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.

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.

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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

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:

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

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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.

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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;

- 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

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

* - 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:

- o 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

provided by financing activities and investing activities were approximately $1.3 million and $ 0.6 million, respectively, mainly due to proceeds from issuance of shares and proceeds from sale of property and equipment, respectively. To limit our cash expenses in 2003 we have further reduced staff from 35 at March 1, 2002 to 32 on June 9, 2003. These actions were possible due to the transition of our business from outsourced email services to anti-spam solutions. Furthermore, we have reduced our office lease commitments both in Israel and the United States, resulting in both a lowering of actual rental expenditures and future obligations.

Convertible Loan

See discussion under "Item 3. Key Information - Recent Developments - Convertible Loan Agreement.

As of December 31, 2002 and March 31, 2003, we had working capital of $0.5 million and $0.1 million, respectively.

Based on the cash balance at December 31, 2002, current projections of revenues, related expenses, and the completion of the convertible loan transaction, the Company believes it has sufficient cash to continue operations for at least the next twelve months through December 31, 2003.

Class Action Litigation

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 plaintiff's 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.

Effective Corporate Tax Rates

Our tax rate will reflect a mix of the U.S. statutory tax rate on our U.S. income and the Israeli tax rate discussed below. We expect that most of our taxable income will be generated in Israel. Israeli companies are generally subject to corporate tax at the rate of 36% of taxable income. A part of our income, however, is derived from the Company's capital investment program with Approved Enterprise status under the Law for the Encouragement of Capital Investments in three separate plans, and is therefore eligible for certain tax benefits. Pursuant to these benefits, we will enjoy a tax exemption on income derived during the first two years in which such investment plans produce taxable income (provided that we do not distribute such income as a dividend) and a reduced tax rate of 10% to 25% for an additional period of five to eight years depending on the level of foreign investment in Commtouch. All of these tax benefits are subject to various conditions and restrictions. There can be no assurance that we will obtain approval for additional Approved Enterprise programs, or that the provisions of the law will not change. Moreover, notwithstanding these tax benefits, to the extent we receive income from countries other than Israel, such income may be subject to withholding tax. Since we have incurred tax losses in every year through 2001, we have not yet used the tax benefits for which we are eligible.

See item 10 for tax reform

Impact of Inflation and Currency Fluctuations

Most of our sales are in U.S. dollars. However, a portion of our costs relates to our operations in Israel. A substantial portion of our operating expenses in Israel, primarily our research and development expenses, is denominated in NIS. Costs not denominated in U.S. dollars are translated to U.S. dollars, when recorded, at prevailing rates of exchange. This is done for the purposes of our financial statements and reporting. Costs not denominated in U.S. dollars will increase if the rate of inflation in Israel exceeds the devaluation of the Israeli currency as compared to the U.S. dollar or if the timing of such devaluation lags considerably behind inflation. Consequently, we are and will be affected by changes in the prevailing NIS/U.S. dollar exchange rate.

The annual rate of inflation in Israel was 6.5% in 2002, 1.4% in 2001 and 0% in 2000. The NIS was devalued against the U.S. dollar by approximately 7.3% in 2002, 9.3% in 2001 and -2.7% in 2000. The representative dollar exchange rate for converting the NIS to U.S. dollars, as reported by the Bank of Israel, was NIS 4.737 for one U.S. dollar on December 31, 2002. Note that the representative dollar exchange rate was NIS _4.474 at May 14, 2003.

Because exchange rates between the NIS and the dollar fluctuate continuously, exchange rate fluctuations and especially larger periodic devaluations will have an impact on our profitability and period-to-period comparisons of our results. The effects of foreign currency re-measurements are reported in the consolidated financial statements for relevant periods in the statement of operations.

Item 6. Directors, Senior Management and Employees

The following table sets forth certain information regarding our directors at February 7, 2003:

Name	Age	Beneficial Ownership >1%(3)	Position
Amir Lev....................	43	3.3%	Director
Carolyn Chin................	55	1.2%	Chairman of the Board of Directors
Gideon Mantel(1)............	43	7.9%	Director
Nahum Sharfman(1)...........	55	6.1%	Director
Richard Sorkin..............	41	--	Director
Udi Netzer (2)..............	47	--	Director
Ofer Segev(1)(2)............	43	--	Director

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(1) Member of the Compensation Committee

(2) Member of the Audit Committee and Outside Director

(3) For purposes of this table, a person or group of persons is deemed to have beneficial ownership of shares of the Company's common stock which such person or group has the right to acquire on or within 60 days after February 7, 2003. Unless otherwise indicated, to the Company's knowledge the person named has sole voting and investment power and the right to receive the economic benefits, or share such power and rights with such person's spouse, with respect to all shares held by that person. Warrants and options that were underwater as of February 7, 2003 were included in the calculation of beneficial ownership.

Other Management Employees:

The following table sets forth the names and positions of our management employees at February 7, 2003:

Name	Age	Ownership >1%	Position
Gideon Mantel	43	See table above	CEO
Amir Lev	43	See table above	President and Chief Tech
Devyani Patel......	42	___	Vice President, Finance
Avner Amram........	41	___	Executive Vice President
Gary Davis.........	41	___	General Counsel and Corp
Udi Trugman........	32	___	Vice President, Research
		___	Software Ltd.
Ronni Zehavi.......	37	___	Vice President, Operatio
Haggai Carmon......	44	___	Vice President, Marketin

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Amir Lev is a co-founder of Commtouch and has served as its Chief Technology Officer and as a Director since its inception in 1991. Mr. Lev was also the General Manager of Commtouch from January 1997 through April 2000, and in May 2000 became President. Mr. Lev received a B.A. in Computer Science and Economics from Hebrew University, Jerusalem.

Carolyn Chin has served as the Chairman of the Board of Directors since May 2001. Ms. Chin has served as a Director of Commtouch since August 2000. Ms. Chin has 30 years of experience in information technology, marketing, media, telecommunications, retailing, health care, education and small business market segments. She has held a number of senior executive positions including at: Reuters, Market XT, IBM, Citibank, AT&T, Macy's and in the US Government. She has served on over 30 boards and committees. Ms. Chin has also received numerous honors including selection as a White House Fellow and the Committee of 100 (prominent Chinese-Americans). She graduated with an MBA from the Harvard Business School and a BS in Management Engineering from Rensselaer Polytechnic Institute.

Gideon Mantel is a co-founder of Commtouch and served as its Chief Financial Officer from its inception in February 1991 until October 1995, when he became Commtouch's Chief Operating Officer. In November 1997, he became Commtouch's Chief Executive Officer. He has also served as a director of Commtouch since inception. Mr. Mantel received a B.A. in Political Science and an M.B.A from Tel Aviv University.

Nahum Sharfman rejoined the Board in March 2000. Mr. Sharfman is a co-founder of Commtouch and served as its Chief Executive Officer and Chairman of the Board from its inception in February 1991. In November 1997 Mr. Sharfman resigned as Chief Executive Officer to become a founder of Dealtime.com. Mr. Sharfman remained Chairman of the Board of Commtouch and a Director until January 1999. Prior to founding Commtouch, Mr. Sharfman spent eleven years with National Semiconductor Corporation in various development and management roles. Mr. Sharfman received a Ph.D. in High Energy Nuclear Physics from Carnegie Mellon University and M.S. and B.S. degrees in Physics from the Technion- Israel Institute of Technology, Haifa.

Richard Sorkin has served as a Director of Commtouch since July 1999. Since June 1998 Mr. Sorkin has served as an advisor to several early-stage Internet companies and is a director of several private companies. From June 1998 to April 1999 he was the Chairman of the Board of Directors of ZIP2, an Internet media company which was sold to Compaq. From May 1996 to June 1998, he was Chief Executive Officer of ZIP2 and from May 1993 to March 1996 he held various executive positions with Creative Technology, Ltd., a leading provider of

multi-media hardware. Mr. Sorkin received a B.A. with honors in Economics from Yale University and an M.B.A. from Stanford University.

Udi Netzer has served as a Director of Commtouch since February 2002. Mr. Netzer is also currently the active Chairman of Eyeblaster, Inc., a rich media ad management system that allows publishers, agencies and advertisers to independently create and manage out-of-banner advertising campaigns. Mr. Netzer has over 15 years' experience in various sales, marketing and executive positions with companies such as 3Com, Netmanage, and VCON. As a partner in Evergreen, Mr. Netzer was one of the first venture capitalists in Israel.

Ofer Segev has served as a Director of Commtouch since February 2002. Mr. Segev has been CEO of Teleknowledge since January 2002 and its CFO from May 2001. From May 2000 to April 2001 served as CFO for Tundo. Prior to his position at Tundo, Segev spent 15 years with Ernst & Young. Segev has a BA in economics and accounting from Bar Ilan University in Israel, and has studied at the Kellogg Graduate School of Management at Northwestern University.

Avner Amram joined Commtouch in 1996 and currently serves as Executive Vice President. Mr. Amram has over 15 years of experience in the areas of technology, operational management and leadership, and is also a founder of CVDO. Before 2002, Mr. Amram served as COO of Commtouch and was responsible for worldwide operations. Mr. Amram also held a number of positions at Commtouch prior to being appointed COO. From 1995 to 1996, Mr. Amram served

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as project manager for Medatech, a leading provider of customer relationship management (CRM) solutions, developing and managing complex installations at large organizations. Prior to Medatech, Mr. Amram acted as General Manager of Fuga Nursery in Israel, where he was responsible for operations, production, marketing and distribution. Mr. Amram holds a Bachelors of Science (BSC), in Computer Engineering and graduated Cum Laude from the Technion, Israel Institute of Technology.

Devyani Patel joined Commtouch in 1996 as a consultant and became a full-time employee in early 1999. She served as Corporate Controller for Commtouch until November 2001 when she was appointed as the Vice President of Finance. Ms. Patel has nearly 20 years of accounting and finance experience, including technology industry experience. Ms. Patel graduated from the University of Kent, Canterbury, England in Accounting and Law.

Gary Davis joined Commtouch in September 1999 and serves as General Counsel and Corporate Secretary. Mr. Davis has over 17 years of legal experience in both private law firm and corporate practices. Mr. Davis is certified to practice law in both the State of Israel and California. Prior to September 1999, Mr. Davis was in-house counsel to Israel Military Industries and Elta Electronics Industries. He received a B.A. in Political Economy of Industrial Societies from U.C. Berkeley and a J.D. in law from Golden Gate University.

Udi Trugman joined Commtouch in December 1996 and serves as Vice President of Research and Development. Prior to 2002, Mr. Trugman was Senior Director of Systems in the R&D group. Mr. Trugman has over 15 years of software development and management experience. Prior to working at Commtouch, Mr. Trugman specialized in development of commercial applications.

Ronni Zehavi joined Commtouch in June 1999 and serves as Vice President of Operations. Prior to joining Commtouch, Mr. Zehavi was Human Resources and Training Manager for "Mondex - ecach", a subsidiary company of International Mastercard from 1997 to 1999. From 1994 to 1997, Mr. Zehavi was an Organizational Consultant in a counseling firm. Mr. Zehavi received his M.A. degree in Organizational Sociology from Bar-Ilan University and his B.A. degree

in History and Educational Psychology from Tel-Aviv University.

Haggai Carmon joined Commtouch in January 2002 and serves as Vice President of Marketing. From 1998 to 2002, Mr. Carmon was Vice President of Corporate Marketing and of Sales in Asia-Pacific for VCON Telecommunications, a public vendor of corporate videoconferencing solutions, and was also responsible for international pre-sales and technical support. Prior to that, Mr. Carmon was at NetManage Ltd., a public software company of TCP/IP applications for Windows, a founder and CEO of Applico, a Computer-aided Design for Architecture service firm and managed a college of Fine Arts. Mr. Carmon has over 15 years of experience in technology and international management.

Election of Directors

Directors (other than outside directors, as explained below) are elected by shareholders at the annual general meeting of the shareholders and hold office until the next annual general meeting following the general meeting at which such Director is elected and until his successor is elected, or until he is removed. An annual general meeting must be held at least once in every calendar year, but not more than fifteen months after the preceding annual general meeting. Directors may be removed and other directors may be elected in their place or to fill vacancies in the Board of Directors at any time by the holders of a majority of the voting power at a general meeting of the shareholders. Until a vacancy is filled by the shareholders, the Board of Directors may appoint new directors temporarily to fill vacancies on the Board of Directors. The Articles of Association of Commtouch authorize the shareholders to determine, from time to time, the number of directors. The number was most recently fixed at nine directors. There are no family relationships among any of the directors, officers or key employees of Commtouch.

Alternate Directors

The Articles of Association of Commtouch provide that any director may appoint another person to serve as an alternate director and may remove such alternate. Any alternate director possesses all the rights and obligations of the director who appointed him, except that the alternate has no standing at any meeting while the appointing director is present, the alternate may not in turn appoint an alternate for himself (unless the instrument appointing him otherwise expressly provides) and the alternate is not entitled to remuneration. A person who is not qualified to be appointed as a director, or a person who already serves as a director or an alternate director, may not be appointed as an alternate director. Unless the appointing director limits the time or scope of the appointment, the appointment is effective for all purposes until the

appointing director ceases to be a director or terminates the appointment. The appointment of an alternate director does not in itself diminish the responsibility of the appointing director as a director.

Independent and Outside Directors

The Israel Companies Law requires Israeli companies with shares that have been offered to the public in or outside of Israel to appoint at least two outside directors. No person may be appointed as an outside director if the person or the person's relative, partner, employer or any entity under the person's control has or had, on or within the two years preceding the date of the person's appointment to serve as outside director, any affiliation with the company or any entity controlling, controlled by or under common control with the company. The term affiliation includes:

- an employment relationship;

- a business or professional relationship maintained on a regular basis;
- control; and
- service as an office holder.

No person may serve as an outside director if the person's position or other business activities create, or may create, a conflict of interest with the person's responsibilities as an outside director or may otherwise interfere with the person's ability to serve as an outside director. If, at the time outside directors are to be appointed, all current members of the Board of Directors are of the same gender, then at least one outside director must be of the other gender.

Outside directors are to be elected by a majority vote at a shareholders' meeting, provided that either:

- such majority includes at least one-third of the shares held by non-controlling shareholders who are present and voting at the meeting; or
- the total number of shares held by non-controlling shareholders voting against the election of the director at the meeting does not exceed one percent of the aggregate voting rights in the company.

The initial term of an outside director is three years and may be extended for an additional three years. Outside directors may be removed only by the same percentage of shareholders as is required for their election, or by a court, and then only if the outside director ceases to meet the statutory qualifications for their appointment or if they violate their fiduciary duty to the company. Each committee of a company's Board of Directors must include at least one outside director and the audit committee must include both outside directors. An outside director is entitled to compensation as provided in the regulations adopted under the Companies Law and is otherwise prohibited from receiving any other compensation, directly or indirectly, in connection with service provided as an outside director.

In addition, the Nasdaq National Market requires Commtouch to have at least two independent directors on the Board of Directors and to establish an audit committee, at least a majority of whose members are independent of management. We have appointed directors who qualify both as independent directors under the Nasdaq National Market requirements and as outside directors under the Companies Law.

Audit Committee

The Companies Law requires public companies to appoint an audit committee. The responsibilities of the audit committee include identifying irregularities in the management of the company's business and approving related party transactions as required by law. An audit committee must consist of at least three directors, including all of the outside directors. The chairman of the Board of Directors, any director employed by or otherwise providing services to the company, and a controlling shareholder or any relative of a controlling shareholder, may not be a member of the audit committee.

Internal Auditor

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Under the Companies Law, the Board of Directors must appoint an internal auditor, nominated by the audit committee. The role of the internal auditor is to examine, among other matters, whether the company's actions comply with the

law and orderly business procedure. Under the Companies Law, the internal auditor may be an employee of the company but not an interested party or office holder, or a relative of an interested party or office holder, and he or she may not be the company's independent accountant or its representative. The Company appointed a qualified internal auditor during 2002.

Approval of Certain Transactions; Obligations of Directors, Officers and Shareholders

The Israel Companies Law codifies the fiduciary duties that office holders, including directors and executive officers, owe to a company. An office holder's fiduciary duties consist of a duty of care and a duty of loyalty. The duty of loyalty includes avoiding any conflict of interest between the office holder's position in the company and such person's personal affairs, avoiding any competition with the company, avoiding exploiting any corporate opportunity of the company in order to receive personal advantage for such person or others, and revealing to the company any information or documents relating to the company's affairs which the office holder has received due to his or her position as an office holder. Each person listed in the first table that appears above at the beginning of this Item 6 is an office holder.

Under the Israel Companies Law, all arrangements as to compensation of office holders who are not directors require approval of the Board of Directors unless the Articles of Association provide otherwise. Arrangements regarding the compensation of directors also require audit committee and shareholder approval. The Israel Companies Law requires that an office holder promptly disclose any personal interest that he or she may have and all related material information known to him or her, in connection with any existing or proposed transaction by the company. In addition, if the transaction is an extraordinary transaction, the office holder must also disclose any personal interest held by the office holder's spouse, siblings, parents, grandparents, descendants, spouse's descendants and the spouses of any of the foregoing, or by any corporation in which the office holder is a five percent or greater shareholder, director or general manager or in which he or she has the right to appoint at least one director or the general manager. An extraordinary transaction is defined as a transaction not in the ordinary course of business, a transaction that is not on market terms, or a transaction that is likely to have a material impact on the company's profitability, assets or liabilities.

In the case of a transaction that is not an extraordinary transaction, after the office holder complies with the above disclosure requirement, only Board approval is required unless the Articles of Association of the company provide otherwise. Such approval must determine that the transaction is not adverse to the company's interest. If the transaction is an extraordinary transaction, then in addition to any approval required by the Articles of Association, it also must be approved by the audit committee and by the Board and, under specified circumstances, by a meeting of the shareholders. An Israeli company whose shares are publicly traded shall not be entitled to approve such a transaction unless, at the time the approval was granted, two members of the audit committee were outside directors and at least one of them was present at the meeting at which the audit committee decided to grant the approval. An office holder who has a personal interest in a matter that is considered at a meeting of the Board of Directors or the audit committee generally may not be present at this meeting or vote on this matter.

The Israel Companies Law applies the same disclosure requirements to a controlling shareholder of a public company, which includes a shareholder that holds 25% or more of the voting rights if no other shareholder owns more than 50% of the voting rights in the company. Extraordinary transactions with a controlling shareholder or in which a controlling shareholder has a personal interest, and the terms of compensation of a controlling shareholder who is an office holder, require the approval of the audit committee, the Board of

Directors and the shareholders of the company. The shareholder approval must either include at least one-third of the disinterested shareholders who are present, in person or by proxy, at the meeting or, alternatively, the total shareholdings of the disinterested shareholders who vote against the transaction must not represent more than one percent of the voting rights in the company.

