NETWORK 1 SECURITY SOLUTIONS INC
Form 10KSB
September 25, 2003

U. S. Securities and Exchange Commission

WASHINGTON, D.C. 20549

FORM 10-KSB

[X] ANNUAL REPORT UNDER SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2002.

[X] TRANSITION REPORT UNDER SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from ____________ to ___________.

Commission File Number: 1-14896

NETWORK-1 SECURITY SOLUTIONS, INC.
(Name of small business issuer in its Charter)

DELAWARE (State or other jurisdiction of incorporation)	11-3027591 (IRS Employer Identification Number)

445 PARK AVENUE, SUITE 1028
NEW YORK, NEW YORK 10022
(Address of Principal Executive Offices)

Issuer's telephone number : (212) 829-5770

Securities registered under Section 12(b) of the Exchange Act:

Title of each class	Name of each exchange on which registered
Common Stock, $.01 par value	None

Securities registered under Section 12(g) of the Exchange Act:

None

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.
Yes [ ] No [X]

Check if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-B contained in this form, and no disclosure will be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB. [ ]

The issuer's revenues for its most recent fiscal year: $592,000.

The aggregate market value of the voting stock of the registrant held by non-affiliates computed by reference to the price at which the stock was sold on August 29, 2003 was approximately $337,218.

The number of shares of Common Stock outstanding as of August 31, 2003 was 8,314,458.

Transitional Small Business Disclosure Format (Check One): Yes [ ] No [X]

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PART I

THIS ANNUAL REPORT ON FORM 10-KSB CONTAINS CERTAIN STATEMENTS WHICH ARE FORWARD-LOOKING STATEMENTS WITHIN THE MEANING OF THE SAFE HARBOR PROVISIONS OF SECTION 27A OF THE SECURITIES ACT OF 1933, AS AMENDED, AND SECTION 21E OF THE SECURITIES EXCHANGE ACT OF 1934, AS AMENDED. ACTUAL RESULTS, EVENTS AND CIRCUMSTANCES (INCLUDING FUTURE PERFORMANCE, RESULTS AND TRENDS) COULD DIFFER MATERIALLY FROM THOSE SET FORTH IN SUCH STATEMENTS DUE TO VARIOUS RISKS AND UNCERTAINTIES, INCLUDING BUT NOT LIMITED TO, THOSE DISCUSSED IN THE SECTION ENTITLED "RISK FACTORS THAT MAY AFFECT FUTURE RESULTS" IN ITEM 1 OF THIS REPORT AS WELL AS THOSE RISKS DISCUSSED ELSEWHERE IN THIS REPORT.

ITEM 1. DESCRIPTION OF BUSINESS.

BACKGROUND

UNTIL DECEMBER 2002, NETWORK-1 SECURITY SOLUTIONS, INC. (THE "COMPANY") DEVELOPED, MARKETED AND LICENSED SECURITY SOFTWARE PRODUCTS DESIGNED TO PREVENT UNAUTHORIZED ACCESS TO INFORMATION RESIDING ON AN ENTERPRISE'S COMPUTERS. IN DECEMBER 2002, THE COMPANY DISCONTINUED OFFERING ITS SECURITY SOFTWARE PRODUCT LINE AS IT WAS UNABLE TO ACHIEVE SUFFICIENT PRODUCT REVENUE TO SUPPORT THE EXPENSES OF SUCH OPERATIONS. MANAGEMENT IS FOCUSING ITS EFFORTS ON SEEKING A MERGER CANDIDATE FOR THE COMPANY. IN MAY 2003, THE COMPANY COMPLETED THE SALE OF ITS CYBERWALLPLUS TECHNOLOGY AND RELATED INTELLECTUAL PROPERTY TO AN UNAFFILIATED THIRD PARTY FOR $415,000. PROVIDED BELOW IS A DESCRIPTION OF THE BUSINESS OF THE COMPANY DURING THE YEAR ENDED DECEMBER 31, 2002.

Network-1 Security Solutions Inc. (the "Company") developed, marketed, licensed and supported a suite of security software products designed to prevent unauthorized access to critical information residing on networked servers, desktops and laptops. The Company's CyberwallPLUS family of security software products combined the benefits of firewall and intrusion detection technology with central management features to provide an enterprise-class layer of security protection directly on servers, desktops, wireless and mobile computers (the "end-points"). The CyberwallPLUS family of security products competed in the emerging "end-point" security market.

CyberwallPLUS delivered intrusion prevention through its firewall and intrusion detection capabilities, a unique combination of technologies that actively detected and blocked intrusions. CyberwallPLUS interrogated incoming and outgoing traffic on the host servers, desktops and laptops by using stateful inspection and behavior-based intrusion detection. The packet-filtering firewall blocked unauthorized access to any of the 65,000 ports on a computer and prevents the computer from launching attacks of its own directed at other networked computers. The access controls and intrusion filters enabled security policy, which was optimized to the specific computer, and dramatically increased

the machine's ability to deflect attacks or potential compromise.

The Company was incorporated under the laws of the State of Delaware in July 1990. The Company's principal offices are located at 445 Park Avenue, Suite 2900, New York, New York 10022 and its telephone number is 212-829-5770.

THE NETWORK-1 SOLUTION

The CyberwallPLUS family of security software products represented the latest generation of our host-based security solution that integrated a powerful range of security techniques to actively detect and block intrusions thereby providing effective "end-point" security.

CyberwallPLUS combined the benefits of firewall and intrusion detection technology with central management features to provide an enterprise-class layer of robust security protection directly on Microsoft Windows-based servers, desktops, wireless and mobile computers. The Company's distributed intrusion prevention software was a bi-directional layer of defense that protected the network from the host machine, as well as protected the host machine from the network, regardless of whether the source of attack is inside or outside the organization. CyberwallPLUS also protected mobile and wireless computers even when they connected to networks outside the organization's control.

The Company's CyberwallPLUS family of host intrusion prevention products operated on Windows 9x, Windows NT, Windows 2000, and Windows XP operating system platforms. The CyberwallPLUS suite of products was first introduced in January 1999, evolving from the Company's FireWall/Plus suite of security software products and prior practice in security consulting and forensics.

The Company's applications address an organization's need for solutions that improve information security in today's Internet-enabled technology environments. Designed to reduce the total cost of ownership, the Company's solutions deployed without difficulty, offered local or remote centralized management features, integrated easily into existing management infrastructures, and complemented existing security investments.

The Company's solution started out by inhibiting intruders from even discovering computer assets with "stealth mode", a technique that gave the appearance that no system is present at a given IP address. Fine-grained access control, bi-directional protection and stateful packet inspection typically found in high-end perimeter firewalls combined with powerful intrusion detection and prevention capabilities to add a critical second layer of defense behind existing perimeter firewalls.

CyberwallPLUS's centralized policy management enabled detailed security policies to be formulated, distributed, and monitored, maximizing IT security resources. The logging features were designed to meet the requirements for legal forensic evidence as well as timely alerts. CyberwallPLUS coexisted or interoperated easily with many other security and management components, including virus checkers, enterprise monitoring systems, and enterprise VPNs.

PRODUCTS AND SERVICES

The Company maintained two classes of CyberwallPLUS products - host intrusion prevention solutions and network and perimeter firewall solutions - each with a corresponding central manager module.

HOST INTRUSION PREVENTION. The Company's host solutions controlled access to desktops, laptops, and servers. The Company released three revisions of CyberwallPLUS host products, culminating with the release of version 7.3 in July 2002. The product suite included:

> CYBERWALLPLUS FOR DESKTOPS AND LAPTOPS. CyberwallPLUS-WS ran on Windows 9x, Windows NT/2000, and Windows XP client systems and provided a necessary complement to mail-only antivirus scanners. The packet-filtering firewall blocked unauthorized access to any of the 65,000 ports on the end point (computer), and prevented that computer from launching any attacks of its own directed at other network resources. The combination of firewall and intrusion detection technology was comparable to robust perimeter security technology, but optimized for an end point computer. CyberwallPLUS-WS also ensured that a computer operates in stealth mode, making it invisible to scanning programs typically used by hackers to locate computers on the network. In addition, at the option of the network administrator, CyberwallPLUS-WS could have been operated in silent mode so that the computer user did not have access to the product and thus can not make any changes to its configuration.
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> CYBERWALLPLUS FOR SERVERS. The CYBERWALLPLUS-SV server edition was intended for all Microsoft application, database, or infrastructure servers to provide a layer of local self-defense against unauthorized access. Remote access to public servers such as Web servers, Microsoft Exchange Server mail servers, or even Intranet and database servers creates vulnerability in an organization's protection scheme. The access controls and intrusion filters enabled security policy which was optimized to the specific server, and dramatically increased its ability to deflect attacks or compromise.
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> CYBERWALLPLUS CENTRAL MANAGER. CYBERWALLPLUS-CM, a management application enabling control and monitoring of multiple CyberwallPLUS installations, responded to an organization's need to easily and centrally manage and maintain the Company's solution distributed across the corporate network. Complementing existing management environments, CyberwallPLUS offers local, remote, and centralized management; policy deployment and management; logging and reporting to existing management systems; and centralized license deployment and license inventory capabilities.

NETWORK AND PERIMETER FIREWALLS. The Company also offered a set of network and perimeter firewalls to complete a layered network defense strategy. The product suite included:

> CYBERWALLPLUS INTERNET PROTOCOL. Designed to protect a computer network from Internet attacks and intrusions, CYBERWALLPLUS-IP installed as either a transparent bridge or router on the network perimeter. CYBERWALLPLUS-IP, an ICSA (International Computer Security Association) certified product, thwarted malicious attacks originating on either side of the network through its advanced firewall and active intrusion detection/prevention capabilities. The network security software ran on Windows NT/2000 systems configured with two Ethernet interfaces and features an advanced packet filter engine that provided fine-grained network

access controls, sophisticated intrusion detection and prevention algorithms, and detailed traffic audit logs.

CYBERWALLPLUS MULTI-PROTOCOL. Ideally suited for internal network security, CYBERWALLPLUS-MP was a high-speed local area network (LAN) segment firewall controlling access between internal networks. It operated as a two-port Ethernet bridge and supports hundreds of IP and non-IP protocols. It provided network administrators with the network access controls and intrusion detection tools needed to secure multi-protocol Ethernet LANs from outside attacks.

Network-1's solutions contained the following features or attributes:

ADVANCED PACKET FILTERING SYSTEM. CyberwallPLUS provided both inbound and outbound packet filtering; passing traffic based on network access rules. These rules restricted packet flow, protecting the network and the systems connected to the network from unnecessary and potentially malicious traffic.

STATEFUL PACKET INSPECTION AND DYNAMIC PORT ALLOCATION. CyberwallPLUS examined packets to determine whether or not to pass the packet based on the state of the connection. Should the state of the connection be other than anticipated, CyberwallPLUS did not pass the packet to the destination because the packet was not considered stateful. Stateful inspection was also necessary for dynamic port allocation. With dynamic port allocation, certain protocols may request the one-time opening of a subsidiary connection on additional ports that are opened and closed when the application requires them, yet blocked when not in use. Through Stealth mode operation, CyberwallPLUS did not respond to requests on blocked ports, thus making it more difficult for attackers to "fingerprint" or detect the computer for attack, rather than responding to an unauthorized query with a "connection not allowed" message which would reveal the existence of the computer on the network.

SILENT MODE. Silent mode allowed the CyberwallPLUS product to operate without the local user interface present. In enterprise deployments, this gave central administrators control over configuration, policy, and monitoring of host systems without involving or disturbing the end user.

CENTRALIZED MANAGEMENT. Enterprise environments benefit from CyberwallPLUS's scalable creation of groups of individual hosts and the distribution of policies and licenses across a large number of machines. Multiple industry standard logging formats were supported to enhance the integration of CyberwallPLUS with existing enterprise management systems.

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CUSTOMIZED SECURITY POLICIES. Security policies could be customized for individual departments, and individual systems and personnel within the network. In addition, CyberwallPLUS allowed the creation and tailoring of templates to support custom applications, protocols, and non-standard port configurations.

EASE OF USE. CyberwallPLUS was designed to be easily installed, configured and managed by a network or system manager with minimal security skills through an intuitive user interface. To facilitate implementation, CyberwallPLUS came pre-programmed with a wide variety of frequently used default security policies (templates) which required the customer to simply select one of the rule sets and save the selection.

The Company's solutions were licensed on a per-machine basis, with licenses for individual systems, or license packs with volume price breaks for multiple systems, as well as site licenses, where applicable. The Company added to the

completeness of its solution by offering professional training, multi-year product maintenance agreements, and 5/10 technical support plans. Deployment services were offered through the Company's worldwide network of channel partners.

SALES, MARKETING AND DISTRIBUTION

In the U.S., the Company directly marketed its products through a field sales organization supported by inside sales representatives. The Company also indirectly markets its products through regional value-added resellers (VARs) who offer complementary technologies, including specialized government resellers, and national integrators who had a focus or practice in security. Internationally, the Company's network of regional/country resellers or distributors provided sales interface with prospective customers. In July 2002, the Company materially reduced its sales and marketing capacity as part of cost-cutting measures. See "Management's Discussion and Analysis" at page 15 hereof.

DIRECT SALES. The Company`s direct marketing efforts targeted medium and large-scale Microsoft Windows-centric enterprises with a large percentage of mobile or remote employees in financial services, healthcare, higher education, and government agencies or suppliers. The Company's sales professionals qualified, developed and pursued leads based on a variety of marketing awareness and lead generation programs, including event marketing, online advertising, and direct mail, as well as downloaded product trials from its corporate Web site. The first objective of the field sales staff was to develop end user opportunities through a combination of on-site and remote interactions with the prospect. The second objective of the field sales staff was to recruit, cultivate and support indirect channel partners.

During the first half of 2002, the Company continued to expand its international operations to address the rapid global adoption of distributed computing environments. Many foreign countries do not have laws recognizing network intrusion or misuse as a crime or the resources to enforce such laws if they do exist. As a consequence, the Company believed that organizations in such countries would have a greater need for effective security solutions. In the first quarter of 2002, the Company established its Asia Pacific operations which were headquartered in Shanghai, China. These operations

provided product development, sales, marketing and customer support in the Asia Pacific region. In September, 2002, the Company ceased its operations in China as part of significant cost-cutting measures.

INDIRECT SALES. The Company had relationships with national, regional and local resellers and systems integrators. In addition, the Company had relationships with international system integrators, VARs, resellers and distributors. The Company's agreements with resellers generally grant the right to market the Company's products in specified territories on a non-exclusive basis, were terminable on short notice and do not prohibit the reseller from selling products that were competitive with the Company's products.

FALCONSTOR LICENSE AND DISTRIBUTION AGREEMENT

Simultaneously with the closing of the Company's October 2001 private offering of $6,765,000 of securities (See "Management's Discussion and Analysis or Plan of Operation" at page 15 hereof), the Company entered into a ten (10) year License and Distribution with FalconStor, pursuant to which FalconStor had the right to distribute the Company's product offerings in its indirect and OEM channels. As part of the Agreement, FalconStor paid the Company a non-refundable

advance of $500,000 against future royalty payments. On May 30, 2003, as part of the Company's sale of its CyberwallPlus technology and related intellectual property to an unaffiliated third party, the Company assigned its rights under the FalconStor Agreement to the unaffiliated third party. (See "Management's Discussion and Analysis or Plan of Operations" at pages 15-16).

CUSTOMERS

The Company's customers represented a wide range of industries and institutions, both commercial and government, which considered networked-data resources to be among the most important assets within their organizations. During the year ended December 31, 2002 revenue from one customer accounted for 21% of the Company's revenues.

During the years ended December 31, 2002 and 2001, revenue from international customers (licenses and service to foreign end users and international distributors) accounted for 29% and 21% of our revenues, respectively.

COMPETITION

The market for host intrusion prevention solutions is characterized by intense competition and rapidly changing business conditions, customer requirements and technologies.

