BACKWEB TECHNOLOGIES LTD
Form 10-Q
August 14, 2002

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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 June 30, 2002**

**OR**

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

The number of shares of the registrant s Ordinary Shares outstanding as of August 9, 2002 was 39,533,084 shares.

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**BACKWEB TECHNOLOGIES LTD.**

**QUARTERLY REPORT ON FORM 10-Q**

**QUARTERLY PERIOD ENDED JUNE 30, 2002**

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***This Report on Form 10-Q contains express or implied forward-looking statements. The words believes, expects, anticipates, intends, forecasts, projects, plans, estimates and similar expressions identify forward-looking statements. Such statements reflect the Company s current views with respect to future events and financial performance or operations and speak only as of the date the statements are made. Such forward-looking statements involve risks and uncertainties, and readers are cautioned not to place undue reliance on forward-looking statements. The Company s actual results may differ materially from such statements. Factors that may cause or contribute to such differences include, but are not limited to, those discussed elsewhere in this Form 10-Q in, for example, Part I, Item 2, in the section entitled Risk Factors. Although the Company believes that the assumptions underlying its forward-looking statements are reasonable, any of the assumptions could prove inaccurate and, therefore, there can be no assurance 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. The Company undertakes no obligation to publicly update, review or revise 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 statement is based.***

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## PART I FINANCIAL INFORMATION

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

### BACKWEB TECHNOLOGIES LTD.

### CONDENSED CONSOLIDATED BALANCE SHEETS

| | June 30, 2002 | December 31, 2001 |
|---|---|---|
| | Unaudited | Audited |
| | (In thousands, except share and per share data) | |
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | $ 22,446 | $ 17,209 |
| Short-term investments | 11,298 | 24,615 |
| Trade accounts receivable, net of allowance for doubtful accounts of $2,846 and $2,957 at June 30, 2002 and December 31, 2001, respectively | 963 | 3,529 |
| Other accounts receivable and prepaid expenses | 1,462 | 2,015 |
| Total current assets | 36,169 | 47,368 |
| Long-term investments and other long term assets | 2,656 | 2,458 |
| Property and equipment, net | 2,039 | 3,356 |
| Intellectual property and other purchased intangibles, net | 1,764 | 3,330 |
| Total assets | $ 42,628 | $ 56,512 |
| LIABILITIES AND SHAREHOLDERS EQUITY | | |
| Current liabilities: | | |
| Accounts payable and accrued liabilities | $ 5,179 | $ 7,192 |
| Deferred revenue | 1,367 | 2,271 |
| Total current liabilities | 6,546 | 9,463 |
| Accrued severance pay, net | 198 | 240 |
| Long-term deferred revenue | 205 | 228 |
| Shareholders equity: | | |
| Series E preferred stock, nominal value NIS 0.01 per share; one share authorized, issued and outstanding at June 30, 2002 and December 31, 2001 | | 3,454 |
| Ordinary shares, nominal value NIS 0.03 per share; 150,067,829 shares authorized at June 30, 2002 and December 31, 2001; 39,533,083 and 38,613,328 shares issued and outstanding at June 30, 2002 and December 31, 2001, respectively | 150,850 | 147,114 |
| Notes receivable from shareholders | (1,235) | (1,235) |
| Deferred stock compensation | | (216) |
| Accumulated other comprehensive income | 192 | 400 |
| Accumulated deficit | (114,128) | (102,936) |

| | | |
|---|---|---|
| Total shareholders equity | 35,679 | 46,581 |
| Total liabilities and shareholders equity | $ 42,628 | $ 56,512 |

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**

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | June 30, 2002 | June 30, 2001 | June 30, 2002 | June 30, 2001 |
| | (In thousands, except per share data) (Unaudited) | | | |
| Revenues: | | | | |
| License | $ 490 | $ 2,820 | $ 1,423 | $ 8,007 |
| Service | 1,301 | 1,755 | 2,679 | 3,789 |
| Total revenues | 1,791 | 4,575 | 4,102 | 11,796 |
| Cost of revenues: | | | | |
| License | 47 | 174 | 127 | 272 |
| Service | 919 | 1,336 | 1,978 | 3,086 |
| Total cost of revenues | 966 | 1,510 | 2,105 | 3,358 |
| Gross profit | 825 | 3,065 | 1,997 | 8,438 |
| Operating expenses: | | | | |
| Research and development, net | 1,833 | 2,588 | 3,560 | 5,148 |
| Sales and marketing | 2,911 | 5,974 | 6,096 | 13,300 |
| General and administrative | 1,195 | 3,192 | 2,571 | 6,377 |
| Amortization of intellectual property and other intangible assets | 783 | 783 | 1,566 | 1,566 |
| Amortization of deferred stock compensation | 162 | 168 | 216 | 337 |
| Total operating expenses | 6,884 | 12,705 | 14,009 | 26,728 |
| Loss from operations | (6,059) | (9,640) | (12,012) | (18,290) |
| Finance and other income (expense), net | 519 | 533 | 820 | 1,247 |
| Write-down of an equity investment | | (2,500) | | (2,500) |
| Net loss | $ (5,540) | $ (11,607) | $ (11,192) | $ (19,543) |
| Basic and diluted net loss per share | $ (0.14) | $ (0.30) | $ (0.29) | $ (0.51) |
| Weighted average number of shares used in computing basic and diluted net loss per share | 39,151 | 38,161 | 38,931 | 38,064 |

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**

| | Six Months Ended | |
|---|---|---|
| | June 30, 2002 | June 30, 2001 |
| | Unaudited | Unaudited |
| | (In thousands) | |
| **Operating Activities** | | |
| Net loss | $(11,192) | $(19,543) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | |
| Bad debt expense | 251 | 2,193 |
| Amortization of intellectual property and other intangible assets | 1,566 | 1,566 |
| Amortization of deferred stock compensation and premium on investments | 250 | 337 |
| Depreciation | 1,304 | 853 |
| Loss on disposal of property and equipment | 57 | |
| Write-down of an equity investment | | 2,500 |
| Changes in operating assets and liabilities: | | |
| Trade accounts receivable | 2,315 | 3,232 |
| Other accounts receivable, prepaid expenses, and other long-term assets | 400 | 1,079 |
| Accounts payable and accrued liabilities | (2,013) | (2,003) |
| Deferred revenue | (927) | (1,223) |
| Accrued severance pay, net | (42) | 11 |
| Net cash used in operating activities | (8,031) | (10,998) |
| **Investing Activities** | | |
| Purchases of property and equipment | (44) | (734) |
| Purchase of short-term investments | (6,656) | (5,319) |
| Proceeds from short-term investments | 19,686 | 26,206 |
| Net cash provided by investing activities | 12,986 | 20,153 |
| **Financing Activities** | | |
| Repayment of shareholder loans | | (371) |
| Proceeds from shareholders notes receivable | | 506 |
| Proceeds from issuance of ordinary shares, net | 282 | 527 |
| Net cash provided by financing activities | 282 | 662 |
| Net increase in cash and cash equivalents | 5,237 | 9,817 |
| Cash and cash equivalents at beginning of the period | 17,209 | 21,076 |
| Cash and cash equivalents at end of the period | $ 22,446 | $ 30,893 |
| **Supplemental disclosure of noncash investing and financing transactions** | | |
| Exchange of Series E preferred stock to Ordinary Shares | $ 3,454 | $ |

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**

**Note 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 critical communications infrastructure software and application-specific software that enable companies to communicate and distribute business-critical, time-sensitive information throughout their extended enterprise of customers, partners and employees. BackWeb sells its products directly to end users from a variety of industries, including the telecommunications, financial and computer industries, and through OEM and reseller arrangements.

The BackWeb group of companies consists of wholly owned subsidiaries operating as follows: BackWeb Technologies, Inc., a U.S. corporation; BackWeb Canada, Inc., a Canadian corporation; and BackWeb Technologies Europe Limited, a United Kingdom corporation with a branch in Germany.

The following subsidiaries ceased commercial operations in January 2002 but continue to be wholly owned subsidiaries and are registered as BackWeb Technologies B.V., a Netherlands corporation; BackWeb Technologies (U.K.) Ltd., a United Kingdom corporation; BackWeb Technologies GmbH, a German corporation; and BackWeb Technologies S.a.r.l., a French corporation. Two subsidiaries ceased commercial operations in September 2001 but continue to be wholly owned subsidiaries and are registered as BackWeb Technologies A.B., a Swedish corporation, and BackWeb K.K. Ltd., a Japanese corporation.

*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 in consolidation. The balance sheet at December 31, 2001 has been derived from audited financial statements at such date. In the opinion of management, the consolidated financial statements reflect all adjustments, consisting primarily of normal recurring adjustments, to fairly state the Company s financial position, results of operations and cash flows for the period indicated. The interim 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, 2001.

*Revenue Recognition* The Company recognizes software license revenue in accordance with Statement of Position 97-2, Software Revenue Recognition, as amended ( SOP 97-2 ). SOP 97-2 generally requires revenue earned on software arrangements involving multiple elements to be allocated to each element based on the relative fair value of the elements. The Company has also adopted SOP 98-9, Modification of SOP 97-2, Software Revenue Recognition with Respect to Certain Transactions ( SOP 98-9 ), for all transactions entered into after January 1, 2000. 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.

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

Revenue from license fees is recognized when persuasive evidence of an arrangement exists, delivery of the product has occurred, no significant obligations with regard to installation remain, the fee is fixed or determinable, and collectibility is probable. The Company does not 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.

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**BACKWEB TECHNOLOGIES LTD.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

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 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.

We license our products on a perpetual and on a term basis. License revenue arising from the sale of perpetual licenses is recognized in the accounting period that the sale takes place. License revenue arising from term license is recognized over the contractual term of the license. Management defines a term license as one whose term is one year or less from the date of the official order form and sale taking place, and revenue arising during this period is ratably recognized over the license period.

Revenues are primarily derived from contracts with corporate customers and resellers, and royalty fees earned upon delivery of products, which incorporate the Company s software. Revenues on contracts with resellers are not recognized until software is sold through to the end user. Royalty revenues are recognized when reported to the Company after delivery of the related products. In addition, royalty revenue can arise from the right to use the Company s products.

Service revenues are primarily comprised of revenues from standard maintenance agreements, consulting and training fees. Customers licensing our products generally purchase the standard annual maintenance agreement for the products. Revenues from maintenance agreements are recognized on a straight-line basis over the life of the maintenance period. Consulting services are billed at an agreed upon rate, plus out-of-pocket expenses and training services on a per session basis. The Company recognizes service revenues 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* The basic and diluted net loss per share has been computed using the weighted-average number of Ordinary Shares outstanding during the period.