Under the Israel Companies Law, a shareholder has a duty to act in good faith towards the company and other shareholders and refrain from abusing his or her power in the company, including, among other things, in respect to his or her voting at the general meeting of shareholders on the following matters:

- any amendment to the Articles of Association;
- an increase of the company's authorized share capital;
- a merger; or

- approval of interested party transactions that require shareholder approval.

In addition, any controlling shareholder, any shareholder who can determine the outcome of a shareholder vote and any shareholder who, under the company's Articles of Association, can appoint or prevent the appointment of an office holder, is under a duty to act with fairness towards the company. The Israel Companies Law does not describe the substance of this duty.

Compensation Committee Interlocks

The Compensation Committee, which was established by the Board in January 1996, is responsible for determining salaries, incentives and other forms of compensation for Commtouch's directors, officers and other employees and for administering various incentive compensation and benefit plans. The Compensation Committee consists of the Chief Executive Officer and two other Directors. Ofer Segev, as an outside director, and Nahum Sharfman are currently the two other directors on the Compensation Committee.

Indemnification of Directors and Officers; Limitations on Liability

Israeli law permits a company to insure an office holder in respect of liabilities incurred by him or her as a result of the breach of his or her duty of care to the company or to another person, or as a result of the breach of his or her fiduciary duty to the company, to the extent that he or she acted in good faith and had reasonable cause to believe that the act would not prejudice the company. A company can also insure an office holder for monetary liabilities as a result of an act or omission that he or she committed in connection with his or her serving as an office holder. Moreover, a company can indemnify an office holder for (a) monetary liability imposed upon him or her in favor of other persons pursuant to a court judgment, including a compromise judgment or an arbitrator's decision approved by a court, and (b) reasonable litigation expenses, including attorneys' fees, actually incurred by him or her or imposed upon him or her by a court, in an action, suit or proceeding brought against him or her by or on behalf of the company or other persons, or in connection with a criminal action which does not require criminal intent in which he or she was convicted, in each case in connection with his or her activities as an office holder. Our Articles of Association allow us to insure and indemnify office holders to the fullest extent permitted by law provided such insurance or indemnification is approved in accordance with the Israel Companies Law. The Company has acquired directors' and officers' liability insurance covering the officers and directors of the Company and its subsidiaries for certain claims. In addition, the Company entered into an undertaking to indemnify the directors

of the Company in connection with the shareholder-instigated class action lawsuit, subject to certain limitations, and this undertaking was ratified by shareholders. Further, at the annual meeting of shareholders held on November 18, 2002, the shareholders approved a form of indemnification, exculpation and insurance agreement that is applicable to all directors serving the Company.

Compensation of Directors and Officers.

The directors of Commtouch can be remunerated by Commtouch for their services as directors to the extent such remuneration is approved by Commtouch's audit committee, Board of Directors and shareholders. Directors currently do not receive cash compensation for their services as directors but are reimbursed for their expenses for each Board of Directors meeting attended. However, see "Nonemployee Directors Stock Option Plan," below.

The aggregate direct remuneration paid by Commtouch to all directors and executive officers (7 persons) in 2002 was approximately $0.5million. During the same period Commtouch accrued or set aside approximately $23,000 for the same group to provide pension, retirement or similar benefits. As of December 31, 2002, directors and executive officers of Commtouch (7 persons) held stock options to purchase an aggregate of 2,217,580 ordinary shares. In addition, at a meeting of the Board of Directors on April 28, 2003 option grant allocations totaling 975,000 options to certain executive officers, approved previously by the shareholders on November 18, 2002, were approved for grant, subject to the attainment of certain milestones. The grant date will be as of the date of shareholder approval.

Options to Purchase Securities from Registrant or Subsidiaries.

As of December 31, 2002, 4,597,687 stock options to purchase ordinary shares had been granted to employees, consultants, executive officers and non-employee directors under the Company's stock option plans, net of cancelled options. Of that number 4,041,474 had not been exercised and had exercise prices ranging from $0.01 to $35 per share and a weighted average per share exercise price of $0.18, and were held by 24 persons; these options have termination

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dates ranging from February 2006 to December 2012. At December 31, 2002, the persons named in Item 6 as a group (7 persons - executive officers and directors only) held vested options to acquire 1,144,189 ordinary shares. Reference is also made to the information contained in Item 7 below.

Employees

See Item 4: Employees

Item 7. Major Shareholders and Related Party Transactions.

The following table presents information with respect to beneficial ownership of our ordinary shares as of December 31, 2002, including:

- each person or entity known to Commtouch to own beneficially more than five percent of Commtouch's ordinary shares, and

- all executive officers and directors as a group.

Beneficial ownership is determined in accordance with the rules of the Securities and Exchange Commission and includes voting or investment power, or the right to receive the economic benefits of ownership, with respect to shares. To our knowledge, except under applicable community property laws or as otherwise indicated, the persons named in the table have sole voting and sole

investment control and rights to receive economic benefits with respect to all shares beneficially owned. The applicable percentage of ownership for each shareholder is based on 22,219,696ordinary shares outstanding as of December 31, 2002. Ordinary shares issuable upon exercise of options and other rights held and exercisable on or within sixty days of February 7, 2003 are deemed outstanding for the purpose of computing the percentage ownership of the person holding those options and other rights and for all directors and officers as a group, but are not deemed outstanding for computing the percentage ownership of any other person.

	Amount Owned	Percent of Class
Infospace	2,032,057	8.7%(1)
Gideon Mantel	1,815,803	7.94%(2)
OZF Ltd.	1,643,834	7.2%(3)
Nahum Sharfman	1,369,787	6.05%(4)
All directors and officers as a group (7 persons)	4,356,578	16.4%(5)

(1) The above percentage includes warrants and options which are underwater as of February 7, 2003: 4.86% of class

(2) The above percentage includes warrants and options which are underwater as of February 7, 2003: 1.84% of class

(3) The above percentage includes warrants and options which are underwater as of February 7, 2003: 2.70% of class

(4) The above percentage includes warrants and options which are underwater as of February 7, 2003: 1.76% of class

(5) The above percentage includes warrants and options which are underwater as of February 7, 2003: 5.16% of class

Interest of Management in Certain Transactions.

Private Placement of February 2002

In February 27, 2002, Commtouch entered into a private placement agreement with a few of its founders (Gideon Mantel, Nahum Sharfman and Amir Lev) and new investors, whereby Commtouch issued approximately 4.4 million ordinary shares against the investment of approximately $1.3 Million in a private placement; approximately one-third of the shares were purchased by Commtouch's founders, who are also currently Commtouch directors and/or executive officers. The purchasers in the private placement also received five-year warrants to purchase up to an additional 2.66 million ordinary shares (approximately). The exercise price for one-third of the warrants is $0.37 per share, the exercise price for an additional one-third of the warrants is $1.00 per share and the exercise price for the final one-third of the warrants is be $2.00 per share. This agreement was approved by the shareholders on April 8, 2002. The Company has used the proceeds of this placement for general corporate working capital. The funds were received on April 15, 2002.

Relationship with 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. 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 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.

In connection with Commtouch Inc. entering into the original 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. The warrant is non-forfeitable, fully vested and immediately exercisable, and will expire five years from the date of the original email service agreement (July 16, 2004).

Concurrent with Commtouch Inc. entering into the email services agreement in 1999, we issued 896,057 ordinary shares to InfoSpace and 448,029 ordinary shares to Vulcan Ventures in a private placement at $14.88 per share. Pursuant to the share purchase agreement, InfoSpace and Vulcan Ventures have the right to name one director to our board as long as they continue to hold at least 25% of the combined number of shares purchased by them in the private placement and the shares issuable to InfoSpace upon exercise of the warrant. Mr. Thomas Camp, who was appointed to the board pursuant to that agreement, resigned on August 22, 2001 and was not replaced by InfoSpace and Vulcan Ventures, and we believe that Vulcan Ventures divested itself of all of its shareholdings in the Company. In connection with this transaction, we agreed to pay U.S. Bancorp Piper Jaffray an advisory fee of $550,000 under the terms of an engagement letter agreement dated as of July 5, 1999.

We agreed to register the shares and warrant described above promptly after the closing of the initial public offering. The registration statement became effective on January 7, 2000.

At InfoSpace's option, the warrant is exercisable pursuant to a cashless exercise based on the average closing price of the ordinary shares for the five days preceding the exercise. The holder of the warrant is required to avoid becoming a 10% or greater shareholder of the Company as a result of any exercise of the warrant. The holder of the warrant is given the opportunity to profit from a rise in the market price of the ordinary shares and the warrant. The warrant includes provisions which adjust the exercise and price upon the occurrence of certain events which might otherwise dilute the value of the warrant.

Option Exercises and Purchases of Shares By Certain Officers

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Gideon Mantel is the Chief Executive Officer and a Director of Commtouch. On March 17, 1999, Mr. Mantel exercised certain options granted to him by Commtouch. In consideration for the ordinary shares purchased pursuant to the

exercise of the options, he provided Commtouch with a full-recourse promissory note dated March 17, 1999 in the original principal amount of $341,272. The promissory note bears interest at 4.83% annually, with payments of interest only due on March 17 of each year and with the balance due and payable on the fourth anniversary of the date of the promissory note. This loan was used by Mr. Mantel to purchase 286,120 ordinary shares of Commtouch at a weighted average purchase price of $1.19 per share. The promissory note is collateralized by a pledge of the stock purchased. The outstanding principal amount of the note as of December 31, 2002 is $341,272.

Item 8. Financial Information.

See Item 18: Financial Statements

If the Company decides to distribute a cash dividend out of income that has been tax exempt due to an "Approved Enterprise" status under the Law for the Encouragement of Capital Investments, 1959, the amount of cash dividend will be subject to corporate tax at the rate then in effect under Israeli law. The Company has never declared or paid cash dividends on its ordinary shares and does not anticipate paying any cash dividends in the foreseeable future. The Company intends to retain future earnings to finance the development of its business.

Item 9. The Offer and Listing.

The Company's Ordinary Shares have traded publicly on The Nasdaq Stock Market under the symbol "CTCH" since July 13, 1999.

The following table lists the high and low closing sales prices for the Company's Ordinary Shares, for the periods indicated, as reported by The Nasdaq Stock Market:

	High	Low
1999:		
Third Quarter (beginning July 13, 1999)	$ 22.62	$11.0625
Fourth Quarter	49.12	14.3125
2000:		
First Quarter	$ 66.50	$35.5625
Second Quarter	38.56	14.625
Third Quarter	33.93	16.50
Fourth Quarter	$ 19.25	$ 7.44
2001:		
First Quarter	$ 3.81	$ 0.75
Second Quarter	1.19	0.28
Third Quarter	0.67	0.20
Fourth Quarter	$ 0.46	$ 0.20
2002:		
First Quarter	$ 0.42	$ 0.23
Second Quarter	$ 0.25	$ 0.11
Third Quarter	$ 0.15	$ 0.08
Fourth Quarter	$ 0.06	$ 0.22
Most Recent Six Months:		
November 2002	$ 0.22	$ 0.09
December 2002	0.21	0.11
January 2003	0.16	0.14
February 2003	0.15	0.13

March 2003	0.14	0.10
April 2003	0.41	0.12

Item 10. Additional Information.

Under current Israeli regulations, any dividends or other distributions paid in respect of ordinary shares purchased by non-residents of Israel with certain non-Israeli currencies (including dollars) will be freely repatriable in such non-Israeli currencies at the rate of exchange prevailing at the time of conversion, provided that Israeli income tax has been paid on, or withheld from, such payments.

Neither the Articles of Association of the Company nor the laws of the State of Israel restrict in any way the ownership or voting of ordinary shares by non-residents of Israel, except with respect to subjects of countries which are at a state of war with Israel.

DESCRIPTION OF SHARES

Set forth below is a summary of the material provisions governing our share capital. This summary is not complete and should be read together with our Memorandum of Association and Restated and Amended Articles of Association, copies of which have been filed as exhibits to this and our prior Annual Reports on Form 20-F, as amended (subject to further amendment of our Articles of Association from time to time).

As of December 31, 2002, our authorized share capital consisted of 40,000,000 ordinary shares, NIS 0.05 par value. As of December 31, 2002, there were 22,219,696 ordinary shares issued and outstanding.

DESCRIPTION OF ORDINARY SHARES

All issued and outstanding ordinary shares of Commtouch are duly authorized and validly issued, fully paid and nonassessable. The ordinary shares do not have preemptive rights. Neither our Memorandum of Association, Articles of Association nor the laws of the State of Israel restrict in any way the ownership or voting of ordinary shares by non-residents of Israel, except with respect to subjects of countries which are in a state of war with Israel.

DIVIDEND AND LIQUIDATION RIGHTS

The ordinary shares are entitled to their full proportion of any cash or share dividend declared.

Subject to the rights of the holders of shares with preferential or other special rights that may be authorized, the holders of ordinary shares are entitled to receive dividends in proportion to the sums paid up or credited as paid up on account of the nominal value of their respective holdings of the shares in respect of which the dividend is being paid (without taking into account the premium paid up on the shares) out of assets legally available therefor and, in the event of our winding up, to share ratably in all assets remaining after payment of liabilities in proportion to the nominal value of their respective holdings of the shares in respect of which such distribution is being made, subject to applicable law. Declaration of a dividend requires Board of Director approval.

VOTING, SHAREHOLDER MEETINGS AND RESOLUTIONS

Holders of ordinary shares have one vote for each ordinary share held on all matters submitted to a vote of shareholders. Such rights may be affected by the

future grant of any special voting rights to the holders of a class of shares with preferential rights. Once the creation of a class of shares with preference rights has been approved, the Board of Directors may issue preferred shares, unless the Board is limited from doing so by the Articles of Association or a contractual provision.

An annual general meeting must be held once every calendar year at such time (not more than 15 months after the last preceding annual general meeting) and at such place, either within or outside the State of Israel, as may be determined by the Board of Directors. The quorum required for a general meeting of shareholders consists of at least two shareholders present in person or by proxy and holding, or representing, more than one-quarter of the voting rights of the issued share capital. A meeting adjourned for lack of a quorum may be adjourned to the same day in the next week at the same time and place, or to such time and place as the Board of Directors may determine in a notice to shareholders. At such reconvened meeting any two shareholders entitled to vote present in person or by proxy will

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constitute a quorum. Shareholder resolutions will be deemed adopted if approved by the holders of a majority of the voting power represented at the meeting, in person or by proxy, and voting thereon.

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ANTI-TAKEOVER PROVISIONS UNDER ISRAELI LAW

Under the Companies Law, a merger is generally required to be approved by the shareholders and board of directors of each of the merging companies. If the share capital of the company that will not be the surviving company is divided into different classes of shares, the approval of each class is also required. In addition, a merger can be completed only after all approvals have been submitted to the Israeli Registrar of Companies and at least seventy days have passed from the time that a proposal for approval of the merger was filed with the Registrar.

The Companies Law provides that an acquisition of shares in a public company must be made by means of a tender offer if as a result of the acquisition the purchaser would become a 25% shareholder of the company. This rule does not apply if there is already another 25% shareholder of the company. Similarly, the Companies Law provides that an acquisition of shares in a public company must be made by means of tender offer if as a result of the acquisition the purchaser would become a 45% shareholder of the company, unless someone else already holds a majority of the voting power of the company. These rules do not apply if the acquisition is made by way of a merger. Regulations promulgated under the Companies Law provide that these tender offer requirements do not apply to companies whose shares are listed for trading outside of Israel if, according to the law in the country in which the shares are traded, including the rules and regulations of the stock exchange on which the shares are traded, either:

- there is a limitation on acquisition of any level of control of the company; or

- the acquisition of any level of control requires the purchaser to do so by means of a tender offer to the public.

Finally, Israeli tax law treats specified acquisitions, including a stock-for-stock swap between an Israeli company and a foreign company, less favorably than does U.S. tax law. For example, Israeli tax law may subject a shareholder who exchanges his ordinary shares for shares in a foreign

corporation to taxation before it would become taxable in the United States, and even though the investment has not become liquid.

TRANSFER OF SHARES AND NOTICES

Fully paid ordinary shares that are issued and not subject to any legal restrictions on transference may be transferred freely. Each shareholder of record is entitled to receive at least twenty-one days' prior notice of shareholder meetings. For purposes of determining the shareholders entitled to notice and to vote at such meeting, the Board of Directors may fix a record date not exceeding 40 days prior to the date of any shareholder meeting.

MODIFICATION OF CLASS RIGHTS

If at any time the share capital is divided into different classes of shares, then, unless the conditions of allotment of such class provide otherwise, the rights, additional rights, advantages, restrictions and conditions attached or not attached to any class, at any given time, may be modified, enhanced, added or abrogated by resolution at a meeting of the holders of the shares of such class.

DESCRIPTION OF INVESTOR OPTIONS AND WARRANTS

INFOSPACE WARRANT

The discussion regarding the Infospace warrant under Item 5. Operating and Financial Review and Prospects--Strategic Transaction with Go2Net (InfoSpace) and Item 7. "Major Shareholders and Related Party Transactions-- Interest of Management in Certain Transactions--Relationship with InfoSpace" is incorporated herein by reference.

WINGRA WARRANTS AND OPTIONS

In connection with our acquisition of Wingra, we assumed warrants and options to purchase 137,233 shares issued to the Wingra investors (subsequently reduced to 121,329 due to expiration of certain options), and options to purchase 168,382 ordinary shares issued to Wingra employees (subsequently reduced to 162,257 due to expiration of options of terminating employees). Upon effectiveness of the merger, these warrants and options became immediately exercisable.

The assumed investor warrants and options were originally issued by Wingra in connection with loans to Wingra by banks and shareholders. The exercise prices of those warrants and options range from $6.29 to $9.35 and the expiration dates range from July 2002 through March 2004.

The employee stock options were originally granted to Wingra employees under the Wingra Technologies, LLC 1998 Unit Option Plan. The exercise prices of those options range from $0.2010 to $3.5010 and the expiration dates range from August 2008 through July 2010. At the time of the merger, we assumed the rights and obligations under that Option Plan.

EQUITY OFFICE PROPERTIES WARRANT

The discussion regarding the Equity Office Properties warrant under Item 19, Note 13 to the Notes to Consolidated Financial Statements - Shareholders' Equity is incorporated herein by reference.

COMPAQ WARRANT

The discussion regarding the Compaq warrant under Item 19, Note 13 to the Notes

to Consolidated Financial Statements - Shareholders' Equity is incorporated herein by reference.

