STORAGE COMPUTER CORP
Form 10-Q
November 16, 2001

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(MARK ONE)

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2001

[ ] 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 STREET NASHUA, NH 03062
(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES, INCLUDING ZIP CODE)

(603) 880-3005
REGISTRANT'S TELEPHONE NUMBER, INCLUDING AREA CODE:

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 [X] No [_]

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

CLASS	OUTSTANDING AT NOVEMBER 2, 2001
Common Stock	15,960,184

PART I - FINANCIAL INFORMATION

PART I. FINANCIAL INFORMATION

ITEM 1. Financial Statements

Storage Computer Corporation
Consolidated Balance Sheets

	September 30, 2001	December 31, 2000
	(UNAUDITED)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 7,313,205	$ 14,852,259
Accounts receivable, net	1,294,475	847,829

Inventories	4,380,387	4,316,104
Due from officers and directors	1,584,360	-
Other current assets	279,425	399,302
Total current assets	14,851,852	20,415,494
Property and equipment, net	954,473	1,141,299
Goodwill and other intangibles, net	20,954,751	23,317,443
Other assets	105,796	244,040
Total assets	$ 36,866,872	$ 45,118,276
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 884,649	$ 896,049
Accrued expenses	2,404,954	2,436,291
Deferred revenue and customer deposits	533,123	492,028
Current maturities of long-term debt	252,901	263,863
Total current liabilities	4,075,627	4,088,231
Long-term debt, less current maturities	1,239,937	1,489,299
Commitments and contingencies	-	-
Redeemable convertible preferred stock	12,350,491	12,556,661
Shareholders' equity:		
Preferred stock	2,108,822	-
Common stock	15,791	15,042
Additional paid-in capital	64,079,406	57,792,635
Accumulated deficit	(47,003,202)	(30,823,592)
Total shareholders' equity	19,200,817	26,984,085
Total liabilities and shareholders' equity	$ 36,866,872	$ 45,118,276

See Notes to Consolidated Financial Statements.

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Storage Computer Corporation
Statements of Consolidated Operations (Unaudited)

	Three Months Ended		Nine Months Ended	
	September 30,	September 30,	September 30,	September 30

	2001	2000	2001	2000
Revenue	$ 2,176,028	$ 1,037,920	$ 5,186,303	$ 5,187,596
Product cost including inventory restructuring cost in 2000	1,524,368	3,728,058	3,860,888	5,688,941
Gross margin	651,660	(2,690,138)	1,325,415	(501,345
Operating expenses:				
Research and development	884,252	329,911	3,262,381	997,776
Selling and marketing	1,364,027	657,856	3,176,607	1,664,500
General and administrative	1,254,178	713,844	3,040,865	1,702,631
Amortization of intangibles	707,934	186,855	2,123,802	186,855
Restructuring costs	-	740,130	-	740,130
Total operating expenses	4,210,391	2,628,596	11,603,655	5,291,892
Operating loss	(3,558,731)	(5,318,734)	(10,278,240)	(5,793,237
Other income (expense):				
Interest income (expense), net	69,671	(59,618)	258,339	(354,307
Other expense	(180,812)	(249,828)	(77,832)	(128,854
Total	(111,141)	(309,446)	180,507	(483,161
Loss before income taxes	(3,669,872)	(5,628,180)	(10,097,733)	(6,276,398
Provision for income taxes	-	13,763	1,214	13,763
Net loss	(3,669,872)	(5,641,943)	(10,098,947)	(6,290,161
Dividends on preferred stock including amortization of the beneficial conversion features	(3,679,443)	(991,841)	(6,080,663)	(1,613,191
Loss applicable to common stockholders	$(7,349,315)	$(6,633,784)	$(16,179,610)	$(7,903,352
Loss applicable to common stockholders per basic and dilutive share	$(.47)	$(.53)	$(1.03)	$(.63
Basic and dilutive shares	15,785,925	12,522,675	15,658,455	12,417,098

See Notes to Consolidated Financial Statements.