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

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | June 30, 2002 | June 30, 2001 | June 30, 2002 | June 30, 2001 |
| | Unaudited | Unaudited | Unaudited | Unaudited |
| Net loss | $ (5,540) | $ (11,607) | $ (11,192) | $ (19,543) |
| Basic and diluted: | | | | |
| Weighted-average shares | 39,216 | 38,349 | 39,008 | 38,271 |
| Less weighted-average shares subject to forfeiture | (65) | (188) | (77) | (207) |
| Weighted average number of shares used in computing basic and diluted net loss per share | 39,151 | 38,161 | 38,931 | 38,064 |
| Basic and diluted net loss per share | $ (0.14) | $ (0.30) | $ (0.29) | $ (0.51) |

**BACKWEB TECHNOLOGIES LTD.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

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

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | **June 30, 2002** | **June 30, 2001** | **June 30, 2002** | **June 30, 2001** |
| | **Unaudited** | **Unaudited** | **Unaudited** | **Unaudited** |
| Net loss | $(5,540) | $(11,607) | $(11,192) | $(19,543) |
| Change in net unrealized (loss) gain on investments | (75) | (32) | (253) | 145 |
| Change in unrealized gain on forward contracts | 45 | | 45 | |
| Total comprehensive loss | $(5,570) | $(11,639) | $(11,400) | $(19,398) |

*Reclassifications* Certain prior year amounts have been reclassified to conform to the current year presentation.

*Recently Issued Accounting Pronouncements* In June 2001, the Financial Accounting Standards Board issued Statements of Financial Accounting Standards ( SFAS ) No. 141, Business Combinations, and No. 142, Goodwill and Other Intangible Assets (the New Rules ), effective for the fiscal years beginning after December 15, 2001. Under the New Rules, goodwill (and intangible assets deemed to have indefinite lives) will no longer be amortized but will be subject to impairment tests in accordance with the New Rules.

Intangible assets with finite lives will continue to be amortized over their estimated useful lives. As required the Company reviewed SFAS 141 and 142 in the three-month and six-month period ended June 30, 2002. SFAS 141 does not apply to the Company because the acquired intangibles recorded in the financial statements did not arise from a business combination. SFAS 142 was implemented and did not affect the condensed consolidated statement of operations for the three-months or six-months ended June 30, 2002.

In October 2001, the Financial Accounting Standards Board issued SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets ( SFAS 144 ) which supercedes SFAS 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of. SFAS 144 requires, among other things, that long-lived assets be measured at the lower of carrying amount or fair value, less cost to sell, whether reported in continuing operations or in discontinued operations. SFAS 144 is effective for fiscal years beginning after December 15, 2001 and interim periods within those fiscal years. A review of the application of SFAS 144 did not affect the condensed consolidated statement of operations for the three-months or six months ended June 30, 2002. A further review will be undertaken on a quarterly basis to determine if any adjustment should be made due to prevailing uncertain economic environment conditions that may affect certain long-lived assets currently recorded in the financial statements.

**Note 2. Selective Balance Sheet Detail**

*Cash Equivalents and Short-Term Investments* Cash equivalents consist of money market instruments, bank time deposits, commercial paper and debt-securities with original maturities of 90 days or less. Short-term investments consist of debt securities with original maturities between three months and three years.

In February 2001, a thirty-day revolving letter of credit of $300,000 in favor of Equity Office LLC (formerly Speiker Properties LLC) was signed and is considered restricted cash. The letter of credit is with respect to a security deposit for leased offices in the Company headquarters in San Jose, California, United States. The letter of credit extends to the end of the lease in February 2007.

Management determines the appropriate classification of debt and equity securities at the time of purchase and evaluates such designation as of each balance sheet date. To date, all debt securities have been classified as available-for-sale and are carried at fair market value, based on quoted market prices with all

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**BACKWEB TECHNOLOGIES LTD.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

unrealized gains and losses, if any, included as a separate component of shareholders equity. Realized gains and losses, declines in value of securities judged to be other than temporary and amortization of premium or discounts on investments are included in interest income and have not been material to date. The cost of securities sold is based on the specific identification method.

*Forward Exchange Contracts* Effective May 2001, we adopted Financial Accounting Standard No. 133 Accounting for Derivative Instruments and Hedging Activities ( FAS 133 ), which first affected the Company in the three-months ended June 30, 2002 and requires that all derivatives be recorded on the balance sheet at fair value. Changes in the fair value of derivatives that are not designated, or are not effective as hedges, must be recognized currently in earnings.

The Company hedges forecasted committed expenses payable in NewIsraeli Shekels, or NIS. In accordance with FAS 133, hedges of such anticipated transactions are designated and documented at inception as cash flow hedges and are evaluated for effectiveness, excluding time value, at least quarterly. We record effective changes in the fair value of these cash flow hedges in accumulated other comprehensive income ( OCI ) until the transaction occurs, at which time the changes are reclassified to expense. All amounts accumulated in OCI at quarter end will be reclassified to earnings within the next six months. At June 30, 2002, we had forward foreign exchange contracts outstanding with a notional face value of $3.7 million. The amount of unrealized gain on these contracts at June 30, 2002 is $45,000. During the three-months ending June 30, 2002 the Company had entered into and satisfied its obligations on forward contracts with a notional face value of approximately $620,000 and a term of less than two months. The gain recognized from these forward contracts in the three-months ending June 30, 2002 was immaterial. The Company did not record a loss from non-effective hedging during the three-month period ending June 30, 2002.

*Credit Risk* Financial instruments, which potentially subject BackWeb to concentrations of credit risk, consist of cash, cash equivalents, short-term investments and trade account receivables. BackWeb s cash and cash equivalents and short-term investments generally consist of money market funds with high credit quality financial institutions and commercial paper and corporate securities of corporations, which management believes are financially sound and are managed by major banks in the United States. Such investments in the United States may be in excess of insured limits and are not insured in other jurisdictions. Management believes that the financial institutions that hold the Company s investments are financially sound and, accordingly, minimal credit risk exists with respect to these investments. The Company has established guidelines relative to credit ratings, diversification and maturity that seek to maintain safety and liquidity.

BackWeb sells its products to customers primarily in North America and Europe. BackWeb performs ongoing credit reviews of its customers financial condition and generally does not require collateral. BackWeb maintains reserves to provide for estimated credit losses. The Company from time to time engages in selling receivables on a non-recourse basis with established commercial banking institutions.

*Property and Equipment* Property and equipment are stated at cost, net of accumulated depreciation. Property and equipment are depreciated on a straight-line basis over the estimated useful lives of the assets, generally two to three years.

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**BACKWEB TECHNOLOGIES LTD.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Property and equipment, at cost, consists of the following (in thousands):

| | June 30, 2002 | December 31, 2001 |
|---|---|---|
| | Unaudited | Audited |
| Computer and peripheral equipment | $ 3,859 | $ 3,958 |
| Office, furniture and equipment | 2,604 | 2,611 |
| Leasehold improvements | 1,113 | 1,150 |
| | 7,576 | 7,719 |
| Less accumulated depreciation | (5,537) | (4,363) |
| Property and equipment, net | $ 2,039 | $ 3,356 |

*Intellectual Property and Other Purchased Intangibles, Net*

On June 27, 2000, BackWeb completed its acquisition (the Acquisition ) of the software and intellectual property owned, licensed or developed by Mobix Communications Ltd., ( Mobix ) pursuant to a Software and Asset Purchase Agreement. As discussed in Note 1, in January 2002, the Company adopted SFAS 142.

Intellectual property and other purchased intangibles consist of the following (in thousands):

| | As of June 30, 2002 | | | As of December 31, 2001 | | |
|---|---|---|---|---|---|---|
| | Unaudited | | | Audited | | |
| | Gross | Accumulated Amortization | Net | Gross | Accumulated Amortization | Net |
| Intellectual property | $5,525 | $(3,761) | $1,764 | $5,525 | $(2,871) | $2,654 |
| Assembled workforce | 2,700 | (2,700) | | 2,700 | (2,024) | 676 |
| Total | $8,225 | $(6,461) | $1,764 | $8,225 | $(4,895) | $3,330 |

The Company recorded amortization expense of $783,000 and $1,566,000 during the three-months and six-months ended June 30, 2002 and 2001, respectively. Based on the current amount of intangible assets subject to amortization, the estimated amortization expense is $881,000 for both six-month periods ending December 31, 2002 and June 30, 2003. Intellectual property is amortized over three years and assembled workforce was amortized over two years.

*Accounts Payable and Accrued Liabilities*

Accounts payable and accrued liabilities consist of the following (in thousands):

| | June 30, 2002 | December 31, 2001 |
|---|---|---|
| | Unaudited | Audited |
| Accounts payable | $ 483 | $ 461 |
| Accrued compensation and related expense | 1,966 | 3,135 |
| Sales and marketing events | 262 | 385 |
| Restructuring accrual | 97 | 778 |
| Other | 2,371 | 2,433 |
| | $5,179 | $7,192 |

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**BACKWEB TECHNOLOGIES LTD.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

*Series E Preferred Share*

As at June 30, 2002, the Company had one Series E Preferred Share outstanding. The Series E Preferred Share was issued in connection with the acquisition by the Company of Lanacom Inc., in July 1997, and represented shares of Lanacom and/or BackWeb Canada Inc. that were exchangeable on a three-to-one basis for the Company s Ordinary Shares. During the three months ended June 30, 2002, the last holders of the exchangeable shares exchanged their shares for 422,212 Ordinary Shares of the Company. Subsequent to June 30, 2002, the Series E Preferred Share was returned to the Company and converted into Ordinary Shares which are held in the Company s treasury.

**Note 3. Contingencies**

*Contingencies* From time to time, the Company may have certain contingent liabilities that arise in the ordinary course of its business activities. The Company accounts for contingent liabilities when it is probable that future expenditures will be made and such expenditures can be reasonably estimated.

The Company and six of its officers and directors have been 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 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 the Company s 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 the Company s stock. The complaint alleges claims against the Company and its officers and directors under Section 11 of the Securities Act of 1933, as amended (the 33 Act ) and alleges claims against the officers and directors under Section 15 of the 33 Act and pursuant to Rule 10b-5 and Sections 10b and 20(a) of the Securities Exchange Act of 1934. The complaint also names as defendants the underwriters for the Company s initial public offering. On or about July 15, 2002, an omnibus motion to dismiss was filed in the coordinated litigation on behalf of the issuer defendants, of which the Company and its named officers and directors are a part, on common pleadings issues.

We believe we have meritorious defenses and intend to defend this action vigorously; however, the results of any litigation are inherently uncertain and can require significant management attention, and we could be forced to incur substantial expenditures, even if we ultimately prevail. In the event there were an adverse outcome, our business could be harmed. Thus, we cannot provide assurances that this lawsuit will not materially and adversely affect our business, results of operations or our share price. During the three-month period ended December 31, 2001, the Company accrued what it considers an appropriate amount with regard to initial legal expenses related to action.

