BACKWEB TECHNOLOGIES LTD
Form 10-Q
May 17, 2004

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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

[X]	**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934** **For the Quarterly Period Ended March 31, 2004**
	or
[ ]	**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934** **For the Transition period from to**

Commission File Number 000-26241

BackWeb Technologies Ltd.

(Exact Name of Registrant as Specified in its Charter)

Israel	**51-2198508**
(State or Other Jurisdiction of Incorporation or Organization)	*(I.R.S. Employer Identification Number)*
3 Abba Hillel Street, Ramat-Gan, Israel	
(Address of Principal Executive Offices)	**52136** *(Zip Code)*

(972) 3-6118800
(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 [ ]

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

The registrant had 40,710,414 Ordinary Shares outstanding as of May 1, 2004.

BACKWEB TECHNOLOGIES LTD.

REPORT ON FORM 10-Q
FOR THE QUARTER ENDED MARCH 31, 2004

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Cautionary Statement Regarding Forward-Looking Statements

This Quarterly Report on Form 10-Q contains express or implied forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Forward-looking statements are those that predict or describe future events or trends and that do not relate solely to historical matters. For example, our statements regarding revenue and expense trend expectations in this Quarterly Report under the caption Management s Discussion and Analysis of Financial Condition and Results of Operations are forward-looking statements. The words believes, expects, anticipates, intends, forecasts, projects, plans, estimates, ant similar expressions may identify forward-looking statements. Readers are cautioned not to place undue reliance on the Company s forward-looking statements, as they involve many risks and uncertainties. The Company s actual results may differ materially from such statements. Factors that may cause or contribute to such differences include those discussed in this Quarterly Report under the caption Risk Factors and elsewhere, as well as in our most recent Annual Report on Form 10-K on file with the SEC. Although the Company believes that the assumptions underlying its forward-looking statements are reasonable, any of the assumptions could prove inaccurate, and, therefore, we cannot assure you that the results contemplated in such forward-looking statements will be realized. The inclusion of such forward-looking information should not be regarded as a representation by the Company, or any other person, that the future events, plans or expectations contemplated by the Company will be achieved. Forward-looking statements reflect the Company s current views with respect to future events and financial performance or operations and speak only as of the date of this Report. The Company undertakes no obligation to issue any updates or revisions to any forward-looking statements to reflect any change in the Company s expectations with regard thereto or any change in events, conditions, or circumstances on which any such statements are based.

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PART I FINANCIAL INFORMATION

Item 1. ***Condensed Consolidated Financial Statements***

BACKWEB TECHNOLOGIES LTD.

CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands)

	March 31, 2004	December 31, 2003
	(Unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 3,263	$ 4,026
Short-term investments	10,164	10,431
Trade accounts receivable, net	2,048	2,403
Other accounts receivable and prepaid expenses	654	782
Total current assets	16,129	17,642
Long-term investments and other long-term assets	520	572
Property and equipment, net	224	301
Total assets	$ 16,873	$ 18,515
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 297	$ 403
Accrued liabilities	3,492	3,813
Deferred revenue	1,331	1,125
Total current liabilities	5,120	5,341
Long-term liabilities	92	213
Commitments and contingencies (Note 3)		
Shareholders equity:		
Ordinary Shares	151,593	151,496
Accumulated other comprehensive income (loss)	(17)	9
Accumulated deficit	(139,915)	(138,544)
Total shareholders equity	11,661	12,961

Total liabilities and shareholders equity	$ 16,873	$ 18,515

Note: The balance sheet at December 31, 2003 has been derived from the audited financial statements at that date

The accompanying notes are an integral part of the condensed consolidated financial statements

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BACKWEB TECHNOLOGIES LTD.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)

	Three Months Ended	
	March 31, 2004	March 31, 2003
	(Unaudited)	
Revenue:		
License	$ 669	$ 735
Service and maintenance	969	792
Total revenue	1,638	1,527
Cost of revenue:		
License	24	55
Service and maintenance	393	221
Total cost of revenue	417	276
Gross profit	1,221	1,251
Operating expenses:		
Research and development	971	1,168
Sales and marketing	952	1,788
General and administrative	609	992
Total operating expenses	2,532	3,948
Loss from operations	(1,311)	(2,697)
Interest and other income, net	(60)	59
Write-down of an equity investment		(1,000)
Net loss	$ (1,371)	$ (3,638)
Basic and diluted net loss per share	$ (0.03)	$ (0.09)

Weighted average number of shares used in computing basic and diluted net loss per share	40,622	39,787

The accompanying notes are an integral part of the condensed consolidated financial statements.