EXISTING COMPETITION. The Company viewed its competition in several classes as follows:

HOST INTRUSION PREVENTION FOR SERVER SYSTEMS RUNNING MICROSOFT WINDOWS NT/2000. The Company's principal competitors included operating system (OS) intercept vendors Entercept Security Technologies and Okena, Inc.; and host intrusion detection system (IDS) vendors Internet Security Systems, Inc., Enterasys Networks, Inc., Symantec Corporation and NFR Security, Inc. Since there is a

wide array of server operating systems, as well as the types of threats (operating system, application, network, file, etc.) that can exist, no one solution is used independently.

HOST INTRUSION PREVENTION FOR ENTERPRISE DESKTOPS/LAPTOPS RUNNING MICROSOFT WINDOWS 9X, WINDOWS NT/2000, OR WINDOWS XP. The Company competed primarily with personal firewall vendors, such as Internet Security Systems, Inc., Symantec Corporation, Zone Labs, Inc., InfoExpress, Inc. and Sygate Technologies, Inc.; VPN/Firewall vendors, such as Check Point Software Technologies Ltd. and InfoExpress, Inc.; and Host IDS vendors, such as Internet Security Systems, Inc.

NETWORK AND PERIMETER FIREWALL PRODUCTS. The Company's primary source of competition was Check Point Software Technologies Ltd., Symantec Corporation, NetScreen Corporation Inc., SonicWall, Inc., and WatchGuard Technologies, Inc.

Most of the Company's competitors had longer operating histories, greater name recognition, larger installed customer bases and possessed substantially greater financial, technical, marketing and other competitive resources than the Company. As a result, the Company's competitors were able to adapt more quickly to new or emerging technologies or attacks, changes in customer requirements and devote greater resources to the promotion and sale of their products than the

Company. While the Company believed that its CYBERWALLPLUS products did not compete against manufacturers of other categories of security products (such as encryption and authentication products), potential customers may have perceived the products of such other companies as substitutes for the Company's products.

PRODUCT RESEARCH AND DEVELOPMENT

The security software market is dynamic, characterized by rapid changes in technology and customer requirements, new product introductions and enhancements, and emerging industry standards. The Company's research and development department was responsible for the design, development and release of the Company's products, and was focused on the continuous evolution of the Company's products. Organized into development, quality assurance, and documentation disciplines, the research and development team worked closely with sales, marketing, and customer support in order to better understand market needs and user requirements.

A full time development team located at the Company's Waltham, Massachusetts headquarters had the primary responsibility for product development and technology direction, which was augmented by staff located at the Company's Shanghai, China operations center. Consultants were sometimes retained to address specific areas of expertise on a limited basis. Beginning in July 2002, the Company materially reduced its product development capacity as part of cost-cutting measures. (See "Management's Discussion and Analysis" at page 15 hereof).

During the years ended December 31, 2002 and 2001, the Company's total product development costs, including the costs capitalized after technological feasibility had been reached, were $1,599,000, and $2,209,000, respectively.

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CUSTOMER SERVICE AND SUPPORT

One-year maintenance subscriptions were typically sold with software licenses, and optional multi-year maintenance subscriptions were available thereafter. The Company provided customer technical support as a component of its annual maintenance subscriptions, which included phone, email, and Web-based support. The Company's telephone and email support services were available Monday through Friday between the hours of 8am and 6pm eastern standard time in the United States. In November 2002 the Company discontinued offering its annual support contracts and replaced it with a call based support service.

PROPRIETARY RIGHTS

The Company's success was substantially dependent on its proprietary technologies. The Company did not hold any patents and relied on copyright and trade secret laws, non-disclosure agreements with employees, consultants, distributors and customers, including "shrink wrap" license agreements that were not signed by the customer, and technical measures to protect the ideas, concepts and documentation of the Company's proprietary technologies and know-how. Such methods may not have afforded complete protection, and there can be no assurance that third-parties will not independently develop substantially equivalent or superior technologies or obtain access to the Company's technologies, ideas, concepts and documentation. In addition, confidentiality agreements between the Company and its employees, distributors or customers may not have provided meaningful protection for the Company's proprietary information in the event of any unauthorized use or disclosure.

On June 19, 2001, the Company was issued a U.S. trademark registration (Reg. No. 2,462,262) for the mark CyberwallPlus for computer products. Although

the Company is not aware of any challenges to our rights to use this trademark, there can be no assurance that the use of this mark would be upheld if challenged.

Although the Company believed that its technologies and products had been developed independently and did not infringe upon the proprietary rights of others, there can be no assurance that the Company's technologies and products in fact did not infringe. The Company is not aware of any patent infringement charge or any violation of other proprietary rights claimed by any third party relating to the Company or its products.

EMPLOYEES AND CONSULTANTS

As of August 31, 2003, the Company had two employees and one consultant.

RISK FACTORS THAT MAY AFFECT FUTURE RESULTS

The Company operates in a highly competitive environment that involves a number of risks, some of which are beyond the Company's control. The following discussion highlights the most material of the risks.

WE HAVE A HISTORY OF LOSSES, NO REVENUE FROM OPERATIONS AND WE MAY NOT BE ABLE TO CONTINUE OUR OPERATIONS IN THE FUTURE.

We have incurred substantial operating losses since our inception, which has resulted in an accumulated deficit of $40,422,000 as of December 31, 2002. For the years ended December 31, 2002 and 2001, we incurred net losses of $5,905,000 and $8,035,000, respectively. Since December 31, 2002, we have continued to incur operating losses. We have financed our operations primarily through the sales of equity and convertible debt securities as well as the sale of our professional services business in February 2000. In December 2002, we discontinued our offering of security software products and thus we currently have no revenue from operations. While we have significantly reduced our expenses in order to preserve cash for a merger transaction, we may not have sufficient funds to continue our operations if we are unable to complete a merger on a timely basis.

WE COULD BE REQUIRED TO STOP OPERATIONS IF WE ARE UNABLE TO COMPLETE A MERGER.

We anticipate, based on our currently proposed plans and assumptions (including the timetable of, costs and expenses associated with our continued operations), that our current cash position will more likely than not be sufficient to satisfy our operations and capital requirements through at least September 2004. There can be no assurance, however, that such funds will not be expended prior thereto. In the event our plans change, or our assumptions change or prove to be inaccurate (due to unanticipated expenses, difficulties, delays or otherwise), we could have insufficient funds to support our operations prior to September 2004. We are currently actively seeking merger candidates, however we do not have a definitive agreement with respect to any merger transaction. Our inability to consummate a merger transaction on a timely basis would have a material adverse effect on our operations, requiring us to possibly cease operations. In addition, even if we consummate a merger, we still may not have sufficient cash to support our new business operations or achieve material revenues or profitability.

A MERGER TRANSACTION IS LIKELY TO INVOLVE SUBSTANTIAL DILUTION TO OUR EXISTING STOCKHOLDERS.

In the event that we are able to consummate a merger transaction, any such transaction is likely to involve substantial dilution to our existing stockholders.

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

Barry Rubenstein, Wheatley Partners II, L.P. and other affiliated and related entities and parties (the "Wheatley Parties") currently own 32% of our outstanding voting stock (exclusive of any securities owned by FalconStor). In addition, FalconStor currently owns 15.9% of our outstanding voting stock. Barry Rubenstein owns 15.2% of the outstanding

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voting securities of FalconStor and other Wheatley Parties own an additional 10% of the outstanding voting securities of FalconStor. Accordingly, Barry Rubenstein and the Wheatley Parties together with FalconStor currently own 47.9% of our outstanding voting securities (and beneficially own options and warrants to purchase an additional 30.1% of our outstanding voting securities) and as a result of their aggregate holdings would have the ability to control the outcome of all matters submitted to a vote of our stockholders including the election of directors, amendments to our Certificate of Incorporation and approval of mergers and a sale of substantially all of our assets. Such consolidation of voting power could also have the effect of delaying, deterring or preventing a change in control of our company that might be beneficial to other stockholders.

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

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

WORLD INSTABILITY - TERRORISM.

The terrorist attacks on September 11, 2001 in the United States and the declaration of war by the United States against terrorism has created significant instability and uncertainty in the world which may continue to have a material adverse effect on world financial markets, including financial markets in the United States. In addition, such adverse political events may have an adverse impact on economic conditions in the United States. Unfavorable economic conditions in the United States may have an adverse effect on our company including, but not limited to, our ability to consummate a merger transaction.

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

STOCKS.

On March 26, 2003 our common stock was delisted from The Nasdaq Stock Market's SmallCap Market. As a result of the delisting, an investor could find it more difficult to dispose of or to obtain accurate quotations as to the market value of our common stock. Our common stock currently trades on the over-the-counter market in the "pink sheets."

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In addition, since our common stock has been delisted from trading on Nasdaq and the trading price of our common stock is below $5.00 per share, our common stock is considered a penny stock. SEC regulations generally define a penny stock to be an equity security that is not listed on Nasdaq or a national securities exchange and that has a market value of less than $5.00 per share, subject to certain exceptions. The SEC regulations would require broker-dealers to deliver to a purchaser of our common stock a disclosure schedule explaining the penny stock market and the risks associated with it. Various sales practice requirements are also imposed on broker-dealers who sell penny stocks to persons other than established customers and accredited investors (generally institutions). Broker-dealers must also provide the customer with current bid and offer quotations for the penny stock, the compensation of the broker-dealer and monthly account statements disclosing recent price information for the penny stock held in the customer's account. As a result of the delisting of our Common Stock from Nasdaq, investors may find it more difficult to obtain timely and accurate quotes and execute trades in our common stock.

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

As of August 31, 2003, there are outstanding (i) options and warrants to purchase an aggregate of 10,971,182 shares of our common stock at exercise prices ranging from $.13 to $10.125, (ii) 2,714,562 shares of convertible preferred stock which are convertible at any time into 5,358,494 shares of our common stock and (iii) 2,499,130 additional shares of our common stock which may be issued in the future under our stock option plan. To the extent that outstanding options and warrants are exercised or preferred stock is converted, your percentage ownership will be diluted and any sales in the public market of the common stock underlying such options, warrants or convertible debt may adversely affect prevailing market prices for our common stock.

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

Our Board of Directors has the authority, without further action by the stockholders, to issue 10,000,000 shares of preferred stock (of which only 231,054 shares of Series D Preferred Stock are outstanding and 2,483,508 shares of Series E Preferred Stock are outstanding) on such terms and with such rights, preferences and designations as our Board of Directors may determine. Such terms may include restricting dividends on our common stock, dilution of the voting power of our common stock or impairing the liquidation rights of the holders of our common stock. Issuance of such preferred stock, depending on the rights, preferences and designations thereof, may have the effect of delaying, deterring or preventing a change in control. In addition, certain "anti-takeover" provisions in Delaware law may restrict the ability of our stockholders to authorize a merger, business combination or change of control.

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ITEM 2. DESCRIPTION OF PROPERTY

The Company currently occupies approximately 300 square feet of office space in New York City at a cost of $2,700 per month.

ITEM 3. LEGAL PROCEEDINGS

In January 2003, Richard J. Kosinski, former Chief Executive Officer, President and a director, and Murray P. Fish, former Chief Financial Officer and a director, commenced lawsuits against the Company in the Commonwealth of Massachusetts, County of Essex, Superior Court, seeking severance and bonus compensation and other benefits allegedly due them in the aggregate amount of $400,000. Messrs. Kosinski and Fish also moved for an order of attachment, temporary restraining order and preliminary injunction to prevent the Company from transferring an aggregate of $400,000 of its funds pending the outcome of the lawsuits. In February 2003, the Court denied plaintiffs' motions.

In June 2003, the Company entered into a settlement agreement with Mr. Kosinski pursuant to which the Company paid Mr. Kosinski the sum of $127,000 in full settlement of all claims asserted by him in the litigation. In addition, as part of the settlement, Mr. Kosinski agreed to forfeit options to purchase 1,200,000 shares of the Company's Common Stock.

The Company intends to vigorously defend the lawsuit by Mr. Fish seeking $200,000 in severance, bonus and other benefits allegedly due him and believes it has meritorious defenses to the claims asserted.

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

None

PART II

ITEM 5. MARKET FOR COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

MARKET INFORMATION. The Company's Common Stock had traded from November 12, 1998 until March 26, 2003 on the NASDAQ SmallCap Market under the symbol "NSSI." The Company's Common Stock currently trades on the over-the-counter market in the "Pink Sheets". The following table sets forth, for the periods indicated, the range of the high and low closing bid prices for the Common Stock as reported on NASDAQ. Such prices reflect inter-dealer quotations, without retail mark-up, mark-down or commission and may not necessarily represent actual transactions.

YEAR ENDED DECEMBER 31, 2002	HIGH	LOW
Fourth Quarter	$0.56	$0.13
Third Quarter	$0.93	$0.50
Second Quarter	$1.38	$0.62
First Quarter	$2.23	$1.26

YEAR ENDED DECEMBER 31, 2001	HIGH	LOW
Fourth Quarter	$2.26	$1.10
Third Quarter	$1.40	$0.43
Second Quarter	$2.16	$0.91
First Quarter	$4.38	$1.34

On August 29, 2003, the last sale price for the Common Stock as reported on the Pink Sheets was $.05 per share. The number of record holders of the Company's Common Stock was 61 as of July 25, 2003. The Company believes that there are in excess of 1,500 beneficial owners of its Common Stock.

DIVIDEND POLICY. The Company has never declared or paid any cash dividends on its Common Stock and does not intend to declare or pay cash or other dividends in the foreseeable future. The Board of Directors currently expects to retain any future earnings, if any, for use in the operation and expansion of its business. The declaration and payment of any future dividends will be at the discretion of the Board of Directors and will depend upon a variety of factors, including future earnings, if any, operations, capital requirements, the general financial condition of the Company, the preferences of any series of Preferred Stock, the general business conditions and future contractual restrictions on payment of dividends, if any.

RECENT ISSUANCES OF UNREGISTERED SECURITIES. None.

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EQUITY COMPENSATION PLAN INFORMATION

The following table summarizes share and exercise price information about the Company's equity compensation plans as of December 31, 2002.

	NUMBER OF SECURITIES TO BE ISSUED UPON EXERCISE OF OUTSTANDING OPTIONS, WARRANTS AND RIGHTS (A)	WEIGHTED-AVERAGE EXERCISE PRICE OF OUTSTANDING OPTIONS, WARRANTS AND RIGHTS	A
Equity compensation plans approved by security holders	3,154,498	$2.25	
Equity compensation plans not approved by security holders	0	--	
Total	3,154,498	$2.25	

ITEM 6. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

THE FOLLOWING DISCUSSION AND ANALYSIS SHOULD BE READ IN CONJUNCTION WITH THE COMPANY'S FINANCIAL STATEMENTS, INCLUDING THE NOTES THERETO, INCLUDED ELSEWHERE IN THIS FORM 10-KSB. EXCEPT FOR THE HISTORICAL INFORMATION CONTAINED HEREIN, THIS DISCUSSION CONTAINS FORWARD-LOOKING STATEMENTS THAT INVOLVE RISKS AND UNCERTAINTIES, INCLUDING, BUT NOT LIMITED TO, THOSE DISCUSSED IN THE SECTION ABOVE ENTITLED "RISK FACTORS WHICH MAY AFFECT FUTURE RESULTS" IN ITEM 1 OF THIS REPORT AS WELL AS THOSE RISKS DISCUSSED IN THIS SECTION AND ELSEWHERE IN THIS REPORT. BECAUSE SUCH STATEMENTS INVOLVE RISKS AND UNCERTAINTIES, ACTUAL RESULTS MAY DIFFER MATERIALLY FROM THOSE EXPRESSED OR IMPLIED BY SUCH FORWARD-LOOKING STATEMENTS.

OVERVIEW

Until December 2002, the Company continued to license and support a suite of security software products designed to prevent unauthorized access to critical information residing on networked servers, desktops and laptops. In December 2002, the Company discontinued its products offerings, as operating expenses continued to exceed product revenues, in order to preserve cash as the Company seeks a merger transaction. Accordingly, the Company currently has no revenue from operations and does not anticipate revenue until completion of a merger transaction. In May 2003, the Company completed the sale of its CyberwallPlus technology and related intellectual property to a

foreign corporation for an aggregate consideration of $415,000. As a part of this sale, the Company also assigned its rights under the Distribution and License Agreement with FalconStor (as described below).

