

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

FORM 10-QSB

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES  
EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2000

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

COMMISSION FILE NUMBER 1-14896

NETWORK-1 SECURITY SOLUTIONS, INC.

-----  
(EXACT NAME OF SMALL BUSINESS ISSUER AS  
SPECIFIED IN ITS CHARTER)

DELAWARE

11-3027591

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

1601 TRAPELO ROAD, RESERVOIR PLACE, WALTHAM, MASSACHUSETTS 02451

-----  
(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES)

781-522-3400

-----  
(ISSUER'S TELEPHONE NUMBER)

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

As of May 5, 2000 there were 6,147,482 shares of Common Stock, \$.01 par value  
per share, and 197,188 shares of Series D Convertible Preferred Stock, \$.01 par  
value per share, outstanding. Transitional Small Business Disclosure Format  
(check one):  
Yes  No

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NETWORK-1 SECURITY SOLUTIONS, INC.  
BALANCE SHEETS

<TABLE><CAPTION>

	March 31, 2000 (Unaudited)	December 31, 1999 (Audited)
	<C>	<C>
<S>		
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 7,524,000	\$ 3,023,000
Accounts receivable - net of allowance for doubtful accounts of \$35,000 and \$40,000 respectively	157,000	65,000
Prepaid expenses and other current assets	179,000	155,000
Due from officer	0	88,000
	-----	-----
Total current assets	7,860,000	3,331,000
Equipment and fixtures	444,000	425,000
Capitalized software costs - net	538,000	500,000
Security deposits	82,000	82,000
Net assets of discontinued operations	102,000	258,000
	-----	-----
	\$ 9,026,000	\$ 4,596,000
	=====	=====
LIABILITIES		
Current liabilities:		
Accounts payable	\$ 200,000	\$ 320,000
Accrued expenses and other current liabilities	687,000	546,000
Deferred revenue	80,000	58,000
	-----	-----
Total current liabilities	967,000	924,000
Notes payable - related parties	525,000	525,000
Notes payable - others	975,000	975,000
Interest payable - related parties	11,000	1,000
Interest payable - others	22,000	2,000
	-----	-----

	2,500,000	2,427,000
	-----	-----
Commitments and contingencies		
STOCKHOLDERS' EQUITY		
Preferred stock - \$.01 par value; authorized 5,000,000 shares; Series A -10% cumulative, none issued and outstanding Series B - none issued and outstanding Series C - none issued and outstanding		
Series D -197,188 and 491,803 shares issued and outstanding, respectively	2,000	5,000
Common stock - \$.01 par value; authorized 25,000,000 shares; 5,919,262 and 4,935,211 shares issued and outstanding	59,000	50,000
Additional paid-in capital	27,389,000	23,941,000
Accumulated deficit	(20,833,000)	(21,693,000)
Unearned portion of compensatory stock options	(91,000)	(134,000)
	-----	-----
	6,526,000	2,169,000
	-----	-----
	\$ 9,026,000	\$ 4,596,000
	=====	=====

</TABLE>

SEE NOTES TO FINANCIAL STATEMENTS

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

<TABLE><CAPTION>

	Three Months Ended March 31,	
	2000	1999
	-----	-----
	<C>	<C>
Revenues:		
Licenses	\$ 157,000	\$ 70,000
Services	35,000	34,000
	-----	-----
Total revenues	192,000	104,000
Cost of revenues:		
Amortization of software development costs	61,000	135,000
Cost of licenses	6,000	17,000
Cost of services	28,000	48,000
	-----	-----
	95,000	200,000
	-----	-----
Gross profit (loss)	97,000	(96,000)
	-----	-----
Operating expenses:		
Product development	293,000	388,000
Selling and marketing	488,000	774,000
General and administrative	517,000	513,000
	-----	-----
	1,298,000	1,675,000
	-----	-----
Loss from continuing operations before interest	(1,201,000)	(1,771,000)
Interest income - net	33,000	65,000
	-----	-----
Loss from continuing operations	\$(1,168,000)	\$(1,706,000)
Income (loss) from discontinued operations	2,028,000	(124,000)
	-----	-----
Net income (loss)	\$ 860,000	\$(1,830,000)
	=====	=====
Per common share information - basic and diluted		
Loss from continuing operations	\$ (0.22)	\$ (0.39)
Income (loss) from discontinued operations	0.38	(0.03)
	-----	-----
Net income (loss)	\$ 0.16	\$ (0.42)
	=====	=====
Weighted average number of common shares outstanding	5,326,112	4,371,529

