUA, NH 03062

-----

(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES, INCLUDING ZIP CODE)

(603) 880-3005

-----

REGISTRANT'S TELEPHONE NUMBER, INCLUDING AREA CODE

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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  No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes  No

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Number of shares outstanding of the registrant's class of common stock, as of the latest practicable date.

|  |                                   |
|--|-----------------------------------|
| CLASS                                    | OUTSTANDING AT September 30, 2004 |
| Common Stock \$ .001 par value per share | _____38,922,209                   |

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PART I -- FINANCIAL INFORMATION

ITEM 1. Financial Statements.

Storage Computer Corporation  
Consolidated Balance Sheets

|                          |                         |
|--------------------------|-------------------------|
| September<br>30,<br>2004 | December<br>31,<br>2003 |
| -----                    | -----                   |
| (Unaudited)              |                         |

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ASSETS

Current assets:

|                             |              |              |
|-----------------------------|--------------|--------------|
| Cash and cash equivalents   | \$ 9,837     | \$ 72,581    |
| Accounts receivable, net    | 1,046        | 135,730      |
| Inventories                 | 1,052,516    | 1,390,291    |
| Other current assets        | 54,407       | 187,247      |
|                             | -----        | -----        |
| Total current assets        | 1,117,806    | 1,785,849    |
| Property and equipment, net | 235,155      | 345,709      |
| Goodwill                    | 2,692,611    | 2,692,611    |
| Other intangibles, net      | 517,057      | 949,057      |
|                             | -----        | -----        |
| Total assets                | \$ 4,562,629 | \$ 5,773,226 |
|                             | =====        | =====        |

LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIENCY)

Current liabilities:

|  |            |            |
|--|------------|------------|
| Accounts payable                           | \$ 544,027 | \$ 565,182 |
| Accrued expenses                           | 1,952,927  | 1,320,405  |
| Deferred revenue                           | 50,047     | 133,538    |
| Notes and amounts to officer and affiliate | 2,067,700  | 1,333,823  |
|  | -----      | -----      |
| Total current liabilities                  | 4,614,701  | 3,352,948  |
|  | -----      | -----      |

Commitments and contingencies

Stockholders' equity (deficiency):

|  |              |              |
|--|--------------|--------------|
| Preferred Stock                                | 100,000      |              |
| Common stock                                   | 38,922       | 38,650       |
| Additional paid-in capital                     | 85,815,286   | 85,612,531   |
| Accumulated deficit                            | (86,006,280) | (83,230,903) |
|  | -----        | -----        |
| Stockholders' equity (deficiency), net         | (52,072)     | 2,420,278    |
|  | -----        | -----        |
| Total liabilities and stockholders' deficiency | \$ 4,562,629 | \$ 5,773,226 |
|  | =====        | =====        |

See Notes to Consolidated Financial Statements.

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Storage Computer Corporation  
Consolidated Statements of Operations (Unaudited)

|  | Three Month Ended |            |
|--|-------------------|------------|
|  | September 30,     | September  |
|  | 2004              | 2003       |
|  | -----             | -----      |
| Revenues:                                  |                   |            |
| Products and services                      | \$ 86,317         | \$ 215,000 |
| License fees                               | --                | --         |
|  | -----             | -----      |
| Total revenues                             | 86,317            | 215,000    |
|  | -----             | -----      |
| Costs and expenses:                        |                   |            |
| Cost of products and services              | 158,473           | 218,400    |
| Cost of license fees, primarily legal fees | --                | 188,400    |
| Research and development                   | 239,137           | 220,400    |

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|   |              |             |
|---|--------------|-------------|
| Sales and marketing   | 218,792      | 115,4       |
| General and administrative  | 214,829      | 425,9       |
| Amortization of intangibles   | 144,000      | 144,0       |
|   | -----        | -----       |
| Total costs and expenses  | 975,231      | 1,312,7     |
|   | -----        | -----       |
| Operating loss  | (888,914)    | (1,097,7    |
|   | -----        | -----       |
| Other income (expense), net:  |              |             |
| Interest expense, net   | (41,248)     | (7,0        |
| Other income (expense)  | 81           | 4,7         |
|   | -----        | -----       |
| Total other income (expense), net   | (41,167)     | (2,2        |
|   | -----        | -----       |
| Net loss  | \$ (930,081) | \$ (1,099,9 |
| Dividends on preferred stock including amortization of the beneficial conversion features | --           | --          |
|   | -----        | -----       |
| Net Loss applicable to common stockholders  | \$ (930,081) | (1,099,9    |
|   | -----        | -----       |
| Loss applicable to common stockholders per basic and dilutive share                       | \$ (0.02)    | \$ (0.      |
| Basic and dilutive shares outstanding   | 38,922,209   | 36,803,3    |

See Notes to Consolidated Financial Statements.

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Storage Computer Corporation  
Consolidated Statements of Cash Flows (Unaudited)

|   | Nine Months Ended     |                       |
|---|-----------------------|-----------------------|
|   | September 30,<br>2004 | September 30,<br>2003 |
|   | -----                 | -----                 |
| Cash flows from operating activities:                       |                       |                       |
| Net loss  | \$ (2,775,377)        | \$ (3,488,541)        |
| Reconciliation to operating cash flows:                     |                       |                       |
| Depreciation and amortization of property and equipment     | 110,554               | 148,894               |
| Amortization of other intangibles                           | 432,000               | 432,000               |
| Settlement of debt and advances with directors and officers | --                    | (184,784)             |
| Provision for obsolete inventory                            | 118,243               | --                    |
| Common stock issued to 401(k) plan                          | 4,519                 | 16,418                |
| Preferred stock issued for services                         | 100,000               |                       |
| Common stock issued for services                            | 317,568               | 430,467               |
| Non-cash compensation for services                          | 677,213               |                       |
|   |                       |                       |
| Changes in current operating assets and liabilities:        |                       |                       |
| Accounts receivable   | 134,684               | 108,691               |
| Inventories   | 219,532               | 90,768                |
| Due from officers and directors                             | --                    | 3,097                 |
| Other current assets  | 13,780                | (165,463)             |
| Accounts payable, accrued expenses and deferred revenue     | (149,337)             | (35,338)              |
|   | -----                 | -----                 |