**Note 4. 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. Operations in the United States and Canada (collectively, North America ) and member countries of the European Economic Community EEC include sales and marketing. The Company has adopted SFAS No. 131, Disclosures About Segments of an

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**BACKWEB TECHNOLOGIES LTD.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Enterprise and Related Information. The following is a summary of operations within geographic areas based on the location of the legal entity making that sale (in thousands):

| | Six Months Ended | |
|---|---|---|
| | June 30, 2002 | June 30, 2001 |
| | Unaudited | Unaudited |
| Revenues: | | |
| North America | $2,006 | $ 3,674 |
| Israel | 1,589 | 6,780 |
| EEC | 507 | 1,341 |
| | $4,102 | $11,795 |

| | June 30, 2002 | December 31, 2001 |
|---|---|---|
| | Unaudited | Audited |
| Long-lived assets: | | |
| North America | $1,383 | $2,038 |
| Israel | 1,600 | 2,214 |
| Other | 56 | 104 |
| | $3,039 | $4,356 |

Revenues generated in North America and the EEC are all to customers located in those geographic regions. Revenues generated in Israel consist of export sales to customers located in the rest of the world, excluding North America and the EEC; OEM sales to all geographic regions. One OEM accounted for 31% or $1.3 million and 54% or $6.3 million of our revenues in the six-months ended June 30, 2002 and June 30, 2001, respectively.

**Note 5. Restructuring Charge**

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 of office service leases as a result of employee terminations and office consolidation. The restructuring charge recorded during the three months ended September 30, 2001 was $2.8 million of which approximately $97,000 remains in the accrued liabilities as of June 30, 2002. The $2.8 million restructuring charge consists of $1.3 million of severance and benefit cost, $1.4 million of facility cost and $100,000 related to other related restructuring cost. The $1.3 million charge is related to severance and benefits to terminate 63 employees representing approximately 25% of the Company s global workforce employed as of June 30, 2001. The $1.4 million charge represents 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 the EEC, Japan and the United States.

**Note 6. Subsequent Event Nasdaq Listing**

On August 13, 2002, we received a letter from The Nasdaq Listing Qualifications Staff, advising us that our Ordinary Shares have been trading below the $1.00 per share requirement for continued inclusion on The Nasdaq National Market and that we had not regained compliance with this requirement during the previous ninety days. As a result, the Staff advised it would delist our Ordinary Shares from The Nasdaq National Market at the opening of business on August 21, 2002, unless the Company applied to transfer its securities to The Nasdaq SmallCap Market or requested a hearing to appeal the Staff s determination to a Listing

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**BACKWEB TECHNOLOGIES LTD.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Qualification Panel. The Company intends to request a hearing to appeal the Staff s determination to a Listing Qualifications Panel. There can be no assurance that such appeal will be successful. During the pendency of the appeal, our Ordinary Shares will continue to trade on The Nasdaq National Market. The Company is also considering applying to transfer its Ordinary Shares to The Nasdaq SmallCap Market, as well as other potential avenues to take with respect to maintaining its listing. If we lose our Nasdaq National Market status, the Company anticipates that our Ordinary Shares would trade either as a Nasdaq SmallCap issue or in the over-the-counter market, both of which may be viewed by some investors as less desirable, less liquid marketplaces.

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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 Consolidated Financial Statements and Notes thereto included elsewhere herein, as well as the section on Risk Factors 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 Form 10-Q.

**Overview**

BackWeb Technologies Ltd. ( BackWeb or the Company ) is a provider of critical communications infrastructure software and application-specific software that enable companies to communicate and distribute business-critical, time-sensitive information throughout their extended enterprise of customers, partners and employees. BackWeb® technology also enables companies to leverage their enterprise portal by ensuring that critical portal content is automatically distributed to users across the enterprise even when a user is offline.

Our BackWeb ProactivePortal™ solution aims to extend the reach of corporate portals to mobile or disconnected users and users who need to be notified of critical new content, thereby increasing usage of the portal and critical communications and maximizing the return on investment for 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. Thus, for example, sales and service organizations, partners and resellers, and call centers can collect and distribute key data to customers, partners and employees, keeping them updated and with confidence that users will 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.

We were incorporated on August 31, 1995, and commenced our operations in November 1995. During the period from commencement of operations through December 31, 1996, we were in a development stage and had insignificant revenues. Operating activities during this period related primarily to developing our products, building our corporate infrastructure and raising capital. In December 1996, we shipped the first commercial version of our software.

In August 1997, in an effort to expand the features and functionalities of our product offerings, we acquired all the outstanding shares of Lanacom Inc., a Canadian corporation. The acquisition has been accounted for using the purchase method of accounting, and accordingly the purchase price has been allocated to the tangible and intangible assets acquired and the liabilities assumed on the basis of their respective fair value on the acquisition date. The purchase price of $3.9 million was determined based on the value of shares originally issued and options granted. Of the total purchase price, approximately $3.2 million was allocated to goodwill, representing the excess of the aggregate purchase price on the fair value of tangible and intangible assets. The remainder of the purchase price was allocated to net tangible liabilities assumed ($103,000), developed technology ($400,000) and other identifiable intangible assets ($383,000). Goodwill, developed technology and other identified intangibles are amortized on a straight-line basis over the estimated useful life which ranges from 24 to 30 months. The first BackWeb product, BackWeb Foundation Version 4.0, incorporating Lanacom s Headliner product, was released in January 1998.

In early 1998, we engaged in a comprehensive re-examination of our business strategy and changed our strategic focus from a consumer-oriented to an enterprise-oriented Internet communication company. In connection with this change in strategy, we undertook a fundamental repositioning and reorganization of our work force, particularly in our sales organization. During 1998, we continued to enhance our infrastructure software, BackWeb Foundation Version 5.0, and, in December 1998, released our first packaged application, BackWeb Sales Accelerator.

On June 27, 2000, BackWeb completed its acquisition of the software and intellectual property owned, licensed or developed by Mobix Communications Ltd. ( Mobix ) for an aggregate amount of $16.4 million pursuant to a Software and Asset Purchase Agreement among the Company, Mobix and the principal

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shareholder of Mobix. BackWeb allocated the excess purchase price over the fair value of net tangible assets acquired to the following intangible assets: $8.4 million to in-process research and development ( IPR&D ), $5.3 million to intellectual property and $2.7 million to assembled work force and to other intangibles. As of the acquisition date, technological feasibility of the in-process technology had not been established and the technology had no alternative future use; therefore, BackWeb expensed the amount of the purchase price allocated to IPR&D of approximately $8.4 million as of the date of the acquisition in accordance with generally accepted accounting principles. The capitalized intangible assets are being amortized on a straight-line basis over their extended useful lives of two to three years.

In 2001, the Company re-positioned itself to focus on the enterprise portal space, which market analysts generally expect to be one of the fastest-growing software markets in the foreseeable future. We intend to establish BackWeb ProactivePortal technology as the leading software system for offline enterprise portal communications and enterprise portal notification. We believe that the adoption of our BackWeb Foundation and our BackWeb e-Accelerator application by leading companies and partners across various industries validates our technology and should facilitate broad market acceptance of our ProactivePortal solution. In addition, we believe that the selection of our products by industry leaders should promote the adoption of our critical communications solution by these companies, as well as their partners, suppliers and distributors. We also believe that this adoption, along with the competitive advantages achieved with our products, will drive other industry participants to adopt our products as their preferred solution. We intend to continue to focus our development efforts on increasing the functionality and flexibility of BackWeb ProactivePortal technology to facilitate its adoption and to increase technological barriers to entry.

Since our inception, revenues have been derived from the licensing of our products and from maintenance, consulting and training services. The rate of growth of our service revenue is not commensurate with the costs of service revenues such as salaries and related expenses of our customer support and consulting organizations and cost of third party contractors to provide consulting services. Accordingly, our gross margins on service revenue are significantly lower than our gross margins on license revenue. Our products are marketed worldwide through a combination of the direct sales force, reseller channel, system integrators and OEMs.

**Critical Accounting Policies**

Our critical accounting policies are as follows:

Revenue recognition;

Estimating valuation allowances and accrued liabilities, specifically the trade receivable allowances for doubtful debts;

Reviewing goodwill, intellectual property and other intangible assets arising on capitalized purchased technology for impairment; and

Review of equity investments for impairment.

***Revenue recognition***

We recognize software license revenue in accordance with Statement of Position 97-2, Software Revenue Recognition , as amended ( SOP 97-2 ). SOP 97-2 generally requires revenue earned on software arrangements involving multiple elements to be allocated to each element based on the relative fair value of the elements. We have also adopted SOP 98-9, Modification of SOP 97-2, Software Revenue Recognition with Respect to Certain Transactions ( SOP 98-9 ), for all transactions entered into after January 1, 2000. SOP 98-9 requires that revenue 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.

We derive our revenue from license fees of our products, maintenance, customer training and the rendering of consulting services. Our products are generally sold through the direct sales force, resellers and

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OEMs. As described below, management estimates must be made and used in connection with the revenue recognized in any accounting period.

We license our products on a perpetual and on a term basis. License revenue arising from the sale of perpetual licenses is recognized in the accounting period that the sale takes place. License revenue arising from term licenses is recognized over the contractual term of the license. Management defines a term license as one that is one year or less from the effective date of the official order form, and revenue arising during this period is ratably recognized over the license period. Management defines a perpetual license as one that is more than one year, in which case revenue is recognized in the accounting period in which the official order form is signed and the sale takes place.

The determination criterion for the definition of a license sale is when persuasive evidence of an agreement has been delivered, the fee is fixed and determinable, and the collection of the resulting receivable is reasonable assured. Delivery generally occurs when the product is delivered to a common carrier.

At the time of the transaction, we assess whether the fee associated with our license sale is fixed and determinable. 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. The fee is assessed by comparing with the price list and if a discount from the price list is applicable, and whether the discount is in accordance with what management believes to be generally acceptable discounts. The principal factors taken into account when giving a discount are among others the volume of licenses in the transaction, the strategic nature of the deal and customer and the future likelihood of further transactions with the same customer. In addition, we assess whether or not collection is reasonably assured. We assess the granting of payment terms associated with the transaction, which are generally 30 to 90 days from the effective date of the order form. In cases where we do not establish reasonable assurance of collection, revenue is recognized only on the receipt of payment. Payment terms outside of these parameters are generally recognized as the fees become due.

We assess collection based on a number of factors, including past transaction history, 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 at the time the official order form is signed, we defer the fee and recognize revenue at the time collection is made, which is generally upon the receipt of cash.

For all sales through the direct channel we use a Software License and Service Agreement ( SLSA ) signed by both parties and an official order form for each sale made signed by both parties. For sales through a reseller, a standard reseller agreement is executed and evidence of orders from customers is supplied before revenue is recognized.

We recognize maintenance over the contractual period for the maintenance, 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, we value the maintenance as an undelivered element at standard rates and defer this over the contractual maintenance period for revenue recognition purposes. It is optional whether a customer chooses to buy a maintenance contract.