</TABLE>

SEE NOTES TO FINANCIAL STATEMENTS

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NETWORK-1 SECURITY SOLUTIONS, INC.  
STATEMENTS OF STOCKHOLDERS' EQUITY

<TABLE><CAPTION>

	Common Stock		Preferred Stock			
	Shares	Amount	Shares	Amount		
	<C>	<C>	<C>	<C>		
Balance - December 31, 1998		4,366,520	\$ 44,000	562,836	\$	6,000
Amortization of compensatory stock options		--	--	--		--
Issuance of common stock and options for services rendered and payment of liability		5,855	--	--		--
Conversion of Series C preferred stock		562,836	6,000	(562,836)		(6,000)
Issuance of Series D preferred stock and warrants, net of expense of \$34,000		--	--	491,803		5,000
Beneficial conversion feature of Series D preferred stock and related imputed dividend		--	--	--		--
Net Loss		--	--	--		--
Balance - December 31, 1999		4,935,211	50,000	491,803		5,000
Amortization of compensatory stock options		--	--	--		--
Conversion of Series D preferred stock		294,615	3,000	(294,615)		(3,000)
Exercise of employee & non-employee stock options		454,192	4,000	--		--
Exercise of Warrants		235,244	2,000	--		--
Compensation charge for issuance of non-qualified stock options		--	--	--		--
Net Income		--	--	--		--
Balance - March 31, 2000		5,919,262	\$ 59,000	197,188	\$	2,000

</TABLE>

NETWORK-1 SECURITY SOLUTIONS, INC.  
STATEMENTS OF STOCKHOLDERS' EQUITY(continued)

<TABLE><CAPTION>

	Paid-in Capital	Accumulated Deficit	Compensatory Stock Options	Total		
	<C>	<C>	<C>	<C>		
Balance - December 31, 1998		\$ 20,819,000	\$(13,247,000)	\$ (383,000)	\$	7,239,000
Amortization of compensatory stock options		--	--	249,000		249,000
Issuance of common stock and options for services rendered and payment of liability		161,000	--	--		161,000
Conversion of Series C preferred stock		--	--	--		0
Issuance of Series D preferred stock and warrants, net of expense of \$34,000		1,461,000	--	--		1,466,000
Beneficial conversion feature of Series D preferred stock and related imputed dividend		1,500,000	(1,500,000)	--		0
Net Loss		--	(6,946,000)	--		(6,946,000)
Balance - December 31, 1999		23,941,000	(21,693,000)	(134,000)		2,169,000
Amortization of compensatory stock options		--	--	43,000		43,000
Conversion of Series D preferred stock		--	--	--		--
Exercise of employee & non-employee stock options		2,200,000	--	--		2,204,000
Exercise of Warrants		723,000	--	--		725,000

Compensation charge for issuance of non-qualified stock options	525,000	--	--	525,000
Net Income	--	860,000	--	860,000
Balance - March 31, 2000	\$ 27,389,000	\$ (20,833,000)	\$ (91,000)	\$ 6,526,000

</TABLE>

SEE NOTES TO FINANCIAL STATEMENTS

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NETWORK-1 SECURITY SOLUTIONS, INC.  
STATEMENTS OF CASH FLOWS FOR THE QUARTER ENDED

