COMMTOUCH SOFTWARE LTD
Form 20-F
July 15, 2003

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

FORM 20-F

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

OR

[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 For the fiscal year ended December 31, 2002

OR

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

For the transition period from _________________ to ________________

Commission file number 000-26495

COMMTOUCH SOFTWARE LTD.
(Exact name of Registrant as specified in its charter and translation of Registrant's name into English)

Israel
(Jurisdiction of incorporation or organization)

1A Hazoran Street Poleg Industrial Park, P.O. Box 8511 Netanya 42504, Israel 011-972-9-863-6888
(Address of principal executive offices)

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

Title of each class	Name of each exchange on which registered
N/A	None

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

Ordinary Shares, par value NIS 0.05 per share
(Title of Class)

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 (December 31, 2002).

Ordinary Shares, par value NIS 0.05 22,219,696

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes [X] No [ ]

Indicate by check mark which financial statement item the registrant has elected to follow. Item 17 [ ] Item 18 [X]

PART I

Recent Development: Transition to Anti-Spam Business

During 2002, concurrent with the divestiture of the Company's outsourced email businesses in transactions with MailCentro Inc. and Telecomputing, Inc. (see discussion under "Item 5. Operating and Financial Review and Prospects" below), and the sale of the Company's subsidiary Wingra, Inc., the Company began marketing to service providers its "Commtouch Messaging Platform" ("CMP"), which had been in development by the Company prior to that time. Following a concerted effort to penetrate the email server market and a determination that the continuing unfavorable economic conditions would hamper potential sales of CMP, and given the Company's inherent knowledge of anti-spam solutions based on its many years as an ASP in the outsourced email market and the growing worldwide attention that has been directed to the problem of spam, the Company transitioned its focus to the anti-spam market in mid-2002. While no uniform definition of spam exists, the Company generally defines "spam" as the sending of unsolicited bulk email for commercial and non-commercial purposes.

During the latter half of 2002, the Company directed all of its research and development resources into completing the development of its anti-spam solution for the enterprise market. In early 2003, the Company completed the first version of its anti-spam solution known as ASAP!(TM) (Anti-Spam Adaptive Protection), which offers real-time enterprise protection against spam based on a patent-pending technology. ASAP!, which integrates with the Microsoft(R) Exchange Server, adapts its detection capabilities to recognize and counter spam attacks as they are launched over the Internet to pre-emptively block spam. This adaptability feature is derived from ASAP!'s architecture, which combines an Enterprise Gateway application (i.e. software) with a remote Service Center to deliver to customers the benefits of in-house installation and outsourced service in a single solution.

The Service Center enables Commtouch to analyze daily the characteristics of millions of email messages, so that a spam attack can be identified and a detection 'signature' created and communicated to the Enterprise Gateway before the attack can reach the corporate customer. The Enterprise Gateway provides the customer's IT managers with the ability to customize ASAP!'s detection parameters to the needs of the organization and its employees.

The Company is marketing and selling ASAP! through a reseller (channel) program, and as of June 9, 2003, the Company has contracted with 25 resellers. The Company's current market focus is on enterprise customers located in North America. The Company anticipates that it will begin commercially shipping ASAP! by mid to late June 2003.

In or about the period that the Company transitioned to the anti-spam business, it entered into two strategic agreements with AxcessNet Ltd., under which the Company is receiving consulting and fundraising services from AxcessNet (see discussion under "Item 10. Additional Information - Material Contracts" below).

As the Company shifted its focus to the anti-spam market during 2002, it continued to receive royalty payments from MailCentro and Telecomputing. However, it is noted that these royalty payments will not recur to any significant extent during 2003 and thereafter. Furthermore, revenues in 2002 from the few customers previously retained by the Company in connection with its prior email business are currently insignificant, as most of the related agreements have terminated.

Item 1. Identity of Directors, Senior Management and Advisers.

Not applicable.

Item 2. Offer Statistics and Expected Timetable.

Not Applicable

Item 3. Key Information.

Unless otherwise indicated, all references in this document to "Commtouch," "the Company," "we," "us" or "our" are to Commtouch Software Ltd. or its wholly-owned subsidiaries, Commtouch Inc. and Commtouch (UK) Ltd and, as relating to consolidated financial information contained herein former wholly-owned subsidiaries Commtouch Latin America Inc. and Wingra, Inc., which were dissolved and sold respectively during 2002, and former majority-owned

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subsidiary, Commtouch K.K. (Japan) (during 2002 Commtouch divested itself of its majority holdings and retained an equity interest in this company, which is now known as Imetrix).

The selected consolidated statements of operations data for the years ended December 31, 2000, 2001 and 2002 and the selected consolidated balance sheet data as of December 31, 2001 and 2002 have been derived from the Consolidated Financial Statements of Commtouch included elsewhere in this report. The selected consolidated statements of operations data for the years ended December 31, 1998 and 1999 and the selected consolidated balance sheet data as of December 31, 1998, 1999 and 2000 have been derived from the Consolidated Financial Statements of Commtouch not included elsewhere in this report. Our historical results are not necessarily indicative of results to be expected for any future period. The data set forth below should be read in conjunction with "Item 5. Operating and Financial Review and Prospects" and the Consolidated Financial Statements and the Notes thereto included elsewhere herein:

	Year Ended December 31,			
	1998	1999	2000*	20
	(USD in thousands, except per s			
Consolidated Statements of Operations Data:				
Revenues:				
Email services	$ 389	$ 4,251	$ 17,771	$ 13
Software licenses, maintenance and services	--	--	1,000	
Total revenues	389	4,251	18,771	13
Cost of revenues:				
Email services	569	3,643	11,800	13
Software licenses, maintenance and services	--	--	--	
Total cost of revenues	569	3,643	11,800	13
Gross profit (loss)	(180)	608	6,971	

Operating expenses:				
Research and development, net	1,149	2,942	10,244	5
Sales and marketing	2,001	7,722	26,534	12
General and administrative	604	4,328	13,455	10
Amortization of prepaid marketing expenses	--	3,263	4,508	
Write-off of property and equipment and other	--	--	--	10
Amortization of stock-based employee deferred compensation	91	3,436	3,050	2
Total operating expenses	3,845	21,691	57,791	41
Operating loss	(4,025)	(21,083)	(50,820)	(41
Interest and other income (expenses), net	(326)	1,232	2,886	
Equity in losses of affiliate	--	--	--	
Write-off of impaired long-term investments	--	--	(5,000)	(2
Minority interest	--	--	55	
Loss from continuing operations	(4,351)	(19,851)	(52,879)	(42
Gain on disposal of Wingra	--	--	--	
Discontinued operations - Wingra	--	--	(1,346)	(18
Income (Loss) from sale of discontinued operations	--	--	(1,346)	(18
Net Loss	$(4,351)	$(19,851)	$(54,225)	$(61
Basic and diluted net loss per share				
Loss from continuing operations	$ (3.00)	$ (2.65)	$ (3.42)	$ (
Income (Loss) from sale of discontinued operations	--	--	(0.09)	(
Net loss	$ (3.00)	$ (2.65)	$ (3.51)	$ (
Weighted average number of shares used in Computing basic and diluted net loss per share	1,450	7,487	15,462	17

	December 31,				
	1998	1999	2000	2001	2002
	(in thousands)				
Consolidated Balance Sheet Data:					
Cash and cash equivalents	$ 834	$ 65,996	$20,831	$ 2,248	$1,388
Marketable securities	--	18,050	8,607	--	--
Working capital (deficit)	(1,440)	88,053	23,768	(607)	549
Total assets	2,366	100,336	77,280	9,545	2,984
Long-term liabilities	530	497	1,825	940	413
Shareholders' equity (deficit)	(815)	95,312	61,728	4,059	1,437

* - Reclassified to conform to the current years classification mainly due to divestiture of Wingra.

FORWARD LOOKING STATEMENTS

This report contains forward-looking statements that involve risks and uncertainties. These statements relate to our future plans, objectives, beliefs, expectations and intentions. In some cases, you can identify forward-looking statements by our use of words such as "expects," "anticipates," "believes," "intends," "plans," "seeks" and "estimates" and similar expressions. Our actual results, levels of activity, performance or achievements may differ materially from those expressed or implied by these forward-looking statements. Factors that could cause or contribute to these differences include those discussed below and elsewhere in this report.

RISK FACTORS

You should carefully consider the following risk factors before you decide to buy our ordinary shares. You should also consider the other information in this report. If any of the following risks actually occur, our business, financial condition, operating results or cash flows could be materially adversely affected. This could cause the trading price of our ordinary shares to decline, and you could lose part or all of your investment. The risks described below are not the only ones facing us. Additional risks not presently known to us, or that we currently deem immaterial, may also impair our business operations.

Business Risks

If the market does not respond favorably to our new anti-spam solutions, we will fail to generate revenues.

Our success will depend on the acceptance and use of our anti-spam solutions by enterprise customers. We cannot estimate the size or growth rate of the potential market for our anti-spam offerings. If the market for anti-spam solutions fails to grow or grows more slowly than we currently anticipate, our business will suffer dramatically. Even if that market grows, our solutions may not achieve broad market acceptance. Since we have only recently released our new anti-spam solution for general distribution, we do not have experience to evaluate whether it will achieve broad market acceptance. Also, because a preponderance of our future revenue will be derived directly or indirectly from our anti-spam solutions, if that market does not grow, our business will likely fail.

Dependence upon resellers and product concentration

The Company expects that it will continue to be dependent upon resellers for a significant portion of its revenues. If anticipated orders from these resellers fail to materialize, the Company's business, operating results and financial condition will be materially adversely affected.

The Company expects to derive the vast majority of its revenues in the foreseeable future from sales of its anti-spam solutions. See "Item 5 -- "Operating and Financial Review and Prospects" and "Item 4 - Information on the Company."

Our future revenues are unpredictable and our quarterly operating results may fluctuate which could adversely affect the value of your investment.

Because we have a limited history with our new anti-spam solutions and because of the emerging nature of the markets in which we compete, our revenue is unpredictable. Our current and future expense levels are to a large extent fixed. We may be unable to adjust spending quickly to compensate for any revenue shortfall, and any significant revenue shortfall would have an immediate negative effect on our results of operations and share price.

