STORAGE COMPUTER CORP
Form 10-Q
August 14, 2001

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(MARK ONE)

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

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2001

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

FOR THE TRANSITION PERIOD FROM ____________ TO ____________ .

COMMISSION FILE NUMBER 1-13616

STORAGE COMPUTER CORPORATION
(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

DELAWARE	02-0450593
(STATE OR OTHER JURISDICTION OF INCORPORATION OR ORGANIZATION)	(I.R.S. EMPLOYER IDENTIFICATION NO.)

11 RIVERSIDE STREET NASHUA, NH 03062
(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES, INCLUDING ZIP CODE)

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes [X] No [_]

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

CLASS	OUTSTANDING AT JULY 31, 2001

Common Stock.	15,784,479

PART I -- FINANCIAL INFORMATION

PART I. FINANCIAL INFORMATION

ITEM 1. Financial Statements

Storage Computer Corporation
Consolidated Balance Sheets

	June 30, 2001	December 31, 2000

	(UNAUDITED)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 7,965,305	$14,852,259
Accounts receivable, net	701,374	847,829
Inventories	4,549,056	4,316,104
Other current assets	395,744	399,302
Total current assets	13,611,479	20,415,494
Property and equipment, net	994,286	1,141,299
Goodwill and other intangibles, net	21,662,685	23,317,443
Other assets	117,770	244,040
Total assets	$36,386,220	$45,118,276
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 1,179,947	$ 896,049
Accrued expenses	1,938,861	2,436,291
Deferred revenue and customer deposits	996,976	492,028
Current maturities of long-term debt	267,364	263,863
Total current liabilities	4,383,148	4,088,231
Long-term debt, less current maturities	1,366,571	1,489,299
Commitments and contingencies		
Redeemable convertible preferred stock	12,152,548	12,556,661
Shareholders' equity:		
Preferred stock	-	-
Common stock	15,778	15,042
Additional paid-in capital	58,122,062	57,792,635
Accumulated deficit	(39,653,887)	(30,823,592)
Total shareholders' equity	18,483,953	26,984,085
Total liabilities and shareholders' equity	$ 36,386,220	$ 45,118,276

See Notes to Consolidated Financial Statements.

Storage Computer Corporation
Statements of Consolidated Operations (Unaudited)

	Three Months Ended June 30, 2001	Three Months Ended June 30, 2000	Six Months Ended June 30, 2001	Six Months Ended June 30, 2000
Revenue	$ 950,913	$2,054,678	$ 3,010,275	$4,149,676
Product Cost	973,956	1,058,001	2,336,520	1,960,883
Gross margin	(23,043)	996,677	673,755	2,188,793
Operating expenses:				
Research and development	781,000	283,494	2,378,129	667,865
Selling and marketing	1,154,696	477,074	1,812,580	1,006,644
General and administrative	1,416,915	625,114	1,786,687	988,787
Amortization of intangibles	701,938	-	1,415,868	-
Total operating expenses	4,054,549	1,385,682	7,393,264	2,663,296
Operating loss	(4,077,592)	(389,005)	(6,719,509)	(474,503)
Other income (expense):				
Interest income (expense), net	77,590	(125,769)	188,668	(294,689)
Other income (expense)	(12,330)	17,584	102,980	120,974
Total	65,260	(108,185)	291,648	(173,715)
Loss before income taxes	(4,012,332)	(497,190)	(6,427,861)	(648,218)
Provision (credit) for income taxes	(1,889)	-	1,214	-
Net loss	(4,010,443)	(497,190)	(6,429,075)	(648,218)
Dividends on preferred stock including amortization of the beneficial conversion features	(811,853)	(621,350)	(2,401,220)	(621,350)
Loss applicable to common stockholders	$(4,822,296)	$(1,118,540)	$(8,830,295)	$(1,269,568)
Loss applicable to common stockholders per basic and dilutive share	$(.31)	$(.09)	$(.57)	$(.10)
Basic and dilutive shares	15,777,717	11,837,807	15,593,664	11,837,807

See Notes to Consolidated Financial Statements.