Our arrangements do not generally include acceptance. However if such an acceptance provision exists, then revenue recognition is deferred until written acceptance of the product has been received from the customer. All agreements we make are non-refundable and non-cancelable.

We also recognize revenue from consulting activities, which is generally evidenced by a signed Statement of Work ( SOW ). A SOW may be time and materials based, and the revenue is recognized at the time of invoicing the customer. If an acceptance clause is contained in the SOW, revenue is deferred until written acceptance is obtained from the customer. An SOW may also be a fixed bid. Management interprets fixed bids in a similar manner to an SOW containing an acceptance clause and defers revenue recognition until the customer supplies a certificate of work completion, at which time the revenue is recognized. The majority of SOWs that are written are based on a time and materials basis.

Revenue recognition for training to customers is determined when the training has been delivered to the customer.

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

***Estimating valuation allowances and accrued liabilities, specifically the trade receivable allowance for doubtful debts***

Management reviews on a continuing basis the uncollectibility of the trade accounts receivable and the adequacy of the allowance for doubtful debts against the trade receivables. Management specifically analyzes customer accounts, account receivable aging reports, history of bad debts and the business or industry sector to which they belong, customer concentrations, customer credit-worthiness, current economic trends and any other pertinent factors that come to light. Generally, a provision will be made when a trade receivable becomes 90 days past due. In exceptional cases, a provision after 90 days past due will be waived when, in the judgment of management after due diligence with the customer, management is confident that the receivable is still collectible and the customer has demonstrated that payment is forthcoming. During the six-month period ended June 30, 2002, and the twelve month period ended December 31, 2001, management provided for $251,000 and $2.9 million, respectively, of doubtful debt provision arising primarily from the Internet-centric business in the business-to-consumer market, that arose mainly as a result of the economic uncertainty leading to certain customers no longer being able to continue business. These provisions applied to revenue of which a majority was generated during the fiscal year ending December 31, 2000.

Management is able to make reasonably objective judgments on the adequacy of other provisions relating to trade accruals. In the case of contingent liabilities, no provision has been made. This has involved significant management judgment that either management will prevail in the case of litigation or has sufficient insurance to cover an adverse outcome of any such material proceeding. A discussion of outstanding material litigation is set forth below in Part II, Item 1.

***Reviewing goodwill, 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 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 the company; and

Significant negative industry or economic trends,

The determination that the carrying value of intangibles, long-lived assets and goodwill arising on the purchase of intellectual property may not be recoverable is based upon the existence of one or more of the above factors. An impairment review based on a projected discounted cash flow method using a discount rate commensurate with the risk inherent in our current business model is performed to determine the impaired amount that needs to be recorded. Net intangible assets at June 30, 2002 and December 31, 2001 amounted to $1.8 million and $3.3 million, respectively.

In 2002, SFAS No. 142, Goodwill and Other Intangible Assets, became effective and is not expected to have an effect on the Company s statements of operations during 2002.

***Review of Equity Investments for impairment***

Management has made certain equity investments in other companies that it believes are in the interests of the Company and its strategic objectives. Before the investment(s) are executed, they are approved by the Company s executive management and the Company s Board of Directors. Generally, management designates an executive staff member to either serve on the Board of Directors of the investee as a voting member or as an observer. This process serves management to monitor the investment and to determine when an

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impairment review of the investment may be needed. Management performs a review of equity investments on a quarterly basis to determine if a provision for impairment is required. This process while based on reasonably objective evidence supplied by the investee is combined with due diligence sought from general economic trends and indicators. During 2001, management carried out such reviews and accounted for an impairment charge against one of its equity investments for the full amount of the equity investment in the amount of $2.5 million. Significant management judgment is made when conducting these reviews and future developments in the investee may result in the impairment provision becoming a write-off or reversed to some extent.

**Results of Operations**

*Revenues*

The Company s license revenue is derived from BackWeb ProactivePortal, BackWeb e-Accelerator and BackWeb Foundation. The Company s service revenue is derived from maintenance, consulting and training. Total revenues for the three-months ended June 30, 2002 were $1.8 million, a decrease of approximately $2.8 million or 60.9% from $4.6 million in the three-months ended June 30, 2001. Total revenues for the six-months ended June 30, 2002 were $4.1 million, a decrease of approximately $7.7 million or 65.2% from $11.8 million in the six-months ended June 30, 2001. The decrease is primarily due to a decrease in license revenues and to a lesser extent a decrease in service revenue.

Customers outside of North America accounted for 57.8% of revenues in the three-months ended June 30, 2002 compared to 64.2% of revenues in the three-months ended June 30, 2001. Customers outside of North America accounted for 51.1% of revenues in the six-months ended June 30, 2002 compared to 68.8% of revenues in the six-months ended June 30, 2001. One OEM accounted for 41.9% or $750,000 and 48.8% or $2.2 million of our revenues in the three-months ended June 30, 2002 and 2001, respectively and accounted for 30.8% or $1.3 million and 53.7% or $6.3 million of our revenues in the six-months ended June 30, 2002 and 2001, respectively.

Excluding indirect revenues from our OEM customer, whose contract with the Company terminated in early 2002 had revenues arising outside of North America accounted for 27.4% in the three-months ended June 30, 2002 compared to 30.0% of revenues in the three-months ended June 30, 2001. Excluding indirect revenues from our OEM customer, revenues arising outside of North America accounted for 29.4% in the six-months ended June 30, 2002 compared to 32.8 % of revenues in the six-months ended June 30, 2001.

License revenues were approximately $490,000 or 27.4% of revenues in the three-months ended June 30, 2002 compared to $2.8 million or 61.6% of revenues in the three-months ended June 30, 2001. License revenues were $1.4 million or 34.7% of revenues in the six-months ended June 30, 2002 compared to $8.0 million or 67.9% of revenues in the six-months ended June 30, 2001. The decreases in license revenue as a percentage of total revenue were primarily due to the decrease of both deal volume and average deal size as compared with previous fiscal quarters.

Service revenues were $1.3 million or 72.6% of revenues in the three-months ended June 30, 2002 compared to $1.8 million or 38.4% of revenues in the three-months ended June 30, 2001. Service revenues were $ 2.7 million or 65.3% of revenues in the six-months ended June 30, 2002 compared to $3.8 million or 32.1% of revenues in the six-months ended June 30, 2001.

*Cost of Revenues*

Cost of license revenues consists primarily of expenses related to media duplication and packaging of products. Cost of license revenues was $47,000 or 9.6% of license revenues for the three-months ended June 30, 2002 compared to $174,000 or 6.2% of license revenues for the three-months ended June 30, 2001. Cost of license revenues was $127,000 or 8.9% of license revenues for the six-months ended June 30, 2002 compared to $272,000 or 3.4% of license revenues for the six-months ended June 30, 2001.

Cost of service revenues consists primarily of expenses related to salaries and expenses of the customer support and professional service organizations, including related expenses of BackWeb consultants and third party consultants. Cost of service revenues was $919,000 or 70.6% of service revenues, in the three-months

ended June 30, 2002 compared to $1.3 million or 76.1% of service revenues, in the three-months ended June 30, 2001. Cost of service revenues was $2.0 million, or 73.8% of service revenues, in the six-months ended June 30, 2002 compared to $3.1 million or 81.4% of service revenues, in the six-months ended June 30, 2001. The decrease in cost of service revenues was due to the reduced level of headcount.

**Operating Expenses**

*Research and Development, Net*

Research and development expenses consist of personnel and related costs of our research and development employees, equipment and supply costs for our development efforts. These expenses are charged to operations as incurred. We have research and development facilities primarily based in Israel. Research and development expenses were $1.8 million in the three-months ended June 30, 2002 compared to $2.6 million in the three-months ended June 30, 2001. Research and development expenses were $3.6 million in the six-months ended June 30, 2002 compared to $5.1 million in the six-months ended June 30, 2001. The decrease in research and development expenses is due to the reduced level of headcount, more effective cost management and the devaluation of the N.I.S. against the U.S dollar. Research and development expenses were 102.3% and 56.6% of total revenues in the three-months ended June 30, 2002 and 2001, respectively. Research and development expenses were 86.8% and 43.6% of total revenue in the six-months ended June 30, 2002 and 2001, respectively. The increase in research and development expenses as a percentage of total revenue is due to a smaller decrease in research and development expenses compared to the decrease in total revenues.

*Sales and Marketing*

Sales and marketing expenses consist of personnel and related costs for our direct sales force, business development, marketing employees and marketing programs, including trade shows, advertising, collateral, sales materials, seminars and public relations. We have sales personnel in offices located in the United States, Canada and Europe. Sales and marketing expenses were $2.9 million for the three-months ended June 30, 2002 compared to $6.0 million in the three-months ended June 30, 2001. Sales and marketing expenses were $6.1 million for the six-months ended June 30, 2002 compared to $13.3 million in the six-months ended June 30, 2001. The decrease in sales and marketing expense is due to the reduced level of headcount and more effective cost management. Sales and marketing expenses were 162.5% and 130.6% of total revenues in the three months ended June 30, 2002 and 2001, respectively. Sales and marketing expenses were 148.6% and 112.8% of total revenues in the six-months ended June 30, 2002 and 2001, respectively.

The increase in sales and marketing expenses as a percentage of total revenues is due to a smaller decrease in sales and marketing expenses compared to the decrease in total revenues.

*General and Administrative*

General and administrative expenses consist primarily of personnel and related costs for general corporate functions, including finance, accounting, general management, human resources, information services, legal and provision for bad and doubtful debts. General and administrative expenses were $1.2 million in the three-months ended June 30, 2002 compared to $3.2 million in the three-months ended June 30, 2001. General and administrative expenses were $2.6 million in the six-months ended June 30, 2002 compared to $6.4 million in the six-months ended June 30, 2001. General and administrative expenses were 66.7% and 69.8% of total revenues in the three months ended June 30, 2002 and 2001, respectively. General and administrative expenses were 62.7% and 54.1% of total revenues in the six-months ended June 30, 2002 and 2001, respectively. Excluding the provision for bad and doubtful debts of zero and $1.1 million for the three-months ending June 30, 2002 and 2001, respectively, the general and administrative expenses were $1.2 million and $2.1 million for the three-months ending June 30, 2002 and 2001, respectively. Excluding the provision for bad and doubtful debts of $251,000 and $2.2 million for the six-months ending June 30, 2002 and 2001, respectively, the general and administrative expenses were $2.3 million and $4.2 million for the six-months ending June 30, 2002 and 2001, respectively. The decrease in general and administrative expenses is due to the reduced level of headcount and more effective cost management. Excluding the provision for bad and doubtful

debts general and administrative expenses were 66.7% and 45.7% of total revenues in the three-months ended June 30, 2002 and 2001, respectively. Excluding the provision for bad and doubtful debts general and administrative expenses were 56.6% and 35.5% of total revenues in the three-months ended June 30, 2002 and 2001, respectively. The increase in general and administrative expenses excluding the provision for bad and doubtful debts as a percentage of total revenues is due to a smaller decrease in general and administrative expenses compared to the decrease in total revenues.