INVESTMENT ROUND WARRANTS

The discussion regarding the February 2002 investment round warrants under Item 19, Note 13 to the Notes to Consolidated Financial Statements - Shareholders' Equity is incorporated herein by reference.

CONVERTIBLE LOAN WARRANTS

The discussion regarding the January 2003 convertible loan warrants under Item 19, Note 13 to the Notes to Consolidated Financial Statements - Shareholders' Equity is incorporated herein by reference.

AXCESSNET WARRANT

The discussion regarding the AxcessNet warrant under Item 19, Note 13 to the Notes to Consolidated Financial Statements - Shareholders' Equity is incorporated herein by reference.

AGRON WARRANT

The discussion regarding the Agron warrant under Item 19, Note 13 to the Notes to Consolidated Financial Statements - Shareholders' Equity is incorporated herein by reference.

REGISTRATION RIGHTS

The holders of convertible preferred shares which were converted into 7,109,800 ordinary shares (the "Registrable Securities") upon effectiveness of the initial public offering, have certain rights to register those shares under the Securities Act. If requested by holders of a majority of the Registrable Securities after the second anniversary of the date of the initial public offering, Commtouch must file a registration statement under the Securities Act covering all Registrable Securities requested to be included by all holders of such Registrable Securities. Commtouch may be required to effect up to two such registrations. Commtouch has the right to delay any such registration for up to 120 days under certain circumstances, but not more than once during any 12-month period.

In addition, if Commtouch proposes to register any of its ordinary shares under the Securities Act other than in connection with a company employee benefit plan or a corporate reorganization pursuant to Rule 145 under the Securities Act, or a registration on any registration form that does not permit secondary sales or does not include substantially the same information as would be required to be included in a registration statement covering the sale of Registrable Securities, the holders of Registrable Securities may require Commtouch to include all or a portion of their shares in such registration, although the managing underwriter of any such offering has certain rights to limit the number of shares in such registration.

Further, a majority of the holders of Registrable Securities may require Commtouch to register all or any portion of their Registrable Securities on Form F-3, subject to certain conditions and limitations. All expenses incurred in connection with all registrations (other than fees, expenses and disbursements of counsel retained by the holders of the Registrable Shares, and underwriters' and brokers' discounts and commissions) will be borne by Commtouch.

The registration rights described in the preceding three paragraphs expire five years after the closing date of our initial public offering (July 16, 2004).

In addition, the Company granted registration rights as follows:

a. to InfoSpace, Vulcan Ventures and Microsoft, pursuant to which their holdings in the Company (including the warrant issued to InfoSpace) were registered on January 7, 2000;

b. under the terms of the Wingra acquisition agreement, we were required to register the 1,568,869 shares issuable to the Wingra investors and employees, including shares issuable under options and warrants described above. The registration statements were filed to fulfill this requirement and became effective, respectively, on September 6, 2001 and July 20, 2001;

c. to investors under the private placement of February 27, 2002, whereby Commtouch issued approximately 4.4 million ordinary shares against the investment of approximately $1.3 million. The investors in the private placement also received five-year warrants to purchase up to an additional 2.66 million ordinary shares (approximately). The shares issued under this private placement, including shares to be issued upon the exercise of the warrants, were registered on May 28, 2002;

d. to lenders under the convertible loan agreement of January 29, 2003, as amended, whereby a maximum possible loan amount of $1,250,000 will be provided to the Company. The Company has received the total loan amount of $1,250,000 from the lenders. 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 $.25 per Ordinary Share ("Conversion Price"). Also, warrants exercisable for purchase of up to 5,000,000 of the Company's ordinary shares have been issued to the lenders covering the stated loan amount, based on such loan amount divided by the Conversion Price. Warrants shall also be issued on an annual basis for any accumulated interest on the loan. Registration rights have been granted to the lenders in connection with the conversion rights and warrants described above, covering a total of 13,310,000 shares. Demand registration rights (exercisable by the "Lender Majority", as defined in the agreement) shall be in effect until three (3) months following the third anniversary of the last applicable warrant issuance date. No demand served on the Company shall be effective until at least the Lender Majority has effected a conversion of the loan into equity; and

e. piggy-back registration rights were included in all warrants detailed above in this Item 10.

ACCESS TO INFORMATION

We file reports with the Israeli Registrar of Companies regarding our registered address, our registered capital, our shareholders of record and the number of shares held by each, the identity of the directors and details regarding security interests on our assets. In addition, Commtouch must file with the Israeli Registrar of Companies its Articles of Association and any amendments thereto The information filed with the Registrar of Companies is available to the public. In addition to the information available to the public, our shareholders are entitled, upon request, to review and receive copies of all minutes of meetings of our shareholders.

TRANSFER AGENT AND REGISTRAR

The transfer agent and registrar for our ordinary shares is Wells Fargo Bank Minnesota N.A.

MATERIAL CONTRACTS IN 2002.

Consulting and Fundraising Agreements

On September 1, 2002, Commtouch entered into two agreements with AxcessNet Ltd., one for the providing of consulting services to Commtouch ("agreement 1") and the other for the facilitating of fundraising and strategic commercial transactions ("agreement 2"). Under agreement 1, AxcessNet is to receive a payment of $200,000, comprised of cash of $140,000 and warrants valued at $60,000. Under agreement 2, as amended on December 1, 2002,

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AxcessNet is entitled to receive 5% of proceeds received by Commtouch from fundraising activities (and in the case of a business combination, a minimum fee of $100,000), as well as from commercial transactions entered into by Commtouch through the efforts of AxcessNet. The compensation to be paid under agreement 2 is payable in either cash or warrants, at AxcessNet's discretion, but if the warrants are to exceed 250,000, Commtouch has the right to pay any excess in cash. Furthermore, in the event that Commtouch is acquired by a third party, any continuing payment obligations of Commtouch to AxcessNet under agreement 2 at the time of such acquisition may be fully liquidated by a payment of the lesser of twenty four months worth of payments or the number of months remaining under Commtouch's obligations to AxcessNet. During their relationship under agreement 1 and agreement 2, Commtouch and AxcessNet have been working together closely in furtherance of the Company's business, and are in constant communications with one another. AxcessNet is also a lender under the convertible loan agreement entered into in early 2003. See "Item 3. Key Information - Recent Developments - Convertible Loan Transaction."

Private Placement of February 2002

See "Item 7. Major Shareholders and Related Party Transactions - Private Placement of February 2002".

Lease Termination Agreement between Young Woo & Assoc., LLC and Commtouch Inc. and Commtouch Software Ltd. (as guarantor) dated September 6, 2002

Pursuant to the agreement with Young Woo, Commtouch and Young Woo agreed to terminate the New York facilities lease agreement. Within the framework of this agreement Commtouch made certain payments to Young Woo and transferred ownership to certain furniture, and Young Woo released Commtouch from the remainder (approximately two years) of the lease term under the original agreement and the related guarantee.

Surrender Agreement between Omni South Beach, L.P. and Commtouch Latin America Inc. dated August 31, 2002

Pursuant to the agreement with Omni, Commtouch and Omni agreed to terminate the Miami facilities lease agreement. Within the framework of this agreement Commtouch made certain payments to Omni, terminated a sublease agreement with a third party sublessee of Commtouch and transferred ownership to certain furniture to Omni, and Omni released Commtouch from the remainder (approximately five years) of the lease term under the original agreement.

Amended and Restated 1999 Non-Employee Directors Stock Option Plan

The allotment of shares under the original 1999 Non-Employee Directors Stock Option Plan was in the amount of 180,000 ordinary shares, with an additional allotment in 2000 bringing the plan's total allotment to 500,000 shares, an allotment in 2001 bringing the plan's total to 750,000 ordinary shares and two allotments during 2002 totaling 700,000 ordinary shares bringing the plan's

total to 1,450,000. During 1999, each individual who first joined the Board of Directors as a non-employee director on or after the effective date of the initial public offering received an option grant for 10,000 shares. Subsequent to July 2000, individuals who joined the board received an initial grant of 30,000 options. Directors who are reelected at the annual meeting of shareholders are generally entitled to additional grants of 10,000 shares, though those directors reelected at the August 22, 2001 annual meeting of shareholders were entitled to a grant of 33,750, those directors in office immediately after the extraordinary general meeting of shareholders on February 25, 2002 were granted a one-time option grant of 150,000 ordinary shares and those directors in office immediately after the annual meeting of shareholders on November 18, 2002 were granted a one-time option grant of 50,000 ordinary shares. Also, in addition to the grant of shares for her reelection as a director in August 2001, Carolyn Chin, in recognition of her activities as Chairman of the Board, received an additional grant of 221,250 ordinary shares.

Each option granted under the Non-Employee Directors Plan originally was to have become exercisable with respect to one-fourth of the number of shares covered by such option three months after the date of grant and with respect to one-third of the remaining shares subject to the option every three months thereafter; however, this changed pursuant to an amendment to the plan approved by shareholders at the August 10, 2000 annual meeting of shareholders, such that options become exercisable at a rate of 1/16th of the shares every three months. Each option has an exercise price equal to the fair market value of the ordinary shares on the grant date of such option. However, certain options outstanding and unexercised at the time of the effective date of the Tender Offer Statement of July 20, 2001, as amended, were

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repriced in accordance with the terms of the Tender Offer Statement, as amended. Each option has a maximum term of ten years, but will terminate earlier if the optionee ceases to be a member of the Board of Directors.

See the discussion under Item 4 "Information on the Company - Description of Property" for an indication of where the Company's Amended and Restated Articles of Association may be inspected. In addition, the Articles are attached as an exhibit to this Form 20-F.

ISRAELI TAXATION AND INVESTMENT PROGRAMS

The following discussion summarizes the material Israeli tax consequences relating to Commtouch, its shareholders and ownership and disposition of its ordinary shares. This summary does not discuss all aspects of Israeli tax law that may be relevant to a particular investor in light of his personal investment circumstances or to certain types of investors subject to special treatment under Israeli law (for example, traders in securities or persons that own, directly or indirectly, 10% or more of Commtouch's outstanding voting shares). The following also includes a discussion of certain Israeli government programs benefiting various Israeli businesses such as Commtouch. To the extent that the discussion is based on new legislation yet to be subject to judicial or administrative interpretation, there can be no assurance that the views expressed herein will accord with any such interpretation in the future. This discussion does not cover all possible tax consequences or situations, and investors should consult their tax advisors regarding the tax consequences unique to their situation.

Tax Reform

On January 1, 2003 a comprehensive tax reform took effect in Israel. Pursuant to the reform, resident companies are subject to Israeli tax on income accrued or derived in Israel or abroad. In addition, the concept of controlled foreign

corporation was introduced according to which an Israeli company may become subject to Israeli taxes on certain income of a non-Israeli subsidiary if the subsidiaries primary source of income is passive income (such as interest, dividends, royalties, rental income or capital gains). The tax reform also substantially changed the system of taxation of capital gains.

General Corporate Tax Structure

The regular general corporate tax rate in Israel is 36%. However, the effective rate payable by a company which derives income from an Approved Enterprise (as further discussed below) may be considerably less. See "Law for the Encouragement of Capital Investments, 1959."

Taxation Under Inflationary Conditions

The Income Tax Law (Adjustment for Inflation), 1985 (the "Adjustment for Inflation Law") attempts to overcome some of the problems experienced in a traditional tax system by an economy experiencing rapid inflation, which was the case in Israel at the time the Adjustment for Inflation Law was enacted. Generally, the Adjustment for Inflation Law was designed to neutralize for Israeli tax purposes the erosion of capital investments in businesses and to prevent unintended tax benefits resulting from the deduction of inflationary financing expenses. The Adjustment for Inflation Law applies a supplementary set of inflationary adjustments to a normal taxable profit computed according to regular historical cost principles.

The Adjustment for Inflation Law introduced a special adjustment for the preservation of equity for tax purposes based on changes in the Israeli CPI, whereby corporate assets are classified broadly into fixed (inflation resistant) assets and non-fixed assets. Where shareholders' equity, as defined in the Adjustment for Inflation Law, exceeds the depreciated cost of fixed assets, a corporate tax deduction - which takes into account the effect of inflationary change on such excess - is allowed (up to a ceiling of 70% of taxable income in any single tax year, with the unused portion permitted to be carried forward on an inflation-linked basis with no ceiling). If the depreciated cost of fixed assets exceeds shareholders' equity, then such excess multiplied by the annual rate of inflation is added to taxable income.

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In addition, subject to certain limitations, depreciation on fixed assets and loss carry forwards are adjusted for inflation based on changes in the Israeli CPI. The net effect of the Adjustment for Inflation Law on Commtouch might be that Commtouch's taxable income, as determined for Israeli corporate tax purposes, will be different from Commtouch's U.S. dollar income, as reflected in its financial statements, due to the difference between the annual changes in the CPI and in the NIS exchange rate with respect to the U.S. Dollar, causing changes in the actual tax rate.

Law for the Encouragement of Industry (Taxes), 1969

Commtouch is currently viewed as qualifying as an "Industrial Company" within the meaning of the Law for the Encouragement of Industry (Taxes), 1969 (the "Industry Encouragement Law"). According to the Industry Encouragement Law, an "Industrial Company" is a company resident in Israel, at least 90% of the income of which in any tax year, determined in Israeli currency (exclusive of income from defense loans, capital gains, interest and dividends) is derived from an "Industrial Enterprise" that it owns. An "Industrial Enterprise" is defined by that law as an enterprise whose major activity in a given tax year is industrial production activity.

Included among the tax benefits for an Industrial Company are:

- deductions of 12.5% per annum of the purchase price of a patent or of know-how that is utilized in the development or advancement of its enterprise;

- an election under certain conditions to file a consolidated return with additional related industrial companies;

- accelerated depreciation rates on equipment and buildings; and

- deduction of expenses incurred in connection with a public issuance of shares listed for trading over a three year period. The tax authorities may construe this benefit to be relevant only upon a public issuance of shares in Israel.

Eligibility for the benefits under the Industry Encouragement Law is not subject to receipt of prior approval from any governmental authority. No assurance can be given that Commtouch is and will continue to be considered as an "Industrial Company" or that the benefits described above will be available in the future.

Law for the Encouragement of Capital Investments, 1959

The Law for the Encouragement of Capital Investments, 1959, as amended (the "Investment Law"), provides that a capital investment in production facilities (or other eligible facilities) may, upon application to the Israel Investment Center, be designated as an Approved Enterprise. Each certificate of approval for an Approved Enterprise relates to a specific capital investment program delineated both by its financial scope, including its capital sources, and its physical characteristics, i.e. the equipment to be purchased and utilized pursuant to the program. The tax benefits derived from any such certificate of approval relate only to taxable profits attributable to the specific Approved Enterprise.

Commtouch's investment plans have been granted the status of an Approved Enterprise under the Investment Law, in three separate investment programs, one of which was cancelled in early 2002. These programs provide Commtouch with certain tax benefits as described below; with regard to the first program, Commtouch also received long-term loans guaranteed by the State of Israel. Under the terms of Commtouch's Approved Enterprise programs, income earned by Commtouch from its Approved Enterprises will be tax exempt for a period of two years, commencing with the year in which it first earns taxable income, and subject to a reduced corporate tax rate of 10% to 25% for an additional period of five to eight years (provided that the total period of tax benefits will not extend past (i) 12 years from the year of commencement of production or (ii) 14 years from the year of approval of approved enterprise status). The reduced corporate tax rate, to which Commtouch's Approved Enterprise program will be subject, is dependent on the level of foreign investment in Commtouch. In the event a company operates under more than one approval or only part of its capital investments are approved (a "Mixed Enterprise"), its effective corporate tax rate is the result of a weighted combination of the various applicable rates. Notwithstanding these tax benefits, to the extent Commtouch receives income from countries other than Israel, such income may be subject to withholding tax.

Dividends paid by companies owning approved enterprises, the source of which is income derived from an approved enterprise during the applicable benefits period, are generally taxed at a reduced rate of 15% if the dividends are paid

during the benefits period or at any time up to 12 years after the benefits period. This tax must be withheld at source by the company paying the dividend.

In the case of a "foreign investor's company," the 12 year limitation on reduced withholding tax on dividends does not apply. Subject to various conditions, a foreign investor's company is a company more than 25% of whose share capital, in terms of shares, rights to profits, voting and appointment of directors, and of whose combined share and loan capital, is owned by non-Israeli residents. A dividend paid from income derived from an enterprise owned by a company which has elected the "alternative benefits program" during the period in which it is exempt from tax is also generally subject to the 15.0% tax rate; this would render the company liable for corporate tax on the amount distributed, which is defined for this purpose as including the amount of the corporate tax that applies as a result of the distribution, at the rate that would have been applicable had the company not elected the alternative benefits program, which is generally 25.0%. Generally, any dividends distributed are considered to be attributable to the entire enterprise, and the effective tax rate is the result of a weighted combination of the various applicable tax rates. However, a company may elect to attribute any dividend distributed by it only to income not subject to the alternative benefits program.

The Investment Law also provides that a company with an Approved Enterprise is entitled to accelerated depreciation on its property and equipment included in an approved investment program.

Future applications to the Investment Center will be reviewed separately, and decisions as to whether or not to approve such applications will be based, among other things, on the then prevailing criteria set forth in the Investment Law, on the specific objectives of the applicant company set forth in such applications and on certain financial criteria of the applicant company. Accordingly, there can be no assurance that any such applications will be approved. In addition, the benefits available to an Approved Enterprise are conditional upon the fulfillment of certain conditions stipulated in the Investment Law and its regulations and the criteria set forth in the specific certificate of approval, as described above. In the event that these conditions are violated, in whole or in part, the Company would be required to refund the amount of tax benefits, with the addition of the CPI linkage adjustment and interest.

Capital Gains and Income Taxes Applicable to Non-Israeli Resident Shareholders

Under existing regulations any capital gain realized by an individual shareholder with respect to the ordinary shares acquired on or after the listing of such shares for trading will be exempt from Israeli capital gains tax if the ordinary shares are listed on an approved foreign securities market (which includes Nasdaq in the United States), provided that the company continues to qualify as an Industrial Company under Israeli law and provided the individual does not hold such shares for business purposes.

If we do not maintain our status as an Industrial Company, then subject to any applicable tax treaty the Israeli capital gains tax rates would be up to 50% for non-Israeli resident individuals and 36% for companies. Upon a distribution of dividends other than bonus shares (stock dividends), income tax is generally withheld at source at the rate of 25% (or the lower rate of 15% payable with respect to Approved Enterprises), unless double taxation treaty is in effect between Israel and the shareholder's country of residence that provides for a lower tax rate in Israel on dividends.