Storage Computer Corporation
Statements of Consolidated Cash Flows (Unaudited)

	Nine Months Ended September 30, 2001	Nine Months Ended September 30, 2000
Cash flows from operating activities:		
Net loss	$(10,098,947)	$ (6,290,161)
Reconciliation to operating cash flows:		
Depreciation and amortization of property and equipment	408,113	572,262
Amortization of goodwill and other intangibles	2,123,802	186,855
Provision for restructuring costs	-	3,737,712
Stock issued to 401(k) plan	42,707	30,868
Changes in operating assets and liabilities:		
Accounts receivable	(446,646)	(472,256)
Inventories	(54,443)	404,865
Advances to directors and officers	(1,584,360)	
Other current assets	119,877	517,523
Accounts payable and accrued expenses	(662,152)	569,605
Net cash used in operations	(10,152,049)	(742,727)
Cash flows from investing activities:		
Capital expenditures	(221,287)	(181,348)
Other assets	138,243	482,708
CyberStorage acquisition cost adjustments	238,885	-
Net cash provided by investing activities	155,841	301,360
Cash flows from financing activities:		
Net payments on credit line	-	(6,600,445)
Reduction of long-term debt	(260,324)	1,162,168
Net proceeds from issuance of common stock for stock options and warrants	27,649	829,036
Issuance of preferred stock	4,830,217	9,324,169
Redemption of preferred stock	(2,130,548)	-
Net cash provided by financing activities	2,466,994	4,714,928
Effect of exchange rate changes on cash	(9,840)	(14,617)
Net decrease in cash and cash equivalents	(7,539,054)	(4,258,944)
Cash and cash equivalents-beginning of period	14,852,259	1,182,194
Cash and cash equivalents-end of period	$ 7,313,205	$ 5,441,138
Supplemental cash flow information:		
Cash payments of interest	$ 112,615	$ 167,809
Cash payments of income taxes	$ 1,214	$ 10,380

Non-cash investing and financing activities:		
Acquisition of CyberStorage:		
Fair value of assets acquired		$ 24,725,096
Common stock issued		(22,440,000)
Liabilities assumed		(2,285,096)
		$ -
Preferred stock dividends paid in common stock	$ 300,492	$ 94,458

See Notes to Consolidated Financial Statements.

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Storage Computer Corporation
Notes to Consolidated Financial Statements
September 30, 2001

Note A - The Company and Basis of Presentation

Storage Computer Corporation ("Company", "we" and "us") and our subsidiaries are engaged in the development, manufacture, and sale of computer disk arrays and computer equipment worldwide. The consolidated financial statements include the accounts of the Company and those of our wholly-owned subsidiaries CyberStorage Systems Corporation, Storage Computer Europe GmbH, Vermont Research Products, Inc., Storage Computer UK, Ltd., and Storage Computer France S.A. All significant intercompany accounts and transactions have been eliminated in consolidation. We have a 20% investment in Storage Computer (Asia) Ltd. which is accounted for by the equity method.

The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles 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, 2000. In our opinion, the accompanying financial statements reflect all adjustments, all of which are of a normal, recurring nature, to fairly present our consolidated financial position, results of operations and cash flows. The results of operations for the nine months ended September 30, 2001 are not necessarily indicative of the results to be expected for the full year.

During the fourth quarter of 2000, the Financial Accounting Standards Board issued Emerging Issues Task Force (EITF) 00-27 "Application of EITF issue No. 98-5, Accounting for Convertible Securities with Beneficial Conversion Features or Contingency Adjustable Conversion Ratios, to certain Convertible Instruments". EITF No. 00-27 requires the remeasurement of the original issue discount on preferred stock with characteristics similar to the convertible preferred stock issued by the Company, during fiscal year 2000. This accounting change requires the value of the warrants issued with the preferred stock to be included in the calculating the beneficial conversion value. This resulted in a cumulative charge of $809,364 to loss applicable to common stockholders in the fourth quarter of 2000 reported in our Annual Report Form 10-K for 2000. In addition, the quarterly results of operations for the second and third quarters of 2000 were restated in Note M of our Annual Report Form 10-K from the amounts previously reported in our quarterly reports Forms 10-Q for the quarters ended June 30, 2000 and September 30, 2000. The loss applicable to common stockholders for the quarter ended September 30, 2000 has been restated in this Form 10-Q to properly reflect the results for the three and nine months ended September 30, 2000 in accordance with EITF 98-5.

Certain 2000 amounts have been reclassified to conform with the current period presentation.