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A number of factors, many of which are enumerated in this "Risk Factors" section, are likely to cause fluctuations in our operating results and/or cause our share price to decline. Other factors which may cause such fluctuations include:

- Our ability to successfully develop and market our anti-spam solutions to new markets;
- The market acceptance of our new anti-spam solutions
- The size, timing and fulfillment of orders for our new anti-spam solutions;
- Our ability to expand our workforce with qualified personnel, as may be needed;
- Unanticipated bugs or other problems arising in providing our new anti-spam solutions to enterprise customers;
- The success of our resellers sales efforts to potential enterprise customers;
- The solvency of our resellers and their ability to allocate sufficient resources towards the marketing of our new anti-spam solutions to their potential enterprise customers;
- The rate of adoption of anti-spam solutions by enterprise customers in the current economic environment;
- The threat of de-listing by the NASDAQ;
- The receipt or payment of irregular or nonrecurring revenues or expenses;
- Our ability to successfully develop and market new, modified and/or upgraded solutions, as may be needed;
- The substantial decrease in information technology spending in general;
- Pricing of our solutions;
- Our ability to timely collect fees owed by resellers/customers; and
- Effectiveness of our customer support, whether provided by our resellers or directly by Commtouch.

Because of differing operational factors and the material changes to our business model, period-to-period comparisons of our operating results are not a good indication of our future performance. It is likely that our operating results in some quarters will be below market expectations. Because we are going to market with new solutions and have not had anti-spam solution sales during 2002, it is difficult to evaluate our business and prospects.

We commenced operations in 1991, but we are only beginning to try to sell our new anti-spam solutions after having ceased our efforts to sell our software messaging solution during 2002 and, prior to that time, having provided outsourced Web-based email services from 1998 through 2001 (which itself was a change from our initial focus on the sale, maintenance and servicing of stand-alone email client software products for mainframe and personal computers). In mid-2002, we began focusing exclusively on completing development of and selling our new anti-spam solutions. This change required us to once again adjust our business processes and to readjust the workforce at Commtouch (predominantly, the sales force). Therefore, we have no operating history as a provider of our new anti-spam solutions upon which you may be able to evaluate our business and prospects. It is too early to judge whether this business will succeed.

We have many established competitors who are offering a multitude of solutions to the spam problem

The market for anti-spam solutions is intensely competitive and we expect it to be increasingly competitive. Increased competition could result in pricing pressures, low operating margins and the realization of little or no market share, any of which could cause our business to suffer.

In the market for anti-spam solutions, there are a large number of providers offering "content filtering" solutions (solutions focusing solely on the content of potential spam email). Other providers that offer forms of software (gateway) and/or service based solutions and which may be viewed as direct competitors to Commtouch include Brightmail(R) and Postini(R). There is a great likelihood that, as the market for anti-spam solutions further develops and given the difficult technological hurdles in attempting to create an effective solution, established Internet security players will enter the market, who may be able to leverage their market position and resources to capture a portion of the anti-spam market.

As this market continues to develop, a number of companies with greater resources than ours could attempt to increase their presence in this market by acquiring or forming strategic alliances with our competitors or business partners. Competitors could introduce products with superior features, scalability and functionality at lower prices than our products and could also bundle existing or new products with other more established products that discourage users from purchasing our products. In addition, because there are relatively low barriers to entry for the software market, we expect additional competition from other established and emerging companies. Increased competition is likely to result in price reductions, reduced gross margins and loss of market share, any of which could harm our business.

Also, there are companies that develop and maintain in-house anti-spam solutions, such as Microsoft(R)and Yahoo(R). These and other companies could potentially leverage their existing capabilities and relationships to enter the anti-spam industry.(R)Brightmail, Postini, Microsoft and Yahoo are trademarks of Brightmail, Inc., Postini, Inc., Microsoft Corporation and Yahoo! Inc. respectively.

Our market's level of competition is likely to increase as current competitors increase the sophistication of their offerings and as new participants enter the market. In the future, as we expand our offerings, we may encounter increased competition in the development and distribution of these solutions. Many of our current and potential competitors have longer operating histories, larger customer bases, greater brand recognition and greater financial, technical, sales, marketing and other resources than we do and may enter into strategic or commercial relationships on more favorable terms. Some of these competitors have research and development capabilities that may allow them to develop new or improved products that may compete with product lines we market and distribute. New technologies and the expansion of existing technologies may increase competitive pressures on us. We may not be able to compete successfully against current and future competitors.

Our ability to increase our revenues will depend on our ability to successfully execute our sales and marketing plan.

The complexity of the underlying technological base of our anti-spam solutions and the current landscape of the anti-spam market require highly trained sales and marketing personnel to educate prospective resellers and customers regarding the use and benefits of our solutions. We have limited experience in selling anti-spam solutions to enterprise customers. It will take time for our current and future employees and resellers to learn how to market our solutions. Additionally, we are unable to predict the possibility of success selling newly introduced solutions for which we have no marketing experience and are relying on these solutions to produce a substantial portion of our revenues in the future. As a result of these factors, our sales and marketing organization may not be able to compete successfully against bigger and more experienced sales and marketing organizations of our competitors.

We have a history of losses and may never achieve profitability.

We incurred net losses of approximately $54.2 million in 2000, $61.0 in 2001, $4.9 million in 2002 and a net loss of $1.14 million for the first quarter of 2003. As of December 31, 2002 and March 31, 2003, we had an accumulated deficit of approximately $151.7 million and approximately $152.8 million, respectively. We have not achieved profitability in any period, and we might continue to incur net losses in the future. If we do not achieve profitability, our share price may decline further.

Possible need for additional funds

The Company remains very thinly capitalized. As such, we might become dependent upon raising additional funds to finance our business. Our cash balance at December 31, 2002 and March 31, 2003 was approximately $1.4 million and approximately $1.1 million, respectively. If we are unable to raise additional funds, the Company could fail. There can be no assurance that we will be able to raise necessary funds or that we will be able to do so on terms acceptable to us.

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If needed, our inability to obtain adequate capital would limit our ability to continue our operations. Any such additional funding may result in significant dilution to existing stockholders.

As discussed below under "Item 10. Additional Information. ISRAELI TAXATION AND INVESTMENT PROGRAMS--Law for the Encouragement of Industrial Research and Development, 1984," in the past we have received funds for the development of our business from the OCS. However, under our Convertible Loan Agreement, we have agreed to limit our total funding received or receivable from the OCS to a maximum in the aggregate of $1,500,000 during the term of the loan. Grants received from the OCS through 2002 that the Company potentially will be obligated to repay totaled $800,000 approximately, and the Company has been informed that the OCS has approved an additional grant of approximately $480,000 in 2003.

Risk of Litigation

Legal proceedings can be expensive, lengthy and disruptive to normal business operations, regardless of their merit. Moreover, the results of complex legal proceedings are difficult to predict and an unfavorable resolution of a lawsuit or proceeding could have a material adverse effect on the Company's business, results of operations or financial condition.

Indemnification of Directors and Officers

The Company has agreements with its directors, subject to Israeli law (Item 5 - "Operating and Financial Review and Prospects"), that provide for the Company to indemnify these directors for (a) any monetary obligation imposed upon them for the benefit of a third party by a judgment, including a settlement agreed to in writing by the Company, or an arbitration decision certified by the court, as a result of an act or omission of such person in his capacity as a director of the Company, and (b) reasonable litigation expenses, including legal fees, incurred by such a director for which he/she is obligated to pay by a court order, in a proceeding brought against him/her by or on behalf of the Company or by others, or in connection with a criminal proceeding in which he/she was acquitted, in each case relating to acts or omissions of such person in his/her capacity as a director of the Company.

Risk due to economic conditions

Should economic conditions fail to improve, our ability to sell our new anti-spam solutions could be negatively impacted. Furthermore, even if we are successful in selling our solutions, our ability to collect outstanding receivables may be significantly impacted by liquidity issues of our resellers' customers and/or our resellers themselves, which may negatively affect our ability to recognize future revenue based on sales. As a result, we may experience shortfalls in our future revenues.

The loss of our key employees would adversely affect our ability to manage our business, therefore causing our operating results to suffer and the value of your investment to further decline.

Our success depends on the skills, experience and performance of our senior management and other key personnel. The loss of the services of any of our senior management or other key personnel, including Gideon Mantel, our Chief Executive Officer and Amir Lev, our President and Chief Technical Officer, could materially and adversely affect our business. The loss of our software developers may also adversely affect our anti-spam solutions, therefore causing our operating results to suffer and the value of your investment to decline. We do not have employment agreements inclusive of set periods of employment with any of these key personnel. We cannot prevent them from leaving at any time. We do not maintain key-person life insurance policies on any of our employees.

Our low head-count of 32 employees (as of May 2003) continues to strain our operational resources, and although the Company added additional sales personnel in the early months of 2003, the lack of sufficient personnel may compromise our ability to enhance revenues.

Our business and operating results could suffer if we do not successfully address the risks inherent in doing business overseas.

At December 31, 2002, we had sales offices in Israel and the United States. Depending on the success of our marketing efforts in North America, we may pursue the marketing of our anti-spam solutions in international markets by utilizing

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appropriate distributorship channels. However, we may not be able to compete effectively in international markets due to various risks inherent in conducting business internationally, such as:

- differing technology standards;
- inability of distribution channels to successfully market our anti-spam solutions;
- export restrictions, including export controls relating to encryption technologies;
- difficulties in collecting accounts receivable and longer collection periods;
- unexpected changes in regulatory requirements;

- political and economic instability;
- potentially adverse tax consequences; and
- potentially reduced protection for intellectual property rights.

Any of these factors could adversely affect the Company's prospective international sales and, consequently, business and operating results.

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

On September 11, 2001, the United States was the target of terrorist attacks of unprecedented scope. These attacks caused major instability in the U.S. and other financial markets. There could be further acts of terrorism in the United States or elsewhere that could have a similar impact. Leaders of the U.S. government have announced their intention to actively pursue and take military and other action against those behind the September 11, 2001 attacks and to initiate broader action against national and global terrorism. In this regard, the U.S. recently led a coalition of forces in attacks on Afghanistan and Iraq. The worldwide ramifications of such attacks are unknown at this time. Armed hostilities or further acts of terrorism would cause further instability in financial markets and could directly impact our financial condition and our results of operations.

Technology Risks

We might not have the resources or skills required to adapt to the changing technological requirements and shifting preferences of our customers and their users.