A tax treaty between the United States and Israel (the "Treaty"), provides for a maximum tax of 25% on dividends paid to a resident of the United States (as defined in the Treaty). Dividends distributed by an Israeli company and derived from the income of an approved enterprise are subject to a 15% dividend withholding tax. The Treaty further provides that a 12.5% Israeli dividend withholding tax applies to dividends paid to a United States corporation owning 10% or more of an Israeli company's voting shares throughout the current year to

the date the dividend is paid and the preceding taxable year (as applicable). The 12.5% rate applies only on dividends from a company that does not have an Approved Enterprise in the applicable period.

If for any reason shareholders do not receive the above exemption for a sale of shares in an Industrial Company, the Treaty provides U.S. resident investors with an exemption from Israeli capital gains tax in certain circumstances (there may still be U.S. taxes) upon a disposition of shares in Commtouch if they held under 10% of the Company's voting stock throughout the 12 months before the share disposition. If Israeli capital gains tax is payable, it can be credited against U.S. federal tax under the circumstances specified in the Treaty.

A non-resident of Israel who has had dividend income derived or accrued in Israel from which the applicable tax was withheld at source is currently exempt from the duty to file an annual Israeli tax return with respect to such income,

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provided such income was not derived from a business carried on in Israel by such non-resident and that such non-resident does not derive other non-passive income from sources in Israel.

Tax Benefits for Research and Development

Israeli tax law allows under certain conditions a tax deduction in the year incurred for expenditures in scientific research and development projects, if the expenditures are approved by the relevant Israeli Government Ministry (determined by the field of research) and the research and development is for the promotion of the enterprise. Expenditures not so approved are deductible over a three-year period. However, expenditures made out of the proceeds of government grants are not deductible, i.e. Commtouch will be able to deduct the unfunded portion of the research and development expenditures and not the gross amount.

Law for the Encouragement of Industrial Research and Development, 1984

Under the Law for the Encouragement of Industrial Research and Development, 1984 (the "Research Law") and the Instructions of the Director General of the Ministry of Industry and Trade, research and development programs and the plans for the intermediate stage between research and development, and manufacturing and sales approved by a governmental committee of the Office of Chief Scientist (OCS) (the "Research Committee") are eligible for grants of up to 50% of the project's expenditure if they meet certain criteria. These grants are issued in return for the payment of royalties from the revenues derived from the sale of the product developed in accordance with the program, as follows: 3% of revenues during the first three years, 4% of revenues during the following three years, and 5% of revenues in the seventh year and thereafter, with the total royalties not to exceed 100% of the dollar value of the OCS grant (or in some cases up to 300%). Following the full payment of such royalties, there is no further liability for payment.

The Israeli government further requires that products developed with government grants be manufactured in Israel. However, in the event that any portion of the manufacturing is not conducted in Israel, if approval is received from the OCS, the Company would be required to pay royalties that are adjusted in proportion to manufacturing outside of Israel as follows: when the manufacturing is performed outside of Israel by the Company or an affiliate company, the royalties are to be paid as described above with the addition of 1%, and when the manufacturing outside of Israel is not performed by the Company or an affiliate the royalties paid shall be equal to the ratio of the amount of grant received from the OCS divided by the amount of grant received from the OCS and the investment(s) made by the Company in the project. The payback will also be

adjusted to 120%, 150% or 300% of the grant if the portion of manufacturing that is performed outside of Israel is up to 50%, between 50% and 90%, or more than 90%, respectively. The technology developed pursuant to the terms of these grants may not be transferred to third parties without the prior approval of the Research Committee. Such approval is not required for the export of any products resulting from such research or development. Approval of the transfer of technology may be granted only if the recipient abides by all the provisions of the Research Law and regulations promulgated thereunder, including the restrictions on the transfer of know-how and the obligation to pay royalties in an amount that may be increased. The Company is subject to various provisions of the Research Law and regulations and derivatives thereunder.

In order to meet certain conditions in connection with the grants and programs of the OCS, the Company has made certain representations to the Israel government about the Company's future plans for its Israeli operations. From time to time the extent of the Company's Israeli operations has differed and may in the future differ, from the Company's representations. If, after receiving grants under certain of such programs, the Company fails to meet certain conditions to those benefits, including, with respect to grants received from the OCS, the maintenance of a material preserve in Israel, or if there is any material deviation from the representations made by the Company to the Israeli government, the Company could be required to refund to the State of Israel taxes or other benefits previously received (including interest and CPI linkage difference) and would likely be denied receipt of such grants or benefits, and participation of such programs, thereafter.

The Company has participated in programs sponsored by the OCS for the support of research and development activities. Through December 31, 2002, the Company had recorded grants from OCS aggregating approximately $_1.4_ million for certain of the Company's research and development projects. These grants were recorded as a reduction of research and development costs. As noted, 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 2002, related to the 2002 grants, since we had

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not started generating revenue for the product developed with such grants, but we may have obligations for royalties in 2003 and future years.

With regard to grants before 2002, the Company claims that all of these programs, which were funded at a total of $1.2 million, had failed and therefore it will not be obligated to pay royalties. In March 2002, the Company submitted an application for project failure with regard to projects from 2001 and prior years. This application was accepted by the OCS in August 2002. Accordingly, the Company has determined that as of December 31, 2002 there are no contingent liabilities for royalties under those projects.

Each application to the OCS is reviewed separately, and grants are based on the program approved by the Research Committee. Expenditures supported under other incentive programs of the State of Israel are not eligible for OCS grants. As a result, there can be no assurance that applications to the OCS will be approved or, if approved, what the amounts of the grants will be.

Fund for the Encouragement of Marketing Activities

The Company has received grants relating to its overseas marketing expenses from the Marketing Fund. These grants are awarded for specific expenses incurred by the Company for overseas marketing and are based upon the expenses reported by the Company to the Marketing Fund. All marketing grants recorded from the Marketing Fund until 1997 are linked to the dollar and are repayable as

royalties at the rate of 3% of the amount of increases in export sales realized by the Company from the Marketing Fund. Grants recorded beginning January 1, 1998 bear royalties of 4% plus interest at LIBOR rates. The Company will face royalty obligations on grants from the Marketing Fund only to the extent it actually achieves increases in export sales. The proceeds of these grants are presented in the Company's consolidated Financial Statements as offsets to marketing expenses. Through December 31, 2000, the Company had received grants from the Marketing Fund in the amount of approximately $279,000.

U.S. TAX CONSIDERATIONS REGARDING ORDINARY SHARES ACQUIRED BY U.S. TAXPAYERS

The following discussion summarizes the material U.S. federal income tax consequences arising from the purchase, ownership and sale of the ordinary shares. This summary is based on the provisions of the Internal Revenue Code of 1986, as amended (the "Code"), final, temporary and proposed U.S. Treasury Regulations promulgated thereunder, and administrative and judicial interpretations thereof, in effect as of the date of this report, all of which are subject to change, possibly with retroactive effect. Commtouch will not seek a ruling from the Internal Revenue Service with regard to the United States federal income tax treatment relating to investment in the ordinary shares and, therefore, no assurance exists that the Internal Revenue Service will agree with the conclusions set forth below. The summary below does not purport to address all federal income tax consequences that may be relevant to particular investors. This summary does not address the consequences that may be applicable to particular classes of taxpayers, including investors that hold ordinary shares as part of a hedge, straddle or conversion transaction, insurance companies, banks or other financial institutions, broker-dealers, tax-exempt organizations and investors who own (directly, indirectly or through attribution) 10% or more of Commtouch's outstanding voting stock. Further, it does not address the alternative minimum tax consequences of an investment in ordinary shares or the indirect consequences to U.S. Holders, as defined below, of equity interests in investors in ordinary shares. This summary is addressed only to holders that hold ordinary shares as a capital asset within the meaning of Section 1221 of the Code, are U.S. citizens, individuals resident in the United States for purposes of U.S. federal income tax, domestic corporations or partnerships and estates or trusts treated as "United States persons" under Section 7701 of the Code ("U.S. Holders").

EACH INVESTOR SHOULD CONSULT WITH HIS OR HER OWN TAX ADVISOR AS TO THE PARTICULAR U.S. FEDERAL INCOME TAX CONSEQUENCES OF THE PURCHASE, OWNERSHIP AND SALE OF ORDINARY SHARES, INCLUDING THE EFFECTS OF APPLICABLE STATE, LOCAL, FOREIGN OR OTHER TAX LAWS AND POSSIBLE CHANGES IN THE TAX LAWS.

Tax Basis of Ordinary Shares

A U.S. Holder's tax basis in his or her ordinary shares will be the purchase price paid therefore by such U.S. Holder. The holding period of each ordinary share owned by a U.S. Holder will commence on the day following the date of the U.S. Holder's purchase of such ordinary share and will include the day on which such U.S. Holder sells the ordinary share.

Sale or Exchange of Ordinary Shares

A U.S. Holder's sale or exchange of ordinary shares will result in the recognition of gain or loss by such U.S. Holder in an amount equal to the difference between the amount realized and the U.S. Holder's basis in the ordinary shares sold. Subject to the following discussion of the consequences of Commtouch being treated as a Passive Foreign Investment Company or a Foreign Investment Company, such gain or loss will be capital gain or loss if such ordinary shares are a capital asset in the hands of the U.S. Holder. Gain or

loss realized on the sale of ordinary shares will be long-term capital gain or loss if the ordinary shares sold had been held for more than one year at the time of their sale. Long-term capital gains recognized by certain taxpayers generally are subject to a reduced rate of federal tax (currently a maximum of 15%). If the U.S. Holder's holding period on the date of the sale or exchange was one year or less, such gain or loss will be short-term capital gain or loss. Short-term capital gains generally are subject to tax at the same rates as ordinary income. In general, any capital gain recognized by a U.S. Holder upon the sale or exchange of ordinary shares will be treated as U.S.-source income for U.S. foreign tax credit purposes.

See discussion under this Item 10 "Israeli Taxation and Investment Programs--Capital Gains and Income Taxes Applicable to Non-Israeli Shareholders" for a discussion of taxation by Israel of capital gains realized on sales of capital assets.

Treatment of Dividend Distributions

For U.S. federal income tax purposes, gross dividends (including the amount of any Israeli taxes withheld therefrom) paid to a U.S. Holder with respect to his or her ordinary shares will be included in his or her ordinary income to the extent made out of current or accumulated earnings and profits of Commtouch, as determined based on U.S. tax principles, at the time the dividends are received and will be treated as foreign source dividend income for purposes of the foreign tax credit limitation described below. Such dividends will not be eligible for the dividends received deduction allowed to U.S. corporations under Section 243 of the Code. Dividend distributions in excess of Commtouch's current and accumulated earnings and profits will be treated first as a non-taxable return of the U.S. Holder's tax basis in his or her ordinary shares to the extent thereof and then as a gain from the sale of ordinary shares. Dividends paid in NIS will be includible in income in a U.S. dollar amount based on the exchange rate at the time of their receipt, and any gain or loss resulting from currency fluctuations during the period from the date a dividend is paid to the date such payment is converted into U.S. dollars generally will be treated as ordinary income or loss.

Any Israeli withholding tax imposed on dividends paid to a U.S. Holder will be a foreign income tax eligible for credit against such U.S. Holder's U.S. federal income tax liability subject to certain limitations. Alternatively, a U.S. Holder may claim a deduction for such amount, but only for a year in which a U.S. Holder elects to do so with respect to all foreign income taxes. The overall limitation on foreign taxes eligible for credit is calculated separately with respect to specific classes of income. Dividends distributed by Commtouch with respect to ordinary shares will generally constitute "passive income". Foreign income taxes exceeding the credit limitation for the year of payment or accrual may be carried back for two taxable years and forward for five taxable years in order to reduce U.S. federal income taxes, subject to the credit limitation applicable in each of such years. Other restrictions on the foreign tax credit include a general prohibition on the use of the credit to reduce liability for the U.S. individual and corporation alternative minimum taxes by more than 90% and an allowance of foreign tax credits for alternative minimum tax purposes only to the extent of foreign-source alternative minimum taxable income. See under this Item 10 "Israeli Taxation and Investment Programs -- Capital Gains and Income Taxes Applicable to Non-Israeli Shareholders."

Information Reporting and Backup Withholding

Any dividends paid on, or proceeds derived from a sale of, the ordinary shares to, or by, U.S. Holders may be subject to U.S. information reporting requirements and the 28% U.S. backup withholding tax unless the holder (i) is a corporation or other exempt recipient or (ii) provides a United States taxpayer identification number, certifies as to no loss of exemption from backup

withholding and otherwise complies with any applicable withholding requirements. Any amounts withheld under the U.S. backup withholding tax rules will be allowed as a refund or a credit against the U.S. Holder's U.S. federal income tax, provided the required information is furnished to the U.S. Internal Revenue Service.

Tax Status of Commtouch for U.S. Federal Income Tax Purposes

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Passive Foreign Investment Company. If Commtouch were deemed to be a passive foreign investment company (a "PFIC") for U.S. federal income tax purposes, any gain recognized by a U.S. Holder upon the sale of ordinary shares (or the receipt of certain distributions) generally would be treated as ordinary income, such income would be allocated over such U.S. Holder's holding period for such ordinary shares and an interest charge would be imposed on the amount of deferred tax on such income which is allocated to prior taxable years. Generally, Commtouch will be treated as a PFIC for any tax year if, in such tax year or any prior tax year, either (i) 75% or more of its gross income is passive in nature, or (ii) on average, 50% or more of its assets by value produce or are held for the production of passive income. Commtouch does not believe it satisfies either of the tests for PFIC status for any of its pre-2003 tax years. Commtouch expects that the majority of its assets will continue to generate sufficient levels of active income, and the percentage (by value) of its assets not producing or held for the production of passive income will continue to be sufficient, for it to avoid PFIC treatment for U.S. federal income tax purposes in post-2002 tax years. However, since the determination whether Commtouch is a PFIC will be made annually based on facts and circumstances that, to some extent, may be beyond Commtouch's control, there can be no assurance that Commtouch will not become a PFIC at some time in the future. If Commtouch were determined to be a PFIC, however, a U.S. Holder could elect to treat his or her ordinary shares as an interest in a qualified electing fund (a "QEF Election"), in which case, the U.S. Holder would be required to include in income currently his or her proportionate share of Commtouch's earnings and profits in years in which Commtouch is a PFIC whether or not distributions of such earnings and profits are actually made to such U.S. Holder, but any gain subsequently recognized upon the sale by such U.S. Holder of his or her ordinary shares generally would be taxed as a capital gain. Alternatively, a U.S. Holder may elect to mark the ordinary shares to market annually, recognizing ordinary income or loss (subject to certain limitations) equal to the difference between the fair market value of its ordinary shares and the adjusted basis of such stock. See "U.S. Tax Considerations Regarding Ordinary Shares Acquired by U.S. Taxpayers - Sale or Exchange of Ordinary Shares" above. U.S. Holders should consult with their own tax advisers regarding the eligibility, manner and advisability of making a QEF Election if Commtouch is treated as a PFIC.

Controlled Foreign Corporations. Sections 951 through 964 and Section 1248 of the Code relate to controlled foreign corporations ("CFC"). The CFC provisions may impute some portion of such a corporation's undistributed income to certain U.S. shareholders on a current basis and convert into dividend income some portion of gains on dispositions of stock which would otherwise qualify for capital gains treatment. In general, the CFC provisions will apply to Commtouch only if U.S. shareholders, who are U.S. Holders and who own, directly or indirectly or by attribution, 10% or more of the total combined voting power of all classes of voting stock own in the aggregate (or are deemed to own after application of complex attribution rules) more than 50% (measured by voting power or value) of the outstanding ordinary shares of Commtouch. It is possible that Commtouch could become a CFC in the future. Even if Commtouch were classified as a CFC in a future year, however, the CFC rules referred to above would apply only with respect to U.S. shareholders, who are U.S. Holders and who own, directly or indirectly or by attribution, 10% or more of the total combined

voting power of all classes of voting stock of Commtouch.

Personal Holding Company/Foreign Personal Holding Company/Foreign Investment Company. A corporation will be classified as a personal holding company, or a PHC, if (i) five or fewer individuals at any time during the last half of a tax year (without regard to their citizenship or residence) directly or indirectly or by attribution own more than 50% in value of the corporation's stock and (ii) at least 60% of its ordinary gross income for the taxable year, as specially adjusted, consists of personal holding company income (defined generally to include dividends, interest, royalties, rents and certain other types of passive income). A PHC is subject to a United States federal income tax of 15% on its undistributed personal holding company income (generally limited, in the case of a foreign corporation, to United States source income).

A corporation will be classified as a foreign personal holding company, or an FPHC, and not a PHC if at any time during a tax year (i) five or fewer individual United States citizens or residents directly or indirectly or by attribution own more than 50% of the total combined voting power or value of the corporation's stock and (ii) at least 60% of its gross income consists of (50% for years following the first year it becomes a FPHC) FPHC income (defined generally to include dividends, interest, royalties, rents and certain other types of passive income). Each United States shareholder in an FPHC is required to include in gross income, as a dividend, an allocable share of the FPHC's undistributed foreign personal holding company income (generally the taxable income of the FPHC, as specially adjusted).

A corporation will be classified as a foreign investment company, or an FIC, if for any taxable year it (i) is registered under the Investment Company Act of 1940, as amended, as a management company or unit investment trust or is engaged primarily in the business of investing or trading in securities or commodities (or any interest therein) and (ii)

50% or more of the total value or the total combined voting power of all classes of the corporation's stock is owned directly or indirectly (including stock owned through the application of attribution rules) by United States persons. In general, unless an FIC elects to distribute 90% or more of its taxable income (determined under United States tax principles as specially adjusted) to its shareholders, any gain on the sale or exchange of stock in a foreign corporation which was a FIC at any time during the period during which a taxpayer held such stock is treated as ordinary income (rather than capital gain) to the extent of such shareholder's ratable share of the corporation's accumulated earnings and profits.

CONDITIONS IN ISRAEL

Commtouch is incorporated under the laws of the State of Israel, and substantially all of our research and development and significant executive facilities are located in Israel. Accordingly, Commtouch is directly affected by political, economic and military conditions in Israel. Our operations would be materially adversely affected if major hostilities involving Israel should occur or if trade between Israel and its present trading partners should be curtailed.