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|  |           |             |
|--|-----------|-------------|
| Net cash used in operations                                | (796,621) | (2,643,791) |
| <hr style="border-top: 1px dashed black;"/>                |           |             |
| Cash flows from investing activities:                      |           |             |
| Capital expenditures                                       | --        | (8,542)     |
| <hr style="border-top: 1px dashed black;"/>                |           |             |
| Net cash (used in) investing activities                    | --        | (8,542)     |
| <hr style="border-top: 1px dashed black;"/>                |           |             |
| Cash flows from financing activities:                      |           |             |
| Increase in notes and amounts due to officer and affiliate | 733,877   | 13,788      |
| <hr style="border-top: 1px dashed black;"/>                |           |             |
| Net cash (used in) provided by financing activities        | 733,877   | 13,788      |
| <hr style="border-top: 1px dashed black;"/>                |           |             |
| Effect of exchange rate changes on cash                    | --        | --          |
| <hr style="border-top: 1px dashed black;"/>                |           |             |
| Net decrease in cash and cash equivalents                  | (62,744)  | (2,638,545) |
| Cash and cash equivalents-beginning of period              | 72,581    | 2,680,599   |
| <hr style="border-top: 1px dashed black;"/>                |           |             |
| Cash and cash equivalents-end of period                    | \$ 9,837  | \$ 42,054   |
| <hr style="border-top: 3px double black;"/>                |           |             |
| Supplemental cash flow information:                        |           |             |
| Cash payments of interest                                  | \$ --     | \$ 8,889    |
| Preferred stock dividends paid in common stock             | \$ --     | \$ 44,917   |

See Notes to Consolidated Financial Statements.

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Storage Computer Corporation  
Notes to Consolidated Financial Statements  
September 30, 2004

### Note A - The Company

Storage Computer Corporation (the "Company "SCC" or "we"), a pioneer in RAID ("Redundant Array of Independent Disks") technology is a provider of high performance storage software solutions focused on developing advanced storage architectures to address the emerging needs of high-bandwidth and other "performance-impaired" applications. Storage Computer's technology supports a variety of applications including advanced database activities, wide area network storage and sophisticated business continuity topologies including:

- o Networked Attached Storage
- o Storage Area Networks
- o Direct Attached Storage
- o Storage Wide Area Networking

### Note B - Basis of Presentation

The condensed consolidated financial statements include the accounts of Storage Computer Corporation and its wholly owned subsidiaries. All significant inter-company balances and transactions have been eliminated in consolidation.

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The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information. Accordingly, they do not include all the information and footnotes required by generally accepted accounting principles for complete financial statements and should be read in conjunction with the financial statements and related notes included in our Annual Report on Form 10-K filed with the Securities and Exchange Commission, containing our financial statements for the fiscal year ended December 31, 2003. In management's opinion, the accompanying consolidated financial statements reflect all adjustments, all of which are of a normal, recurring nature, to fairly present our consolidated financial position, consolidated results of operations and consolidated cash flows. The results of operations for the three and nine months ended September 30, 2004 are not necessarily indicative of the results to be expected for the full year.

### Note C- Liquidity Matters

The accompanying consolidated financial statements have been prepared on a going concern basis, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. The Company has suffered recurring losses from operations and negative cash flows that raise substantial doubt about its ability to continue as a going concern.

Management recognizes that the Company's continuation as a going concern is dependent upon its ability to generate sufficient cash flow to allow the Company to satisfy its obligations on a timely basis. The generation of sufficient cash flow is dependent on the successful expansion of the Company's share of the market for its software, controlling costs and securing new financing. Management's efforts in regard to these matters are described below. The consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

Our future success depends on maintaining adequate liquidity and working capital to meet our operational requirements; Revenues from products and services have fallen dramatically in the previous two fiscal years and continued to fall in the first nine months of 2004. We did not receive any revenue from license fees in 2003 or in the first nine months of 2004, and there can be no assurances that we will be able to secure license fees at all during the coming twelve months. Furthermore, given the continued volatility of the global securities markets and, in particular, the market for the securities of technology companies, as well as the recent results of our pending legal actions concerning enforcement of our intellectual property rights, we cannot assure you that we will be able to secure additional debt or equity financing. Our failure to maintain adequate liquidity and working capital would have a material adverse effect on the Company, our financial condition and results of operations.

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We have incurred operating losses for the last several years and we continue to incur operating losses at this time. While the development and introduction of our new products continues, our actual sales revenue has declined significantly over the last two fiscal years and continues to be at a low level. In response, we have implemented cost reduction programs primarily in employee headcount, the use of independent software subcontractors and the level of expenses for development, marketing, sales and administration. In January 2004 salaries were reduced further in response to the need to preserve cash flow. Reductions in 2004 salaries are compensated for through a stock based compensation plan (requires no cash expenditure).

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In August 2003 our Chief Executive Officer and principal stockholder, through an affiliate of the Company controlled by him, began advancing funds to supplement the Company's cash flow for operating expenses and occupancy costs until operating cash flows improve and permanent additional financing can be arranged. The amounts advanced were \$1,081,021 and \$ 488,245 at September 30, 2004 and December 31, 2003, respectively. Advances are secured by all the assets of the Company and accrue interest at the affiliate's cost of funds, which is currently 8.5% .The affiliates cost of funds have ranged from 8.5% to 26% during the first nine months of 2004 compared with 21% for the same period in 2003. Interest expense related to this obligation amounted to \$ 121,555 and \$3,022 for the nine months ended September 30, 2004 and 2003 respectively.

In July 2003, we engaged iCapital Finance, Inc. of Irvine, California as the Company's investment banking firm to assist us in structuring financing, providing access to capital resources, identifying candidates for marketing and distribution alliances, and to advise the Company on other strategic decisions. In addition, in April 2004 we engaged another investment banking firm to pursue a specific financing opportunity.

The Company is currently pursuing an opportunity that would provide new financing. However, there can be no assurances that the Company will be able to obtain new financing and, if new financing, is obtained it could result in significant dilution to existing shareholders.

We continued to focus our core business activity toward the Storage Wide Area Networking (SWAN) market segment for our CyberNAS Network Attached Storage and CyberVSA Storage Operating System. While our new products have been available and we have entered into new strategic alliance relationships with channel partners significant new sales have not materialized, as it has taken longer and been more difficult than we anticipated for these channel partners to become productive. We are continuing to explore and negotiate additional strategic alliance relationships to market our products.

The Company received notification from the American Stock Exchange (AMEX) on April 29, 2003 that the Company was not in compliance with certain listing standards relating to stockholders' equity and net losses. In June 2003 the Company submitted to AMEX a plan to regain compliance with the AMEX continuing listing standards. On July 28, 2003, AMEX notified the Company that it had accepted the proposed plan and granted an extension until October 31, 2004 to regain compliance. During such period, the Company's common stock continued to trade on AMEX and the Company was subject to periodic review of its progress consistent with its plan. On November 10, 2004 the AMEX notified the Company that it had determined that the Company had not regained compliance with the continuing listing standards by October 31, 2004. and was subject to being delisted from the Exchange. The Company will appeal this determination and request a hearing before a Committee of the Exchange. There can be no assurance the Company's request for continued listing will be granted.