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Storage Computer Corporation
Statements of Consolidated Cash Flows (Unaudited)

	Six Months Ended	
	June 30, 2001	June 30, 2000
Cash flows from operating activities:		
Net loss	$(6,429,075)	$ (648,218)
Reconciliation to operating cash flows:		
Depreciation and amortization of property and equipment	256,804	319,694
Amortization of goodwill and other intangibles	1,415,868	--
Stock issued to 401(k) plan	20,958	20,500
Changes in operating assets and liabilities:		
Accounts receivable	146,455	(198,450)
Inventories	(191,664)	484,909
Other current assets	3,558	282,172
Accounts payable and accrued expenses	(82,873)	(326,776)
Net cash used in operations	(4,859,969)	(66,169)
Cash flows from investing activities:		
Capital expenditures	(109,797)	(17,065)
Other assets	126,270	(9,385)
CyberStorage acquisition cost adjustments	238,890	--
Net cash provided by (used in) investing activities	255,363	(26,450)
Cash flows from financing activities:		
Net payments on credit line	--	(6,593,770)
Reduction of long-term debt	(119,227)	--
Net proceeds from issuance of common stock for stock options and warrants	8,715	919,223
Issuance (redemption) of preferred stock	(2,130,548)	5,683,809
Net cash provided by (used in) financing activities	(2,241,060)	9,262
Effect of exchange rate changes on cash	(41,288)	(21,915)

Net decrease in cash and cash equivalents	(6,886,954)	(105,272)
Cash and cash equivalents-beginning of period	14,852,259	1,182,194
Cash and cash equivalents-end of period	$ 7,965,305	$ 1,076,922
Supplemental cash flow information:		
Cash payments of interest	$ 75,444	$ 129,933
Cash payments of income taxes	$ 1,214	--
Noncash financing activities:		
Preferred stock dividends paid in common stock	$ 333,081	--

See Notes to Consolidated Financial Statements.

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

Note A - The Company and Basis of Presentation

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

The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information. Accordingly, they do not include all the information and footnotes required by generally accepted accounting principles for complete financial statements and should be read in conjunction with the financial statements and related notes included in our Annual Report on Form 10-K filed with the Securities and Exchange Commission, containing our financial statements for the fiscal year ended December 31, 2000. In our opinion, the accompanying financial statements reflect all adjustments, all of which are of a normal, recurring nature, to fairly present our consolidated financial position, results of operations and cash flows. The results of operations for the six months ended June 30, 2001 are not necessarily indicative of the results to be expected for the full year.

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

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

Note B - Stockholders' Equity

A summary of changes in stockholders' equity in the six months ended June 30, 2001 and 2000 follows:

	Common Stock		Additional	
	Shares	Par Value	Paid-In Capital	Retained Deficit
Balance--December 31, 1999	11,434,880	$ 11,435	$13,968,263	$ (9,963,058)
Exercise of stock options	571,630	572	852,460	
Stock issued to 401 (k) plan	3,248	3		20,497
Net loss	(618,218)			
Balance--June 30, 2000	12,009,758	$ 12,010	$14,841,220	$(10,611,276)
Balance--December 31, 2000	15,041,882	$ 15,042	$57,792,635	$(30,823,592)
Exercise of stock options	3,433	4	8,709	
Stock issued to 401(k) plan	3,069	3	20,955	
Conversion of redeemable convertible preferred shares into common shares and related accrued dividends paid in common shares	671,256	671	61,487	
Amortization of beneficial conversion feature of preferred stock				(1,770,886)
Dividends on preferred stock	58,077	58	238,276	(630,334)
Net loss				(6,429,075)
Balance-June 30, 2001	15,777,717	$15,778	$58,122,062	$(39,653,887)

Note C - Recent Accounting Pronouncements

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

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

The Company's previous business combinations were accounted for using the purchase method. As of June 30, 2001, the net carrying amount of goodwill is $17,223,635 and other intangible assets is $4,439,050. Amortization expense during the six-month period ended June 30, 2001 was $1,415,868. Currently, the Company is assessing but has not yet determined how the adoption of SFAS 141 and SFAS 142 will impact its financial position and results of operations.

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

CAUTIONARY STATEMENT

Forward-looking Statements

THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1996 CONTAINS CERTAIN SAFE HARBORS REGARDING FORWARD-LOOKING STATEMENTS. FROM TIME TO TIME, INFORMATION PROVIDED BY US OR STATEMENTS MADE BY OUR DIRECTORS, OFFICERS OR EMPLOYEES MAY CONTAIN "FORWARD-LOOKING" INFORMATION SUBJECT TO NUMEROUS RISKS AND UNCERTAINTIES. ANY STATEMENTS MADE HEREIN THAT ARE NOT STATEMENTS OF HISTORICAL FACT ARE FORWARD-LOOKING STATEMENTS INCLUDING, BUT NOT LIMITED TO, STATEMENTS CONCERNING THE CHARACTERISTICS AND GROWTH OF OUR MARKETS AND CUSTOMERS, OUR OBJECTIVES AND PLANS FOR FUTURE OPERATIONS AND PRODUCTS AND OUR EXPECTED LIQUIDITY AND CAPITAL RESOURCES. SUCH FORWARD-LOOKING STATEMENTS ARE BASED ON A NUMBER OF ASSUMPTIONS AND INVOLVE A NUMBER OF RISKS AND UNCERTAINTIES, AND, ACCORDINGLY, ACTUAL RESULTS COULD DIFFER MATERIALLY. FACTORS THAT MAY CAUSE SUCH DIFFERENCES INCLUDE, BUT

