

BOS BETTER ONLINE SOLUTIONS LTD
Form 20-F/A
November 28, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

AMENDMENT NO. 1
TO

FORM 20-F

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, 2006

OR

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

OR

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

Date of event requiring this shell company report _____

For the transition period from _____ to _____

Commission file number 001-14184

B.O.S. BETTER ONLINE SOLUTIONS LTD.

(Exact name of Registrant as specified in its charter)

ISRAEL

(Jurisdiction of incorporation or organization)

20 Freiman Street, Rishon LeZion, 75100, Israel

(Address of principal executive offices)

Securities registered or to be registered pursuant to Section 12(b) of the Act: Ordinary Shares, nominal value NIS 4.00 per share

Securities registered or to be registered pursuant to Section 12(g) of the Act: NONE

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Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act: NONE

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: 6,744,798 Ordinary Shares, nominal value NIS 4.00 per share, as of December 31, 2006; and 8,492,213 Ordinary Shares, nominal value NIS 4.00 per share, as of April 30, 2007.

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes No

If this report is an annual or transition report, indicate by check-mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

Yes No

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 whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer

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

Item 17 Item 18

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

EXPLANATORY NOTE

This Amendment No. 1 to the Annual Report on Form 20-F for the year ended December 31, 2006, of B.O.S Better Online Solutions Ltd. (the Registrant) is filed in order to correct and supplement the description of a claim brought against the Registrant by BosaNova EURL in France. In particular, in the Registrant's previous description, it was mistakenly reported that the claim was filed in March 2005, for the amount of 1.4 million Euros whereas the claim was served on the Registrant in April 2006, for approximately 3.3 million Euros and additional remedies.

This Amendment No. 1 contains item 8 and the Company's Consolidated Financial Statements, in which a corresponding revision was made in Notes 14.b.3 and 20.b, and which also include an updated auditors report. Except as described above, this Amendment No. 1 to the Form 20-F continues to speak as of June 5, 2007 and no other changes have been made to the Annual Report. This Amendment No. 1 does not amend or update any other information set forth in the Annual Report and we have not updated disclosures contained therein to reflect any events that occurred at a date subsequent to the filing of the Annual Report.

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Item 8: Financial Information.**8A. Consolidated Statements and Other Financial Information***Consolidated Financial Statements*

See Item 18.

Sales Outside Israel

The total amount of export revenues of the Company has been as follows:

| Year | export revenues | % of all revenues |
|------|-----------------|-------------------|
| 2006 | \$ 6,040,000 | 29% |
| 2005 | \$ 10,693,000 | 44% |
| 2004 | \$ 4,552,000 | 66% |

Legal Proceedings

In April 2006, BOSNOVA EURL, a French company and former distributor of the Company, served the Company with a claim filed with the French Trade Tribunal alleging breach of exclusive distributor rights in France and asserting ownership to certain intellectual property rights in the Company's products. The plaintiff seeks an amount of approximately 3.3 million Euros and additional remedies. This claim follows a previous motion for temporary injunctive relief that was filed against the Company's new French distributor, said motion ultimately denied by French Trade Tribunal. On September 18, 2007, the French Trade Tribunal rejected the Company's assertion that jurisdiction is with the Israeli courts, and the Company has appealed this decision. The Company assesses the prospect of the claimant to prevail and recover a significant amount as remote. The Company's financial statements include a provision in this respect.

On May 10, 2006 the Company received a written demand from IDEAL Software GmbH (IDEAL), a German corporation, in which it claims that the Company owes it for unpaid license fees. On June 11, 2006 the Company filed with the Haifa District Court in Israel a claim against IDEAL. Recently, we announced that we entered into a settlement of this dispute with IDEAL, pursuant to which, on December 21, 2006, we paid IDEAL an amount of 110,000 Euros, and we agreed to withdraw the claim we filed in Israel.

Dividend Policy

The Company does not currently have a dividend policy. The declaration and payment of any cash dividends in the future will be determined by the Board of Directors in light of the conditions existing at that time. This will include our earnings and financial condition. We may only pay cash dividends in any fiscal year, out of profits, as defined under Israeli law. Any dividends paid out of Approved Enterprise earnings (i.e. tax exempt income) will be liable to tax. As we cannot currently distribute dividends, no provision has been made for this additional tax in our Financial Statements.

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8B. Significant Changes

Not applicable.

Item 19: Exhibits

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

1.1

Item 19: Exhibits

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Memorandum of Association, as amended (incorporated by reference to Exhibit 1.1 of the Company's Annual Report on Form 20-F filed with the SEC on June 28, 2006).

- 1.2 Articles of Association, as amended (incorporated by reference to Exhibit 1.2 of the Company's Annual Report on Form 20-F filed with the SEC on June 28, 2006).
- 4.1 Form of Indemnification Agreement between the Company and its officers and directors, as amended (incorporated by reference to Exhibit 4.1 of the Company's Annual Report on Form 20-F filed with the SEC on June 28, 2006).
- 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 (incorporated by reference to the Company's Annual Report on Form 20-F filed on June 17, 2004).
- 4.3 Services Agreement, dated as of April 15, 2003, between Cukierman & Co. Investment House Ltd., BOScom Ltd. and the Registrant (incorporated by reference to the Company's Annual Report on Form 20-F filed on June 17, 2004).
- 4.4 M&A Addendum to the Service Agreement, as of August 22, 2004, between Cukierman & Co. Investment House Ltd., BOScom Ltd. and the Registrant (incorporated by reference to the Company's Annual Report on Form 20-F filed on June 27, 2005).
- 4.5 Securities Purchase Agreement and Master Security Agreement and Registration Rights Agreement, dated as of June 10, 2004, by and between Laurus Master Fund Ltd. and the Registrant (incorporated by reference to the Company's Annual Report on Form 20-F filed on June 17, 2004), and Amendment no. 1 to the Securities Purchase Agreement dated as of November 16, 2004 (incorporated by reference to the Company's Registration Statement on Form F-3 no. 333-117529).
- 4.6 Securities Purchase Agreement and Master Security Agreement, dated as of September 29, 2005, by and between Laurus Master Fund Ltd. and the Registrant (incorporated by reference to Exhibit 4.1 of the Company's Annual Report on Form 20-F filed with the SEC on June 28, 2006; the Secured Convertible Term Note, Ordinary Shares Purchase Warrant and Registration Rights Agreement are incorporated by reference to the Company's Registration Statement on Form F-3 no. 333-130048).
- 4.7* Securities Purchase Agreement and Master Security Agreement, dated as of August 16, 2006, by and between Laurus Master Fund Ltd. and the Registrant (the Secured Convertible Term Note, Ordinary Shares Purchase Warrant and Registration Rights Agreement are incorporated by reference to the Company's Registration Statement on Form F-3 no. 333-137153)

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- 4.8 Distribution Agreement, dated as of January 15, 2003, by and between BOScom Ltd. and BOSaNOVA Inc. (incorporated by reference to the Company's Annual Report on Form 20-F/A filed on January 6, 2005).
 - 4.9 Asset Purchase Agreement, dated as of September 29, 2004, by and between Quasar Communication Systems Ltd. and the Registrant (incorporated by reference to the Company's Registration Statement on Form F-3 no. 333-117529).
 - 4.10 Share Purchase Agreement, dated as of November 2, 2004, by and between Jacob and Sara Neuhof, Odem Electronic Technologies 1992 Ltd. and the Registrant (incorporated by reference to the Company's Registration Statement on Form F-3 no. 333-117529).
 - 4.11 Agreement, dated as of September 29, 2005, by and between Jacob and Sara Neuhof and the Registrant, for the purchase of the shares of Odem Electronic Technologies 1992 Ltd. held by the Jacob and Sara Neuhof (incorporated by reference to Exhibit 4.1 of the Company's Annual Report on Form 20-F filed with the SEC on June 28, 2006).
 - 4.12 Share Purchase Agreement, dated as of May 24, 2005, by and between certain investors and the Registrant (incorporated by reference to the Company's Annual Report on Form 20-F filed on June 27, 2005).
 - 4.13 Asset Purchase Agreement and Amendments no. 1 and 2 to Agreement, dated as of July 18, 2005, August 31, 2005 and September 25, 2005, respectively, by and between BOSCom, Consist Technologies Ltd. and Consist International Inc., and Escrow Agreement and Amendment no. 1 to Escrow Agreement between the parties, dated as of July 18, 2005 and August 31,

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2005, respectively (incorporated by reference to Exhibit 4.1 of the Company's Annual Report on Form 20-F filed with the SEC on June 28, 2006).

- 4.14 Asset Purchase Agreement, Amendment no. 1 to the Agreement and Amendment no. 2 to the Agreement, dated as of October 26, 2005, November 2, 2005, and December 31, 2005, respectively, by and between Qualmax, Inc., BOScom Ltd. and the Registrant; Loan Agreement dated as of December 31, 2005, by and between Qualmax Ltd. and the Registrant; Registration Rights Agreement, dated as of December 31, 2005, by and between Qualmax Inc. and the Registrant; and Form of warrant dated as of December 31, 2005, issued by Qualmax Inc. to the Registrant (incorporated by reference to Exhibit 4.1 of the Company's Annual Report on Form 20-F filed with the SEC on June 28, 2006).
- 4.15 Letter agreement among New World Brands, Inc., Qualmax, Inc., IP Gear, Ltd., P&S Spirit, LLC and B.O.S Better Online Solutions Ltd., dated December 31, 2006 (incorporated by reference to Exhibit 10.17 to the Company's Registration Statement on Form F-1/A filed with the SEC on February 12, 2007).
- 4.16 The Registrant's Israeli 2003 Share Option Plan (incorporated by reference to the Company's Registration Statement on Form S-8 No. 333-11650).
- 8.1 List of subsidiaries (incorporated by reference to Item 4C of this Annual Report on Form 20-F).
- 11* Statement of Computation of Earnings Per Share
- 12.1** Certification by Chief Executive Officer pursuant to Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934.

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- 12.2** Certification by Chief Financial Officer pursuant to Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934.
- 13.1** 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.
- 23.1** Consent of Kost Forer Gabbay & Kasierer, a member of Ernst & Young Global.
- 23.2* Consent of Kesselman & Kesselman, a member of PricewaterhouseCoopers International Limited.

* Previously filed.

** Filed herewith.

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Signatures

The Registrant hereby certifies that it meets all of the requirements for filing on Amendment No. 1 to the Form 20-F and that it has duly caused and authorized the undersigned to sign this Amendment No. 1 to the annual report on its behalf.

B.O.S. Better Online Solutions Ltd.

By: /s/ Shmuel Koren

By: /s/ Eyal Cohen

Shmuel Koren
President and Chief Executive Officer

Eyal Cohen
Chief Financial Officer

Signatures

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Date: November 28, 2007

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**B.O.S. BETTER ONLINE SOLUTIONS LTD.
AND ITS SUBSIDIARIES
CONSOLIDATED FINANCIAL STATEMENTS
AS OF DECEMBER 31, 2006
U.S. DOLLARS IN THOUSANDS
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n **Kost Forer Gabbay & Kasierer** n Phone: 972-3-6232525
3 Aminadav St. Fax: 972-3-5622555
Tel-Aviv 67067, Israel

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Shareholders of

B.O.S. BETTER ONLINE SOLUTIONS LTD.

We have audited the accompanying consolidated balance sheets of B.O.S Better Online Solutions Ltd. (the Company) and subsidiaries as of December 31, 2006 and 2005, and the related consolidated statements of operations, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2006. 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 December 31, 2004 financial statements of Odem Electronic Technologies 1992 Ltd. (Odem), a subsidiary whose statements reflect total revenues for the period from November 18, 2004 (date of acquisition of Odem) to December 31, 2004 constituting 23.5% of the related consolidated total revenues. Those statements were audited by other auditors whose reports have been furnished to us, and our opinion, insofar as it relates to amounts included for Odem, is based solely on the reports of the other auditors. Those auditors expressed an unqualified opinion on those statements in their report dated March 25, 2005.

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. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management and evaluating the overall financial statement presentation. We believe that our audits and the report of the other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits and the report of 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 at December 31, 2006 and 2005, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2006, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 2t to the consolidated financial statements, effective January 1, 2006, the Company adopted the provision of Statement of Financial Accounting Standard No. 123(R), Shared-Based Payment .

Tel-Aviv, Israel
March 26, 2007, except as to
Note 14b(3), as to which
the date is November 27, 2007

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

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Shareholders of

ODEM ELECTRONIC TECHNOLOGIES 1992 LTD.

We have audited the consolidated balance sheets of Odem Electronic Technologies 1992 Ltd. (the Company) and its subsidiaries as of December 31, 2003 and 2004 and the related consolidated statements of operations, changes in shareholders' equity and cash flows for each of the years ended on those dates. These financial statements are the responsibility of the Company's Board of Directors and management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in Israel and the standards of the Public Company Accounting Oversight Board (United States), including those prescribed by the Israeli Auditors (Mode of Performance) Regulations, 1973. 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 the Company's Board of Directors and management, as well as evaluating the overall financial statement presentation. We believe that our audit provide a reasonable basis for our opinion.

In our opinion, 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, 2003 and 2004 and the consolidated results of operations, changes in shareholders' equity and cash flows for each of the years ended on those dates, in conformity with accounting principles generally accepted in the United States of America.