If the Company's stock ceases to be listed on the AMEX a transfer of the listing to the OTC Bulletin Board or other markets will be sought. The outcome of these uncertainties and their impact on the price and liquidity of our common stock and our access to the capital markets cannot be predicted.

There can be no assurances that our marketing efforts will be successful or that we will obtain additional capital or continue to receive funds from the affiliate of the Company as described above. If we are not successful in obtaining financing or other capital, the ability of the Company to continue operations at this level will be seriously impaired.

In addition, reference should be made to Liquidity and Capital Resources in Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations below.

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## Note D - Stockholders' Equity

At our Annual Meeting held on July 15, 2004 stockholders voted to approve an amendment to the Company's Certificate of Incorporation to increase the authorized number of shares of Common Stock from 50,000,000 shares to 100,000,000 shares.

In January 2004 the Board of Directors authorized the designation and issuance of up to 30,000 shares of Series F preferred stock valued at \$1,000 per share, convertible after one year of issuance into common stock, with interest at 4%, payable in common stock. The shares have a five year maturity, and can be redeemed by the Company for 115% of face value upon 30 days written notice. Conversion to common stock is priced at 105% of the prior three day closing average price of the common stock at the time of issue. The Company issued 100 shares of Series F stock for sales and marketing services in the quarter ended September 30, 2004.

A summary of changes in stockholders' (deficiency) for the Nine months ended September 30,

|  | Preferred Stock |                | Common Stock |           | Additional      | A     |
|--|-----------------|----------------|--------------|-----------|-----------------|-------|
|  | Shares          | Carrying Value | Shares       | Par Value | Paid-In Capital | A     |
|  | -----           | -----          | -----        | -----     | -----           | ----- |
| Balance--December 31, 2003   |                 |                | 38,650,060   | \$ 38,650 | \$ 85,612,531   | \$ (  |
| Stock issued to 401(k) plan  |                 |                | 12,149       | 12        | 4,507           |       |
| Stock issued and compensatory stock options granted for investment banking and consulting services, respectively |                 |                | 260,000      | 260       | 198,248         |       |
| Preferred Stock Issued   | 100             | \$ 100,000     |              |           |                 |       |
| Net loss   |                 |                |              |           |                 |       |
| Balance--September 30, 2004  | 100             | \$ 100,000     | 38,922,209   | \$ 38,922 | \$ 85,815,286   | \$    |

## Note E - Related Party Transactions

In August 2001, the Company's Board of Directors approved the issuance of advances secured by demand notes receivable with interest at prime plus 1% to executive officers and directors of the Company in the aggregate amount of \$500,000 for the purpose of purchasing the common stock of the Company in the public market. In May of 2003, \$130,150 of demand notes receivable from three directors were forgiven and charged to other income (expense) in recognition of previous service on the Board of Directors

John Thonet resigned his position as a director of the Company on April 30, 2003. At the time of his resignation, the Company owed Mr. Thonet a balance of \$177,101 plus accrued and unpaid interest on a note payable representing the balance of sums advanced by him to CyberStorage Systems that was acquired by the Company in 2000, and Mr. Thonet was due \$156,333 in accrued and unpaid salary by CyberStorage Systems. The Company also had a note receivable due from Mr. Thonet of \$44,729 plus accrued interest. On April 30, 2003, the Company and Mr. Thonet



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agreed to offset the note receivable and accrued interest against the note payable and accrued interest and Mr. Thonet agreed to accept a cash payment of \$40,000 in exchange for cancellation by him of the balance of the note payable. In addition, Mr. Thonet gave up any and all claims to accrued and unpaid salary and any other amounts due to him as of that date in exchange for the extension of the period for exercise of his vested stock options to purchase 62,500 shares of common stock until May 1, 2004. There was no charge to income related to the modification of the terms of this option since the exercise price was greater than the market value at that date.

In August 2003 our Chief Executive Officer and principal stockholder, through an affiliate of the Company controlled by him, began advancing funds to supplement the Company's cash flow for operating expenses and occupancy costs until operating cash flows improve and permanent additional financing can be arranged. The amounts advanced were \$1,081,021 and \$ 488,245 at September 30, 2004 and December 31, 2003, respectively. Advances are secured by all the assets of the Company and accrue interest at the affiliate's cost of funds, which is currently 8.5%. The affiliates cost of funds have ranged from 8.5% to 26% during the first nine months of 2004 compared with 21% for the same period in 2003. Interest expense related to this obligation amounted to \$ 121,555 and \$3,022 for the nine months ended September 30, 2004 and 2003 respectively.

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Notes payable in the amount of \$487,899 at September 30, 2004 and December 31, 2003 is due to the Chief Executive Officer and principal shareholder of the Company. The debt is unsecured, and \$387,899 bears interest at prime plus 1%, and \$100,000 bears interest at 6% and is convertible into the Company's common stock at \$4.00 per share. Interest expense related to this obligation amounted to \$ 19,546 and \$ 19,476 for the nine months ended September 30, 2004 and 2003 respectively. This debt is due upon demand.

The Company leases plant and office facilities from an affiliate of the Company controlled by our Chief Executive Officer and principal stockholder under a non-cancelable, five-year, triple net operating lease agreement, which was entered into as of December 1, 2000. The lease provides for monthly rental payments of \$25,000 commencing in January 2001, and is increased annually based on a change in the consumer price index. The monthly rental payments for 2004 and 2003 were \$26,509 and \$25,992 respectively. Additionally, the lease provides for an additional five-year renewal option by the Company and contains no purchase option. Minimum future rental payments on this lease amount to \$318,104 annually for the years 2004 through 2005.

The total amount currently due to the Chief Executive Officer and the affiliate of the Company described above, including accrued interest, amounted to \$ 2,067,700 and 1,333,823 at September 30, 2004 and December 31, 2003 respectively.

ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

### CAUTIONARY STATEMENT

#### Forward-looking Statements

The Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934 contain certain safe harbors regarding forward-looking statements. From time to time, information provided by the Company or statements made by our directors, officers or employees may contain "forward-looking" information subject to numerous risks and uncertainties. Any statements made herein that are not

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statements of historical fact are forward-looking statements including, but not limited to, statements concerning the characteristics and growth of our markets and customers, our objectives and plans for future operations and products and our expected liquidity and capital resources. Such forward-looking statements are based on a number of assumptions and involve a number of risks and uncertainties, and, accordingly, actual results could differ materially. Factors that may cause such differences include, but are not limited to: the continued and future acceptance of our products; the rate of growth in the industries of our products; the presence of competitors with greater technical, marketing and financial resources; our ability to promptly and effectively respond to technological change to meet evolving customer needs; risks associated with sales in foreign countries; and our ability to successfully expand our operations. See "Factors That May Affect Future Results" below. We undertake no duty to update forward-looking statements.