ARE NOT LIMITED TO: THE CONTINUED AND FUTURE ACCEPTANCE OF OUR PRODUCTS; THE RATE OF GROWTH IN THE INDUSTRIES OF OUR PRODUCTS; THE PRESENCE OF COMPETITORS WITH GREATER TECHNICAL, MARKETING AND FINANCIAL RESOURCES; OUR ABILITY TO PROMPTLY AND EFFECTIVELY RESPOND TO TECHNOLOGICAL CHANGE TO MEET EVOLVING CUSTOMER NEEDS; RISKS ASSOCIATED WITH SALES IN FOREIGN COUNTRIES; AND OUR ABILITY TO SUCCESSFULLY EXPAND OUR OPERATIONS.

INTRODUCTION

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

LIQUIDITY AND CAPITAL RESOURCES

CASH FLOW

Operations used $4,860,000 of cash during the first six months of 2001 compared to $66,000 in the first six months of 2000.

The use of cash by operations in the first six months of 2001 resulted from the net loss for that period and net cash used for changes in operating assets and liabilities partially offset by a $540,000 customer order deposit, which were offset in part by non cash charges relating to depreciation and amortization of $1,673,000. The cash used by operations in the first six months of 2000 resulted primarily from the net loss for that period and net cash provided by changes in operating assets and liabilities, which were offset in part by non cash charges relating to depreciation and amortization of $320,000.

Investing activities generated positive cash flow of $255,000 in the first six months of 2001 from other assets partially offset by capital expenditures. Investing activities used cash flow in the first six months of 2000 primarily for capital expenditures.

Financing activities used $2,241,000 of cash in the first six months of 2001 primarily for the redemption of Series A and B preferred stock for $2,131,000 in May. During the first six months of 2000, our bank credit facility was virtually paid off with the proceeds of the sale of Series A preferred stock and through the exercise of options and warrants.

BORROWING ARRANGEMENTS

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

WORKING CAPITAL

Our working capital at June 30, 2001 was $9,228,000 compared with $16,327,000 at December 31, 2000. In management's opinion, our current working capital position and cash from operations, will be sufficient to accommodate working capital requirements through the fiscal year ending December 31, 2001.

EQUITY FINANCING

During 2000, we successfully raised over $22 million from several investors through the sale of 112,000 shares of Series A, Series B and Series C Preferred Stock and related warrants. These sales to investors have significantly improved our cash liquidity and working capital position.

RESULTS OF OPERATIONS

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

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

REVENUE

Revenue for the three month period and six month periods ended June 30, 2001 were $951,000 and $3,010,000 compared to $2,055,000 and $4,150,000 for the respective periods in 2000. Revenue growth for both international and domestic products continue to be impacted by the factors described above. For the three month period ended June 30, 2001, U.S. domestic product sales and international product sales were 73% and 27%, respectively, of total revenue compared to 67% and 37% for the same period in 2000. For the six month period ended June 30, 2001, U.S. domestic product sales and international product sales were 69% and 31%, respectively, of total revenue compared to 49% and 51% for the same period in 2000.

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

PRODUCT COST

The increase in product cost percentage between 2000 and 2001 of approximately 23% experienced in the first quarter continued to increase to 31% for the year to date and 99% for the three months ended June 30, 2001. This was the result of increased factory costs of enhanced quality assurance programs and higher technical service expenditures both of which have been implemented in anticipation of our planned growth in sales but are incurred currently on lower sales volumes and lower margin product mix.

RESEARCH AND DEVELOPMENT

Research and development expenses for the three month periods ended June 30, 2001 and 2000 were $781,000 and $283,000, respectively, and $2,378,000 and $668,000, respectively, for the six month periods ended June 30, 2001 and 2000. The $883,000 increase in expenditures between the three month periods ended March 31, 2000 and 2001 was reduced to an increase of $498,000 for the three month periods ended June 30, 2001 and 2000. This is a direct result of increased research and product development personnel who have permanently joined our staff and a reduction in the utilization of independent software engineers for short term assignments.