Note B - Stockholders' Equity

A summary of changes in stockholders' equity in the nine months ended September 30, 2001follows:

		Common Stock		Addit
	Preferred Stock	Shares	Par Value	Paid Capi
Balance - December 31, 2000	$ _	15,041,882	$ 15,042	$57,79
Exercise of stock options		13,294	13	2
Stock issued to 401(k) plan		6,499	7	4
Dividends on preferred stock paid in common shares		58,077	58	23
Accrued dividends on preferred stock				
Conversion of redeemable convertible preferred stock and accrued dividends into common shares		671,256	671	6
Issuance of Series E preferred stock and warrants to purchase common stock:				
Proceeds, net of issuance costs	4,830,217			
Allocation of fair value to warrants using the Black-Scholes option-pricing model	(2,804,000)			2,80
Beneficial conversion feature at commitment date charged directly to accumulated deficit				3,11
Amortization of preferred stock beneficial conversion feature, warrants and other costs charged to accumulated deficit	82,605			
Net loss				
Balance - September 30, 2001	$2,108,822	15,791,008	$ 15,791	$64,07

Note C - Recent Accounting Pronouncements

In June 2001, the Financial Accounting Standards Board finalized FASB Statements No. 141, Business Combinations ("SFAS 141"), and No. 142, Goodwill and Other Intangible Assets ("SFAS 142"). SFAS 141 requires the use of the purchase method of accounting and prohibits the use of the pooling-of-interests method of accounting for business combinations initiated after June 30, 2001. SFAS 141 also requires that the Company recognize acquired intangible assets apart from goodwill if the acquired intangible assets meet certain criteria. SFAS 141 applies to all business combinations initiated after June 30, 2001 and for purchase business combinations completed on or after July 1, 2001. It also requires, upon adoption of SFAS 142, that the Company reclassify the carrying amounts of intangible assets and goodwill based on the criteria in SFAS 141.

SFAS 142 requires, among other things, that companies no longer amortize goodwill, but instead test goodwill for impairment at least annually. In addition, SFAS 142 requires that the Company identify reporting units for the purposes of assessing potential future impairments of goodwill, reassess the useful lives of other existing recognized intangible assets, and cease amortization of intangible assets with an indefinite useful life. An intangible asset with an indefinite useful life should be tested for impairment in accordance with the guidance in SFAS 142. SFAS 142 is required to be applied in fiscal years beginning after December 15, 2001 to all goodwill and other intangible assets recognized at that date, regardless of when those assets were initially recognized. SFAS 142 requires the Company to complete a transitional goodwill impairment test six months from the date of adoption. The Company is also required to reassess the useful lives of other intangible assets within the first interim quarter after adoption of SFAS 142.

The Company's previous business combinations were accounted for using the purchase method. As of September 30, 2001, the net carrying amount of goodwill is $16,756,000 and other intangible assets is $4,199,000. Amortization expense during the nine-month period ended September 30, 2001 was $2,123,802. Currently, the Company is assessing but has not yet determined how the adoption of SFAS 141 and SFAS 142 will impact its financial position and results of operations.

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 1996 CONTAINS CERTAIN SAFE HARBORS REGARDING FORWARD-LOOKING STATEMENTS. FROM TIME TO TIME, INFORMATION PROVIDED BY US 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 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.

INTRODUCTION

This discussion summarizes the significant factors affecting the liquidity, capital resources and result of all operations for the periods ended September 30, 2001 and 2000. The discussion should be read in connection with the Consolidated Financial Statements and other financial information included in our 2000 Annual Report on Form 10-K filed with the Securities and Exchange Commission.

LIQUIDITY AND CAPITAL RESOURCES

CASH FLOW

Operations used $10,152,000 of cash during the first nine months of 2001 compared to $743,000 in the first nine months of 2000.

The use of cash by operations in the first nine months of 2001 resulted from the net loss for that period and net cash used for changes in operating assets and liabilities including advances to directors and officers which were offset by non-cash charges relating to depreciation and amortization of $2,532,000. The cash used by operations in the first nine months of 2000 resulted primarily from the net loss for that period which was offset in part by net cash provided by changes in operating assets and liabilities, by non-cash charges relating to depreciation and amortization of $759,000 and a provision for restructuring costs of $3,738,000.

Investing activities provided cash flow of $156,000 in the first nine months of 2001 from an adjustment to the purchase price of CyberStorage and other assets partially offset by capital expenditures. Investing activities provided cash flow of $301,000 in the first nine months of 2000 primarily from other assets partially offset by capital expenditures.