### Introduction

This discussion summarizes the significant accounting policies, accounting estimates and other significant factors affecting the liquidity, capital resources and results of operations of the Company for the periods ended September 30, 2004 and 2003. This discussion should be read in conjunction with the Consolidated Financial Statements and other financial information included in our 2003 Annual Report on Form 10-K filed with the Securities and Exchange Commission.

### Critical Accounting Policies and Estimates

We prepare our financial statements in conformity with accounting principles generally accepted in the United States of America. These accounting principles require management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements. Our management is also required to make certain judgments that affect the reported amounts of revenues and expenses during the reporting period. We periodically evaluate our estimates including those relating to the allowance for doubtful accounts; inventory reserves for lower of cost or market adjustments, excess quantities and discontinued products; estimated lives and impairment of tangible and intangible long-life assets; litigation and other contingencies. We base our estimates on historical experience and various other assumptions that we believe to be reasonable based on the specific circumstances, the results of which form the basis for making judgments about the carrying value of certain assets and liabilities that are not readily apparent from other sources. Actual results could differ from these estimates.

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We believe the following critical accounting policies impact the most significant judgments and estimates used in the preparation of our consolidated financial statements:

### Revenue Recognition

We recognize revenue from product sales at the time of shipment, provided that the price is fixed and determinable, no significant obligations remain, collectibility is probable and returns are estimable. Revenue is recognized at the time of shipment since the terms of shipment are FOB shipping point and legal title to the product passes to the customer at this time. We consider post shipment obligations such as installation and training to be relatively insignificant given the underlying nature of the product and of its installation. Revenue from services is recognized over the contract period or as

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services are provided. Revenue from license fees is recognized over the contract period or when received for fully paid license agreements. These revenue accounting policies do not require significant estimates by management.

### Impairment of Goodwill and Intangible Assets

All of our goodwill and other intangibles resulted from our acquisition of CyberStorage Systems in 2000 that was accounted for using the purchase method. In connection with the implementation of Statement of Financial Accounting Standards (SFAS) No. 142, as of January 1, 2002, we have ceased amortizing goodwill and determined that our entire business constitutes one reporting unit for purposes of assessing potential impairment of goodwill.

Our annual evaluation of goodwill required under SFAS 142 was conducted as of September 30, 2004. Consistent with the accounting policy adopted in 2002, we used a fair value approach to test our existing goodwill for impairment at September 30, 2004. The market approach was used to determine the fair value of the reporting unit. Under the fair value approach, the quoted market prices in active securities markets are used as the basis for the determination of fair value. The fair value so determined indicated no impairment of goodwill existed as of September 30, 2004. Additionally, in accordance with SFAS No. 144, we conducted an evaluation of the carrying values of our identifiable intangible assets and found no impairment existed as of September 30, 2004.

### Stock-Based Compensation

We account for our stock-based compensation plans under Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees", and accordingly account for employee stock-based compensation utilizing the intrinsic value method. SFAS No.123, "Accounting for Stock-Based Compensation," established a fair value based method of accounting for stock-based compensation plans. We have adopted the disclosure only alternative under SFAS No.123, which requires disclosure of the pro forma effects on earnings and earnings per share as if SFAS No. 123 had been adopted as well as certain other information.

In December 2002, the Financial Accounting Standards Board (FASB) issued SFAS No. 148, "Accounting for Stock-Based Compensation--Transition and Disclosure--an amendment of SFAS Statement No. 123". This statement amends SFAS No. 123 to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, SFAS No.148 amends the disclosure requirements of SFAS No. 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. SFAS No. 148 also requires that those effects be disclosed more prominently by specifying the form, content, and location of those disclosures. We adopted the increased disclosure requirements of SFAS No. 148 during the year ended December 31, 2002. We will continue to use the intrinsic value method of accounting for stock-based employee compensation.

The additional disclosures required by SFAS No. 148 are as follows:

|  |    | Three months end<br>September 30<br>2004 | 2003<br>-----<br>----- |
|--|----|--|------------------------|
| Net loss applicable to common stockholders, as reported  | \$ | (930,081)                                | \$(1,099               |
| Deduct: Total stock based employee compensation expense determined under the fair value based method of all awards, net of tax |    | (460,238)                                | (605                   |

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|   |                |            |
|---|----------------|------------|
| Pro forma net loss applicable to common stockholders                      | \$ (1,390,319) | \$ (1,705) |
| <hr/>   |                |            |
| Net loss applicable to common stockholders per basic and dilutive shares: |                |            |
| As reported   | \$ (0.02)      | \$ (       |
| Pro forma   | \$ (0.04)      | \$ (       |

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### Allowance for Doubtful Accounts

We record an allowance for doubtful accounts based on specifically identified amounts that we believe to be uncollectible which are determined based on historical experience and our assessment of the general financial conditions affecting our customer base. If our actual collections experience changes, revisions to our allowance may be required. After all attempts to collect a receivable have failed, the receivable is written off against the allowance.

### Inventory:

Inventories consist primarily of finished goods and are stated at the lower of cost (average cost method) or market. We regularly monitor inventory values and quantities on hand and record a provision for excess and obsolete inventories based primarily on our estimate of the future realizable value of this inventory

### Intellectual Property Rights, Contingencies and Litigation

We have a substantial portfolio of patents, claims and other intellectual property rights. Costs and expenses in connection with the development of and the enforcement of our rights are expensed when incurred. Certain contingent fees for legal services are due upon the receipt of license fees over contract periods or upon receipt of payment for paid-up license arrangements. We currently are in legal proceedings in connection with the enforcement of our intellectual property rights the results of which cannot be predicted. Our failure to successfully enforce our patent rights could have a material adverse effect on our business, operating results and financial condition.

In the normal course of our business, we are subject to various other proceedings, lawsuits and claims relating to product, technology, labor and other matters as further described in Part II, Item 1. Legal Proceedings. We are required to assess the likelihood of any adverse outcomes and the potential range of probable losses in these matters. The amount of loss accrual, if any, is determined after careful analysis of each matter, and is subject to adjustment if warranted by new developments or revised strategies. We believe that none of the existing matters will result in a material adverse effect on our business, operating results and financial condition.

### Liquidity and Capital Resources

The accompanying consolidated financial statements have been prepared on a going concern basis, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. The Company has suffered recurring losses from operations and negative cash flows that raise substantial doubt about its ability to continue as a going concern.