Jerusalem, Israel
March 25, 2005

Kesselman & Kesselman
Certified Public Accountants (Israel)
A member of PricewaterhouseCoopers International Limited

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**B.O.S. BETTER ONLINE SOLUTIONS LTD.
AND ITS SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS**

U.S. dollars in thousands

| | December 31, | |
|--|--------------|----------|
| | 2006 | 2005 |
| ASSETS | | |
| CURRENT ASSETS: | | |
| Cash and cash equivalents | \$ 2,033 | \$ 2,232 |
| Marketable securities (Note 5) | - | 1,333 |
| Trade receivables (net of allowance for doubtful accounts of \$23 and \$3 at December 31, 2006 and 2005, respectively) | 5,632 | 4,844 |
| Other accounts receivable and prepaid expenses (Note 3) | 858 | 504 |
| Inventories (Note 4) | 4,017 | 3,320 |

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| | | |
|---|-------------------|-------------------|
| <u>Total</u> current assets | 12,540 | 12,233 |
| | <u> </u> | <u> </u> |
| LONG-TERM ASSETS: | | |
| Severance pay fund | 741 | 907 |
| Investment in other companies (Note 6) | 8,082 | 5,412 |
| | <u> </u> | <u> </u> |
| <u>Total</u> long-term assets | 8,823 | 6,319 |
| | <u> </u> | <u> </u> |
| OTHER ASSETS | 65 | 49 |
| | <u> </u> | <u> </u> |
| PROPERTY, PLANT AND EQUIPMENT, NET (Note 7) | 520 | 667 |
| | <u> </u> | <u> </u> |
| GOODWILL (Note 9) | 952 | 952 |
| | <u> </u> | <u> </u> |
| CUSTOMER LIST, NET (Note 8) | 1,629 | 1,836 |
| | <u> </u> | <u> </u> |
| ASSETS RELATED TO DISCONTINUED OPERATIONS (Note 1d) | - | 590 |
| | <u> </u> | <u> </u> |
| | <u>\$ 24,529</u> | <u>\$ 22,646</u> |

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

**B.O.S. BETTER ONLINE SOLUTIONS LTD.
AND ITS SUBSIDIARIES**

CONSOLIDATED BALANCE SHEETS

U.S. dollars in thousands, except share and per share data

| | December 31, | |
|--|------------------|------------------|
| | 2006 | 2005 |
| LIABILITIES AND SHAREHOLDERS EQUITY | | |
| CURRENT LIABILITIES: | | |
| Short-term bank loans (Note 10) | \$ 2,931 | \$ 2,271 |
| Current maturities of long-term bank loans and convertible note | 1,157 | 354 |
| Trade payables | 3,844 | 3,073 |
| Employees and payroll accruals | 460 | 709 |
| Deferred revenues | 103 | 258 |
| Accrued expenses and other liabilities (Note 11) | 999 | 1,406 |
| | 9,494 | 8,071 |
| Total current liabilities | 9,494 | 8,071 |
| LONG-TERM LIABILITIES: | | |
| Long-term bank loans (net of current maturities) (Note 12) | - | 17 |
| Convertible note (net of current maturities) (Note 13) | 1,171 | 921 |
| Deferred taxes | 362 | 422 |
| Accrued severance pay | 916 | 1,157 |
| Other long-term liabilities | 237 | - |
| | 2,686 | 2,517 |
| Total long-term liabilities | 2,686 | 2,517 |
| LIABILITIES RELATED TO DISCONTINUED OPERATIONS (Note 1d) | - | 792 |
| COMMITMENTS AND CONTINGENT LIABILITIES (Note 14) | | |
| SHAREHOLDERS EQUITY (Note 15): | | |
| Share capital | | |
| Ordinary shares of NIS 4.00 parvalue: Authorized: 35,000,000 shares at December 31, 2006 and 2005; Issued and outstanding: 6,744,798 and 6,589,385 shares at December 31, 2006 and 2005, respectively; | 6,571 | 6,432 |
| Additional paid-in capital | 48,330 | 47,588 |
| Deferred share-based compensation | - | (112) |
| Accumulated other comprehensive income | 19 | 21 |
| Accumulated deficit | (42,571) | (42,663) |
| | 12,349 | 11,266 |
| Total shareholders equity | 12,349 | 11,266 |
| Total liabilities and shareholder s equity | \$ 24,529 | \$ 22,646 |

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

March 26, 2007

Date of approval of the financial statements

Shmuel Koren
President and
Chief Executive Officer
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Eyal Cohen
Chief Financial Officer

**B.O.S. BETTER ONLINE SOLUTIONS LTD.
AND ITS SUBSIDIARIES**

CONSOLIDATED STATEMENTS OF OPERATIONS

U.S. dollars in thousands, except per share data

| | Year ended December 31, | | |
|--|-------------------------|-------------------|-------------------|
| | 2006 | 2005 | 2004 |
| Revenues | \$ 20,917 | \$ 24,099 | \$ 6,919 |
| Cost of revenues | 16,200 | 17,854 | 3,659 |
| Gross profit | 4,717 | 6,245 | 3,260 |
| Operating costs and expenses: | | | |
| Research and development | 486 | 893 | 669 |
| Sales and marketing | 2,019 | 2,425 | 1,015 |
| General and administrative (including share-based compensation expense of \$727, \$348 and \$117 in 2006, 2005 and 2004, respectively) | 3,268 | 2,667 | 1,271 |
| Total operating costs and expenses | 5,773 | 5,985 | 2,955 |
| Operating income (loss) | (1,056) | 260 | 305 |
| Financial expenses, net (Note 17a) | (626) | (448) | (158) |
| Other income, net (Note 1d) | - | 355 | - |
| Income (loss) before taxes on income | (1,682) | 167 | 147 |
| Tax benefit (taxes on income) (Note 16) | 89 | (204) | (20) |
| Net income (loss) after taxes on income | (1,593) | (37) | 127 |
| Equity in losses of an affiliate | - | (1,750) | (308) |
| Minority interest in earnings of a subsidiary | - | (223) | (17) |
| Loss from continuing operations | (1,593) | (2,010) | (198) |
| Income (loss) from to discontinued operations (Note 1d) | 1,685 | (1,595) | (1,855) |
| Net income (loss) | \$ 92 | \$ (3,605) | \$ (2,053) |
| Basic and diluted loss per share from continuing operations (Note 17b) | \$ (0.24) | \$ (0.36) | \$ (0.04) |
| Basic and diluted net earnings (loss) per share from discontinued operations (Note 17b) | \$ 0.25 | \$ (0.28) | \$ (0.40) |

Basic and diluted net earnings (loss) per share (Note 17b)

| | | | |
|----|-------------------|-------------------|-------------------|
| | <u> </u> | <u> </u> | <u> </u> |
| \$ | 0.01 | \$ (0.64) | \$ (0.44) |
| | <u> </u> | <u> </u> | <u> </u> |

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

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**B.O.S. BETTER ONLINE SOLUTIONS LTD.
AND ITS SUBSIDIARIES**

STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY

U.S. dollars in thousands, except share data

| | Ordinary shares | Share capital | Additional paid in capital | Deferred share-based compensation | Accumulated other comprehensive income | Treasury shares | Accumulated deficit | Total comprehensive loss | Total shareholders equity |
|---|--------------------|------------------|----------------------------------|---|---|--------------------|------------------------|--------------------------------|---------------------------------|
| Balance at January 1, 2004 | 4,167,509 | \$ 4,309 | \$ 43,247 | \$ - | \$ - | (150) | \$ (36,865) | | \$ 10,541 |
| Deferred share-based compensation | - | - | 179 | (179) | - | - | - | | - |
| Amortization of deferred share-based compensation | - | - | - | 5 | - | - | - | | 5 |
| Issuance of shares related to the acquisitions of Quasar and Odem, net | 570,149 | 514 | 784 | - | - | 150 | (140) | | 1,308 |
| Share-based compensation related to warrants issued to service providers | - | - | 117 | - | - | - | - | | 117 |
| Warrants related to a convertible note issued to lenders | - | - | 99 | - | - | - | - | | 99 |
| Other comprehensive loss: | | | | | | | | | |
| Net loss | - | - | - | - | - | - | (2,053) | (2,053) | (2,053) |
| Unrealized gain on available-for-sale marketable securities | - | - | - | - | 5 | - | - | 5 | 5 |
| Foreign currency translation adjustments | - | - | - | - | 26 | - | - | 26 | 26 |
| Total comprehensive loss | | | | | | | \$ (2,022) | | |
| Balance at December 31, 2004 | 4,737,658 | 4,823 | 44,426 | (174) | 31 | - | (39,058) | | 10,048 |
| Amortization of deferred share-based compensation | - | - | - | 62 | - | - | - | | 62 |
| Conversion of convertible note | 640,293 | 570 | 1,046 | - | - | - | - | | 1,616 |
| Issuance of shares related to acquisition of Odem, net | 232,603 | 202 | 330 | - | - | - | - | | 532 |
| Issuance of shares related to the private placement, net | 953,743 | 815 | 1,225 | - | - | - | - | | 2,040 |
| Issuance of Ordinary shares for options exercised | 25,088 | 22 | 28 | - | - | - | - | | 50 |
| Share-based compensation related to warrants issued to | - | - | 348 | - | - | - | - | | 348 |

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| | | | | | | | | | |
|--|---|---|-----|---|-----|---|---------|------------|---------|
| service providers | | | | | | | | | |
| Warrants related to a convertible note issued to lenders | - | - | 185 | - | - | - | - | - | 185 |
| Other comprehensive loss: | | | | | | | | | |
| Net loss | - | - | - | - | - | - | (3,605) | \$ (3,605) | (3,605) |
| Loss on available-for-sale marketable securities | - | - | - | - | (4) | - | - | (4) | (4) |
| Foreign currency translation adjustments | - | - | - | - | (6) | - | - | (6) | (6) |
| | | | | | | | | | |
| Total comprehensive loss | | | | | | | \$ | (3,615) | |

| | | | | | | | | | |
|------------------------------|-----------|-------|--------|-------|----|---|----------|--|--------|
| Balance at December 31, 2005 | 6,589,385 | 6,432 | 47,588 | (112) | 21 | - | (42,663) | | 11,266 |
|------------------------------|-----------|-------|--------|-------|----|---|----------|--|--------|

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

**B.O.S. BETTER ONLINE SOLUTIONS LTD.
AND ITS SUBSIDIARIES**

STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY

U.S. dollars in thousands, except share data

| | Ordinary shares | Share capital | Additional paid in capital | Deferred share-based compensation | Accumulated other comprehensive income | Treasury shares | Accumulated deficit | Total comprehensive income | Total shareholders equity |
|--|--------------------|------------------|----------------------------------|---|---|--------------------|------------------------|----------------------------------|---------------------------------|
| Balance at January 1, 2006 | 6,589,385 | 6,432 | 47,588 | (112) | 21 | - | (42,663) | | 11,266 |
| Reversal of deferred share-based compensation | - | - | (112) | 112 | - | - | - | | - |
| Issuance of Ordinary shares for options exercised | 68,747 | 61 | 74 | - | - | - | - | | 135 |
| Share-based compensation expense | 21,666 | 20 | 411 | - | - | - | - | | 431 |
| Share-based compensation related to warrants issued to service providers | 65,000 | 58 | 238 | - | - | - | - | | 296 |
| Warrants related to a convertible note issued to lenders | - | - | 131 | - | - | - | - | | 131 |
| Other comprehensive income: | | | | | | | | | |
| Net income | - | - | - | - | - | - | 92 | \$ 92 | 92 |
| Loss on available-for-sale marketable securities | - | - | - | - | (2) | - | - | (2) | (2) |
| Total comprehensive income | | | | | | | \$ 90 | | |
| Balance at December 31, 2006 | 6,744,798 | \$ 6,571 | \$ 48,330 | \$ - | \$ 19 | \$ - | (42,571) | | \$ 12,349 |

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

**B.O.S. BETTER ONLINE SOLUTIONS LTD.
AND ITS SUBSIDIARIES**

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

| | Year ended December 31, | | |
|---|-------------------------|----------------|----------------|
| | 2006 | 2005 | 2004 |
| Cash flows from operating activities: | | | |
| Net income (loss) | \$ 92 | \$ (3,605) | \$ (2,053) |
| Adjustments to reconcile net income (loss) to net cash used in operating activities: | | | |
| Loss (income) from discontinued operations | (1,685) | 1,595 | 1,855 |
| Depreciation and amortization | 378 | 474 | 311 |
| Amortization of premium and accretion of accrued interest on available-for-sale marketable securities | - | 35 | 47 |
| Impairment of investment | 39 | - | - |
| Severance pay, net | (75) | (75) | 8 |
| Equity in losses of an affiliate | - | 1,750 | 308 |
| Minority interest in earnings of a subsidiary | - | 223 | 17 |
| Share-based compensation related to warrants issued to service providers | 296 | 59 | 5 |
| Capital gain from sale of product line | - | (273) | - |
| Net loss from decrease in value of Put options | - | 8 | - |
| Capital loss from sale of property and equipment | - | 3 | 5 |
| Share-based compensation related to employees | 431 | 244 | 121 |
| Financial expenses related to warrants issued in connection with long-term convertible note | 162 | 120 | 78 |
| Increase in trade receivables | (788) | (547) | (118) |
| Decrease in deferred taxes | (70) | (88) | (47) |
| Decrease (increase) in other accounts receivable and prepaid expenses | (595) | 86 | 160 |
| Increase in inventories | (697) | (1,971) | 357 |
| Increase (decrease) in trade payables | 790 | (172) | 531 |
| Decrease in employees and payroll accruals, deferred revenues, accrued expenses and other liabilities | (231) | (123) | (111) |
| Net cash provided by (used in) operating activities from continuing operations | (1,953) | (2,257) | 1,474 |
| Net cash used in operating activities from discontinued operations | (446) | (1,647) | (2,593) |
| Net cash used in operating activities | (2,399) | (3,904) | (1,119) |
| Cash flows from investing activities: | | | |
| Purchase of property and equipment | (24) | (245) | (214) |
| Proceeds from sale of property and equipment | - | 13 | 38 |
| Proceeds from sale of product line | - | 257 | - |
| Investment in long-term marketable securities | - | (607) | (1,247) |
| Proceeds from redemption of marketable securities | 1,331 | 2,316 | 1,000 |
| Investment in other companies | (676) | - | - |
| Acquisitions, net of cash acquired (a) | - | (1,124) | (1,385) |
| Net cash provided by (used in) investing activities from continuing operations | 631 | 610 | (1,808) |
| Net cash used in investing activities from discontinued operations | (221) | (1,087) | (58) |