Financing activities provided $2,467,000 of cash in the first nine months of 2001 primarily from the proceeds of $4,830,217 from the sale of Series E preferred stock, net of the costs of the redemption of Series A and B preferred stock of $2,131,000. During the first nine months of 2000, our bank credit facility was paid off with the proceeds of the sale of Series A preferred stock and through the exercise of options and warrants.

BORROWING ARRANGEMENTS

We currently have no outstanding bank loans, lines of credit, or credit facilities. We previously had a revolving credit facility that we repaid and terminated in August 2000.

WORKING CAPITAL

Our working capital at September 30, 2001 was $10,776,000 compared with $16,327,000 at December 31, 2000. In management's opinion, our current working capital position and cash from operations, will be sufficient to accommodate working capital requirements through the fiscal year ending December 31, 2001.

EQUITY FINANCING

During 2000, we successfully raised over $22 million from several investors through the sale of Series A, Series B and Series C preferred stock, related warrants and exercise of stock options. In August 2000 we designated a Series D preferred stock but no shares were issued. The series expired on July 31, 2001 by its own terms. In August 2001 we raised an additional $5 million through the sale of Series E preferred stock. These sales to investors have significantly improved our cash availability to fund our working capital requirements.

RESULTS OF OPERATIONS

Our operating results have fluctuated in the past and may in the future fluctuate significantly, depending upon a variety of factors. During 2000 we undertook the following actions to facilitate our focus towards revenue growth: appointed a new President, a new Chief Financial Officer and a new Chief Operating Officer who is responsible for sales and marketing and, after the acquisition of CyberStorage Systems Corporation, commenced a restructuring, including the expansion of North America territories from three designated regions to seven regions, the initiation of the plan to re-establish the re-seller sales channel, and consolidation of the European sales, marketing and service organizations; implemented strategic marketing programs and product development and repositioning. We believe these actions and the recruitment of new sales and marketing management, and staff, in 2001, will provide revenue growth that will enable us to return to profitability. Currently, we are experiencing an extended cycle for receipt of new orders due to the introduction of our new sales and marketing management and staff persons, the marketing and training cycles related to the new sales staff and the introduction of new products and the current economic climate for the storage sector.

Additional factors that may contribute to variability of operating results include: trends in national and world-wide economic growth or recession; the pricing and mix of products offered by us; changes in pricing of our products and services due to competitive pressures; our ability to obtain sufficient supplies of sole or limited source components; the ability to manage future growth and expansion; the continual development of new products; the ability to successfully identify, target, acquire and integrate suitable acquisitions.

REVENUE

Revenue for the three month period and nine month periods ended September 30, 2001 were $2,176,000 and $5,186,000 compared to $1,038,000 and $5,188,000 for the respective periods in 2000. Revenue growth for both international and domestic products continue to be impacted by the factors described above. For the three month period ended September 30, 2001, U.S. domestic product sales and international product sales were 77% and 23%, respectively, of total revenue compared to 47% and 53% for the same period in 2000. For the nine month period ended September 30, 2001, U.S. domestic product sales and international product sales were 73% and 27%, respectively, of total revenue compared to 65% and 35% for the same period in 2000.

All United States export sales are denominated in United States dollars to limit the amount of foreign currency risk. Export sales from the European sales offices are denominated in United States dollars. Sales which occur through our subsidiaries located in England, Germany and France are conducted in the local currency.

PRODUCT COST

After adjusting for the $3 million inventory restructuring costs in the third quarter of 2000, product costs for the three months ended September 30, 2001 and 2000 were approximately 70% of sales in both periods and for the nine month periods ended September 30, 2001 and 2000 the product cost percentages were approximately 74% and 52%, respectively. This was the result of increased factory costs of enhanced quality assurance programs and higher technical service expenditures both of which have been implemented in anticipation of our planned growth in sales but are incurred currently on lower sales volumes partially offset in the three months ended September 30, 2001 by higher margins on product mix sold compared to the same period in 2000.

RESEARCH AND DEVELOPMENT

Research and development expenses for the three month periods ended September 30, 2001 and 2000 were $884,000 and $330,000, respectively, and $3,263,000 and $998,000, respectively, for the nine month periods ended September 30, 2001 and 2000. The $883,000 increase in expenditures between the three month periods ended March 31, 2000 and 2001 was reduced to an increase of $498,000 for the three month periods ended June 30, 2001 and 2000 and increased to $554,000 for the three months ended September 30, 2001 and 2000. This is a direct result of increased research and product development personnel who have permanently joined our staff and a reduction in the utilization of independent software engineers for short term assignments.