Political Conditions

Since the establishment of the State of Israel in 1948, a number of armed conflicts have taken place between Israel and its Arab neighbors. A state of hostility, varying from time to time in intensity and degree, has led to security and economic problems for Israel. Despite a peace agreement between Israel and Egypt signed in 1979, a peace agreement between Israel and Jordan signed in 1994 and, since 1993, several agreements between Israel and

Palestinian representatives, Israel continues to face hostile actions and threats from various elements in the region. Further, Israel has not entered into any peace agreement with Syria or Lebanon, and there have been major difficulties accompanied by violence in the negotiations with the Palestinians. We cannot be certain as to how the current hostilities affecting the region will develop or what effect they may have upon Commtouch.

Certain countries, companies and organizations continue to participate in a boycott of Israeli firms. Commtouch does not believe that the boycott has had a material adverse effect on Commtouch, but restrictive laws, policies or practices directed towards Israel or Israeli businesses may have an adverse impact on the expansion of Commtouch's business.

Generally, all male adult citizens and permanent residents of Israel under the age of 51 are obligated to perform up to 39 days, or longer under certain circumstances, of military reserve duty annually. Additionally, all such residents are subject to being called to active duty at any time under emergency circumstances. Currently, a majority of our officers and employees are obligated to perform annual reserve duty. While we have operated effectively under these requirements since we began operations, no assessment can be made as to the full impact of such requirements on our workforce or business if conditions should change, and no prediction can be made as to the effect on us of any expansion or reduction of such obligations.

Economic Conditions

Israel's economy has been subject to numerous destabilizing factors, including a period of rampant inflation in the early to mid-1980s, low foreign exchange reserves, fluctuations in world commodity prices, military conflicts and civil unrest. The Israeli government has, for these and other reasons, intervened in various sectors of the economy, employing, among other means, fiscal and monetary policies, import duties, foreign currency restrictions and controls of wages, prices and foreign currency exchange rates. The Israeli government has periodically changed its policies in all these areas.

Until May 1998, Israel imposed extensive restrictions on transactions in foreign currency. These restrictions were largely lifted in May 1998, and since January 1, 2003, all exchange control restrictions have been removed, although there are still reporting requirements for foreign currency transactions. However, legislation remains in effect pursuant to which currency controls can be imposed by administrative action at any time. Nonresidents of Israel who purchase our ordinary shares are able to repatriate in non-Israeli currency both dividends (after deduction of withholding tax) and the proceeds from the sale of the shares.

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Trade Agreements

Israel is a member of the United Nations, the International Monetary Fund, the International Bank for Reconstruction and Development and the International Finance Corporation. Israel is also a signatory to the General Agreement on Tariffs and Trade, which provides for reciprocal lowering of trade barriers among its members. In addition, Israel has been granted preferences under the Generalized System of Preferences from Australia, Canada and Japan. These preferences allow Israel to export the products covered by such programs either duty-free or at reduced tariffs.

Israel has entered into preferential trade agreements with the European Union, the United States and the European Free Trade Association. In recent years, Israel has established commercial and trade relations with a number of the other nations, including Russia, China and India, with which Israel had not previously had such relations.

Assistance from the United States

Israel receives significant amounts of economic and military assistance from the United States, averaging approximately $3 billion annually over the last several years. In addition, in 1992, the United States approved the issuance of up to $10 billion of loan guarantees during U.S. fiscal years 1993 to 1998 to help Israel absorb a large influx of new immigrants, primarily from the republics of the former Soviet Union. Under the loan guarantee program, Israel may issue up to $2 billion in principal amount of guaranteed loans each year, subject to reduction in certain circumstances. There is no assurance that foreign aid from the United States will continue at or near amounts received in the past. If the grants for economic and military assistance or the United States loan guarantees are eliminated or reduced significantly, the Israeli economy could suffer material adverse consequences.

Item 11. Qualitative and Quantitative Disclosure about Market Risk.

We develop our technology in Israel and seek to provide our software products worldwide. As a result, our financial results could be affected by factors such as changes in foreign currency exchange rates or weak economic conditions in foreign markets. As most of our sales are currently made in U.S. dollars, a strengthening of the dollar could make our services less competitive in foreign markets. Due to the nature and level of our debts, we have concluded that there is currently no material market risk exposure. Therefore, no quantitative tabular disclosures are required.

Item 12. Description of Securities Other than Equity Securities.

Not applicable.

PART II

Item 13. Defaults, Dividend Arrearages and Delinquencies.

Not applicable.

Item 14. Material Modifications to the Rights of Security Holders and Use of Proceeds.

Not applicable.

Item 15. Controls and Procedures

(a) Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of the effectiveness of our disclosure controls and procedures, as such term is defined under Rule 13a-14(c) promulgated under the Exchange Act, within 90 days of the filing date of this report. Based on their evaluation, our principal executive officer and principal financial officer concluded that the Company's disclosure controls and procedures are effective.

(b) There have been no significant changes (including corrective actions with regard to significant deficiencies or material weaknesses) in our internal controls or in other factors that could significantly affect these controls subsequent to the date of the evaluation referenced in paragraph (a) above, including any corrective actions with regard to significant deficiencies and material weaknesses.

Item 16. Reserved

PART III

Item 17. Financial Statements.

The Company has responded to Item 18.

Item 18. Financial Statements

(a) Financial Statements

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(b) Financial Statement Schedule:

The following financial statement schedule of Commtouch Software Ltd. for each of the three years in the period ended December 31, 2002 is filed as part of the Annual Report and should be read in conjunction with the consolidated financial statements of Commtouch Software, Ltd.

Schedule II --Valuation and Qualifying Accounts

Schedules not listed above have been omitted because the information required to be set forth therein is not applicable or is shown in the consolidated financial statements or notes thereto.

Item 19 Exhibits

The list of exhibits required by this Item is incorporated by reference to the Exhibit Index which precedes the exhibits to this report.

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REPORT OF INDEPENDENT AUDITORS

To the Shareholders of COMMTOUCH SOFTWARE LTD.

We have audited the accompanying consolidated balance sheets of Commtouch Software Ltd. ("the Company") and its subsidiaries as of December 31, 2001 and 2002, and the related consolidated statements of operations, changes in shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2002. Our audits also included the financial statement schedule listed in the Index at item 18(b). These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

We conducted our audits in accordance with generally accepted auditing standards, in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial

statements are free of material misstatements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by the Company's management, as well as evaluating the overall financial statements presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above, present fairly, in all material respects, the consolidated financial position of Commtouch Software Ltd. and its subsidiaries as of December 31, 2001 and 2002, and the consolidated results of their operations and cash flows for each of the three years in the period ended December 31, 2002, in conformity with accounting principles generally accepted in the United States. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, present fairly in all material respect the information set forth therein.

Tel-Aviv, Israel
March 7, 2003

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

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COMMTOUCH SOFTWARE LTD.

CONSOLIDATED BALANCE SHEETS
(USD in thousands, except share and per share data)

	D
	2001
Assets	
Current Assets:	
Cash and cash equivalents	$ 2,2
Trade receivables, net	8
Prepaid expenses and other accounts receivable	7
Total current assets	3,8
Long-term lease deposits	2
Severance pay fund	3
Property and equipment, net	5,1
Equity investment	
	$ 9,5
Liabilities and Shareholders' Equity	
Current Liabilities:	
Bank credit line and current maturities of bank loans and capital leases	$ 7
Accounts payable	1,3
Employees and payroll accruals	6
Deferred revenues	8
Accrued expenses and other liabilities	7

Total current liabilities	4,4
Long-term bank loans and capital leases	2
Other liabilities	2
Accrued severance pay	4
	9
Minority interest	1
Commitments and Contingencies	
Shareholders' Equity	
Ordinary Shares, nominal value NIS 0.05 par value- Authorized: 40,000,000 shares as of December 31, 2001 and 2002; Issued and outstanding: 17,496,819 and 22,219,696 shares as of December 31, 2001 and 2002, respectively	2
Additional paid-in capital	152,1
Deferred stock compensation	(8
Notes receivable from shareholders	(7
Accumulated deficit	(146,7
Total shareholders' equity	4,0
	$ 9,5

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

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COMMTOUCH SOFTWARE LTD.

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

	Ye Dec	
	2000*	
Revenues:		
Email services	$ 17,771	$
Software licenses	1,000	
Total revenues	18,771	
Cost of revenues:		
Email services	11,800	
Software licenses	--	
Total cost of revenues	11,800	
Gross profit (loss)	6,971	

	2000
Operating expenses:	
Research and development, net	10,244
Sales and marketing	26,534
General and administrative	13,455
Amortization of the prepaid marketing expenses	4,508
Amortization of stock-based employee deferred compensation (1)	3,050
Write-off of property and equipment and other	--
Total operating expenses	57,791
Operating loss	(50,820)
Interest and other income (expense), net	2,886
Equity in losses of affiliate	--
Write-off of impaired long-term investments	(5,000)
Minority interest	55
Loss from continuing operations	(52,879)
Discontinued operations	
Gain from disposal of Wingra	--
Discontinued operations - Wingra	(1,346)
Income (Loss) from discontinued operations	(1,346)
Net loss	$ (54,225)
Basic and diluted net loss per share	
Loss from continuing operations	$ (3.42)
Income (Loss) from discontinued operations	(0.09)
Net loss	$ (3.51)
Weighted average number of shares used in computing basic and diluted net loss per share	15,462

	2000
(1) Stock-based Employee Compensation Relates to the following:	
Cost of revenues	$ 102
Research and development, net	284
Sales and marketing	795
General and administrative	1,869
Total	$ 3,050

* - Reclassified to conform to the current years classification mainly due to divestiture of Wingra. The accompanying notes are an integral part of these consolidated financial statements.

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COMMTOUCH SOFTWARE LTD.

STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY

(USD in thousands, except share and per share data)

	Ordinary shares		Additi paid capi
	Shares	Amount	
Balance as of January 1, 2000	15,199,344	213	133,
Issuance of shares upon exercise of options....................................	440,384	6	1,
Amortization of deferred stock compensation................................	--	--	
Repayment of notes receivable..................	--	--	
Other comprehensive income-unrealized holding losses on marketable securities..................................	--	--	
Issuance of shares to minority interest in Japan-Note 2i...............................	--	--	1,
Issuance of shares and vested options and warrants in consideration of the acquisition of Wingra....................................	1,285,294	17	14,
Net loss..	--	--	
Total comprehensive loss........................	--	--	
Balance as of December 31, 2000....................	16,925,022	236	150,
Issuance of shares, net.........................	315,789	2	
Issuance of shares upon exercise of options....................................	256,008	1	
Stock based compensation related to warrants granted to a service provider................	--	--	
Amortization of deferred stock compensation................................	--	--	
Deferred stock based compensation...............	--	--	
Repayment of notes receivable..................	--	--	
Forgiveness of notes receivable.................	--	--	
Other comprehensive income-unrealized holding losses on marketable securities..................................	--	--	
Issuance of shares to minority interest in Japan-Note 2i.............................	--	--	
Net loss..	--	--	
Total comprehensive loss........................	--	--	
Balance as of December 31, 2001....................	17,496,819	239	152,
Issuance of shares, net.........................	4,434,932	48	1,
Issuance of shares upon exercise of options....................................	287,945	3	
Amortization of deferred stock based compensation.......................	--	--	
Repayment of notes receivable..................	--	--	
Valuation allowance for notes receivable.........	--	--	
Net loss..	--	--	
Balance as of December 31, 2002....................	22,219,696	$ 290	$153,

	Stock-based employee deferred compensation	Notes receivable from shareholders	Accumulated other comprehensive income	Acc d
Balance as of January 1, 2000	(5,779)	(1,060)	63	(
Issuance of shares upon exercise of options	--	--	--	
Amortization of deferred stock based compensation	3,050	--	--	
Repayment of notes receivable	--	19	--	
Other comprehensive income--unrealized holding losses on marketable securities	--	--	(42)	
Issuance of shares to minority interest in Japan-Note 2i	--	--	--	
Issuance of shares and vested options and warrants in consideration of the acquisition .... of Wingra	--	--	--	
Net loss	--	--	--	(
Total comprehensive loss	--	--	--	
Balance as of December 31, 2000	(2,729)	(1,041)	21	(
Issuance of shares, net	--	--	--	
Issuance of shares upon exercise of options	--	--	--	
Amortization of deferred stock based compensation	2,204	--	--	
Stock based compensation related to warrants granted to a service provider	--	--	--	
Deferred stock compensation	(303)	--	--	
Repayment of notes receivable	--	144	--	
Forgiveness of notes receivable	--	143	--	
Other comprehensive income--unrealized holding losses on marketable securities	--	--	(21)	
Issuance of shares to minority interest in Japan-Note 2i	--	--	--	
Net loss	--	--	--	(
Total comprehensive loss	--	--	--	
Balance as of December 31, 2001	(828)	(754)	--	(1
Issuance of shares, net	--	--	--	
Issuance of shares upon exercise of options	--	--	--	
Amortization of deferred stock based compensation	551	--	--	
Repayment of notes receivable	--	4	--	
Valuation allowance for notes receivable	--	385	--	
Net loss	--	--	--	
Balance as of December 31, 2002	$ (277)	$ (365)	$--	$(1

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

COMMTOUCH SOFTWARE LTD.

CONSOLIDATED STATEMENTS OF CASH FLOWS
(USD in thousands)

	Year End December	
	2000*	2001
Cash flows from operating activities:		
Net loss	$(54,225)	$(61,0
Less loss for the period from discontinued operations	1,346	18,0
Adjustments to reconcile net loss to net cash used in Operating activities:		
Depreciation and amortization	5,891	7,4
Amortization of stock-based employee deferred compensation and warrants issued for services received and bank line of credit	3,050	2,2
Amortization of prepaid marketing expenses	4,508	--
Write-off of impaired long-term investments	5,000	2,0
Write-off of property, equipment and other	--	10,1
Loss from sale of property and equipment	--	7
Gain from sale of discontinued operations	--	--
Loss from sale of shares in consolidated subsidiary	--	--
Share of equity interest	--	--
Valuation allowance of notes receivable	--	--
Changes in assets and liabilities:		
Trade receivables, net	(1,541)	3,7
Prepaid expenses and other accounts receivable	(1,931)	2,9
Accounts payable	2,118	(3,0
Employee and payroll accruals, accrued expenses and other liabilities	4,109	(5,1
Deferred revenues	612	(7
Accrued severance pay, net	(64)	2
Forgiveness of notes receivable	--	1
Minority interest in losses of a consolidated subsidiary	(55)	(2
Other	(99)	(1,9
Net cash used in operating activities	(31,281)	(24,6
Cash flows from investing activities:		
Proceeds from sales of marketable securities	18,969	8,5
Purchases of marketable securities	(9,568)	--
Purchase of long-term investments	(7,000)	--
Long-term lease deposits	(163)	2
Proceeds from acquisition of Wingra	305	--
Sale of Wingra	--	--
Sale of consolidated subsidiary	--	--
Proceeds from sale of property and equipment	337	1
Purchase of property and equipment	(19,092)	(3,2
Net cash (used) provided in investing activities	(16,212)	5,6
Cash flows from financing activities:		
Repayment of note receivable by shareholder	19	1
Repayment of bank loans and notes payable	--	(9
Principal payment of capital lease	(619)	(
Proceeds from issuance of shares, net	1,707	4
Proceeds from minority interest in consolidated subsidiary	1,090	4
Contribution from minority interest of consolidated subsidiary	131	3
Net cash provided by financing activities	2,328	3
Decrease in cash and cash equivalents	(45,165)	(18,5
Cash and cash equivalents at the beginning of the year	65,996	20,8
Cash and cash equivalents at the end of the year	$ 20,831	$ 2,2

======== ======

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

Supplemental disclosure of cash flows activity: Cash paid during the year:
Interest.. $ 31 $ 1

Proceeds from acquisition of Wingra, for year ended December 31, 2000 were as follows:

Tangible assets acquired	$ 475
Liabilities assumed	(3,054)
Net liabilities assumed:	(2,579)
Customer base	1,340
Workforce-in-place	550
Intellectual Property	1,660
In-process research & development expenses	1,280
Goodwill	12,590
Intangibles acquired:	17,420
Cash acquired:	305
Purchase price	$ 15,146

The proceeds from the sale of Wingra, for year ended December 31, 2002 were as follows:

Tangible assets sold	$ 314
Liabilities transferred	(1,521)
Net liabilities transferred:	(1,207)
Cash transferred:	193
Gain from sale of Wingra	$ (1,014)

The proceeds from the of shares in consolidated subsidiary (Commtouch K.K. (Japan), now known as Imetrix), for year ended December 31, 2002 were as follows:

Tangible assets	$ 421
Liabilities	(267)
Net assets transferred:	154
Cash received:	1
Loss from sale of consolidated subsidiary	$ 153

The accompanying notes are an integral part of these consolidated financial

statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 1: GENERAL

a. Commtouch Software Ltd. ("Commtouch", "the Company") was incorporated under the laws of Israel in 1991. Commtouch has five subsidiaries: Commtouch Inc., Commtouch (UK) Ltd, Commtouch Latin America Inc. (dissolved during 2002), Wingra, Inc. ("Wingra") (sold during 2002) and Commtouch K.K. (Japan) (now known as Imetrix) (majority owned during a portion of 2002, and in which Commtouch currently holds a 32% interest). The Company and its subsidiaries develop and provide email anti-spam solutions to enterprises. Until December 31, 2002, the Company and its subsidiaries provided email and messaging solutions, to customers ranging from service providers to large and small businesses, who offered the Company's Web-based email through their website to their end users.

In 2002, the Company sold its migration service business and most of its hosted email services and, while it initially changed its focus to providing email and messaging solutions to service providers (see Note 1b below), it subsequently ceased promoting its email and messaging solutions and began concentrating solely on developing its anti-spam solutions.

In consideration of the sale of most of its hosted email services, the Company received up front non-refundable license fee and is entitled to royalties from the sales to its past customers. Royalties are paid according to the collection from these customers.

During 2002, approximately 57% of the revenues were derived from two customers (39% from customer A and 18% from customer B). During 2001 and 2000, no single customer accounted for more than 10% of the revenues.

b. Discontinued operations

In November 2000, the Company acquired Wingra Technologies Inc. ("Wingra"), a provider of messaging integration and migration solutions for large enterprises (see also Note 3).

In February 2002, the Company sold off its migration service business, Wingra, to Wingra's senior management. The results of operations of Wingra have been eliminated from the consolidated results of operations of Commtouch as a result of the disposal transaction.

The proceeds from the sale of Wingra, for year ended December 31, 2002 were as follows:

Tangible assets:	$ 314
Liabilities transferred	(1,521)
Net liabilities transferred:	(1,207)
Cash transferred:	193
Gain from sale of Wingra	$ 1,014

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.

