

BOS BETTER ONLINE SOLUTIONS LTD

Form 20-F/A

February 28, 2005

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

AMENDMENT NO. 2
TO

FORM 20-F/A

REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR (g) OF THE
SECURITIES EXCHANGE ACT OF 1934

OR

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934

For the fiscal year ended DECEMBER 31, 2003

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934

Commission file number 001-14184

B.O.S BETTER ON LINE SOLUTIONS LTD.
(Exact name of Registrant as specified in its charter)

ISRAEL
(Jurisdiction of incorporation or organization)

BEIT RABIN, 100 BOS ROAD, TERADYON INDUSTRIAL PARK, MISGAV, 20179, ISRAEL
(Address of principal executive offices)

Securities registered or to be registered pursuant to Section 12(b) of the Act:

NONE
(Title of each class)

Securities registered or to be registered pursuant to Section 12(g) of the Act:

ORDINARY SHARES, PAR VALUE NIS 4.00 PER SHARE
(Title of Class)

Securities for which there is a reporting obligation pursuant to Section 15(d)
of the Act:

NONE
(Title of Class)

Indicate the number of outstanding shares of each of the issuer's classes of
capital or common stock as of the close of the period covered by the annual
report:

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4,167,509 ORDINARY SHARES, NIS 4.00 PAR VALUE PER SHARE, AS OF DECEMBER 31, 2003

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 No

Indicate by check mark which financial statement item the registrant has elected to follow:

Item 17 Item 18

EXPLANATORY NOTE

This Amendment no. 2 to the Annual Report on Form 20-F for the year ended December 31, 2003, of B.O.S Better On-Line Solutions Ltd. (the "Company") includes the consolidated financial statements of Surf Communication Solutions Ltd. ("Surf"), as well as the reports of the independent auditors of Surf and its subsidiaries, Surf Communication Solutions, Inc. and Surf Communication Solutions BV.

ITEM 18: FINANCIAL STATEMENTS

The restated financial statements of the Registrant have been previously filed in Amendment No. 1 of Form 20-F.

The consolidated financial statements of Surf Communication Solutions Ltd., are also filed as part of this Annual Report.

ITEM 19: EXHIBITS

The following exhibits are filed as part of this Annual Report:

- 1.1 Memorandum of Association, as amended (incorporated by reference to the Company's Annual Report on Form 20-F filed on June 27, 2003).
- 1.2 Articles of Association, as amended (incorporated by reference to the Company's Annual Report on Form 20-F filed on June 27, 2003).
- 4.1 Form of Indemnification Agreement between the Company and its officers and directors (incorporated by reference to the Company's Current Report on Form 6-K filed on January 17, 2003).
- 4.2* Share Purchase Agreement, dated as of February 23, 2003, and Option Agreement and Registration Rights Agreement, dated as of March 30, 2003, by and between Catalyst Investments L.P. and the Registrant.
- 4.3* Share Purchase Agreement and Registration Rights Agreement, dated as of December 14, 2003, by and between Hillswood Holdings Limited and Vamos Inc. and the Registrant.
- 4.4* Services Agreement, dated as of April 15, 2003, between Cukierman & Co. Investment House Ltd., BOScom Ltd. and the Registrant.

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4.5* Management Agreement between Signum Ltd., Adiv Baruch and the Registrant, dated as of January 1, 2004.

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4.6* Securities Purchase Agreement, Master Security Agreement and Registration Rights Agreement, dated as of June 10, 2004, by and between Laurus Master Fund Ltd. and the Registrant.

4.7* Distribution Agreement, dated as of January 15, 2003, by and between Boscom Ltd. and Bosanova Inc.

8.1 List of subsidiaries (incorporated by reference to Item 4C of this Annual Report on Form 20-F).

10.1 Consent of Kost Forer Gabbay & Kasierer, a member of Ernst &Young Global.

10.2 Consent of Walter Fey, CPA.

10.3 Consent of Mazars Paardekooper Hoffman.

31.1 Certification by Chief Executive Officer pursuant to Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934.

31.2 Certification by Chief Financial Officer pursuant to Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934.

32.1 Certification by Chief Executive Officer and Chief Financial Officer pursuant to Rule 13a-14(b) or Rule 15d-14(b) of the Securities Exchange Act of 1934.

* previously filed

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SIGNATURES

The Registrant hereby certifies that it meets all of the requirements for filing on Form 20-F and that it has duly caused and authorized the undersigned to sign this Amendment No. 2 to its annual report on its behalf.

B.O.S. Better On-Line Solutions, Ltd.

/s/ Adiv Baruch

Adiv Baruch
President and Chief Executive Officer

/s/ Nehemia Kaufman

Nehemia Kaufman
Chief Financial Officer

Date: February 28, 2005

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SURF-COMMUNICATION SOLUTIONS LTD. AND SUBSIDIARIES

CONSOLIDATED FINANCIAL STATEMENTS

AS OF DECEMBER 31, 2003

IN U.S. DOLLARS

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ERNST & YOUNG

o KOST FORER GABBAY & KASIERER
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REPORT OF INDEPENDENT AUDITORS

TO THE SHAREHOLDERS OF

SURF-COMMUNICATION SOLUTIONS LTD.