The spam and anti-spam industry is characterized by difficult technological challenges, sophisticated "spammers" and constantly evolving spam practices and targets that could render our anti-spam solutions and proprietary technology ineffective. Our success depends, in part, on our ability to continually enhance our existing anti-spam solutions and to develop new solutions, functions and technology that address the potential needs of prospective customers and their users. The development of proprietary technology and necessary enhancements entails significant technical and business risks and requires substantial expenditures and lead-time. We may not be able to keep pace with the latest technological developments. We may not be able to use new technologies effectively or adapt to customer or end user requirements or emerging industry standards. Also, we must be able to act more quickly than our competition, and may not be able to do so. See "Item 4 - Information on the Company."

Our software may be adversely affected by defects, which could cause our customers or end users to stop using our solutions.

Our anti-spam solutions are based in part upon new and complex software. Complex software often contains defects, particularly when first introduced or when new versions are released. Although we conduct extensive testing, we may not discover software defects that affect our new or current solutions or enhancements until after they are delivered.

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Although we have not experienced any material software defects to date in our anti-spam solutions offering, it is possible that, despite testing by us, defects may exist in the software we license. These defects could cause interruptions in our anti-spam solutions for customers that could damage our reputation, create legal risks, cause us to lose revenue, delay market acceptance or divert our development resources, any of which could cause our business to suffer.

Investment Risks

We may need additional capital.

We have invested heavily in technology development. We expect to continue to spend financial and other resources on developing and introducing new offerings and maintaining our corporate organizations and strategic relationships. We also expect to invest resources in research and development projects to develop enhanced anti-spam solutions for enterprises and, possibly, other target markets.

Based on the cash balance at March 31, 2003, current projections of revenues, related expenses, the ability to further curtail certain discretionary expenses and completion of the convertible loan transaction (as discussed above under paragraph a of this Item 3 and below under Item 5, "Operating and Financial Review and Prospects - Liquidity and Capital Resources"), the Company believes it has sufficient cash to continue operations for at least the next twelve months.

We are subject to a class action lawsuit which may have a material adverse effect on us.

Following our restatement of revenues for the first three quarters of 2000, several class action lawsuits were filed in the United States District Court for the Northern District of California against the Company and certain of our officers and a director, alleging violations of the antifraud provisions of the Securities Exchange Act of 1934 arising from the Company's financial statements. These lawsuits were consolidated into one action in late 2001. Thereafter, the Company filed a Motion to Dismiss, which was granted. The plaintiffs then filed a second amended and consolidated complaint, and our second motion to dismiss was only partially accepted, with the end result being that the plaintiffs filed a third amended and consolidated complaint. We (including the individual defendants) filed an answer to that complaint, and the case then moved into the discovery stage, with the case being set for trial in January 2004. In May 2003, a settlement agreement was signed between the plaintiffs and defendants and the court thereafter issued a preliminary order approving the settlement. The settlement calls for the payment of $15 million to the plaintiffs, with this amount to be fully funded by the Company's Directors and Officers policy. While the payment to plaintiffs under this settlement should not cause the Company any financial hardship, we are unable to predict whether the whole or a substantial portion of the class members will choose to participate in the settlement and whether ultimately the court will issue a final order approving the settlement. The settlement does not contain any admissions or findings of wrongdoing on the part of the defendants, and we continue to maintain that the Company and individual defendants acted properly at all times.

If we cannot satisfy Nasdaq's maintenance requirements, it may delist our ordinary shares from its Smallcap Market and we may not have an active public market for our ordinary shares. The absence of an active trading market would likely make our ordinary shares an illiquid investment.

Our ordinary shares are quoted on the Nasdaq SmallCap Market. To continue to be listed, we are required to maintain shareholders' equity of at least $2,500,000, or market value of our outstanding shares (excluding shares held by company insiders and principal shareholders) of at least $35,000,000, or we must have realized at least $500,000 in net income from continuing operations in our last fiscal year or in two of our last three fiscal years.

Currently, we are not in compliance with any of these tests and Nasdaq may delist our ordinary shares. If this occurs, trading in our shares may be conducted in the over-the-counter market in the so-called "pink sheets" or, if available, the "OTC Bulletin Board Service." As a result, an investor would likely find it significantly more difficult to dispose of, or to obtain accurate quotations as to the value of, our shares. The Company recently has been advised by Nasdaq that it no longer meets the requirements for listing on the SmallCap Market and is in the process of discussing with Nasdaq appropriate efforts to become compliant.

Also, Nasdaq may delist our ordinary shares if it deems it necessary to protect investors and the public interest.

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Nasdaq also may delist our shares if it deems it necessary to protect investors and the public interest.

If our shares are delisted, they may become subject to the SEC's "penny stock" rules and be more difficult to sell.

SEC rules require brokers to provide information to purchasers of securities traded at less than $5.00 and not traded on a national securities exchange or quoted on the Nasdaq Stock Market. If our shares become "penny stock" that is not exempt from these SEC rules, these disclosure requirements may have the effect of reducing trading activity in our shares and making it more difficult for investors to sell. The rules require a broker-dealer to deliver a standardized risk disclosure document prepared by the SEC that provides information about penny stocks and the nature and level of risks in the penny stock market. The broker must also give bid and offer quotations and broker and salesperson compensation information to the customer orally or in writing before or with the confirmation. The SEC rules also require a broker to make a special written determination that the penny stock is a suitable investment for the purchaser and receive the purchaser's written agreement to the transaction before a transaction in a penny stock.

Our directors, executive officers and principal shareholders will be able to exert significant influence over matters requiring shareholder approval and could delay or prevent a change of control.

Our directors and affiliates of our directors, our executive officers and our shareholders who currently individually beneficially own over five percent of our ordinary shares, beneficially own, in the aggregate, approximately 31.3% of our outstanding ordinary shares as of February 7, 2003 plus warrants and options exercisable within 60 days thereof. If they vote together (especially if they were to convert all beneficial holdings into shares entitled to voting rights in the Company), these shareholders will be able to exercise significant influence over all matters requiring shareholder approval, including the election of directors and approval of significant corporate transactions. This concentration of ownership could also delay or prevent a change in control of Commtouch. The above percentage of beneficial ownership includes warrants and options totaling 11.24% of the outstanding ordinary shares which are underwater as of February 7, 2003.

InfoSpace beneficially owns approximately 8.7% of our outstanding ordinary shares (inclusive of a warrant underwater as of February 7, 2003 constituting 4.9% of the outstanding ordinary shares). InfoSpace merged with Go2Net in October 2000. In connection with this merger InfoSpace assumed Go2Net shares, warrants and rights. In 1999, in connection with entering into an email services agreement, we issued to InfoSpace a warrant to purchase 1,136,000 ordinary shares at an exercise price of $12.80 per share. Concurrent with Commtouch Inc.

entering into the email services agreement, we issued 896,057 ordinary shares to InfoSpace and 448,029 in ordinary shares to Vulcan Ventures in a private placement at $14.88 per share. We believe that Vulcan Ventures divested itself of all of its shareholdings in the Company. The warrant is non-forfeitable, fully vested and immediately exercisable, and will expire in July 2004.

Pursuant to the Ordinary Shares and Warrants Purchase Agreement dated February 27, 2002:

- OZF Ltd. acquired beneficial ownership of approximately 7.2% of our outstanding ordinary shares (inclusive of warrants underwater as of February 7, 2003 constituting 2.7% of the outstanding ordinary shares);

- Gideon Mantel, CEO and a director in the Company, acquired additional shares and warrants to purchase shares in the Company. Together with his prior holdings in the Company, Mr. Mantel beneficially owns approximately 7.9% of our outstanding ordinary shares (inclusive of warrants underwater as of February 7, 2003 constituting 1.8% of the outstanding ordinary shares); and

- Nahum Sharfman, a director in the Company, acquired additional shares and warrants to purchase shares in the Company. Together with his prior holdings in the Company, Mr. Sharfman beneficially owns approximately 6.1% of our outstanding ordinary shares (inclusive of warrants and options underwater as of February 7, 2003 constituting 1.8% of the outstanding ordinary shares).

These significant shareholders will be able to significantly influence and possibly exercise control over most matters requiring approval by our shareholders, including the election of directors and approval of significant corporate

transactions. This concentration of ownership may also have the effect of delaying or preventing a change in control. InfoSpace will also have the right to name one director to our Board as long as it continues to hold at least 620,022 shares, including the shares issuable upon exercise of the InfoSpace warrant. It named Thomas Camp to the Board under this provision, who resigned on August 22, 2001 and was not replaced by Infospace. In addition, conflicts of interest may arise as a consequence of these significant shareholders control relationship with us, including:

- conflicts between significant shareholders, and our other shareholders whose interests may differ with respect to, among other things, our strategic direction or significant corporate transactions;

- conflicts related to corporate opportunities that could be pursued by us, on the one hand, or by these shareholders, on the other hand; or

- conflicts related to existing or new contractual relationships between us, on the one hand, and these shareholders, on the other hand.

Substantial sales of our ordinary shares could adversely affect our share price.

The sale, or availability for sale, of substantial quantities of our ordinary shares may have the effect of further depressing its market price. A large number of our ordinary shares which were previously subject to resale restrictions, are currently eligible for resale. In addition a significant number of shares are eligible for resale in the future (i.e. those shares covered by warrants issued in the private round of financing of February 2002 and those shares that may be issued if the lenders in the convertible loan transaction decide to exercise warrants and/or convert the Company's loan obligations to equity, as discussed below under paragraph a of Item 3 and Item 5, "Operating and Financial Review and Prospects - Liquidity and Capital Resources").

Also, the shares that could be issued under the Convertible Loan Agreement would dilute existing shareholders

Risk of occurrence of event of default under Convertible Loan Agreement

The Company is required to abide by the terms and provisions of the Convertible Loan Agreement. Upon failure to do so, for example, failure to pay principal or interest, failure to obtain the registration with the SEC of the shares that may be issued to lenders under the agreement, failure to maintain consolidated cash reserves of at least $500,000, upon the lenders' demand, we would be in default of the agreement. The lenders were granted security interests in all of the Company's assets. If an event of default is not cured by the Company, the loan would accelerate and all amounts due under the loan would immediately become due and payable. If the Company is unable to repay the loan amounts, the lenders, among other things, would have the right to foreclose on their security interests in the Company's assets by seizing and selling all the Company's assets. See the discussion under Item 4 "Information on the Company".

Intellectual Property Risks

If we fail to adequately protect our intellectual property rights or face a claim of intellectual property infringement by a third party, we could lose our intellectual property rights or be liable for significant damages.