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BACKWEB TECHNOLOGIES LTD.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	Three Months Ended	
	March 31, 2004	**March 31, 2003**
	(Unaudited)	
Cash flows from operating activities:		
Net loss	$(1,371)	$ (3,638)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation	93	269
Write down of an equity investment		1,000
Changes in operating assets and liabilities:		
Trade accounts receivable	355	(93)
Other accounts receivable, prepaid expenses, and other long-term assets	72	428
Accounts payable and accrued liabilities	(427)	(425)
Deferred revenue	193	310
Net cash used in operating activities	(1,085)	(2,149)
Cash flows from investing activities:		
Purchases of property and equipment	(16)	(36)
Proceeds from short-term investments	241	5,516
Net cash provided by investing activities	225	5,480
Cash flows from financing activities:		
Proceeds from issuance of ordinary shares, net	97	9
Net cash provided by financing activities	97	9
Net change in cash and cash equivalents	(763)	3,340
Cash and cash equivalents at beginning of the period	4,026	18,272
Cash and cash equivalents at end of the period	$ 3,263	$21,612

The accompanying notes are an integral part of the condensed consolidated financial statements.

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BACKWEB TECHNOLOGIES LTD.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Organization and Summary of Significant Accounting Policies

Organization BackWeb Technologies Ltd. was incorporated under the laws of Israel in August 1995 and commenced operations in November 1995. BackWeb Technologies Ltd., together with its subsidiaries (collectively, BackWeb or the Company), is a provider of off-line Web infrastructure and application-specific software that enable companies to extend the reach of their Web assets to the mobile community of their customers, partners, and employees. The Company s products address the need of mobile users who are disconnected from a network to access and transact with critical enterprise Web content and applications, such as sales tools, forecast management, contact lists, service repair guides, expense report updates, pricing data, time sheets, collaboration sessions, work orders, and other essential documents and applications. BackWeb sells its products primarily to end users in a variety of industries, including high technology manufacturing, pharmaceutical, financial services and insurance, telecommunications, entertainment and media, and government, through its direct sales force, resellers, and OEMs.

Basis of Presentation The unaudited interim condensed consolidated financial statements include the accounts of BackWeb Technologies Ltd. and its wholly owned subsidiaries. They have been prepared in accordance with established guidelines for interim financial reporting and with the instructions of Form 10-Q and Article 10 of Regulation S-X. All significant intercompany balances and transactions have been eliminated on consolidation. The balance sheet at December 31, 2003 has been derived from audited financial statements at that date but does not include all of the information and footnotes required by generally accepted accounting principles in the United States for complete financial statements. In the opinion of management, the interim condensed consolidated financial statements reflect all adjustments (consisting of normal recurring adjustments) required to fairly state the Company s financial position, results of operations and cash flows for the periods indicated. The condensed consolidated balance sheet at December 31, 2003 has been derived from the audited consolidated financial statements at that date but does not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. The interim condensed consolidated financial statements should be read in conjunction with the notes to the consolidated financial statements included in the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 2003. The results of the Company s operations for the interim periods presented are not necessarily indicative of operating results for the full fiscal year or any future interim period.

The condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States.

Revenue Recognition To date, the Company has derived its revenue from license fees for its products, maintenance, training, and rendering of consulting services. The Company sells its products primarily through its direct sales force, resellers, and OEMs.

