



*The Insurance Technology People*

**Sapiens International**  
**Annual Report 2002**

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# Letter to Our Shareholders

## Dear Shareholders,

The year 2002 marked the beginning of a new chapter in the history of Sapiens. Sapiens delivered on its promise to establish a strong foothold in the global insurance industry, while improving the Company's financial performance. Our efforts to enable insurance enterprises to consolidate and enhance their processes and legacy IT systems have begun to gain momentum. During the past twelve months, our management team has built and marketed a focused vision, creating a visible resource for the insurance industry's value chain.

The insurance industry is recovering in certain segments and I expect that it will need to upgrade its IT systems in order to adapt to changes in the market. I remain both confident and optimistic in our continued efforts to become a leading supplier to the insurance world. Following the launch of the **Sapiens INSIGHT™** solution suite, early adopters who have put their new systems in production, report significant return on their investments. At the same time, we are gaining increased recognition for our solutions within the insurance marketplace and expect new insurance companies to join our customer base.

### **2002: The Year of Insurance Transition**

Our move into insurance necessitates a serious internal strategic realignment in terms of how we best use our personnel resources, research and development capabilities and other assets.

During 2002, we made significant progress in becoming a leader in fulfilling the needs of the insurance sector.

- We launched our Insurance Solutions Practice (ISP) in North America, the United Kingdom and EMEA to better service the increasing business and technology needs of the insurance sector. The practice focuses on fulfilling the business process demands of the **property and casualty (P&C)** and **life and pension (L&P)** insurance markets by providing modular, web-enabled business solutions that help align IT systems to improve operational performance and effectiveness. The practice includes a group of insurance domain specialists who not only lead our efforts but provide thought-leadership to the industry. In the last twelve months, we have welcomed to our ranks Judy Johnson, Debby Lerman, Brian Meigh and Mely Lerman, each one a recognized insurance expert bringing decades of experience to the Company. Their creativity is already helping our customers in addressing their business needs.
- We strengthened senior management with the recruitment of David Ofek as corporate EVP for Business Development & Marketing, and Dan Trajman as the President of Sapiens Americas. David brings with him years of experience as a senior executive in the Scitex Corporation group, including CEO of Objet-Geometries and President & CEO of Scitex Europe. Dan comes to Sapiens after serving as

CEO in iKnowledge Inc. and CTI Squared Inc., a co-founder and managing director in LTMI and Executive Vice President of marketing and business development with L&H N.V.

- We introduced and deployed Sapiens INSIGHT™, a suite of modular business solutions that make use of existing assets to quickly and cost-effectively modernize insurance business processes.
  - In the US this year, the Company helped insurance provider OneBeacon become an industry leader. Utilizing innovative technology and a team of industry experts, the Company helped to consolidate OneBeacon's seven systems, yielding a common platform and operational cost reductions of more than 60%. The significant streamlining has led to a more satisfied agent community and better service to the consumer. Agents can now dynamically set choices and change parameters to modify a product for increased personalization in drastically shorter time frames. Our Policy INSIGHT solution for the P&C insurance sector is now a marketable business model for Sapiens, which can be used by insurance organizations to bridge the technology gap, improve customer service and reduce administration costs significantly.
  - In the UK, Sapiens generated significant cost savings for Liverpool Victoria, the UK's largest Friendly Society that provides a wide range of products and services in Life Assurance, Pensions, General Insurance and Banking. The implementation of our Closed Books INSIGHT solution has reduced the cost of

administration of its 3.5 million policies by about 50%, to make Liverpool Victoria the leader in policy administration efficiencies and a market benchmark. The new solution offers one-stop process execution, reduced training needs and costs, greater transactional throughput, better management information, improved reliability and improved financial control.

### **Financial Highlights**

The 2002 financial results reflect overall improvement when compared to those of 2001:

- Revenues remained virtually unchanged (a slight increase of 2%). However, within the total revenues, there was 24% growth in product revenues resulting from our focused efforts on sales of licenses and license upgrades.
- Gross profit increased 38%, fueled by the improved ratio of product revenues within the revenues mix, together with the continued realignment of costs and improved utilization of resources. The reduced dollar value of gross profit from consulting and other services was largely offset by the high increase of gross profit from products.
- Gross margin from product revenues was up 46%, and from services, up 13%. The positive shift toward sales of software solutions, with improved pricing and efficient deliveries to customers, was the major contributor to the improvement. In addition, we were able to improve the gross margin from services by concentrating on those services which provided higher profit margins.