We regard our patent pending technology, copyrights, service marks, trademarks, trade secrets and similar intellectual property as critical to our success, and rely on patent, trademark and copyright law, trade secret protection and confidentiality or license agreements with our employees and customers to protect our proprietary rights. Third parties may infringe or misappropriate our patent pending technology, trade secrets, copyrights, trademarks and similar proprietary rights. We have recently filed a provisional patent application covering certain aspects of our anti-spam technology, and we may convert this application into a formal patent application or seek to patent certain additional software or other technology in the future. Any such future patent applications may not be issued within the scope of the claims we seek, or at all. We cannot be certain that our software does not infringe issued patents that may relate to our anti-spam solutions. In addition, because patent applications in the United States are not publicly disclosed until the patent is issued, applications previously may have been filed which relate to our anti-spam solutions.

Other parties may assert infringement claims against us. We may also be subject to legal proceedings and claims from time to time in the ordinary course of our business, including claims of alleged infringement of the patents, trademarks

and other intellectual property rights of third parties by ourselves and our licensees. Such claims, even if not meritorious, could result in the expenditure of significant financial and managerial resources.

Despite our precautions, unauthorized third parties may copy certain portions of our technology or reverse engineer or obtain and use information that we regard as proprietary. In addition, the laws of some foreign countries do not protect proprietary rights to the same extent as do the laws of the United States. Our means of protecting our proprietary rights in the United States or abroad may not be adequate and competitors may independently develop similar technology.

We also continue to hold a perpetual mail server license which was utilized in our hosted service offering and is still being utilized by us to service a current customer, and may license other technology as the need arises. We cannot be certain that, apart from the mail server license, other third-party content licenses will be available to us on commercially reasonable terms or that we will be able to successfully integrate the technology into our products. These third-party licenses may expose us to increased risks, including risks associated with the assimilation of new technology, the diversion of resources from the development of our own proprietary technology, and our inability to generate revenues from new technology sufficient to offset associated acquisition and maintenance costs. The inability to obtain any of these licenses could result in delays in product development until equivalent technology can be identified, licensed and integrated. Any such delays could cause our business/financial condition and operating results to suffer.

Governmental regulation and legal uncertainties could impair the growth of the Internet, decrease the distribution of unsolicited bulk (spam) email and decrease demand for our anti-spam solutions or increase our cost of doing business.

While laws aimed at curtailing the spread of spam have been adopted by some states, enforcement has not been widespread and the lack of a body of federal anti-spam law has highlighted an increase in the amount of spam traffic. The growth and development of the spam market may prompt calls for more stringent Internet user protection laws that may limit the ability of companies promoting or delivering spam online. Moreover, the applicability to the Internet of existing laws in various jurisdictions governing issues such as property ownership, sales and other taxes, libel and personal privacy is uncertain and may take years to resolve. The adoption of additional laws or regulations, or the application of existing laws or regulations to the Internet, may impair the growth of the Internet or commercial online services. All or some of the above laws could decrease the demand for our anti-spam solutions and increase our cost of doing business, or otherwise harm our business and operating results.

Risks Relating to Operations in Israel

We have important facilities and resources located in Israel, which has historically experienced severe economic instability and military and political unrest.

We are incorporated under the laws of the State of Israel. Our principal research and development facilities are located in Israel. Although substantially all of our past sales were made to customers outside Israel, we are nonetheless directly influenced by the political, economic and military conditions affecting Israel. Any major hostilities involving Israel, or the interruption or curtailment of trade between Israel and its present trading partners, could significantly harm our business, operating results and financial condition.

Israel's economy has been subject to numerous destabilizing factors, including a period of rampant inflation in the early to mid-1980's, low foreign exchange reserves, fluctuations in world commodity prices, military conflicts and civil unrest. In addition, Israel and some companies doing business with Israel have been the subject of an economic boycott by Arab countries since Israel's establishment. These restrictive laws and policies may have an adverse impact on our operating results, financial condition or expansion of our business.

Since the establishment of the State of Israel in 1948, a state of hostility has existed, varying in degree and intensity, between Israel and certain Arab countries. Since September 2000, a continuous armed conflict with the Palestinian Authority has been taking place. Although Israel has entered into various agreements with certain Arab countries and the Palestinian Authority, and various declarations have been signed in connection with efforts to resolve some of the economic and political problems in the Middle East, Israel continues to face hostile actions and threats from various elements in the region. We cannot predict whether or in what manner these problems will be resolved.

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

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

Because a substantial portion of our revenues historically have been generated in U.S. dollars and a portion of our expenses have been incurred in New Israeli Shekels, our results of operations may be adversely affected by inflation and currency fluctuations.

We have generated a substantial portion of our revenues in U.S. dollars and incurred a portion of our expenses, principally salaries and related personnel expenses in Israel, in New Israeli Shekels, commonly referred to as NIS. As a result, we have been exposed to the risk that the rate of inflation in Israel will exceed the rate of devaluation of the NIS in relation to the dollar or that the timing of any devaluation may lag behind inflation in Israel. In 2002 and for a number of prior to 1999, the rate of devaluation of the NIS against the dollar exceeded the rate of inflation. We cannot be assured that this reversal will continue. If the dollar cost of our operations in Israel increases, our dollar-measured results of operations will be adversely affected. Our operations also could be adversely affected if we are unable to guard against currency fluctuations in the future. Accordingly, we may enter into currency hedging transactions to decrease the risk of financial exposure from fluctuations in the exchange rate of the dollar against the NIS. These measures, however, may not adequately protect us from material adverse effects due to the impact of inflation in Israel.

The government programs and benefits which we currently receive require us to meet several conditions and may be terminated or reduced in the future.

Prior to 1998, we received grants from the Government of Israel, through the Office of the Chief Scientist (OCS), for the financing of a significant portion of our research and development expenditures in Israel. In 2001 and 2002, we applied for additional grants and we may apply for additional grants in the future. In 1999 and 2000, we did not receive any grants from the OCS. In 2001 we received \$0.6 million and in 2002 we received \$0.2 million. While we have applied for an additional grant in 2003, the OCS budget has been subject to reductions which may affect the availability of funds for this prospective grant and other grants in the future. Therefore, we cannot be certain that we will continue to receive grants at the same rate, or at all. In addition, the terms of any future OCS grants may be less favorable than our past grants. In connection with research and development grants received from the OCS, we must pay royalties to the OCS on the revenue derived from the sale of products, technologies and services developed with grants from the OCS.

The terms of the OCS grants and the law pursuant to which the grants are made restrict our ability to manufacture products or transfer technologies developed using OCS grants outside of Israel. This restriction may limit our ability to enter into agreements for those products or technologies, without OCS approval.

We cannot be certain that the approvals of the OCS will be obtained on terms that are acceptable to us, or at all. In connection with our grant applications, we have made representations and covenants to the OCS. The funding from the OCS is subject to the accuracy of these representations and covenants and to our compliance with the conditions and restrictions imposed by the OCS. If we fail to comply with any of these conditions or restrictions, we could be required to repay any grants previously received, together with interest and penalties, and would likely be ineligible to receive OCS grants in the future.

The Company received grants from the Government of Israel, through the OCS, for the financing of a significant portion of its research and development expenditures in Israel relating to some of Commtouch's previous products. The related funded projects ultimately failed and the relevant royalty payments were made by the Company to the OCS on behalf of the revenues generated from these projects. The Company will not be obligated to pay future royalties for such projects undertaken in 2001 or earlier years, since no future revenue is expected from these projects. Accordingly, the Company decided to write down the $0.4 million accrual it recorded in past years and determined that as of December 31, 2001 there were no contingent liabilities for royalties from these projects. In March 2002, the Company submitted an application for project failure with regard to these projects, and the OCS subsequently approved the application. Also, we received royalty-bearing grants in 2002 totaling $0.2 million. The OCS is entitled to revisit the status of past projects it has confirmed as "failed" to ensure that the Company is not currently utilizing technology developed under such projects.

Also, under our Convertible Loan Agreement, we have agreed to limit our total funding received or receivable from the OCS to a maximum in the aggregate of $1,500,000 during the term of the loan. Grants received from the OCS through 2002 that the Company potentially will be obligated to repay totaled $800,000 approximately, and the Company has been informed that the OCS has approved an additional grant of approximately $480,000 in 2003.

The tax benefits we are currently entitled to from the Government of Israel may be reduced or terminated in the future.

Pursuant to the Law for the Encouragement of Capital Investments, the Government of Israel through the Investment Center has granted "approved enterprise" status to a portion of our capital investment programs. The portion of our income derived from our approved enterprise program will be exempt from tax for a limited period of two years commencing in the first year in which we have taxable income, and will be subject to a reduced tax for an additional period of five to eight years dependent on the percentage of foreign shareholders. The benefits available to an approved enterprise are conditioned upon the fulfillment of conditions regarding a required amount of investments in fixed assets and a portion of these investments being made with net proceeds of equity capital raised by us as stipulated in applicable law and in the specific certificates of approval. If we fail to comply with these conditions, in whole or in part, we may be required to pay additional taxes for the period in which we benefited from the tax exemption or reduced tax rates and would likely be denied these benefits in the future. In addition, the law and regulations prescribing the benefits provide for an expiration date for the grant of new benefits. The expiration date has been extended several times in the past. The expiration date currently is end of December 2003 and no new benefits will be granted after that date unless the expiration date is extended. We cannot assure you that new benefits will be available after December 2003 or that benefits will be continued in the future at their current levels or at all. Out of our three approved enterprise programs, two were cancelled as of December 31, 2002.

Israeli courts might not enforce judgments rendered outside of Israel and it might therefore be difficult for an investor to recover any judgment against any of our officers or directors resident in Israel.

We are organized under the laws of Israel, and we maintain significant operations in Israel. Certain of our officers and directors named in this report reside outside of the United States. Therefore, you might not be able to enforce any judgment obtained in the U.S. against us or any of such persons. You might not be able to bring civil actions under U.S. securities laws if you file a lawsuit in Israel. However, we have been advised by our Israeli counsel that, subject to several limitations, Israeli courts may enforce a final judgment of a U.S. court for liquidated amounts in civil matters after a hearing in Israel. We have appointed Commtouch Inc., our U.S. subsidiary, as our agent to receive service of process in any action against us arising from this report. We have not given our consent for our agent to accept service of process in connection with any other claim and it may therefore be difficult for an investor to effect service of process against us or any of our non-U.S. officers, directors and experts relating to any other claims. If a foreign judgment is enforced by an Israeli court, it may be payable in Israeli currency.