*Amortization of Intellectual Property, Other Intangible Assets and Deferred Stock Compensation*

Amortization of intellectual property, other intangible assets and deferred stock compensation is due to the acquisition of intellectual property and other intangible assets of Mobix Communications Ltd. in June 2000 and deferred stock compensation in 1999. Deferred stock compensation represents the aggregate differences between the respective exercise price of options at their dates of grant and the deemed fair market value of our Ordinary shares for accounting purposes. Intellectual property and other intangibles are being amortized on a straight-line basis over the estimated useful life, generally two to three years. Deferred stock compensation is presented as a reduction of shareholders equity and is amortized over the vesting period of the underlying options based on an accelerated vesting method. Total amortization expense was $945,000 for the three-months ended June 30, 2002 compared to $951,000 in the three-months ended June 30, 2001. Total amortization expense was $1.8 million for the six-months ended June 30, 2002 compared to $1.9 million in the six-months ended June 30, 2001.

*Finance and Other Income and Expense, Net*

Finance and other income and expense, includes interest income earned on our cash, cash equivalents and short-term investments offset by interest expense. Finance and other income and expense also includes the effects of exchange gains and losses arising from the re-measurement of transactions in foreign currencies. For the three-months ended June 30, 2002, finance and other income was $519,000 compared to $533,000 in the three-months ended June 30, 2001. For the six-months ended June 30, 2002, finance and other income was $820,000 compared to $1.2 million in the six-months ended June 30, 2001. The decrease in finance and other income is primarily due to lower interest earned on the decreasing balance of cash, cash equivalents and short-term investments. This is partially offset by a foreign exchange gain in the three-months ending June 30, 2002.

**Liquidity and Capital Resources**

As of June 30, 2002, the Company had cash, cash equivalents and short-term investments (hereinafter cash ) of $33.7 million, which represents a decrease of $8.1 million from December 31, 2001.

Net cash used in operating activities was $8.0 million and $11.0 million for the six-months ended June 30, 2002 and 2001, respectively, and was primarily used for funding the operations of the ongoing business needs. Cash provided by investing activities was $13.0 million and $20.2 million for the six-months ended June 30, 2002 and 2001, respectively. Cash provided by financing activities was $282,000 and $662,000 for the six-months ended June 30, 2002 and 2001, respectively, and consists primarily of proceeds from the issuance of Ordinary Shares.

Our capital requirements depend on numerous factors, including market acceptance of our products, the resources we devote to developing, marketing, selling and supporting our products, the timing and extent of adding international operations and other factors. We believe that our current cash balances based on our current burn rate will be sufficient to fund our operations for at least the next 18 months. However, if the Company is able to perform and maintain to its latest financial and operational plans then the Company will be able to revert to being cash positive at some point in 2003 and therefore will be able to fund its operations on a continuing basis.

On August 13, 2002, we received a letter from The Nasdaq Listing Qualifications Staff, advising us that our Ordinary Shares have been trading below the $1.00 per share requirement for continued inclusion on The Nasdaq National Market and that we had not regained compliance with this requirement during the previous ninety days. As a result, the Staff advised it would delist our Ordinary Shares from The Nasdaq National

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Market at the opening of business on August 21, 2002, unless the Company applied to transfer its securities to The Nasdaq SmallCap Market or requested a hearing to appeal the Staff s determination to a Listing Qualifications Panel. The Company intends to appeal the Staff s determination to a Listing Qualifications Panel. There can be no assurance that such an appeal will be successful. During the pendency of the appeal our Ordinary Shares will continue to trade on The Nasdaq National Market. The Company is also considering applying to transfer its Ordinary Shares to The Nasdaq SmallCap Market, as well as other potential avenues to take with respect to maintaining its listing. If we lose our Nasdaq National Market status, the Company anticipates that our Ordinary Shares would trade either as a Nasdaq SmallCap issue or in the over-the-counter market, both of which may be viewed by some investors as less desirable, less liquid marketplaces.

**Effective Corporate Tax Rates**

Our tax rate will reflect a mix of the U.S. statutory tax rate on our U.S. income, European country tax rates on our individual European country income and the Israeli tax rate discussed below. We expect that most of our taxable income will be generated in Israel. Israeli companies are generally subject to income tax at the rate of 36% of taxable income. The majority of our income, however, is derived from our Company s capital investment program with Approved Enterprise status under the Law for the Encouragement of Capital Investments, and is eligible therefore for tax benefits. As a result of these benefits, we will have a tax exemption on income derived during the first two years in which this investment program produces taxable income, provided that we do not distribute such income as a dividend, and a reduced tax rate of 10%-25% for the next 5 to 8 years, depending upon the proportion of foreign ownership of the Company.

All of these tax benefits are subject to various conditions and restrictions. See Israeli Taxation and Investment Programs-Law for the Encouragement of Capital Investments Act 1959. There can be no assurance that we will obtain approval for additional Approved Enterprise Programs, or that the provisions of the law will not change.

Since we have incurred tax losses through June 30, 2002, we have not yet used the tax benefits for which we are eligible. See below Risk Factors Risks Relating to our Business.

**Impact of Inflation and Currency Fluctuations**

Most of our sales are in U.S. dollars. However a significant portion of our costs are incurred in Israel in relation to our operations. Our research and development costs are primarily denominated in NIS. Costs not denominated in U.S. dollars are translated to U.S. dollars, when recorded, at prevailing rates of exchange. This is done for the purposes of our financial statements and reporting. Costs not denominated in U.S. dollars will increase if the rate of inflation in Israel exceeds the devaluation of the Israeli currency as compared to the U.S. dollar or if the timing of such devaluations were to lag considerably behind inflation. Consequently, we are and will be affected by changes in the prevailing NIS/U.S. dollar exchange rate. The Company on an arms-length basis tries to minimize the exposure for the exchange rate between the U.S. dollar and the NIS by buying forward contracts on a non-speculative basis through established commercial banks. We might also be affected by the U.S. dollar exchange rate to the major European currencies due to the fact that we have operations in EEC.

**Other Information**

On June 17, 2002, the Audit Committee of the Board of Directors of the Company authorized and approved (1) the engagement of Ernst & Young International as the independent auditors for the Company for the fiscal year 2002 and (2) the provision of non-audit services during fiscal 2002 by certain firms within Ernst & Young International, consisting of the preparation of tax returns for the Company s subsidiaries located in North America, Japan and the EEC and found that such did not compromise the independence of the auditors.

**Risk Factors**

The Company operates in a rapidly changing environment that involves numerous risks and uncertainties, some of which are beyond the Company s control. The following discussion highlights some of these risks and uncertainties.

You should consider the following factors, as well as other information set forth in this Report, in connection with any investment in our Ordinary Shares. If any of the risks described below occurs, our business, results of operations and financial condition could be adversely affected. In such cases, the price of our Ordinary Shares could decline, and you could lose part or all of your investment. Although we believe that the expectations reflected in our forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements, or other future events. Moreover, neither we nor anyone else assumes responsibility for the accuracy or completeness of forward-looking statements. You should consider our forward-looking statements in light of the following risk factors and other information in this Report. If any of the risks described below occurs, our business, results of operation and financial condition could differ from those projected in our forward-looking statements. We are under no duty to update any of our forward-looking statements after the date of this Report. You should not place undue reliance on forward-looking statements.

**Risks Relating to Our Business**

***The economic outlook has adversely affected, and may continue to adversely affect, the demand for our current products and the Company s results of operations***

Current predictions for the general economy indicate continued uncertain economic conditions. Weak economic conditions may continue to cause a reduction in information technology spending generally. Consequently, there may continue to be an adverse impact on the demand for our products, which would adversely affect our results of operations. In addition, predictions regarding economic conditions have a low degree of certainty, and further predicting the effects of the changing economy is even more difficult. We may not accurately gauge the effect of the general economy on our business. As a result, we may not react to such changing conditions in a timely manner that may result in an adverse impact on our results of operations. Any such adverse impacts to our results of operations from a changing economy may cause the price of our Ordinary Shares to decline.

***Our business is difficult to evaluate because our operating history is limited, and we have recently changed our strategic focus and repositioned our product line***

We have a limited operating history generally and an even more limited history operating the business as currently conducted. We cannot be certain that our business strategy will be successful. We were incorporated on August 31, 1995, and did not begin generating revenues until December 1996. In early 1998, we changed our strategic focus from a consumer-oriented to an enterprise-oriented Internet communications company. In 2001, we re-positioned the Company s products to focus on the portal market. These changes required us to adjust our business processes and make a number of significant personnel changes. We do not know if our new strategic and product focus will be successful. To the extent we do not succeed in generating revenue from licensing our ProactivePortal Server, our business, operating results and financial conditions will suffer.

***We have a history of losses and we expect future losses***

We have not achieved profitability and expect to continue to incur net losses for at least the fiscal year 2002. We incurred net losses of $11.2 million for the six-months ended June 30, 2002, approximately $34.7 million for the year ended December 31, 2001, $19.2 million for the year ended December 31, 2000, and $11.5 million for the year ended December 31, 1999. As of June 30, 2002, we had an accumulated deficit of approximately $114.1 million. We expect to continue to incur significant sales and marketing, product development and administrative expenses during 2002. However we expect these expenses to decrease in 2002 compared to 2001. As a result, we will need to generate significant revenues to achieve and maintain

profitability. In addition, some of our customers continue to operate based on Internet-centric business models and are experiencing a significant economic slowdown and an inability to raise additional capital, which could have a material adverse effect on our revenue and consequently our earnings.

***Our quarterly operating results are subject to fluctuations and seasonality***

Our operating results are difficult to predict. Our revenues and operating results may vary significantly from quarter to quarter due to a number of factors, *inter alia:*

demand for our products and services;

internal budget constraints and approval processes of our current and prospective customers;

the timing and mix of revenues generated by product licenses and professional services;

the length and unpredictability of our sales cycle;

loss of customers;

changes in the growth rate of Internet usage;

delays in introducing new products and services;

new product introductions by competitors;

changes in our pricing policies or the pricing policies of our competitors;

costs related to acquisitions of technology or businesses; and

economic conditions generally, as well as those specific to the Internet and related industries.

Due to the foregoing factors, we believe that quarter-to-quarter comparisons of our operating results are not a good indication of our future performance. In some recent quarters our operating results have been below the expectations of public market analysts and investors. It is likely that in some future quarters, our operating results may also be below such expectations.