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Management recognizes that the Company's continuation as a going concern is dependent upon its ability to generate sufficient cash flow to allow the Company to satisfy its obligations on a timely basis. The generation of sufficient cash flow is dependent on the successful expansion of the Company's share of the market for its software, controlling costs and securing new financing. Management's efforts in regard to these matters are described below. The consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

Our future success depends on maintaining adequate liquidity and working capital to meet our operational requirements. Revenues from products and services have fallen dramatically in the previous two fiscal years and continued to fall in the first nine months of 2004. We did not receive any revenue from license fees in 2003 or in the first nine months of 2004, and there can be no assurances that we will be able to secure license fees at all during the coming twelve months. Furthermore, given the continued volatility of the global securities markets and, in particular, the market for the securities of technology companies, as well as the recent results of our pending legal actions concerning enforcement of our intellectual property rights, we cannot assure you that we will be able to secure additional debt or equity financing. Our failure to maintain adequate liquidity and working capital would have a material adverse effect on the Company, our financial condition and results of operations.

We have incurred operating losses for the last several years and we continue to incur operating losses at this time. While the development and introduction of our new products continues, our actual sales revenue has declined significantly over the last two fiscal years and continues to be at a low level. In response, we have implemented cost reduction programs primarily in employee headcount, the use of independent software subcontractors and the level of expenses for development, marketing, sales and administration. In January 2004, salaries were reduced further in response to the need to preserve cash flow. Reductions in 2004 salaries are compensated for through a stock based compensation plan (requires no cash expenditure).

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In August 2003, our Chief Executive Officer and principal stockholder, through an affiliate of the Company controlled by him, began advancing funds to supplement the Company's cash flow for operating expenses and occupancy costs until operating cash flows improve and permanent additional financing can be arranged. The amounts advanced were \$1,081,021 and \$ 488,245 at September 30, 2004 and December 31, 2003, respectively. Advances are secured by all the assets of the Company and accrue interest at the affiliate's cost of funds, which is currently 8.5% .The affiliates cost of funds have ranged from 8.5% to 26% during the first nine months of 2004 compared with 21% for the same period in 2003. Interest expense related to this obligation amounted to \$ 121,555 and \$3,022 for the nine months ended September 30, 2004 and 2003 respectively

In July 2003, we engaged iCapital Finance, Inc. of Irvine, California as the Company's investment banking firm to assist us in structuring financing, providing access to capital resources, identifying candidates for marketing and distribution alliances, and to advise the Company on other strategic decisions. In addition, in April 2004 we engaged another investment banking firm to pursue a specific financing opportunity.

The Company is currently pursuing an opportunity that would provide new financing However, there can be no assurances that the Company will be able to obtain new financing and, if new financing is obtained, it could result in significant dilution to existing shareholders.

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We continued to focus our core business activity toward the Storage Wide Area Networking (SWAN) market segment for our CyberNAS Network Attached Storage and CyberVSA Storage Operating System. While our new products have been available and we have entered into new strategic alliance relationships with channel partners significant new sales have not materialized, as it has taken longer and been more difficult than we anticipated for these channel partners to become productive. We are continuing to explore and negotiate additional strategic alliance relationships to market our products.

The Company received notification from the American Stock Exchange (AMEX) on April 29, 2003 that the Company was not in compliance with certain listing standards relating to stockholders' equity and net losses. In June 2003 the Company submitted plan to AMEX a plan to regain compliance with the AMEX continuing listing standards. On July 28, 2003, AMEX notified the Company that it had accepted the proposed plan and granted an extension until October 31, 2004 to regain compliance. During such period, the Company's common stock continued to trade on AMEX and the Company was subject to periodic review of its progress consistent with its plan. On November 10, 2004 the AMEX notified the Company that it had determined that the Company had not regained compliance with the continuing listing standards by October 31, 2004. and was subject to being delisted from the Exchange. The Company will appeal this determination and request a hearing before a Committee of the Exchange. There can be no assurance the Company's request for continued listing will be granted.

If the Company's stock ceases to be listed on the AMEX a transfer of the listing to the OTC Bulletin Board or other markets will be sought. The outcome of these uncertainties and their impact on the price and liquidity of our common stock and our access to the capital markets cannot be predicted.

### Cash Flows

|                              | Position at        |                   |
|------------------------------|--------------------|-------------------|
|                              | September 30, 2004 | December 31, 2003 |
| Cash and cash equivalents    | \$ 9,837           | \$ 72,581         |
| Working capital (deficiency) | \$ (3,496,895)     | \$ (1,567,099)    |

  

|  | Nine months ended  |                    |
|--|--------------------|--------------------|
|  | September 30, 2004 | September 30, 2003 |
| Net cash (used) in operations                    | \$ (796,621)       | \$ (2,643,791)     |
| Net cash (used) by investing activities          | --                 | \$ (8,542)         |
| Net cash provided (used) by financing activities | \$ 733,877         | \$ 13,788          |

The Company used cash of \$796,621 to fund operations in the first nine months of 2004. The cash used in operations was principally the result of a net loss of \$2,775,377 offset by non-cash expenses of \$1,760,097 and a net reduction in operating assets of \$218,659. Included in non-cash expenses is depreciation and amortization of \$542,554, a provision for inventory obsolescence of \$118,243 and non-cash charges for compensation and services of \$1,099,300. The major changes in operating assets were decreases accounts receivable of \$134,684, inventories of \$219,532 and accrued expenses and deferred revenue of \$149,337 (included in accrued expenses on the balance sheet is an increase \$677,213 for deferred compensation. It is anticipated that preferred stock will be issued to satisfy this obligation)

Cash flow from financing activities consisted primarily of \$733,877 in cash advances received from an affiliate controlled by our Chief Executive Officer and principal stockholder.

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### COMMITMENTS.

We lease office facilities from an affiliate under a non-cancelable operating lease. Minimum future rental payments on this lease amount to \$318,108 annually for the years 2004 and 2005.

### Borrowing Arrangements

Other than advances from the affiliate of the Company as described above, we currently have no outstanding bank loans, lines of credit, or credit facilities. See comments under Liquidity and Capital Resources above with respect to current advances received from an affiliate of the Company.

### Results of Operations

Our operating results have fluctuated in the past and may in the future fluctuate significantly, depending upon a variety of factors. After the acquisition of CyberStorage Systems Corporation in September 2000, we commenced a corporate-wide restructuring, including the expansion of our North America sales territories to seven regions; the initiation of a plan to re-establish our re-seller sales channel; consolidation of our European sales, marketing and service organizations; and implemented strategic marketing initiatives and programs for product development and repositioning. Although we believed these actions and the introduction of new products would provide the revenue growth that would enable us to return to profitability, this has not yet materialized due to the time and difficulty of finding and training qualified channel partners. In September 2003, we established a sales representation relationship with Latin American Sales Solutions Consultants for our product offerings into the Latin American market. In March 2004, we signed an OEM agreement with RAID Incorporated (RAID). RAID will private label the CyberNAS software and integrate it into their extensive software and hardware suite. In April 2004, we signed a strategic alliance partnership agreement with MTC direct (Micro Technology Concepts, Inc.). MTC Direct will carry Storage Computer's CyberNAS software product offering in their portfolio for distribution and private labeling worldwide. In May 2004, we signed a distribution agreement with Beijing Challenger Group of China. Beijing Challenger will carry Storage Computer's CyberNAS software product offering in their portfolio for distribution throughout China.