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| | | | |
|---|-------------------|-------------------|-------------------|
| Net cash provided by (used in) investing activities | 410 | (477) | (1,866) |
| | <u> </u> | <u> </u> | <u> </u> |
| Cash flows from financing activities: | | | |
| Repayment of short-term and long-term bank loans | (26) | (55) | (93) |
| Proceeds from short-term bank loans | 686 | 933 | - |
| Proceeds from long-term convertible note and warrants, net of issuance expenses | 1,319 | 1,246 | 1,787 |
| Payment of long-term convertible note | (438) | (55) | (80) |
| Proceeds from exercise of options | 135 | 2,090 | - |
| | <u> </u> | <u> </u> | <u> </u> |
| Net cash provided by financing activities | 1,676 | 4,159 | 1,614 |
| | <u> </u> | <u> </u> | <u> </u> |
| Decrease in cash and cash equivalents | (313) | (222) | (1,371) |
| Increase (decrease) in cash and cash equivalents from discontinued operations | 114 | 163 | (208) |
| Effect of exchange rate changes on cash and cash equivalents | - | (13) | 11 |
| Cash and cash equivalents at the beginning of the year | 2,232 | 2,304 | 3,872 |
| | <u> </u> | <u> </u> | <u> </u> |
| Cash and cash equivalents at the end of the year | \$ 2,033 | \$ 2,232 | \$ 2,304 |
| | <u> </u> | <u> </u> | <u> </u> |

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

**B.O.S. BETTER ONLINE SOLUTIONS LTD.
AND ITS SUBSIDIARIES**

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

| | Year ended December 31, | | |
|--|-------------------------|----------|----------|
| | 2006 | 2005 | 2004 |
| <u>Supplemental disclosure of cash flow activities:</u> | | | |
| (i) Net cash paid during the year for: | | | |
| Interest | \$ 532 | \$ 126 | \$ 129 |
| Income tax | \$ 180 | \$ 309 | \$ - |
| (ii) <u>Non-cash activities:</u> | | | |
| Conversion of convertible note into shares | \$ - | \$ 1,614 | \$ - |
| Sale of the communication segment in consideration for shares in Qualmax | \$ 958 | \$ 4,690 | \$ - |
| Conversion of Qualmax's debt into New World Brand's shares | \$ 1,480 | \$ - | \$ - |
| <u>Sale of PrintBOS:</u> | | | |
| Consideration, net | \$ - | \$ 275 | \$ - |
| Disposal of fixed assets | - | (28) | - |
| Disposal of liability | - | 100 | - |
| Related expenses | - | (74) | - |
| Capital gain | \$ - | \$ 273 | \$ - |
| <u>Sale of the communication segment:</u> | | | |
| Consideration, net | \$ 2,437 | \$ 3,690 | \$ - |
| Disposal of tangible and intangible assets | (752) | (2,425) | - |
| Related expenses | - | (486) | - |
| Capital gain | \$ 1,685 | \$ 779 | \$ - |
| (a) <u>Acquisition of Odem:</u> | | | |
| Fair value of net tangible assets acquired (excluding cash and cash equivalents) and liabilities assumed at acquisition date | \$ - | \$ 1,020 | \$ 1,366 |
| Fair value of net intangible assets acquired at acquisition date | - | 718 | 927 |
| Less - | - | - | - |

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| | | | |
|---------------------------------------|-------------------|-------------------|-------------------|
| Amount acquired by issuance of shares | - | 532 | 769 |
| Payables | - | 219 | 139 |
| Add- | - | | |
| Cancellation of Put and Call options | - | 137 | - |
| | <u> </u> | <u> </u> | <u> </u> |
| | \$ - | \$ 1,124 | \$ 1,385 |
| | <u> </u> | <u> </u> | <u> </u> |

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

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**B.O.S. BETTER ONLINE SOLUTIONS LTD.
AND ITS SUBSIDIARIES**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except for share and share data)

NOTE 1: GENERAL

- a. B.O.S. Better Online Solutions Ltd. is an Israeli corporation (together with its subsidiaries the Company).

The Company manages its operations through two wholly-owned subsidiaries:

- BOScom Ltd. (BOScom) is engaged in the software solutions segment of the Company s business. BOScom was involved in cross platform printing solutions answering a demand for central printing and output management solutions in organizations which were sold during 2005 (see c); and
- Odem Electronic Technologies 1992 Ltd. (Odem) is engaged in the supply chain solutions segment of the Company s business. In September and November 2005, the Company purchased an additional 23.9% and 12.3%, respectively, of the outstanding shares of Odem. Following these purchases, the Company owns 100% of Odem. Odem is a solutions supplier of electronic components and systems to the technologies sector (see b).

BOS communication segment (the communication segment) included: BOScom s business of communication solutions which provide multi-path, intelligent routing voice over IP gateways and the Company s wholly-owned subsidiary Quasar Telecom (2004) Ltd. (Quasar), which provide communication solutions based on cellular technology. The assets and liabilities of this segment have been sold as part of the disposal of the communication segment in December 2005 (see d).

In addition, the Company holds shares in two other companies:

1. Surf Communication Systems Ltd. (Surf), a developer and supplier of access and network convergence software solutions to the wire line and wireless telecommunications and data communications industries. In June 2006, the Company invested \$300, following which, the Company holds 7.8% of Surf s issued and outstanding shares (see Note 6).
2. Qualmax Inc. (Qualmax), a U.S. public corporation listed on the Pink Sheets (QMXI.PK), and its subsidiaries New World Brands Inc. (OTC: NWBD.OB) and IPGear. Qualmax and its subsidiaries are developers and suppliers of voiceover IP technology products and services. The Company holds 18% of the issued and outstanding shares of Qualmax Inc. and Preferred shares in New World Brands Inc. that can be converted into 4.2% of New World Brands Inc. issued and outstanding shares. The Company s holdings in Qualmax were received as the consideration for the sale of the communication segment (see d).

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**B.O.S. BETTER ONLINE SOLUTIONS LTD.
AND ITS SUBSIDIARIES**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except for share and share data)

NOTE 1: GENERAL (Cont.)

b. Business combination:

Acquisition of Odem:

On November 18, 2004 the Company purchased 63.8% of the outstanding shares of Odem, from Odem's existing shareholders. In consideration for Odem's shares the Company (i) issued 290,532 of the Company's Ordinary shares subject to lock-up periods of 2 to 4 years and (ii) paid an amount of \$1,971 in cash. In addition, Odem's selling shareholders and the Company had certain Put and Call options, based on performance, with respect to all of the remaining Odem shares held by such sellers, exercisable for a consideration comprised of additional cash and issuance of additional Ordinary shares of the Company. The Company recorded assets and liability with respect to these options at fair value. The Put option liability will be measured periodically until it expires or is exercised and the changes in the fair value will be charged to financial expenses.

On September 29, 2005 and November 1, 2005, the Company purchased an additional 23.9% and 12.3% of the outstanding shares of Odem respectively, from Odem's minority shareholders. Following these purchases, the Company owns 100% of Odem. In consideration for the 12.3% of Odem's shares purchased in November 2005 the Company paid \$554, in cash and for the 23.9% of Odem's shares purchase in September 2005 the Company (i) issued 232,603 of the Company's Ordinary shares subject to lock up periods of 2 to 4 years and (ii) an amount of \$716 to be paid in cash.

The Company's consolidated financial statements reflect the purchase price determined as follows:

| | Odem | | | |
|--------------------------------------|---------------------|-----------------------|----------------------|-----------------|
| | November 1, 2005 | September 29, 2005 | November 18, 2004 | Total |
| Issuance of shares (1) | \$ - | \$ 532 | \$ 769 | \$ 1,301 |
| Cash consideration | 554 | 716 | 1,971 | 3,241 |
| Transaction costs | 19 | 54 | 139 | 212 |
| Cancellation of Put and Call options | (33) | (104) | - | (137) |
| Total purchase price | \$ 540 | \$ 1,198 | \$ 2,879 | \$ 4,617 |

- (1) The value of the Ordinary shares issued was determined based on the average market price of the Company's Ordinary shares over the period of two days before and after the terms of the transaction were agreed to and announced.

**B.O.S. BETTER ONLINE SOLUTIONS LTD.
AND ITS SUBSIDIARIES**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except for share and share data)

NOTE 1: GENERAL (Cont.)

The Company has allocated the total purchase price in 2004 as follows:

| Allocation of purchase price | Odem | Estimated useful life |
|--|-------------------|--------------------------|
| Cash | \$ 586 | |
| Tangible assets | 780 | |
| Put option to minority shareholders (2) | (359) | |
| Call option to minority shareholders (2) | 230 | |
| Customer list (1) | 1,406 | 10 years |
| Deferred tax liability | (430) | |
| Goodwill | 666 | 10 years |
| | <u> </u> | |
| Total purchase price | \$ 2,879 | |

- (1) The Company's allocation of purchase price valued the acquired customer list by calculating cash flow benefit as a direct result of the customer relationship.
- (2) The Put and Call options were valued by using the Black-Scholes options pricing model.

The acquisitions have been treated using the purchase method of accounting in accordance with SFAS 141 Business Combinations. The purchase price has been allocated to the assets acquired and liabilities assumed based on their estimated fair value at the date of acquisition. The excess of the purchase price over the estimated fair value of the tangible and intangible assets acquired has been recorded as goodwill.

The Company has allocated the total cost of Odem acquisition in 2005 as follows.

| Allocation of purchase price | November 1, 2005 | September 29, 2005 | Total | Estimated useful life |
|------------------------------|---------------------|-----------------------|-------------------|--------------------------|
| Tangible assets | \$ 340 | \$ 681 | \$ 1,021 | |
| Customer list (1) | 85 | 509 | 594 | 9 years |
| Deferred tax liability | (23) | (136) | (159) | |
| Goodwill | 138 | 144 | 282 | 9 years |
| | <u> </u> | <u> </u> | <u> </u> | |

| | | | | | | |
|----------------------|----|-----|----|-------|----|-------|
| Total purchase price | \$ | 540 | \$ | 1,198 | \$ | 1,738 |
|----------------------|----|-----|----|-------|----|-------|

- (1) The Company's allocation of purchase price valued the acquired customer list by calculating cash flow benefit as a direct result of the customer relationship.

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**B.O.S. BETTER ONLINE SOLUTIONS LTD.
AND ITS SUBSIDIARIES**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except for share and share data)

NOTE 1: GENERAL (Cont.)

c. Sale of product line:

On July 18, 2005, BOScom signed an asset purchase agreement with Consist Technologies Ltd. and Consist International Inc. (collectively, Consist), for the sale of its PrintBOS product line in consideration of \$500 and a contingent payment in each of the next three years equal to 6%-10% of future revenues exceeding \$1,000 per year, Consist will generate from the PrintBOS product line. The Company has recognized a gain of \$273 in 2005 with respect of this sale. As of December 31, 2005, the Company has received \$375 and the remaining \$125 has been placed in an escrow for a period of three years, pending repayment of royalties to the Office of the Chief Scientist (OCS) on sales of PrintBOS products. For the year ended December 31, 2006, total revenues generated by Consist from the PrintBOS products were less than \$1,000 and, therefore, the Company did not receive any royalties in 2006.

d. Discontinued operations:

1. Sale of communication segment:

On December 31, 2005, the Company sold its communication segment, including its property and equipment, goodwill, technology, trade name, existing distribution channels and related contingent liability to the Office of the Chief Scientist to IP Gear Ltd. (IP Gear), a wholly owned Israeli subsidiary of Qualmax. The consideration paid to the Company in the transaction was approximately 3.2 million Qualmax shares of Common stock constituting approximately 16% of Qualmax 's total issued and outstanding Common stock and \$800 in royalties to be paid at a rate of 4% from future revenues IP Gear will generate from the disposed segment (Royalties) with the entire \$800 due no later than 90 days from the third anniversary of the closing of the transaction. Additional shares may be issued to the Company at the end of four consecutive fiscal quarters following the closing of the transaction, contingent upon IP Gear generating by then a certain level of revenues from the disposed segment (Earn Out Shares). The maximum number of Earn Out Shares that may further be issued to the Company is approximately 1 million, constituting an additional 5% of Qualmax outstanding shares. In June 2006, the Company received 250,000 of Qualmax shares, valued at \$1.43 per share, as part of the Earn Out Shares consideration.

The Company received certain piggy-back registration rights with respect to the Qualmax shares. The Company does not have a representative on the Board of Qualmax.

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**B.O.S. BETTER ONLINE SOLUTIONS LTD.
AND ITS SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

U.S. dollars in thousands (except for share and share data)

NOTE 1: GENERAL (Cont.)

In addition, the Company and IP Gear entered into an Outsourcing Agreement, pursuant to which the Company provided IP Gear with certain operating services relating to the sold communication segment through December 31, 2006. In accordance with the Outsourcing Agreement, the first three months of services were provided for no charge. For services rendered from April 2006 through December 2006, the Company charged IP Gear \$240, which was paid by issuing the Company Qualmax subsidiary's shares in December 2006, as part of an agreement signed by the parties (see below).

The Company also granted a bridge loan to IP Gear in the amount of \$1,000. The term of the loan is three years and it bears interest equal to the Prime rate plus 2.5%, up to a maximum of 12%. In the first 18 months, IP Gear shall pay only the interest accrued on the loan and monthly principal and interest payments shall commence thereafter. The loan granted to IP Gear is secured by a first priority floating charge, which may be subordinated to a charge in favor of a major financial institution in the event such charge is recorded. In addition, repayment is guaranteed by Qualmax Inc.

The loan agreement provides that if the disposed segment would incur in the first quarter of 2006, losses that exceed \$250, the principal amount to be repaid under the loan shall be reduced by the excess losses. In such event, Qualmax shall issue to the Company additional shares of Common stock against such reduction, valued at a predetermined price of \$1.43 per share. Pursuant to this provision, in May 2006, Qualmax issued to the Company 244,755 shares, at a price of \$1.43 per share, resulting in an amount of \$350. In June 2006, Qualmax issued BOS an additional 174,825 shares, reducing the principal amount of the loan to \$400 following which, the Company holds approximately 17.8% of Qualmax's total issued and outstanding Common stock. As part of the agreement signed between the parties in December 2006, the loan was fully repaid by issuance of additional shares of Qualmax (see below).

Qualmax also issued to the Company a five-year warrant for the purchase of up to 107,143 shares, constituting less than 1%, of its outstanding shares in Qualmax, at the exercise price of \$2.80 per share (Warrants). The Company received certain piggy-back registration rights with respect to the shares underlying the warrants.