To date the Company has incurred significant losses and, at December 31, 2002, had an accumulated deficit of $(40,422,000). During the third and fourth quarters of 2002, the Company instituted certain measures to preserve cash including substantial reductions in employees and the closing of its China development office and Taiwan sales office. Beginning in July 2002, the Company in a series of layoffs reduced its employees from 39 to its current level of 2 employees. At July 31, 2003, the Company had approximately $1,500,000 of cash and cash equivalents. (See "Liquidity and Capital Resources" at page 18 hereof). Although the Company is actively seeking a merger transaction, the Company may not be able to consummate a merger transaction. In addition, in the event the Company consummates a merger transaction, there is no assurance that it will be successful. In addition, a merger transaction is likely to involve substantial dilution in the interests of the Company's then existing stockholders. In connection with a merger transaction, the Company may seek financing from third parties and/or existing stockholders.

On October 2, 2001, the Company completed a $6,765,000 private offering of Series E Preferred Stock and Warrants pursuant to a Securities Purchase Agreement with investors (the "2001 Financing"). In accordance with the Securities Purchase Agreement, an aggregate of 3,191,037 shares of Series E Preferred Stock were sold to investors at a price of $2.12 per share together with warrants to purchase 6,882,074 shares of Common Stock at an exercise price of $1.27 per share. Such warrants expire on October 2, 2003. Each share of Series E Preferred Stock is convertible into two (2) shares of Common Stock, subject to adjustment. As the largest investor ($2,300,000) in the Financing, FalconStor Software, Inc. ("FalconStor"), a storage networking infrastructure software company, received an additional warrant to purchase 500,000 shares of the Company's Common Stock (the "Additional Warrant"). Simultaneously with the closing of the Financing, the Company and FalconStor entered into a ten year Distribution and License Agreement (the "FalconStor Agreement") pursuant to which FalconStor had the right to distribute the Company's product offerings in its indirect and OEM channels. As part of the Distribution and License Agreement, FalconStor paid the Company a non-refundable advance of $500,000 against future royalty payments of which, in accordance with accounting principles generally accepted in the United States of America, $350,000 has been accounted for as the purchase price of the Additional Warrant and this resulted in total proceeds allocated to the 2001 Financing of $7,115,000. The balance of deferred revenue related to this agreement at December 31, 2002 is $130,000. In May 2003, as part of the Company's sale of its CyberwallPlus technology to a foreign corporation, the Company assigned its rights under the FalconStor Agreement.

The Company had committed significant product and development resources to its CyberwallPLUS family of products. The Company capitalizes and amortizes software development costs in accordance with Statement of Financial Accounting

Standards No. 86. These costs consist of salaries, consulting fees and applicable overhead. The Company upon reviewing the valuation in accordance with Financial Accounting Standards no. 144, "Accounting for the Impairment or Disposal of Long-lived Assets", has written-off the remaining unamortized value of the capitalized software of $401,000 during the year ended December 31, 2002.

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CRITICAL ACCOUNTING POLICIES:

Revenue recognition:

License revenue is recognized upon delivery of software or delivery of a required software key. License revenue from distributors or resellers is recognized as the distributor or reseller delivers software or the required software key to end users or original equipment manufacturers. Service revenues consist of maintenance and training services. Annual renewable maintenance fees are a separate component of each contract, and are recognized ratably over the contract term. Training revenues are recognized as such services are performed. Revenue from advance license fees are deferred until they are earned pursuant to the agreements.

Software development costs:

Costs to maintain developed programs and development costs incurred to establish the technological feasibility of computer software are expensed as incurred. The Company capitalized costs incurred in producing computer software after technological feasibility of the software has been established through the date that the software is ready for general release to customers. Such costs are amortized based on current and estimated future revenue of each product with an annual minimum equal to the straight-line amortization over the remaining estimated economic life of the product. The Company estimates the economic life of its software to be three years. At each balance sheet date, the unamortized capitalized software costs of each product are compared with the estimated net realizable value of that product and any excess capitalized costs are written off.

Impairment of long-lived assets:

In accordance with Statement of Financial Accounting Standards ("SFAS") No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets", the Company records impairment losses on long-lived assets used in operations or expected to be disposed of when indicators of impairment exist and the cash flows expected to be derived from those assets are less than carrying amounts of those assets. During the year ended December 31, 2002, the Company recorded an impairment charge related to its network security software of approximately $401,000, which has been included in amortization of software development costs. Subsequently, in May 2003, the Company sold its network security software (see Note L[4]). The Company also reduced the carrying value of its fixed assets to their net realizable amount (see Note C).

Use of estimates:

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS:

In May 2002, the Financial Accounting Standards Board ("FASB") issued SFAS No. 145, "Recession of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections." SFAS No. 145 rescinds the requirement that all gains and losses from extinguishment of debt be classified as an extraordinary item. Additionally, SFAS No. 145 requires that certain lease modifications that have economic effects similar to sale-lease back transactions be accounted for in the same manner as sale-lease back transactions. This statement is effective for the Company beginning in 2003. Management has not yet determined what impact the adoption of SFAS No. 145 will have on the Company's financial statements.

In June 2002, the FASB issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities," which addresses financial accounting and reporting for costs associated with exit or disposal activities and supersedes Emerging Issues Tax Force ("EITF") Issue 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity" (including "Certain Costs Incurred in a Restructuring"). SFAS No. 146 requires that a liability for a cost associated with an exit or disposal activity be recognized when the liability is incurred. Under EITF Issue 94-3, a liability for an exit cost as defined in EITF Issue 94-3 was recognized at the date of an entity's commitment to an exit plan. SFAS No. 146 also establishes that the liability should initially be measured and recorded at fair value. SFAS No. 146 is effective for exit and disposal activities initiated after December 31, 2002. Management is currently evaluating the provisions of SFAS No. 146 but expects that it will not have a material impact on the Company's results of operations and financial position upon adoption.

In December 2002, the FASB issued SFAS No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure." This statement amends SFAS No. 123, "Accounting for Stock-Based Compensation," to provide alternative methods of transition for an entity that changes to the fair value method of accounting for stock-based employee compensation. In addition, SFAS No. 148 amends the disclosure provisions of SFAS No. 123 to require expanded and more prominent disclosures in annual financial statements about the method of accounting for stock-based compensation and the pro forma effect on reported results of applying the fair value method for entities that use the intrinsic value method. The pro forma disclosures are also required to be displayed prominently in interim financial statements. The Company does not intend to change to the fair value method of accounting and has included the disclosure requirements of SFAS No. 148 in the accompanying financial statements.

SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity", which was issued in May 2003, will require redeemable preferred stock to be classified, in certain circumstances, as a liability, upon adoption by a public company at the beginning of the first interim period beginning after June 15, 2003. SFAS No. 150 provides that mandatorily redeemable preferred stock should be classified as a liability if it embodies an unconditional obligation requiring the issuer to redeem the shares by transferring its assets at a specified or determinable date or upon an event certain to occur. Management believes that the provisions of SFAS No. 150 will not have a material impact on the Company's results of operations and financial position upon adoption.

In November 2002, the FASB issued Interpretation No. 45, "Guarantor's

Accounting and Disclosures Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others" ("FIN 45"). FIN 45 requires that upon issuance of a guarantee, the guarantor must recognize a liability for the fair value of the obligation it assumes under that guarantee. FIN 45 is effective on a prospective basis to guarantees issued or modified after December 15, 2002, but has certain disclosure requirements effective for financial statements of interim or annual periods ending after December 15, 2002. The Company does not currently have any guarantees. The Company does not anticipate that the adoption of the disclosure requirements of FIN 45 will have a material effect on its financial position or results of operations.

RESULTS OF OPERATIONS

YEAR ENDED DECEMBER 31, 2002 COMPARED TO YEAR ENDED DECEMBER 31, 2001.

Revenues decreased by $454,000 or 43%, from $1,046,000 for the year ended December 31, 2001 ("2001") to $592,000 for the year ended December 31, 2002 ("2002"). License revenues decreased by $435,000 or 54%, from $809,000 for 2001 to $374,000 for 2002, primarily due to material reductions in sales and marketing expenditures as well as material reductions in personnel in sales, marketing and product development. Service revenues from maintenance and training decreased by $19,000 or 9% from $237,000 in 2001 to $218,000 in 2002 resulting from decreased sales of the Company's software products and expiration of licenses from sales generated in earlier periods. The Company's revenues from customers in the United States represented 71% of its revenues in 2002 and 79% of its revenues in 2001.

Cost of revenues consists of amortization of software development costs, cost of licenses and cost of services. Cost of revenues increased $296,000 or 49%, from $607,000 for 2001 to $903,000 for 2002, representing 58% and 153% of revenues, respectively. The increase in cost of revenues was primarily due to increase of amortization of software development costs offset by reduction in cost of services. Amortization of software development costs increased by $364,000 or 97% from $377,000 for 2001 to $741,000 for 2002. The amortization of software development costs includes the write-off of the unamortized balance of capitalized software costs of $401,000 during 2002.

Cost of licenses consists of software media (disks) documentation, product packaging, production costs and product royalties. Cost of licenses decreased $15,000 or 50%, from $30,000 for 2001 to $15,000 for 2002, representing 4% of license revenues for both years. The decrease in the cost of licenses resulted primarily from material reduction in sales of software to end users.

Cost of services consists of salaries, benefits and overhead associated with the technical support of maintenance contracts. Cost of services decreased by $53,000 or 27%, from $200,000 for 2001 to $147,000 for 2002 primarily due to the reduction of service personnel.

The gross profit decreased by $750,000 or 171%, from gross profit of $439,000 for 2001, representing 42% of revenues, to gross loss of $(311,000) for 2002. The decrease

in gross profit was primarily due to a material decrease in sales of software products along with a material increase in cost of revenues as described above.

Product development costs consists of salaries, benefits, bonuses, travel and related costs of the Company's product development personnel, including consulting fees, the costs of computer equipment used in product and technology development. Product development expenses decreased by $610,000 or 28%, from

$2,209,000 for 2001 to $1,599,000 for 2002, representing 211% and 270% of revenues, respectively. The decrease in product development costs was due primarily to reduction of product development efforts, including layoffs and office closings and decreased use of outside consultants. During 2001 and 2002, the Company capitalized $313,000 and $180,000, respectively, of additional software development costs associated with the development and enhancement of its CYBERWALLPLUS family of products.

Sales and marketing expenses consist primarily of salaries, including commissions, benefits, bonuses, travel, advertising, public relations, consultants and trade shows. Sales and marketing expenses decreased by $820,000 or 31%, from $2,651,000 for 2001 to $1,831,000 for 2002, representing 253% and 309% of revenues, respectively. The decrease in sales and marketing expenses was due primarily to a decrease of $608,000 in personnel and commission costs related to the substantial head count reduction in 2002 and a $1,831,000 reduction in advertising and trade shows of $238,000.

General and administrative expenses include employee costs, including salary, benefits, travel and other related expenses associated with management, finance and accounting operations, and legal and other professional services provided to the Company. General and administrative expenses decreased by $39,000 or 2%, from $2,268,000 for 2001 to $2,229,000 for 2002, representing 217% and 376% of revenues for 2001 and 2002, respectively. The decrease in general and administrative expenses in dollar amount was due primarily to an increase of $261,000 in professional fees including accounting, legal and business consulting which was partially offset by a decrease in personnel costs. The increase in general and administrative expense as a percent of revenue was due primarily to the material reduction in Company revenues for 2002.

Interest income decreased by $74,000 or 53% from $139,000 in 2001 to $65,000 in 2002 primarily due to the increased funds used for operations and decreased funds invested in short term instruments.

The discontinued operations were sold on February 9, 2000 to Exodus Communications. The gain from discontinued operations in 2001 of $714,000 was attributed to the contingent payouts received offset by related contingent expenses pertaining to the sale paid in 2001.

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

As a result of the foregoing, the net loss decreased by $2,130,000 or 27%, from $8,035,000 for 2001 to $5,905,000 for 2002. The net loss for 2001 includes a $2,163,000 charge for the beneficial conversion feature of the Company's Series E Preferred Stock.

LIQUIDITY AND CAPITAL RESOURCES

As a result of discontinuing its product offerings in December 2002, the Company has no revenue from operations. At December 31, 2002, the Company had $2,029,000 of cash and cash equivalents and working capital of $1,110,000. The Company has financed its operations primarily through sales of equity and debt securities, and the sale of its professional services group. Net cash used in operating activities was $4,947,000 during 2001 and $4,927,000 during 2002. Net cash used in operating activities for 2002 was primarily attributable to the net loss of $5,905,000, partially offset by the non-cash expense of $55,000 attributable to the issuance of options, depreciation and amortization expense

of $1,154,000 (which includes $661,000 for the write-off of capitalized software costs and equipment and fixtures) offset in part by an increase in accounts payable, accrued expenses and other current liabilities of $277,000. In May 2003, the Company received $415,000 from the sale of its CyberwallPlus technology and related intellectual property.

The Company's operating activities during 2002 were financed primarily with the funds raised in the 2001 Financing of $6,765,000. The Company does not currently have a line of credit from a commercial bank or other institution.

The Company anticipates, based on currently proposed plans and assumptions, that its cash balance of approximately $1,500,000 as of July 31, 2003 will be sufficient to satisfy the Company's limited operations and capital requirements until at least September 2004. There can be no assurance, however, that such funds will not be expended prior thereto. In the event the Company's plans change, or its assumptions change, or prove to be inaccurate (due to unanticipated expenses, difficulties, delays or otherwise), the Company may have insufficient funds to support its operations prior to September 2004. In the third and fourth quarters of 2002, the Company instituted certain measures to reduce its overhead including decreasing its headcount from 39 employees to its current level of two employees and one consultant and the closing of its China development office and its Taiwan sales office. In December 2002 the Company discontinued its product offering in order to preserve cash as the Company continues to seek a merger transaction. In May 2003, the Company completed the sale of its CyberwallPlus technology and related intellectual property for an aggregate consideration of $415,000. The Company is actively engaged in seeking merger candidates. There is, however, no assurance that the Company will consummate a merger transaction, or that any such merger will be successful. The inability of the Company to consummate a merger transaction would have a material adverse effect on the Company. In addition, a merger transaction is likely to involve substantial dilution to the interests of the Company's existing stockholders.

ITEM 7. FINANCIAL STATEMENTS

The financial statements required hereby are located on pages F-1 through F-22 which follow Part III.

ITEM 8. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE.

None.

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PART III

ITEM 9. DIRECTORS, EXECUTIVE OFFICERS, PROMOTERS, AND CONTROL PERSONS; COMPLIANCE WITH SECTION 16(A) OF THE EXCHANGE ACT.

NAME	AGE	POSITION
Edward James	55	Interim Chief Executive Officer, Chief Financial Officer and Director
Corey M. Horowitz	48	Chairman of the Board of Directors and Secretary
Harry B. Schessel	39	Director

EDWARD JAMES, age 55, has served as Interim Chief Executive Officer and Chief Financial Officer of the Company since January 2003. In December 2002, Mr. James became a director of the Company. During the period February 2002 until January 2003, Mr. James was a financial consultant to the Company. Since 1993, he has been an independent financial consultant for various companies, venture capital firms and investors. Mr. James serves as interim Chief Executive Officer and Chief Financial Officer of the Company on a part-time basis as he continues to serve as a financial consultant to other companies and individuals.

COREY M. HOROWITZ, AGE 48, became Chairman of the Board of Directors of the Company in January 1996 and has been a member of the Board of Directors since April 1994. In January 2003, Mr. Horowitz also became Secretary of the Company. Mr. Horowitz is a private investor and President and sole shareholder of CMH Capital Management Corp., a New York investment advisory and merchant banking firm, which he founded in September 1991. From January 1986 to February 1991, Mr. Horowitz was a general partner in charge of mergers and acquisitions at Plaza Securities Co., a New York investment partnership.