<TABLE><CAPTION>

	MARCH 31,	
	2000	1999
	(Unaudited)	(Unaudited)
<S>	<C>	<C>
Cash flows from operating activities:		
Loss from continuing operations		\$(1,168,000) \$(1,706,000)
Adjustments to reconcile net loss from continuing operations to net cash used in operating activities:		
Issuance of common stock and warrants for services rendered	43,000	144,000
Provision for doubtful accounts	(5,000)	60,000
Depreciation and amortization	90,000	165,000
Changes in:		
Accounts receivable	(87,000)	(11,000)
Prepaid expenses and other current assets		(23,000) (135,000)
Accounts payable, accrued expenses and other current liabilities	21,000	299,000
Interest Payable	30,000	-
Deferred revenue	22,000	(12,000)
Net cash used in continuing operations	(1,077,000)	(1,196,000)
Cash provided by (used in) discontinued operations	10,000	(245,000)
Net cash provided by (used in) operating activities	(1,067,000)	(1,441,000)
Cash flows from investing activities:		
Acquisitions of equipment and fixtures	(49,000)	(214,000)
Capitalized software costs	(100,000)	(100,000)
Security deposit		(78,000)
Loan to officer	88,000	-
Proceeds from sale of professional services group	2,700,000	-
Net cash provided by (used in) investing activities	2,639,000	(392,000)
Cash flows from financing activities:		
Proceeds from exercise of options and warrants	2,929,000	-
Net cash provided by financing activities	2,929,000	-
Net increase (decrease) in cash and cash equivalents	4,501,000	(1,833,000)
Cash and cash equivalents - beginning of period	3,023,000	6,423,000
Cash and cash equivalents - end of period	\$ 7,524,000	\$ 4,590,000

</TABLE>

SEE NOTES TO FINANCIAL STATEMENTS

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

1. FINANCIAL STATEMENT PRESENTATION

a. The financial statements included herein have been prepared by the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission with respect to Form 10-QSB. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations, although the Company believes that the disclosures made herein are adequate to make the information contained herein not misleading. These interim financial statements and the notes thereto should be read in conjunction with the financial statements included in the Company's 10-KSB filed March 21, 2000 for the year ended December 31, 1999. In the Company's opinion, all adjustments (consisting only of normal recurring adjustments) necessary for a fair presentation of the information shown have been included.

b. The results of operations for the three months ended March 31, 2000 presented herein are not necessarily indicative of the results of operations that may be expected for the year ending December 31, 2000.

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

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

THIS QUARTERLY REPORT ON FORM 10-QSB CONTAINS FORWARD-LOOKING STATEMENTS WITHIN THE MEANING OF SECTION 27A OF THE SECURITIES ACT OF 1933, AS AMENDED (THE "SECURITIES ACT"), AND SECTION 21E OF THE SECURITIES EXCHANGE ACT OF 1934, AS AMENDED (THE "EXCHANGE ACT"). ACTUAL RESULTS, EVENTS AND CIRCUMSTANCES (INCLUDING FUTURE PERFORMANCE, RESULTS AND TRENDS) COULD DIFFER MATERIALLY FROM THOSE SET FORTH IN SUCH STATEMENTS DUE TO VARIOUS RISKS AND UNCERTAINTIES, INCLUDING, BUT NOT LIMITED TO, THOSE DISCUSSED IN THE COMPANY'S ANNUAL REPORT ON FORM 10-KSB FOR THE YEAR ENDED DECEMBER 31, 1999 IN THE SECTION ENTITLED "RISK FACTORS THAT MAY AFFECT FUTURE RESULTS" AS WELL AS THESE RISKS DISCUSSED ELSEWHERE IN THIS REPORT.

### Overview

The Company develops, markets, licenses and supports a family of network security software products designed to provide comprehensive security to computer networks, including Internet based systems and internal networks and computing resources. From inception (July 1990) through December 31, 1994, the Company was primarily engaged in providing consulting and training services. In 1995, the Company began to shift its focus from consulting and training to the development and marketing of network security software products. The Company introduced its first network software product (FIREWALL/PLUS) in June 1995. In January 1999, the Company introduced its CYBERWALLPLUS family of network security products. Accordingly, the Company has a limited relevant operating history as a software developer and has made only limited sales of its CYBERWALLPLUS product, upon which an evaluation of its prospects and future performance can be made. Such prospects must be considered in light of the risks, expenses and difficulties frequently encountered in the operation and expansion of a new business and the shift from research and product development to commercialization of products based on rapidly changing technologies in a highly specialized and emerging market. The Company will be required to significantly expand its product and development capabilities, introduce new products, introduce enhanced features to existing products, expand its in-house sales force, establish and maintain distribution channels through third-party vendors, increase marketing expenditures, and attract additional qualified personnel. In addition, the Company must adapt to the demands of an emerging and

rapidly changing computer network security market, intense competition and rapidly changing technology and industry standards. The Company may not be able to successfully address such risks, and the failure to do so would have a material adverse effect on the Company's business, results of operations and financial condition.