Provisions of Israeli law may delay, prevent or make difficult an acquisition of Commtouch, which could prevent a change of control and therefore depress the price of our shares.

Israeli corporate law regulates mergers, votes required to approve mergers and acquisitions of shares through tender offers, requires special approvals for transactions involving significant shareholders and regulates other matters that may be relevant to these types of transactions. Furthermore, Israel tax considerations may make potential transactions unappealing to us or to some of our shareholders.

Tax reform in Israel may reduce our tax benefits, which might adversely affect our profitability.

Item 4. Information on the Company.

Overview

We are a provider of anti-spam solutions to enterprise customers (See PART I, "Recent Development: Transition to Anti-Spam Business" for additional detailed information). The Company offers its anti-spam solutions to small, medium and large enterprises through a variety of distribution channels, namely various reseller channels. The solutions are also available for integration with security, content filtering, anti-virus and other filtering solutions through alliances and strategic partnerships.

In its previous capacity as a dedicated email service provider to millions of users, the Company found it necessary to design an effective strategy to eliminate millions of unsolicited commercial email messages daily. It is this strategy that has led the Company to develop and deliver its current anti-spam solutions, which are positioned to tackle sophisticated spam attacks. A combination of proprietary and patent-pending technologies makes it possible for Commtouch to detect, alert and block most spam attacks as they are distributed over the Internet.

Commtouch Offerings

We offer a comprehensive anti-spam solution (known as "ASAP!"), consisting of both a software element (the "Enterprise Gateway") and a service component (the "Service Center"). At the Enterprise Gateway, messages are filtered at the organization's entry point, before being distributed to recipients, with added user-level controls and a top level of secure spam detection services from the Service Center, all allowing for real-time reaction to worldwide spam attacks. At the heart of the ASAP! solution, however, is the Service Center, which detects new spam attacks as soon as they are launched and distributed over the Internet. The Service Center provides real-time spam detection services to enterprise customers by maintaining constant communication with Enterprise Gateways that are locally installed at customer premises in different locations worldwide. The Service Center collects information from multiple sources about new spam attacks, analyzes the input using Commtouch patent-pending technology, identifies and detects spam, classifies the data, matches its stored information against outstanding queries for spam detection from Enterprise Gateways and replies in real-time back to the Enterprise Gateways with a prioritized and accurate resolution. The whole process takes no more than 300ms. Enterprise privacy is kept at a maximum because the content of incoming email messages is not seen by the Service Center.

In particular, ASAP! operates to help eliminate spam as follows:

Inbound email enters the ASAP! Enterprise Gateway, a software add-on to the enterprise SMTP server.

The ASAP! Enterprise Gateway matches key characteristics of the message with predefined spam policies created by IT managers or end-users.

If ASAP! does not match the message to a known source, either spam or not spam, it compares characteristics of the incoming message against the ASAP! Gateway database of recently identified spam.

If the message remains suspicious, but cannot be confirmed as spam, the ASAP! Gateway queries the ASAP! Service Center for remote spam detection and classification services.

The outgoing query consists of encrypted digital signatures taken from e-mail header information to ensure enterprise security and confidentiality.

The ASAP! Service Center weighs the values of the outstanding query against its vast database of real-time information about known spam messages and sources of spam, and replies to the ASAP! Enterprise Gateway with a unique and up-to-date classification.

The ASAP! Enterprise Gateway applies a locally predefined action to the message and may store the information internally to match against new incoming messages bearing similar characteristics.

We also offer an ASAP! Software Development Kit ("SDK"). The ASAP! SDK enables third-party vendors to integrate ASAP! advantages into their existing offerings, providing them with full spam identification and spam classification services from the ASAP! Service Center. These vendors benefit from ASAP! expertise in blocking spam and other unwanted email traffic without the need to develop and dedicate a service department in-house. The SDK communicates fully with the remote Service Center, receiving results to queries about suspicious messages and acting according to set policies on the customer side. Each such vendor has the flexibility to determine how best to integrate the SDK results into their solution. For example, if the Service Center classifies a specific message as spam, the

vendor's application may respond by either quarantining the message, rejecting it completely or sending a bounce-back message to its sender or any other option provided by the vendor's specific application.

The SDK consists of a set of APIs, which receive characteristics of incoming messages as input from the vendor's application, returning the status of the message as output from the Service Center. The vendor has the option of installing an API, which returns a deterministic result classifying messages as either spam or non-spam, or using an API that classifies messages based on the level of suspicion that the message is spam. Each vendor can implement its solution differently, making the unique advantages of SDK flexible to match particular needs.

Products that may benefit from integration of the SDK solution include:

- Anti-virus applications
- Content filtering solutions
- Firewall systems
- Security servers
- Other network appliances

Competitive Landscape

The markets in which Commtouch competes are intensely competitive and rapidly changing. We believe there is no single competitor that offers the complete package of anti-spam protection that Commtouch provides. We are aware of competitors that provide anti-spam products either alone or as part of a complete messaging system or email security system.

Commtouch's principal competition are companies that offer various e-mail content filtering products. Companies that sell products that compete with some of the features within our products include Brightmail(R), Postini(R), Tumbleweed, CipherTrust, SurfControl, Clearswift Technologies, CipherTrust, Inc., and Trend Micro Incorporated.

The principal competitive factors in our industry include price, product functionality, product integration, platform coverage and ability to scale, worldwide sales infrastructure and global technical support. Some of our competitors have greater financial, technical, sales, marketing and other resources than we do, as well as greater name recognition and a larger installed customer base. Additionally, some of these competitors have research and development capabilities that may allow them to develop new or improved products that may compete with product lines we market and distribute.

We expect that the market for anti-spam solutions will become more consolidated with larger companies being better positioned to compete in such an environment in the long term. As this market continues to develop, a number of companies with greater resources than ours could attempt to increase their presence in this market by acquiring or forming strategic alliances with our competitors or business partners. Our success will depend on our ability to adapt to these competing forces, to develop more advanced products more rapidly and less expensively than our competitors, and to educate potential customers as to the benefits of licensing our products rather than developing their own products. Competitors could introduce products with superior features, scalability and functionality at lower prices than our products and could also bundle existing or new products with other more established products that discourage users from purchasing our products. Increased competition is likely to result in price reductions, reduced gross margins and loss of market share, any of which could harm our business.

See also disclosure under "Item 3. Key Information- RISK FACTORS--Business Risks--We have many established competitors who are offering solutions to the spam problem."

Convertible Loan Transaction

To enhance the Company's overall financial position, on January 29, 2003, Commtouch entered into a Convertible Loan Agreement ("Convertible Loan Agreement"), including certain ancillary agreements and documents attached as exhibits thereto, with certain lenders identified in Exhibit "A" to such Convertible Loan Agreement. The Convertible Loan Agreement allowed for a maximum possible loan amount of $1,250,000. As of March 26, 2003, the lenders had agreed to advance Commtouch a loan of $905,000. On March 28, 2003, by way of Addendum 1 to the Convertible Loan Agreement, the Company and the lenders amended the Convertible Loan Agreement to provide an option to certain of

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the lenders, their affiliates and investors from the Company's previous round of financing the right to loan the Company an amount of up to $345,000, representing the difference between the maximum loan amount originally contemplated and the amount of the loan as at March 26, 2003. This option was exercised on May 11, 2003.

The Company has received the total loan amount of $1,250,000 from the lenders. The loan is to be repaid after three years, unless converted into equity by the lenders or a defined default or other event triggering early repayment is met, and it bears interest at a rate of ten percent per annum to be paid with priciple. Furthermore, the loan principal and interest may be converted by the lenders into equity in the Company at any time during the loan term, at a conversion price of $0.25 per Ordinary Share ("Conversion Price"). Warrants exercisable for purchase of up to 5,000,000 of the Company's ordinary shares have been issued to the lenders (based on loan amounts advanced divided by the Conversion Price). Each one-third of the warrants are exercisable at prices per Ordinary Share of $0.25, $0.33 and $0.50 respectively, and the warrants are exercisable at any time within five years of issuance. Warrants shall also be issued on an annual basis for any accumulated interest on the loan.

As security for repayment of the loaned amounts, the lenders have been granted security interests in all of the assets of the Company. Also, the lenders are entitled to nominate one director for election to the Board of Directors of the Company or appoint one observer to the Board.

Also, the Company has agreed that, among other things, until all loans are repaid, it will;

- not pay any dividends or make any distribution on its outstanding Ordinary Shares, or redeem any Shares for consideration without the prior written consent of 50% of all the lenders;

- not alter its capital structure or permit any corporate reorganization and/or disposal of assets outside the ordinary course of business, except as authorized by vote of its board of directors and shareholders;

- secure approval of 50% of the lenders before issuing preferred shares or other preferential liquidation rights;

- not create any security interests on indebtedness that will rank prior to advances under the Convertible Loan Agreement and the security interest granted under the instruments provided for in the Agreement, without approval of 50% of the lenders;

- along with its subsidiaries, continue to engage substantially in the same businesses and not to enter into certain business combination transactions;

- limit its total funding received or receivable from the Israeli Office of Chief Scientist ("OCS") to a maximum in the aggregate of $1,500,000 during the term of the loan.

Lenders comprising not less than 50% of all the lenders may require the Company to register with the SEC the resale of all Ordinary Shares issuable to the lenders under the Agreement. The lenders may also sell their shares in other registration statements that the Company files for its own benefit or that of third parties who wish to sell shares. This right expires three (3) months after the third anniversary of the last applicable Warrant issuance date. The maximum number of shares that may be registered is 13,310,000. The Company will pay the expenses of these registrations, except for underwriting discounts and commissions and the fees and expenses of any lender's counsel. The Company has also agreed to indemnify the lenders against certain liabilities arising from the public offer and sale of their shares pursuant to the registration.