The Company recognizes software license revenue in accordance with Statement of Position 97-2, Software Revenue Recognition, as amended (SOP 97-2), and SOP 98-9, Modification of SOP 97-2, Software Revenue Recognition with Respect to Certain Transactions (SOP 98-9). SOP 98-9 requires that revenue be recognized under the Residual Method when vendor specific objective evidence (VSOE) of fair value exists for all undelivered elements and no VSOE exists for the delivered elements. Under the Residual Method any discounts in the arrangement are allocated to the delivered element.

Revenue from software license agreements is recognized when all of the following criteria are met as set forth in SOP 97-2: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred; (3) the fee is fixed or determinable; and (4) collectibility is probable. The Company does not generally grant a right of return to its customers. When a right of return exists, the Company defers revenue until the right of return expires, at which time revenue is recognized provided that all other revenue recognition criteria have been met. If the fee is not fixed or determinable, revenue is recognized as payments become due from the customer provided that all other revenue recognition criteria have been met.

When contracts contain multiple elements wherein VSOE of fair value exists for all undelivered elements, the Company accounts for the delivered elements in accordance with the Residual Method prescribed by SOP 98-9. Maintenance revenue included in these

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arrangements is deferred and recognized on a straight-line basis over the term of the maintenance agreement. The VSOE of fair value of the undelivered elements (maintenance, training, and consulting services) is determined based on the price charged for the undelivered element when sold separately.

The Company licenses its products on a perpetual and on a term basis. The Company recognizes license revenue arising from the sale of perpetual licenses and multi-year term licenses upon delivery. For term licenses with a contract period of less than two years, revenue arising from the sale of such licenses is recognized ratably on a monthly basis.

The Company derives revenue primarily from software license fees paid by corporate customers and resellers, and from royalty fees from OEMs earned upon delivery of products. Revenue derived from resellers is not recognized until the software is sold through to the end user. Royalty revenue is recognized when reported to the Company by the OEM after delivery of the applicable products. In addition, the Company has granted the right to use the Company s products to OEM s and distributors, from which royalty revenue can arise.

Service revenue is primarily comprised of revenue from standard maintenance agreements, consulting and training fees. Customers licensing products generally purchase the standard annual maintenance agreement for the products. The Company recognizes revenue from maintenance over the contractual period of the maintenance agreement, which is generally one year. Maintenance is available at multiple levels of support and is priced as a percentage of the license revenue. For those agreements where the maintenance and license is quoted as one fee, the Company values the maintenance as an undelivered element at standard rates and defers this over the contractual maintenance period for revenue recognition purposes. The customer may choose to buy a maintenance contract at its option. Consulting services are billed at an agreed upon rate, plus out-of-pocket expenses and training services are billed on a per session basis. The Company recognizes service revenue from consulting and training when provided to the customer.

Deferred revenue includes amounts billed to customers or cash received from customers for which revenue has not been recognized.

Net Loss Per Share Basic and diluted net loss per share have been computed using the weighted average number of Ordinary Shares outstanding during the applicable period. Basic net loss per share is comprised of the weighted average number of Ordinary Shares outstanding during each period. Diluted net loss per share is computed based on the weighted average number of Ordinary Shares outstanding during the period plus potentially dilutive Ordinary Shares considered outstanding during the period in accordance with SFAS No. 128, Earnings per Share. The total number of Ordinary Shares subject to outstanding options excluded from the earnings per share calculation because they would be considered anti-dilutive was 6,877,508 and 8,351,598 at March 31, 2004 and March 31, 2003, respectively.

The following table presents the calculation of the basic and diluted net loss per share (in thousands, except per share data):

	Three Months Ended	
	March 31, 2004	March 31, 2003
	Unaudited	Unaudited
Net loss	$ (1,371)	$ (3,638)

Basic and diluted:		
Weighted-average shares	40,622	39,787
Less weighted-average shares subject to forfeiture		
Weighted average number of shares used in computing basic and diluted net loss per share	40,622	39,787
Basic and diluted net loss per share	$ (0.03)	$ (0.09)

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Comprehensive Loss The following table presents the components of comprehensive loss (in thousands):

	Three Months Ended	
	March 31, 2004	March 31, 2003
	Unaudited	Unaudited
Net loss	$(1,371)	$(3,638)
Change in net unrealized gain (loss) on investments	(26)	31
Total comprehensive loss	$(1,397)	$(3,607)

Stock Compensation BackWeb has elected to follow Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25), and FASB Interpretation No. 44, Accounting for Certain Transactions Involving Stock Compensation (FIN 44), in accounting for its employee stock options. Under APB 25, when the exercise price of the Company s stock options is less than the market price of the underlying shares on the date of grant, compensation expense is recognized.