To date, the Company has incurred significant losses and, at March 31, 2000, had an accumulated deficit of \$20,833,000. In addition, since March 31, 2000, the Company has continued to incur significant operating losses. The Company expects to incur substantial operating expenses in the future to support its product development activities, as well as continue to expand its domestic and international sales activities and marketing capabilities.

In February 2000, the Company completed the sale of its professional services business for a sales price of \$4.0 million which included \$1.3 million held in escrow subject to certain former employees of the Company remaining employed by the purchaser for at least one year and the purchaser securing certain minimum purchase orders within ninety (90) days of the closing. The sale has been accounted for by the Company as a sale of a discontinued operation and the Company recorded a gain on the sale of \$2,028,000 in the first quarter of 2000. The Company's professional services business accounted for 77% and 62% of its total revenues during the fiscal years ended December 31, 1999 and December 31, 1998, respectively. Accordingly, as a result of the sale of its professional services business, the Company's cash flow from operations is likely to be materially adversely effected until, if ever, the Company generates sufficient revenue from the licensing of its software products. In connection with the sale, the Company agreed not to offer any professional consulting services competitive with the purchaser until the second anniversary of the closing. Effective upon the sale, the Company granted options to acquire 104,063 shares of Common Stock at \$2.91 per share to certain employees of the professional services business. In connection therewith, the Company incurred a compensation charge of \$525,000 based upon the intrinsic value of the portion of the options vesting at such date. The balance of the options vest one year after the closing provided that the employees are still employed by Exodus. An additional charge of \$863,000 will be incurred at such date assuming all the options vest.

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The Company's software products have not yet achieved significant market acceptance. The future success of the Company is largely dependent upon the size of market acceptance of its CYBERWALLPLUS family of software products. While the Company believes that its family of software products offer advantages over competing products for network security, license revenue from network security software products since the introduction of FIREWALL/PLUS (June 1995), a predecessor product line, through March 31, 2000 has only been \$3,079,000, including a non-refundable pre-paid royalty of \$500,000 in 1997. From January 1999 through March 31, 2000, license revenue from CYBERWALLPLUS has only been \$352,000. CYBERWALLPLUS may not achieve significant market acceptance. Revenue from such commercial products depend on a number of factors, including the influence of market competition, technological changes in the network security market, the Company's ability to design, develop and introduce enhancements on a timely basis, and the ability of the Company to successfully establish and maintain distribution channels. The failure of CYBERWALLPLUS to achieve significant market acceptance as a result of competition, technological change or other factors, would have a material adverse effect on the Company's business, operating results and financial condition.

The Company has committed significant product and development resources to its CYBERWALLPLUS family of products. The Company's anticipated levels of expenditures for product development are based on its plans for product enhancements and new product development. The Company capitalizes and amortizes software development costs in accordance with Statement of Financial Accounting Standards No. 86. These costs consist of salaries, consulting fees and applicable overhead. The Company will use a portion of the proceeds from its private offering, the sale of its professional services business and proceeds from option and warrant exercises during 2000 to significantly increase its product development expenditures.

## RESULTS OF OPERATIONS

### THREE MONTHS ENDED MARCH 31, 2000 COMPARED TO THREE MONTHS ENDED MARCH 31, 1999

Revenues increased by \$88,000 or 85%, from \$104,000 for the three

months ended March 31, 1999 to \$192,000 for the three months ended March 31, 2000, primarily as a result of an increase in license revenues during the three months ended March 31, 2000. License revenues increased by \$87,000 or 124%, from \$70,000 for the three months ended March 31, 1999 to \$157,000 for the three months ended March 31, 2000, primarily due to increased selling and marketing activities. In addition, because of the recent attacks on such websites as E-Bay and Yahoo, management believes that customers are becoming more aware of the potential impact of security breaches, and that companies are allocating increasing resources to safeguard their assets. Service revenues increased by \$1,000 or 3%, from \$34,000 for the three months ended March 31, 1999 to \$35,000 for the three months ended March 31, 2000. The Company's revenues from customers in the United States represented 90% and 87% of its revenues during the three months ended March 31, 1999 and 2000, respectively.