The Company will be in default under the Convertible Loan Agreement and subject to prior conversion in accordance unless agreed otherwise by the Lender Majority (""Lender Majority" shall mean those Lenders who have lent collectively to the Company over 50% of the Loan Amount"), all amounts due thereunder will accelerate and immediately become due and payable if certain events occur, including the following:

- the Company's failure to repay amounts due under the Convertible Loan Agreement;

- the Company's failure to repay amounts due on any debt ranking prior to or on a parity with the Convertible Loan Agreement or the occurrence of any event of default in any loan arrangement ranking prior to or on a parity with the Convertible Loan Agreement;

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- if certain statements made by the Company in connection with the Convertible Loan Agreement were materially untrue

- if the Company's cash reserves on a consolidated basis fall below $500,000;

- the Company admits in writing to a lender under the Convertible Loan Agreement its inability to pay its debts;

- the filing any proceedings regarding the Company in bankruptcy, insolvency, winding up, dissolution, liquidation, moratorium, receivership or reorganization for the benefit of creditors, which in the case of proceedings brought against the Company, have not been withdrawn or dismissed within ninety (90) days;

- the commencement by a third party creditor of a proceeding to foreclose a security interest or lien in any property or assets of the Company upon default in the payment or performance of any debt of the Company, in excess of $250,000 which is secured thereby; and

- the entry against the Company of a final judgments in excess of $250,000 that are not discharged, provided for, stayed or appealed in thirty days an attachment is levied against the assets of the Company involving an amount in excess of $250,000 and the levy is not vacated, bonded or otherwise terminated within thirty days.

In some cases, the Convertible Loan Agreement provides the Company will a cure period for an event of default, and if the Company is unable to cure the breach it will be in default.

A more complete description of this convertible loan transaction may be found in the Company's Form 6-K filed with the SEC for the month of April 2003, which is incorporated herein by reference under Exhibit 2.9 to this Form 20-F. This description is qualified in its entirety by reference to the text of the Convertible Loan Agreement which is incorporated by reference into this Form 20-F as Exhibit 2.9.1.

Intellectual Property

We regard our patent pending anti-spam techonolgy, copyrights, service marks, trademarks, trade secrets and similar intellectual property as critical to our success, and rely on patent, trademark and copyright law, trade secret protection and confidentiality and/or license agreements with our employees, customers, partners and others to protect our proprietary rights. We are only actively maintaining our registered trademark for "COMMTOUCH", which is currently registered in the U.S., Israel, European Union, China, Mexico, Norway, Taiwan, Russian Federation, South Korea and Australia. While previous registrations of PRONTO (Canada and South Korea); COMMTOUCH SOFTWARE (Australia and New Zealand); PRONTO MAIL (New Zealand) may still be in force, we are not currently actively maintaining these trademarks. The Company may decide to actively maintain some or all of these trademarks in the future, as circumstances may justify. We also have the following pending trademark applications: COMMTOUCH (India, Canada and Brazil). We are also claiming trademark rights in "ASAP!", as applicable to our anti-spam solutions, as from the beginning of 2003.

It may be possible for unauthorized third parties to copy or reverse engineer certain portions of our products or obtain and use information that we regard as proprietary. In addition, the laws of some foreign countries do not protect proprietary rights to the same extent as do the laws of the United States. There can be no assurance that our means of protecting our proprietary rights in the United States or abroad will be adequate or that competing companies will not independently develop similar technology.

Other parties may assert infringement claims against us. We may also be subject to legal proceedings and claims from time to time in the ordinary course of our business, including claims of alleged infringement of the trademarks and other intellectual property rights of third parties by ourselves and our licensees. Such claims, even if not meritorious, could result in the expenditure of significant financial and managerial resources.

We also continue to hold a perpetual mail server license which was utilized in our hosted service offering and is still being utilized by us to service a current customer, and may license other technology as the need arises. We cannot be certain that, apart from the mail server license, other third-party content licenses will be available to us on commercially

reasonable terms or that we will be able to successfully integrate the technology into our products. These third-party licenses may expose us to increased risks, including risks associated with the assimilation of new technology, the diversion of resources from the development of our own proprietary technology, and our inability to generate revenues from new technology sufficient to offset associated acquisition and maintenance costs. The inability to obtain any of these licenses could result in delays in product development until equivalent technology can be identified, licensed and integrated. Any such delays could cause our business/financial condition and operating results to suffer.

Government Regulation

While laws aimed at curtailing the spread of spam have been adopted by some states, enforcement has not been widespread and the lack of a body of federal anti-spam law has highlighted an increase in the amount of spam traffic. The growth and development of the spam market may prompt calls for more stringent Internet user protection laws that may limit the ability of companies promoting or delivering spam online. Moreover, the applicability to the Internet of existing laws in various jurisdictions governing issues such as property ownership, sales and other taxes, libel and personal privacy is uncertain and may take years to resolve. The adoption of additional laws or regulations, or the application of existing laws or regulations to the Internet, may impair the growth of the Internet or commercial online services. All or some of the above laws could decrease the demand for our anti-spam solutions and increase our cost of doing business, or otherwise harm our business and operating results.

Employees

As of December 31, 2002, 2001 and 2000, we had 22, 92 and 486 full-time employees, respectively. None of our U.S. employees are covered by a collective bargaining agreement. As of June 9, 2003, we had 32 employees. We believe that our relations with our employees are good.

Israeli law and certain provisions of the nationwide collective bargaining agreements between the Histadrut (General Federation of Labor in Israel) and the Coordinating Bureau of Economic Organizations (the Israeli federation of employers' organizations) apply to Commtouch's Israeli employees. These provisions principally concern the maximum length of the workday and workweek, minimum wages, contributions to a pension fund, insurance for work-related accidents, procedures for dismissing employees, determination of severance pay and other conditions of employment. Furthermore, pursuant to such provisions, the wages of most of Commtouch's Israeli employees are subject to cost of living adjustments, based on changes in the Israeli Consumer Price Index. The amounts and frequency of such adjustments are modified from time to time. Israeli law generally requires the payment of severance pay upon the retirement or death of an employee or upon termination of employment by the employer or, in certain circumstances, by the employee. We currently fund our ongoing severance obligations by making monthly payments for insurance policies and by an accrual. A general practice in Israel followed by Commtouch, although not legally required, is the contribution of funds on behalf of certain employees to an individual insurance policy known as "Managers' Insurance." This policy provides a combination of savings plan, insurance and severance pay benefits to the insured employee. It provides for payments to the employee upon retirement or death and secures a substantial portion of the severance pay, if any, to which the employee is legally entitled upon termination of employment. Each participating employee contributes an amount equal to 5% of such employee's base salary, and the employer contributes between 13.3% and 15.8% of the employee's base salary. Full-time employees who are not insured in this way are entitled to a savings account, to which each of the employee and the employer makes a monthly contribution of 5% of the employee's base salary. We also provide certain Israeli employees with an Education Fund, to which each participating employee contributes an amount equal to 2.5% of such employee's base salary, and the employer contributes an amount equal to 7.5% of the employee's base salary, up to a certain maximum base salary.

Description of Property

Our principal executive offices are located at 1A Hazoran Street, Poleg Industrial Park, P.O.Box 8511, Netanya 42504, Israel, where our telephone number is 011-972-9-863-6888, and 1300 Crittenden Lane, Suite 102, Mountain View, California 94043, where our telephone number is (650) 864-2000. All of our facilities are leased. We were incorporated in Israel under the laws of Israel on February 5, 1991. Our Articles of Association are on file in Israel with the office of the Israeli Registrar of Companies and available for public inspection from the Registrar.

Item 5. Operating and Financial Review and Prospects.

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The following discussion should be read in conjunction with the Consolidated Financial Statements and the Notes thereto included elsewhere in this report. This discussion contains forward-looking statements based upon current expectations that involve risks and uncertainties. Any statements contained herein that are not statements of historical fact may be deemed to be forward-looking statements. For example, the words "expects," "anticipates," "believes," "intends," "plans," "seeks" and "estimates" and similar expressions are intended to identify forward-looking statements. Commtouch's actual results and the timing of certain events may differ significantly from those projected in the forward-looking statements. Factors that might cause future results to differ materially from those projected in the forward-looking statements include, but are not limited to, those set forth under "Item 3. Key Information." and in the Company's other filings with the Securities and Exchange Commission.

Overview

During 2002, our main business was providing outsourced integrated Web-based email and messaging solutions to a few businesses that remained as customers following the transfer of our consumer outsource web-based email business and sale of our Hosted Exchange email business during late 2001 and early 2002 in transactions with MailCentro Inc. and Telecomputing, Inc. respectively. During early 2002, concurrent with the divestiture of the Company's above-stated businesses, the Company began marketing to service providers its messaging software platform ("CMP"), which had been in development by the Company prior to that time. Following a concerted effort to penetrate the email server market and a determination that the continuing unfavorable economic conditions would hamper potential sales of CMP, and given the Company's inherent knowledge of anti-spam solutions based on its many years as an ASP in the outsourced email market and the growing worldwide attention that has been directed to the problem of spam, the Company transitioned its focus to the anti-spam market in mid-2002. While no uniform definition of spam exists, the Company generally defines "spam" as the sending of unsolicited bulk email for commercial and non-commercial purposes.

In February 2002, the Company sold off its migration service business, Wingra, to Wingra's senior management. The operations of Wingra have been eliminated from the operations of the entity as a result of the disposal transaction. The Company has no intent to continue its activity in the migration service.

The results of operations including revenue, operating expenses and other income and expense of Wingra for 2000, 2001 and 2002 have been reclassified in the accompanying statements of operations as discontinued operations.

Critical Accounting Policies and Estimates

Operating and Financial Review and Prospects are based upon the Company's consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosure of contingent assets and liabilities. Management believes the critical accounting policies and areas that require the most significant judgments and estimates to be used in the preparation of the consolidated financial statements are revenue recognition and commitments and contingencies.

Revenue recognition

Revenue is recognized when the earnings process is complete, as evidenced by an agreement between the customer and the company, when delivery has occurred or services have been rendered, when the fee is fixed or determinable and when collection is probable. The company's revenue recognition policy is discussed in Note 2 of Notes to Consolidated Financial Statements. The recognition of revenue in conformity with accounting principles generally accepted in the United States requires the company to make estimates and assumptions that affect the reported amounts of revenue. Estimates related to the recognition of revenue include the accumulated provision for revenues subject to refund and other. As additional information becomes available, or actual amounts are determinable, the recorded estimates are revised. Consequently, current operating results can be affected by revisions to prior accounting estimates.

Allowance for Doubtful Accounts and promissory notes

We maintain allowances for doubtful accounts for estimated losses from our customers' inability to make payments they owe us and for estimated losses from our former employees inability to pay amounts guaranteed by promissory notes. In order to estimate the appropriate level of this allowance, we analyze historical bad debts, customer concentrations, current customer credit-worthiness, current economic trends and changes in our customer payment patterns. If the financial condition of our customers/employees were to deteriorate and to impair their ability to make payments to us, additional allowances might be required in future periods.