Obligations to employees for severance and other benefits resulting from the discontinuation have been reflected in the financial statements on an accrual basis.

Summary operating results from the discontinued operation for the years ended December 31, 2000, 2001 and 2002 are as follows:

	Year Ended December 31,		
	2000	2001	2002
Revenues	$ 344	$ 1,730	$ 157
Cost of revenues	64	643	76
Gross profit	280	1,087	81
Operating expenses	261	3,029	416
Amortization and impairment of goodwill and other intangible assets	85	16,074	--
In-process research and development	1,280	--	--
Operating loss	$ (1,346)	$ (18,016)	$ (335)

NOTE 2: SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States ("U.S. GAAP").

a. Use of Estimates:

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

b. Financial Statements in U. S. Dollars:

A majority of the revenues of the Company and its subsidiaries is made in United States dollars ("dollars"). In addition, a substantial portion of their costs is incurred or determined in dollars. The Company's management believes that the dollar is the primary currency of the economic environment in which the Company and each of its subsidiaries operate. Thus the dollar is their functional and reporting currency. Accordingly, monetary accounts maintained in currencies other than the dollar are remeasured into U.S. dollars, in accordance with Statement of Financial Accounting Standard No. 52 "Foreign Currency Translation" ("SFAS No. 52"). All transaction gains and losses of the remeasured monetary

balance sheet items are reflected in the statements of operations as financial income or expenses, as appropriate.

c. Principles of Consolidation:

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries and majority-owned subsidiary. All inter-company balances and transactions have been eliminated in consolidation.

d. Cash and Cash Equivalents:

The Company considers all highly liquid investments originally purchased with maturities of three months or less to be cash equivalents.

e. Property and Equipment:

Property and equipment are stated at cost and depreciated using the straight line method over the estimated useful lives of the assets ranging from two to seven years. Leasehold improvements are amortized by the straight-line method over the lease term.

The Company and its subsidiary's long-lived assets are reviewed for impairment in accordance with Statement of Financial Accounting Standard No.144 "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS 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 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 had impairment losses totaling $ 750, which were recorded as operating expenses.

During 2001, due to the economic slowdown, the reduction of the employee headcount and the transfer into new facilities, the Company assesses the recoverability of the carrying amount of 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 accordance with Statement of Financial Accounting Standard No. 121 "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of". According to the evaluation the Company decided to record impairment losses totaling $10,166, which were recorded as operating expenses.

f. Long-Term Investments:

Long-term investments are recorded at lower of cost or estimated fair value according to Accounting Principle Board Opinion No. 18 "The Equity Method of Accounting for Investments in Common Stocks", since the Company does not have the ability to exercise significant influence over operating and financial policies of the investee. Long-term investments are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of

such investments may not be recoverable. Determination of recoverability is based on an estimate of undiscounted future cash flows resulting from the use of the investment. Measurements of an impairment loss for long-term investments that management expects to hold are based on the fair value of the investment.

The Company invested $7,000 in the first nine months of 2000 in three Internet centric companies in which the Company believed it had a significant ongoing strategic interest.

Due to the economic slowdown and the significant decline in capital available to and in valuations of its investment in privately funded Internet centric companies, the Company believes all of these investments are impaired. During 2000 and 2001, based on a comprehensive review of the Company's investments, the Company recorded a non-cash charge of $5,000 and $2,000, respectively, to write-down the recorded investment values.

g. Goodwill and Other Purchased Intangible Assets:

Goodwill represents excess of the costs over the net assets of businesses acquired. Goodwill arose from acquisition prior July 1, 2001 was amortized until December 31, 2001 on a straight-line basis over 5 years. Under Statement of Financial Accounting Standard No. 142, "Goodwill and Other Intangible Assets" ("SFAS No.142") goodwill acquired in a business combination for which date is on or after July 1, 2001, shall not be amortized.

Intangible assets included workforce-in-place, intellectual property and customer base subject to amortization arose from acquisition prior July 1, 2001, are being amortized on a straight-line basis over their useful lives, which are three, four and three years, respectively in accordance with APB Opinion No. 17 "Intangible Assets" ("APB 17").

The carrying value of goodwill and other purchased intangible assets were periodically reviewed by management, based on the expected future undiscounted operating cash flows over the remaining goodwill amortization period in accordance with APB No. 17.

At December 31, 2001, due to the economic slowdown, the Company performed a comprehensive review of the Company's goodwill and other purchased intangible assets. As a result, the Company recorded a non-cash charge of $13,280, to write-down the recorded values to zero.

h. Minority Interest:

Minority interest represents a shareholders' proportionate share of the equity of Commtouch, K.K. (Japan). 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) (now known as Imetrix).

During 2001, the Company's strategic partner in Japan, CSK, invested approximately $800 in Commtouch, K.K. (Japan). According to Staff Accounting Bulletin No. 84 "Accounting for Sales of Stock by a Subsidiary", the Company had not recognized gains from this issuance of shares since it is considered to be an early stage company and thus classified it to Shareholders' Equity section of

the balance sheet under Additional paid-in capital. In April 2002, as part of the Company's focus change, the Japanese subsidiary's employees purchased 38% of Commtouch, K.K. (Japan) shares from the Company for approximately $1 (the par value of the shares). Consequently the Company's holdings decreased from 70% to approximately 32%. The sale of the shares resulted in a loss of $153 that was recorded as part of the equity in losses of an affiliate.

i. Research and Development Costs:

Research and development costs are charged to the statement of operations as incurred. Statement of Financial Accounting Standards No. 86 "Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed" requires capitalization of certain software development costs subsequent to the establishment of technological feasibility.

Based on the Company's product development process, technological feasibility is established upon completion of a working model. The Company did not incur any material costs between the completion of the working model and the point at which the product is ready for general release. Therefore, through December 31, 2000, 2001 and 2002, the Company has charged all software development costs to research and development expense in the period incurred.

j. Revenue Recognition:

During 2002, the Company derives its revenues from providing hosted email services, royalties for the sale of its hosted Email services and from software license agreements.

Revenues from Email services are recognized in accordance with Staff Accounting Bulletin No. 101 "Revenue Recognition in Financial Statements" ("SAB No. 101") when delivery has occurred, persuasive evidence of an agreement exists, the vendor's fee is fixed and determinable and collectibility is probable. Revenues from contracts that are not dependent upon the number of mailboxes and provide non-refundable fixed payments are recognized ratably over the contract term. Revenues from contracts specifying a contractual rate per mailbox per month are recognized monthly for mailboxes covered by the respective contracts. Revenues from contracts based on a share of advertising revenues earned by business partners are recognized when such revenues are earned. Amounts received in advance of service delivery are recorded as deferred revenues. Other service revenues are primarily comprised of revenues from consulting and training fees. Consulting services are billed at an agreed upon rate plus out-of-pocket expenses and training services on a per session basis. The Company recognizes service revenues from consulting and training when provided to the customer.

The Company accounts for software license revenue in accordance with Statement of Position 97-2, "Software Revenue Recognition", as amended ("SOP 97-2"). SOP 97-2 generally requires revenue earned on software arrangements involving multiple elements to be allocated to each element based on the relative fair value of the elements. The Company has also adopted SOP 98-9, "Modification of SOP 97-2, Software Revenue Recognition with Respect to Certain Transactions" ("SOP 98-9"), for all multiple elements transactions entered into after January 1, 2000. SOP 98-9 requires that revenue be recognized under the "Residual Method" when "Vendor Specific Objective Evidence" ("VSOE") of fair value exists for all undelivered elements and no VSOE exists for the delivered elements.
Revenue from software licenses fees to end users are recognized when persuasive evidence of an arrangement exists, delivery of the software has occurred, no significant obligation with regard to the implementation remain, the fee is fixed and determinable and collectibility is probable.

Royalties for the sale of the hosted email services are recognized when persuasive evidence of an arrangement exists, services are provided, no significant obligation with regard to the implementation remain, the fee is

fixed and determinable and collectibility is probable.

k. Concentrations of Credit Risk:

SFAS No. 105, "Disclosure of Information About Financial Instruments with off-Balance-Sheet Risk and Financial Instruments with Concentration of Credit Risk" requires disclosure of any significant off-balance-sheet and credit risk concentrations. The Company and its subsidiaries have no significant off-balance-sheet concentration of credit risk such as foreign exchange contracts, option contracts or other foreign hedging arrangements.

Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of trade receivables and cash and cash equivalents. The majority of the Company's cash and cash equivalents are invested in dollar and dollars linked investments and are deposited in major banks in United States and Israel. Such investments in the United States may be in excess of insured limits and are not insured in other jurisdictions. Management believes that the financial institutions that hold the Company's investments are financially sound and, accordingly, minimal credit risk exists with respect to these investments.

The trade receivables of the Company are derived from transactions with companies located primarily in North America, Europe, Israel and the Far East. An allowance for doubtful accounts is determined with respect to those amounts that the Company and its subsidiaries have determined to be doubtful of collection. The allowance for doubtful accounts is composed of specific debts that are doubtful of collection amounting to $582 and $41 at December 31, 2001 and 2002, respectively. Bad debt expense (recovery) for the years-ended December 31, 2000, 2001 and 2002 were $2,000, $260 and $(40), respectively.

l. Accounting for Stock-Based Compensation:

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

In December 2002, the FASB issued SFAS 148, "Accounting for Stock Based Compensation Transition and Disclosure" - an amendment of FASB Statement No. 123 ("SFAS 148"). SFAS 148 permits two additional transition methods for entities that adopt the fair value based method of accounting for stock-based employee compensation. The statement also requires new disclosures about the ramp-up effect of stock-based employee compensation on reported results. The Statement also requires that those effects be disclosed more prominently by specifying the form, content, and location of those disclosures. The transition guidance and annual disclosure provisions of SFAS 148 are effective for fiscal years ending after December 15, 2002, with earlier application permitted in certain circumstances. The interim disclosure provisions are effective for financial reports containing financial statements for interim periods beginning after December 15, 2002. As at the balance sheet date, the Company continues to apply APB 25 (See also Note 13f).

Pro forma information under SFAS 123 is as follows:

	2000	2001	2002
Net loss as reported	$ (54,225)	$ (61,007)	$ (4,911)
Pro forma net loss	$ (68,309)	$ (65,734)	$ (8,627)
Pro forma basic and diluted net loss per share	$ (4.42)	$ (3.83)	$ (0.41)

The Company applies SFAS 123 and Emerging Issues Task Force 96-18 "Accounting for Equity Instruments that are Issued to Other than Employees for Acquiring, or in Conjunction with Selling, Goods or Services" ("EITF 96-18") with respect to options issued to non-employees. SFAS 123 requires use of an option valuation model to measure the fair value of these options at the grant date. In accounting for warrants granted to those other than employees, the Company applied the provisions of SFAS No. 123, and EITF 96-18. The fair value of these warrants was estimated at the grant date, using the Black-Scholes option-pricing model.

m. Royalty-bearing Grants;

Royalty-bearing grants from the Government of Israel for funding approved research and development projects are recognized at the time the Company is entitled to such grants, on the basis of the costs incurred and included as a deduction of research and development costs. Research and development grants amounted to zero, $600 and $200 in 2000, 2001 and 2002, respectively.

n. Basic and Diluted Net Loss Per Share:

Basic and diluted net loss per share are presented in accordance with Statement of Financial Accounting Standard No. 128, "Earnings per Share", for all periods presented.

Basic net loss per share has been computed using the weighted-average number of ordinary shares outstanding during the year. Diluted net loss per share is computed based on the weighted average number of ordinary shares outstanding during each year, plus the weighted average number of dilative potential ordinary shares considered outstanding during the year.

All outstanding stock options and warrants have been excluded from the calculation of the diluted loss per share because all such securities are anti-dilative for all periods presented. The total number of shares related to outstanding options and warrants excluded from the calculations of diluted net loss per share were 4,096,455, 4,990,673 and 8,525,460 for 2000, 2001 and 2002, respectively.

o. Severance Pay:

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

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

Severance expenses for 2000, 2001 and 2002 were approximately $483, $754 and $ 58, respectively.

p. Fair Value of Financial Instruments:

The following methods and assumptions were used by the Company in estimating its fair value disclosures for financial instruments. The carrying amounts of cash and cash equivalents, trade receivables, other accounts receivable and accounts payable, approximate their fair values due to the short-term maturities of these instruments.

q. Reclassification:

Certain amounts from prior years have been reclassified to conform to the current year's presentation. The reclassification had no effect on previously reported net loss, shareholder's equity or cash flows.

r. Recently Issued Accounting Pronouncements:

In June 2002, The FASB issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities" ("SFAS No. 146"). This statement addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies EITF Issue No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)" ("EITF 94-3"). SFAS No. 146 requires that a liability for a cost associated with an exit or disposal activity be recognized when the liability is incurred. EITF 94-3 allowed for an exit cost liability to be recognized at the date of an entity's commitment to an exit plan. SFAS No. 146 also requires that liabilities recorded in connection with exit plans be initially measured at fair value. SFAS No. 146 will be effective for exit or disposal activities that are initiated after December 27, 2002.

In November 2002, the EITF issued No. 00-21, "Accounting for Revenue Arrangements with Multiple Deliverables." EITF No. 00-21 addresses certain aspects of the accounting by a vendor for arrangements under which it will perform multiple revenue-generating activities. EITF No. 00-21 establishes three principles: revenue should be recognized separately for separate units of

accounting, revenue for a separate unit of accounting should be recognized only when the arrangement consideration is reliably measurable and the earnings process is substantially complete, and consideration should be allocated among the separate units of accounting in an arrangement based on their relative fair values. EITF No. 00-21 is effective for all revenue arrangements entered into in fiscal periods beginning after June 15, 2003, with early adoption permitted.

In January 2003, the FASB issued Interpretation No. 46, "Consolidation of Variable Interest Entities" ("FIN 46"). The objective of FIN 46 is to improve financial reporting by companies involved with variable interest entities. A variable interest entity is a corporation, partnership, trust, or any other legal structure used for business purposes that either (a) does not have equity investors with voting rights or (b) has equity investors that do not provide sufficient financial resources for the entity to support its activities. FIN 46 requires a variable interest entity to be consolidated by a company if that company is subject to a majority of the risk of loss from the variable interest entity's activities or entitled to receive a majority of the entity's residual returns or both. FIN 46 also requires disclosures about variable interest entities that the company is not required to consolidate but in which it has a significant variable interest. The consolidation requirements of FIN 46 apply immediately to variable interest entities created after January 31, 2003. The consolidation requirements apply to older entities in the first fiscal year or interim period beginning after June 15, 2003. Certain of the disclosure requirements apply in all financial statements issued after January 31, 2003, regardless of when the variable interest entity was established.

The Company does not expect the adoption of the above mentioned pronouncements to have a material impact, if any, on the Company's consolidated financial statements.

Note 3: WINGRA:

a. Acquisition of Wingra Technologies Inc. ("Wingra")

On November 24, 2000, the Company entered into a definitive acquisition agreement to acquire Wingra. Wingra is a provider of messaging integration and migration solutions for large enterprises.

Pursuant to the Wingra Agreement, the shareholders of Wingra received an aggregate of 1,285,294 of Commtouch ordinary shares. In addition, all outstanding Wingra options and warrants converted into fully-vested options and warrants to purchase 305,615 of Commtouch ordinary shares. The Company also assumed certain operating assets and liabilities of Wingra. The 137,500 assumed warrants were granted by Wingra in connection with loans granted to Wingra by banks and shareholders. The exercise price of those warrants range from $0.00625 to $0.00939 and the expiration dates range from March 2001 through August 2002. The acquisition was accounted for under the purchase method, for accounting purposes, in accordance with Accounting Principles Board 16 "Business Combinations". The purchase price was allocated to the assets acquired and liabilities assumed based on their respective fair values. The purchase price was determined to be $15,146 (based on the closing price of Commtouch ordinary shares on the date of the final agreement). The consolidation of the assets and liabilities affected the Company's balance sheet at December 31, 2000, as described in the following tables:

Total purchase price:	
Ordinary shares	$11,970
Options and warrants	2,847
Acquisition expenses	329
Purchase price	$15,146

The purchase price was allocated to the acquired assets and assumed liabilities in the accompanying consolidated financial statements as follows:

	Estimated Useful Life (In Years)	
Customer base	3	$ 1,340
Workforce-in-place	3	550
Intellectual property	4	1,660
In-process research & development	expensed	1,280
Goodwill	5	12,590
Less assumed net tangible liabilities	n/a	(2,274)
		$ 15,146

The Company recorded a one-time charge of $1,280 in the fourth quarter of 2000 for purchased in-process technology related to a development project that had not reached technological feasibility, had no alternative future use, and for which successful development was uncertain.

The fair value of the in-process technology was determined using the income approach. Under the income approach, the expected future cash flows from each project under development are estimated and discounted to their net present value at an appropriate risk-adjusted rate of return. Significant factors considered in the calculation of the rate of return are the weighted-average cost of capital and return on assets, as well as the risks inherent in the development process, including the likelihood of achieving technological success and market acceptance. Each project was analyzed to determine the unique technological innovations, the existence and reliance upon core technology, the existence of any alternative future use or current technological feasibility, and the complexity, cost and time to complete the remaining development. Future cash flows for each project were estimated based upon forecasted revenues and costs, taking into account product life cycles, and market penetration and growth rates.

Pursuant to a review of the Company's goodwill and other purchased intangible assets, the Company recorded during 2001 a non-cash charge of $13,280, to write-down the recorded values to zero. Amortization expenses amounted to approximately $85, $2,794 and zero for 2000, 2001 and 2002, respectively.

See Notes 2h and 2i for impairment charges during 2001.

b. Sale of Wingra - see Note 1b.

The results of operations of Wingra have been reclassified in the statements of operations as discontinued operations, See Note 1a.

NOTE 4: PREPAID EXPENSES AND OTHER ACCOUNTS RECEIVABLES

	December 31, 2001	December 31, 2002
Prepaid Expenses	$ 374	$ 138
Other accounts receivable	326	93
Prepaid expenses and other accounts receivables	$ 700	$ 231

NOTE 5: PROPERTY AND EQUIPMENT, NET

	December 31, 2001	December 31, 2002
Cost:		
Computers and peripheral equipment	$ 7,314	$ 5,222
Office furniture and equipment	1,168	477
Motor vehicles	88	88
Leasehold improvements	1,217	694
	9,787	6,481
Less accumulated depreciation	(4,635)	(5,452)
Property and equipment, net	$ 5,152	$ 1,029

Depreciation expenses amounted to approximately $5,846, $7,462 and $1,988 for 2000, 2001 and 2002, respectively.

See Note 2 e for impairment charges during 2001 and 2002.