We have audited the accompanying consolidated balance sheets of

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Surf-Communication Solutions Ltd. (the "Company") and its subsidiaries as of December 31, 2002 and 2003, and the related consolidated statements of operations, changes in shareholders' equity (deficiency) and cash flows for each of the two years in the period ended December 31, 2003. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the financial statements of two wholly-owned subsidiaries, which statements reflect total assets constituting 7% and 12% as of December 31, 2002 and 2003, respectively, and total revenues constituting 27% and 36% of the related consolidated totals for the years ended December 31, 2002 and 2003, respectively. Those statements were audited by other auditors whose reports have been furnished to us, and our opinion, insofar as it relates to data included for those subsidiaries is based solely on the reports of the other auditors.

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

In our opinion, based on our audit and the reports of the other auditors, the consolidated financial statements referred to above, present fairly, in all material respects, the consolidated financial position of the Company and its subsidiaries as of December 31, 2002 and 2003, and the consolidated results of their operations and cash flows for each of the two years in the period ended December 31, 2003, in conformity with accounting principles generally accepted in the United States.

Tel-Aviv, Israel
April 4, 2004

KOST FORER GABBAY & KASIERER
A Member of Ernst & Young Global

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WALTER FEY, CPA
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Arlington, MA 02474
TEL (781) 641-9889

To the Board of Directors and shareholders
Surf Communication Solutions, Inc.
495 Old Connecticut Path, Suite 320
Framingham, MA 01701

INDEPENDENT AUDITOR'S REPORT

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I have audited the accompanying balance sheets of Surf Communication Solutions, Inc. as of December 31, 2003 and 2002 and the related statements of operations and accumulated deficit and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. My responsibility is to express an opinion on these financial statements based on my audit.

I conducted my audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that, I plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management as well as evaluating the overall financial statement presentation. I believe that my audits provides a reasonable basis for my opinion.

As explained in Note D to the financial statements, certain related party transactions with the Company's parent have not been recorded in the financial statements. U.S. generally accepted accounting principles require such related party transactions to be recorded at their fair value at the date they were incurred. It was not practical to determine the effects of the unrecorded related party transactions on the financial statements.

In my opinion, except for the effects of not recording certain related party transactions, as discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of Surf Communication Solutions, Inc. as of December 31, 2003 and 2002 and the results of its operations and changes in cash flows for the years then ended in conformity with accounting principles generally accepted in the United States.

/S/ Walter Fey

January 16, 2004

AUDITOR'S REPORT

INTRODUCTION

We have audited the accompanying balance sheets of Surf Communication Solutions BV. (the "Company") as of December 31, 2002 and 2003, and the related statements of operations, changes in shareholders' equity (deficiency) and cash flows for each of the two years in the period ended December 31, 2003. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

SCOPE

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a

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test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

OPINION

In our opinion, based on our audit, the financial statements referred to above, present fairly, in all material respects, the financial position of the Company as of December 31, 2002 and 2003, and the results of their operations and cash flows for each of the two years in the period ended December 31, 2003, in conformity with accounting principles generally accepted in the United States.

Amsterdam, April 2, 2004

/S/ MAZARS PAARDEKOOPER HOFFMAN

MAZARS PAARDEKOOPER HOFFMAN

F.D.N. Walta RA

SURF-COMMUNICATION SOLUTIONS LTD. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

U.S. DOLLARS IN THOUSANDS

| | DECEMBER 31, | |
|------------------------------------|--------------|---------|
| | 2002 | 2003 |
| | ----- | ----- |
| ASSETS | | |
| CURRENT ASSETS: | | |
| Cash and cash equivalents | \$7,048 | \$3,552 |
| Short-term deposits | 121 | 1,124 |
| Trade receivables (Note 3) | 475 | 434 |
| Other accounts receivable (Note 4) | 208 | 229 |
| | ----- | ----- |
| Total current assets | 7,852 | 5,339 |
| | ----- | ----- |
| LONG-TERM INVESTMENTS: | | |
| Long-term deposits | 73 | 34 |
| Severance pay fund | 391 | 388 |
| | ----- | ----- |
| Total long-term investments | 464 | 422 |
| | ----- | ----- |

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| | | |
|--------------------------------------|---------|---------|
| PROPERTY AND EQUIPMENT, NET (Note 5) | 818 | 471 |
| | ----- | ----- |
| | \$9,134 | \$6,232 |
| | ===== | ===== |

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

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SURF-COMMUNICATION SOLUTIONS LTD. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