Impairment of long-lived assets

We assess the fair value and recoverability of our long-lived assets whenever events and circumstances indicate the carrying value of an asset may not be recoverable from estimated future cash flows expected to result from its use and eventual disposition. In doing so, we make assumptions and estimates regarding future cash flows and other factors to make our determination. The fair value of our long-lived assets is dependent upon the forecasted performance of our business, changes in our industry and the overall economic environment. When we determine that the carrying value of our long-lived assets and goodwill may not be recoverable, we measure any impairment based upon a forecasted discounted cash flow method. If these forecasts are not met, we may have to record additional impairment charges not previously recognized.

During 2002, we performed an assessment of the our property and equipment, pursuant to SFAS No. No.144 "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS No.144"). Pursuant to SFAS No. No.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. Assets to be disposed of by sale are reported at the lower of the carrying amount or fair value less costs to sell. For the year ended December 31, 2002 the Company recognized impairment losses totaling $ 0.8 million, which were recorded as operating expenses.

Contingencies

Commtouch periodically records the estimated impacts of various conditions, situations or circumstances involving uncertain outcomes. These events are called "contingencies", and Commtouch's accounting for such events is prescribed by Statement of Financial Accounting Standards No. 5, "Accounting for Contingencies" ("SFAS No. 5")

SFAS No. 5 defines a contingency as "an existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur."

SFAS No. 5 does not permit the accrual of gain contingencies under any circumstances. For loss contingencies, the loss must be accrued if (1) information is available that indicates it is probable that the loss has been incurred, given the likelihood of the uncertain future events; and (2) that the amount of the loss can be reasonably estimated.

The accrual of a contingency involves considerable judgment on the part of management. Commtouch uses its internal expertise, and outside experts (such as lawyers, tax specialists and engineers), as necessary, to help estimate the probability that a loss has been incurred and the amount (or range) of the loss. The Company has recorded contingencies in situations where management determined it was probable a loss had been incurred and the amount could be reasonably estimated.

Revenue Sources

Service Fees. During 2000 - 2002, most of our email service revenues resulted from contracts that required our customers to pay us a monthly per emailbox price subject to a minimum commitment fee and fees for direct marketing and communications services. In addition, the Company recognized revenue from sales of software licenses to end users. During that time, we recognized no revenues from our new anti-spam offering.

Direct E-marketing. During 2002, we did not recognize any revenues from this type of activity, as our business model had changed (see above discussion under "Overview"). Prior to 2002, because of our installed user base and our agreements with our customers, we could assist e-commerce companies (those seeking marketing channels) in distributing their services to our customers' end users who opted to receive offers by email. We shared with our customers the revenues from this direct e-marketing, which were earned either on a per-message basis, a referral basis, or as a commission on products sold. In 2001 and 2000, no direct e-marketing customer provided more then 10% of revenues.

Strategic Transaction with Go2Net (InfoSpace)

InfoSpace merged with Go2Net in October 2000. In connection with this merger InfoSpace assumed Go2Net shares, warrants and rights.

In 1999, concurrent with the sale of our shares in the initial public offering, we entered into a service agreement with InfoSpace, a network of branded, technology- and community-driven websites focused on personal finance, commerce, and games. InfoSpace also develops Web-related software. Pursuant to the agreement we were offering InfoSpace's end users a private label email service, including our email, calendaring and other services. The services were customized to the look and feel of InfoSpace's websites. The terms of this agreement were substantially the same as our commercial agreements with other customers except that we had agreed to share a materially greater portion of our advertising revenues with InfoSpace than we were sharing under other similar agreements. In addition, in connection with the agreement, we issued to InfoSpace a warrant to purchase 1,136,000 ordinary shares at a per share exercise price of $12.80, subject to adjustment as set forth in the warrant. The warrant is fully vested and non-forfeitable. The warrant will expire on July 16, 2004, the fifth anniversary of the initial public offering. The fair value of the warrant, estimated at $5.8 million, was amortized to operating expenses ratably over the minimum term of the agreement (one year) and was fully amortized at the end of 2000. Simultaneously with the sale of the shares in the initial public offering, we issued a total of 1,344,086 ordinary shares to InfoSpace and Vulcan Ventures Incorporated at $14.88 per share in a private placement. In the future, we may have to issue in-the-money warrants to acquire our ordinary shares to marketing channels or strategic partners who provide us with business leads. The issuance of in-the-money warrants to marketing channels or strategic partners may further dilute our shareholders, increase our operating loss in the future and cause our stock price to fall. The service agreement of 1999 was replaced by a new agreement, effective February 1, 2002 having a one year duration, but InfoSpace had the right to terminate the agreement at any time upon thirty (30) days written notice. InfoSpace also had the right to terminate the agreement if there were technical problems with the products or services provided. The performance specifications set forth in the agreement include the maintenance of certain levels of email system availability and response time. Infospace was to pay a quarterly fee of $7,500 for use of up to 10,000 mailboxes. This agreement was assigned to MailCentro, Inc., the party which assumed the servicing of

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most of our consumer business, effective March 1, 2002. As of March 1, 2003, Commtouch Inc. was no longer entitled to receive a portion of the revenues from this agreement.

Results of Operations

The following table sets forth financial data for the years ended December 31, 2000, 2001 and 2002 (in thousands):

	Year Ended Decem	
	2000*	2001*
Revenues:		
Email services	$ 17,771	$ 13,318
Software license revenues	1,000	270
Total revenues	18,771	13,588
Cost of revenues:		
Email services	11,800	13,962
Software license revenues	--	--
Total cost of revenues	11,800	13,962
Gross profit (loss)	6,971	(374
Operating expenses:		
Research and development, net	10,244	5,884
Sales and marketing	26,534	12,894
General and administrative	13,455	10,337
Amortization of prepaid marketing expenses	4,508	--
Amortization of stock-based employee deferred compensation	3,050	2,204
Write-off of property and equipment and other	--	10,166

Total operating expenses	57,791	41,485
Operating loss	(50,820)	(41,859
Interest and other income, net	2,886	583
Equity in losses of affiliate	--	--
Write-off impaired long-term investments	(5,000)	(2,000
Minority interest	55	285
Loss from continuing operations	(52,879)	(42,991
Gain on disposal of Wingra	--	--
Discontinued Operations - Wingra	(1,346)	(18,016
Income (Loss) from sale of discontinued operations	(1,346)	(18,016
Net loss	$ (54,225)	$ (61,007

* - Reclassified to conform to the current years classification mainly due to divestiture of Wingra.

Comparison of Years Ended December 31, 2002 and 2001

Revenues. Email service revenues decreased 74% from $13.3 million in 2001 to $3.4 million in 2002. We recognized revenue of $0.3 million, from the sale of licenses in 2001 and none in 2002. In 2002 we had two customers whose revenue exceeded 10%, representing 57% of the 2002 revenues. No customer accounted for more than 10% of revenues in 2001.

Cost of Revenues. Cost of revenues decreased 88% from $14.0 million in 2001 to $1.7 million in 2002.We have decreased our hosting infrastructure costs due to the agreement with MailCentro and sale of the Hosted Exchange business.

Research and Development, Net. Research and development expenses decreased 62% from $5.9 million in 2001to $2.2 million in 2002 due to the decrease in personnel and other related costs. In 2002 and 2001, we received royalty-bearing grants totaling $0.2 and $0.6 million, respectively, from the Israeli government, which were recorded as a reduction of research and development costs. The Israeli government requires beneficiaries of such grants to pay royalties to the Israeli government based on the revenues derived from the sale of products, technologies and services developed with such grants. We believe that we have no obligation for royalties in 2001, related to the 2001 grants, since we had not started generating revenue for the product developed with

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such grants, but we may have obligations for royalties in 2002 and future years. Moreover, we believe that we have no obligation for royalties in 2001 for the previous years' funded projects as these projects failed and we do not generate revenue or expect to generate revenue from these projects. Nevertheless, the ultimate liability is subject to review by the OCS.

During 2001, we reduced research and development personnel by eliminating certain projects, while only maintaining a core project aligned with our strategic direction.

Sales and Marketing. Sales and marketing expenses decreased 91% from $12.9 million in 2001 to $1.2 million in 2002, due to the agreement with MailCentro and sale of the Hosted Exchange business, as well as the change in business strategy.

General and Administrative. General and administrative expenses decreased 75%

from $10.3 million in 2001 to $2.6 million in 2002, due primarily to curtailment of costs.

Amortization of Stock-Based Employee Deferred Compensation. Our stock-based employee deferred compensation expenses decreased 75% from $2.2 million for 2001 to $0.6 million for 2002. The deferred compensation is being amortized using the sum-of-digits method over the vesting schedule, generally four years. Amortization of these amounts will conclude during the third quarter of 2003. Deferred compensation expenses also included $0.2 million and $0.3 million in 2002 and 2001, respectively, relating to the repricing of stock options during 2001. The total amortization charge of $1.0 million related to the repricing will be amortized using the straight-line method over a three year vesting schedule.

Write-off of Impaired Intangibles and Other Assets. Impairment and other charges consist of costs and/or charges that are not directly associated with other expense classification or ongoing operations. The Company periodically assesses the recoverability of the carrying amount of intangible assets, property and equipment and provides for any possible impairment loss based upon the difference between the carrying amount and fair value of such assets. In 2002, the company had written off $0.8 million regarding unused property and equipment. In 2001, impairment and other charges of $23.4 million included a $13.3 million impairment of goodwill and other intangibles related to our acquisition of Wingra, Inc., $4.4 million impairment of leasehold improvements at unused leased facilities, $3.6 million impairment of computer hardware which is idle and not being used, an accrual of $1.0 million for costs related to early termination of these unused facilities and a $1.1 million write-off of a customer relationship module (a software tool for managing customer relations), which portion will no longer be utilized. The impairment charges of the goodwill and other intangible assets were classified to discontinued operation due to the divestiture of Wingra.

Interest and Other Income, Net. Our interest and other income, net, decreased from a net income of $.6 million for 2001 to a net loss of $0.1 million for 2002, due primarily to decreased interest income earned from cash equivalents, as the funds depleted in 2002.

Write-Off of Impaired Long-term Investments. The Company invested $7 million in the first nine months of 2000 in certain Internet centric companies in which the company believed it had a significant ongoing strategic interest. However, due to the economic slowdown and the significant decline in capital available to and valuations of these privately funded Internet centric companies, the Company believes that these investments are fully impaired. Accordingly, the Company recorded a charge of $2.0 million in 2001 to reflect impairment of these assets.