SELLING AND MARKETING EXPENSES

Selling and marketing expenses for the three month period and the nine month period ended September 30, 2001 continued to reflect the increased head count in corporate, marketing and field sales organizations over the comparable period in 2000. During 2001 increased costs are associated with greater trade show activity of $170,000 and marketing materials and web site development costs of $80,000 and increases in salesmen's travel and commissions.

GENERAL AND ADMINSTRATIVE EXPENSES

General and administrative expenses for the three month period and the nine month period September 30, 2001, reflect the higher level of personnel due to the CyberStorage acquisition. In the three month and nine month period ended September 30, 2001 costs were incurred by U.K. attorneys and by expert witnesses aggregating $395,000 and $748,000, respectively, in connection with our intellectual properties litigation.

AMORTIZATION OF INTANGIBLES

Amortization of intangibles relates to the amortization of goodwill and other intangibles acquired in the CyberStorage acquisition over periods of five to ten years.

INTEREST INCOME (EXPENSE)

The interest income (expense) for the three month periods and the nine month periods ended September 30, 2001, respectively, reflect the elimination of bank borrowing by us as compared to the same periods in the prior year and the increase in cash and cash equivalents.

NET LOSS

We incurred a net loss for the three month period ended September 30, 2001 of $3,670,000 compared to $1,902,000 for the three month period ended September 30, 2000 after adjusting for the $3,740,000 provision for restructuring in 2000. The increase in net loss of $1,768,000 is lower compared to the increase in net loss for the first and second quarter of $2,268,000 and $3,513,000, respectively, is primarily attributable to the higher sales volume and product mix and related effect on gross margin, the changes in operating expenses described above and the non-cash charges for amortization of intangibles of $707,000 during the three months ended September 30, 2001, in connection with the acquisition of CyberStorage in 2000.

We are heavily committed in the near term to rebuilding our sales force and increasing our revenue base, which will also require near term expenses for marketing and new product development. This will negatively affect our short term operating results.

FOREIGN CURRENCY TRANSACTIONS

We do not currently utilize any derivative products to hedge our minimal foreign currency risk. Our foreign subsidiaries' obligations to us are denominated in U.S. dollars. There is a potential for a foreign currency gain or loss based upon fluctuations between the U.S. dollar and its subsidiaries' functional currencies, currently German, British, and French. This exposure is limited to the period between the time of accrual of such liability to us in our subsidiaries' functional currency and the time of their payment to us in U.S. dollars.

Other than the intercompany balances noted above, we do not believe we have material unhedged monetary assets, liabilities or commitments that are denominated in a currency other than the operations' functional currencies. We expect such exposure to continue until our foreign subsidiaries reach a more mature level of operation. We currently have no plans to utilize any derivative products to hedge our foreign currency risk.

RECENT ACCOUNTING PRONOUNCEMENTS

In June 2001, the Financial Accounting Standards Board finalized FASB Statements No. 141, Business Combinations ("SFAS 141"), and No. 142, Goodwill and Other Intangible Assets ("SFAS 142"). SFAS 141 requires the use of the purchase method of accounting and prohibits the use of the pooling-of-interests method of accounting for business combinations initiated after June 30, 2001. SFAS 141 also requires that the Company recognize acquired intangible assets apart from goodwill if the acquired intangible assets meet certain criteria. SFAS 141 applies to all business combinations initiated after June 30, 2001 and for purchase business combinations completed on or after July 1, 2001. It also requires, upon adoption of SFAS 142, that the Company reclassify the carrying amounts of intangible assets and goodwill based on the criteria in SFAS 141.

SFAS 142 requires, among other things, that companies no longer amortize goodwill, but instead test goodwill for impairment at least annually. In addition, SFAS 142 requires that the Company identify reporting units for the purposes of assessing potential future impairments of goodwill, reassess the useful lives of other existing recognized intangible assets, and cease amortization of intangible assets with an indefinite useful life. An intangible asset with an indefinite useful life should be tested for impairment in accordance with the guidance in SFAS 142. SFAS 142 is required to be applied in fiscal years beginning after December 15, 2001 to all goodwill and other intangible assets recognized at that date, regardless of when those assets were initially recognized. SFAS 142 requires the Company to complete a transitional goodwill impairment test six months from the date of adoption. The Company is also required to reassess the useful lives of other intangible assets within the first interim quarter after adoption of SFAS 142.