U.S. DOLLARS IN THOUSANDS (EXCEPT FOR SHARE DATA)

| | DECEMBER |
|---|----------|
| | 2002 |
| | ----- |
| LIABILITIES AND SHAREHOLDERS' EQUITY | |
| CURRENT LIABILITIES: | |
| Trade payables | \$ 177 |
| Accrued expenses and other liabilities (Note 6) | 609 |
| | ----- |
| Total current liabilities | 786 |
| | ----- |
| LONG-TERM LIABILITIES: | |
| Accrued severance pay | 470 |
| | ----- |
| COMMITMENTS AND CONTINGENT LIABILITIES (Note 7) | |
| SHAREHOLDERS' EQUITY (Note 8): | |
| Ordinary shares of NIS 0.01 par value: | |
| Authorized: 15,631,286 shares as of December 31, 2002 and 2003; Issued and outstanding: 965,000 and 1,055,471 shares as of December 31, 2002 and 2003, respectively | 3 |
| Preferred shares of NIS 0.01 par value: | |
| Authorized: 4,368,714 shares as of December 31, 2002 and 2003; Issued and outstanding: 3,300,034 shares as of December 31, 2002 and 2003; | |
| Aggregate liquidation preference of \$ 43,062 as of December 2002 and 2003 | 7 |
| Additional paid-in capital | 30,773 |
| Deferred stock compensation | (207) |
| Accumulated deficit | (22,698) |
| | ----- |

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| | |
|----------------------------|----------|
| Total shareholders' equity | 7,878 |
| | ----- |
| | \$ 9,134 |
| | ===== |

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

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SURF-COMMUNICATION SOLUTIONS LTD. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

U.S. DOLLARS IN THOUSANDS

| | YEAR ENDED DECEMBER 31, | |
|----------------------------------|----------------------------|----------|
| | 2002 | 2003 |
| | ----- | ----- |
| Revenues: | | |
| Software licenses | \$ 798 | \$ 1,242 |
| Royalties | 310 | 161 |
| | ----- | ----- |
| Total revenues | 1,108 | 1,403 |
| | ----- | ----- |
| Cost of revenues: | | |
| Software license | 687 | 522 |
| Royalties | 71 | 41 |
| | ----- | ----- |
| Total cost of revenues | 758 | 563 |
| | ----- | ----- |
| Gross profit | 350 | 840 |
| | ----- | ----- |
| Operating expenses: | | |
| Research and development, net | 3,797 | 2,035 |
| Selling and marketing (Note 10a) | 2,518 | 1,486 |
| General and administrative | 640 | 577 |
| Non-recurring costs | 224 | 234 |
| | ----- | ----- |
| Total operating expenses | 7,179 | 4,332 |
| | ----- | ----- |
| Operating loss | 6,829 | 3,492 |
| Financial income, net (Note 10b) | (70) | (72) |
| Other expenses | 10 | - |

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| | | |
|--------------------------|----------|----------|
| | ----- | ----- |
| Loss before income taxes | 6,769 | 3,420 |
| Income taxes | 4 | 7 |
| | ----- | ----- |
| Net loss | \$ 6,773 | \$ 3,427 |
| | ===== | ===== |

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

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SURF-COMMUNICATION SOLUTIONS LTD. AND SUBSIDIARIES

STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

U.S. DOLLARS IN THOUSANDS (EXCEPT FOR SHARE AMOUNTS)

| | ORDINARY SHARES | | PREFERRED SHARES | | ADDITIONAL PAID-IN CAPITAL | DE COM |
|---|-----------------|--------|------------------|--------|----------------------------------|-----------|
| | SHARES | AMOUNT | SHARES | AMOUNT | | |
| Balance as of January 1, 2002 | 965,000 | \$ 3 | 2,308,475 | \$ 5 | \$ 22,624 | \$ |
| Issuance of Preferred C shares, net | - | - | 991,559 | 2 | 8,016 | |
| Deferred compensation related to options issued to employees | - | - | - | - | 133 | |
| Amortization of deferred stock compensation | - | - | - | - | - | |
| Net loss | - | - | - | - | - | |
| | ----- | ----- | ----- | ----- | ----- | ----- |
| Balance as of December 31, 2002 | 965,000 | 3 | 3,300,034 | 7 | 30,773 | |
| Deferred compensation related to options issued to employees | - | - | - | - | 108 | |
| Amortization of deferred stock compensation | - | - | - | - | - | |
| Exercise of stock options | 90,471 | *) | - | - | - | |
| Net loss | - | - | - | - | - | |
| | ----- | ----- | ----- | ----- | ----- | ----- |
| Balance as of December 31, 2003 | 1,055,471 | \$ 3 | 3,300,034 | \$ 7 | \$ 30,881 | \$ |
| | ===== | ===== | ===== | ===== | ===== | ===== |

*) Represents an amount lower than \$ 1.