Minority Interest. At December 31, 2001 and 2002, the Company owned 70.6% and 32%, respectively, of the equity and voting rights of Commtouch, K.K. (Japan).

Income Taxes. As of December 31, 2002, we had approximately $28.0 million of Israeli net operating loss carry-forwards and $73.6 million of U.S. federal net operating loss carry-forwards available to offset future taxable income. The Israeli net operating loss carry-forwards have no expiration date. The U.S. net operating loss carry-forwards will expire in various amounts in the years 2008 to 2022. Utilization of U.S. net operating losses may be subject to the substantial annual limitation due to the "change in ownership" provisions of the Internal Revenue Code of 1986 and similar state provisions. The annual limitation may result in the expiration of net operating losses before utilization.

Comparison of Years Ended December 31, 2001 and 2000 -

Revenues. Email service revenues decreased 25% from $17.8 million in 2000 to $13.3 million in 2001. We recognized revenue of $0.3 million and $1.0 million, from the sale of licenses in 2001 and 2000, respectively. In 2001 and 2000, no customer accounted for more than 10% of revenues.

Cost of Revenues. Cost of revenues increased 18% from $11.8 million in 2000 to $14.0 million in 2001, due to the increase in depreciation costs as we ramped up during 2000. Cost of revenues consisted primarily of costs related to Internet data center services from third-party providers, depreciation of equipment, Internet access, personnel and related costs. In 2000 we sized our hosting infrastructure for substantial growth.

Research and Development, Net. Research and development expenses decreased 43% from $10.2 million in 2000 to $5.9 million in 2001 due to the decrease in personnel and other related costs. In 2001, we received royalty-bearing grants totaling $0.6 million from the Israeli government, which were recorded as a reduction of research and development costs. The Israeli government requires beneficiaries of such grants to pay royalties to the Israeli government based on the revenues derived from the sale of products, technologies and services developed with such grants. We believe that we have no obligation for royalties in 2001, related to the 2001 grants, since we had not started generating revenue for the product developed with such grants, but we may have obligations for royalties in 2002 and future years. Moreover, we believe that we have no obligation for royalties in 2001 for the previous years' funded projects as these projects failed and we do not generate revenue or expect to generate revenue from these projects. Nevertheless, the ultimate liability is subject to review by the OCS.

During 2001, we reduced research and development personnel by eliminating certain projects, while only maintaining a core project aligned with our strategic direction.

Sales and Marketing. Sales and marketing expenses decreased 51% from $26.5 million in 2000 to $12.9 million in 2001, due to decreased personnel and related costs, public relations, other marketing expenses and direct sales costs in line with reduced expected revenue levels and the Company's channel selling and marketing focus in 2001. Previously, Company personnel were focused on direct sales efforts.

General and Administrative. General and administrative expenses decreased 24% from $13.5 million in 2000 to $10.3 million in 2001, due primarily to curtailment of costs.

Amortization of Prepaid Marketing Expenses. Our amortization of prepaid marketing expenses related to the InfoSpace and Microsoft warrants decreased from $4.5 million in 2000 to zero in 2001, since it was fully amortized at the end of 2000. The prepaid marketing expense was amortized using the straight-line method over the one-year minimum term of each of the commercial agreements.

Amortization of Stock-Based Employee Deferred Compensation. Our stock-based employee deferred compensation expenses decreased 28% from $3.1 million for 2000 to $2.2 million for 2001. The deferred compensation is being amortized using the sum-of-digits method over the vesting schedule, generally four years. Amortization of these amounts will conclude during the third quarter of 2003. Deferred compensation expenses also included $0.3 million related to the repricing of stock options during 2001. The total amortization charge of $1.0 million related to the repricing will be amortized using the straight-line method over a three year vesting schedule.

Write-off of Impaired Intangibles and Other Assets. Impairment and other charges consist of costs and/or charges that are not directly associated with other expense classification or ongoing operations. The Company periodically assesses the recoverability of the carrying amount of intangible assets, property and equipment and provides for any possible impairment loss based upon the difference between the carrying amount and fair value of such assets. During 2001, impairment and other charges of $23.4 million included a $13.3 million impairment of goodwill and other intangibles related to our acquisition of Wingra, Inc., $4.4 million impairment of leasehold improvements at unused leased facilities, $3.6 million impairment of computer hardware which is idle and not being used, an accrual of $1.0 million for costs related to early termination of these unused facilities and a $1.1 million write-off of a customer relationship module (a software tool for managing customer relations), which portion will no longer be utilized.

Interest and Other Income, Net. Our interest and other income, net, decreased from a net income of $2.9 million for 2000 to a net income of $0.6 million for 2001, due primarily to decreased interest income earned from cash equivalents and marketable securities, as the funds depleted in 2001.

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Write-Off of Impaired Long-term Investments. The Company invested $7 million in the first nine months of 2000 in certain Internet centric companies in which the company believed it had a significant ongoing strategic interest. However, due to the economic slowdown and the significant decline in capital available to and in valuations of these privately funded Internet centric companies, the Company believes that these investments are fully impaired. Accordingly, the Company recorded a charge of $5 million and $2.0 million, in 2000 and 2001, respectively, to reflect impairment of these assets.

Minority Interest. Minority interest represents a stockholders' proportionate share of the equity of Commtouch, K.K. (Japan) or 5.83%. At December 31, 2000 and 2001, the Company owned 94.17% and 70.6%, respectively, of the equity and voting rights of Commtouch, K.K. (Japan).

Income Taxes. As of December 31, 2001, we had approximately $22.6 million of Israeli net operating loss carry-forwards and $67.6 million of U.S. federal net operating loss carry-forwards available to offset future taxable income. The U.S. net operating loss carry-forwards will expire in various amounts in the years 2008 to 2022. The Israeli net operating loss carry-forwards have no expiration date. Utilization of U.S. net operating losses may be subject to the substantial annual limitation due to the "change in ownership" provisions of the Internal Revenue Code of 1986 and similar state provisions. The annual limitation may result in the expiration of net operating losses before utilization.

Quarterly Results of Operations (Unaudited)

The following table sets forth certain unaudited quarterly statements of operations data for the eight quarters ended December 31, 2002. This information has been derived from the Company's consolidated unaudited financial statements, which, in management's opinion, have been prepared on the same basis as the audited consolidated financial statements, and include all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of the information for the quarters presented. This information should be read in conjunction with our audited consolidated financial statements and the notes thereto included elsewhere in this report. The operating results for any quarter are not necessarily indicative of the operating results for any future period.

Three Months Ended

	Mar. 31, 2001*	Jun. 30, 2001*	Sept. 30, 2001*	Dec. 31, 2001*	Mar. 31, 2002	Jun. 3 2002
				(in thousands) (unaudited)		
Email service revenues	$ 3,658	$ 3,838	$ 3,495	$ 2,597	$ 1,271	$ 1,00
Cost of email service revenues	4,656	3,573	3,553	2,180	933	40
Gross profit (loss)	(998)	265	(58)	417	338	59
Operating expenses:						
Research and development, net	2,587	2,166	1,078	53	573	53
Sales and marketing	6,346	2,683	2,447	1,418	521	24
General and administrative	5,504	2,639	1,958	236	766	42
Amortization of stock-based employee compensation	481	481	694	548	138	13
Write-off of property and equipment and other	--	--	6,485	3,681	--	--
Total operating expenses	14,918	7,969	12,662	5,936	1,998	1,33
Operating loss	(15,916)	(7,704)	(12,720)	(5,519)	(1,660)	(73
Interest and other income (expenses), net	344	492	89	(342)	44	(2
Write-off of impaired long-term investments	--	--	(2,000)	--	--	--
Eequity interesting losses of affiliate..........................	--	--	--	--	--	1
Minority interest	22	21	137	105	63	1
Loss from continuing operations	(15,550)	(7,191)	(14,494)	(5,756)	(1,553)	(72
Gain on disposal of Wingra	--	--	--	--	1,014	--
Discontinued operations - Wingra ...	(1,581)	(1,335)	(13,352)	(1,748)	(335)	--
Income (Loss) from sale of discontinued operations	(672)	(444)	(385)	(441)	679	--
Net loss	$(17,131)	$ (8,526)	$(27,846)	$(7,504)	$ (874)	$ (72

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* - Reclassified to conform to the current quarters classification mainly due to divestiture of Wingra.

Fluctuations in Quarterly Results

We have incurred operating losses since inception, and we cannot be certain that we will achieve profitability on a quarterly or annual basis in the future. Our results of operations have fluctuated and are likely to continue to fluctuate significantly from quarter to quarter as a result of a variety of factors, many of which are outside of our control. A relatively large expense in a quarter could have a negative effect on our financial performance in that quarter. Additionally, as a strategic response to a changing competitive environment, we may elect from time to time to make certain pricing, service, marketing or acquisition decisions that could have a negative effect on our quarterly financial performance. Other factors that may cause our future operating results to fluctuate include, but are not limited to:

- continued growth of the Internet, email usage and the spread of spam email;

- demand for anti-spam solutions;
- our ability to attract and retain customers and maintain customer satisfaction;
- our ability to upgrade, develop and maintain our systems and infrastructure;
- the amount and timing of operating costs and capital expenditures relating to expansion of our business and infrastructure;
- the size, timing and fulfillment of orders for our anti-spam solutions;
- the receipt or payment of irregular or nonrecurring revenues or expenses;
- technical difficulties or system outages;
- foreign exchange rate fluctuations;
- the announcement or introduction of new or enhanced solutions by our competitors;
- our ability to attract and retain qualified personnel with Internet industry expertise, particularly sales and marketing personnel;
- the pricing policies of our competitors;
- failure to increase our sales; and
- governmental regulation relating to the Internet, and spam practices in particular.

In addition to the factors set forth above, our operating results will be impacted by the extent to which we incur non-cash charges associated with stock-based arrangements with employees and non-employees.

Liquidity and Capital Resources

We have financed our operations principally from the issuance of equity securities and, to a lesser extent from private loans, bank loans and research and development grants from the Israeli government.

As of December 31, 2002 and March 31, 2003 respectively, we had approximately $1.4million and approximately $1.1 million of cash to fund operations in 2003. In 2002 we utilized $2.8 million of cash to fund operating losses. Net cash