HARRY B. SCHESSEL, age 38, has been a director of the Company since July 2001. Since July 2002, Mr. Schessel has been a real estate developer. From July 2001 until July 2002, Mr. Schessel was employed at Kroll, Inc. ("Kroll") as the Global Practice Leader for the Information Security Group. From June 2000 to July 2001, Mr. Schessel advised security companies, including Kroll, in the areas of strategy, operations, marketing and business development and also as a consultant to investment banking firms and venture capital firms for purposes of evaluating investments in the information security industry. From March 2000 until June 2000, Mr. Schessel was Vice President of Cybersafe, Inc., a security software company. In June 1997, Mr. Schessel co-founded Centrax, Inc., a company engaged in the development and marketing of intrusion detection software, and was employed from June 1997 until its sale in March 1999 in various capacities, including Chief Operating Officer and Executive Vice President.

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MEETINGS AND COMMITTEES OF THE BOARD OF DIRECTORS

In August 1998, the Board of Directors established an Audit Committee and a Compensation Committee. During 2002 the Audit Committee consisted of Harry Schessel and Emanuel Pearlman, until Mr. Pearlman's resignation as a Director in December 2002. Harry Schessel is currently the sole member of the Audit Committee. The Audit Committee meets with the Company's independent auditors at least annually to review the scope and results of the annual audit; reviews with the Company's independent auditors the Company's quarterly reports on Form 10-QSB prior to filing, recommends to the Board the independent auditors to be retained; and receives and considers the auditors' comments as to internal controls, accounting staff and management performance and procedures in connection with audit and financial controls. The Audit Committee has adopted a written Audit Committee Charter. Emanuel Pearlman and Jonathan Mark served as members of the Compensation Committee during 2002 until their resignations as directors in December 2002. The Compensation Committee is also currently composed of Harry Schessel. The Compensation Committee is responsible for determining compensation for the executive officers of the Company, including bonuses and benefits, and administration of the Company's compensation programs, including the Company's Stock Option Plan.

The Board of Directors does not have a nominating committee. The selection of nominees for the Board of Directors is made by the entire Board of Directors. The Board of Directors may from time to time establish other committees to facilitate the management of the Company.

During the past fiscal year, the Company's Board of Directors held 12 meetings. The Board of Directors' Compensation Committee met 6 times during the past fiscal year. The Audit Committee met 5 times during the past fiscal year. No incumbent director failed to participate in at least 75% of all meetings of the Board of Directors and the committees on which he served during the past fiscal year.

LIMITATION ON LIABILITY AND INDEMNIFICATION MATTERS

The Company's Certificate of Incorporation limits the liability of directors to the maximum extent permitted by Delaware law. Delaware law provides that directors of a corporation will not be personally liable for monetary damages for breach of their fiduciary duties as directors, except for liability (i) for any breach of their duty of loyalty to the corporation or its stockholders, (ii) for acts or omissions not in good faith or that involve intentional misconduct or a knowing violation of law, (iii) for unlawful payments of dividends or unlawful stock repurchases or redemptions as provided in Section 174 of the Delaware General Corporation Law or (iv) for any transaction from which the director derived an improper personal benefit. The Company's Bylaws provide that the Company shall indemnify its directors, officers, employees and agents to the fullest extent permitted by law. The Company's Bylaws also permit the Company to secure insurance on behalf of any officer, director, employee or other agent for any liability arising out of his or her actions in such capacity. The Company currently maintains liability insurance for its officers and directors. At present, there is no pending material litigation or proceeding involving any director, officer, employee or agent of the Company where indemnification will be required or permitted. The Company is not aware of any threatened litigation or proceeding that might result in a material claim for such indemnification.

DIRECTOR COMPENSATION

The Company has compensated each director, who is not also an employee of the Company, by granting to each outside director (upon joining the Board) stock options to purchase 20,000 shares of Common Stock, at an exercise price equal to the closing price of the Common Stock on the date of grant, with the options vesting over a one year period in equal quarterly amounts. In addition, each non-employee director receives an option grant to purchase 5,000 shares of Common Stock for each year of service (after the first year) as a member of the Board of Directors. Such options vest over a one year period in equal quarterly amounts. In addition to the aforementioned option grants, directors may be granted additional options in the discretion of the Board of Directors and the Compensation Committee. In this regard, in January 2003 Harry Schessel and Edward James each received options to purchase 55,000 and 30,000 shares of Common Stock, respectively, at an exercise price of $.14 per share.

SECTION 16(A) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE

Section 16(a) of the Exchange Act requires the Company's executive officers, directors, and persons who own more than 10% of the Company's outstanding Common Stock to file initial reports of ownership and changes in ownership with the Securities and Exchange Commission. Officers, directors and greater than 10% stockholders are required by Commission regulations to furnish the Company with copies of all Section 16(a) forms they file. The Company believes that its executive officers, directors, and greater than 10% stockholders complied during the year ended December 31, 2002 with the reporting requirements of Section 16(a) except that Bradford Winkler, former Vice President of Sales, inadvertently made a late Form 3 filing with the SEC on May 22, 2002 with respect to becoming an executive officer of the Company and

receipt of an option to purchase 200,000 shares of Common Stock. Mr. Winkler's Form 3 filing was due on May 9, 2002.

ITEM 9A. CONTROLS AND PROCEDURES

Based on their evaluation, as of a date within 90 days of the filing of this Form 10-KSB, the Company's Chief Executive Officer and Chief Financial Officer have concluded that the Company's disclosure controls and procedures (as defined in Rules 13a-14 and 15d-14 under the Securities Exchange Act of 1934) are effective. There have been no significant changes in internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

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ITEM 10. EXECUTIVE COMPENSATION

The following table summarizes compensation, for the fiscal years indicated, awarded to, earned by or paid to the Company's Chief Executive Officer ("CEO") and to each of its executive officers, (collectively, the "Named Executive Officers") who received annual salary and bonus in excess of $100,000 for the year ended December 31, 2002 for services rendered in all capacities to the Company.

SUMMARY COMPENSATION TABLE

		ANNUAL COMPENSATION		
NAME AND PRINCIPAL POSITION	YEAR ENDED DECEMBER 31	SALARY ($)	BONUS ($)	OTHER ANNUAL COMPENSATION(1)
Richard J. Kosinski	2002	$162,161(2)	--	--
President and Chief	2001	--	--	--
Executive Officer	2000	--	--	--
Murray P. Fish	2002	$193,000(3)	--	--
President	2001	$169,356	$62,613	--
Chief Financial Officer	2000	$138,461	$17,713	--
and Secretary				
Joseph A. Donohue	2002	$150,000(4)	--	$2885
Vice President of	2001	$150,000	$21,488	--
Engineering	2000	$138,462	$16,588	--
Alex Chen	2002	$188,215(5)	--	--
Vice President and General	2001	--	--	--
Manager Asia Pacific Operations	2000	--	--	--

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(1) The Company has concluded that the aggregate amount of perquisites and other personal benefits paid to each of the Named Executive Officers did not exceed the lesser of ten percent (10%) of such individual's annual salary and bonus for each fiscal year indicated or $50,000.

(2) In March 2002, Mr. Kosinski became Chief Executive Officer and President at an annual salary of $200,000. Mr. Kosinski's employment was terminated by the Company in January 2003.

(3) In June 2001, Mr. Fish assumed the office of President on an interim basis and also continued to serve as Chief Financial Officer and Secretary. In March 2002, the Company hired Richard J. Kosinski as President and Chief Executive Officer and Mr. Fish continued to serve as Chief Financial Officer and Secretary. Mr. Fish's employment as Chief Financial Officer was terminated by the Company in January 2003.

(4) Mr. Donohue was no longer employed by the Company as of December 31, 2002.

(5) Mr. Chen was hired by the Company in January 2002. Mr. Chen was no longer employed by the Company as of September 2002.

EMPLOYMENT CONTRACTS, TERMINATION OF EMPLOYMENT AND CHANGE-IN-CONTROL ARRANGEMENTS

On June 29, 2001, the Company entered into an employment agreement with Murray P. Fish pursuant to which Mr. Fish agreed to serve as the Company's President (on an interim basis) and Chief Financial Officer for a two year term at an annual salary of $185,000 per annum, and was also eligible to receive a cash bonus of up to $50,000 per annum. In the event Mr. Fish's employment agreement was terminated "other than for cause" (as defined in the employment agreement), he would be entitled to, among other things, a severance equal to the lesser of (i) twelve (12) months base salary or (ii) the

remaining base salary for the balance of the term of the agreement. Mr. Fish agreed not to disclose any confidential information of the Company during the term of his employment or at any time thereafter and not to compete with the Company during the term of his agreement and for a period of two years thereafter, in the event of termination for cause. In January 2003, Mr. Fish commenced litigation against the Company seeking $200,000 in severance, bonus and other benefits allegedly due him under his employment agreement (See Item 3 - "Legal Proceedings"). Upon notice of the litigation, the Company terminated Mr. Fish's employment for "cause" in accordance with the terms of his employment agreement.

On March 4, 2002, the Company entered into an employment agreement with Richard J. Kosinski pursuant to which Mr. Kosinski agreed to serve as the Company's President and Chief Executive Officer for a two (2) year term at an annual base salary of $200,000 per annum. Mr. Kosinski was also eligible to receive bonus compensation of up to $150,000 per year upon the Company achieving certain objectives. In addition, Mr. Kosinski was issued options to purchase 1,200,000 shares of the Company's Common Stock, at an exercise price of $1.65 per share, which vested as follows: 25% of the shares (300,000 shares) on March 11, 2003, and 6.25% (75,000 shares) at the end of each three month period for the subsequent three years. In the event Mr. Kosinski's employment was terminated by the Company "other than for cause" (as such term is defined in the Employment Agreement) or by Mr. Kosinski for "Good Reason" (as such term is defined in the Employment Agreement), Mr. Kosinski shall be entitled to (i) a severance of nine (9) months base salary and (ii) the vesting all options that would have vested within twelve (12) months of termination. Mr. Kosinski agreed not to disclose any confidential information of the Company during the term of his employment or at any time thereafter or to compete with the Company during the term of his agreement and for a period of two years thereafter in the event of "Termination for Cause" or without "Good Reason." In January 2003, Mr. Kosinski commenced litigation against the Company seeking $200,000 in severance, bonus and other benefits allegedly due him. Upon receipt of notice of the litigation, the Company terminated Mr. Kosinski's employment for "cause" in accordance with the terms of his employment agreement. In June 2003, following the Company's termination of Mr. Kosinski's employment in January 2003, the

Company and Mr. Kosinski entered into a settlement agreement to resolve litigation commenced by Mr. Kosinski relating to a dispute under his employment agreement. (See Item 3 - "Legal Proceedings").

On April 29, 2002, the Company entered into an offer letter with Bradford Winkler, pursuant to which Mr. Winkler agreed to serve as the Company's Vice President of Sales on an at-will basis at an annual base salary of $150,000 per annum. Mr. Winkler was also eligible to receive quarterly incentive compensation of up to $12,500 per quarter upon the Company achieving certain objectives. In addition, Mr. Winkler was issued options to purchase 200,000 shares of the Company's Common Stock, at an exercise price of $1.14 per share, which vested as follows: 25% of the shares (50,000 shares) on April 29, 2003, and 6.25% (12,500 shares) at the end of each three month period for the subsequent three years. In November 2002, Mr. Winkler's employment was terminated by the Company and he received a severance of six months base salary in accordance with the terms of his offer letter.

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OPTION GRANTS IN 2002

The following stock options were granted to each of the Named Executive Officers during the year ended December 31, 2002:

	NUMBER OF SHARES UNDERLYING OPTIONS GRANTED	% OF TOTAL OPTIONS GRANTED TO EMPLOYEES IN 2002(1)	EXERCISE PRICE PER SHARE(2)	EXPIRATION DATE
Richard J. Kosinski	957,600(3) 242,400(3)	69%	$1.65	3/11/12
Murray P. Fish	-0-	--	--	--
Joseph Donohoe	-0-	--	--	--
Alex Chen	150,000(4)	9%	$1.84	1/7/12

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(1) The number of options granted to employees during the year ended December 31, 2002 used to compute this percentage is based on 792,400 incentive stock options and 957,600 non-qualified stock options.

(2) All options were granted at an exercise price equal to the fair market value of the Company's Common Stock at the date of grant, as determined by the Board of Directors.

(3) In June 2003, Mr. Kosinski agreed to forfeit all of these options in accordance with a settlement agreement reached with the Company (See Item 3 "Legal Proceedings").

(4) In October 2002, the options granted to Mr. Chen expired unexercised.

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FISCAL YEAR-END OPTION VALUES

No options were exercised by any of the Named Executive Officers during the year ended December 31, 2002. The following table sets forth information

relating to the fiscal year-end value of unexercised options held by Named Executive Officers on an aggregated basis:

	Number of Securities Underlying Unexercised Options at 12/31/2002		Value of Unexercised In-the-Money Options at Fiscal Year-End ($)(1)	
Name	Exercisable	Unexercisable	Exercisable	Unexercisable
Richard J. Kosinski	-0-	1,200,000(2)	$-0-	$-0-
Murray P. Fish(3)	220,815	60,454	$-0-	$-0-
Joseph Donohue(4)	114,519	51,880	$-0-	$-0-
Alex Chen	-0-	-0-	$-0-	$-0-

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(1) Options are "in-the-money" if the market price of the Common Stock on December 31, 2002 ($.14) exceeds the exercise price of such options. The value of such options is calculated by determining the difference between the aggregate market price of the Common Stock underlying the options on December 31, 2002 and the aggregate exercise price of such options.

(2) Pursuant to a settlement agreement reached in June 2003, Mr. Kosinski agreed to forfeit these options (See Item 3 - "Legal Proceedings").

(3) All of the options held by Mr. Fish expired unexercised in February 2003 following the termination of Mr. Fish's employment except for non-qualified stock options to purchase 100,000 shares of Common Stock.

(4) All of these options held by Mr. Donohue expired unexercised in January 2003 following the termination of Mr. Donohue's employment.

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ITEM 11. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The following table sets forth information regarding the beneficial ownership of the Company's shares of Common Stock and Preferred Stock (the "Voting Stock") as of August 31, 2003 (i) each person known by the Company to be the beneficial owner of more than 5% of the outstanding shares of Voting Stock, (ii) each director and nominee, (iii) each of the executive officers of the Company, and (iv) all executive officers and directors of the Company as a group.

NAME AND ADDRESS(1) OF BENEFICIAL OWNER	NUMBER OF SHARES BENEFICIALLY OWNED	PERCENTAGE OF SHARES BENEFICIALLY OWNED(2)
Barry Rubenstein(3)	5,523,257	35%
FalconStor Software, Inc.(4)	4,839,740	29.6%
Irwin Lieber (5)	2,882,382	19.8%
Barry Fingerhut (6)	2,792,978	19.3%
Corey M. Horowitz(7) CMH Capital Management Corp.	1,839,749	12.4%
Wheatley Partners II, L.P. (8)	1,572,015	11.3%
Woodland Venture Fund(9)	1,305,072	9.1%

Seneca Ventures(10)	946,347	6.7%
Edward James(11)	12,500	*
Harry B. Schessel(12)	33,750	*
All officers and directors as a group (3 Persons)	1,885,999	12.7%

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* Less than 1%.

(1) Except as otherwise indicated, the address for each beneficial owner is c/o Network-1 Security Solutions, Inc., 445 Park Avenue, Suite 1028, New York, New York 10022

(2) Unless otherwise indicated, the Company believes that all persons named in the above table have sole voting and investment power with respect to all shares of Voting Stock beneficially owned by them. A person is deemed to be the beneficial owner of securities that can be acquired by such person within 60 days from the date hereof upon the exercise of options, warrants or convertible securities. Each beneficial owner's percentage ownership is determined by assuming that options, warrants and convertible securities held by such person (but not those held by any other person except for outstanding shares of Preferred Stock) and which are exercisable or convertible within 60 days have been exercised and converted. Assumes a base of 13,672,952 shares of Voting Stock including (i) 8,314,458 shares of outstanding Common Stock (ii) 4,967,016 shares of Common Stock issuable upon conversion of 2,495,300 outstanding shares of Series E Preferred Stock and (iii) 391,478 shares of Common Stock issuable upon conversion of 231,054 shares of outstanding Series D Preferred Stock.