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

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SURF-COMMUNICATION SOLUTIONS LTD. AND SUBSIDIARIES

 CONSOLIDATED STATEMENTS OF CASH FLOWS
 U.S. DOLLARS IN THOUSANDS

| | YEAR ENDED D |
|---|------------------------|
| | ----- 2002 ----- |
| CASH FLOWS FROM OPERATING ACTIVITIES: | |
| Net loss | \$ (6,773) |
| Adjustments to reconcile net loss to net cash used in operating activities: | |
| Depreciation | 490 |
| Increase (decrease) in accrued severance pay, net | (100) |
| Loss on sale and write-off of property and equipment | 10 |
| Amortization of deferred stock compensation | 143 |
| Interest rate income on short-term deposits | - |
| Decrease in trade receivables | 1,239 |
| Increase in other accounts receivable | (133) |
| Decrease in trade payables | (206) |
| Increase (decrease) in accrued expenses and other liabilities | (1,679) |
| | ----- |
| Net cash used in operating activities | (7,009) |
| | ----- |
| CASH FLOWS FROM INVESTING ACTIVITIES: | |
| Purchase of property and equipment | (46) |
| Long-term deposits | 60 |
| Short-term bank deposit | - |
| | ----- |
| Net cash provided by (used in) investing activities | 14 |
| | ----- |
| CASH FLOWS FROM FINANCING ACTIVITIES: | |
| Repayment of third party's loan | (3,214) |
| Proceeds from issuance of Preferred shares, net | 8,018 |
| | ----- |
| Net cash provided by financing activities | 4,804 |
| | ----- |
| Decrease in cash and cash equivalents | (2,191) |
| Cash and cash equivalents at the beginning of the year | 9,239 |
| | ----- |
| Cash and cash equivalents at the end of the year | \$ 7,048 |
| | ===== |
| NON-CASH ACTIVITY: | |
| Write-off of property against other liabilities | \$ 12 |
| | ===== |

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

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SURF-COMMUNICATION SOLUTIONS LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS

NOTE 1:- GENERAL

Surf-Communication Solutions Ltd. ("the Company") was incorporated and commenced its activities under the laws of Israel in 1996. The Company is a developer and global supplier of universal access and network convergence software solutions to the wireline and wireless telecommunications and data communications industries.

The Company owns and controls 100% of its subsidiaries "Surf Communication Solutions Inc.", registered in the USA and "Surf Communication Solutions B.V." registered in Holland.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES

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

a. Use of estimates:

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

b. Financial statements in U.S. dollars:

The functional currency of the Company and its subsidiaries is the U.S. dollar, as the U.S. dollar is the primary currency of the economic environment in which the Company and its subsidiaries have operated and expect to continue to operate in the foreseeable future. The majority of the Company's operations is currently conducted in Israel and most of the Israeli expenses are currently paid in new Israeli shekels ("NIS"). A majority of the revenues of the Company and its subsidiaries is generated in U.S. dollars ("dollar"). Financing activities including loans, equity transactions and cash investments, are made in U.S. dollars.

The Company's transactions and balances denominated in U.S. dollars are presented at their original amounts. Non-dollar transactions and balances have been remeasured to U.S. dollars in accordance with Statement No. 52 of the Financial Accounting Standards Board ("SFAS"). All transaction gains and losses from remeasurement of monetary balance sheet items denominated in non-dollar currencies are reflected in the statements of operations as financial income or expenses, as

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appropriate. For the years ended December 31, 2002 and 2003, these expenses were immaterial (see Note 10b)

c. Principles of consolidation:

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. Intercompany transactions and balances have been eliminated upon consolidation.

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SURF-COMMUNICATION SOLUTIONS LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

d. Cash equivalents:

Cash equivalents are short-term highly liquid investments that are readily convertible to cash with original maturities of three months or less.

e. Short-term deposits:

Bank deposits with maturities of more than three months but less than one year are included in short-term deposits. The short-term deposits are presented at their cost, including accrued interest.

f. Property and equipment:

Property and equipment are stated at cost, net of accumulated depreciation. Depreciation is calculated by the straight-line method over the estimated useful lives of the assets at the following annual rates:

| | % |
|------------------------------------|----------------------------|
| | ----- |
| Computers and peripheral equipment | 33 |
| Office furniture and equipment | 6 - 15 |
| Motor vehicles | 15 |
| Leasehold improvements | over the term of the lease |

The Company and its subsidiaries periodically assess the recoverability of the carrying amount of property and equipment and provide for any possible impairment loss based upon the difference between the carrying amount and fair value of such assets. As of December 31, 2003, no impairment losses have been identified.

g. Research and development costs:

FASB No. 86, "Accounting for the Costs of Computer Software to be Leased or Otherwise Marketed", requires capitalization of certain software development costs subsequent to the establishment of technological feasibility.

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Based on the Company's product development process, technological feasibility is established upon completion of a working model. The Company does not incur material costs between the completion of the working model and the point at which the products are ready for general release. Therefore, research and development costs are charged to the statement of operations as incurred.

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SURF-COMMUNICATION SOLUTIONS LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

h. Income taxes:

The Company accounts for income taxes in accordance with FASB No. 109, "Accounting for Income Taxes". This Statement prescribes the use of the liability method whereby deferred tax assets and liability account balances are determined based on differences between financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. The Company provides a valuation allowance, if necessary, to reduce deferred tax assets to their estimated realizable value.

i. Revenue recognition:

The Company has adopted Statement of Position ("SOP") 97-2, "Software Revenue Recognition," as amended. 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," 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 licensing fees and royalties on its products, maintenance and support, and rendering of consulting services, including implementation, training and installation. The Company sells its products primarily through its direct sales force.