The Company signed in December 2006 an agreement with Qualmax and its subsidiaries, New World Brands Inc. (NWB) and IP Gear, pursuant to which, the outstanding debt of Qualmax to the Company, in the amount of \$1,480 (which included long-term debt, outsourcing fees, royalties and other debts), was repaid to the Company through the issuance of 5,506,652 shares of series A Convertible Preferred stock of NWB which are convertible into approximately 16,450,000 shares of NWB Common stock, reflecting a conversion rate of \$0.09 per one share of Common stock. Conversion of the series A Preferred stock into Common stock will take place automatically upon effectiveness of an amendment to the NWB's certificate of incorporation authorizing an increase in the number of outstanding shares of Common stock. Following the conversion, the Company holds 18% in Qualmax and 4.2% in NWB. The Company's registration rights with respect to the Qualmax shares shall also apply to NWB shares.

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**B.O.S. BETTER ONLINE SOLUTIONS LTD.
AND ITS SUBSIDIARIES**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except for share and share data)

NOTE 1: GENERAL (Cont.)

In connection with the transaction, the Company agreed to grant NWB, contingent upon the satisfaction of certain conditions, a three-year option to purchase up to 30% of the NWB's shares held by the Company, at prices ranging from \$0.12 to \$0.24 per share of Common stock.

In addition, the Company agreed to enter into a lock up agreement, restricting the transfer of the share holdings in Qualmax and in NWB, for up to two years.

The Company accounts for its holdings in Qualmax shares on the cost basis since it is unable to exercise significant influence over Qualmax financial policies and since the shares held in Qualmax are restricted stock which do not meet the fair value availability criteria of FAS 115.

For the years ended December 31, 2006 and 2005, the Company's consolidated financial statements reflected a capital gain from the sale of the communication segment, which was determined as follows:

| | Year ended December 31, | |
|---|-------------------------|----------|
| | 2006 | 2005 |
| Consideration: | | |
| Ordinary shares of Qualmax (1) | \$ 957 | \$ 4,586 |
| 107,143 warrants (2) | - | 104 |
| 5.50652 series A Preferred stock of NWB (3) | 1,480 | |
| Debt conversion (loan granted to IP Gear) | - | (1,000) |
| | 2,437 | 3,690 |
| Cost: | | |
| Disposal of assets (liabilities) related to the communication segment | 752 | 2,425 |
| Transactions related costs | - | 486 |
| | 752 | 2,911 |
| Capital gain | \$ 1,685 | \$ 779 |

(1) Valuated at \$1.43 per share.

(2) Valuated at \$0.97 per warrant.

(3)

5.50652 series A Preferred stock convertible into 16.5 million Common stock of NWB. Each Common stock is valued at \$0.09 per share.

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**B.O.S. BETTER ONLINE SOLUTIONS LTD.
AND ITS SUBSIDIARIES**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except for share and share data)

NOTE 1: GENERAL (Cont.)

Following the agreement, signed in December 2006, under which the Company has accounted for the communication segment as a discontinued operation, in accordance with EITF 03-13 Applying the Conditions in Paragraph 42 of FASB Statement 144 in Determining Whether to Report Discontinued Operations. As such, the results of operations, including revenues, cost of revenues, operating expenses, and other income and expenses of the communication segment for 2005 and 2004, have been reclassified in the accompanying statements of operations as discontinued operations. The Company's balance sheet as of December 31, 2005 reflects the net assets and liabilities of the communication segment as assets and liabilities related to discontinued operations.

2. Discontinued product line:

On June 1, 1998, the Company acquired 100% of the share capital of Pacific Information Systems Inc. (PacInfo), a U.S. corporation. PacInfo was a reseller of computer networking products.

During the fourth quarter of 2002, the Company initiated a plan to cease operations of PacInfo.

The results of operations, including operating expenses and other income and expenses of PacInfo for 2004, have been reclassified in the accompanying statement of operations as discontinued operations. The Company's balance sheet at December 31, 2005 reflects the net assets and liabilities of PacInfo as assets and liabilities related to discontinued operations.

3. The carrying amounts of the major classes of assets and liabilities included as part of the discontinued operations are:

| | December 31, 2005 |
|--|------------------------------|
| Cash and cash equivalents | \$ 114 |
| Trade receivables, net | 355 |
| Other accounts receivable and prepaid expenses | 88 |
| Inventories | 3 |
| Severance pay fund | 30 |
| Trade payables | (488) |
| Accrued expenses and other liabilities | (271) |
| Accrued severance pay | (33) |
| | (202) |
| Net liabilities related to discontinued operations | \$ (202) |

**B.O.S. BETTER ONLINE SOLUTIONS LTD.
AND ITS SUBSIDIARIES**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except for share and share data)

NOTE 1: GENERAL (Cont.)

The results of operations, including revenues, cost of revenues, operating expenses and other income and expenses of the communication segment and PacInfo's operations for 2006, 2005 and 2004, have been reclassified in the statements of operations. Taxes were not attributed to the discontinued operations due to utilization of losses from previous years, for which a valuation allowance was provided.

Summarized selected financial information and cash flows of the discontinued operations is as follows:

| | <u>Year ended December 31,</u> | | |
|--|--------------------------------|-------------|-------------|
| | <u>2006</u> | <u>2005</u> | <u>2004</u> |
| Revenues | \$ - | \$ 2,954 | \$ 1,363 |
| Cost of revenues | - | 2,171 | 949 |
| Operating expenses | 752 | 3,157 | 2,269 |
| Operating loss | (752) | (2,374) | (1,855) |
| Gain derived from sale of the discontinued operation | 2,437 | 779 | - |
| Net income (loss) | \$ 1,685 | \$ (1,595) | \$ (1,855) |
| | <u>Year ended December 31,</u> | | |
| | <u>2006</u> | <u>2005</u> | <u>2004</u> |
| <u>Cash flows from operating activities</u> | | | |
| Gain (loss) from discontinued operation | \$ 1,685 | \$ (1,595) | \$ (1,846) |
| Depreciation and amortization of equipment and intangibles | - | 107 | 40 |
| Capital gain | (2,052) | (779) | - |
| Adjustments due to changes in working capital | (79) | 620 | (787) |
| <u>Net cash flows used in operating activities</u> | \$ (446) | \$ (1,647) | \$ (2,593) |
| <u>Cash flows from investing activities</u> | | | |
| Communication sales costs | \$ (221) | \$ - | \$ - |
| Purchase of property and equipment | - | (27) | - |
| Payment on account of sale of Communication Segment | - | (1,060) | - |
| Investment in Company | - | - | (58) |

**B.O.S. BETTER ONLINE SOLUTIONS LTD.
AND ITS SUBSIDIARIES**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except for share and share data)

NOTE 2: SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements are prepared according to United States generally accepted accounting principles (U.S. GAAP).

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:

A substantial portion of the Company's revenues is generated in U.S. dollar (dollars). In addition, most of the Company's costs are incurred in dollars. Company's management believes that the dollar is the primary currency of the economic environment in which the Company operates. Thus, the functional and reporting currency of the Company is the dollar.

Accordingly, monetary accounts maintained in currencies other than the dollar are remeasured into U.S. dollars in accordance with Statement 52 of the Financial Accounting Standards Board (FASB) Foreign Currency Translation . All transactions gains and losses from the remeasurement of monetary balance sheet items are reflected in the statement of operations as financial income or expenses as appropriate.

The financial statements of Odem, a subsidiary, whose functional currency as of December 31, 2004, was other than dollar have been translated into dollars, but on April 1, 2005, due to significant changes in circumstances initiated by management, like transition of Odem's majority of sales, expenses and budget from New Israeli Shekels (NIS) to dollars, indicate a functional currency change. Since the functional currency changed from a foreign currency to the reporting currency, dollars, as of March 31, 2005, the translation adjustments for non-monetary assets prior to the change, became the accounting basis for the periods starting April 1, 2005.

c. Principles of consolidation:

The consolidated financial statements include the accounts of the Company and its subsidiaries. Intercompany transactions and balances including profits from intercompany sales not yet realized outside the Company have been eliminated upon consolidation.

d. Cash equivalents:

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except for share and share data)

NOTE 2: SIGNIFICANT ACCOUNTING POLICIES (Cont.)

e. Marketable securities:

The Company accounts for investments in debt securities in accordance with Statement of Financial Accounting Standard 115, Accounting for Certain Investments in Debt and Equity Securities (FAS 115). Management determines the appropriate classification of its investments in debt and equity securities at the time of purchase and reevaluates such determinations at each balance sheet date. Until November 30, 2005, debt securities have been classified as held-to-maturity since the Company had the positive intent and ability to hold the securities to maturity and they are stated at amortized cost. The amortized cost of held-to-maturity securities is adjusted for amortization of premiums and accretion of discounts to maturity. Such amortization and decline in value judged to be other than temporary and interest are included in financial income, net. Beginning December 1, 2005, the debt securities are classified as available-for-sale since the Company does not have the intent to hold the securities to maturity, and are stated at fair value. Due to the change in classification of the securities to available-for-sale , the unrealized holding gain at the date of transfer has been reported in other comprehensive income.

Available-for-sale securities are carried at fair value with unrealized gains, and are reported as a separate item under other comprehensive loss .

f. Inventories:

Inventory write-offs are provided to cover risks arising from slow-moving items or technological obsolescence. As of December 31, 2006 and 2005, inventory is presented net of \$100 and \$100, respectively, for technological obsolescence and slow moving items (see also Note 4).

Inventories are valued at the lower of cost or market value. Cost is determined as follows:

Raw and packaging materials - moving average cost method.

Products in progress and finished products - moving average cost method.

g. Grants and royalty-bearing grants:

Grants and royalty-bearing grants from the Chief Scientist of the Ministry of Industry and Trade in Israel for funding certain approved research and development projects are recognized at the time the Company is entitled to such grants, on the basis of the related costs incurred, and are presented as a deduction of research and development costs.

h. Investment in an affiliate:

An affiliate is a company in which the Company is able to exercise significant influence, but that is not a subsidiary and is accounted for by the equity method, net of write-down for decrease in fair value which is not of a temporary nature. The Company's investment in Surf has been included as an affiliate until September 30, 2005 (see Note 6).

**B.O.S. BETTER ONLINE SOLUTIONS LTD.
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except for share and share data)

NOTE 2: SIGNIFICANT ACCOUNTING POLICIES (Cont.)

The investment in an affiliate represents investments in Ordinary shares and Preferred shares of that company. The Company applies EITF 99-10, Percentage Used to Determine the Amount of Equity Method Losses. Accordingly, losses of the affiliate are recognized based on the ownership level of the particular security of the affiliate held by the Company.

The Company's investment in this company is reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the investment may not be recoverable, in accordance with Accounting Principle Board Opinion 18 The Equity Method of Accounting for Investments in Common Stock (APB 18). During 2005, an impairment of \$1,385 has been recorded in equity in losses of an affiliate in the statement of operations. In 2004, based on management's analysis, no impairment losses were identified.

i Investment in other companies:

Investment in other companies are investments in which the Company is unable to exercise significant influence over the investee's financial policies and which do not meet the fair value availability criteria of FAS 115 (Readily Determined Sales Price Currently Available on a Security Exchange), consequently such investments are accounted for by the cost method.

The Company's investment in such companies is reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the investment may not be recoverable in accordance with APB 18. During 2006, an impairment loss of \$39 has been recorded. During 2005 and 2004, no impairment losses have been identified.

j. Property, plant and equipment:

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

| | % | |
|--------------------------------|---------|--|
| Computers and software | 20 - 33 | (mainly 33%) |
| Office furniture and equipment | 6 - 15 | (mainly 10%) |
| Leasehold improvements | 10 | (over the shorter of the period of the lease or the life of the assets) |
| Vehicles | 15 | |
| Plant | 4 | |
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except for share and share data)

NOTE 2: SIGNIFICANT ACCOUNTING POLICIES (Cont.)

k. Impairment of long-lived assets:

The Company's long-lived assets are reviewed for impairment in accordance with Statement of Financial Accounting Standard 144 Accounting for the Impairment or Disposal of Long-Lived Assets (SFAS 144) whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to the future undiscounted cash flows expected to be generated by the assets. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. During 2006, 2005 and 2004, no impairment losses have been identified.

l. Goodwill:

Goodwill represents excess of the costs over the net assets of businesses acquired. SFAS 142 requires goodwill to be tested for impairment at least annually or between annual tests in certain circumstances, and written-down when impaired. Goodwill attributable to each of the reporting units is tested for impairment by comparing the fair value of each reporting unit with its carrying value. Fair value is determined using income and market approaches. Significant estimates used in the methodologies include estimates of future cash flows, future short-term and long-term growth rates, weighted average cost of capital and estimates of market multiples for each of the reportable units. During 2006, 2005 and 2004, no impairment losses have been identified.

m. Research and development costs:

Statement of Financial Accounting Standards 86 Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed, (SFAS 86) requires capitalization of certain software development costs subsequent to the establishment of technological feasibility. Based on the Company's product development process, technological feasibility is established upon completion of a working model. Research and development costs incurred in the process of developing product improvements or new products, are generally charged to expenses as incurred, net of participation of the Office of the Chief Scientist of the Israeli Ministry of Industry and Trade. Costs incurred by the Company between completion of the working model and the point at which the product is ready for general releases are insignificant.

n. Severance pay:

The Company's liability for severance pay for Israeli resident employees is calculated pursuant to the 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 its Israeli resident employees is covered by insurance policies designed solely for distributing severance pay. The value of these policies is recorded as an asset in the Company's balance sheet.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except for share and share data)

NOTE 2: SIGNIFICANT ACCOUNTING POLICIES (Cont.)

The insurance policies include profits accumulated up to the balance sheet date. The insurance policies may be withdrawn only upon complying with the 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 profits.

Severance expenses for 2006, 2005 and 2004 amounted to \$298, \$256 and \$214, respectively.

o. Revenue recognition:

The Company sells its products through direct sales, distributors and resellers channels.

The Company derives its revenues from the sale of products, license fees for its products, commissions, support and services.

Revenues from product sales are recognized in accordance with Staff Accounting Bulletin 104 - Revenue Recognition in Financial Statements (SAB 104) when delivery has occurred, persuasive evidence of an arrangement exists, the vendor's fee is fixed or determinable, no further obligation exists, and collectibility is reasonably assured.