(3) Includes (i) 1,194,659 shares of Common Stock, 188,678 shares of Common Stock issuable upon conversion of Series E Preferred Stock and 188,678 shares of Common Stock subject to currently exercisable warrants held by Wheatley Partners II,L.P., (ii) 173,584 shares of Common Stock issuable upon conversion of Series E Preferred Stock and 173,584 shares of Common Stock subject to currently exercisable warrants held by Wheatley Partners, L.P., (iii) 15,094 shares of Common Stock issuable upon conversion of Series E Preferred Stock and 15,094 shares of Common Stock subject to currently exercisable warrants held by Wheatley Foreign Partners, L.P., (iv) 31,040 shares of Common Stock held by Mr. Rubenstein, (v) 47,500 shares of common stock subject to currently exercisable stock options held by Mr. Rubenstein, (vi) 151,628 and 133,780 shares of Common Stock held by Woodland Venture Fund and Seneca Ventures, respectively, (vii) 424,528, 330,188, 235,848, 188,678 and 94,338 shares of Common Stock issuable upon conversion of Series E Preferred Stock held by Woodland Venture Fund, Seneca Ventures, Brookwood Partners, L.P., Woodland Partners and Barry Rubenstein, respectively, (viii) 611,366, 423,605, 282,095, 235,848, 145,335 and 1,333 shares of common stock subject to currently exercisable warrants held by Woodland Venture Fund, Seneca Ventures, Woodland Partners, Brookwood Partners, L.P., Barry Rubenstein and Marilyn Rubenstein, respectively and (ix) 117,550, 58,774, 58,774, 839 and 839 shares of Common Stock issuable upon conversion of Series D Preferred Stock held by Woodland Venture Fund, Seneca Ventures, Woodland Partners, Barry Rubenstein and Marilyn Rubenstein, respectively. Does not include options to purchase 11,875 shares of Common Stock held by Mr. Rubenstein which are not currently exercisable. Barry Rubenstein is a general partner of Wheatley Partners II, L.P. and a member of the general partner of each of Wheatley Partners, L.P. and Wheatley Foreign Partners, L.P. Barry Rubenstein and Woodland Services Corp. are the general partners of Woodland Venture Fund and Seneca Ventures. Barry Rubenstein is the President and sole director of

Woodland Services Corp. Marilyn Rubenstein is the wife of Barry Rubenstein. Mr. Rubenstein disclaims beneficial ownership of the shares of Common Stock held by Wheatley Partners II, L.P., Wheatley Partners, L.P. and Wheatley Foreign Partners, L.P., except to the extent of his equity interest therein. The address of Barry Rubenstein is 68 Wheatley Road, Brookville, New York 11545. The address of Wheatley Partners II, L.P. and Wheatley Partners, L.P. is 60 Cuttermill Road, Great Neck, New York 11021. The address of Wheatley Foreign Partners, L.P. is c/o Fiduciary Trust, One Capital Place, Snedden Road, P.O. Box 162, Grand Cayman, British West Indies. The address for Woodland Venture Fund, Seneca Ventures, Brookwood Partners, L.P. and Woodland Partners is c/o Barry Rubenstein, 68 Wheatley Road, Brookville, New York 11545.

(4) Includes (i) 2,169,870 shares of Common Stock issuable upon conversion of Series E Preferred Stock and (ii) 2,669,870 shares of Common Stock subject to currently exercisable warrants. FalconStor Software, Inc. has agreed to vote all of its Preferred Stock (and any subsequent common stock owned by it) in the same manner as voted by the holders of a majority of the Series E Preferred Stock so long as the holders of the outstanding shares of Series E Preferred Stock own at least 10% of the voting stock of the Company. The address of FalconStor Software, Inc. is 125 Baylis Road, Melville, New York 11747.

(5) Includes (i) 1,194,659 shares of Common Stock, 188,678 shares of Common Stock issuable upon conversion of Series E Preferred Stock and 188,678 shares of Common Stock subject to currently exercisable warrants held by Wheatley Partners II,L.P., (ii) 173,584 shares of Common Stock issuable upon conversion of Series E Preferred Stock and 173,584 shares of Common Stock subject to currently exercisable warrants held by Wheatley Partners, L.P., (iii) 15,094 shares of Common Stock issuable upon conversion of Series E Preferred Stock and 15,094 shares of Common Stock subject to currently exercisable warrants held by Wheatley Foreign Partners, L.P., (iv) 23,280 shares of Common Stock owned by Mr. Lieber, (v) 47,500 shares of Common Stock subject to

currently exercisable stock options owned by Mr. Lieber, (vi) 330,188 shares of Common Stock issuable upon conversion of Series E Preferred Stock owned by Mr. Lieber, (vii) 58,774 shares of Common Stock issuable upon conversion of Series D Preferred Stock owned by Mr. Lieber, and (viii) 473,269 shares of Common Stock subject to currently exercisable warrants owned by Mr. Lieber. Does not include options to purchase 11,875 shares of Common Stock owned by Mr. Lieber which are not currently exercisable. Mr. Lieber disclaims beneficial ownership of the shares of Common Stock held by Wheatley Partners II, L.P., Wheatley Partners, L.P. and Wheatley Foreign Partners, L.P., except to the extent of his equity interest therein. The address of Irwin Lieber is c/o Wheatley Partners, II, L.P., 80 Cuttermill Road, Great Neck, New York 11021.

(6) Includes (i) 1,194,659 shares of Common Stock, 188,678 shares of Common Stock issuable upon conversion of Series E Preferred Stock and 188,678 shares of Common Stock subject to currently exercisable warrants held by Wheatley Partners II, L.P., (ii) 173,584 shares of Common Stock issuable upon conversion of Series E Preferred Stock and 173,584 shares of Common Stock subject to currently exercisable warrants held by Wheatley Partners, L.P., (iii) 15,094 shares of Common Stock issuable upon conversion of Series E Preferred Stock and 15,094 shares of Common Stock subject to currently exercisable warrants held by Wheatley Foreign Partners, L.P., (iv) 31,040 shares of Common Stock owner by Mr. Fingerhut, (v) 330,188 shares of Common Stock issuable upon conversion of Series E Preferred Stock

owned by Mr. Fingerhut, (vi) 58,774 shares of Common Stock issuable upon conversion of Series D Preferred Stock owned by Mr. Fingerhut, and (vii) 423,605 shares of Common Stock subject to currently exercisable warrants owned by Mr. Fingerhut. Mr. Fingerhut disclaims beneficial ownership of the shares of Common Stock held by Wheatley Partners II, L.P., Wheatley Partners, L.P. and Wheatley Foreign Partners, L.P., except to the extent of his equity interest therein. The address of Barry Fingerhut is c/o Wheatly Partner, II, L.P., 80 Cuttermill Road, Great Neck, New York 11021.

(7) Includes (i) 486,303 shares of Common Stock held by Mr. Horowitz, (ii) 42,500 shares of Common Stock subject to currently exercisable stock options held by Mr. Horowitz, (iii) 155,463 shares of Common Stock held by CMH Capital Management Corp. ("CMH"), (iv) 924,936 shares of Common Stock subject to currently exercisable warrants held by CMH, (v) 85,220 shares of Common Stock subject to currently exercisable warrants held by Mr. Horowitz, (vi) 70,754 shares of Common Stock issuable upon conversion of Series E Preferred Stock, 70,754 shares of Common Stock subject to currently exercisable warrants and 1,528 shares of Common Stock, all owned by Donna Slavitt, the wife of Mr. Horowitz and (vii) 2,291 shares of Common Stock held by Horowitz Partners, a general partnership of which Mr. Horowitz is a partner. Does not include warrants and options to purchase 510,625 shares of Common Stock which are not currently exercisable. The address of CMH Capital Management Corp. is 445 Park Avenue, New York, New York 10022.

(8) Includes (i) 1,194,659 shares of Common Stock, (ii) 188,678 shares of Common Stock issuable upon conversion of Series E Preferred Stock and (iii) 188,678 shares of Common Stock subject to currently exercisable warrants. Does not include (i) 316,448, 23,280, 31,040, 4,656 and 3,104 shares of Common Stock beneficially owned by Barry Rubenstein, Irwin Lieber, Barry Fingerhut, Seth Lieber and Jonathan Lieber, respectively, each of whom is a general partner of Wheatley Partners II, L.P. and (ii) an aggregate of 7,140,407 shares of Common Stock subject to currently exercisable warrants, options, Series D Preferred Stock and Series E Preferred Stock beneficially owned by Barry Rubenstein (3,634,794 shares), Irwin Lieber (1,287,087 shares), Barry Fingerhut (1,189,923 shares), Jonathan Lieber (604,079 shares) and Seth Lieber (424,524 shares). Each of Messrs. Rubenstein, I. Lieber, Fingerhut, J. Lieber and S. Lieber disclaims beneficial ownership of the securities held by Wheatley Partners II, L.P., except to the extent of their equity interest therein.

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Jonathan Lieber and Seth Lieber each beneficially owns less than 1% of the outstanding Voting Stock of the Company exclusive of shares beneficially owned by Wheatley Partners II, L.P., Wheatley Partners, L.P. and Wheatley Foreign Partners, L.P. and as such have not been included in the beneficial ownership table. Wheatley Partners II, L.P.'s business address is 80 Cuttermill Road, Great Neck, New York 11021.

(9) Includes (i) 151,628 shares of Common Stock, (ii) 424,528 shares of Common Stock issuable upon conversion of Series E Preferred Stock, (iii) 611,366 shares of Common Stock subject to currently exercisable warrants and (iv) 117,550 shares of Common Stock issuable upon conversion of Series D Preferred Stock. Woodland Venture Fund's business address is 68 Wheatley Road, Brookville, New York 11546.

(10) Includes (i) 133,780 shares of Common Stock, (ii) 330,188 shares of Common Stock issuable upon conversion of Series E Preferred Stock, (iii) 423,605 shares of Common Stock subject to currently exercisable warrants, and (iv) 58,774 shares of Common Stock issuable upon conversion of Series D

Preferred Stock. Seneca Venture's business address is 68 Wheatley Road, Brookville, New York 11546.

(11) Includes 12,500 shares of Common Stock subject to currently exercisable stock options issued to Mr. James pursuant to the Stock Option Plan. Does not include 37,500 shares of Common Stock subject to stock options which are not currently exercisable.

(12) Includes 33,750 shares of Common Stock subject to currently exercisable stock options issued to Mr. Schessel pursuant to the Stock Option Plan. Does not include 41,250 shares of Common Stock subject to stock options which are not currently exercisable.

The Equity Compensation Plan information presented in Item 5 of this Annual Report is incorporated herein in its entirety.

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ITEM 12. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

Since June 2001 the Company has paid CMH Capital Management Corp ("CMH") a monthly fee of $17,500 and issued to CMH warrants to purchase an aggregate of 1,300,000 shares of Common Stock (at exercise prices ranging from $.70 per share to $1.48 per share) in consideration for financial advisory and consulting services rendered. CMH continues to render financial advisory and consulting services to the Company on a month-to-month basis and receive the aforementioned cash compensation. Corey M. Horowitz, Chairman of the Board of Directors and a principal stockholder of the Company, is the sole officer, director and stockholder of CMH. In addition, in connection with such financial advisory and consulting services, CMH was reimbursed for expenses during 2001 and 2002 in the amount of $44,000 and $51,000, respectively, including the allocable portion of rent for office space in New York City.

In February 2003, the Company closed its principal offices in Waltham, Massachusetts and moved its principal offices to space in New York City occupied by CMH. Network-1 pays CMH rent on a month to month basis of $2,700 per month for its New York City office.

During 2002, Edward James was paid consulting fees of $68,164 by the Company. In December 2002 Mr. James became a Director of the Company and was elected interim Chief Executive Officer and Chief Financial Officer in January 2003. Since January 2003 Mr. James has been paid $12,500 per month for his services as interim Chief Executive Officer and Chief Financial Officer.

On October 2, 2001, the Company completed a private offering of $6,765,000 of preferred stock and warrants to a group of investors (the "October 2001 Offering"). The October 2001 Offering included the issuance of 3,191,037 shares of our Series E Preferred Stock at $2.12 per share and warrants to purchase 6,882,074 shares of the Company's common stock at an exercise price of $1.27 per share, subject to certain adjustments. Such warrants expire on October 2, 2003. Each share of Series E Preferred Stock is convertible into two shares of common stock, subject to certain adjustments. Investors in the October 2001 Offering included FalconStor Software Inc. ($2,300,000), Barry Rubenstein and affiliated entities, ($1,400,000), Wheatley Partners II, L.P. and related entities ($400,000), Irwin Lieber ($350,000) and Barry Fingerhut ($350,000), all principal stockholders of the Company, and Donna Slavitt ($75,000), the wife of Corey M. Horowitz, Chairman of the Board of Directors of the Company and a principal stockholder of the Company.

On October 2, 2001, simultaneously with the closing of the October 2001 Offering, the Company entered into a ten (10) year Distribution and License

Agreement with FalconStor Software, Inc. ("FalconStor"), pursuant to which FalconStor has the right to distribute the Company's product offerings in its indirect and OEM channels. As part of the Distribution and License Agreement, FalconStor paid the Company a non-refundable advance of $500,000 against future royalty payments. On May 30, 2003, as part of the Company's sale of its CyberwallPlus technology and related intellectual property to an unaffiliated third party, the Company assigned its rights under the agreement with FalconStor to the unaffiliated third party.

ITEM 13. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

NO.	DESCRIPTION
3.1	Certificate of Incorporation, as amended. Previously filed as Exhibit 3.1 to the Company's Registration Statement on Form SB-2 (Registration No. 333-59617), declared effective by the SEC on November 12,1998 (the "1998 Registration Statement"), and incorporated herein by reference.
3.1.1	Certificate of Amendment to the Certificate of Incorporation dated November 27, 2001. Previously filed as Exhibit 3.1.1 to the Company's Registration Statement on Form S-3 (Registration No. 333-81344) declared effective by the SEC on February 12, 2002, and incorporated herein by reference (the "February 2002 Form S-3")
3.2	Certificate of Designations of Series D Preferred Stock. Previously filed as Exhibit 3.1 to the Company's current report on Form 8-K filed January 5, 2000 and incorporated herein by reference.
3.3	Certificate of Designations of Series E Preferred Stock. Previously filed as Exhibit 3.1 to the Company's current report on Form 8-K filed October 12, 2001 (the "October 2001 Form 8-K") and incorporated herein by reference.
3.4	By-laws, as amended. Previously filed as Exhibit 3.2 to the 1998 Registration Statement and incorporated herein by reference.
4.1	Form of Common Stock certificate. Previously filed as Exhibit 4.1 to the 1998 Registration Statement and incorporated herein by reference.
10.1	Securities Purchase Agreement, dated as of October 2, 2001, between the Company and the investors listed therein. Previously filed as Exhibit 10.21 to the October 2001 Form 8-K and incorporated herein by reference.
10.2	Form of Warrant, dated October 2, 2001, issued by the Company to the holder listed thereon. Previously filed as Exhibit B to Exhibit 10.21 to the October 2001 Form 8-K and incorporated herein by reference.
10.3	Financial Advisory and Investment Banking Agreement, dated December 1, 2001, by and between EarlyBirdCapital, Inc. and the Company. Previously filed as Exhibit 10.3 to the October 2002

Form S-3 and incorporated by reference herein.

10.4	Agreement dated, January 29, 2002, between the Company and CMH Capital Management Corp. relating to extension of the consulting agreement. Previously filed as Exhibit 10.4 to the October 2002 Form S-3 and incorporated by reference herein.
10.5	Employment Agreement, dated June 29, 2001, between the Company and Murray P. Fish. Previously filed as Exhibit 10.19 to the Company's 10-QSB for the quarterly period ended June 30, 2002.