***Our quarterly operating results may depend on a small number of large orders***

We may derive a significant portion of our product license revenues in each quarter from a small number of relatively large orders. Our operating results for a particular fiscal quarter could be materially adversely affected if we are unable to complete one or more substantial license sales forecasted for that quarter. Additionally, we also offer volume-based pricing, which may affect operating margins.

***If we lose a major customer, our revenues could suffer because of our customer concentration***

We have generated a substantial portion of our annual and quarterly historical revenues from a limited number of customers. As a result, if we lose a major customer, or if there is a decline in end-users in any of our customers licenses, our revenues would be adversely affected. One OEM customer, whose contract with the Company terminated in early 2002, accounted for more than 41.9%, 30.8% and 52.0% for the three-month and six-month period ended June 30, 2002 and the twelve-month period ended December 31, 2001, respectively. We are currently in negotiations with this customer for a new contract; however, there can be no assurance that a new contract will be signed or that we will generate revenue from this customer in the future. In addition, in 2001, two other customers together accounted for an aggregate of 11% of our revenues. In 2000, one OEM customer accounted for more than 27% of our revenues. In 1999, revenues from one end-user customer represented 13% of our revenues. It is possible that a small number of customers will continue to account for a substantial portion of revenues for the foreseeable future and revenues from one or more of these customers may represent more than 10% of our revenues in future years.

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***We depend on increased business from new customers, as well as additional business from existing customers, and if we fail to grow our customer base or generate repeat business, our operating results could be harmed***

Our business model generally depends on the sale of our products to new customers as well as on expanded use of our products within our existing customers organizations. If we fail to grow our customer base or generate repeat and expanded business from our current and future customers, our business and operating results will be seriously harmed. In some cases, our customers initially make a limited purchase of our products and services for trials, pilot or proof of concept programs. These customers may not acquire additional licenses to expand their use of our products.

In addition, as we have introduced new versions of our products or new products, such as our ProactivePortal Server, we have experienced a decline in licenses of our older products, such as Foundation and e-Accelerator, and we anticipate future declines in these licenses. However, it is also possible that our current customers might not require the functionality of our new products and might not ultimately license these products. Because the total amount of maintenance and support fees we receive in any period depends in large part on the size and number of licenses that we have previously sold, any downturn in our software license revenue would negatively affect our future maintenance and support revenue. In addition, if customers elect not to renew their maintenance agreements, our services revenue could decline significantly. Further, some of our customers are telecom or information technology companies, which have been forced to significantly reduce their operations in light of limited access to sources of financing and the current national and global economic slowdown. If customers are unable to pay for their current products or are unwilling to purchase additional products, our revenues will decline and this will likely materially impact adversely our revenue, operating results and stock price.

***Our business will suffer if our target customers do not accept Internet solutions***

Our future revenues and profits, if any, depend upon the widespread acceptance and use of the Internet as an effective medium of business and communication by our customers. Rapid growth in the use of and interest in the Internet has occurred only recently. As a result, acceptance and use may not continue to develop at historical rates, and a sufficiently broad base of consumers may not adopt, and continue to use, the Internet and other online services as a medium of commerce and communication. Our success will depend, in large part, on the acceptance of the Internet in the commercial marketplace and on the ability of third parties to provide reliable Internet infrastructure network with the speed, data capacity, security and hardware necessary for reliable Internet access and services. To the extent that the Internet continues to experience increased numbers of users, increased frequency of use or increased bandwidth requirements of users, the Internet infrastructure may not be able to support the demands placed on it and the performance or reliability of the Internet could suffer.

***Rapid technological changes could cause our products to become obsolete***

The Internet communications market is characterized by rapid technological change, frequent new product introductions, changes in customer requirements and evolving industry standards. If we are unable to develop and introduce products or enhancements in a timely manner to meet these technological changes, we may not be able to successfully compete. In addition, our products may become obsolete in which event we may not be a viable business.

***Our failure to adapt to technology trends and evolving industry standards would hinder our competitiveness***

Our market is susceptible to rapid changes due to technology innovation, evolving industry standards, and frequent new service and product introductions. New services and products based on new technologies or new industry standards expose us to risks of technical or product obsolescence. We will need to use leading technologies effectively, continue to develop our technical expertise and enhance our existing products on a timely basis to compete successfully in this industry. We cannot be certain that we will be successful in using new technologies effectively, developing new products or enhancing existing products on a timely basis or that any new technologies or acceptance.

***Our inability to integrate our products with other third-party software could adversely affect market acceptance of our products***

Our ability to compete successfully also depends on the continued compatibility and interoperability of our products with products and systems sold by various third parties, such as system integrators or portal framework firms. Currently, these vendors have open applications program interfaces, which facilitate our ability to integrate with their systems. These vendors have also been open to licensing us rights to build integrations to their products and use their development tools. If any one of them should close their programs interface or fail to grant us necessary licenses, our ability to provide a close integration of our products could become more difficult and could delay or prevent our products integration with future systems.

***Failure to successfully develop versions and updates of our products that run on the operating systems used by our current and prospective customers could reduce our sales***

Many of our products run on the Microsoft Windows NT, Microsoft Windows 2000 or certain versions of the Sun Solaris Unix operating systems, and some require the use of third party software. Any change to our customers operating systems could require us to modify our products and could cause us to delay product releases. In addition, any decline in the market acceptance of these operating systems we support may force us to ensure that all of our products and services are compatible with other operating systems to meet the demands of our customers. If potential customers do not want to use the Microsoft or Sun Solaris operating systems we support, we will need to develop more products that run on other operating systems adopted by our customers. If we cannot successfully develop these products in response to customer demands, our business could be adversely impacted. The development of new products in response to these risks would require us to commit a substantial investment of resources, and we might not be able to develop or introduce new products on a timely or cost-effective basis, or at all, which could lead potential customers to choose alternative products.

In addition, the Company s products may face competition from operating system software providers that may elect to incorporate similar technology into their own products.

***Competition in the Internet communications market may reduce the demand for, or price of, our products***

The Internet communications market is intensely competitive and rapidly changing. We expect that competition will intensify in the near-term because there are very limited barriers to entry. Our primary long-term competitors may not have entered the market yet because the Internet communications market is new. Competition could result in price reductions, fewer customer orders, reduced gross margin and loss of market share, any of which could cause our business to suffer. We may not be able to compete successfully, and competitive pressures may harm our business. Many of our current and potential competitors have greater name recognition, longer operating histories, larger customer bases and significantly greater financial, technical, marketing, public relations, sales, distribution and other resources than we do. Some of our potential competitors are among the largest and most well-capitalized software companies in the world.

***The loss of our right to use software licensed to us by third parties could harm our business***

We license technology that is incorporated into our products from third parties, including security and encryption software. Any interruption in the supply or support of any licensed software could disrupt our operations and delay our sales, unless and until we can replace the functionality provided by this licensed software. Because our products incorporate software developed and maintained by third parties, we depend on these third parties to deliver and support reliable products, enhance their current products, develop new production on a timely and cost-effective basis and respond to emerging industry standards and other technological changes.

***Our growth may suffer because of the difficulties in implementing our products***

The use of our products by our customers often requires implementation services. Although we currently provide implementation services sufficient to meet our current business level, our growth will be limited in the

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event we are unable to expand our implementation services personnel or subcontract these services to qualified third parties.

***Factors outside our control may cause the timing of our license revenues to vary from quarter-to-quarter, possibly adversely affecting our operating results***

Applicable accounting policies may cause us to report new license agreements as deferred revenue. We generally recognize revenue from a customer sale when persuasive evidence of an agreement exists, the product has been delivered, the arrangement does not involve significant customization of the software, the license fee is fixed or determinable and collection of the fee is probable. If an arrangement requires acceptance testing or customization services, recognition of the associated license and service revenue could be delayed. The timing of the commencement and completion of the these services is subject to factors that may be beyond our control, as this process may require access to the customer s facilities and coordination with the customer s personnel after delivery of the software. In addition, customers could delay product implementations. Implementation typically involves working with sophisticated software, computers and communications systems. If we experience difficulties with implementation or do not meet project milestones in a timely manner, we could be obligated to devote more customer support, engineering and other resources to a particular project. If new or existing customers have difficulty deploying our products or require significant amounts of our professional services support for customized features, our revenue recognition could be further delayed and our costs could increase, causing increased variability in our operating results.

***Our long and unpredictable sales cycle depends on factors outside our control and may cause license revenues to vary significantly***

To date, our customers have taken a long time to evaluate our products before making their purchase decisions. The long, and often unpredictable, sales and implementation cycles for our products may cause license revenues and operating results to vary significantly from period to period. Sales of licenses and implementation schedules are subject to a number of risks over which we have little or no control, including customer budgetary constraints, customer internal acceptance reviews, the success and continued internal support of customers own development efforts, the efforts of business with which we have relationships, the nature, size and specific needs of a customer and the possibility of cancellation of projects by customers. Along with our distribution partners, we spend a lot of time educating and providing information to our prospective customers regarding the use and benefits of our products. In addition, our customers often begin by purchasing our products on a pilot basis before they decide whether or not to purchase additional licenses for full deployment. For example, even after purchase, our customers tend to deploy e-Accelerator slowly, depending upon the skill set of the customer, the size of the deployment, the complexity of the customer s network environment and the quantity of hardware and the degree of hardware configuration necessary to deploy the products. We anticipate that we will have a similar situation with the deployment of our ProactivePortal software.

***Failure to expand our sales and marketing organizations could limit our growth***

If we fail to substantially expand our direct and indirect sales and marketing operations in our existing markets, our growth will be limited. Currently, we believe we will need to expand our sales and marketing organization for significant revenue growth. We might not be able to hire or retain the kind and number of sales and marketing personnel that could be required because competition for qualified sales and marketing personnel in the Internet communications market is intense.

***Failure to develop key strategic relationships could limit our growth***

We believe that our success in penetrating our target markets depends in part on our ability to develop and maintain strategic relationships with key independent software vendors, resellers, systems integrators, distribution partners and customers. If we fail to develop these strategic partnerships, our growth could be limited. As of June 30, 2002, we had entered into various alliances, remarketing and partnership agreements

with certain portal framework vendors and system integrators. We do not know if these will prove to be successful relationships in the future or if they will result in any material revenue for the Company.

We depend on strategic relationships and business alliances for continued growth of our business. Our development, marketing and distribution strategies rely increasingly on our ability to form strategic relationships with portal software and other technology companies. If we fail to continue developing these relationships, our growth could be limited. These business relationships often consist of cooperative marketing programs, joint customer seminars, lead referrals and cooperation in product development. Some of these relationships are not contractual and depend on the continued voluntary cooperation of each party with us. Even where there are written agreements in place, divergence in strategy or change in focus by, or competitive product offerings by, any of these companies may interfere with our ability to develop, market, sell or support our products, which in turn could harm our business. Further, if these companies enter into strategic alliances with other companies or are acquired, they could reduce their support of our products. Our existing relationships may be jeopardized if we enter into alliances with competitors of our strategic partners. In addition, one or more of these companies may use the information they gain from their relationship with us to develop or market competing products.