Cost of revenues consists of cost of licenses, amortization of software development costs and cost of services. Cost of licenses consist of software media (disks), documentation, product packaging, production costs and product royalties. Cost of licenses decreased by \$11,000 or 65%, from \$17,000 for the three months ended March 31, 1999 to \$6,000 for the three months ended March 31, 2000, representing 24% and 4% of license revenues, respectively. The decrease in cost of licenses was due to royalties paid in 1999 on third party product revenues. Cost of licenses as a percentage of license revenues may fluctuate from period to period due to changes in product mix, changes in the number or size of transactions recorded in a given period or an increase or decrease in licenses of products which would require the Company to pay royalties to third parties.

Amortization of software development costs decreased by \$74,000 or 55%, from \$135,000 for the three months ended March 31, 1999 to \$61,000 for the three months ended March 31, 2000, representing 193% and 39% of license revenues, respectively. The decrease in amortization of software development costs was due to the write-off in 1999 of unamortized capitalized software costs associated with the Company's predecessor product line, FIREWALL/PLUS, and other technology discontinued or replaced.

Cost of services consist of salaries, benefits and overhead associated with technical support and maintenance contracts. Cost of services decreased by \$20,000 or 42%, from \$48,000 for the three months ended March 31, 1999 to \$28,000 for the three months ended March 31, 2000, representing 141% and 80% of service revenues, respectively. The decrease in cost of services in dollar amount and as a percentage of service revenues resulted primarily from a reduction in personnel costs as a result of the consolidation of the Company's former Texas facility. Cost of services as a percentage of service revenues may fluctuate from period to period due to changes in support headcount and related benefit costs.

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Gross profit was \$97,000 for the three months ended March 31, 2000 compared to a gross loss of (\$96,000) for the three months ended March 31, 1999, representing 51% and (92%) of revenues, respectively. The increase in gross profit was primarily due to the increase in license revenue and the decrease in amortization of capitalized software costs.

Product development consists of salaries, benefits, bonuses, travel and related costs of the Company's product development personnel, including consulting fees, the costs of computer equipment used in product and technology development. Product development expense decreased \$95,000 or 24%, from \$388,000 for the three months ended March 31, 1999 to \$293,000 for the three months ended March 31, 2000, representing 373% and 153% of revenues, respectively. Total product developments costs, including capitalized costs of \$100,000, were \$488,000 and \$393,000 for the three months ended March 31, 1999 and March 31, 2000, respectively. The decrease in total product development costs was due primarily to the reduction in personnel costs as a result of the consolidation of the Company's former Texas facility, the discontinuation in the use of outside development consultants and the expiration of computer equipment operating leases. The Company currently anticipates that product development costs will increase as the Company hires additional software engineers and developers to support the Company's growth.

Sales and marketing expenses consist primarily of salaries, including commissions, benefits, bonuses, travel, advertising, public relations, consultants and trade shows. Selling and marketing expenses decreased by

\$286,000 or 37%, from \$774,000 for the three months ended March 31, 1999 to \$488,000 for the three months ended March 31, 2000, representing 744% and 254% of revenues, respectively. The decrease in selling and marketing expenses was due primarily to a decrease in personnel costs and travel expenditures related to the outside sales team in 1999 which was replaced primarily with an inside sales team late in 1999, a decrease in use of outside consultants, an international sales program based mostly on inside sales, a decrease in recruitment fees, a decrease in public relations costs, and a decrease in costs associated with redesigning the Company's web-site which was partially offset by increases in trade show participation. The Company currently anticipates that selling and marketing expenses will increase as the Company hires additional personnel to support its growth.