Revenue from license fees is recognized when persuasive evidence of an agreement exists, delivery of the product has occurred, no significant obligations with regard to implementation remain, the fee is fixed or determinable, and collectibility is probable. The Company generally 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. The Company considers all arrangements with payment terms extending beyond 180 days not to be fixed or determinable. If the fee is not fixed or determinable, revenue is recognized as payments become due from the customer

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provided that all other revenue recognition criteria have been met.

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

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SURF-COMMUNICATION SOLUTIONS LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

The Company is entitled to royalties from revenue sharing upon the sublicensing of the Company's products to end-users. Royalties out of revenue sharing arrangements are recognized when such royalties are reported to the Company.

Arrangements that include consulting services are evaluated to determine whether those services are essential to the functionality of other elements of the arrangement. When services are considered essential, revenue under the arrangement is recognized using contract accounting. When services are not considered essential, the revenue allocable to the software services is recognized as the services are performed. To date, the Company had determined that the services are not considered essential to the functionality of other elements of the arrangement.

Revenues from software license that require significant customization, integration and installation are recognized using contract accounting on a percentage of completion method based on the relationship of actual costs incurred to total costs estimated to be incurred over the duration of the contract.

j. Concentrations of credit risk:

Financial instruments that potentially subject the Company and its subsidiaries to concentrations of credit risk consist principally of cash, cash equivalents, short-term deposits and trade receivables.

Cash and cash equivalents and short-term deposits are invested in major banks in Israel and the United States. Such deposits 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 trade receivables of the Company and its subsidiaries are mainly derived from sales to customers located primarily in the U.S., Europe and Asia. The Company performs ongoing credit evaluations of its customers and to date has not experienced any material losses. An allowance for doubtful accounts is determined with respect to those amounts that the Company has determined to be doubtful of collection.

The Company has no significant off-balance-sheet concentration of

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credit risk such as foreign exchange contracts, option contracts or other foreign hedging arrangements.

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SURF-COMMUNICATION SOLUTIONS LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

k. Accounting for stock-based compensation:

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

The Company applies FASB 123 and EITF 96-18, "Accounting for Equity Instruments that are Issued to Other than Employees for Acquiring, or in Conjunction with Selling Goods or Services" with respect to options issued to non-employees. FASB 123 requires use of an option valuation model to measure the fair value of the options at the grant date.

l. Government grant:

Royalty-bearing grants from the Government of Israel for funding approved research and development projects are recognized at the time the Company is entitled to such grants, on the basis of the costs incurred and included as a deduction of research and development costs. Research and development grants amounted to \$ 257 in 2003. Total royalties, accrued or paid, amounted to \$ 19 in 2003, and were recorded as part of the cost of goods sold.

m. Severance pay, net:

The Company's liability for severance pay is calculated pursuant to Israeli severance pay law based on the most recent salary of the employees multiplied by the number of years of employment, as of the balance sheet date. Employees are entitled to one month's salary for each year of employment or a portion thereof. The Company's liability for all of its employees, is fully provided by monthly deposits with insurance policies and by an accrual. The value of these policies is recorded as an asset in the Company's balance sheet.

The deposited funds include profits accumulated up to the balance sheet date. The deposited funds may be withdrawn only upon the fulfillment of the obligation pursuant to Israeli severance pay law or labor agreements. The value of the deposited funds is based on the cash surrendered value of these policies, and includes immaterial profits.

Severance pay expenses for the years ended December 31, 2002 and 2003, amounted to approximately, \$ 183 and \$ 92, respectively.

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SURF-COMMUNICATION SOLUTIONS LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

n. Fair value of financial instruments:

The following methods and assumptions were used by the Company and its subsidiaries in estimating their fair value disclosures for financial instruments:

The carrying amounts of cash and cash equivalents, short-term deposits, trade receivables, other accounts receivable, short-term loans and trade payables approximate their fair value due to the short-term maturity of such instruments.

The carrying amount of the Company's long-term borrowing approximates its fair value. The fair value was estimated using discounted cash flow analyses, based on the Company's incremental borrowing rates for similar type of borrowing arrangements.

NOTE 3:- TRADE RECEIVABLES

| | DECEMBER 31, | |
|---------------------------------------|--------------|--------|
| | 2002 | 2003 |
| Accounts receivable | \$ 605 | \$ 486 |
| Less: allowance for doubtful accounts | 130 | 52 |
| | \$ 475 | \$ 434 |
| | ===== | ===== |

NOTE 4:- OTHER ACCOUNTS RECEIVABLE

| | | |
|-----------------------------|--------|--------|
| Government authorities | \$ 163 | \$ 186 |
| Prepaid expenses and others | 45 | 43 |
| | \$ 208 | \$ 229 |
| | ===== | ===== |

NOTE 5:- PROPERTY AND EQUIPMENT

| | | |
|------------------------------------|---------|---------|
| Cost: | | |
| Computers and peripheral equipment | \$1,735 | \$1,780 |
| Office furniture and equipment | 271 | 256 |
| Leasehold improvements | 180 | 188 |
| Motor vehicles | 22 | 22 |
| | 2,208 | 2,246 |
| | ===== | ===== |
| Accumulated depreciation: | | |
| Computers and peripheral equipment | 1,243 | 1,577 |
| Office furniture and equipment | 64 | 93 |