***We may experience difficulties managing our expected growth and geographic dispersion***

Our ability to successfully offer products and services and to implement our business plan in the rapidly evolving Internet communications market requires an effective planning and management process. These factors together with our anticipated future operations and geographic dispersion will continue to place, a significant strain on our management systems and resources. We expect that we will need to continue to improve our financial and managerial controls and reporting systems and procedures, and expand, train and manage our work force worldwide.

***Our international operations are subject to additional risks***

Revenues from customers outside the United States represented approximately $2.1 million or 51.1% and $14.4 million, or 70% of our total revenues for the six-months ended June 30, 2002 and the twelve-months ended December 31, 2001, respectively. Our international operations will continue to be subject to a number of other risks, including, but not limited to:

- laws and business practices favoring local competition
- compliance with multiple, conflicting and changing laws and regulations
- longer sales cycles
- greater difficulty or delay in accounts receivable collection
- import and export restrictions and tariffs
- difficulties in staffing and managing foreign operations
- investing at appropriate levels in foreign operations to compete effectively
- political and economic instability

Our international operations also face foreign-currency-related risks. To date, substantially all of our revenues have been denominated in U.S. dollars, but we believe that in the future, an increasing portion of our revenues may be denominated in foreign currencies, including the NIS, Euro Dollar and British Pound. Fluctuations in the value of foreign currencies may cause further volatility in our operating results, reduce the accuracy of our financial forecasts and could have a material adverse effect on our business, operating results and financial condition.

***Our intellectual property could be used by third parties without our consent because protection of our intellectual property is limited***

Our success and ability to compete are substantially dependent upon our internally developed technology, which we protect through a combination of patent, copyright, trade secret and trademark law. However, we may not be able to adequately protect our proprietary rights, which may harm our business. Unauthorized parties may attempt to copy or otherwise obtain and use our products or technology. Policing unauthorized use of our products is difficult, and we cannot be certain that the steps we have taken will prevent misappropriation of our technology, particularly in foreign countries where the laws may not protect our proprietary rights as fully as in the United States.

***Our efforts to protect our proprietary rights may be inadequate***

To protect our proprietary rights, we rely primarily on a combination of patent, copyright, trade secret and trademark laws, confidentiality agreements with employees and third parties, and protective contractual provisions such as those contained in license agreements with customers, consultants and vendors. We have not signed such agreements in every case. Despite our efforts to protect our proprietary rights, unauthorized parties may copy aspects of our products and obtain and use information that we regard as proprietary. Other parties may breach such confidentiality agreements and other protective contracts. We may not become aware of, or have adequate remedies in the event of, such breaches.

We pursue the registration of some of our trademarks and service marks in the United States and in certain other countries, but we have not secured registration of all our marks. We license certain trademark rights to third parties. Such licensees may not abide by compliance and quality control guidelines with respect to such trademark rights and may take actions that would adversely affect our trademarks.

We do not conduct comprehensive patent searches to determine whether the technology used in our products infringes patents held by third parties. Product development is inherently uncertain in a rapidly evolving technological environment in which there may be numerous patent applications pending, which are confidential when filed, with regard to potentially similar technologies. We expect that software products may be increasingly subject to third-party infringement claims as the number of competitors in our industry segment grows and the functionality of products in different industry segment overlaps. Although we believe that our products do not infringe the proprietary rights of any third parties, third parties could assert infringement claims against us in the future. The defense of any such claims would require us to incur substantial costs and would divert management s attention and resources to defend against any claims relating to proprietary rights, which could materially and adversely affect our financial condition and operations. Royalty or licensing agreements, if required, may not be available on acceptable terms, if at all. If a party succeeded in making such a claim we could be liable for substantial damages, as well as injunctive or equitable relief that could effectively block our ability to sell our products and services. Any such outcome could have a material adverse effect on our business, financial condition, operating results and stock price.

***Our products may be used in an unintended and negative manner***

Our products are used to transmit information through the Internet. Our products could be used to transmit harmful applications, negative messages, unauthorized reproduction of copyrighted material, inaccurate data or computer viruses to end-users in the course of delivery. Any such transmission could damage our reputation or could give rise to legal claims against us. We could spend a significant amount of time and money defending against these legal claims.

***We may not have sufficient insurance to cover all potential product liability and warranty claims***

Our products are integrated into our customers networks. The sale and support of our products may entail the risk of product liability or warranty claims based on damage to these networks. In addition, the failure of our products to perform to customer expectations could give rise to warranty claims. Although we carry general liability and errors and omissions insurance, our insurance may not cover potential claims of this type or may not be adequate to protect us from all liability that may be imposed.

***We may not have sufficient insurance to cover all potential claims against our officers and directors nor may we be able to renew our directors and officers ( D&O ) insurance policy at a reasonable rate or obtain sufficient coverage***

Although the Company carries D&O insurance, our insurance may not cover all potential claims against our directors and officers. As of August 2, 2002 the Company renewed its D & O insurance policy for a period of twelve months to August 1, 2003. There is no assurance we could renew such policy after August 1, 2003. As a result, it may be difficult to retain or attract qualified directors or officers.

***Our business could suffer if we lose the services of key personnel***

If we fail to attract qualified personnel or retain current employees, including, our executive officers and other key employees, our revenues may not increase and could decline and our operations in general could be impacted. None of our officers or key employees is bound by an employment agreement for any specific term. Our relationships with these officers and key employees are at will. Moreover, we do not have key person life insurance policies covering any of our employees.

***Terrorist attacks such as the attacks that occurred in New York and Washington, D.C. on September 11, 2001 and other attacks or acts of war may adversely affect the markets on which our Ordinary Shares trade, our financial condition and our results of operations***

On September 11, 2001, the United States was the target of terrorist attacks of unprecedented scope. These attacks caused major instability in the U.S. and other financial markets. There could be further acts of terrorism in the United States or elsewhere that could have a similar impact. Leaders of the U.S. government have announced their intention to actively pursue and take military and other action against those behind the September 11, 2001 attacks and to initiate broader action against national and global terrorism. Armed hostilities or further acts of terrorism would cause further instability in financial markets and could directly impact our financial condition and our results of operations.

**Risks Relating to Our Location in Israel**

***Any major developments in the political or economic conditions in Israel could cause our business to suffer because we are incorporated in Israel and have important facilities and resources located in Israel***

We are incorporated under the laws of the State of Israel. Our principal research and development facilities as well as significant executive offices are located in Israel. Although substantial portions of our sales currently are to customers outside of Israel, any major hostilities involving Israel or the interruption or curtailment of trade between Israel and its present trading partners could significantly harm our business. Since September 2000, a continuous armed conflict with the Palestinian Authority has been taking place. Any devaluation of the New Israeli Shekel, or NIS, against the U.S. dollar could have an impact on our financial results. Since a significant portion of our research and development expenses are incurred in NIS, we may be positively affected by devaluation in the exchange rate between the NIS and the U.S. dollar. If Israel s economy is hurt by a high inflation rate or if the timing of such devaluations were to lag considerably behind inflation our operations and financial condition may be negatively impacted to the extent that the inflation rate exceeds the rate of devaluation of the NIS against the U.S. dollar.

The NIS was devalued against the U.S. dollar by approximately 8% and 3% in the six-months ended June 30, 2002 and 2001, respectively. The representative dollar exchange rate for converting the NIS to U.S. dollars, as reported by the Bank of Israel, was NIS 4.769 and NIS 4.416 for one U.S. dollar on June 30, 2002 and December 31, 2001, respectively.

***Any future profitability may be diminished if tax benefits from the State of Israel are reduced or withheld***

Pursuant to the Law for the Encouragement of Capital Investments, the Israel Government has granted Approved Enterprise status to our existing capital investment programs. Consequently, we are eligible for tax benefits for the first several years in which we generate taxable income. Our future profitability may be diminished if all or portions of these tax benefits are reduced. These tax benefits may be cancelled in the event

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of changes in Israeli government policies or if we fail to comply with requisite conditions and criteria. Currently the most significant conditions that we must continue to meet include making specified investments in fixed assets, maintaining the development and production nature of our facilities, and financing of at least 30% of these investments through the issuance of capital stock.

***Israeli regulations may limit our ability to engage in research and development and export our products***

Under Israeli law, we are required to obtain an Israeli government license to engage in research and development of and export of the encryption technology incorporated in our products. Our current government license to engage in these activities expires May 2003. Our research and development activities in Israel together with our ability to export our products out of Israel would be limited if the Israeli government revokes our current license, our current license is not renewed, our license fails to cover the scope of the technology in our products, or Israeli law regarding research and development or export of encryption technologies were to change.

***Israeli courts might not enforce judgments rendered outside of Israel that may make it difficult to collect on judgments rendered against us***

We are incorporated in Israel. Some of our directors and executive officers are not residents of the United States and some of their assets and our assets are located outside the United States. Service of process upon our non-U.S. resident directors and executive officers, and enforcement of judgments obtained in the United States against us, and our directors and executive officers, may be difficult to obtain within the United States. BackWeb Technologies, Inc., our U.S. subsidiary, is the U.S. agent authorized to receive service of process in any action against us in any federal or state court arising out of our initial public offering or any related purchase or sale of securities. We have not given consent for this agent to accept service of process in connection with any other claim.

We have been informed by our legal counsel in Israel, Naschitz, Brandes & Co., that there is doubt as to the enforceability of civil liabilities under U.S. securities laws in original actions instituted in Israel. However, subject to certain time limitations, an Israeli court may declare a foreign civil judgment enforceable if it finds that:

- the judgment was rendered by a court which was, according to the laws of the state of the court, competent to render the judgment;
- the judgment is no longer appealable;
- the obligation imposed by the judgment is enforceable according to the rules relating to the enforceability of judgments in Israel and the substance of the judgment is not contrary to public policy; and
- the judgment is executory in the state in which it was given.

Even if the above conditions are satisfied, an Israeli court will not enforce a foreign judgment if it was given in a state whose laws do not provide for the enforcement of judgments of Israeli courts (subject to exceptional cases) or if its enforcement is likely to prejudice the sovereignty or security of the State of Israel. An Israeli court also will not declare a foreign judgment enforceable if:

- the judgment was obtained by fraud;
- there was no due process;
- the judgment was rendered by a court not competent to render it according to the laws of private international law in Israel;
- the judgment is at variance with another judgment that was given in the same matter between the same parties and which is still valid; or

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at the time the action was brought in the foreign court a suit in the same matter and between the same parties was pending before a court or tribunal in Israel.

***We have adopted anti-takeover provisions that could delay or prevent an acquisition of BackWeb, even if an acquisition would be beneficial to our shareholders***

Provisions of Israel corporate and tax law and of our articles of association may have the effect of delaying, preventing or making more difficult a merger or other acquisition of BackWeb, even if an acquisition would be beneficial to our shareholders.