NOTE 6: LONG TERM BANK LOANS AND CAPITAL LEASES

	Weighted Average Interest Rate	December 31, 2001
Promissory notes with shareholders-Wingra	9.74%	$ 585
Promissory notes with financial institutions-Wingra	11.00%	126
Capital lease obligations-Wingra		45
Royalties in connection with Wingra's product		218
		974
Less - current maturities		(714)
Total Long-term debt		$ 260

The long term bank loans and capital leases were transferred in the beginning of 2002 as part of Wingra sale (see Note 1b).

NOTE 7: COMMITMENTS AND CONTINGENCIES

a. Operating Leases:

The Company leases its facility in Israel under an operating lease agreement expiring through 2003. 2003 minimum lease payments under this non-cancelable lease are $300.

The Company leases its facility in the US under operating lease agreement expiring through 2003. 2003 minimum lease payments under this non-cancelable lease are $8.

Rent expenses for 2000, 2001 and 2002 were approximately $2,300, $2,800 and $400, respectively. The above rent expense is net of sub-lease rental income from various of the Company's unused premises totaling approximately $700 in 2002, $100 in 2001 and none in 2000.

b. Royalties:

From 1993 until 2000 the Company received funding from the OCS. In 2001, the Company reversed the $400 accrual it recorded in past years and determined that as of December 31, 2001 there are no contingent liabilities for royalties for these projects. In March 2002, the Company received an approval for project failure from the OCS, stating that there are no contingent liabilities for royalties for these projects.

In 2002 and 2001, the Company received royalty bearing grants totaling $200 and $600, respectively, from the Israeli government, which were recorded as a reduction of research and development expenses. The Company is committed to pay royalties of 3% to 5% to the Government of Israel on proceeds from sales of products resulting from the research and development projects in which the Government participated in financing such projects through the Office of the Chief Scientist ("the OCS"), up to the amount equal to 100% of the grants received by the Company, linked to the dollar

and bears interest at an annual rate of LIBOR. As of December 31, 2002 the Company had a contingent liability to pay royalties of approximately $800.

c. Employee Options Withholding Tax

In April 2001, the Israeli Tax Authority ("ITA") demanded withholding tax from the Company on behalf of former employees who exercised options and a reserve was recorded. As of December 31, 2001, the Company did not believe it had any liability and thus the reserve was cancelled. During 2002, the Company received a final assessment from the ITA, according to which the Company does not have any withholding tax liability.

d. Bank Line of Credit:

Due to the acquisition of Wingra, Inc., the Company assumed a revolving credit

arrangement with a financial institution. The credit agreement was collateralized by certain assets of the Company. The provisions of the credit agreement enable the Company to borrow up to $100 on a revolving line of credit at annual interest rate of 14.25%. The amount outstanding at December 31, 2001 was approximately $100.
Due to the sale of Wingra in the beginning of 2002 there is no outstanding bank line of credit as of December 31, 2002.

e. Class Action Litigation

Following the 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 its 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 the Company's second motion to dismiss was only partially accepted, with the end result being that the plaintiff's filed a third amended and consolidated complaint. The Company (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 (See also Note 12 for subsequent events).

NOTE 8: RESTRUCTURING CHARGES

During 2001, the Company announced that it was implementing strategic initiatives intended to further reduce costs. In connection with the strategic initiatives, and in accordance with SFAS 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets To Be Disposed Of", SAB 100 "Restructuring and Impairment Charges" and EITF 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (Including Certain Costs in a Restructuring)" (EITF 94-3), the Company recorded restructuring and other non-recurring charges of approximately $11,166. The restructure included curtailing expenses and reducing the number of employees.

As a part of the cost containment efforts, the Company reached settlements agreements with a few of its vendors. Some of the settlement agreements included issuance of shares or warrants while other included only cash payments. The amount written off totaled approximately $800, which was deducted from the relevant categories of operating expenses, and the Company also recorded approximately $100 compensation expenses regarding the warrants issued (see Note 12b) and agreed to pay a letter of credit for approximately $1,000 it granted its landlord.

As a result of strategic initiatives, approximately 118 positions were eliminated in the Company during 2001.

The following table summarizes the restructuring accruals status as of December 31, 2001:

	Restructuring charge	Utilized		Balance December 2001
		Cash	Non-cash	
Employee termination benefits and related costs	$ 1,000	$ 575	$ --	$425
Impairment of property and equipment	9,191	--	9,191	--
Written down due to settlement agreement	975	--	975	--
	$11,166	$ 575	$10,166	$425

During 2002, the Company continued implementing strategic initiatives intended to further reduce costs. In connection with the strategic initiatives, and in accordance with SFAS 142 and EITF 94-3, the Company recorded restructuring and other non-recurring charges of approximately $1,125. The restructure included curtailing expenses and reducing the number of employees. As a result of strategic initiatives, approximately 37 positions were eliminated in the Company during 2002

The following table summarizes the restructuring accruals status as of December 31, 2002:

	Restructuring charge	Utilized		Balance December 2002
		Cash	Non-cash	
Lease deposits and termination fees	$ 128	$128	$--	$--
Impairment of property and equipment	750	--	750	--
Loss on sale of assets	247	--	247	--
	$1,125	$128	$ 997	$--

NOTE 9: INCOME TAXES

Israeli Income Tax:

The Company's production facilities in Israel have been granted "Approved Enterprise" status for three separate investment programs in 1992, 1996 and 2000 by the Israeli Investment Center under the Law for Encouragement of Capital Investments, 1959 ("the Law"). The Company's first program was approved in 1995. The Company's second and third programs (which were later cancelled) received a letter of approval in April 1996 and in December 2000, respectively.

During 2001, the "Approved Enterprise" status for the 1996 investment program was cancelled. During 2002, the "Approved Enterprise" status for the 2000 investment program was cancelled.

Undistributed Israeli income derived from each of its "Approved Enterprise" programs entitle the Company to a tax-exemption for a period of two years commencing with the first year it will earn taxable income (not commenced yet)

and to a reduced tax rate of 10%-25% for an additional period of five to eight years (depending on the level of foreign investment in the Company). These tax benefits cannot continue beyond the earlier of twelve years from commencement of operations, or fourteen years from receipt of approval. Thereafter, the Company's income will be subject to the regular income tax rate of 36%. Income that was not derived from "Approved Enterprise" during the benefits period is taxed at the regular rate of 36%. As currently only a part of the Company's capital investments are approved (a "Mixed Enterprise"), its effective corporate tax rate (once it earns taxable income) will be the determined by the weighted combination of the various applicable rates.

As of December 31, 2002, the tax benefits period for the outstanding valid program has not yet commenced.

The tax exempt income attributable to the "Approved Enterprise" can be distributed to shareholders without subjecting the Company to taxes only upon the complete liquidation of the Company.

Distribution of cash dividends from income that was tax exempt due to the "Approved Enterprise" status is subject to corporate tax at the rate that would have been applicable to the income of the Company had the Company not been tax exempt. In addition, these dividends will generally be subject to a 15% withholding tax.

The Company's Board of Directors has determined that such tax-exempt income will not be distributed as dividends.

Distribution of cash dividends from income that was not derived from "Approved Enterprise" generally is subject to 25% withholding tax.

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

The Company is currently viewed as qualifying as an "industrial company" under the Law for the Encouragement of Industry (Taxation), 1969 and as such is entitled to certain tax benefits, mainly accelerated rates of depreciation and the right to deduct public issuance expenses.

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

On January 1, 2003, a comprehensive tax reform took effect in Israel. Pursuant

to the reform, resident companies are subject to Israeli tax on income accrued or derived in Israel or abroad. In addition, the concept of "controlled foreign corporation" was introduced, according to which an Israeli company may become subject to Israeli taxes on certain income of a non-Israeli subsidiary if the subsidiary's primary source of income is passive income (such as interest, dividends, royalties, rental income or capital gains). The tax reform also substantially changed the system of taxation of capital gains.

As of December 31, 2002, Israeli net operating loss and capital losses carry-forwards amounted to $44,000. Such net operating loss may be carried forward indefinitely and offset against future taxable income. The Company expects that during the period these tax losses are utilized its income would be substantially tax exempted. Accordingly, there will be no tax benefit from such losses and no deferred income taxes have been included in these financial statements.

U.S. Income Tax:

Commtouch Inc. is taxed based upon tax laws in the U.S.

As of December 31, 2002, Commtouch Inc. had a U.S. federal net operating loss carry-forward of approximately $73,600. The net operating loss expires in various amounts between the years 2008 and 2023. 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.

Deferred Income Taxes:

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

	December 31,	
	2001	2002
Deferred tax assets are as follows:		
U.S. operating loss carry-forwards....................	$ 25,020	$ 27,699
Reserves and allowances not currently deductible.......	2,565	496
Net deferred tax asset before valuation allowance......	27,585	28,195
Valuation allowance..................................	(27,585)	(28,195)
Net deferred tax asset...............................	$ --	$ --

As of December 31, 2002, the Company has provided a 100% valuation allowance with respect to deferred tax assets resulting from tax loss carry-forwards. Management currently believes that since the Company and Commtouch Inc. have a history of losses it is more likely than not that the deferred tax regarding the loss carry-forwards and other temporary differences will not be realized in the

foreseeable future.

Pretax loss:

Pretax losses are as follows:

	2000	2001	2002
Israel..................	$ 23,209	$ 26,951	$ 4,320
U.S.....................	27,821	33,419	1,940
Other...................	3,195	637	(1,349)
	$ 54,225	$ 61,007	$ 4,911

NOTE 10: SHAREHOLDERS' EQUITY

The ordinary shares of the Company are traded on the NASDAQ National Market, since July 1999.

Warrants to Private Placement Investors.

On February 27, 2002, Commtouch entered into a private placement agreement, whereby Commtouch issued approximately 4.4 million ordinary shares against the investment of approximately $1,343 in a private placement to private investors. The purchasers in the private placement also received five-year warrants to purchase up to an additional 2.66 million ordinary shares. The exercise price for one-third of the warrants is $0.37 per share, the exercise price for an additional one-third of the warrants is $1.00 per share and the exercise price for the final one-third of the warrants is $2.00 per share. These warrants expire on April 15, 2007.

As of December 31, 2002, Commtouch outstanding warrants issued to consultants, were as follows:

Issuance Date	Warrants for Common shares	Exercise price per share		Warrants exercisable	Exercisab
July 1999	1,136,000	$	12.80	1,136,000	July 2004
December 2001	175,000	$	0.26	175,000	December
January 2002	200,000	$	0.29	200,000	January 2
September 2002	206,897	$	0.01	206,897	August 20
October 2002	26,754	$	0.01	26,754	October 2
Total	1,744,651			1,744,651	

Warrants Issued to Strategic Partners and Customers.

Concurrent with the closing of the IPO, the Company entered into a customary commercial email service agreement with InfoSpace (Formerly, Go2Net), a related party. Under this agreement, the Company provides email services to the end users of InfoSpace's various email properties. In connection with this agreement, the Company issued a warrant expiring in July 2004 to purchase 1,136,000 ordinary shares at an exercise price of $12.80 per share. As of December 31, 2002, this warrant had not been exercised. At the grant date, the fair value of this warrant was estimated as $5,800 and was amortized to operating expenses over the minimum term of the contract (twelve months through July 2000).

Warrants to service providers in connection with Settlement Agreements.

As part of the settlement of significant outstanding and future lease obligations to Commtouch Inc's Mountain View facility lessor, Equity Office Properties ("EOP"), as well as Commtouch Inc's equipment vendor, Compaq Financial Services, the Company issued warrants to these services providers. The EOP fully vested warrant was issued in December 2001 and allows for purchase of up to 175,000 ordinary shares at a price of $0.26, and the Compaq fully vested warrant was issued in January 2002 and allows for purchase of up to 200,000 ordinary shares at a price of $0.29 per share. These warrants expire in December 2006 and January 2007, respectively.

The fair value for the EOP and Compaq warrants were estimated at the date of grant using a Black-Scholes Option Pricing Model with the following weighted-average assumptions: risk-free interest rates of 4.0%, dividend yields of 0%, volatility factors of the expected market price of the Company's ordinary shares of 1.482 and an expected life of the warrant of 5 years after the warrant is vested. Accordingly, the Company recorded approximately $113 as compensation expense and included the amount in operating expenses.

Warrants to AxcessNet Resources LLC.

As consideration for consulting services, on September 1, 2002 the Company issued a fully vested warrant to AxcessNet Resources LLC for purchase of up to 206,897 of the Company's ordinary shares at a price of $0.01 per share. The warrant expires on August 31, 2007.

The fair value for the warrant was estimated at the date of grant using a Black-Scholes Option Pricing Model with the following weighted-average assumptions: risk-free interest rates of 3.7%, dividend yields of 0%, volatility factors of the expected market price of the Company's ordinary shares of 1.482 and an expected life of the warrant of 5 years. The fair value of the warrant was immaterial.

Warrants to service provider.

As consideration for consulting services, on October 1, 2002 the Company issued a fully vested warrant to a service provider to purchase of up to 26,754 of the Company's ordinary shares at a price of $0.01 per share. The warrant expires on October 1, 2007.

The fair value for the warrant was estimated at the date of grant using a Black-Scholes Option Pricing Model with the following weighted-average assumptions: risk-free interest rates of 3.7%, dividend yields of 0%, volatility factors of the expected market price of the Company's ordinary shares of 1.482 and an expected life of the warrant of 5 years. The fair value of the warrant was immaterial.

c. Issuance of Ordinary Shares Against Promissory Notes:

From February 1, 2000 through August 10, 2000 the Company granted certain loans

to certain officers and directors to enable them to finance an early exercise of their options into restricted shares. In December 2000, the Company was notified by its legal counsel, that under the new Israeli Companies Law, effective February 1, 2000, the Company was

currently prohibited from financing a third party purchase of its shares. Accordingly, the loans to officers and directors were in violation of Israeli corporate law and considered null and void. Upon notification, the Company decided to void the loans and the underlying exercise of options.

During 1999, several employees and officers early exercised 670,180 options granted to them by Commtouch. In consideration for the ordinary shares purchased pursuant to the early exercise of the options, they provided Commtouch with full recourse promissory notes in the original principal amount of approximately $1,060. The promissory notes bear interest at 4.83%, with interest payment due at the end of each calendar year, with the principal due on the fourth anniversary of the date of the promissory notes.

During 2001, the Company had forgiven a promissory notes of $143 for one of its employees and demanded the then current value of the shares ($7 relating to the 7,500 shares) and the full interest on the original note. Both interest and the adjusted note were repaid in March 2001. The Company accounted for this note in accordance with EITF 00-23 "Issues Related to the Accounting for Stock Compensation under APB 25 and FASB Interpretation No. 44" and EITF 95-16 "Accounting for Stock Compensation Arrangements with Employer Loan Features under APB Opinion No. 25". During 2001, a note for $137 was repaid by another employee for 94,560 shares.

As of December 31, 2002, three notes remain outstanding. One pertains to a current executive officer. As the Company and such officer have agreed that the Company will withhold all of the officer's salary (since September 2002) as security and/or payment on behalf of the relevant note, and the officer has made a commitment to repay the note by the end of 2003, the Company believes that the loan will be fully repaid during 2003. The Company continues to negotiate with one former employee in connection with the employee's note, and believes that a resolution will be reached that is agreeable to both parties. Regarding the last outstanding note, while the Company has attempted to resolve the matter with an ex-employee, it has been unsuccessful to date. As the Company has been unable to collect the principal and interest amounts under the notes from the two former employees, a doubt exists if such notes will be satisfied. Accordingly, the Company recorded a valuation allowance on the full amounts of the notes in the sum of $439, and recorded an expense in the statement of operations.

d. Employee Stock Purchase Plan:

Commtouch reserved a total of 1,229,156 shares for issuance under the plan. Eligible employees were able to purchase ordinary shares at 85% of the lower of the market value of the Company's Ordinary shares on the first day of the applicable offering period or the last day of the applicable purchase period. The total shares issued under the plan were 80,545, 136,782 and zero for the years 2000, 2001 and 2002, respectively. This Plan terminated in late 2001.

e. Repricing

On April 30, 2001, the Company's Board of Directors approved the "repricing" of options previously granted to employees according to the criteria stated below. Accordingly, the Company filed a Tender Offer, which expired on September 14, 2001, and Commtouch has accepted for exchange options to purchase 1,273,513 Ordinary Shares. Previously granted options were cancelled and new options were issued with an exercise price equal to the par value of the shares. In order to enjoy the repricing mechanism, previously granted stock options must have met the following conditions:

- o The exercise price of the original options exceeds $10

- o The option is issued but not exercised

The repriced stock options vest over three years with 1/3 vesting on February 15, 2002 and the remaining 2/3 vesting every six months for the following two years. In connection with this repricing, the Company charged approximately $300 as compensation expense in 2002 and 2001.

During October 2001, the Company decided that 1/3 of the options granted on September 14, 2001 to employees dismissed during October 2001 will not expire upon termination of employment. The Company decided that this portion

of the options will vest according to the original grant terms on February 15, 2002 and will be exercisable until August 15, 2002.

The modification of the grant term was accounted for under APB 25 and FIN 44 and resulted in no effect.

f. Stock Options:

In 1996, the Company adopted the 1996 CI Stock Option Plan for granting options to its U.S. employees and consultants to purchase ordinary shares of the Company. Until 1999, the Company issued options to purchase ordinary shares to its Israeli employees pursuant to individual agreements. In 1999 the Company approved the 1999 Section 3(i) Share Option Plan for its Israeli employees and consultants, which was amended in 2001 to include Section 102 applicability (the sections relate to code sections under the Israel tax law).

The Company has reserved 6,406,100 ordinary shares for issuance under employee stock option plans and agreements. As of December 31, 2002, an aggregate of 3,672,555 ordinary shares of the Company are still available for future grant. Options granted under such plans and agreements expire generally after 10 years from the date of grant and terminate upon termination of the optionee's employment or other relationship with the Company. The options generally vest ratably over a 4-year period. Certain repriced stock options offered to employees in a Tender Offer Statement of July 20, 2001, as amended, vest over a three year period. The exercise price of the options granted under the individual agreements may not be less than the nominal value of the shares into which such options are exercisable. Any options that are canceled or not exercised within the options period become available for future grant.

As a result of the Wingra acquisition, the Company assumed stock options granted to employees under Wingra's stock option plan. At the date of acquisition these stock options were immediately converted into approximately 168,000 fully vested

stock options convertible into Commtouch ordinary shares.