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| | | |
|------------------------|--------|--------|
| Leasehold improvements | 72 | 91 |
| Motor vehicles | 11 | 14 |
| | ----- | ----- |
| | 1,390 | 1,775 |
| | ----- | ----- |
| Depreciated cost | \$ 818 | \$ 471 |
| | ===== | ===== |

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SURF-COMMUNICATION SOLUTIONS LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS

NOTE 6:- ACCRUED EXPENSES AND OTHER LIABILITIES

| | DECEMBER 31 | |
|--|-------------|---------|
| | 2002 | 2003 |
| | ----- | ----- |
| Accrued expenses and other liabilities | \$ 71 | \$ 336 |
| Employees and payroll accruals | 423 | 421 |
| Deferred revenue | 37 | 207 |
| Provision for warranty costs | 78 | 78 |
| | ----- | ----- |
| | \$ 609 | \$1,042 |
| | ===== | ===== |

NOTE 7:- COMMITMENTS AND CONTINGENT LIABILITIES

a. Lease commitments:

The facilities of the Company and its subsidiaries are rented under operating leases, for periods ending in 2005. Future minimum lease commitments under non-cancelable leases for the years ended December 31, are as follows:

| | |
|------|--------|
| 2004 | 209 |
| 2005 | 136 |
| | ----- |
| | \$ 345 |
| | ===== |

Rent expenses for the years ended December 31, 2002 and 2003, amounted to \$ 267 and \$ 234, respectively.

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b. Guarantees:

The Company purchased bank guarantees in the amount of \$ 100 as security for the rental of its facilities.

c. Royalties:

The Company participated in a program sponsored by the Israeli Government for the support of research and development activities. Through December 31, 2003, the Company had obtained a grant from the Office of the Chief Scientist of the Israeli ministry of Industry and Trade ("the OCS") aggregating to \$ 257 for certain of the Company's research and development projects. The Company is obligated to pay royalties to the OCS, amounting to 3-5% of the sales of the products and other related revenues generated from such projects, up to 100%-150% of the grants received, linked to the U.S. dollars and bearing interest at the rate of LIBOR. The obligation to pay these royalties is contingent on actual sales of the products and in the absence of such sales no payment is required.

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SURF-COMMUNICATION SOLUTIONS LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS (EXCEPT FOR SHARE DATA)

NOTE 8:- SHAREHOLDERS' EQUITY

a. Share capital:

| | DECEMBER 31, | | | |
|------------------------------|------------------|---------------------------|------------|---------------------------|
| | 2002 | | 2003 | |
| | AUTHORIZED | ISSUED AND OUTSTANDING | AUTHORIZED | ISSUED AND OUTSTANDING |
| | NUMBER OF SHARES | | | |
| Shares of NIS 0.01par value: | | | | |
| Ordinary shares (1) | 15,631,286 | 965,000 | 15,631,286 | 1,055,471 |
| Preferred "A" shares (2) | 340,000 | 336,704 | 340,000 | 336,704 |
| Preferred "A1" shares (2) | 130,000 | 128,300 | 130,000 | 128,300 |
| Preferred "B" shares (2) | 169,500 | 169,500 | 169,500 | 169,500 |
| Preferred "B1" shares (2) | 18,834 | 18,834 | 18,834 | 18,834 |
| Preferred "C" shares (2) | 3,710,380 | 2,646,696 | 3,710,380 | 2,646,696 |
| | 20,000,000 | 4,265,034 | 20,000,000 | 4,355,505 |

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In October 2001, the Company issued 2,428,432 Preferred "C" shares of NIS 0.01 par value each. 1,655,137 of those shares were fully paid for net proceeds in the amount of \$ 14,488, of which \$ 2,580 were received by conversion of bridge loans. The net proceeds for the remaining shares in the amount of \$ 6,201, including an accumulated interest rate of \$ 142, were accepted in November 2002.

In March 2002, the Company issued additional 218,264 Preferred "C" shares to new investors for net proceeds of \$ 1,817.

The Company granted to the Preferred C investors and previous bridge loan lender a total of 866,297 warrants to purchase Preferred C shares at exercise prices between \$ 7.33 and \$ 9.16 per share, exercisable until four years from the grant date.

- (1) The Ordinary shares confer upon the holders the right to receive notice to participate and vote in shareholders meetings of the Company and to receive dividend, if declared.
- (2) The Preferred shares ("A", "A1", "B", "B1" and "C") have the same rights as the Ordinary shares (except for the Preferred "A1" and "B1" shares, which do not confer voting rights). In addition, the shares are convertible into Ordinary shares, have an aggregate preference in liquidation of \$ 43,062 as of December 31, 2003 and 2002 and have veto rights in certain matters. The Preferred shares are convertible, at the holders' option, upon an IPO of the Company, into Ordinary shares.

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SURF-COMMUNICATION SOLUTIONS LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS (EXCEPT FOR SHARE DATA)

NOTE 8:- SHAREHOLDERS' EQUITY (CONT.)

b. Stock Option Plans:

Under the Company's 1999 and 2003 Stock Option Plans, options may be granted to officers, directors, employees and consultants of the Company or its subsidiaries.