The Company's previous business combinations were accounted for using the purchase method. As of June 30, 2001, the net carrying amount of goodwill is $16,756,000 and other intangible assets is $4,199,000. Amortization expense during the nine-month period ended September 30, 2001 was $2,123,802. Currently, the Company is assessing but has not yet determined how the adoption of SFAS 141 and SFAS 142 will impact its financial position and results of operations.

FACTORS THAT MAY AFFECT FUTURE RESULTS

OUR STOCK PRICE IS VOLATILE

Our stock price, like that of other technology companies, is subject to significant volatility because of factors such as the announcement of new products, services or technological innovations by us or our competitors; quarterly variations in our operating results; changes in revenue or earnings estimates by the investment community; speculation in the press or investment community; and failure to meet earning expectations.

In addition, our stock price may be affected by general market conditions and domestic and international economic factors unrelated to our performance. Further, until recently, our common stock was thinly traded. Because of these factors, recent trends should not be considered 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, there can be no assurance 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. Therefore, there can be no assurance that we will be able to adequately protect our proprietary technology against unauthorized third-party copying or use, which could adversely affect our competitive position. Further, there can be no assurance that we will be able to obtain licenses to any technology that it may require to conduct its business or that, if obtainable, such technology can be licensed at a reasonable cost.

We are aggressively pursuing the enforcement of our intellectual property rights after an extensive patent review conducted in 1999. Subsequently, in 2000, we retained a major law firm to enforce these rights against infringing parties, which our management believes to be extensive. In 2001, we commenced litigation against several companies in the United States and the United Kingdom, alleging infringement of our patents. One of the defendants has filed a counterclaim, alleging, among other things, that we have infringed upon a patent held by them.

Despite our legal representatives' efforts, there can be no assurance or predictability as to any amount of recovery, if any, or the length of time it will take us to recover any damages that may be recoverable. Additionally, despite our efforts to protect our intellectual property rights, unauthorized use may still occur, particularly in foreign countries.

TERRORIST ATTACKS MAY HAVE AN ADVERSE EFFECT ON OUR BUSINESS IN THE FUTURE

Following the September 11, 2001 terrorist attacks, we have experienced no material adverse effect on our business. However, we are unable to predict with certainty any future adverse impact from these types of attacks or related outbreaks of hostilities.

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. 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 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 us. 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.

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), network attached storage (NAS) and the increasing storage density in disk drive technologies, have caused an increase in new product development and shorter time to bring the new products to market. While we believe that our Virtual Storage Architecture and StorageSuite products are advanced when compared to competitive products, and complement many other products utilized in total customer solutions, there can be no assurance 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.

BUSINESS ALLIANCES

Many companies have formed 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 their 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. Our failure to open these sales channels will have a negative effect on our operating results and financial condition.

OPERATIONS

Our products operate near the limits of electronic and physical performance, and are designed and manufactured with relatively small tolerances. If flaws in design, production, assembly or testing were to occur by us or our suppliers, we could experience a rate of failure in our products that would result in substantial repair or replacement costs and potential damage to our reputation. Continued improvement in manufacturing capabilities and control of material and manufacturing quality and costs are critical factors in our future growth. We frequently revise and update manufacturing and test processes to address engineering and component changes to our products and evaluate the reallocation of manufacturing resources among our facilities. There can be no assurance that our efforts to monitor, develop and implement appropriate test and manufacturing processes for our products will be sufficient to permit us to avoid a rate of failure in our products that results in substantial delays in shipment, significant repair or replacement costs and potential damage to our reputation, any of which could have a material adverse effect on our business, results of operations or financial condition.

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, there can be no assurance that key employees will not leave our employment in the future. The failure to maintain key employees could adversely affect our operating and financial results in the future.

LIQUIDITY AND WORKING CAPITAL

Our future success depends on maintaining adequate liquidity and working capital to meet our operational requirements. Given the recent volatility in the securities markets and, in particular, the securities of technology companies, there can be no assurances that additional investors' capital will be available to us and that we will receive additional equity financing. Our failure to maintain adequate liquidity and working capital could have a material adverse impact on us.