Israeli corporate law regulates acquisitions of shares through tender offers, requires special approvals for transactions involving significant shareholders and regulates other matters that may be relevant to these types of transactions. Furthermore, Israel tax considerations may make potential transactions unappealing to us or to some of our shareholders. In addition, our charter documents provide for a staggered board of directors.

***The new tax reform in Israel may reduce our tax benefit, which might adversely affect our profitability***

On July 24, 2002 Israel s Knesset approved significant tax reform legislation. The tax reform will go into effect primarily on January 1, 2003 and will be implemented on a gradual basis. We have not yet analyzed the likely implications of the new tax reform legislation on its results and operations. There is a risk that the impact may be material due to the underlying substantive changes in the basis of both the corporate and individual taxation framework. Furthermore, the new tax reform legislation may reduce, but not eliminate the tax benefits available to approved enterprises such as our company.

***Our results of operations may be negatively affected by the obligation of key personnel to perform military service***

Certain of our officers and employees are currently obligated to perform annual reserve duty in the Israel Defense Forces and are subject to being called for active military duty at any time. Although the Company has operated effectively under these requirements since its inception, we cannot predict the effect of these obligations on the Company in the future. Our operations could be disrupted by the absence, for a significant period, of one or more of our officers or key employees due to military service.

**Risks Relating to Our Ordinary Shares**

***Our stock price has been volatile and could fluctuate in the future***

The market price of our Ordinary Shares has been volatile. We expect our stock price to continue to fluctuate:

- in response to quarterly variations in operating results;
- in response to announcements of technological innovations or new products by us or our competitors or partners;
- because of market conditions in the enterprise software or portal industry;
- in reaction to changes in financial estimates by securities analysts, and our failure to meet or exceed the expectations of analysts or investors;
- in response to our announcements of strategic relationships or joint ventures; and
- in response to sales of our Ordinary Shares

In the past, following periods of volatility in the market price of a particular company s securities, securities class action litigation has often been brought against that company. We are currently subject to a securities class action and the volatility of our stock price could make us a target for additional suits. Securities class action litigation could result in substantial costs and a diversion of our management s attention and

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resources. See the discussion of outstanding material litigation in Part II, Item 1 Legal Proceedings set forth below.

***Our continued Nasdaq National Market listing is not assured***

Our Ordinary Shares are presently authorized for quotation on The Nasdaq National Market. We remain subject to all requirements of our listing agreement with The Nasdaq Stock Market, Inc. Among the events which could cause us to have our status as a Nasdaq National Market issuer terminated is a failure to maintain a minimum bid price for the Ordinary Shares of $1.00 per share.

On August 13, 2002, we received a letter from The Nasdaq Listing Qualifications Staff, advising us that our Ordinary Shares have been trading below the $1.00 per share requirement for continued inclusion on The Nasdaq National Market and that we had not regained compliance with this requirement during the previous ninety days. As a result, the Staff advised it would delist our Ordinary Shares from The Nasdaq National Market at the opening of business on August 21, 2002, unless we apply to transfer our securities to The Nasdaq SmallCap Market or request a hearing to appeal the Staff s determination to a Listing Qualification Panel. We intend to request a hearing to appeal the Staff s determination to a Listing Qualifications Panel. There can be no assurance that such an appeal will be successful. During the pendency of the appeal, our Ordinary Shares will continue to trade on the Nasdaq National Market. The Company is also considering applying to transfer its Ordinary Shares to The Nasdaq SmallCap Market, as well as other potential avenues to take with respect to maintaining its listing on The Nasdaq National Market. If we lose our Nasdaq National Market status, the Company anticipates that our Ordinary Shares would trade either as a Nasdaq SmallCap issue or in the over-the-counter market, both of which may be viewed by some investors as less desirable, less liquid marketplaces.

The lack of liquidity may make it more difficult for us to raise capital in the future. In addition, current and prospective customers and strategic partners may limit or cease their business relationships with us because of concerns or perceptions regarding our listing status and future liquidity.

***Holders of our Ordinary Shares who are United States residents face income tax risks***

There is a substantial risk that we are a passive foreign investment company, or PFIC, for U.S. federal income tax purposes. Our treatment as a PFIC could result in a reduction in the after-tax return to the holders of our Ordinary Shares and may cause a reduction in the value of such shares. For U.S. federal income tax purposes, we will be classified as a PFIC for any taxable year in which either (i) 75% or more of our gross income is passive income, or (ii) at least 50% of the average value of all of our assets for the taxable year produce or are held for the production of passive income. For this purpose, cash is considered to be an asset which produces passive income. Passive income also includes dividends, interest, royalties, rents, annuities and the excess of gains over losses from the disposition of assets, which produce passive income. As a result of our substantial cash position and the decline in the value of our stock, we are a PFIC under a literal application of the asset test that looks solely to market value. If we are a PFIC for U.S. federal income tax purposes, holders of our Ordinary Shares who are residents of the United States ( U.S. Holders ) would be required, in certain circumstances, to pay an interest charge together with tax calculated at maximum rates on certain excess distributions, including any gain on the sale of Ordinary Shares.

The consequences described above can be mitigated if the U.S. Holder makes an election to treat us as a qualified electing fund, or QEF. A shareholder making the QEF election is required for each taxable year to include in income a pro rata share of the net capital gain of the QEF as long-term capital gain, subject to a separate election to defer payment of taxes, which deferral is subject to an interest charge. We have agreed to supply U.S. Holders with the information needed to report income and gain pursuant to a QEF election. The QEF election is made on a shareholder-by-shareholder basis and can be revoked only with the consent of the Internal Revenue Service, or IRS.

As an alternative to making the QEF election, the U.S. Holder of PFIC stock which is publicly traded could mitigate the consequences of the PFIC rules by electing to mark the stock to market annually, recognizing as ordinary income or loss each year an amount equal to the difference as of the close of the

taxable year between the fair market value of the PFIC stock and the U.S. Holder s adjusted tax basis in the PFIC stock. Losses would be allowed only to the extent of net mark-to market gain previously included by the U.S. Holder under the election for prior taxable years.

All U.S. Holders are advised to consult their own tax advisers about the PFIC rules generally and about the advisability, procedures and timing of their making any of the available tax elections, including the QEF or mark-to-market elections.

***Our officers, directors and affiliated entities own a large percentage of BackWeb and could significantly influence the outcome of actions***

Our executive officers, directors and entities affiliated with them, in the aggregate, beneficially own approximately 39% of our outstanding Ordinary Shares. These shareholders, if acting together, would be able to significantly influence all matters requiring approval by our shareholders, including the election of directors and the approval of mergers or other business combination transactions.

**Item 3.** ***Quantitative and Qualitative Disclosures About Market Risk***

We develop products in Israel and sell them in North America, Asia and Europe. As a result, our financial results could be affected by factors such as changes in foreign currency exchange rates or weak economic conditions in foreign markets. As most of our sales are currently made in U.S. dollars, a strengthening of the dollar could make our products less competitive in foreign markets. Our interest income is sensitive to changes in the general level of U.S. interest rates, particularly since the majority of our investments are in short-term instruments. We regularly assess these risks and have established policies and business practices to protect against the adverse effects of these and other potential exposures. As a result, the Company does not anticipate material losses in these areas. Due to the nature of our short-term investments, we have concluded that there is no material market risk exposure. Therefore, no quantitative tabular disclosures are required.

The NIS was devalued against the U.S. dollar by approximately 8% and 3% in the six-months ended June 30, 2002 and 2001, respectively. The representative dollar exchange rate for converting the NIS to U.S. dollars, as reported by the Bank of Israel, was NIS 4.769 and NIS 4.416 for one U.S. dollar on June 30, 2002 and December 31, 2001, respectively.

## PART II OTHER INFORMATION

**Item 1.** ***Legal Proceedings***

The Company and six of its officers and directors have been 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 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 the Company s 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 the Company s stock. The complaint alleges claims against the Company and its officers and directors under Section 11 of the Securities Act of 1933, as amended (the 33 Act ) and alleges claims against the officers and directors under Section 15 of the 33 Act and pursuant to Rule 10b-5 and Sections 10b and 20(a) of the Securities Exchange Act of 1934. The complaint also names as defendants the underwriters for the Company s initial public offering. On or about July 15, 2002, an omnibus motion to dismiss was filed in the coordinated litigation on behalf of the issuer defendants, of which the Company and its named officers and directors are a part, on common pleadings issues. The Company and its officers and directors believe the allegations against them are without merit and intend to defend the action vigorously.

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**Item 2.** ***Changes in Securities and Use of Proceeds***

As at June 30, 2002, the Company had one Series E Preferred Share outstanding. The Series E Preferred Share was issued in connection with the acquisition by the Company of Lanacom Inc., in July 1997, and represented shares of Lanacom and/ or BackWeb Canada, Inc. that were exchangeable on a three-to-one basis for the Company s Ordinary Shares. During the three months ended June 30, 2002, the last holders of the exchangeable shares exchanged their shares for 422,212 Ordinary Shares of the Company. Subsequent to June 30, 2002, the Series E Preferred Share was returned to the Company and converted into Ordinary Shares which are held in the Company s treasury.

**Item 3.** ***Defaults Upon Changes of Senior Securities***

None.

**Item 4.** ***Submission of Matters to a Vote of Security Holders***

None

**Item 5.** ***Other Information***

On June 17, 2002, the Audit Committee of the Board of Directors of the Company authorized and approved (1) the engagement of Ernst & Young International as the independent auditors for the Company for the fiscal year 2002 and (2) the provision of non-audit services during fiscal 2002 by certain firms within Ernst & Young International, consisting of the preparation of tax returns for the Company s subsidiaries located in North America, Japan and the EEC and found that such did not compromise the independence of the auditors.

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

(a) *Exhibits*

The following exhibits are filed herewith or are incorporated by reference to exhibits previously filed with the Commission.

| Exhibit No. | Description |
|---|---|
| 3.1 | Articles of Association of Registrant* |
| 3.2 | Memorandum of Association of Registrant (English translation)* |
| 4.1 | Specimen of Ordinary Share Certificate* |
| 4.2 | Fourth Amended and Restated Rights Agreement* |
| 4.3 | Form of Liquidity Proposal between BackWeb Technologies, Ltd. and the Exchangeable Shareholders* |

* Incorporated herein by reference to the corresponding Exhibit from the Company s Registration Statement on Form F-1 (File No. 333-10358).

(b) *Reports on Form 8-K*

The Company filed no reports on Form 8-K during the three-months ended June 30, 2002.

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## SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized.

BACKWEB TECHNOLOGIES LTD.

Date: August 14, 2002

By: /s/ CHRISTOPHER C. MARSHALL

Christopher C. Marshall
*Vice President of Finance and*
*Chief Accounting Officer*

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