- We reduced selling, general and administrative expenses by 17%. Continuing the processes and efforts instituted in 2001, we reduced costs in almost every area of the Company's activities by reducing headcount and streamlining our operations.
  - For the first time in four years, our operations generated positive cash flow of about \$1 million. Cost reductions, increased efficiency and improved collections all made their mark. Setting aside certain non-recurring accruals, 2002 would have been operationally profitable.
  - We still had a net loss of \$5.2 million for the year but that was an improvement of over 71% from the previous year's loss of \$18 million.
- Sapiens is the major supplier for the joint venture between EDS and Abbey National (the second largest provider of mortgages and savings in the UK) in the development and enhancement of their platform for loans and mortgages.
  - Sapiens eMerge was selected as the core rules-based engine for the Internal Revenue Service's modernization program led by CSC as the prime contractor.

It should be noted that in spite of the year over year improvement, we experienced a slowdown in revenues toward the end of the year that impacted the results of the fourth quarter. This trend continued into the early part of 2003 as well.

### **Operational Highlights**

The year 2002 saw continued strengthening in various aspects of our operations. Sapiens UK continued its strong performance. Sapiens Americas grew significantly to catch up to the UK, while our French and German subsidiaries underperformed as they shed older, non-profitable and non-strategic elements of the business.

I would like to expand on some of the areas in which a solid infrastructure is being constructed up going forward:

- In both the UK and the Americas we increased our application development business related to Sapiens eMerge™, our rules-based rapid application development (RAD) suite.
- We expanded considerably our Service Maintenance Practice (SMP), offering our customers improved efficiencies and reduced costs for maintaining and enhancing their applications.
- In order to accelerate our market positioning, we have successfully entered into relationships with leading insurance consulting and management firms such as Impact Plus and Rowlings in the UK and CastleBay and Blue Cod in North America. In France, Germany and Israel, we have engaged insurance industry experts and created advisory boards.
- The quality of our products and deliveries, based on our eMerge technology and RAD methodology, proved Sapiens unique delivery capabilities throughout the year, demonstrated by a marked improvement in customer satisfaction.
- We implemented an integrated ERP information system that fully supports all financial, project management and customer relations needs.
- We were greatly aided in all our activities by the additional investment of \$10 million by the Formula Group late in the year. As a result of Formula's conversion of its previous holdings

of preferred shares to common stock, the 2002 investment and additional open-market purchases in 2003, Formula now holds a little more than 50% of our outstanding common shares. The support of the Formula Group, an international, publicly held software group, will enhance Sapiens' efforts to become a leading provider of technology solutions for the global insurance industry.

### **2003 and beyond**

The progress we made in 2002 does not completely dispel our concerns for the future. The year 2002 began strong but the continuing slowdown in the global economy contributed to a decrease of revenues and an operational loss for the fourth quarter of 2002 and the early part of 2003.

It is no secret that economic conditions across all markets continue to be difficult and the signs of recovery that have emerged are still far from the imminent realization we all hope for. The IT market, which has been our traditional bread and butter, remains sluggish. The insurance sector, Sapiens' long-term strategic market, is experiencing its most challenging period in recent history. Increased liabilities, failed investments in capital markets, escalating operational costs and new legislative and regulatory requirements all point to a need for a revised insurance business model, driven by significant cost cutting.

Building on successes during 2002 and the positive indications of recovery that we are seeing in the insurance market, the Company moves forward with a single, clear focus on the global insurance industry. We will continue to streamline our business objectives and make the maximum

use of our multidisciplinary teams to build and support superior insurance solutions so that our clients can create competitive advantage.

In closing, I want to express my highest regard to our customers for the confidence they place in Sapiens. It is our privilege and honor to serve them in the best way possible. I also want to thank my colleagues – employees and management – for devoting their outstanding talents and never-ending efforts to achieving Sapiens' goals. The road ahead remains “bumpy,” but we are dedicated to achieving consistent profitability for the Company. I fully believe, as I have since I joined Sapiens in late 2000, that the Company will be able to justify the commitment that you, our shareholders, have demonstrated in these demanding times.

Until next year,



**Yitzhak Sharir**  
President and  
Chief Executive Officer

## Operating and Financial Review

The following management's discussion and analysis of financial condition and results of operations should be read in conjunction with our financial statements and the notes thereto. Certain matters discussed below and throughout this annual report are forward-looking statements that are based on our beliefs and assumptions as well as information currently available to us. Such forward-looking statements may be identified by the use of the words "anticipate," "believe," "estimate," "expect," "may," "will," "plan" and similar expressions. Such statements reflect our current views with respect to future events and are subject to certain risks and uncertainties. While we believe such forward-looking statements are based on reasonable assumptions, should one or more of the underlying assumptions prove incorrect, or these risks or uncertainties materialize, our actual results may differ materially from those described herein. Please read the section below entitled "Risk Factors" to review conditions that we believe could cause actual results to differ materially from those contemplated by the forward-looking statements and keep in mind the other cautionary statements appearing in this section and elsewhere in this annual report.