Pro forma information regarding the Company s net loss and net loss per share is required by SFAS 123 and has been determined as if the Company had accounted for its employee stock options under the fair value method prescribed by SFAS 123.

The Company calculated the fair market value of each option grant on the date of grant using the Black-Scholes option-pricing model as prescribed by SFAS 123 and the following assumptions:

	Three Months Ended	
Stock Options	March 31, 2004	March 31, 2003
Risk-free interest rates	2.8%	2.8%
Expected lives (in years)	5	5
Dividend yield	0%	0%
Expected volatility	70%	109%

Three Months Ended

Stock Purchase Shares	**March 31, 2004**	**March 31, 2003**
Risk-free interest rates	2.8%	2.8%
Expected lives (in years)	0.5	0.5
Dividend yield	0%	0%
Expected volatility	70%	109%

Pro forma information under SFAS 123, is as follows (in thousands, except per share data):

	Three Months Ended	
	March 31, 2004	**March 31, 2003**
Net loss as reported	$(1,371)	$(3,638)
Add stock based expense reported in net loss		
Less stock based compensation expense determined under the fair value method	(377)	(667)
Pro forma net loss	$(1,748)	$(4,305)
Pro forma basic and diluted net loss per share	$ (0.04)	$ (0.11)
Basic and diluted net loss per share	$ (0.03)	$ (0.09)

Reclassification Certain prior year amounts have been reclassified to conform to the current period presentation.

Recent Accounting Pronouncements. In January 2003, the FASB issued FIN 46, Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51. FIN 46 requires certain variable interest entities to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. FIN 46 is effective for all new variable interest entities created or acquired after January 31, 2003. For variable interest entities created or acquired prior to February 1, 2003, the provisions of FIN 46 must be applied for the first interim or annual period ending after March 15, 2004. The adoption of FIN 46 has not and is not expected to have a material impact on the Company s results of operations or financial position.

Note 2. Write-Down of Equity Investments

The Company invested $3.5 million during 2000 and 2001 in certain development companies in Internet-centric businesses in which the Company believed it had a significant strategic interest. However, due to an extended economic slowdown and the significant decline in capital available to, and in the valuation of, the privately funded Internet-centric businesses, the Company believed that a portion of these investments became impaired during 2001 and recorded a charge of $2.5 million to reflect impairment of these assets below their recorded cost to represent what the Company considered to be a fair value.

In the three months ended March 31, 2003, the Company concluded that the balance of these investments in the amount of $1 million was impaired, and the decline in fair value was other-than-temporary. Accordingly, in the three months ended March 31, 2003, the Company recorded a charge of $1 million to reflect the impairment to the carrying value of these assets. As of March 31, 2004, there were no remaining amounts on the balance sheet related to these investments.

Note 3. Contingencies

Litigation

On November 13, 2001, BackWeb, six of its officers and directors, and various underwriters for BackWeb s initial public offering were named as defendants in a consolidated action captioned *In re BackWeb Technologies Ltd. Initial Public Offering Securities Litigation,* Case No. 01-CV-10000, a purported securities class action lawsuit filed in the United States District Court, Southern District of New York. Similar cases have been filed alleging violations of the federal securities laws in the initial public offerings of more than 300 other companies, and these cases have been coordinated for pretrial proceedings as *In re Initial Public Offering Securities Litigation,* 21 MC 92. A consolidated amended complaint filed in the BackWeb case asserts that the prospectus from our June 8, 1999 initial public offering failed to disclose certain alleged improper actions by the underwriters for the offering, including the receipt of excessive brokerage commissions and agreements with customers regarding aftermarket purchases of shares of our stock. The complaint alleges violations of Sections 11 and 15 of the Securities Act of 1933, Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, and Rule 10b-5 promulgated under the Securities Exchange Act of 1934. On or about July 15, 2002, an omnibus motion to dismiss was filed in the coordinated litigation on behalf of defendants, including BackWeb, on common pleadings issues. In October 2002, the Court dismissed all six individual defendants from the litigation without prejudice, pursuant to a stipulation. On February 19, 2003, the Court denied the motion to dismiss with respect to the claims against BackWeb. No trial date has yet been set.