Revenue from license fees is recognized in accordance with Statement of Position (SOP) 97-2 - Software Revenue Recognition , 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.

Revenues support is recognized ratably over the period of the support contract. The fair value of the support is determined based on the price charged when it is sold separately or renewed.

Revenues from commissions are recognized upon their actual receipt, since under agreements with suppliers consideration is received on the basis of collection from customers.

p. Warranty:

BOScom provides a warranty of between 3 to 36 months at no extra charge, whereby defective hardware covered by the warranty should be sent back to the company. The Company estimates the costs that may be incurred under its warranty and records a liability in the amount of such costs at the time product revenue is recognized. Factors that affect the Company's warranty liability include the number of installed units, historical and anticipated rates of warranty claims, and cost per claim. The Company periodically assesses the adequacy of its recorded warranty liabilities and adjusts the amounts as necessary.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except for share and share data)

NOTE 2: SIGNIFICANT ACCOUNTING POLICIES (Cont.)

q. Income taxes:

The Company accounts for income taxes in accordance with Statement of Financial Accounting Standards 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 has provided valuation allowances, in respect of deferred tax assets resulting from tax loss carryforward and other reserves and allowances due to its history of operating losses and current uncertainty concerning its ability to realize these deferred tax assets in the future.

r. Concentrations of credit risk:

Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of cash and cash equivalents, trade receivables, other accounts receivable and marketable securities.

Cash and cash equivalents are invested mainly in U.S. dollars in deposits with major banks in Israel. Investments in marketable securities are conducted through a bank in Israel and include investments in corporate and governmental debentures. Management believes that the financial institutions that hold the Company's investments are financially sound, the portfolio is well diversified and, accordingly, minimal credit risk exists with respect to these investments.

The trade receivables of the Company are derived from sales to customers located primarily in Israel, United States, Europe and the Far East. The Company generally does not require collateral; however, in certain circumstances, the Company may require letters of credit, other collateral, additional guarantees or advanced payments. An allowance for doubtful accounts is determined with respect to specific debts that are doubtful of collection.

The loan granted to IP Gear is secured by a first priority floating charge, which may be subordinated to a charge in favor of a major financial institution in the event such charge is recorded. In addition, repayment is guaranteed by Qualmax Inc. (see Note 1d).

The Company has no off-balance-sheet concentrations of credit risk such as foreign exchange contracts, option contracts or other foreign hedging arrangements.

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**B.O.S. BETTER ONLINE SOLUTIONS LTD.
AND ITS SUBSIDIARIES**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except for share and share data)

NOTE 2: SIGNIFICANT ACCOUNTING POLICIES (Cont.)

- s. Basic and diluted net earnings (loss) per share:

Basic net earnings (loss) per share are calculated based on the weighted average number of Ordinary shares outstanding during each year. Diluted net earnings (loss) per share is calculated based on the weighted average number of Ordinary shares outstanding during each year, plus dilutive potential Ordinary shares considered outstanding during the year, in accordance with SFAS 128, Earnings Per Share .

The total number of shares related to the outstanding options and warrants excluded from the calculations of diluted net earnings (loss) per share, since they would have an anti-dilutive effect, were 1,386,424, 1,506,803 and 855,783 for the years ended December 31, 2006, 2005 and 2004, respectively.

- t. Accounting for share-based compensation:

On January 1, 2006, the Company adopted Statement of Financial Accounting Standards 123 (revised 2004),

Share-Based Payment (SFAS 123(R)) which requires the measurement and recognition of compensation expense based on estimated fair values for all share-based payment awards made to employees and directors. SFAS 123(R) supersedes Accounting Principles Board Opinion 25, Accounting for Stock Issued to Employees (APB 25), for periods beginning in fiscal 2006. In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin 107 (SAB 107) relating to SFAS 123(R). The Company has applied the provisions of SAB 107 in its adoption of SFAS 123(R).

SFAS 123(R) requires companies to estimate the fair value of equity-based payment awards on the date of grant using an option pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as an expense over the requisite service periods in the Company's consolidated statement of operations. Prior to the adoption of SFAS 123(R), the Company accounted for equity-based awards to employees and directors using the intrinsic value method in accordance with APB 25 as allowed under Statement of Financial Accounting Standards 123, Accounting for Share-based Compensation (SFAS 123).

The Company adopted SFAS 123(R) using the modified prospective transition method, which requires the application of the Accounting Standard starting from January 1, 2006, the first day of the Company's fiscal year 2006. Under that transition method, compensation cost recognized in the year ended December 31, 2006 includes: (a) compensation cost for all share-based payments granted prior to, but not yet vested as of January 1, 2006, based on the date of grant fair value estimated in accordance with the original provisions of SFAS 123, and (b) compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the date of grant fair value estimated in accordance with the provisions of SFAS 123(R). Results for prior periods have not been restated.

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**B.O.S. BETTER ONLINE SOLUTIONS LTD.
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except for share and share data)

NOTE 2: SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Prior to January 1, 2006, the Company applied the intrinsic value method of accounting for stock options as prescribed by APB 25, whereby compensation expense is equal to the excess, if any, of the quoted market price of the stock over the exercise price on the date of grant of the award.

The Company recognizes compensation expenses for the value of its awards granted subsequent to January 1, 2006 based on the straight line method over the requisite service period of each of the awards, net of estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Estimated forfeitures are based on actual historical pre-vesting forfeitures. For awards granted prior to January 1, 2006, the Company recognizes compensation expenses based on the accelerated attribution method over the requisite service period of each of the awards. Forfeitures were previously accounted for as they occurred, but have been estimated with the adoption of SFAS 123(R) for those awards not yet vested. The compensation expenses related to the stock options granted to employees, for the year ended December 31, 2006, was \$360.

As a result of adopting SFAS 123(R) on January 1, 2006, the Company's income before income taxes and net income for the year ended December 31, 2006, is \$370 lower than if it had continued to account for share-based compensation under APB 25. Basic and diluted net earnings per share for the year ended December 31, 2006, are \$0.06 and \$0.05, respectively, lower than if the Company had continued to account for share-based compensation under APB 25.

The Company estimates the fair value of stock options granted using the Black-Scholes options pricing model. The option-pricing model requires a number of assumptions, of which the most significant are expected stock price volatility and the expected option term. Expected volatility was calculated based upon actual historical stock price movements over the most recent periods ending on the date of grant, equal to the expected option term. The expected option term represents the average of the options contractual life and the vesting period in accordance with SAB 107 guidance. The risk-free interest rate is based on the yield from U.S. Treasury zero-coupon bonds with an equivalent term. The Company has historically not paid dividends and has no foreseeable plans to pay dividends.

The fair value for options granted in 2006 and 2005 is estimated on the date of grant using a Black-Scholes options pricing model with the following weighted average assumptions:

| | December 31, | |
|--------------------------|--------------|-------|
| | 2006 | 2005 |
| Risk free interest | 4.91% | 4.00% |
| Dividend yields | 0% | 0% |
| Volatility | 78% | 120% |
| Expected term (in years) | 3 | 3 |

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**B.O.S. BETTER ONLINE SOLUTIONS LTD.
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except for share and share data)

NOTE 2: SIGNIFICANT ACCOUNTING POLICIES (Cont.)

The pro-forma table below reflects the Company's stock based compensation expense, net loss and basic and diluted net loss per share for the years ended December 31, 2005 and 2004, had the Company applied the fair value recognition provisions of SFAS 123, as follows:

| | December 31, | |
|--|--------------|------------|
| | 2005 | 2004 |
| Net loss from continuing operations, as reported | \$ (2,010) | \$ (198) |
| Add: share-based compensation expenses related to employee stock options determined under intrinsic value method included in the reported net loss | 62 | 5 |
| Deduct: share-based compensation expense related to employee stock options determined under fair value method for all awards | (246) | (96) |
| Pro forma net loss from continuing operations | (2,194) | (289) |
| Pro forma net loss from discontinued operations | (1,595) | (1,855) |
| Pro forma net loss | \$ (3,789) | \$ (2,144) |
| Basic and diluted net loss per share from continuing operations, as reported | \$ (0.36) | \$ (0.04) |
| Basic and diluted net loss per share from discontinued operations, as reported | \$ (0.28) | \$ (0.40) |
| Basic and diluted net loss per share, as reported | \$ (0.64) | \$ (0.44) |
| Basic and diluted net loss per share, including the effect of share-based compensation expense | \$ (0.67) | \$ (0.46) |

The Company applies SFAS 123 Accounting for stock Based Compensation (SFAS 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 warrants issued to non-employees. SFAS 123 requires the use of option valuation models to measure the fair value of the warrants at the date of grant.

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**B.O.S. BETTER ONLINE SOLUTIONS LTD.
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except for share and share data)

NOTE 2: SIGNIFICANT ACCOUNTING POLICIES (Cont.)

u. Fair value of financial instruments:

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

The carrying amounts of cash and cash equivalents, trade receivables, other accounts receivable and trade payables approximate their fair value due to the short-term maturities of such instruments. The fair value for marketable securities is based on quoted market prices. The fair value of investments in other companies is based on independent third-party evaluations.

v. Impact of recently issued accounting pronouncements:

In June 2006, the FASB issued Interpretation 48 (FIN 48), Accounting for Uncertainty in Income Taxes (FIN 48), an interpretation of FASB Statement 109, Accounting for Income Taxes . The Interpretation addresses the determination of whether tax benefits claimed or expected to be claimed on a tax return should be recorded in the financial statements. Under FIN 48, the Company may recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by the tax authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position should be measured based on the largest benefit that has a greater than fifty percent likelihood of being realized upon ultimate settlement. FIN 48 also provides guidance on de-recognition, classification, interest and penalties on income taxes, accounting in interim periods and requires increased disclosures. FIN 48 applies to all tax positions related to income taxes subject to SFAS 109. This includes tax positions considered to be routine as well as those with a high degree of uncertainty. FIN 48 specifically prohibits the use of a valuation allowance as a substitute for de-recognition of tax positions. The provisions of FIN 48 are effective beginning January 1, 2007. The Company is currently assessing the impact that FIN 48 will have on its consolidated financial statements.

In September 2006, the Financial Accounting Standards Board (FASB) issued SFAS 157, Fair Value Measurements (SFAS 157). This Standard defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The Company is currently assessing the impact that SFAS 157 will have on its consolidated financial statements.

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**B.O.S. BETTER ONLINE SOLUTIONS LTD.
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except for share and share data)

NOTE 2: SIGNIFICANT ACCOUNTING POLICIES (Cont.)

In February 2007, the FASB issued SFAS 159, The Fair Value Option for Financial Assets and Financial Liabilities (SFAS 159). SFAS 159 permits companies to choose to measure certain financial instruments and certain other items at fair value. The Standard requires that unrealized gains and losses on items for which the fair value option has been elected be reported in earnings. SFAS 159 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years, although earlier adoption is permitted. The Company is currently assessing the impact that SFAS 159 will have on its consolidated financial statements

NOTE 3: OTHER ACCOUNTS RECEIVABLE AND PREPAID EXPENSES

| | | December 31, | |
|------------------------|-------------------------------|--------------|--------|
| | | 2006 | 2005 |
| Government authorities | Income tax advances and V.A.T | \$ 279 | \$ 295 |
| Advances to suppliers | | 296 | - |
| Other | | 283 | 209 |
| | | \$ 858 | \$ 504 |

NOTE 4: INVENTORIES

| | | |
|---|----------|----------|
| Raw materials (including packaging materials) | \$ 117 | \$ 107 |
| Products in progress | 3 | 56 |
| Finished products | 3,897 | 3,157 |
| | \$ 4,017 | \$ 3,320 |

The inventories are presented net of provision for technological obsolescence and slow moving items of \$100 and \$100 as of December 31, 2006 and 2005, respectively.

**B.O.S. BETTER ONLINE SOLUTIONS LTD.
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U.S. dollars in thousands (except for share and share data)

NOTE 5: MARKETABLE SECURITIES

The following is a summary of securities:

| December 31, | | | | | | | |
|----------------------------|------------------------------|-------------------------------|--------------------------------------|-------------------|------------------------------|-------------------------------|--------------------------------------|
| 2006 | | | | 2005 | | | |
| Amortized cost | Gross unrealized gains | Gross unrealized losses | Estimated fair market value | Amortized cost | Gross unrealized gains | Gross unrealized losses | Estimated fair market value |
| <u>Available-for-sale:</u> | | | | | | | |
| Corporate debentures | \$ - | \$ - | \$ - | \$ 1,332 | \$ 1 | \$ - | \$ 1,333 |
| | | | | | | | |

NOTE 6: INVESTMENT IN OTHER COMPANIES

- a. Investment in Surf Communication Systems Ltd.:

In November 2001, the Company invested \$1,000 as part of a private placement in Surf Communication Systems Ltd. (Surf). At the same time, the Company converted its convertible loan in the amount of \$1,042 (principal and accrued interest) into Preferred shares of Surf at an exercise price equal to Surf's fair value as determined in the investment agreement. As a result of this private placement, the Company's holding in Surf was diluted to 17%. Accordingly, the investment was accounted based on the cost accounting method.

In March 2003, the Company engaged with Catalyst Investors L.P. (Catalyst), in order to purchase additional 191,548 series C Preferred shares of Surf. In consideration, the Company issued to Catalyst 633,102 Ordinary shares, at a purchase price of \$2.77, aggregating to \$1,755 and incurred transaction cost of \$155. The value of the Ordinary shares issued was determined based on the average market price of the Company's Ordinary shares over the period including two days before and after the terms of the transaction were agreed to and announced.

As a result of this investment, the Company had the ability to exercise significant influence over Surf. As a result, the investment in Surf had become qualified to be accounted for under the equity method. According to APB 18, when an investment qualifies for use of the equity method, the investor should adopt the equity method of accounting by adjusting retroactively the investment, results of operations (current and prior periods presented), and retained earnings, in a manner consistent with the accounting for a step-by-step acquisition of a subsidiary.