General and administrative expenses include employee costs, including salary, benefits, travel and other related expenses associated with management, finance and accounting operations, and legal and other professional services provided to the Company. General and administrative expenses increased by \$4,000 or 1%, from \$513,000 for the three months ended March 31, 1999 to \$517,000 for the three months ended March 31, 2000, representing 493% and 269% of revenues, respectively. Increases in legal expense of \$56,000 or 172% was offset by decreases in telecommunication costs, costs associated with establishing the new corporate office and non-cash charges of \$52,000 relating to the amortization of the value of stock options granted to the Company's Chief Executive Officer in May 1998. The Company currently anticipates that general and administrative expenses will increase as the Company hires additional personnel to support its growth in future periods.

Net interest income decreased by \$32,000 or 49%, from \$65,000 for the three months ended March 31, 1999 to \$33,000 for the three months ended March 31, 2000, representing 63% and 17% of revenues, respectively. The Company completed a Series D Preferred Stock, warrant and promissory note financing on December 22, 1999 which resulted in an interest charge of \$30,000 for the three months ended March 31, 2000. At the Company's April 28, 2000 annual meeting, the stockholders of the Company approved the conversion feature of the promissory notes into preferred stock and warrants. Accordingly, in the second quarter of 2000, the Company will incur an interest charge of \$1,500,000 related to the excess of the market value of the common stock (on the closing date of the December financing) issuable upon conversion of the preferred stock and exercise of the warrants issuable upon conversion of the notes.

Income from discontinued operations was \$2,028,000 for the three months ended March 31, 2000 compared with a loss of \$124,000 for the three months ended March 31, 1999. Income from discontinued operations for the three months ended March 31, 2000 was due primarily to proceeds from the sale of the professional services group in February 2000 of \$2,700,000 less value of net assets of the business and a non-cash charge of \$525,000 relating to the issuance of non-qualified options which were granted on November 8, 1999 at fair market value but were contingent upon the closing of the transaction which resulted in the charge for the three (3) months ended March 31, 2000. The balance of the options vest one year after the closing provided that the employees are still employed by the purchaser. An additional charge of \$863,000 will be incurred at such date assuming all the options vest. The \$1.3 million of the purchase price held in escrow includes (i) \$300,000 conditioned upon purchaser securing a

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minimum of \$300,000 of purchase orders or commitments for consulting services from certain customers within ninety (90) days of the closing, and (ii) \$1,000,000 conditioned upon the Company's former employees remaining employed by purchaser for at least one (1) year from the closing of the sale. In connection with such sale, the Company has agreed not to offer any professional or consulting services competitive with those services offered by purchaser for a period of two years from the closing date. The Company has agreed to pay an aggregate 14% of the \$1.0 million of the escrow proceeds to the former employees provided that they remain with purchaser for at least one year.

No provision for or benefit from federal, state or foreign income taxes was recorded for the three months ended March 31, 1999 because the Company incurred net operating losses and fully reserved its deferred tax assets as their future realization could not be determined. For the three months ended March 31, 2000, no provision for or benefit from federal, state or foreign income taxes was recorded due to the availability of net operating tax loss carryforwards to offset the taxable gain on sale of the professional services

group.

As a result of the foregoing, the Company had net income for the three months ended March 31, 2000 of \$860,000 compared with a net loss of \$1,830,000 for the three months ended March 31, 1999.

#### Liquidity and Capital Resources

The Company's capital requirements have been and will continue to be significant, and its cash requirements have been exceeding its cash flow from operations. At March 31, 2000, the Company had \$7,524,000 of cash and cash equivalents and a working capital of \$6,893,000. The Company has financed its operations primarily through private sales of equity and debt securities, the consummation of its IPO in November 1998 and the sale of its professional services division in February 2000. Net cash used in operating activities from continuing operations was \$1,196,000 during the three months ended March 31, 1999 and \$1,077,000 during the three months ended March 31, 2000. Net cash used in operating activities from continuing operations for the three months ended March 31, 1999 was primarily attributable to a net loss from continuing operations of \$1,706,000 and by increases in prepaid expenses and other current assets of \$135,000 which was partially offset by an increase in accounts payable, accrued expenses and other current liabilities of \$299,000, depreciation and amortization of \$165,000, the issuance of Common Stock and warrants for services rendered of \$144,000, and an increase in provision for doubtful accounts of \$60,000. Net cash used in operating activities from continuing operations for the three months ended March 31, 2000 was primarily attributable to a net loss from continuing operations of \$1,168,000 and an increase in accounts receivable of \$87,000 which was partially offset by the issuance of common stock and warrants for services rendered of \$43,000, depreciation and amortization expense of \$90,000 and an increase in accrued interest payable of \$30,000.