A proposal has been made for the settlement and release of claims against the issuer defendants, including BackWeb. The settlement is subject to a number of conditions, including approval of the proposed settling parties and the court.

If the settlement does not occur, and litigation against BackWeb continues, BackWeb believes it has meritorious defenses and intends to defend the case vigorously. However, the results of any litigation are inherently uncertain and can require significant management attention, and BackWeb could be forced to incur substantial expenditures, even if it ultimately prevails. In the event there were an adverse outcome, BackWeb s business could be harmed.

From time to time BackWeb is involved in litigation incidental to the conduct of its business. Apart from the litigation described above, BackWeb is not party to any lawsuit or proceeding that, in BackWeb s opinion, is likely to seriously harm its business.

The Company and certain of its officers are currently parties to various other legal proceedings and may become involved, from time to time, in other legal proceedings in the ordinary course of the Company s business activities in the future. In the event there were an adverse outcome with respect to any of these proceedings, the Company s business could be harmed. Thus, the Company cannot provide assurances that these lawsuits will not materially and adversely affect the Company s business, results of operations or share price.

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Note 4. Restructuring Liabilities

On September 30, 2002, the Company announced a restructuring plan, which was implemented in the three months ended December 31, 2002. The restructuring plan included a reduction in workforce, vacating certain facilities, canceling of office service leases and impairment of fixed assets as a result of employee terminations and office consolidation. The Company recorded a charge in 2002 of $4.7 million which consisted of $1.6 million of severance and benefit costs, which included forgiveness of a $221,000 shareholder note receivable to one employee, $2.7 million of facility costs representing early termination penalties, office restoration costs and an accrual of certain lease commitments, $200,000 related to the write-down of fixed assets and $200,000 related to other related restructuring costs. In November 2003, the Company accrued an additional charge of approximately $443,000 due to a change in estimate on its facilities costs, of which approximately $289,000 related to the impairment of lease space in its Canadian subsidiary, $120,000 related to an exchange of warrants to the landlord as part of the final settlement of lease space at its headquarters in San Jose, California and approximately $34,000 of other office lease impairment charges.

On July 2, 2001, the Company announced a restructuring plan, which was implemented in the three months ended September 30, 2001. The restructuring plan included a reduction in workforce, vacating certain facilities and canceling office service leases as a result of employee terminations and office consolidation. The Company recorded a charge of $2.8 million, which consisted of $1.3 million of severance and benefit costs, $1.4 million of facility costs representing early termination penalties, office restoration costs and an accrual of certain lease commitments as a result of the restructuring plan announced on July 2, 2001 related to the closure and consolidation of offices in Europe, Japan and the United States, and $100,000 related to other related restructuring costs.

The remaining restructuring accrual is expected to be substantially utilized for servicing operating lease payments of operating lease commitments, through December 31, 2004.

The following table summarizes the costs and activities related to the 2001 and 2002 restructurings (in thousands):

	Involuntary Terminations	Facilities and Other	Total
Total charge 2001 restructuring	$ 1,300	$ 1,500	$ 2,800
Cash payments 2001 restructuring	(700)	(1,300)	(2,000)
Balance at December 31, 2001	600	200	800
Cash payments 2001 restructuring	(600)	(200)	(800)
Total charge 2002 restructuring	1,600	3,100	4,700
Cash payments 2002 restructuring	(1,300)	(2,000)	(3,300)
Balance at December 31, 2002	300	1,100	1,400
Change in estimate 2002 restructuring		400	400
Cash payments 2002 restructuring	(300)	(1,000)	(1,300)
Balance at December 31, 2003		500	500