In September 2005, Surf entered into a private placement that is considered an event of change in circumstances having a significant adverse effect on the fair value of the investment. Therefore, the Company has evaluated its investment in Surf and determined that it amounts to \$722 as of December 31, 2005 based on management's analysis (supported by an independent third-party valuation). As a result, the Company has recorded an impairment of \$1,385, which has been included in the equity in losses of an affiliate in the statement of operations for the year December 31, 2005.

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NOTE 6: INVESTMENT IN OTHER COMPANIES (Cont.)

In June 2006, as part of the investment round, the Company invested \$300 in Surf, following which, the Company holds 7.8% of Surf's issued and outstanding shares.

Moreover, following the private placement in Surf, the Company's voting rights have been diluted to 8.7% of the total voting rights in Surf. As a result, the Company ceased to have the ability to exercise significant influence over Surf and, accordingly, the adjusted carrying amount of the investment of \$722 is accounted for based on the cost accounting method.

Summarized combined financial information of Surf for the years in which the investment was accounted using the equity method was as follows:

| | Year ended December 31, | |
|---|--------------------------------|-------------|
| | 2005 | 2004 |
| Revenues | \$ 2,055 | \$ 2,762 |
| Cost of sales | \$ 660 | \$ 700 |
| Operating expenses from continuing operations | \$ 3,694 | \$ 4,037 |
| Net loss | \$ 2,334 | \$ 1,971 |

b. The Company's investments in companies comprise of:

| | December 31, | |
|---------------------------------|---------------------|-------------|
| | 2006 | 2005 |
| Surf Communication Systems Ltd. | \$ 983 | \$ 722 |
| Qualmax Inc. (1) | 5,619 | 4,690 |
| New World Brands Inc. (1) | 1,480 | - |

\$ 8,082 \$ 5,412

(1) See Note 1d.

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**B.O.S. BETTER ONLINE SOLUTIONS LTD.
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except for share and share data)

NOTE 7: PROPERTY, PLANT AND EQUIPMENT

| | December 31, | |
|----------------------------------|--------------|----------|
| | 2006 | 2005 |
| Cost: | | |
| Computers and software | \$ 1,697 | \$ 1,683 |
| Office furniture and equipment | 458 | 448 |
| Leasehold improvements and plant | 1,116 | 1,116 |
| Vehicles | 89 | 89 |
| | 3,360 | 3,336 |
| Accumulated depreciation: | | |
| Computers and software | 1,569 | 1,511 |
| Office furniture and equipment | 301 | 288 |
| Leasehold improvements and plant | 906 | 816 |
| Vehicles | 64 | 54 |
| | 2,840 | 2,669 |
| Depreciated cost | \$ 520 | \$ 667 |

Depreciation expenses amounted to \$171, \$317 and \$294 for the years ended December 31, 2006, 2005 and 2004, respectively.

NOTE 8: CUSTOMER LIST, NET

| | December 31, | |
|---------------------------|--------------|----------|
| | 2006 | 2005 |
| Cost: | | |
| Customer list | \$ 2,010 | \$ 2,010 |
| Accumulated amortization: | | |
| Customer list | 381 | 174 |
| Amortized cost | \$ 1,629 | \$ 1,836 |

Amortization expenses amounted to \$207, \$157 and \$17 for the years ended December 31, 2006, 2005 and 2004, respectively.

Estimated amortization expenses for the years ended:

| | <u>December 31,</u> |
|-------------|---------------------|
| 2007 | \$ 207 |
| 2008 | 207 |
| 2009 | 207 |
| 2010 | 207 |
| 2011 - 2014 | 801 |
| | <u>1,629</u> |

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except for share and share data)

NOTE 9: GOODWILL

Goodwill attributed to operating segments for the years ended December 31, 2006 and 2005 is as follows:

| | Software solutions | Supply chain solutions | Total |
|--|-----------------------|------------------------------|----------|
| Balance as of January 1, 2005 | \$ 903 | \$ 666 | \$ 1,569 |
| Foreign currency translation adjustments | - | 4 | 4 |
| Exercise of options in Odem | - | 282 | 282 |
| Disposal of the communication segment | (903) | - | (903) |
| Balance as of December 31, 2005 | \$ - | \$ 952 | \$ 952 |
| Balance as of December 31, 2006 | \$ - | \$ 952 | \$ 952 |

NOTE 10: SHORT-TERM BANK LOANS

| | Weighted interest rate | December 31, | |
|-----|------------------------------|--------------|----------|
| | | 2006 | 2005 |
| NIS | 7.42 | \$ 2,931 | \$ 2,271 |

Regarding collateral given to insure short-term credit and loans, see Note 12c.

NOTE 11: ACCRUED EXPENSES AND OTHER LIABILITIES

| | December 31, | |
|--|--------------|--------|
| | 2006 | 2005 |
| Government of Israel royalties and V.A.T | \$ 319 | \$ 306 |

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| | | |
|------------------------|-------------------|-------------------|
| Provision for warranty | 73 | 73 |
| Professional services | 255 | 84 |
| Accrued expenses | - | 738 |
| Other | 352 | 205 |
| | <u> </u> | <u> </u> |
| | \$ 999 | \$ 1,406 |
| | <u> </u> | <u> </u> |

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**B.O.S. BETTER ONLINE SOLUTIONS LTD.
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except for share and share data)

NOTE 12: LONG-TERM BANK LOANS

- a. Classified by linkage terms and interest rates, the total amount of the loans is as follows:

| | Weighted interest rate | December 31, | |
|-------------------------------|------------------------------|--------------|-------|
| | % | 2006 | 2005 |
| NIS linked to the Israeli CPI | 7.95 | \$ 18 | \$ 33 |
| NIS | 6.95 | - | 12 |
| | | 18 | 45 |
| Less current maturities | | 18 | 28 |
| | | \$ - | \$ 17 |

- b. The loans mature in the following years subsequent to the balance sheet dates:

| | December 31, |
|---------------------------------|--------------|
| First year (current maturities) | \$ 18 |

- c. Odem has registered fixed pledges on its real estate, plant, equipment and vehicles.

NOTE 13: LONG-TERM CONVERTIBLE NOTE

On June 10, 2004, the Company entered into a Securities Purchase Agreement (the Purchase Agreement), with Laurus Master Fund Ltd. (the Investor), under which the Company issued to the Investor in a private placement (i) a Secured Convertible Term Note of a \$2,000 principal amount, due June 10, 2007 (the Note); and (ii) a warrant to purchase 130,000 Ordinary shares at an exercise price of \$4.04 per share (the Warrant). According to the agreement, several fees in the amount of \$115 were paid to the Investor. These fees are presented as discount of the principal convertible loan. The Note is convertible into Ordinary shares at a price of \$3.08 per share. The principal amount of the Note is repayable in monthly installments, commencing September 2004, in the initial amount of \$20 eventually increasing to \$74. The Note bears prime interest rate plus 3% which subject to reduction in certain conditions. The Warrant is exercisable, in whole or in part, until June 10, 2011. Pursuant to its undertaking in the Registration Rights Agreement with the Investor the Company filed with the Securities and Exchange Commission a registration statement on Form F-3 covering the resale of Ordinary shares that are issuable upon conversion of

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the Note and/or exercise of the Warrants, and/or issuable in payment of principal and interest on the Note. The Registration Rights Agreement provided that any delay in registration and/or effectiveness of the underlying shares of the transaction, or failure to maintain their effectiveness, will result in penalties to be paid in cash, as liquidated damages. The registration statement became effective on March 11, 2005. Due to the delay in the effectiveness of the registration of the shares, the Company paid the Investor liquidated damages of \$ 92.

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**B.O.S. BETTER ONLINE SOLUTIONS LTD.
AND ITS SUBSIDIARIES**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except for share and share data)

NOTE 13: LONG-TERM CONVERTIBLE NOTE (Cont.)

The Note conversion price is subject to proportional adjustment in the event of stock splits, combinations, subdivisions of the Ordinary shares or if dividend is paid on the Ordinary shares in Ordinary shares. In addition, if the Company issues stock in certain types of transactions at a price lower than the initial conversion price, then the conversion price will be adjusted to a lower price based on a weighted average formula.

The fair value of the warrants was calculated using the Black-Scholes options pricing model with the following assumptions: a risk-free interest rate of 3.34%, a dividend yield of 0%, a volatility of the expected market price of the Company's Ordinary shares of 100% and a weighted-average contractual life of 7 year. The fair value of the warrants in the amount of \$99 is presented as a component in shareholders' equity. Since the effective conversion price was greater than the share price at the commitment date, no beneficial conversion feature exists.

In March 2005, the Investor elected to convert \$308 of the Convertible note principal into 100,000 Ordinary shares of the Company. Due to the private placement agreement secured by the Company in June 2005, the conversion price was adjusted to \$2.94 per share, and in July 2005, the Investor completed the conversion of the balance of the Convertible Note principal, which had not been previously converted or repaid, and the accrued interest into an additional 540,293 Ordinary shares for approximately \$1,580.

In September 2005, the Company entered into a Second Securities Purchase Agreement (the Second Purchase Agreement) with the Investor, under which the Company issued to the Investor in a private placement (i) a Secured Convertible Term Note of a \$1,500 principal amount, due September 2008 (the Note), and (ii) a warrant to purchase 73,052 ordinary shares at an exercise price of \$4.04 per share (the Warrant). According to the Second Agreement, several fees in the total amount of \$116 were paid to the Investor. These fees are presented as a discount of the principal convertible loan. The Note is convertible into Ordinary shares at a price of \$3.08 per share. The principal amount of the Note is repayable in monthly installments, commencing as of January 2006, in the initial amount of \$15 eventually increasing to \$55. The Note bears prime interest rate plus 1.5% which is subject to reduction under certain conditions. The Warrant is exercisable, in whole or in part, until September 29, 2012. Pursuant to its undertaking in the Registration Rights agreement with the Investor, the Company filed with the Securities and Exchange Commission a registration statement on Form F-3 covering the resale of Ordinary shares that is issuable upon conversion of the Note and/or exercise of the Warrants, and/or issuable in payment of principal and interest on the Note. The Registration Rights agreement provided that any delay in registration and/or effectiveness of the underlying shares of the transaction, or failure to maintain their effectiveness, will result in penalties to be paid in cash, as liquidated damages. The registration statement became effective on February 8, 2006.

The note conversion price is subject to proportional adjustment in the event of stock splits, combinations, subdivisions of the Ordinary shares or if dividend is paid on the Ordinary shares in Ordinary shares. In addition, if BOS issues stock in certain types of transactions at a price lower than the initial conversion price, then the conversion price will be adjusted to a lower price based on a weighted average formula.

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**B.O.S. BETTER ONLINE SOLUTIONS LTD.
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except for share and share data)

NOTE 13: LONG-TERM CONVERTIBLE NOTE (Cont.)

The fair value of the warrants was calculated using the Black-Scholes options pricing model with the following assumptions: a risk-free interest rate of 4.08%, a dividend yield of 0%, a volatility of the expected market price of the Company's Ordinary shares of 100% and a weighted-average contractual life of seven years. The fair value of the warrants in the amount of \$144 is offset against the note, amortized over the period of the note and presented as a component in shareholders' equity.

On August 17, 2006 the Company entered into a Third Securities Purchase Agreement (the Third Agreement) with the investor under which the Company issued to the Investor in a private placement (i) a third Convertible Term Note of a \$1,500 principal amount, due August 2009 (the Note), and (ii) a warrant to purchase 73,052 Ordinary shares at an exercise price of \$4.04 per share (the Warrant). The Note is convertible into Ordinary shares at a price of \$3.08 per share for the first 500,000 and \$4.08 for any additional amount payable thereunder. The principal amount of the Note is repayable in monthly installments, commencing as of December 2006, in the initial amount of \$15 eventually increasing to \$55. The Note bears prime interest rate plus 1.5% which is subject to reduction under certain conditions. The Warrant is exercisable, in whole or in part, until August 16, 2013 at an exercise price of \$4.04 for the first 24,351 Ordinary shares acquirable thereunder, and of \$5.30 per share for the additional 48,701 acquirable thereunder. Pursuant to its undertaking in the Registration Rights agreement with the Investor, the Company filed with the Securities and Exchange Commission a registration statement on Form F-3 covering the resale of Ordinary shares that is issuable upon conversion of the Note and/or exercise of the Warrants, and/or issuable in payment of principal and interest on the Note. The Registration Rights agreement provided that any delay in registration and/or effectiveness of the underlying shares of the transaction, or failure to maintain their effectiveness, will result in penalties to be paid in cash, as liquidated damages. The registration statement became effective on December 5, 2006.

The fair value of the warrants was calculated using the Black-Scholes options pricing model with the following assumptions: a risk-free interest rate of 4.83%, a dividend yield of 0%, a volatility of the expected market price of the Company's Ordinary shares of 80% and a weighted-average contractual life of seven years. The fair value of the warrants in the amount of \$131 is offset against the note, amortized over the period of the note and presented as a component in shareholders' equity.

The maturity of the loans is as follows:

| | December 31, | |
|---------------------------------|--------------|----------|
| | 2006 | 2005 |
| First year (current maturities) | \$ 1,139 | \$ 326 |
| Second year | 1,104 | 663 |
| Third year | 331 | 496 |
| | 2,574 | 1,485 |
| Less discount | 264 | 238 |
| | \$ 2,310 | \$ 1,247 |

**B.O.S. BETTER ONLINE SOLUTIONS LTD.
AND ITS SUBSIDIARIES**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except for share and share data)

NOTE 14: COMMITMENTS AND CONTINGENT LIABILITIES

a. Commitments:

1. Royalty commitments:

- a) Under the Company's research and development agreements with the Office of the Chief Scientist (OCS) and pursuant to applicable laws, the Company is required to pay royalties at the rate of 3.5% of sales of products developed with funds provided by the OCS, up to an amount equal to 100% of the research and development grants (dollar-linked) received from the OCS. The obligation to pay these royalties is contingent upon actual sales of the products. Royalties payable with respect to grants received under programs approved by the OCS after January 1, 1999, are subject to interest on the U.S. dollar-linked value of the total grants received at the annual rate of LIBOR applicable to U.S. dollar deposits at the time the grants are received.

As of December 31, 2006, the Company has an outstanding contingent obligation to pay royalties in the amount of approximately \$3,430, in respect of these grants.