The 2003 Employee Stock Option Plan is designed to benefit from, and is made pursuant to the provisions of Section 102 of the Israeli Income Tax Ordinance.

As of December 31, 2003, an aggregate of 1,992,737 Ordinary shares of the Company are still available for future grant.

Each option granted under the Plans is exercisable until ten years from the grant date. The exercise price of the options granted under the Plans may not be less than the nominal value of the shares, into which such options are exercised. Each option granted can be exercised to one Ordinary share of the Company. The options vest over one to four years. Any options, which are forfeited or not exercised before expiration, become available for future grants.

In February 2002, 211,521 previously granted options with exercise

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prices ranging from \$ 6 to \$ 14 were repriced to par value of NIS 0.01, which resulted in a total compensation expense of \$ 133, of which an amount of \$ 87 was recognized in 2002 for the portion already vested, and the remaining amount of \$ 46 was deferred to be recognized over the remaining vesting period ending in 2006.

In July 2003, 175,155 previously granted options with an exercise price of \$ 6 were repriced to par value of NIS 0.01 resulting in a total compensation expense of \$ 108, of which 30 was recognized in 2003 for the portion already vested and \$ 78 was deferred to be recognized over the remaining vesting period ending in 2006.

A summary of the Company's stock option activity and related information is as follows:

| | YEAR ENDED DECEMBER 31, | | | |
|--|-------------------------|--|-------------------------|--|
| | 2002 | | 2003 | |
| | NUMBER OF OPTIONS | WEIGHTED AVERAGE EXERCISE PRICE | NUMBER OF OPTIONS | WEIGHTED AVERAGE EXERCISE PRICE |
| Outstanding at the beginning of the year | 667,139 | \$ 4.69 | 837,369 | \$ 1.93 |
| Granted | 237,015 | \$ 6 | 779,046 | \$ - |
| Exercised | - | \$ - | (90,471) | \$ - |
| Forfeited | (66,785) | \$ 14 | (145,887) | \$ 2.23 |
| | ----- | | ----- | |
| Outstanding at the end of the year | 837,369 | \$ 1.93 | 1,380,057 | \$ 0.15 |
| | ===== | | ===== | |
| Exercisable options | 305,502 | \$ 0.57 | 502,838 | \$ 0.41 |
| | ===== | | ===== | |

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SURF-COMMUNICATION SOLUTIONS LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS (EXCEPT FOR SHARE DATA)

NOTE 8:- SHAREHOLDERS' EQUITY (CONT.)

The options outstanding as of December 31, 2003, have been separated into ranges of exercise price as follows:

| OPTIONS OUTSTANDING AS OF | WEIGHTED AVERAGE REMAINING | WEIGHTED AVERAGE | OPTIONS EXERCISABLE AS OF | EXE PRI |
|---------------------------------|----------------------------------|---------------------|---------------------------------|------------|
|---------------------------------|----------------------------------|---------------------|---------------------------------|------------|

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| EXERCISE PRICE | DECEMBER 31, 2003 | CONTRACTUAL LIFE | EXERCISE PRICE | DECEMBER 31, 2003 | OP EXE |
|----------------|-------------------|------------------|----------------|-------------------|--------|
| \$ 0.01-1.36 | 1,360,457 | 8 | \$ 0.03 | 483,238 | \$ |
| \$ 6-9.75 | 14,100 | 6 | \$ 7.33 | 14,100 | \$ |
| \$ 10-14 | 5,500 | 5 | \$ 13.64 | 5,500 | \$ |
| | 1,380,057 | | | 502,838 | |
| | ===== | | | ===== | |

c. Options issued to consultants:

- The Company's outstanding options to consultants as of December 31, 2002, are as follows:

| ISSUANCE DATE | OPTIONS FOR ORDINARY SHARES | EXERCISE PRICE PER SHARE | OPTIONS EXERCISABLE |
|---------------|-----------------------------|--------------------------|---------------------|
| April 1998 | 22,012 | \$ 1.36 | 22,012 |
| | ===== | ===== | ===== |

- The fair value for these options was estimated using a Black-Scholes option-pricing model with the following weighted-average assumptions for 2002 and 2003: risk-free interest rates of 0%, dividend yields of 0%, volatility factors of the expected market price of the Company's Ordinary shares of 0 for each year, and a weighted-average expected life of the options of approximately 4 years.

d. Dividends:

In the event that cash dividends are declared in the future, such dividends will be paid in NIS. The Company does not intend to pay cash dividends in the foreseeable future.

NOTE 9:- TAXES ON INCOME

- Measurement of taxable income under the Income Tax (Inflationary Adjustments) Law, 1985:

Results for tax purposes are measured in terms of earnings in NIS after certain adjustments for increases in the Israeli CPI. As explained in Note 2b, the financial statements are measured in U.S. dollars. The difference between the annual change in the Israeli CPI and in the NIS/dollar exchange rate causes a further difference between taxable income and the income before taxes shown in the financial statements. In accordance with paragraph 9(f) of SFAS No. 109, the Company has not provided deferred income taxes on the difference between the reporting currency and the tax bases of assets and liabilities.