We continue to explore and negotiate strategic alliance relationships to market our new products and seek financial support from these alliances.

### Revenue

Revenues from sales of products and services for the three and nine month periods ended September 30, 2004 were \$86,317 and \$299,475 compared to \$215,047 and \$640,807 for the respective periods in 2003. Revenue from software sales was not significant in either the 2004 or 2003 periods. Revenue from product and services were primarily from domestic sources for the periods being reported. There was no license fee revenue in the 2004 or 2003 periods and there can be no assurance that we will be able to secure any license fee revenue in the coming twelve months. We continued to focus our core business activity toward the Storage Wide Area Networking (SWAN) market segment for our CyberNAS Network Attached Storage and CyberVSA Storage Operating System. New products are available and new channel partners have been added. However, significant new sales have not materialized it has taken longer and been more difficult than we anticipated to find and train qualified channel partners.

### Cost of Products and Services

Product and service costs for the three and nine-month periods ended September 30, 2004 were \$158,473 and \$552,241, or 183% and 184% of revenue from

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product and services compared to \$218,442 and \$697,144 or 102% and 109% of revenue from products and services for the respective periods in 2003. The decrease in aggregate dollars was due primarily to reductions in overhead costs, primarily headcount. Cost of product and services includes a \$118,243 increase in the reserve for inventory obsolescence for the nine months ended September 30, 2004. There were no such adjustments in the 2003 periods. The change in costs as a percentage of revenue from 2003 to 2004 periods is primarily related to lower revenue and changes in costs.

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### Cost of License Fees

Costs associated with the enforcement of our patent and other intellectual property rights for the three and nine month periods ended September 30, 2004 were \$0, compared to \$118,468 and \$717,549 for the corresponding periods in 2003. These costs relate to legal fees for counsel and experts consulting fees and expenses incurred in connection with the enforcement of our patent and other intellectual property rights. Certain work performed by our legal counsel in defending our intellectual property is done under a contingency fee arrangement. The work performed in 2004 was done primarily under this arrangement.

### Research and Development Expenses

Research and development expenses for the three and nine month periods ended September 30, 2004 were \$239,137 and \$670,228, respectively compared to \$220,413 and \$865,984 for the corresponding periods in 2003. The decrease in research and development expenses for the nine month period in 2004 was due primarily to reductions in staffing and salary levels

### Selling and Marketing Expenses

Selling and marketing expenses for the three and nine month periods ended September 30, 2004 were \$218,792 and \$438,758 respectively compared to \$115,449 and \$439,565 for the corresponding periods in 2003. The three and nine month periods in 2004 reflect a charge for the issuance of \$100,000 of Series F 4% Redeemable Convertible Preferred Stock for sales and marketing services. Excluding this charge selling and marketing expenses declined due primarily to reductions in staffing, salary levels and other overhead costs.

### General and Administrative Expenses

General and administrative expenses for the three and nine month periods ended September 30, 2004 were \$214,829 and \$733,498 respectively compared to \$425,993 and \$1,159,402 for the corresponding periods in 2003. The decrease in general and administrative expenses in aggregate dollars was due primarily to reductions in staffing, salary levels and other overhead costs.

### Amortization of Intangibles

Amortization of other intangible assets for the three and nine month periods ended September 30, 2004 was \$144,000 and \$432,000 respectively compared to the same amounts for the corresponding periods in 2003. Identifiable intangible assets are amortized over an estimated life of 5 to 7 years.

### Other Income (Expense), Net

Interest expense, net for the three and nine month periods ended September 30, 2004 was \$41,248 and \$141,099 respectively compared to \$7,015 and \$16,577 for the corresponding periods in 2003. The increase in interest expense in 2004 is due to an increase in both the amount of outstanding debt and the related rate of interest.



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Other income (expense), net for the nine-month period ended September 30, 2004 was a net expense of \$107,028 compared to income of \$ 198,843 for the corresponding period in 2003. The expense in the 2004 relates primarily to foreign exchange translation adjustments related to an obligation denominated in a non U.S. Currency. The income in the 2003 period relates primarily to gain on settlement of a note payable and accrued compensation due to a former officer and director. These gains were offset in part by the forgiveness of advances to three directors during the second quarter of 2003 in recognition of previous service on the Board of directors. The total amount of advances to directors forgiven amounted to \$130,150, including accrued interest,

### Income Taxes

The effective tax rate for all periods reported was 0%. No tax benefit was recognized relating to the loss in those periods, as the ability of the company to use the tax benefit of its net operating losses is not assured.

### Factors That May Affect Future Results

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We caution you that the following important factors, among others, in the future could cause our actual results to differ materially from those expressed in forward-looking statements made by or on behalf of us in filings with the Securities and Exchange Commission, press releases, communications with investors and oral statements. Any and all forward-looking statements in this quarterly report on Form 10Q, and in any other public statements we make may turn out to be wrong. They can be affected by inaccurate assumptions we might make or by known or unknown risks and uncertainties. Many factors mentioned in the discussion below are important in determining future results. We undertake no obligation to publicly update any forward-looking statements; whether as a result of new information, future events or otherwise. You are advised, however, to consult any further disclosures we make in our reports filed with the Securities and Exchange Commission Liquidity and Capital Resources

See information with respect to our liquidity and capital resources presented above.

### Our Stock Price is Volatile

Our stock price is subject to significant volatility because of factors such as:

- o The announcement of new products, services or technological innovations by us or our competitors
- o Quarterly variations in our operating results
- o Decreasing product and services revenues
- o Speculation in the press or investment community
- o Failure to meet earning expectations
- o The results of intellectual property litigation

In addition, our stock price may be affected by general market conditions, short selling activities, and domestic and international economic factors unrelated to our performance. Further, until recently, our stock was thinly traded. Because of these factors, any recent trends may not be considered

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reliable indicators of future stock prices or financial results.