SELLING AND MARKETING EXPENSES

Selling and marketing expenses for the three month periods and the six month periods ended June 30, 2001 and 2000 continue to reflect the increased head count in corporate marketing and field sales organizations and in the three months ended June 30, 2001 costs associated with greater trade show activity of $170,000 and marketing materials and web site development costs of $80,000.

GENERAL AND ADMINSTRATIVE EXPENSES

General and administrative expenses for the three month periods and the six month periods ended June 30, 2001 and 2000, respectively, reflect the higher level of personnel due to the CyberStorage acquisition. In the three months ended June 30, 2001 costs were incurred by U.K. attorneys and by expert witnesses aggregating $280,000 in connection with our intellectual properties litigation.

AMORTIZATION OF INTANGIBLES

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

INTEREST EXPENSE

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

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NET LOSS

We incurred a net loss for the three month period ended June 30, 2001 of $4,010,000 compared to $497,000 for the three month period ended June 30, 2000. The increase in net loss of $3,513,000 compared to the increase in net loss for the first quarter of $2,268,000 is primarily attributable to the lower sales volume and related effect on gross margin, the changes in operating expenses described above and the non-cash charges for amortization of intangibles of $714,000 during the three months ended June 30, 2001, in connection with the acquisition of CyberStorage Systems Corporation in 2000.

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

FOREIGN CURRENCY TRANSACTIONS

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

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

RECENT ACCOUNTING PRONOUNCEMENTS

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

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The Company's previous business combinations were accounted for using the purchase method. As of June 30, 2001, the net carrying amount of goodwill is $17,223,635 and other intangible assets is $4,439,050. Amortization expense during the six-month period ended June 30, 2001 was $1,415,868. Currently, the Company is assessing but has not yet determined how the adoption of SFAS 141 and SFAS 142 will impact its financial position and results of operations.

FACTORS THAT MAY AFFECT FUTURE RESULTS

OUR STOCK PRICE IS VOLATILE

Our stock price, like that of other technology companies, is subject to significant volatility because of factors such as:

- the announcement of new products, services or technological innovations by us or our competitors
- quarterly variations in our operating results
- changes in revenue or earnings estimates by the investment community
- speculation in the press or investment community
- failure to meet earning expectations

In addition, our stock price may be affected by general market conditions and domestic and international economic factors unrelated to our performance. Further, until recently, our common stock was thinly traded. Because of these factors, recent trends should not be considered reliable indicators of future stock prices or financial results.

OUR BUSINESS MAY SUFFER IF WE CANNOT PROTECT OUR INTELLECTUAL PROPERTY

We generally rely upon patent, copyright, trademark and trade secret laws and contract rights in the United States and in other countries to establish and maintain our proprietary rights in our technology and products. However, there can be no assurance that any of our proprietary rights will not be challenged, invalidated or circumvented. In addition, the laws of certain countries do not protect our proprietary rights to the same extent, as do the laws of the United States. Therefore, there can be no assurance that we will be able to adequately protect our proprietary technology against unauthorized third-party copying or use, which could adversely affect our competitive position. Further, there can be no assurance that we will be able to obtain licenses to any technology that it may require to conduct its business or that, if obtainable, such technology can be licensed at a reasonable cost.

We are aggressively pursuing the enforcement of our intellectual property rights after an extensive patent review conducted in 1999. During the first quarter in 2000, we retained a major law firm to enforce these rights against infringing parties, which we believe to be extensive. During the first quarter in 2001, we filed lawsuits against Hitachi Data Systems Ltd. in the United Kingdom and Seagate Technologies, Inc. in Federal District Court in Texas, regarding their alleged infringement of our patents. Despite our efforts and those of our legal representatives, there can be no assurance or predictability as to any amount of recovery or the length of time it will take us to recover any royalties or license fees which may be recoverable. Despite our efforts to protect our intellectual property rights, unauthorized use may still occur, particularly in foreign countries.

DEVELOPMENT OF NEW PRODUCTS AND SOLUTIONS

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

COMPETITION

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

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

RAPID TECHNOLOGICAL CHANGES

The computer industry is changing both dramatically and rapidly. The development of "open systems computing", the introduction of the Internet, new fibre technologies (SAN), network attached storage (NAS) and the increasing storage density in disk drive technologies, have caused an increase in new product development and shorter time to bring the new products to market. While we believe that our Virtual Storage Architecture and StorageSuite products are advanced when compared to competitive products, and complement many other products utilized in total customer solutions, there can be no assurance that this will continue in the future. The failure to remain consistently ahead of competitive technologies would have a negative impact on our operating results and financial condition.