FAILURE OF SUPPLIERS TO PROVIDE QUALITY PRODUCTS

We purchase several sophisticated components and products from one or a limited number of qualified suppliers. These components and products include disk drives, high density memory components and power supplies. We have experienced delivery delays from time to time because of high industry demand or the inability of some vendors to consistently meet their quality and delivery requirements. If any of our suppliers were to fail to meet the quality or delivery requirements needed to satisfy customer orders for our products, we could lose time-sensitive customer orders and have significantly decreased quarterly revenues and earnings, which would have a material adverse effect on our business, results of operations or financial condition. Additionally, we periodically transition our product line to incorporate new technologies. The importance of transitioning our customers smoothly to new technologies, along with our historically uneven pattern of quarterly sales, intensifies the risk that a supplier who fails to meet its delivery or quality requirements will have an adverse impact on our revenues and earnings.

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 us or our products 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, there can be no assurance that the results of any of these actions will not have a material adverse effect on our business, results of operations or financial condition.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

The market risk inherent in our financial instruments relates primarily in fluctuations in the prime rate of interest to be charged to us under the terms of a promissory note to one of our senior executive officers. We do not use derivative products or have any material unhedged monetary assets, except for the inter-company balances outstanding, which are detailed above in Item 2 "Foreign Currency Transactions."

PART II. OTHER INFORMATION

Item 1. Legal Proceedings.

During March 2001 we filed legal actions against Hitachi Data Systems Ltd. in the United Kingdom for infringement of one of the patents in our intellectual property rights portfolio. Additionally, we filed an action against XIOTech Corporation and its parent company, Seagate Technology Inc., in the Federal District Court for the Northern District of Texas claiming that one of their products infringes one of our patents. In October 2001 we filed an action against Veritas Software Corporation in the Federal District Court for the Northern District of Texas claiming that certain of their products infringes one of our patents. One of the defendants has filed a counterclaim, alleging, among other things, that we have infringed upon a patent held by them. Our involvement in these proceedings cannot possibly be predicted as to any recovery or length of time required to recover our damages, but we intend to vigorously pursue our claims against manufacturers whose products we believe infringe on our patents.

We are involved in several other minor legal claims in our ordinary course of business. While we believe that our involvement in these claims will have no material effect our operations or financial condition, we cannot predict what our continuing involvement in, any judicial decision rendered, or the resolution of the set of claims will have upon our business, operating results, or financial condition.

Item 2. Changes in Securities and Use of Proceeds.

During the quarter ended September 30, 2001, we completed a $5,000,000 private placement of a new Series E Convertible Preferred Stock to the holder of our Series C Preferred Stock. The Series E shares are convertible into 771,605 shares at a fixed conversion price of $6.48 and may be converted at any time until October 31, 2003 when conversion is automatic. In connection with the investment we issued a warrant to purchase 771,605 shares of common stock at $10.80 per share.

Item 3. Defaults Upon Senior Securities.

There has not been any material default in the payment of principal, interest, or any other material default not cured within 30 days with respect to any of our indebtedness and our subsidiaries during the nine month period ended September 30, 2001.

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. Exhibit

Number	Description
4.2	Certificate of Designation of Series E Convertible Preferred Stock of Storage Computer Corporation (incorporated by reference to Exhibit 3.1 to our Report on Form 8-K filed August 22, 2001).
4.3	Registration Rights Agreement dated as of August 15, 2001 by and among Storage Computer Corporation and the investors name therein (incorporated by reference to Exhibit 4.1 to our Report on Form 8-K filed August 22, 2001).
4.4	Stock Purchase Warrant dated as of August 16, 2001 to purchase 771,605 shares of Storage Computer Corporation common stock (incorporated by reference to Exhibit 4.2 to our Report on Form 8-K filed August 22, 2001).
10.1	Securities Purchase Agreement dated as of August 15, 2001 by and among Storage Computer Corporation and the buyers named therein (incorporated by reference to Exhibit 10.1 to our Report on Form 8-K filed August 22, 2001).
10.2	Form of Demand Note (filed herewith).

B. Reports on Form 8-K

In our Report on Form 8-K filed August 22, 2001 we reported the completion of a $5,000,000 financing through a private placement of our Series E Convertible Preferred Stock to an existing institutional investor that is the holder of our Series C Convertible Preferred Stock.

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

/s/ PETER N. HOOD

Peter N. Hood
Chief Financial Officer

Date: November 16, 2001

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