10.6	Employment Agreement, dated March 4, 2002, between the Company and Richard J. Kosinski. Previously filed as Exhibit 10.6 to the Company's current report on Form 8-K filed March 25, 2002 and incorporated herein by reference.
10.7**	License and Distribution Agreement between the Company and FalconStor Software, Inc. Previously filed as Exhibit 10.21 to October 2001 Form 8-K and incorporated herein by reference.
10.8	Extension of Consulting Agreement, dated July 2, 2002, between the Company and CMH Capital Management Corp. previously filed as Exhibit 10.8 to the Company's Quarterly Report on Form 10-QSB for the period ended June 30, 2002 and incorporated herein by reference.
10.9	Assignment Agreement, dated May 20, 2003, between the Company and Trend Micro Incorporated (including exhibits). Previously filed as Exhibit 10.8 to the Company's Current Report on Form 8-K filed June 2, 2003 and incorporated herein by reference.
23.1*	Consent of Eisner LLP, independent certified public accountants.
31.1*	Controls and Procedure Certification of Chief Executive Officer and Chief Financial Officer dated as of September 24, 2003.
32.1*	Certification of Interim Chief Executive Officer and Chief Financial Officer dated September 24, 2003.

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* Filed herewith.

** Confidentiality treatment has been granted for certain provisions.

(b) Reports on Form 8-K

On November 12, 2002, the Company filed a current report on Form 8-K with respect to issuing a press release announcing strategic alternatives with respect to its CyberwallPlus technology and its focus on a merger transaction.

SIGNATURES

In accordance with the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Framingham, Commonwealth of Massachusetts, on the 24 day of September 2003.

NETWORK-1 SECURITY SOLUTIONS, INC.

By /s/ Edward James

Edward James
Interim Chief Executive Officer
and Chief Financial Officer

In accordance with the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant caused this report to be signed on its behalf by the following persons in the capacities and on the dates indicated:

NAME	TITLE
/s/ Edward James Edward James	Interim Chief Executive Officer, Chief Financial Officer and Director (principal executive officer, principal financial officer and principal accounting officer.)
/s/ Corey M. Horowitz Corey M. Horowitz	Chairman of the Board of Directors

NETWORK-1 SECURITY SOLUTIONS, INC.

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INDEPENDENT AUDITORS' REPORT

Board of Directors and Stockholders
Network-1 Security Solutions, Inc.
New York, New York

We have audited the accompanying balance sheets of Network-1 Security Solutions, Inc. (the "Company") as of December 31, 2002 and 2001 and the related statements of operations, stockholders' equity and cash flows for each of the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements enumerated above present fairly, in all material respects, the financial position of Network-1 Security Solutions, Inc. as of December 31, 2002 and 2001 and the results of its operations and its cash flows for each of the years then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Notes A and L, the Company terminated substantially all of its operations during December 2002 and in May 2003 sold its intellectual property. Management plans are also described in Note A.

New York, New York
July 2, 2003

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NETWORK-1 SECURITY SOLUTIONS, INC.

BALANCE SHEETS

	DECEMBE
	2002
ASSETS	
Current assets:	
Cash and cash equivalents	$ 2,029,000
Accounts receivable - net of allowance for doubtful accounts of $0 and $73,000, respectively	6,000
Prepaid expenses and other current assets	96,000
Total current assets	2,131,000
Equipment and fixtures - net	22,000
Capitalized software costs - net	
Security deposits	8,000
	$ 2,161,000
LIABILITIES	
Current liabilities:	
Accounts payable	$ 193,000
Accrued expenses and other current liabilities	610,000
Deferred revenue	218,000
Total current liabilities	1,021,000
Liability to be settled with equity instrument	55,000
Commitments and contingencies	
STOCKHOLDERS' EQUITY	
Preferred stock - $.01 par value; 10,000,000 shares authorized;	
Series D - convertible, voting, authorized 1,250,000 shares; 231,054 shares issued and outstanding at December 31, 2002 and 2001, respectively, liquidation preference of $705,000 at December 31, 2002 and 2001, respectively	2,000
Series E - convertible, authorized 3,500,000 shares; 2,483,508 and 3,191,037 shares issued and outstanding at December 31, 2002 and 2001,	

respectively, liquidation preference of $5,265,000 and $6,765,000 at December 31, 2002 and 2001, respectively	25,000
Common stock - $.01 par value; authorized 50,000,000 shares; 8,314,458 and 6,781,374 shares issued and outstanding at December 31, 2002 and 2001, respectively	83,000
Additional paid-in capital	41,397,000
Accumulated deficit	(40,422,000)
	1,085,000
	$ 2,161,000

SEE NOTES TO FINANCIAL STATEMENTS

NETWORK-1 SECURITY SOLUTIONS, INC.

STATEMENTS OF OPERATIONS

	YEAR EN DECEMBE
	2002
Revenues:	
Licenses	$ 374,000
Services	218,000
Total revenues	592,000
Cost of revenues:	
Amortization and impairment of software development costs	741,000
Cost of licenses	15,000
Cost of services	147,000
Total cost of revenues	903,000
Gross (loss) profit	(311,000)
Operating expenses:	
Product development costs	1,599,000
Selling and marketing	1,831,000
General and administrative	2,229,000
Total operating expenses	5,659,000
Loss from continuing operations before interest income (expense)	(5,970,000)
Interest income	65,000
Interest expense	
Interest expense - related parties	

Loss from continuing operations	(5,905,000)
Gain on sale of discontinued operations, including $65,000 of interest income on contingency payments received in 2001	
NET LOSS	(5,905,000)
Imputed dividend on preferred stock	
NET LOSS ATTRIBUTABLE TO COMMON STOCKHOLDERS	$(5,905,000)
PER COMMON SHARE - BASIC AND DILUTED:	
Loss from continuing operations	$ (0.78)
Income from discontinued operations	
Loss per share - basic and diluted	$ (0.78)
WEIGHTED AVERAGE NUMBER OF COMMON SHARES OUTSTANDING	7,584,911

SEE NOTES TO FINANCIAL STATEMENTS F-4

NETWORK-1 SECURITY SOLUTIONS, INC.

STATEMENTS OF STOCKHOLDERS' EQUITY

	SERIES D CONVERTIBLE PREFERRED STOCK	
	SHARES	AMOUNT
BALANCE - JANUARY 1, 2001	115,220	$ 1,000
Amortization of compensatory stock options and warrants		
Charge for vesting of contingent options to former employees - discontinued operations		
Conversion of Series D preferred stock	(8,197)	
Conversion of notes and accrued interest into Series D preferred stock	124,031	1,000
Conversion of notes and accrued interest into common stock		
Issuance of warrants and options for services		
Issuance of Series E preferred stock and warrants		
Offering costs of Series E preferred stock and warrants offering		
Beneficial conversion feature of Series E preferred stock		
Net loss		
BALANCE - DECEMBER 31, 2001	231,054	2,000
Conversion of Series E preferred stock		
Exercise of Series E warrants		
Exercise of Series D warrants		
Net loss		

BALANCE - DECEMBER 31, 2002	231,054	$ 2,000

	COMMON STOCK	
	SHARES	AMOUNT
BALANCE - JANUARY 1, 2001	6,448,363	$ 65,000
Amortization of compensatory stock options and warrants		
Charge for vesting of contingent options to former employees - discontinued operations		
Conversion of Series D preferred stock	8,197	
Conversion of notes and accrued interest into Series D preferred stock		
Conversion of notes and accrued interest into common stock	324,814	3,000
Issuance of warrants and options for services		
Issuance of Series E preferred stock and warrants		
Offering costs of Series E preferred stock and warrants offering		
Beneficial conversion feature of Series E preferred stock		
Net loss		
BALANCE - DECEMBER 31, 2001	6,781,374	68,000
Conversion of Series E preferred stock	1,415,058	14,000
Exercise of Series E warrants	9,432	
Exercise of Series D warrants	108,594	1,000
Net loss		
BALANCE - DECEMBER 31, 2002	8,314,458	$ 83,000

	ACCUMULATED DEFICIT	TOTAL
BALANCE - JANUARY 1, 2001	$(26,482,000)	$ 4,182,
Amortization of compensatory stock options and warrants		107,
Charge for vesting of contingent options to former employees - discontinued operations		230,
Conversion of Series D preferred stock		
Conversion of notes and accrued interest into Series D preferred stock		378,
Conversion of notes and accrued interest into common stock		366,
Issuance of warrants and options for services		545,
Issuance of Series E preferred stock and warrants		7,115,
Offering costs of Series E preferred stock and warrants offering		(192,
Beneficial conversion feature of Series E preferred stock	(2,163,000)	
Net loss	(5,872,000)	(5,872,
BALANCE - DECEMBER 31, 2001	(34,517,000)	6,859,
Conversion of Series E preferred stock		
Exercise of Series E warrants		12,
Exercise of Series D warrants		119,

Net loss	(5,905,000)	(5,905,
BALANCE - DECEMBER 31, 2002	$(40,422,000)	$ 1,085,

SEE NOTES TO FINANCIAL STATEMENTS F-5

NETWORK-1 SECURITY SOLUTIONS, INC.

STATEMENTS OF CASH FLOWS

	YEAR DECE
	2002
CASH FLOWS FROM OPERATING ACTIVITIES:	
Loss from continuing operations	$(5,905,000)
Adjustments to reconcile loss from continuing operations to net cash used in operating activities:	
Interest expensed and converted to Series D convertible preferred stock	
Issuance of options and warrants for services rendered	55,000
Provision for doubtful accounts	
Amortization of compensatory stock options	
Depreciation, amortization and impairment charge	1,154,000
Changes in:	
Accounts receivable	56,000
Prepaid expenses and other current assets	17,000
Accounts payable, accrued expenses and other current liabilities	(277,000)
Interest payable	
Deferred revenue	(27,000)
Net cash used in operating activities	(4,927,000)
CASH FLOWS FROM INVESTING ACTIVITIES:	
Acquisitions of equipment and fixtures	(116,000)
Capitalized software costs	(180,000)
Refund of security deposit	
Proceeds from sale of discontinued operations, net	
Net cash (used in) provided by investing activities	(296,000)
CASH FLOWS FROM FINANCING ACTIVITIES:	
Proceeds from exercise of options and warrants	131,000
Payments on note payable	
Proceeds from issuance of Series E convertible preferred stock and warrants	
Offering costs	
Net cash provided by financing activities	131,000
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(5,092,000)

Cash and cash equivalents - beginning of year	7,121,000
CASH AND CASH EQUIVALENTS - END OF YEAR	$ 2,029,000

SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:
Cash paid for interest
Noncash transactions:
Issuance of common stock in connection with conversion of notes payable and accrued interest
Issuance of preferred stock in connection with conversion of notes payable and accrued interest

SEE NOTES TO FINANCIAL STATEMENTS

NETWORK-1 SECURITY SOLUTIONS, INC.

NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2002 AND 2001

NOTE A - THE COMPANY

Network-1 Security Solutions, Inc. (the "Company") developed, marketed, licensed and supported its proprietary network security software products designed to provide comprehensive security to computer networks. The Company also provided maintenance and training services. The Company also provided consulting services in network security and network design through its Professional Services Group, which was sold in February 2000 and has been accounted for as a discontinued operation (see Note G).

In December 2002, the Company discontinued its software product line and associated operations, ceased its product development and substantially eliminated its sales and marketing efforts and during May 2003, sold substantially all of its intellectual property. Through a series of layoffs, the Company has reduced its workforce to a current level of two employees and a consultant. The Company has closed its various offices upon termination of leases during 2002 and 2003 (see Notes L[3] and L[4]). Management is focusing its efforts on seeking a merger candidate for the Company.

NOTE B - SIGNIFICANT ACCOUNTING POLICIES

[1] CASH EQUIVALENTS:

The Company considers all highly liquid short-term investments purchased with a maturity of three months or less to be cash equivalents.

[2] REVENUE RECOGNITION:

License revenue is recognized upon delivery of software or delivery of a required software key. License revenue from distributors or resellers is recognized as the distributor or reseller delivers software or the required software key to end users or original equipment manufacturers. Service revenues consist of maintenance and training services. Annual renewable maintenance fees are a separate component of each contract, and are recognized ratably over the contract term. Training revenues are recognized as such services are performed. Revenue from advance license fees are deferred until they are earned pursuant to the agreements.

[3] EQUIPMENT AND FIXTURES:

Equipment and fixtures are stated at cost and are depreciated using the straight-line method over their estimated useful lives of five years.

[4] SOFTWARE DEVELOPMENT COSTS:

Costs to maintain developed programs and development costs incurred to establish the technological feasibility of computer software are expensed as incurred. The Company capitalized costs incurred in producing computer software after technological feasibility of the software has been established through the date that the software is ready for general release to customers. Such costs are amortized based on current and estimated future revenue of each product with an annual minimum equal to the straight-line amortization over the remaining estimated economic life of the product. The Company estimates the economic life of its software to be three years. At each balance sheet date, the unamortized capitalized software costs of each product are compared with the estimated net realizable value of that product and any excess capitalized costs are written off.

NOTE B - SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

[5] IMPAIRMENT OF LONG-LIVED ASSETS:

In accordance with Statement of Financial Accounting Standards ("SFAS") No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets", the Company records impairment losses on long-lived assets used in operations or expected to be disposed of when indicators of impairment exist and the cash flows expected to be derived from those assets are less than carrying amounts of those assets. During the year ended December 31, 2002, the Company recorded an impairment charge related to its network security software of approximately $401,000, which has been included in amortization of software development costs. Subsequently, in May 2003, the Company sold its network security software (see Note L[4]). The Company also reduced the carrying value of its fixed assets to their net realizable amount (see Note C).

[6] INCOME TAXES:

The Company utilizes the liability method of accounting for income taxes. Under such method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates in effect at the balance sheet date. The resulting asset or liability is adjusted to reflect enacted changes in tax law. Deferred tax assets are reduced, if necessary, by a valuation allowance when the likelihood of realization is not assured.

[7] LOSS PER SHARE:

Basic loss per share is calculated by dividing the net loss by the weighted average number of outstanding common shares during the year. Diluted per share data includes the dilutive effects of options, warrants

and convertible securities. Potential common shares of 18,081,581 and 18,311,543 at December 2002 and 2001, respectively, are anti-dilutive, and are not included in the calculation of diluted loss per share. Such potential common shares reflect options, warrants, convertible preferred stock and convertible notes. For the year ended December 31, 2001, the loss per share is increased by the value of the beneficial conversion feature on the Series E preferred stock, which is accounted for as a preferred stock dividend (see Note F).

[8] USE OF ESTIMATES:

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

[9] FINANCIAL INSTRUMENTS:

The carrying amounts of cash and cash equivalents, accounts receivable, accounts payable and accrued expenses approximate their fair value due to the short period to maturity of these instruments.

NOTE B - SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

[10] STOCK-BASED COMPENSATION:

The Company accounts for stock-based employee compensation under Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees", and related interpretations. The Company has adopted the disclosure-only provisions of SFAS No. 123, "Accounting for Stock-Based Compensation" and SFAS No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure," which was released in December 2002 as an amendment of SFAS No. 123. The following table illustrates the effect on net loss and loss per share if the fair value-based method had been applied to all awards:

	YEAR ENDED DECEMBER 31,	
	2002	2001
Reported net loss attributable to common stockholders	$(5,905,000)	$(8,035,000)
Stock-based employee compensation expense included in reported net loss		26,000
Stock-based employee compensation determined under the fair value-based method	(298,000)	(1,001,000)

Pro forma net loss	$(6,203,000)	$(9,010,000)
Loss per common share (basic and diluted):		
As reported	$ (0.78)	$ (1.24)
Pro forma	$ (0.82)	$ (1.39)

The fair value of options on the date of grant is estimated using the Black-Scholes option pricing model utilizing the following weighted average assumptions:

	YEAR ENDED DECEMBER 31,	
	2002	2001
Risk-free interest rates	2.63 - 6.44%	4.61%
Expected option life in years	6.60	6.60
Expected stock price volatility	112.00%	113.00%
Expected dividend yield	0.00%	0.00%

[11] ADVERTISING COSTS:

Advertising costs are expensed as incurred. Advertising expense was $93,000 and $164,000 for the years ended December 31, 2002 and 2001, respectively.