- b) The Israeli Government, through the Overseas Marketing Fund, awarded the Company grants for participation in expenses for overseas marketing. The Company is committed to pay royalties to the Fund for Encouragement of Marketing Activities at the rate of 3% of the increase in export sales, up to the amount of the grants received by the Company linked to the dollar and bearing interest of LIBOR.

As of December 31, 2006, the Company has an outstanding contingent obligation to pay royalties of \$89 with respect to these grants.

2. Other commitments:

The facilities of the Company are rented under operating lease agreements that expire on various dates ending in 2009. Minimum future rental payments for 2007, 2008 and 2009 are \$39, 14 and \$14 respectively.

The Company's motor vehicles are rented under various cancelable operating lease agreements. The lease agreements for the motor vehicles expire on various dates ending in 2008. The maximum breach of contract fees can amount to \$40.

Lease payments for the facilities occupied by the Company and the Company's motor vehicles in 2006, 2005 and 2004 amounted to \$343, \$408 and \$385, respectively.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except for share and share data)

NOTE 14: COMMITMENTS AND CONTINGENT LIABILITIES (Cont.)

- b.
 1. In July 2002, the Company received a claim letter from a car leasing vendor, under which it claims that the Company's termination notice of the leasing agreement in March 2002 constitutes a breach of the agreement and the vendor is demanding compensation in which the nominal claim amount is of \$292. No legal proceeding has yet been filed. At this stage, according to the Company's legal counsel assessment, the prospects of vendor to prevail and recover a significant amount seem remote. The financial statements do not include any provision in that regard.
 2. In 1998, as part of PacInfo Share Purchase Agreement between the Company and Mr. Lee and Ms. Lee (the Sellers), the Company may be obligated to grant the Sellers a loan on a full recourse basis for certain tax payments the Sellers may be liable for and reimburse the Sellers for certain interest on taxes that they may owe, currently estimated at approximately \$2 million. The Company will receive a security interest in shares of the Company that the Sellers holds at the time of the loan with a fair market value as of the date of the loan of at least 125% of the amount of the loan as security for the repayment of the loan. It is possible that the windup of PacInfo during 2002 and 2003 may have triggered such a tax event for the Sellers, which would result in an obligation by the Company to lend the Sellers such amount and to reimburse them for interest expenses incidental to the tax event. Based on the Company's legal counsel opinion and management estimation, no provision was recorded.
 3. In April 2006, BOSâNOVA EURL, a French company and former distributor of the Company, served the Company with a claim filed with the French Trade Tribunal alleging breach of exclusive distributor rights in France and asserting ownership to certain intellectual property rights in the Company's products. The plaintiff seeks an amount of approximately 3.3 million Euros and additional remedies. This claim follows a previous motion for temporary injunctive relief that was filed against the Company's new French distributor, said motion ultimately denied by French Trade Tribunal. The Company assesses the prospects of claim to prevail and recover a significant amount, as remote. The financial statements include provision in the respect. (See also Note 20).

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**B.O.S. BETTER ONLINE SOLUTIONS LTD.
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except for share and share data)

NOTE 15: SHAREHOLDERS EQUITY

a. Private placement:

In June 2005, the Company completed a private placement for the Company's Ordinary shares. The Company issued to the investors 953,743 Ordinary shares at a purchase price of \$2.30 per share, for a consideration of approximately \$2,040 (net of \$154 of issuance expenses).

The private placement included warrants of 572,219 for Ordinary shares. The exercise price of the warrants is \$2.50 per Ordinary share during the first year from their issue date, and increasing to \$2.75 per Ordinary share and \$3.03 per Ordinary share, on the first and second anniversaries of the issue date, respectively. The warrant is exercisable, in whole or in part during a period of three years from issuance of the warrants. Pursuant to its undertaking in the Registration Rights Agreement, the Company filed with the Securities and Exchange Commission a registration statement on Form F-3 covering the Ordinary shares (including those underlying the warrants). The registration statement became effective with no delay on February 8, 2006.

The Company's outstanding warrants to shareholders as of December 31, 2006 are as follows:

| Issuance date | Warrants for Ordinary shares | Exercise price per share | Warrants exercisable | Exercisable through |
|---------------|---------------------------------|-----------------------------|-------------------------|------------------------|
| June 2005 | 441,785 | \$ (*) | 441,785 | June 2008 |
| July 2005 | 130,434 | \$ (*) | 130,434 | June 2008 |
| | 572,219 | | 572,219 | |

*) The exercise price of the warrants is \$2.50 per Ordinary share during the first year from their issue date, and increasing to \$2.75 per Ordinary share and \$3.03 per Ordinary share, on the first and second anniversaries of the issue date.

b. Stock option plans:

In May 2003, the Company's shareholders approved the adoption of the 2003 Stock Option Plan, pursuant to which 625,000 Ordinary shares are reserved for purchase by employees, directors, consultants and service providers of the Company. In June 2005, the Company's shareholders approved an increase of the number of Ordinary shares reserved for issuance under the 2003 Stock Option Plan, to 1,000,000. In May 2006, the Company's shareholders approved an increase of the number of Ordinary shares reserved for issuance under the 2003 Stock Option Plan, to 1,500,000. Any option which is canceled or forfeited before expiration, will become available for future grants.

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**B.O.S. BETTER ONLINE SOLUTIONS LTD.
AND ITS SUBSIDIARIES**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except for share and share data)

NOTE 15: SHAREHOLDERS EQUITY (Cont.)

As of December 31, 2006, an aggregate 200,073 of these options are still available for future grants. Each option granted under the Plans expires between 3-10 years from the date of the grant. The options vest gradually over a period of up to up to four years.

During 1994, 1995, 1999, 2000, 2001, the Company's Board adopted stock option plans (the Plans) pursuant to which 656,250 options for the purchase of the Company's Ordinary shares may be granted to officers, directors, consultants and employees of the Company. The Board has resolved that no further grants shall be made from these Plans.

A summary of employee option activity under the Company's stock option plans as of December 31, 2006, 2005 and 2004 and changes for the years then ended are as follows:

| | Year ended December 31, | | | | | |
|--|-------------------------|--|----------------------|--|----------------------|--|
| | 2006 | | 2005 | | 2004 | |
| | Number of options | Weighted average exercise price | Number of options | Weighted average exercise price | Number of options | Weighted average exercise price |
| Options outstanding at beginning of year | 400,250 | \$ 4.77 | 430,576 | \$ 9.47 | 426,252 | \$ 11.93 |
| Changes during the year: | | | | | | |
| Granted | 535,237 | \$ 2.67 | 107,000 | \$ 2.91 | 92,500 | \$ 0.54 |
| Exercised | (68,747) | \$ 1.98 | (25,088) | \$ 2.00 | - | \$ - |
| Forfeited or cancelled | (44,080) | \$ 10.68 | (112,238) | \$ 21.66 | (88,176) | \$ 11.97 |
| Options outstanding at end of year | 822,660 | \$ 3.36 | 400,250 | \$ 4.77 | 430,576 | \$ 9.47 |
| Options exercisable at end of year | 162,423 | \$ 7.29 | 217,750 | \$ 7.40 | 248,790 | \$ 5.49 |

The weighted-average date of grant fair value of options granted during the years ended December 31, 2006, 2005 and 2004 were \$1.45, \$2.13 and \$2.58, respectively.

As of December 31, 2006, there was \$611 of total unrecognized compensation cost related to non-vested share-based compensation arrangements granted to employees and directors under the Company's Plans. That cost is expected to be recognized over a weighted-average period of 1.5 years.

On November 18, 2004, upon acquisition of Odem, the Company granted 73,000 options to one of Odem's key employee. Each option can be exercised to purchase one Ordinary share of the Company without consideration. The options vest at the end of three years from the date of grant and expire ten years from the date of the grant. The market price of the Company's shares on the date of grant was \$2.5. Accordingly, the Company recorded in the year ended

December 31, 2005, a compensation expense of \$62. This expense was included as part of general and administrative expenses.

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**B.O.S. BETTER ONLINE SOLUTIONS LTD.
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except for share and share data)

NOTE 15: SHAREHOLDERS EQUITY (Cont.)

As part of the disposition of the communication segment and the PrintBOS product line, the Company extended the options contractual life of employees who became the buyers' employees. As a result, the Company recorded an expense of \$104 in 2005 which was offset from the capital gain derived from the sale of this segment and product line in 2005.

On May 18, 2006, the shareholders approved to grant a bonus of 21,666 Ordinary shares to the Chairman of the Company's Board at no consideration. The fair value of the shares granted was \$60 at the date of grant.

Except for these options, all other options granted to employees in 2006, 2005 and 2004, have an exercise price equal to or higher than the market value of the Ordinary shares at the date of grant.

The options granted to employees outstanding as of December 31, 2006 have been separated into ranges of exercise prices, as follows:

| Range of exercise price | Options outstanding as of December 31, 2006 | Weighted average exercise price | Weighted average remaining contractual life (years) | Options exercisable as of December 31, 2006 | Weighted average exercise price of options exercisable |
|-------------------------------|---|--|---|---|---|
| \$ 0 | 73,000 | \$ 0.00 | 7.99 | - | \$ 0.00 |
| \$ 1.84-2.00 | 67,961 | \$ 1.89 | 3.00 | 67,961 | \$ 1.89 |
| \$ 2.28-3.08 | 628,237 | \$ 2.70 | 5.18 | 41,000 | \$ 2.46 |
| \$ 6.8 | 26,137 | \$ 6.80 | 1.34 | 26,137 | \$ 6.80 |
| \$ 18.00 | 750 | \$ 18.00 | 2.36 | 750 | \$ 18.00 |
| \$ 28.00 | 26,575 | \$ 28.00 | 1.35 | 26,575 | \$ 28.00 |
| | 822,660 | \$ 3.36 | 5.01 | 162,423 | \$ 7.29 |

c. Options issued to service providers:

The Company accounts for these options in accordance with the provisions of SFAS 123 and EITF 96-18. The fair value for these options was estimated at the date of grant using Black-Scholes options pricing model with the following assumptions for the years ended December 31, 2006 and 2005: risk-free interest rate of 4.9% and 1.5%, respectively, dividend yields of 0% and 0%, respectively, volatility of 77% and 70%, respectively, and an expected life of 4.2 years and 2.5 years, respectively.

The compensation expenses that have been recorded in the consolidated financial statements regarding these stock options for the years ended December 31, 2006, 2005 and 2004 were \$116, \$348 and \$117 respectively.

On May 18, 2006, the shareholders approved to grant a bonus of 65,000 Ordinary shares to the Company's former President and CEO at no consideration. The fair value of the shares granted was \$180 at the date of grant.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except for share and share data)

NOTE 15: SHAREHOLDERS EQUITY (Cont.)

The Company's outstanding options to service providers as of December 31, 2006 are as follows:

| Issuance date | Options for Ordinary shares | Exercise price per share | Options exercisable | Exercisable through |
|----------------|-----------------------------------|--------------------------------|------------------------|--------------------------------|
| October 2002 | 75,000 | \$ 4.00 | 75,000 | June 2011 |
| January 2004 | 216,282 | \$ 3.00 | 216,282 | May 2013 |
| June 2004 | 130,000 | \$ 4.04 | 130,000 | June 2011 |
| March 2005 | 10,000 | \$ 3.08 | 10,000 | March 2007 |
| March 2005 | 10,000 | \$ 3.08 | 3,334 | March 2010 |
| June 2005 | 20,000 | \$ 3.08 | 15,002 | June 2010 |
| September 2005 | 73,052 | \$ 4.04 | 73,052 | September 2012 |
| March 2006 | 10,000 | \$ 2.30 | 10,000 | December 2010 |
| May 2006 | 187,100 | \$ 2.68 | - | May 2010 - through May 2012 |
| August 2006 | 48,701 | \$ 5.30 | 48,701 | August 2013 |
| August 2006 | 24,351 | \$ 4.04 | 24,351 | August 2013 |
| | 804,486 | | 605,722 | |

NOTE 16: TAXES ON INCOME

a. Reduction in corporate tax rate:

In June 2004, an amendment to the Income Tax Ordinance (No. 140 and Temporary Provision), 2004 was passed by the Knesset (Israeli parliament) and on July 25, 2005, another law was passed, the amendment to the Income Tax Ordinance (No. 147) 2005, according to which the corporate tax rate is to be progressively reduced to the following tax rates: 2004 - 35%, 2005 - 34%, 2006 - 31%, 2007 - 29%, 2008 - 27%, 2009 - 26%, 2010 and thereafter - 25%.

The Odem operation is subject to regular income tax rate while the Company and BOScom enjoy the status of an Approved Enterprise, as described below.

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

The Company's production facilities have been granted an Approved Enterprise status under the Investment Law, with respect to four separate investment programs. According to the Investments Law, the Company has elected to receive for the first program state-guaranteed loans and grants and for the second and third programs, the Company has elected to receive only state-guaranteed loans. As for the fourth program, the Company has elected the alternative benefits and has waived Government grants in return for a tax exemption.

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**B.O.S. BETTER ONLINE SOLUTIONS LTD.
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except for share and share data)

NOTE 16: TAXES ON INCOME (Cont.)

The Company is also a Foreign Investors Company, as defined by the above mentioned law, and as such, is entitled to a 10-year period of benefits and to an additional reduction in tax rates, up to 10% or 25% (based on the percentage of foreign ownership in each taxable year).

Income from the second, third and fourth programs, which commenced operations in 1992, 1994, 1997, respectively, may be exempt from income tax for a period of ten years commencing with the first year in which they generate taxable income. During 2002, as part of the transfer of operations from the Company to BOScom, all tax benefits that were related to the Approved Enterprise of the Company were transferred to BOScom. In addition, since 2002, the Company's investments are not subject to the Approved Enterprise program. Accordingly, taxable income generated in that period will be split according to the assets ratio method into a taxable income that is entitled to the benefits of the Approved Enterprise and into an income that will be taxed at the regular corporate tax rate as described in article a above.

BOScom also has a production facility, which was granted an Approved Enterprise status and had a separate investment program. BOScom elected to receive the alternative benefits. Income derived from BOScom's investment programs, which commenced operations in 1997 and 2002, may be exempt from income tax for a period of ten years commencing with the first year in which taxable income is generated.