A summary of the Company's share option activity under the plans is as follows:

	Number of Shares			
	2000	2001	2002	2000
Outstanding at beginning of period	1,383,110	2,650,455	2,915,689	$ 9.6
Granted......................	2,046,520	3,009,388*	2,058,521	24.1
Exercised....................	(359,839)	(119,268)	(261,490)	2.6
Canceled.....................	(419,336)	(2,624,886)	(1,979,175)	21.7
Outstanding at end of period...	2,650,455	2,915,689	2,733,545	$ 19.9
Exercisable at end of period...	526,986	281,830	716,407	$ 8.6

* - Includes 1,273,513 options repriced to par value during 2001.

The options outstanding as of December 31, 2002, have been separated into ranges of exercise price, as follows:

Exercise Price	Options Outstanding as of December 31, 2002	Weighted Average Remaining Contractual Life (years)	Weighted Average Exercise Price	Options Exercisable as December 31, 2002
$0.01-$0.11	1,888,335	8.83	$ 0.04	584,550
$0.28-$1.45	844,210	7.41	$ 0.37	131,232
$35	1,000	7.48	$ 35	625
$ 0.01-$35	2,733,545	8.29	$ 0.17	716,407

Weighted average fair values and weighted average exercise prices of options whose exercise price is less or equals market price of the shares at date of grant are as follows:

For exercise prices on the		
Equals market price Year ended December 31,		
2000	2001	2002

Weighted average exercise prices...............	$ 24.10	$ 0.27	$ 0.16
Weighted average fair values on date of grant...	$ 20.20	$ 0.10	$ 0.16

Under SFAS 123, pro forma information regarding net income (loss) and earnings (loss) per share is required and has been determined as if the Company had accounted for its employee stock options under the fair value method of that Statement. The fair value for these options was estimated at the date of grant using a Black-Scholes option valuation model with the following weighted-average assumptions for 2000, 2001 and 2002: risk-free interest rates of 5.5% for 2000, 4.0% for 2001, and 3.7% for 2002, dividend yields of 0%, volatility factors of the expected market price of the Company's ordinary shares of 1.348 for 2000, 1.482 for 2001, and 1.416 for 2002 and an expected life of the option of 6 months after the option is vested for 2000, 2001 and 2002.

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions, including the expected stock price volatility. Because the Company's employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options.

The Company recorded deferred compensation representing the difference between the exercise price and the deemed fair value of the Company's ordinary shares at the date of grant. Such amount is being amortized using the sum-of-digits or the straight-line method over the vesting period of the options, generally four years.

Deferred stock based compensation is as follows:	
Balance as of January 1, 2002............................	$ 828
Less amortization of deferred stock based compensation.....	(551)
Balance as of December 31, 2002..........................	$ 277

g. Amended and Restated Non-Employee Directors Stock Option Plan:

The Company adopted the 1999 Non-Employee Directors Stock Option Plan. The original allotment of shares in this plan was in the amount of 180,000 ordinary shares. The Company, with shareholder approval, has amended this allotment over the past few years as follows:

a. In 2000, an increase was approved bringing the plan's total allotment to 500,000 shares;

b. In 2001, an increase was approved bringing the plan's total allotment to 750,000 ordinary shares; and

c. In 2002, two increases were approved bringing the plan's total allotment to 1,450,000.

Further, during 1999, each individual who first joined the Board of Directors as a non-employee director on or after the effective date of the initial public offering received an option grant for 10,000 shares. This amount was increased at a shareholders meeting in 2000, such that going forward, individuals first joining the Board receive an initial grant of 30,000 options.

Directors who are reelected at the annual meeting of shareholders are generally entitled to additional grants of 10,000 shares. However, this amount has been increased over the past few years pursuant to shareholder approvals, such that:

a. Directors reelected at the August 22, 2001 annual meeting of shareholders were entitled to a grant of 33,750;

b. Directors in office immediately after the extraordinary general meeting of shareholders on February 25, 2002 were granted a one-time option grant of 150,000 ordinary shares; and

c. Directors in office immediately after the annual meeting of shareholders on November 18, 2002 were granted a one-time option grant of 50,000 ordinary shares.

Also, in addition to the grant of shares for her reelection as a director in August 2001, Carolyn Chin, on behalf of her activities as Chairman of the Board, received an additional grant of 221,250 ordinary shares.

Each option granted under the Non-Employee Directors Plan originally was to have become exercisable with respect to one-fourth of the number of shares covered by such option three months after the date of grant and with respect to one-third of the remaining shares subject to the option every three months thereafter; however, this changed pursuant to an amendment to the plan approved by shareholders at the August 10, 2000 annual meeting of shareholders, such that options under subsequent grants become exercisable at a rate of 1/16th of the shares every three months. Each option has an exercise price equal to the fair market value of the ordinary shares on the grant date of such option. However, certain options outstanding and unexercised at the time of the effective date of the Tender Offer Statement of July 20, 2001, as amended, were repriced in accordance with the terms of the Tender Offer Statement, as amended. Each option has a maximum term of ten years, but will terminate earlier if the optionee ceases to be a member of the Board of Directors.

During 2002, the Company granted 1,000,000 options to non-employee directors at a weighted average exercise price of $0.24 per share. As of December 31, 2002, 291,560 options were vested and 1,378,750 were outstanding under the Amended and Restated 1999 Non-Employee Directors Stock Option Plan.

NOTE 11: GEOGRAPHIC INFORMATION

The Company conducts its business on the basis of one reportable segment (see Note 1 for brief description of the Company's business). The Company has adopted Statement of Financial Accounting Standard No. 131, "Disclosures About Segments of an Enterprise and Related Information".

Revenues from external customers:

	Revenues		
	2000	2001	2002
Israel...................	$ 196	$ 451	$ 416

U.S.A....................	10,703	5,806	1,207
Europe...................	1,927	2,500	1,436
Japan....................	1,295	656	356
Latin America............	4,085	2,910	23
Other....................	565	1,265	---
	$18,771	$ 13,588	$ 3,438

The Company's long-lived assets are as follows:

	2001	2002
Israel............	$ 2,953	$ 441
U.S.A.............	1,773	588
Other.............	426	---
	$ 5,152	$ 1,029

NOTE 12: SUBSEQUENT EVENTS (UNAUDITED)

a. Convertible Loan Transaction

On January 29, 2003 Commtouch entered into a Convertible Loan Agreement with certain lenders according to which the Company is entitled to receive up to a maximum possible loan (the "Loan") amount of $1,250.

Through June 2003 the Company has received the total Loan amount of $1,250 from the lenders. The Loan is to be repaid after three years, unless converted into Commtouch shares by the lenders or a defined event triggering early repayment is met. The Loan bears interest at a rate of ten percent per annum and is to be repaid together with the loan. Furthermore, the Loan's 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 such 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.

b. Class action litigation

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 $15,000 to the plaintiffs, with this amount to be fully funded by the Company's Directors and Officers insurance policy. While the payment to plaintiffs under this settlement should not cause the Company any financial hardship, the Company is 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 the Company continues to maintain that it and individual defendants acted properly at all time.

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SIGNATURES

The registrant hereby certifies that it meets all of the requirements for filing on Form 20-F and that it has duly caused and authorized the undersigned to sign this annual report on its behalf.

COMMTOUCH SOFTWARE LTD.

By: /s/ Devyani Patel

Devyani Patel
V.P. Finance July 15, 2003

CERTIFICATIONS

I, Gideon Mantel, certify that:

1. I have reviewed this annual report on Form 20-F of Commtouch Software Ltd.;

2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;

3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:

a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;

b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this annual report (the "Evaluation Date"); and

c) presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):

a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officer and I have indicated in this annual report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: July 15, 2003

/s/Gideon Mantel

Gideon Mantel
Chief Executive Officer

I, Devyani Patel, certify that:

1. I have reviewed this annual report on Form 20-F of Commtouch Software Ltd.;

2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;

3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:

a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;

b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this annual report (the "Evaluation Date"); and

c) presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of

registrant's board of directors (or persons performing the equivalent function):

a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officer and I have indicated in this annual report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: July 15, 2003

/s/Devyani Patel

Devyani Patel
V.P. Finance

COMMTOUCH SOFTWARE LTD.

SCHEDULE II -- VALUATION AND QUALIFYING ACCOUNTS
U.S. Dollars in thousands

	Balance at the beginning of the period	Charged to cost and expenses	Deduct
Year ended December 31, 2000:			
Bad debt.....................................	$ 405	$ 1,990	$(1,
Year ended December 31, 2001:			
Bad debt.....................................	$ 862	$ 259	$ (
Year ended December 31, 2002:			
Bad debt.....................................	$ 570	$ 40	$ (

Item 19. Exhibits

Exhibit Number	Description of Document
1.1	Memorandum of Association of the Registrant.(1)

1.2	Amended and Restated Articles of Association of the Registrant, as amended on May 15, 2003.
2.1	Specimen Certificate of Ordinary Shares.(1)
2.2	Amended and Restated Registration Rights Agreement dated as of April 19, 1999.(1)
2.2.1	Amendment No. 1 to Amended and Restated Registration Rights Agreement dated as of December 29, 1999.(4)
2.2.2	Amendment No. 2 to Amended and Restated Registration Rights Agreement dated as of March 10, 2000.(5)
2.3	Reserved.
2.4	Form of Drag-Along Letter dated as of April 15, 1999.(1)
2.5	Ordinary Shares Purchase Agreement between Commtouch Software Ltd. And Torneaux Fund Ltd., dated January 23, 2001.(9)
2.6	Amended and Restated Merger and Exchange Agreement dated November 24, 2000 among Commtouch Software Ltd., Commtouch Inc., CW Acquisition Corporation, Wingra, Incorporated, the holder of certain of the outstanding capital stock of Wingra, Incorporated, and the holders of all the outstanding membership interests in Wingra Technologies, LLC other than that owned by Wingra, Incorporated.(10)
2.7	Registrant hereby agrees to furnish the Securities and Exchange Commission, upon request, with the instruments defining the rights of holders of long-term debt of the registrant with respect to which the total amount of securities authorized does not exceed 10% of the total consolidated assets of the Registrant.
2.8	Ordinary Shares and Warrants Purchase Agreement dated as of February 27, 2002 by and between Commtouch Software Ltd., and the Investors Listed on Exhibit A Thereto(31)
2.9	Text of Report on Form 6-K filed by the Registrant for the month of April 2003 (21)
2.9.1	Convertible Loan Agreement dated January 29, 2003, inclusive of Exhibits "A" through "D" thereto. (22)
2.9.2	Exhibit "F" to Convertible Loan Agreement dated January 29, 2003 - Form of Guaranty (23)
2.9.3	Exhibit "G" to Convertible Loan Agreement dated January 29, 2003- Form of U.S. Subsidiary Security Agreement (24)
2.9.4	Exhibit "H" to Convertible Loan Agreement dated January 29, 2003 - Form of Company Security Agreement (25)
2.9.5	Exhibit "I" to Convertible Loan Agreement dated January 29, 2003 - Form of Collateral Agency Agreement (26)
2.9.6	Exhibit "J" to Convertible Loan Agreement dated January 29,

	2003- Form of Patent and Trademark Security Agreement (27)
2.9.7	Exhibit "K" to Convertible Loan Agreement dated January 29, 2003 - Opinion of Israeli Counsel to the Company (28)
2.9.8	Exhibit "L" to Convertible Loan Agreement dated January 29, 2003- Opinion of US Counsel to the Company (29)
2.9.9	Addendum 1 to Convertible Loan Agreement (30)
2.9.10	Addendum 2 to Convertible Loan Agreement
4.1	Registrant's 1996 CSI Stock Option Plan and forms of agreements thereunder.(1)
4.2	Registrant's form of Stock Option Agreement for Israeli Employees.(1)
4.3	Registrant's 1999 Section 3(i) Share Option Plan and form of agreement thereunder.(1)
4.4	Form of Share Warrant for Go2Net, Inc. to purchase ordinary shares of the Registrant.(3)
4.5	Form of Share Purchase Agreement by and among the Registrant, Go2Net, Inc. and Vulcan Ventures Incorporated.(3)
4.5.1	Form of Registration Rights Agreement by and among the Registrant, Go2Net, Inc. and Vulcan Ventures Incorporated.(3)
4.6	Commtouch Software Ltd. 1999 Section 3(I) Share Option Plan.(8)
4.7	Wingra Technologies, LLC 1998 Unit Option Plan (13)
4.8	Stock Purchase Agreement between Commtouch Software Ltd. and Rideau Ltd., dated June 1, 2001 (12)
4.9	Form of Wingra Technologies, LLC Investor Option Agreement (14)
4.10	Form of Wingra Technologies, LLC Investor Warrant Agreement (15)
4.11	Stock Purchase Agreement between Commtouch Software Ltd. and Hughes Holdings LLC dated June 5, 2001 (16)
4.12	Agreement of Commercial Lease between Am-Ram Pituah Drom Netanya (South Netanya Development) Ltd. as Lessor and Comtouch Software Ltd. as Lessee dated June 3, 2000 for premises in Netanya, Israel.(17)
4.13	Conditional Lease Termination Agreement between EOP-Shoreline Technology Park, L.L.C. and Commtouch Inc. dated December 21, 2001
4.14	Settlement between Compaq Financial Services Corporation and Commtouch Inc. and Commtouch Software Ltd. dated December 21, 2001
4.15	Settlement and Termination of Services Agreement between Exodus Communications, Inc. and Commtouch Inc. dated January 10, 2002

4.16	Amended and Restated 1996 CSI Stock Option Plans and form of agreement thereunder (18)
4.17	Amended and Restated 1999 Section 3(i) Share Option Plan and form of option agreement thereunder (19)
4.18	Amended and Restated 1999 Non-Employee Directors Stock Option Plan
4.19	Agreement of Merger between CP Software Group Inc., Commtouch Software Ltd, MailCentro, Inc. and CPSGNEWCO, Inc. dated November 16, 2001
4.20	Business Unit Purchase Agreement by and between Telecomputing, Inc. and Commtouch Inc. dated January 15, 2002
4.21	Sale and Purchase Agreement by and between Commtouch Software Ltd., Commtouch Inc., Wingra, Incorporated, Wingra Technologies, L.L.C., Jan Eddy and Steven Entine dated February 25, 2002
4.22	Lease Termination Agreement between Young Woo & Assoc., LLC and Commtouch Inc. and Commtouch Software Ltd. (as guarantor) dated September 6, 2002
4.23	Surrender Agreement between Omni South Beach, L.P. and Commtouch Latin America Inc. dated August 31, 2002
4.24	Agreement of September 1, 2002 between AxcessNet Ltd. and Commtouch Software Ltd. plus Warrant for purchase of Registrant's ordinary shares
4.25	Agreement of September 1, 2002 between AxcessNet Ltd. and Commtouch Software Ltd., plus Amendment 1 thereto
8	Subsidiaries of the Company (1. Commtouch Inc., a California corporation, and 2. Commtouch (UK) Ltd. - in process of winding up)
10.1	Consent of Kost, Forer & Gabbay, independent auditors.
10.2	Memorandum of Understanding between the Registrant, Go2Net, Inc. and Vulcan Ventures Incorporated, dated July 7, 1999.(2)
12(a).1	Certification of Registrant's Chief Executive Officer Pursuant to 18 U.S.C. Section 1350
12(a).2	Certification of Registrant's Chief Financial Officer Pursuant to 18 U.S.C. Section 1350

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(1) Incorporated by reference to exhibits in Amendment No. 1 to Registration Statement on Form F-1 of Commtouch Software Ltd., File No. 333-78531.

(2) Reserved.

(3) Incorporated by reference to exhibits in Amendment No. 5 to Registration Statement on Form F-1 of Commtouch Software Ltd., File No. 333-78531.

(4) Incorporated by reference to exhibit in Amendment No. 1 to Registration Statement on Form F-1 of Commtouch Software Ltd., File No. 333-89773.

(5) Incorporated by reference to exhibits in Amendment No. 2 to Registration Statement on Form F-1 of Commtouch Software Ltd., File No. 333-89773, filed March 28, 2000.

(6) Reserved.

(7) Reserved.

(8) Incorporated by reference to Exhibit 10.2 to Registration Statement on Form S-8 No. 333-94995.

(9) Incorporated by reference to Exhibit 2 to Report on Form 6-K for the month of January 2001.

(10) Incorporated by reference to Exhibit 3 to Report on Form 6-K for the month of January 2001.

(11) Reserved.

(12) Incorporated by reference to Exhibit 1 to Report on Form 6-K for the month of May 2001, filed June 1, 2001.

(13) Incorporated by reference to Exhibit 2 to Report on Form 6-K for the month of May 2001, filed June 1, 2001.

(14) Incorporated by reference to Exhibit 3 to Report on Form 6-K for the month of May 2001, filed June 1, 2001.

(15) Incorporated by reference to Exhibit 4 to Report on Form 6-K for the month of May 2001, filed June 1, 2001.

(16) Incorporated by reference to Exhibit 4 to Report on Form 6-K for the month of May 2001, filed June 12, 2001.

(17) Incorporated by reference to Exhibit 10.13 to Amendment No. 1 to Annual Report on Form 20-F for the year ended December 31, 2000.

(18) Incorporated by reference to Exhibit 4 to Schedule TO, filed July 20, 2001.

(19) Incorporated by reference to Exhibit 5 to Schedule TO, filed July 20, 2001.

(20) Reserved

(21) Incorporated by reference to Report on Form 6-K for the month of April 2003, filed April 2, 2003.

(22) Incorporated by reference to Exhibit 1 to Report on Form 6-K for the month of April 2003, filed April 2, 2003.

(23) Incorporated by reference to Exhibit 2 to Report on Form 6-K for the month of April 2003, filed April 2, 2003.

(24) Incorporated by reference to Exhibit 3 to Report on Form 6-K for the month of April 2003, filed April 2, 2003.

(25) Incorporated by reference to Exhibit 4 to Report on Form 6-K for the month of April 2003, filed April 2, 2003.

(26) Incorporated by reference to Exhibit 5 to Report on Form 6-K for the month of April 2003, filed April 2, 2003.

(27) Incorporated by reference to Exhibit 6 to Report on Form 6-K for the month of April 2003, filed April 2, 2003.

(28) Incorporated by reference to Exhibit 7 to Report on Form 6-K for the month of April 2003, filed April 2, 2003.

(29) Incorporated by reference to Exhibit 8 to Report on Form 6-K for the month of April 2003, filed April 2, 2003.

(30) Incorporated by reference to Exhibit 9 to Report on Form 6-K for the month of April 2003, filed April 2, 2003.

(31) Incorporated by reference to Exhibit 2.8 to Annual Report on Form 20-F for the year ended December 31, 2001.