NETWORK-1 SECURITY SOLUTIONS, INC.

NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2002 AND 2001

NOTE B - SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

[12] RECENTLY ISSUED ACCOUNTING STANDARDS:

In May 2002, the Financial Accounting Standards Board ("FASB") issued SFAS No. 145, "Recession of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections." SFAS No. 145 rescinds the requirement that all gains and losses from extinguishment of debt be classified as an extraordinary item. Additionally, SFAS No. 145 requires that certain lease modifications that have economic effects similar to sale-lease back transactions be accounted for in the same manner as sale-lease back transactions. This statement is effective for the Company beginning in 2003. Management has not yet determined what impact the adoption of SFAS No. 145 will have on the Company's financial statements.

In June 2002, the FASB issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities," which addresses financial accounting and reporting for costs associated with exit or disposal activities and supersedes Emerging Issues Tax Force ("EITF") Issue 94-3,

"Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity" (including "Certain Costs Incurred in a Restructuring"). SFAS No. 146 requires that a liability for a cost associated with an exit or disposal activity be recognized when the liability is incurred. Under EITF Issue 94-3, a liability for an exit cost as defined in EITF Issue 94-3 was recognized at the date of an entity's commitment to an exit plan. SFAS No. 146 also establishes that the liability should initially be measured and recorded at fair value. SFAS No. 146 is effective for exit and disposal activities initiated after December 31, 2002. Management is currently evaluating the provisions of SFAS No. 146 but expects that it will not have a material impact on the Company's results of operations and financial position upon adoption.

In December 2002, the FASB issued SFAS No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure." This statement amends SFAS No. 123, "Accounting for Stock-Based Compensation," to provide alternative methods of transition for an entity that changes to the fair value method of accounting for stock-based employee compensation. In addition, SFAS No. 148 amends the disclosure provisions of SFAS No. 123 to require expanded and more prominent disclosures in annual financial statements about the method of accounting for stock-based compensation and the pro forma effect on reported results of applying the fair value method for entities that use the intrinsic value method. The pro forma disclosures are also required to be displayed prominently in interim financial statements. The Company does not intend to change to the fair value method of accounting and has included the disclosure requirements of SFAS No. 148 in the accompanying financial statements.

SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity", which was issued in May 2003, will require redeemable preferred stock to be classified, in certain circumstances, as a liability, upon adoption by a public company at the beginning of the first interim period beginning after June 15, 2003. SFAS No. 150 provides that mandatorily redeemable preferred stock should be classified as a liability if it embodies an unconditional obligation requiring the issuer to redeem the shares by transferring its assets at a specified or determinable date or upon an event certain to occur. Management believes that the provisions of SFAS No. 150 will not have a material impact on the Company's results of operations and financial position upon adoption.

In November 2002, the FASB issued Interpretation No. 45, "Guarantor's Accounting and Disclosures Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others" ("FIN 45"). FIN 45 requires that upon issuance of a guarantee, the guarantor must recognize a liability for the fair value of the obligation it assumes under that guarantee. FIN 45 is effective on a prospective basis to guarantees issued or modified after December 15, 2002, but has certain disclosure requirements effective for financial statements of interim or annual periods ending after December 15, 2002. The Company does not currently have any guarantees. The Company does not anticipate that the adoption of the disclosure requirements of FIN 45 will have a material effect on its financial position or results of operations.

NOTE B - SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

[13] RECLASSIFICATION:

Certain prior year amounts have been reclassified to conform to the 2002 presentation.

NOTE C - EQUIPMENT AND FIXTURES

Equipment and fixtures are summarized as follows:

	DECEMBER 31,	
	2002	2001
Office and computer equipment	$ 649,000	$ 565,000
Furniture and fixtures	146,000	114,000
	795,000	679,000
Less accumulated depreciation	(773,000)	(360,000)
	$ 22,000	$ 319,000

Depreciation expense was $413,000 and $148,000 for the years ended December 31, 2002 and 2001, respectively. Included in depreciation expense for the year ended December 31, 2002 was a write-down of $260,000 to reduce the net book value of fixed assets to the price they were sold for in January 2003.

NOTE D - CAPITALIZED SOFTWARE COSTS

	YEAR ENDED DECEMBER 31,	
	2002	2001
Balance, beginning of year (net of accumulated amortization)	$ 561,000	$ 625,000
Additions	180,000	313,000
Amortization	(741,000)	(377,000)
Balance, end of year (net of accumulated amortization)	$ 0	$ 561,000

During 2002, the Company wrote-off the remaining balance of $401,000 attributable to its capitalized software cost when it discontinued its software product offering and is included in the current year's amortization of $741,000 (see Note B[5]).

NOTE E - NOTES PAYABLE

In December 1999, the Company raised $3,000,000 through the issuance of convertible notes payable, Series D convertible preferred stock and warrants (see Note F[1]).

NETWORK-1 SECURITY SOLUTIONS, INC.

NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2002 AND 2001

NOTE E - NOTES PAYABLE (CONTINUED)

In December 1999, the Company issued $1,500,000 of convertible promissory notes (the "Notes") bearing interest at 8%, which matured in December 2001 ($525,000 of which was payable to related parties). The Notes were convertible into 491,803 shares of Series D preferred stock of the Company (570,492 shares if interest through the maturity of the Notes is considered) and an equal number of five-year warrants to purchase 491,803 shares of common stock (570,492 shares if interest through the maturity of the Notes is considered) at an exercise price of $3.05 per share, subject to certain adjustments. The conversion price of the Series D preferred stock ($1,500,000) and the exercise price of the warrants ($1,475,000) was less than the aggregate market price ($5,102,000) of the common stock obtainable upon conversion and exercise on the closing date of the private placement. Accordingly, upon approval of the conversion feature by a majority vote of the stockholders of the Company in April 2000, the Company incurred an interest charge of $1,500,000, representing the beneficial conversion feature of the preferred stock, limited to the $1,500,000 proceeds received on the issuance of the Notes.

During the year ended December 31, 2001, $339,000 of the Notes, including $300,000 payable to related parties and $39,000 of accrued interest payable on the Notes, including $36,000 payable to related parties were converted, at a conversion price of $3.05 per share, into 124,031 shares of Series D convertible preferred stock and an equal number of five-year warrants. An additional $30,000 of the Notes and $3,000 of accrued interest payable on the Notes were converted, at a conversion price of $3.05 per share, into 10,897 shares of common stock and an equal number of warrants. Pursuant to the Notes' anti-dilution provisions, as a result of the Company's Series E preferred stock and warrant offering in October 2001, the conversion price of the Series D preferred stock was changed to $1.80, the conversion rate at which the Series D convertible preferred stock may be converted into common stock was changed from 1:1 to 1:1.69431, and the exercise price of the warrants outstanding at $3.05 and warrants to be issued upon conversion of the Notes was changed to $1.114. In December 2001, $287,000 of the Notes and $46,000 of accrued interest were converted into 185,278 shares of Series D convertible preferred stock and an equal number of warrants. The Series D convertible preferred stock was simultaneously converted into 313,917 shares of common stock.

The remaining balance of $13,000 of the Notes that were not converted into preferred or common stock, was paid to the noteholder, who was then a director of the Company.

NOTE F - STOCKHOLDERS' EQUITY

[1] PREFERRED STOCK:

(a) Series D preferred stock:

Pursuant to the private placement discussed in Note E, in December 1999 the Company received $1,500,000 from the sale of 491,803 shares of Series D convertible preferred stock at $3.05 per share, including 172,129 shares to related parties. Such stock is convertible into common shares at a conversion rate of 1.69431 (as adjusted), has identical voting rights as the Company's common stock, and is

entitled to equivalent dividend rights as those paid on shares of common stock obtainable on conversion. The holders of the Series D convertible preferred stock are entitled to a liquidation preference of $3.05 per share plus any declared but unpaid dividends before any payments are made to holders of common stock, and rank equal with Series E preferred stock in the event of liquidation, dissolution or winding up of the Company. In connection therewith, the Company also issued five-year warrants to purchase 491,803 shares of common stock at an exercise price of $3.05 per share. The exercise price of the warrants was reduced to $1.00 because the Company did not achieve a specified revenue target. Holders of warrants for 444,857 shares, including 424,411 warrants obtained upon conversion of the Notes and accrued interest (Note E), waived such exercise price reduction. Of these warrants, 147,149 were exercised during 2000.

NOTE F - STOCKHOLDERS' EQUITY (CONTINUED)

[1] PREFERRED STOCK: (CONTINUED)

(a) Series D preferred stock: (continued)

Pursuant to anti-dilution features of the Series D convertible preferred stock, convertible notes and warrants, in connection with the October 2, 2001 private offering of Series E preferred stock and warrants (see (b) below), the holders of (i) outstanding Series D preferred stock, (ii) certain warrants to purchase common stock and (iii) convertible notes (convertible into Series D preferred stock and warrants) in the principal amount of $300,000, all issued in connection with the Company's private offering completed in December 1999, received the right to receive 1,145,207 additional shares of common stock (exclusive of conversion of interest with respect to the convertible notes) upon conversion or exercise of Series D preferred stock, convertible notes and warrants as a result of the anti-dilution provisions of such securities. In addition, the exercise price of outstanding warrants and warrants issuable upon conversion of the promissory notes and accrued interest was adjusted from $3.05 to $1.114.

(b) Series E preferred stock:

On October 2, 2001, the Company completed a $6,765,000 private offering of Series E preferred stock ("Series E") and warrants (the "2001 Financing"). An aggregate of 3,191,037 shares of Series E together with warrants to purchase 6,882,074 shares of common stock were sold. The warrants were issued at the rate of two warrants, each to purchase a share of common stock at $1.27 per share, with every share of Series E, plus an additional warrant to purchase 500,000 shares to an investor, Falconstor Software, Inc. ("Falconstor"), for investing more than $2,000,000 (the "Additional Warrant"). In connection with the 2001 Financing, the Company and Falconstor entered into a ten-year License and Distribution Agreement (the "Falconstor Agreement") pursuant to which Falconstor has the right to distribute the Company's product offerings in its indirect and OEM channels. As part of the Falconstor Agreement, Falconstor paid the

Company a non-refundable advance of $500,000 against future royalty payments (the "Advance"). For accounting purposes, $350,000 of the Advance, representing the estimated fair value of the Additional Warrant was accounted for as its purchase price, resulting in total proceeds attributable to the 2001 Financing of $7,115,000. For accounting purposes, an allocation of $4,952,000 and $2,163,000 was made to the Series E and warrants, respectively, based on the relative fair values of the common stock obtainable upon conversion of the Series E and the warrants on the date of the 2001 Financing. The warrants were valued using the Black-Scholes option pricing model using the following assumptions: volatility of 113.45%, expected life of 1 year and 3 years, dividend yield of 0, and risk-free interest rates of 2.47% and 3.14%, respectively. The difference between the proceeds allocated to the Series E and the fair market value of the common stock obtainable upon conversion of the Series E represents a beneficial conversion feature, which has been imputed as a preferred stock dividend in calculating the net loss available to common stockholders. On May 30, 2003, as part of the Company's sale of its CyberwallPLUS technology and related intellectual property (the "Assets") to an unrelated third party (the "Purchaser"), the Company assigned its rights under the Falconstor Agreement to the Purchaser (see Note L[4]).

NOTE F - STOCKHOLDERS' EQUITY (CONTINUED)

[1] PREFERRED STOCK: (CONTINUED)

(b) Series E preferred stock: (continued)

Holders of the Series E may convert each such share into two shares of common stock at any time, subject to adjustment. During the year ended December 31, 2002, holders of 707,529 shares of Series E converted their shares into 1,415,058 shares of common stock. The Series E is entitled to vote on all matters with the holders of the Company's common stock based on the number of shares of common stock into which such shares may be converted, except that the holders of the Series E have irrevocably waived any increased voting rights that may be afforded to the holders of Series E resulting from anti-dilution protection. Holders of Series E shall receive dividends and other distributions, when, as and if declared by the Board of Directors, out of funds legally available therefore equivalent to those dividends paid on shares of common stock. The holders of Series E will be entitled to a liquidation preference of $2.12 per share plus any declared but unpaid dividends before any payments are made to holders of common stock, and the Series E ranks equal with the Series D preferred stock upon liquidation. The Company also agreed with the holders of the Series E that, without the approval of the Series E designee, a principal stockholder of the Company (see Note K[4]), it will not take certain action, including (i) issue securities except for securities issued under its stock option plan, (ii) incur debt in excess of $250,000, (iii) enter into a merger, acquisition or sale of substantially all of its assets and (iv) take any action to amend its Certificate of Incorporation or By-laws that could in any way adversely affect the rights of the holders of the

Series E. In addition, the investors were granted registration rights with respect to the shares of common stock to be received upon conversion of the Series E preferred stock and exercise of the warrants.

[2] STOCK OPTIONS:

During 1996, the Board of Directors and stockholders approved the adoption of the 1996 Stock Option Plan (the "1996 Plan"). The 1996 Plan, as amended, provides for the granting of both incentive and non-qualified options to purchase common stock of the Company. A total of 4,000,000 shares are available under the 1996 Plan.

The term of options granted under the 1996 Plan may not exceed ten years (five years in the case of an incentive stock option granted to an optionee owning more than 10% of the voting stock of the Company) ("10% stockholder"). The option price for incentive stock options can not be less than 100% of the fair market value of the shares of common stock at the time the option is granted (110% for a 10% stockholder). Option terms and vesting periods are set by the Compensation Committee in its discretion.

[2] STOCK OPTIONS: (CONTINUED)

The following table summarizes stock option activity for the years ended December 31:

	2002		2001
	OPTIONS OUTSTANDING	WEIGHTED AVERAGE EXERCISE PRICE	OPTIONS OUTSTANDING
Options outstanding at beginning of year	1,761,652	$3.36	1,602,842
Granted	2,520,000(b)	1.48	900,595(a)
Exercised			
Cancelled	(1,127,154)	2.26	(741,785)
Options outstanding at end of year	3,154,498	2.25	1,761,652(c)
Options exercisable at end of year	788,165	4.03	960,012

(a) Includes 265,095 options granted in January 2001, with an exercise price of $3.06, the fair value of the common stock on the date of grant, that vest 50% if the closing stock price of the Company's

common stock is at or above $10 per share for 8 out of 10 trading days. The remaining 50% vest if the closing stock price is at or above $15 per share for 8 out of 10 trading days. The options expire in 10 years. Of such options, 26,250 were granted to consultants or service providers. As the vesting of the options is contingent upon the market price of the Company's common stock, but the services have been provided, the valuation of the options, and accordingly the expense recognized, is subject to adjustment based on, among other factors, the market price on the date of the valuation. The Company will estimate the value of the options' at each reporting date until they have vested. In 2001, the Company recognized $32,000 of expense based on the fair value of the options at December 31, 2001 using the Black-Scholes option pricing model of valuation using the following assumptions: volatility of 114%, risk-free interest rate of 5.07%, dividend yield of 0 and an expected life of 8 years. No adjustment was made for the year ended December 31, 2002, since the amount was not significant.

(b) On April 18, 2002, in consideration of additional consulting and financial advisory services, the Company issued to CMH Capital Management Corp. ("CMH") an option to purchase 750,000 shares of the common stock at an exercise price of $1.20 per share, which was the market price of the Company's common stock on the date of issuance. Corey M. Horowitz, Chairman of the Board of Directors of the Company, is the sole owner and officer of CMH. The shares underlying the option shall vest over a three-year period in equal amounts of 250,000 shares per year beginning April 18, 2003. In addition, the shares underlying the option shall vest in full in the event of a "change of control" or in the event that the closing price of the Company's common stock reaches a minimum of $3.50 per share for 20 consecutive trading days. The options were valued utilizing the Black-Scholes option pricing model resulting in an estimated fair value of $55,000, which was charged to expense during the year ended December 31, 2002. These options are treated as contingent options and were originally priced in the quarter ended June 30, 2002 at $416,000.