The period of tax benefits detailed above is subject to limits of the earlier of 12 years from commencement of production, or 14 years from receiving the approval. Accordingly, the period of benefits relating to all investment programs expire in 2001 through 2014.

The entitlement to the above benefits is conditional upon the Company's and BOScom's 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 and BOScom may be required to refund the amount of the benefits, in whole or in part, including interest. The management believes that the companies are meeting the aforementioned conditions.

The tax-exempt income attributable to the Approved Enterprise can be distributed to shareholders without imposing tax liability on the Company only upon the complete liquidation of the Company. In the event of a distribution of such tax-exempt income as a cash dividend in a manner other than in the complete liquidation of the Company and BOScom, the Company and BOScom will be required to pay tax at the rate of 10% to 25% on the amount distributed (based on the percentage of foreign ownership in each taxable year). In addition, these dividends will be subject to 15% withholding tax.

As of December 31, 2006, the Company and BOScom have not yet utilized any tax benefit since they have not generated any taxable income.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except for share and share data)

NOTE 16: TAXES ON INCOME (Cont.)

If the Company and BOScom derive income from sources other than an Approved Enterprise, such income will be taxable at the regular corporate tax rate as described in a above.

On April 1, 2005, an amendment to the Investment Law came into effect (the Amendment) and has significantly changed the provisions of the Investment Law. The Amendment limits the scope of enterprises which may be approved by the Investment Center by setting criteria for the approval of a facility as an Approved Enterprise, such as provisions generally requiring that at least 25% of the Approved Enterprise's income will be derived from export. Additionally, the Amendment enacted major changes in the manner in which tax benefits are awarded under the Investment Law so that companies no longer require Investment Center approval in order to qualify for tax benefits. However, the Investment Law provides that terms and benefits included in any certificate of approval already granted will remain subject to the provisions of the Investment Law as they were on the date of such approval. Therefore, the Israeli subsidiary's existing Approved Enterprise will generally not be subject to the provisions of the Amendment. As a result of the amendment, tax-exempt income generated under the provision of the new law will subject the Company to taxes upon distribution or liquidation and the Company may be required to record deferred tax liability with respect to such tax-exempt income. As of December 31, 2006, the Company did not generate income subject to the provision of the new law.

c. Loss carryforward:

Domestic (Israel):

The Company and its Israeli subsidiary have accumulated losses for Israel income tax purposes as of December 31, 2006, in the amount of approximately \$30,985. These losses may be carryforward (linked to the Israeli Consumer Price Index (CPI)) and offset against taxable income in the future for an indefinite period.

Foreign:

As of December 31, 2006, the U.S. subsidiaries which were classified as discontinued operations had U.S. Federal and State net operating loss carryforward of approximately \$10,265, that can be carried forward and offset against taxable income and expire through 2022. Utilization of U.S. net operating losses may be subject to substantial annual limitations due to the change in ownership provisions of the Internal Revenue Code of 1986 and similar state law provisions. The annual limitations may result in the expiration of net operating losses before utilization.

As of December 31, 2006, BOS UK had net operating loss carryforward of approximately \$3,500. In February 2006, the Company filed with the UK Companies House an application to dissolve BOS UK.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except for share and share data)

NOTE 16: TAXES ON INCOME (Cont.)

d. Deferred income taxes:

Deferred income taxes reflect the net tax effect of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of the Company's deferred tax liabilities and assets are as follows:

| | December 31, | |
|--|--------------|----------|
| | 2006 | 2005 |
| Assets in respect of: | | |
| Property, plant and equipment | \$ 3 | \$ 3 |
| Allowances and provisions | 296 | 865 |
| Net operating loss carryforward | 10,674 | 9,350 |
| | 10,973 | 10,218 |
| Liabilities in respect of intangible assets | (422) | (486) |
| | 10,551 | 9,732 |
| Net deferred tax assets before valuation allowance | 10,551 | 9,732 |
| Valuation allowance (1) | (10,936) | (10,187) |
| | \$ (385) | \$ (455) |

- (1) The Company has provided valuation allowances for BOS, BOScom and Quasar in respect of deferred tax assets resulting from tax loss carryforward and other reserves and allowances due to their history of operating losses and current uncertainty concerning their ability to realize these deferred tax assets in the future.

| | December 31, | |
|-----------------------------|--------------|-------|
| | 2006 | 2005 |
| Presented in balance sheet: | | |
| Current assets | \$ 14 | \$ 13 |
| Long-term assets | 23 | 18 |
| Current liabilities | (60) | (64) |
| Long-term liabilities | (362) | (422) |

| | | |
|----------------------------|-------------------|-------------------|
| Net deferred tax liability | \$ (385) | \$ (455) |
| | <u> </u> | <u> </u> |
| Net deferred tax domestic | \$ (385) | \$ (455) |
| | <u> </u> | <u> </u> |

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**B.O.S. BETTER ONLINE SOLUTIONS LTD.
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except for share and share data)

NOTE 16: TAXES ON INCOME (Cont.)

- e. Tax benefits (taxes on income) are comprised as follows:

| | Year ended December 31, | | |
|----------|-------------------------|-----------------|----------------|
| | 2006 | 2005 | 2004 |
| Current | \$ (17) | \$ (259) | \$ (63) |
| Deferred | 106 | 55 | 43 |
| | <u>\$ 89</u> | <u>\$ (204)</u> | <u>\$ (20)</u> |
| Domestic | \$ 106 | \$ (74) | \$ (20) |
| Foreign | (17) | (130) | - |
| | <u>\$ 89</u> | <u>\$ (204)</u> | <u>\$ (20)</u> |

- f. Effective tax

| | | | |
|---|----------------|---------------|--------------|
| Income (loss) before taxes on income from operating activities related to continuing operations | \$ (1,682) | \$ 167 | \$ 147 |
| Statutory tax rate | 31% | 34% | 35% |
| Provision at statutory tax rate | (521) | 57 | 51 |
| Non-deductible expenses | 21 | 219 | 16 |
| Deferred taxes on losses reserves and allowances for which a valuation allowance was provided | 411 | (72) | (47) |
| | <u>\$ (89)</u> | <u>\$ 204</u> | <u>\$ 20</u> |

- g. Tax assessments:

BOS and BOScom have final assessments through 2000. Odem has final assessment through 2004.
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except for share and share data)

NOTE 17: SUPPLEMENTARY INFORMATION TO STATEMENTS OF OPERATIONS

- a. Financial income (expenses), net:

| | Year ended December 31, | | |
|---|-------------------------|----------|----------|
| | 2006 | 2005 | 2004 |
| Financial income: | | | |
| Interest on bank deposits and marketable securities | \$ 73 | \$ 57 | \$ 98 |
| Other (mainly foreign currency translation income) | 65 | - | 100 |
| | 138 | 57 | 198 |
| Financial expenses: | | | |
| In respect of long-term bank loans and convertible note | (694) | (427) | (324) |
| Other (mainly foreign currency translation losses) | (70) | (78) | (32) |
| | (764) | (505) | (356) |
| | \$ (626) | \$ (448) | \$ (158) |

- b. Earnings (loss) per share:

1. Numerator:

| | | | |
|---|------------|------------|------------|
| Numerator for basic and diluted net earnings (loss) per share: | | | |
| Loss from continuing operations | \$ (1,593) | \$ (2,010) | \$ (198) |
| Income (loss) from discontinued operations | 1,685 | (1,595) | (1,855) |
| | \$ 92 | \$ (3,605) | \$ (2,053) |

2. Denominator (in thousands):

| | | | |
|---|-------|-------|-------|
| Weighted average Ordinary shares outstanding (in thousands) | 6,675 | 5,616 | 4,631 |
|---|-------|-------|-------|

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| | | | |
|--|-----------|-----------|-----------|
| Diluted weighted average shares outstanding (in thousands) | 6,793 | 5,616 | 4,631 |
| Basic and diluted net loss per share from continuing operations | \$ (0.24) | \$ (0.36) | \$ (0.04) |
| Basic and diluted net earnings (loss) per share from discontinued operations | \$ 0.25 | \$ (0.28) | \$ (0.40) |
| Basic and diluted net earnings (loss) per share | \$ 0.01 | \$ (0.64) | \$ (0.44) |

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**B.O.S. BETTER ONLINE SOLUTIONS LTD.
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NOTE 18: SEGMENTS AND GEOGRAPHICAL INFORMATION

Commencing 2006 and subsequent to the disposal of the communication segment in 2006 and the acquisitions of Odem and Quasar, the Company manages its business with two reportable segments, consisting of the software solutions segment (previously named the connectivity segment) and the supply chain solutions segment (previously named the electronic components segment).

The Company's management makes financial decisions and allocates resources, based on the information it receives from its internal management system. The Company allocates resources and assesses performance for each operating segment using information about revenues, gross profit and operating income (loss) before interest and taxes.

- a. Revenues, gross profit and operating income (loss) for the operating segments for the years 2006, 2005 and 2004 were as follow:

| | <u>Software solutions</u> | <u>Supply chain solutions</u> | <u>Not allocated</u> | <u>Consolidated</u> |
|---------------------------|-------------------------------|---------------------------------------|--------------------------|---------------------|
| 2006 | | | | |
| Revenues | \$ 2,058 | \$ 18,859 | \$ - | \$ 20,917 |
| Gross profit | \$ 1,341 | \$ 3,376 | \$ - | \$ 4,717 |
| Operating loss | \$ (35) | \$ (64) | \$ (957) | \$ (1,056) |
| Assets related to segment | \$ 243 | \$ 13,700 | \$ 10,586 | \$ 24,529 |
| 2005 | | | | |
| Revenues | \$ 3,926 | \$ 20,253 | \$ (80) | \$ 24,099 |
| Gross profit | \$ 2,425 | \$ 3,820 | \$ - | \$ 6,245 |
| Operating income (loss) | \$ 235 | \$ 727 | \$ (702) | \$ 260 |
| Assets related to segment | \$ 391 | \$ 11,535 | \$ 10,720 | \$ 22,646 |
| 2004 | | | | |
| Revenues | \$ 5,011 | \$ 1,908 | \$ - | \$ 6,919 |
| Gross profit | \$ 2,933 | \$ 327 | \$ - | \$ 3,260 |
| Operating income (loss) | \$ 1,009 | \$ 66 | \$ (770) | \$ 305 |
| Assets related to segment | \$ 616 | \$ 8,880 | \$ 10,592 | \$ 22,088 |

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U.S. dollars in thousands (except for share and share data)

NOTE 18: SEGMENTS AND GEOGRAPHICAL INFORMATION (Cont.)

- b. The following presents total revenues and long-lived assets for the years 2006, 2005 and 2004 based on the location of customers:

| | Year ended December 31, | | | | | |
|-------------------|-------------------------|-------------------------|-------------------|-------------------------|-------------------|-------------------------|
| | 2006 | | 2005 | | 2004 | |
| | Total revenues | Long-lived assets *) | Total revenues | Long-lived assets *) | Total revenues | Long-lived assets *) |
| United States | \$ 2,848 | \$ - | \$ 3,439 | \$ - | \$ 3,251 | \$ - |
| Far East | 2,019 | - | 6,083 | - | 701 | - |
| Europe | 1,173 | - | 1,171 | - | 600 | - |
| Israel and others | 14,877 | 3,101 | 13,406 | 3,455 | 2,367 | 3,745 |
| | \$ 20,917 | \$ 3,101 | \$ 24,099 | \$ 3,455 | \$ 6,919 | \$ 3,745 |

Total revenues are attributed to geographical areas based on the location of customers in accordance with Statement of Financial Accounting 131, Disclosures about Segments of an Enterprise and Related Information (SFAS 131).

*) Long-lived assets comprise goodwill, intangible assets, property, plant and equipment.

- c. Major customer s data as a percentage of total revenues:

| | Year ended December 31, | | |
|------------|-------------------------|------|------|
| | 2006 | 2005 | 2004 |
| Customer A | 7% | 11% | 46% |
| Customer B | 24% | 16% | - |

Major customer s debt balances as of December 31, 2006 and 2005 are \$6,530 and \$1,433, respectively.

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NOTE 19: RELATED PARTIES

M&A Addendum to the Service Agreement of Cukierman & Co.

In 2003, the Company's audit committee and Board approved the engagement of Cukierman & Co. Investment House Ltd., to provide non-exclusive investment-banking services and business development services to the Company, effective April 15, 2003. Cukierman & Co. is a company indirectly controlled by Mr. Edouard Cukierman. Since June 26, 2003, he serves as Chairman of the Company's Board, and he is also a co-manager of the Catalyst Fund, the Company's largest shareholder. For its services, Cukierman & Co. is paid a monthly sum of \$10,000 plus VAT, in addition to a success fee of 4%-6% for a consummated private placement. According to its terms, the Company may terminate the agreement at any time, by giving one month prior written notice. The agreement provided that the success fees for securing M&A transactions shall be discussed and drafted as an Addendum to the Service Agreement. Such an Addendum was approved on August 22, 2004, and it provides for a success fee of 3.5% of the proceeds exchanged in such a transaction.

The payments the Company paid according to the Service Agreement are:

| | December 31, | |
|---|--------------|--------|
| | 2006 | 2005 |
| Business development | \$ 120 | \$ 109 |
| Success fee in respect of issuance of convertible loan, investment in Odem and private placements | 75 | 397 |
| | \$ 195 | \$ 506 |

Current liabilities in respect of related parties as of December 31, 2006 and 2005 were \$13 and \$23, respectively.

NOTE 20: SUBSEQUENT EVENT

a. Right offering:

On March 11, 2007, the Company announced that the registration statement previously filed by BOS with the Securities and Exchange Commission and the Israel Securities Authority, has been declared effective on March 8, 2007. All of the Company's shareholders, who own shares as of March 19, 2007, the record date, will be entitled to participate in a \$5 million right offering, and receive one right for each 3.3724 Ordinary shares owned on the record date. Each right will entitle the holder to purchase one Ordinary share, at a subscription price of \$2.50.

b. BOSâNOVA EURL lawsuit (UNAUDITED):

On September 18, 2007, the French Trade Tribunal rejected the Company's assertion that jurisdiction is with the Israeli courts. The Company appealed this decision.

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