### Our Business May Suffer If We Cannot Protect Our Intellectual Property

We generally rely upon patent, copyright, trademark and trade secret laws and contract rights in the United States and in other countries to establish and maintain our proprietary rights in our technology and products. However, we cannot assure you that any of our proprietary rights will not be challenged, invalidated or circumvented. In addition, the laws of certain countries do not protect our proprietary rights to the same extent, as do the laws of the United States. In addition, the expense of pursuing these rights is substantial. Therefore, we cannot assure you that we will be able to adequately protect our proprietary technology against unauthorized third party copying or use. The failure to adequately protect our intellectual property rights and to prevail in any pending legal proceedings could have a material adverse effect on us. Despite our efforts to protect these intellectual property rights, unauthorized use may still occur, particularly in foreign countries. Refer to Item 1 of Part II below. Further, we cannot assure you that we will be able to obtain licenses to any technology that may be required to conduct our business or that, if obtainable, such technology can be licensed at a reasonable cost.

### Development of New Products and Solutions

We must make continuous investment in research and development to maintain our ongoing effort to continually improve our products and provide innovative solutions to our customers. The development of software products is a difficult and costly process and subject to many other products' requirements and the availability of substantial capital. Our inability to timely deliver new products in the past has had an adverse effect on our operating and financial results. There can be no assurance that we will be able to effectively develop and timely deliver new products in the future.

### Competition

We compete with many established companies in the computer storage and server industries and certain of these companies have substantially greater financial, marketing and technological resources, larger distribution capabilities, earlier access to customers and more opportunity to address customers' various information technology requirements than we do. Our business may be adversely affected by the announcement or introduction of new products by our competitors, including hardware, software and services, price reductions of our competitors' equipment or services and the implementation of effective marketing strategies by our competitors.

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Competitive pricing pressures exist in the computer storage and server markets and have had and may in the future have an adverse effect on our revenues and earnings. There also has been and may continue to be a willingness on the part of certain competitors to reduce prices in order to preserve or gain market share, which we cannot foresee. We currently believe that pricing pressures are likely to continue. The relative and varying rates of product price and component cost declines could have an adverse effect on our earnings.

### Rapid Technological Changes

The computer industry is changing both dramatically and rapidly. The development of "open systems computing", the introduction of the Internet, new fiber technologies (SAN) and the increasing storage density in disk drive technologies, have caused an increase in new product development and shorter

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time to bring the new products to market. While we believe that our Virtual Storage Architecture (VSA), StorageSuite and CyberBORG products are advanced when compared to competitive products, and complement many other products utilized in total customer solutions, we cannot assure that this will continue in the future. The failure to remain consistently ahead of competitive technologies would have a negative impact on our operating results and financial condition.

### Workforce

Most companies in the high technology arena are under pressure to be able to acquire and retain the services of talented individuals. We have had a decline in revenue in each of the three previous years and comparable reduction in our work force. While we believe that we have the required core personnel to effectively manage and grow, we cannot assure that key employees will not leave the company in the future. The failure to maintain key employees could adversely affect our future operating and financial results.

### Business Alliances

Many companies are forming business alliances with their competitors to be able to provide totally integrated storage solutions to their customers. One result of these alliances is to effectively preclude competitive products from being offered to customers. Many of the relationships are exclusive and our failure to develop similar relationships will effectively reduce the number of qualified sales opportunities we will have for our products in the future. We believe that we address this issue by our return to the reseller channel sales model and having the integrator/solution providers/value added-resellers perform the solution selling required. We have had difficulty opening these sales channels and any continued problems in doing so will have a negative effect on our operating results and financial condition.

### Operations

The Company no longer manufactures its own proprietary hardware and has successfully ported its software products to operate on widely available commodity server hardware. Virtually all of the Company's hardware configurations are available from multiple sources on a subassembly or fully configured basis, usually on an off-the-shelf delivery. Manufacturing activity is now limited to systems integration, final test, quality control and production of CD's for software license sales. As volumes increase these activities may also be outsourced.

### Changes in Laws, Regulations Or Other Conditions That Could Adversely Impair Our Condition

Our business, results of operations and financial condition could be adversely affected if any laws, regulations or standards, both foreign and domestic, relating to our products or us were newly implemented or changed.

### Litigation That We May Become Involved In May Adversely Affect Us

In the ordinary course of business, we may become involved in litigation, administrative proceedings and governmental proceedings. Such matters can be time-consuming, divert management's attention and resources and cause us to incur significant expenses. Furthermore, we cannot assure you that the results of any of these actions will not have a material adverse effect on our business, results of operations or financial condition.

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### ITEM 3. Quantitative and Qualitative Disclosures About Market Risk.

We have the market risk inherent in financial instruments that relates primarily to fluctuations in the prime rate of interest to be charged under the terms of the several promissory notes due to our Chief Executive Officer and other affiliate.

### ITEM 4. Controls and Procedures

(a) Evaluation of disclosure controls and procedures: Under the direction of our Chief Executive Officer and our Chief Financial Officer, we evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e)), and have concluded that, as of September, 2004, our disclosure controls and procedures were effective.

(b) Changes in internal controls over financial reporting: In connection with the evaluation of our internal control over financial reporting (required by paragraph (d) of Exchange Act Rule 13a-15), we have made no changes in, nor taken any corrective actions regarding, our internal controls over financial reporting that have materially affected, or are reasonable likely to materially affect, our internal control over financial reporting subsequent to the date the Company carried out its evaluation.

## PART II--OTHER INFORMATION

### ITEM 1. Legal Proceedings.

In December 2001, Marketlink Technologies, LLC filed a civil action against the Company in the Circuit Court for Oakland County, Michigan, alleging that the Company owed them a \$156,000 termination payment under the terms of a manufacturers representative agreement that the Company terminated for cause in April 2001 because of Marketlink's inability to sell the Company's products and perform the services required by the agreement. In January 2002, the Company filed counterclaims against Marketlink in this matter, including a claim for breach of contract. The case was tried in December 2003. Following the trial, the Court entered its order finding that the Company is liable to Marketlink for the \$156,000. Several post-order motions are currently before the Court that will affect the final amount due. The Company is considering an appeal.

During March 2001, we filed legal actions against Hitachi Data Systems Limited in the United Kingdom for infringement of two of the European patents in our intellectual property portfolio. Hitachi filed a counterclaim against the Company alleging that these two patents were invalid. The trial was completed in July 2002 and in August 2002 the Judge ruled that neither of our patents was shown to be valid in the United Kingdom or infringed by Hitachi. On October 17, 2002, the judgment for the defendant, Hitachi, on their counterclaim was entered and our European Patent (UK) 0,294,287 (`287) and European Patent (UK) 0,539,494 were revoked. The Order for the revocation of the `287 Patent was stayed pending appeal and we were granted permission to appeal the judgment so far as it concerns the `287 Patent. It was also ordered by consent of the parties that there be no order as to costs. On October 31, 2002, we filed an appeal with the Court of Appeal seeking that the judgment with respect to the `287 Patent be set aside and that the Court of Appeal find that the claims of the `287 Patent are valid, that Hitachi infringes the claims of the patent and that there be a certificate of contested validity in respect of the claims of the `287 Patent. On July 30, 2003, the Court of Appeals in London dismissed our appeal.