NOTE F - STOCKHOLDERS' EQUITY (CONTINUED)

[2] STOCK OPTIONS: (CONTINUED)

(c) Includes a five-year option to purchase 294,879 shares of common stock at an exercise price of $2.42 per share issued outside the 1996 Plan which expired in May 2003. The option was issued in May 1998 in connection with an employment agreement with the Company's former President and Chief Executive Officer.

The option vested 34% immediately and then 22% per year thereafter. As the estimated fair value of the Company's common stock at the date of grant of the option ($5.60 per share) was in excess of the exercise price, the Company incurred aggregate compensation expense of approximately $938,000 over the service period, which has been fully charged to expense as of June 2001. Expense pursuant to the options was $26,000 in 2001. In June 2001, the President and Chief

Executive Officer resigned.

(d) On March 11, 2002, the Company entered into a two-year employment agreement with Richard J. Kosinski, as Chief Executive Officer and President, and issued to Mr. Kosinski ten-year options to purchase 1,200,000 shares of the Company's common stock at an exercise price of $1.65 per share. The vesting schedule for these options was as follows: (i) 25% of the shares (300,000 shares) on March 11, 2003 and (ii) the balance of 75% of the shares over a three-year period in equal amounts of 6.25% (75,000 shares) at the end of each three-month period beginning March 11, 2003, subject to acceleration upon a change of control of the Company. In July 2003, all the options issued to Mr. Kosinski were forfeited in connection with the settlement of a lawsuit by Mr. Kosinski against the Company (see Note L[1]).

(e) The following table presents information relating to stock options outstanding and exercisable at December 31, 2002:

RANGE OF EXERCISE PRICES	OPTIONS OUTSTANDING	WEIGHTED AVERAGE EXERCISE PRICE	WEIGHTED AVERAGE REMAINING LIFE IN YEARS	OPTION EXERCISAB
$ 0.13 - $ 2.91	2,504,924	$ 1.45	9.41	320,02
$ 3.00 - $ 3.75	257,651	3.37	8.46	125,00
$ 4.13 - $ 5.69	146,200	5.40	8.04	122,28
$ 6.00 - $ 6.875	169,723	6.14	7.24	163,74
$10.00 - $ 10.125	76,000	10.11	8.37	57,12
	3,154,498	2.25	8.69	788,16

The weighted average fair value on the option grant date, including the accelerated vesting of options for Professional Services Group employees (Note G), during the years ended December 31, 2002 and 2001 were $1.13 and $1.53 per option, respectively.

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NETWORK-1 SECURITY SOLUTIONS, INC.

NOTES TO FINANCIAL STATEMENTS
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NOTE F - STOCKHOLDERS' EQUITY (CONTINUED)

[3] WARRANTS:

As of December 31, 2002, the Company has the following outstanding warrants to purchase shares of common stock:

NUMBER OF WARRANTS	EXERCISE PRICE	EXPIRATION DATE
110,278	$1.00	December 22, 2004
62,080	1.61	October 11, 2003 - January 15, 2004

62,856	2.42	May 18, 2003 - April 4, 2004
100,104	6.44	March 14, 2006 - February 24, 2007
170,000	9.30	November 12, 2003
93,120	9.66	March 14, 2006
20,000	5.00	October 31, 2003 (a)
20,000	7.50	January 2, 2004 (a)
20,000	10.00	February 28, 2004 (a)
300,000	.70	July 11, 2011 (b)
250,000	1.48	October 8, 2006 (b)
1,352,048	1.11	December 22, 2004 (c)
500,000	1.27	October 2, 2006 (d)
6,372,642	1.27	October 2, 2004 (d)
66,621	2.03	April 13, 2006 (e)
64,352	2.00	July 2, 2006 (e)
4,489	2.10	October 1, 2006 (e)
9,568,590		

In November 2000, the Company entered into a business development agreement with a marketing company and issued 200,000 warrants to purchase the Company's common stock. The warrants expired in November 2002, had an exercise price of $3.33, and had a cashless exercise provision. The warrants would have vested as specified performance and revenue targets are attained. Several of the performance targets were attained in 2001, and accordingly, 12,000 warrants vested. Expense of $12,000 was recorded based on the estimated fair value of the warrants when vested during the year ended December 31, 2001. These warrants expired unexercised in November 2002.

(a) Represents warrants issued pursuant to a consulting agreement with an advisory firm. Under the agreement, entered into on October 31, 2000, the Company was required to pay a monthly fee and issue 60,000 warrants. The warrants have exercise prices ranging from $5.00 to $10.00, expire three years after issuance, and are issued 1/3 at the inception of the agreement, 1/3 at 60 days, and 120 days after inception. The warrants were valued at $82,000 using the Black-Scholes option pricing model using the following weighted average assumptions on the issuance dates: risk-free interest rate of 5.60, volatility of 113%, dividend yield of 0 and expected life of 3 years. The value of the warrants was charged to expense over the six-month term of the agreement, resulting in $55,000 being charged to expense in 2001.

[3] WARRANTS: (CONTINUED)

(b) Issued to CMH Capital Management Corp. ("CMH") in 2001, a company owned by the Chairman of the Board (see Note K[1]).

(c) Reflects adjustments required pursuant to anti-dilution provisions of Series D preferred stock and notes payable offering (see Note F[1]).

(d) Issued with private offering of Series E preferred stock (see Note F[1]).

(e) Issued to a software development company for services rendered. The Company recognized an $80,000 expense related to the warrants based on their estimated fair value using the Black-Scholes option pricing model utilizing the following weighted average assumptions: risk free rate of 4.5%, expected life of 3 years, volatility of 113%, and a dividend yield of 0. The software development company has claimed they are entitled to additional warrants for the services rendered (see Note H[4]).

NOTE G - DISCONTINUED OPERATIONS

On February 9, 2000, the Company completed the sale of its Professional Services Group ("PSG") to Exodus Communications, Inc. ("Exodus") for $4.0 million in cash, of which $1.3 million was held in escrow subject to certain conditions. Release to the Company of cash held in escrow was conditioned upon (i) as to $1,000,000, certain PSG employees remaining employed by Exodus for at least one year and (ii) as to $300,000, to the extent purchase orders or commitments are secured by Exodus from certain customers within 90 days of the closing, up to a maximum of $300,000. PSG provided consulting services in network security and network design. Effective upon the sale, the Company granted options to acquire 104,063 shares of common stock at $2.91 per share and accelerated the vesting of 24,556 options that would have otherwise expired, with exercise prices ranging from $1.50 to $6.50 to certain employees of PSG. In connection therewith, the Company incurred a compensation charge of $794,000 based upon the intrinsic value of the portion of the options vesting at such date. The balance of the options vested one year after the closing provided that the employees were still employed by Exodus. In addition, the Company agreed to pay bonuses aggregating $160,000 to the former employees provided that they remained with Exodus for at least one year. Charges relating to the contingent options and the remittance of the bonuses are reflected as reductions of the gain on sale of discontinued operations.

In the first quarter of 2000, Exodus secured $59,000 of purchase orders from the designated customers and the Company recognized the related gain. In 2001, the Company received the $1,000,000 from the escrow for the PSG employees remaining employed by Exodus for one year, $115,000 as satisfaction of the remaining $300,000 escrow, and $65,000 of interest on the two contingency payments. The options vesting in February 2001 were valued at $230,000 using the Black-Scholes option pricing model using the following assumptions on the date of vesting: risk-free interest rate of 5.38%, volatility of 112.58%, dividend yield of 0 and expected life of 6 years. In addition, the Company paid the $160,000 of bonuses to the PSG employees and $17,000 of related payroll taxes. The completion of the sale resulted in an additional net gain recognized in 2001 of $714,000 which was reflected as a "gain on sale of discontinued operations" in the statements of operations.

NOTE H - COMMITMENTS AND CONTINGENCIES

[1] OPERATING LEASES:

At December 31, 2002, the Company leased an office facility in Massachusetts which expired during February 2003. Rental commitment for such facility at December 31, 2002 was approximately $32,000. During 2002, the Company closed its New Hampshire and Shanghai, China office facilities.

Rental expense for the years December 31, 2002 and 2001 aggregated $376,000 and $319,000, respectively.

[2] SOFTWARE DISTRIBUTION AGREEMENTS:

(a) Pursuant to a software distribution agreement entitling the Company to incorporate certain technology into its software, $100,000 of royalties payable was accrued as of December 31, 2001 and has not been paid as of December 31, 2002.

(b) Pursuant to an agreement under which certain technology was developed for the Company, royalty payments of up to $100,000 may be payable. As of December 31, 2002, royalties owed pursuant to such agreement were not significant.

[3] SAVINGS AND INVESTMENT PLAN:

The Company has a Savings and Investment Plan which allows participants to make contributions by salary reduction pursuant to Section 401(k) of the Internal Revenue Code of 1986. The Company also may make discretionary annual matching contributions in amounts determined by the Board of Directors, subject to statutory limits. The Company did not make any contributions to the 401(k) Plan during the years ended December 31, 2002 and 2001.

[4] SOFTWARE DEVELOPMENT CONTRACT DISPUTE:

The Company has a dispute with a software development company pertaining to the number of warrants the Company is required to issue for services rendered. The software development company has claimed they are entitled to approximately 325,000 additional warrants than the Company has included in the warrants outstanding in Note F[3]. The Company has included in accrued expenses any additional liability it reasonably expects to incur regarding this matter.

NOTE I - INCOME TAXES

At December 31, 2002, the Company has available net operating loss carryforwards to reduce future federal taxable income of approximately $29,969,000 for tax reporting purposes, which expire from 2009 through 2022. Pursuant to the provisions of the Internal Revenue Code, future utilization of these past losses is subject to certain limitations based on changes in the ownership of the Company's stock that have occurred.

NOTE I - INCOME TAXES (CONTINUED)

The principal components of the net deferred tax asset are as follows:

	YEAR ENDED DECEMBER 31,	
	2002	2001
Deferred tax assets:		
Net operating loss carryforwards	$ 11,238,000	$ 9,205,0
Options and warrants not yet deducted, for tax purposes	659,000	715,0
Other	382,000	221,0
	12,279,000	10,141,0
Valuation allowance	(12,279,000)	(10,141,0
Net deferred tax assets	$ 0	$

The Company has recorded a valuation allowance for the full amount of its deferred tax assets as the likelihood of its future realization cannot be presently determined. The valuation allowance was increased by $2,138,000 in 2002 and $2,274,000 in 2001.

The reconciliation between the taxes as shown and the amount that would be computed by applying the statutory federal income tax rate to the loss before income taxes is as follows:

	YEAR ENDED DECEMBER 31,	
	2002	2001
Income tax benefit - statutory rate	(34.0)%	(34.
State and local, net	(3.5)	(3.
Increase in valuation allowance on deferred tax assets	37.5	38.
Other		(1.
	0.0 %	0.

NOTE J - CONCENTRATIONS

[1] For the year ended December 31, 2002, one customer accounted for revenues of approximately $122,000 (21%). This customer was a reseller located in Singapore. For the year ended December 31, 2001, two customers accounted for revenues of approximately $154,000 (15%) and $144,000 (14%). The customer representing 14% of revenues was a reseller located in China.

[2] For the years ended December 31, 2002 and 2001, export revenues, which were primarily to Asia, amounted to approximately $168,000 and $219,000, respectively.

[3] The Company places its cash investments in high quality financial institutions insured by the Federal Deposit Insurance Corporation ("FDIC"). At December 31, 2002, the Company maintained cash balances of

$1,959,485 in excess of FDIC limits.

NETWORK-1 SECURITY SOLUTIONS, INC.

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NOTE K - RELATED PARTY TRANSACTIONS AND RELATIONSHIPS

[1] In June 2001, upon the resignation of the Company's Chief Executive Officer, the Company entered into a six-month consulting agreement with CMH, a company owned by the Chairman of the Board of the Company. Pursuant to the agreement, the Company paid CMH $17,500 per month and issued a warrant to purchase 300,000 shares of the Company's common stock at an exercise price of $.70 per share, which was the market price of the common stock on the date of issuance. In addition, CMH was reimbursed for $18,000 and $44,000 of expenses incurred during the years ended December 31, 2002 and 2001, respectively, including the allocable portion of rent for office space in New York City. The warrants were valued utilizing the Black-Scholes option pricing model, resulting in an estimated fair value of $180,000, which was expensed. In addition, in October 2001, in consideration of additional consulting and financial advisory services, the Company issued to CMH an additional warrant to purchase 250,000 shares of the common stock at an exercise price of $1.48 per share, which was the market price of the Company's common stock on the date of issuance. The warrants were valued utilizing the Black-Scholes option pricing model, resulting in an estimated fair value of $256,000, which was expensed upon grant. The weighted average assumptions used in the Black-Scholes valuations were risk-free interest rate of 4.03%, volatility of 114%, expected life of 4.6 years and 0 dividend yield. In January 2002, the agreement was extended to the lesser of six months or three months after the date of hire of a new Chief Executive Officer. In July 2002, the agreement was further extended until December 31, 2002. Since January 2003, the Company has continued its consulting arrangement with CMH on a month-to-month basis.

[2] Investors in the 2001 Financing completed on October 2, 2001 (see Note F[1](b)) included Falconstor ($2,650,000, including $350,000 allocated from the Advance as the purchase price of the additional warrant they received), Barry Rubenstein and affiliated entities ($1,750,000, including $400,000 from Wheatley Partners II, L.P. and related entities), all principal stockholders of the Company, and the wife ($75,000) of the Chairman of the Board of Directors and a principal stockholder of the Company.

[3] In December 2001, the Company entered into a one-year financial advisory agreement with an investment banking firm, which required the Company to pay $200,000 over the next ten months. At the time of entering into the agreement, the firm's Chairman of the Board owned shares of Series E preferred stock and an affiliate was the general partner of a partnership that owned common stock and held convertible notes payable, subsequently converted into common stock. During 2002, the Company agreed with the investment banking firm that no further services would be needed and that payments in the aggregate of $40,000 be considered as full satisfaction under the agreement which was accrued at December 31 and paid in January 2003. The Company charged $153,000 and $17,000 to operations during the years ended December 31, 2002 and 2001, respectively.

[4] As noted in F[1], the Company entered into a ten-year License and

Distribution Agreement with Falconstor, an investor in the 2001 Financing. This agreement requires Falconstor to pay royalties after utilizing the Advance as a credit. Deferred revenue at December 31, 2002 includes $130,000 from this agreement, representing the unearned portion of the $150,000 allocated from the Advance to the license fee, less accumulated royalties earned of $20,000 through December 31, 2002. One of the Company's principal stockholders is also a principal stockholder of Falconstor, and an affiliated entity is the Series E designee noted in F[1]. Also see Note L[4].

NETWORK-1 SECURITY SOLUTIONS, INC.

NOTES TO FINANCIAL STATEMENTS
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NOTE L - SUBSEQUENT EVENTS

[1] In January 2003, the former Chief Executive Officer, President and a director (the "Former CEO") of the Company commenced a lawsuit against the Company for breach of his employment agreement for $200,000. In June 2003, the Company entered into a settlement in which the Company agreed to pay approximately $127,000 to the Former CEO in full settlement of all claims asserted, which is reflected in the accompanying financial statements. In addition, as part of the settlement, the Former CEO agreed to forfeit his options to purchase 1,200,000 shares of the Company's common stock (see Note F[2](d)).

[2] In January 2003, the former Chief Financial Officer and a director of the Company commenced a lawsuit against the Company for breach of his employment agreement for $190,000. Management believes that it has meritorious defenses to the claims asserted. Accordingly, the Company has not accrued any amount at December 31, 2002 that might result from such litigation.

[3] In February 2003, the Company closed its principal offices in Waltham, Massachusetts and moved its principal offices to a space in New York City occupied by CMH. The Company continues to pay rent to CMH of $2,700 per month, on a month-to-month basis.

[4] On May 30, 2003, the Company completed the sale of its "Assets" and assignment of its rights under the Falconstor Agreement to the Purchaser for aggregate proceeds of $415,000. (see Notes F[1](b) and K[4]).