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SURF-COMMUNICATION SOLUTIONS LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS (EXCEPT FOR SHARE DATA)

NOTE 9:- TAXES ON INCOME (CONT.)

- b. Tax benefits under the Law for the Encouragement of Capital Investments, 1959 ("the Law"):

The Company's production facilities were granted the status of "Approved Enterprise", under the law. According to the provisions of said law, the Company elected the "alternative benefits" and waived Government grants, in return for a tax exemption. Income derived from the "Approved Enterprise" will be tax exempt for a period of ten years, commencing with the year in which the Company first earns taxable income. The period of benefits has not yet commenced.

Two expansion projects have been granted "Approved Enterprises" status under the Law.

The two expansion programs are as follows:

1. In December 1997, the Company received approval for the first program, which entitles the Company to a ten-year tax exemption period. The period of benefits for this expansion has not yet commenced.
2. In July 2001, the Company received approval for the second program of its "Approved Enterprises". This program entitles the Company to a ten-year tax exemption period. The period of benefits for this expansion has not yet commenced.

The entitlement to the above benefits is conditional upon the Company fulfilling the conditions stipulated by the above law, regulations published thereunder and the instruments of approval for the specific investments in "Approved Enterprises". In the event of failure to comply with these conditions, the benefits may be canceled and the Company may be required to refund the amount of the benefits, in whole or in part, including interest. As of December 31, 2003, management believes that the Company is meeting all of the aforementioned conditions.

In the event of a distribution of such tax-exempt income as cash dividend in a manner other than in the complete liquidation of the Company, the Company will be taxed at the rate of 10% to 25% on the amount distributed (based on the percentage of foreign ownership in each taxable year).

The period of tax benefits described above is limited to 12 years from the commencement of production, or 14 years from date of approval, whichever is earlier.

Income from sources other than the "Approved Enterprise" will be taxable at the regular tax rate of 36%.

The Law also allows the Company to claim accelerated depreciation on machinery and equipment used by the "Approved Enterprise", during five tax years.

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SURF-COMMUNICATION SOLUTIONS LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS (EXCEPT FOR SHARE DATA)

NOTE 9:- TAXES ON INCOME (CONT.)

- c. Tax benefits under the Law for the Encouragement of Industry (Taxation), 1969:

The Company is qualified as an "industrial company" under the above law and as such is entitled to certain tax benefits, including accelerated depreciation and the deduction of public offering expenses in three equal annual installments.

- d. Net operating losses carryforward:

As of December 31, 2003, the Company's operating loss carryforward amounted to approximately \$ 16,235, which can be carried forward and offset against taxable income in the future for an indefinite period.

As of December 31, 2003, the U.S. subsidiary's operating loss carryforward amounted to approximately \$ 3,789, which can be carried forward and offset against taxable income for 20 years no later than 2022.

NOTE 10:- SELECTED STATEMENTS OF OPERATIONS DATA

- a. Selling and marketing expenses, net:

| | YEAR ENDED DECEMBER 31, | |
|-------------|----------------------------|----------|
| | 2002 | 2003 |
| Salaries | \$ 1,128 | \$ 856 |
| Advertising | 74 | 47 |
| Other | 1,316 | 583 |
| | ----- | ----- |
| | \$ 2,518 | \$ 1,486 |
| | ===== | ===== |

- b. Financial income, net:

| | | |
|--|-------|-------|
| Financial expenses: | | |
| Interest | \$ 8 | \$ 12 |
| Foreign currency remeasurement differences | 29 | 107 |
| | ----- | ----- |
| | 37 | 119 |
| | ----- | ----- |
| Financial income: | | |
| Interest | 84 | 74 |
| Foreign currency remeasurement differences | 23 | 117 |
| | ----- | ----- |

| | |
|---------|---------|
| 107 | 191 |
| ----- | ----- |
| \$ (70) | \$ (72) |
| ===== | ===== |

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SURF-COMMUNICATION SOLUTIONS LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS (EXCEPT FOR SHARE DATA)

NOTE 11:- RELATED PARTIES TRANSACTIONS AND BALANCES

The balances with and the revenues derived from related parties were as follows:

a. Balances with related parties:

| | YEAR ENDED DECEMBER 31, | |
|----------------------|----------------------------|-------|
| | 2002 | 2003 |
| | ---- | ---- |
| Texas Instruments *) | \$ 38 | \$ - |
| | ===== | ===== |

b. Revenues from related parties:

| | YEAR ENDED DECEMBER 31, | |
|-------------------|----------------------------|-------|
| | 2002 | 2003 |
| | ---- | ---- |
| Texas Instruments | \$ 91 | \$ - |
| Motorola Inc. | - | 51 |
| | ----- | ----- |
| | \$ 91 | \$ 51 |
| | ===== | ===== |

c. Expenses to related parties:

| | | |
|---------------|-------|-------|
| Motorola Inc. | \$ 11 | \$ - |
| | ===== | ===== |

*) The balance is unlinked and bears no interest.

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