The Company's operating activities during the three months ended March 31, 1999 were financed primarily with the net proceeds from the IPO consummated on November 17, 1998 which resulted in \$7,931,000 of net proceeds. In December 1999, the Company consummated a \$3.0 million private financing of preferred stock, warrants and notes. In addition, in February 2000, the Company sold its professional services business and received proceeds of \$2.7 million. The Company also received \$2.2 million from the exercise of stock options in February 2000 and \$725,000 from the exercise of preferred stock warrants and service warrants in March 2000. 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 relating to the implementation of its business plan (including the timetable of, costs and expenses associated with, and success of, its marketing efforts), that the net proceeds from the December 1999 financing, the sale of its professional services business and the exercises of stock options and warrants through March 31, 2000, together with projected revenues from operations, will be sufficient to satisfy the Company's operations and capital requirements through January 2001. There can be no assurance, however, that such funds will not be expended prior thereto due to unanticipated changes in economic conditions or other unforeseen circumstances. 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) or projected revenues otherwise prove to be insufficient to fund the implementation of the Company's business plan or working capital requirements, the Company could be required to seek additional financing sooner than currently anticipated. The Company has no current arrangements with respect to any additional financing. Consequently, there can be no assurance that any additional financing will be available to the Company when needed, on commercially reasonable terms or at all. Any inability to obtain additional financing when needed would have a material adverse effect on the Company, requiring it to curtail and possibly

cease its operations. In addition, any additional equity financing may involve substantial dilution to the interests of the Company's then existing stockholders.

#### Fluctuations in Operating Results

The Company anticipates significant quarterly fluctuations in its

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

#### Year 2000 Issue

The Company did not incur material costs with respect to potential software issues associated with the Year 2000.

## PART II. OTHER INFORMATION

### Item 1. LEGAL PROCEEDINGS.

None.

### Item 2. CHANGES IN SECURITIES AND USE OF PROCEEDS.

None.

### Item 3. DEFAULTS UPON SENIOR SECURITIES.

None.

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

None.

### Item 5. OTHER INFORMATION.

None.

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

#### a). Exhibits

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

Exhibit Number	Description of Exhibit
-----	-----

## b). Reports of Form 8-K.

The following reports on Form 8-K were filed during the three (3) months ended March 31, 2000:

- (i) a Report on Form 8-K was filed on January 5, 2000 with respect to the Company's private offering of \$3,000,000 of Series D Preferred Stock, warrants and notes and
- (ii) a Report on Form 8-K was filed on February 9, 2000 with respect to the Company's sale of its professional services business to Exodus Communications, Inc.

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## SIGNATURES

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

NETWORK-1 SECURITY SOLUTIONS, INC.

By: /s/ Avi A. Fogel

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Avi A. Fogel, President and Chief Executive Officer  
(Principal Executive Officer)

By: /s/ Murray P. Fish

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

Date: May 15, 2000

## EXHIBIT INDEX

Exhibit Number	Description of Exhibit
27	Financial data schedule for three month period ended March 31, 2000

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THIS SCHEDULE CONTAINS SUMMARY FINANCIAL INFORMATION EXTRACTED FROM THE UNAUDITED FINANCIAL STATEMENTS OF NETWORK-1 SECURITY SOLUTIONS, INC. FOR THE PERIOD ENDED MARCH 31, 2000 AND IS QUALIFIED IN ITS ENTIRETY BY REFERENCE TO SUCH FINANCIAL STATEMENTS.

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