During October 2002, we entered into a Settlement Agreement and License with Hitachi under which Hitachi agreed not to oppose our appeal of the judgment

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discussed above and not to seek recovery of litigation costs. In return, we granted Hitachi a nonexclusive, fully paid up, perpetual license to sell or distribute products that may be subject to claims of our patents.

In October 2001, we filed a patent infringement action in the United States District Court for the Northern District of Texas against Veritas Software Corporation and Veritas Software Global Corporation alleging that certain Veritas Software Corporation storage products infringe Storage Computer's intellectual property patent number U.S. 5,893,919 entitled "Apparatus and Method for Storing Data with Selectable Data Protection Using Mirroring and Selectable Parity Inhibition." In February 2002, we filed an additional patent infringement action in the United States District Court of the Northern District of Texas, against Veritas Software Corporation and Veritas Software Global Corporation alleging that certain Veritas Software Corporation storage products infringe Storage Computer's intellectual property, specifically U.S. 5,257,367 entitled "Data Storage system with Asynchronous Host Operating System Communication Link". However, we amended our complaint to dismiss claims arising under this patent in September 2002. In March 2002, we filed a third patent infringement action against Veritas Software Corporation and Veritas Software Global Corporation alleging certain Veritas Software Corporation storage products infringe Storage Computer's intellectual property patent number U.S. 6,098,128 entitled "Universal Storage Management System." Our claim is for injunctive relief, damages and legal costs arising from the alleged infringement.

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These actions were referred to a court appointed mediator with an initial mediation date in April 2002 and such mediation concluded without any mutually agreeable basis for settlement having been reached. A trial date was scheduled for November 10, 2003. However, on October 21, 2003, the Court ordered that all matters in this case are stayed pending the resolution of plaintiff's and defendants' motions for summary judgment. On March 12, 2004, the court issued a memorandum opinion granting the Veritas entities motion for summary judgment holding that there is no evidence that the patents in question are infringed by the Veritas entities. To date the court has not entered a final judgment in the case. The Company has filed a notice of appeal.

On September 23, 2002, Veritas asserted a counter claim for patent infringement with respect to patent number U.S. 5,812,753 entitled "Methods for Initializing or Reconstructing Data Consistency Within an Array of Storage Elements." On November 18, 2003, the court issued an order staying all proceedings in the case until there is a final resolution of the reexamination, requested by the Company on September 23, 2003, of the patent by the U.S. Patent and Trademark Office. We believe that this claim is without merit and intend to vigorously defend this action. On March 12, 2004, the Company received through its patent counsel the first office action of the U.S. Patent and Trademark Office, where the majority of the claims of U.S. 5,812,753 were rejected based on prior art.

The outcome in the Veritas patent proceeding is pending. We are currently evaluating results of recent patent litigation and are considering various strategies to protect our intellectual property. The future cost of litigation to enforce our intellectual property rights could be substantial. There is a current need to invest in the development of our core business whereas litigation to enforce our intellectual property rights can, in some cases, be deferred as certain of our patents run as far as 2020. The decision to pursue litigation to enforce these rights will be made on the merits of each case and the impact it will have on the overall success of the Company.

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The Company is involved from time to time in various other minor legal actions in the ordinary course of its business which management believes will not have a material adverse effect on its business, operating results of financial position.

### ITEM 2. Changes in Securities and Use of Proceeds

During the quarter ended September 30, 2004 The Company issued 100 shares of its previously authorized Series F 4% Redeemable Convertible Preferred stock with a stated value of \$1,000 per share. The shares were issued for sales and marketing services valued at \$100,000. These shares were issued in reliance upon the exemption from securities registration afforded by Rule 506 under Regulation D as promulgated by the United States Securities and Exchange Commission under the Securities act of 1933, as amended.

### ITEM 3. Defaults Upon Senior Securities

NONE

### ITEM 4. Submission of Matters to a Vote of Security Holders

At our Annual Meeting of Stockholders held on July 15,2004 the following matters were voted:

| Proposal 1 Election of Directors | Voted for<br>----- | Votes withheld<br>----- |
|----------------------------------|--------------------|-------------------------|
| Theodore J. Goodlander           | 35,686,325         | 620,394                 |
| Edward A. Gardner                | 35,595,133         | 711,586                 |
| Steven S. Chen                   | 35,814,154         | 492,565                 |
| Roger E. Gauld                   | 35,814,154         | 492,565                 |
| Thomas A. Wooters                | 35,719,825         | 586,894                 |

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#### Proposal 2 Amendment to the 1999 Incentive Stock Plan:

| Voted for<br>----- | Voted against<br>----- | Votes withheld<br>----- |
|--------------------|------------------------|-------------------------|
| 18,162,436         | 1,564,530              | 16,579,753              |

#### Proposal 3 Amendment to Certificate of Incorporation:

| Voted for<br>----- | Voted against<br>----- | Votes withheld<br>----- |
|--------------------|------------------------|-------------------------|
| 35,208,544         | 1,063,787              | 34,388                  |

#### Proposal 4 Ratification of Appointment of Auditors

| Voted for<br>----- | Voted against<br>----- | Votes withheld<br>----- |
|--------------------|------------------------|-------------------------|
|--------------------|------------------------|-------------------------|

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35,934,231

254,728

117,760

ITEM 5. Other Information

See Part II, Item 1. Legal proceedings

ITEM 6. Exhibits and Reports on Form 8-K.

(a) Exhibits

| Number | Description   |
|--------|---|
| 31.1   | Rule 13a-14(a) Certification of Theodore J. Goodlander, Chief Executive Officer |
| 31.2   | Rule 13a-14(a) Certification of Michael J. O'Donnell, Chief Financial Officer   |
| 32.1   | Section 1350 Certification of Theodore J. Goodlander, Chief Executive Officer   |
| 32.2   | Section 1350 Certification of Michael J. O'Donnell, Chief Financial Officer     |

(b) Reports On Form 8-K

On August 17, 2004 Storage Computer Corporation filed a Current Report on Form 8K for purposes of filing under item 12 with the Securities and Exchange Commission as an exhibit thereto Storage Computer's press release dated August 17, 2004 announcing its results of operations for the second quarter ended June 30, 2004.

SIGNATURE

Pursuant to the requirements of the Securities and Exchange Act of 1934, as amended, the registrant duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

STORAGE COMPUTER CORPORATION  
Registrant

By: /s/ Michael J. O'Donnell  
-----  
Michael J. O'Donnell  
Chief Financial Officer

Date: November 22, 2004