Cash payments 2002 restructuring			
Balance at March 31, 2004	$	$ 500	$ 500

Note 5. Segments and Geographic Information

BackWeb operates in one industry segment, the development, marketing and sales of network application software. Operations in Israel include research and development and sales. Operations in North America and Europe include sales and marketing. The following is a summary of operations within geographic areas based on the location of the legal entity making that sale (in thousands):

	Three Months Ended	
	March 31, 2004	**March 31, 2003**
	Unaudited	
Revenue:		
North America	$1,189	$ 980
Israel	34	177
Europe	415	370
	$1,638	$1,527

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	Three Months Ended	
	March 31, 2004	December 31, 2003
	Unaudited	
Long-lived assets:		
North America	$156	$ 193
Israel	67	102
Europe		6
	$223	$ 301

Revenue generated in the U.S. and Canada (collectively, North America) and Europe is all to customers located in those geographic regions. Revenue generated in Israel consists of export sales to end-customers located in the rest of the world, excluding North America and Europe. OEM sales are made to all geographic regions. One OEM accounted for 1.6% or $25,000 of our revenues in the three-months ended March 31, 2003. One customer accounted for $400,000, or 24% of our total revenue, in the three months ended March 31, 2004.

Note 6. Guarantees

Under the terms of the Company s standard contract with its customers, the Company agrees to indemnify the customer against certain liabilities and damages to the extent such liabilities and damages arise from claims that such customer s use of the Company s software or services infringes intellectual property rights of a third party. These terms are common in the high technology industry. The Company does not record a liability for potential litigation claims related to indemnification obligations with its customers. The Company does not believe the likelihood of a material obligation is probable.

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

The following discussion and analysis should be read in conjunction with, and is qualified by, our Condensed Consolidated Financial Statements and Notes thereto included elsewhere in this Report, as well as the Risk Factors section that is set forth below. In addition, this discussion contains forward-looking statements and is, therefore, subject to the overall qualification on forward-looking statements that appears at the beginning of this Report.

Overview

BackWeb provides offline Web infrastructure and application-specific software that enable companies to extend the reach of their Web assets to the mobile community of their customers, partners, and employees. Our products address the need of mobile users who are disconnected from a network to access and transact with critical enterprise Web content and applications, such as sales tools, forecast management, contact lists, service repair guides, expense report updates, pricing data, time sheets, collaboration sessions, work orders, and other essential documents and applications.

The BackWeb® Off-line Access Server®, formerly known as the BackWeb ProactivePortal Server, is designed to extend the reach of corporate portals to mobile or disconnected users and users who need to be notified of critical new content, which helps increase usage of the portal and critical communications, thereby increasing companies return on investment from their enterprise portals. Our BackWeb e-Accelerator application allows an extended enterprise or geographically dispersed organization to manage and deliver pertinent information and alerts without the use of a portal. This enables sales and service organizations, partners and resellers, and call centers using our products to collect and distribute up-to-date, key data to customers, partners, and employees, enabling users to interact with the data through alerts and notification features. Our core infrastructure software, BackWeb Foundation , is a platform that allows organizations to efficiently target and deliver sizeable digital data of any format to users desktops throughout the extended enterprise.

Since our inception, we have derived revenue primarily from licensing our products and, to a lesser extent, from maintenance, consulting and training services. Our products are marketed worldwide through a combination of our direct sales force, reseller channels, and OEMs.