BUSINESS ALLIANCES

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

OPERATIONS

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

Additionally, most companies in the high technology arena are under pressure to be able to acquire and retain the services of talented individuals. At present, there is a shortage in the number of qualified employees who are available, creating a lucrative job market for qualified and talented high tech employees. We have had a decline in revenue in each of the three previous years and comparable reduction in our work force. While we believe that we have the required core personnel to effectively manage and grow, there can be no assurance that key employees will not leave our employment in the future. The failure to maintain key employees could adversely affect our operating and financial results in the future.

LIQUIDITY AND WORKING CAPITAL

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

FAILURE OF SUPPLIERS TO PROVIDE QUALITY PRODUCTS

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

CHANGES IN LAWS, REGULATIONS OR OTHER CONDITIONS THAT COULD ADVERSELY IMPAIR OUR CONDITION

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

LITIGATION THAT WE MAY BECOME INVOLVED IN MAY ADVERSELY AFFECT US

In the ordinary course of business, we may become involved in litigation, administrative proceedings and governmental proceedings. Such matters can be time-consuming, divert management's attention and resources and cause us to incur significant expenses. Furthermore, there can be no assurance that the results of any of these actions will not have a material adverse effect on our business, results of operations or financial condition.

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Item 3. Quantitative and Qualitative Disclosures About Market Risk

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

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings.

During March 2001 we filed legal actions against Hitachi Data Systems Ltd. in the United Kingdom for infringement of one of the patents in our intellectual property rights portfolio. Additionally, we filed an action against XIOTech Corporation and its parent company, Seagate Technology Inc., in the Federal District Court for the Northern District of Texas claiming that one of their products infringe one of our patents. Our involvement in both of these proceedings can not possibly be predicted as to any recovery or length of time required to recover our damages, but we intend to vigorously pursue our claims against manufacturers whose products we believe infringe on our patents.

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

Item 2. Changes in Securities and Use of Proceeds. During the quarter ended June 30, 2001, Series B Preferred Stockholders converted 2,000 shares of Series B Preferred stock and accrued dividends into 60,233 shares of our common stock. No cash was received as a result of these conversions. Also, during this quarter we redeemed 7,000 shares of Series A Preferred Stock and 10,000 shares of Series B Preferred Stock, together with accrued dividends, for $2,171,844.

Item 3. Defaults Upon Senior Securities. There has not been any material default in the payment of principal, interest, or any other material default not cured within 30 days with respect to any of our indebtedness and our subsidiaries during the six month period ended June 30, 2001.

Item 4. Submission of Matters to a Vote of Security Holders. At our Annual Meeting of Stockholders held on May 18, 2001 the following matters were voted:

The following individuals were elected to the Board of Directors:

	Votes For	Votes Withheld
Theodore J. Goodlander	9,677,237	53,855
Edward A. Gardner	9,677,309	53,783
Steven S. Chen	9,677,309	53,783
Roger E. Gauld	9,677,309	53,783
John Thonet	9,677,309	53,783

The vote to ratify the action of the Board of Directors in appointing BDO Seidman, LLP as the Company's auditors for the year ending December 31, 2001 was:

Votes For	Votes Against	Votes Withheld
9,709,286	7,844	13,962

The vote to approve the issuance of shares of the Company's Common Stock upon conversion of the Company's Series B 8% Convertible Preferred Stock was:

Votes For	Votes Against	Votes Withheld
9,582,863	131,191	17,038

The vote to approve the issuance of shares of the Company's Common Stock upon conversion of the Company's Series C 8% Convertible Preferred Stock was:

Votes For	Votes Against	Votes Withheld
9,572,003	141,601	17,488

The vote to approve the issuance of shares of the Company's Common Stock upon conversion of the Company's Series D 8% Convertible Preferred Stock was:

Votes For	Votes Against	Votes Withheld
9,573,148	140,093	17,851

The vote to amend the Company's Certificate of Incorporation to increase the authorized number of shares of Common Stock of the Company from 25,000,000 to 50,000,000 shares was:

Votes For	Votes Against	Votes Withheld
9,615,241	99,143	16,708

Item 5. Other Information.

None

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

A. Exhibits -None

B. Reports on Form 8-K - None

SIGNATURE

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

STORAGE COMPUTER CORPORATION
Registrant

/s/ PETER N. HOOD

Peter N. Hood
Chief Financial Officer

Date: August 14, 2001