First Quarter Business Overview

Our total revenue increased 7% in the first quarter of 2004 compared with the first quarter of 2003, and was relatively flat compared to the fourth quarter of 2003. Our revenue mix for the first quarter of 2004 shifted towards a greater percentage of service revenue rather than license revenue due primarily to the changes that we implemented to our sales focus and strategy, as discussed in greater detail below. Our operating expenses in the first quarter of 2004 declined approximately 30% from the first quarter of 2003 and declined over 10% from the fourth quarter of 2003. As a result, we reduced our net loss per share in the first quarter of 2004 by $0.06 compared to the same quarter last year, and by $0.01 from the fourth quarter of 2003. We were successful with a number of follow-on sales activities including licensing additional software to existing customers. During the quarter one of our long-time partners expanded their commitment to our solution, resulting in a significant license transaction for us that represented the majority of our license revenue during the first quarter of 2004. They acquired additional license rights from us in order to have our product serve as the core delivery and infrastructure component of their rich media hosted distribution services. While we were pleased with our expansions into existing customers, we were disappointed with the decrease in revenue from licenses to new customers. We believe that the changes we began implementing to our sales strategy and sales force discussed below contributed to our difficulties in expanding our customer base, in addition to a sluggish market recovery particularly in the technology sector.

During the first quarter of 2004, we implemented some key changes to our sales focus and strategy and also key changes within our sales force. These changes included:

1. During March, we successfully recruited a new Vice President of Worldwide Sales which enabled our CEO, Erez Lorber, to hand off full sales responsibility and focus solely on his duties as CEO, the role to which he was appointed on January 1, 2004.

2. During the quarter, based upon our experiences over the past year and feedback from our customers, we initiated a new sales and marketing focus which places heightened emphasis on business value selling. Accordingly, we will now devote more of our sales efforts to emphasizing how our products can provide greater business value and return on investment to managers who are accountable for the productivity of field sales, services, consulting, and other revenue-related, customer-facing teams. We will also continue to remain actively engaged with information technology, or IT, organizations which are critical in

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evaluating and selecting the right technical solution for the enterprise, as well as ensuring a successful implementation and deployment. We believe our experience in selling our products within IT organizations where we ve been primarily selling our technology benefits will assist us in our business value selling to executives. In effect, we are expanding our sales focus to include what we call the problem owners in addition to our traditional focus on the process owners.

Critical Accounting Policies

Our critical accounting policies are as follows:

Revenue recognition;

Estimating valuation allowances and accrued liabilities, specifically the allowance for doubtful accounts;

Review of intellectual property and other intangible assets arising on capitalized purchased technology for impairment; and

Accrued restructuring charges.

Revenue Recognition

We derive revenue primarily from software license fees, maintenance service fees, and consulting services paid to us directly by corporate customers and resellers and, to a lesser extent, from royalty fees from Original equipment manufacturers (OEMs). Revenue derived from resellers is not recognized until the software is sold through to the end user. Royalty revenue is recognized when reported to us by the OEM after delivery of the applicable products. In addition, royalty revenue can arise from the right of OEMs and other distributors to use our products. As described below, management estimates must be made and used in connection with the revenue we recognize in any accounting period.

We recognize software license revenue in accordance with Statement of Position 97-2, Software Revenue Recognition (SOP 97-2), as amended, and SOP 98-9, Modification of SOP 97-2, Software Revenue Recognition with Respect to Certain Transactions (SOP 98-9). SOP 98-9 requires that revenue be recognized under the Residual Method when vendor specific objective evidence (VSOE) of fair value exists for all undelivered elements and no VSOE exists for the delivered elements. Under the Residual Method any discounts in the arrangement are allocated to the delivered element.

When contracts contain multiple elements wherein VSOE of fair value exists for all undelivered elements, we account for the delivered elements in accordance with the Residual Method prescribed by SOP 98-9. Maintenance revenue included in these arrangements is deferred and recognized on a straight-line basis over the term of the maintenance agreement. The VSOE of fair value of the undelivered elements (maintenance, training, and consulting services) is determined based on the price charged for the undelivered element when sold separately.

Revenue from software license agreements is recognized when all of the following criteria are met as set forth in SOP 97-2: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred; (3) the fee is fixed or determinable; and (4) collectibility is probable. We do not generally grant a right of return to our customers. When a right of return exists, we defer revenue until the right of return expires, at which time revenue is recognized provided that all other revenue recognition criteria have been met. If the fee is not fixed or determinable, revenue is recognized as payments become due from the customer provided that all other revenue recognition criteria have been met.

We license our products on a perpetual and on a term basis. We recognize license revenue arising from perpetual licenses and multi-year term licenses in the accounting period that all revenue recognition criteria have been met, which is generally upon delivery of the software to the end user. For term licenses with a contract period of less than two years, revenue is recognized on a monthly basis.

At the time of each transaction, we assess whether the fee associated with our license sale is fixed or determinable. If the fee is not fixed or determinable, we recognize revenue as payments become due from the customer provided that all other revenue recognition criteria have been met. In determining whether the fee is fixed or determinable, we compare the payment terms of the transaction to our normal payment terms. We assess the likelihood of collection based on a number of factors, including past transaction history, the credit worthiness of the customer and, in some instances, a review of the customer s financial statements. We do not request collateral from our customers. If credit worthiness cannot be established, we defer the fee and recognize revenue at the time collection becomes reasonably assured, which is generally upon the receipt of cash.

Service revenue is primarily comprised of revenue from standard maintenance agreements and consulting services. Customers licensing products generally purchase the standard annual maintenance agreement for the products. We recognize revenue from maintenance over the contractual period of the maintenance agreement, which is generally one year. Maintenance is priced as a percentage of the license revenue. For those agreements where the maintenance and license is quoted as one fee, we value the maintenance as an undelivered element at standard rates and recognize this revenue over the contractual maintenance period. Consulting services are billed at an agreed-upon rate, plus out-of-pocket expenses. We generally charge for our consulting services on a time and materials basis and recognize revenue from such services as they are provided to the customer. We account for fixed fee service arrangements in a similar manner to an agreement containing an acceptance clause. Our arrangements do not generally include acceptance clauses. However if an acceptance provision exists, then we defer revenue recognition until we receive written acceptance of the product from the customer.

Deferred revenue includes amounts billed to customers and cash received from customers for which revenue has not been recognized.

Estimating Valuation Allowances and Accrued Liabilities, Specifically the Allowance for Doubtful Accounts

Management continually reviews the collectibility of trade accounts receivable and the adequacy of the allowance for doubtful accounts against the trade accounts receivable. Management specifically analyzes customer accounts, account receivable aging reports, history of bad debts, the business or industry sector to which the customer belongs, customer concentration, customer credit-worthiness, current economic trends, and any other pertinent factors. Generally, we make a provision for doubtful accounts when a trade receivable becomes 90 days past due. In exceptional cases, we will waive a provision after a trade receivable is 90 days or more past due when, in the judgment of management, after conducting due diligence with the management of the customer, the receivable is still collectible and the customer has demonstrated that payment is imminent.

Management believes that it is able to make reasonably objective judgments on the adequacy of other provisions relating to trade accruals. We have not made any provision for contingent liabilities which has involved significant management judgment that either we will prevail in the case of material litigation or that we have sufficient insurance to cover any adverse outcome. A discussion of our outstanding material litigation is contained in Part II, Item 1 Legal Proceedings of this Form 10-Q.

Reviewing Intellectual Property and Other Intangible Assets Arising on Capitalized Purchased Technology for Impairment

We assess the impairment of long-lived assets, intellectual property and other intangibles whenever an event occurs that indicates that the carrying value of these assets may not be recoverable. The factors we consider important in this assessment include, but are not limited to, the following:

- Significant changes in the manner of our use of the acquired assets or the strategy of our company; and

- Significant negative industry or economic trends.

The determination that the carrying value of intangibles, and long-lived assets may not be recoverable is based upon the existence of one or both of the above factors.

Review of Accrued Restructuring Costs

We have made decisions to provide for certain costs associated with corporate restructurings we believed were required in order to align our cost structure with changing market conditions. Before a charge is executed, our executive management and Board of Directors approve the plan. Our restructuring plans executed in each of our last three fiscal years resulted in a reduction in headcount and the consolidation of facilities through the closing of excess field offices. Our restructuring charges included accruals for the estimated loss on facilities that we intend to either sublease or substantially restructure the lease arrangements with our landlords. We reassess this liability each period based on market condi