### Results of Operations

**Revenues.** Product revenues are comprised of sales of licenses, license upgrades, specially designed products for the insurance industry such as "Policy INSIGHT," "Closed Books INSIGHT" and "Claims INSIGHT," application development and re-engineering projects, and platform and/or computing environment migration projects. These projects are performed either on a fixed-price or time and materials basis. Service revenues include mainly consultants on a time and materials basis and maintenance support.

Total revenues in 2002 increased 2.2% to \$64.8 million from \$63.4 million in 2001 after a decrease of 12.8% from \$72.7 million in 2000. Product revenues in 2002 increased 23.9% to \$42.0 million from \$33.9 million in 2001 and decreased 23.0% in 2001 from \$44.0 million in 2000. Consulting and other service revenues in 2002 decreased 22.7% to

\$22.8 million from \$29.5 million in 2001 and increased 2.8% in 2001 from \$28.7 million in 2000.

Our product revenues for the year ended December 31, 2002 rose mainly due to sales to existing customers of upgrades of Sapiens eMerge licenses to version 4.5 coupled with successful results of increased sales and marketing efforts. The decline in consulting and other service revenues came as a result of lower revenues from consulting, while revenues from maintenance remained flat. Consulting revenues decreased primarily because the Company concentrated on activities with higher profit margins and did not take on activities with lower profit margins.

Revenues from operations within geographic areas based on our customers' locations show growth in the United Kingdom subsidiary and the North American subsidiaries. The UK subsidiary increased its revenues 19.2% in 2002 to \$25.4 million from \$21.3 million 2001 and 20.3% in 2001 from \$17.7 million in 2000. The North American subsidiaries reported revenues of \$20.3 million in 2002, a 9.7% increase from \$18.5 million in 2001 as compared with a 22.5% increase in 2001 from \$15.1 million in 2000. The Company attributes increased revenues in these regions to successful marketing, sales and delivery efforts.

Revenues from our French subsidiaries were \$3.5 million, down 41.7% from \$6.0 million in 2001, which in turn declined 63.9% from \$16.6 million in 2000; from our German subsidiaries, \$2.7 million, which declined 43.8% from \$4.8 million in 2001, as compared with a decline of 23.8% from \$6.3 million in 2000; and from other small subsidiaries (Switzerland and Japan), \$7.2 million, up 5.9 % from \$6.8 million in 2001, as compared with a decline of 40.4% from \$11.4 million in 2000. Our Israeli subsidiary showed a slight decline of 4.9% to \$5.8 million in 2002 from \$6.1 million in 2001 which was an increase of 8.9% from \$5.6 million in 2000.

**Cost of Revenues.** Cost of revenues is mainly comprised of labor costs of software consultants and engineers, direct overhead of professional services,

amortization of capitalized software and royalties to the Office of the Chief Scientist (“OCS”) in Israel. Cost of service revenues also includes depreciation of fixed assets. Our overall gross profit in 2002 increased 38.0% to \$28.7 million from \$20.8 million in 2001 after decreasing 4.6% from \$21.8 million in 2000. Overall gross profit increased in 2002 mainly as a result of increased product revenues in the revenues mix. Gross profit as a percentage of revenues increased by 35.1% to 44.3% in 2002 from 32.8% in 2001, which was an increase of 9.3% from 30.0% in 2000.

Gross profit from product revenues increased 90.2% in 2002 to \$19.4 million from \$10.2 million in 2001 after a decrease of 25.5% from \$13.7 million in 2000. Gross margin from product revenues was 46.2% in 2002, an increase of 53.5% compared with 30.1% in 2001, following a 3.2% decrease from 31.1% in 2000. The increases in gross profit and gross margin from product revenues resulted primarily from the relatively high proportion of licenses and license upgrades accompanied by improved product pricing and delivery efficiencies. The sales of licenses amounted to \$10.2 million, \$11.5 million and \$5.0 million in the years 2002, 2001 and 2000, respectively.

Royalty expense pursuant to the OCS funding programs, included in cost of products, increased 6.7% to \$1.6 in 2002 from \$1.5 million in 2001, and increased 15.4% in 2001 from \$1.3 million in 2000. The growing liability to the OCS from year to year resulted from the sale of a larger proportion of products using technologies based on research and development funding by the OCS.

The salaries and other personnel-related expenses component of the costs of product revenues was 42.1%, 51.9% and 57.7% in the years 2002, 2001 and 2000, respectively. This positive ratio trend reflect the material contribution of improved efficiency and better utilization of the Company’s professional teams and helped to offset the increased spending on royalties to the OCS. As a result, gross margins improved consistently from 2000 to 2002.

In addition, capitalized software development costs decreased 32.5% to \$2.7 million in 2002 compared with \$4.0 million in 2001, which in turn was a 7.0% decrease from \$4.3 million in 2000. Similarly,

amortization of capitalized software decreased 37.0% to \$2.9 million in 2002 compared with \$4.6 million in 2001, after an increase of 43.8% from \$3.2 million in 2000.

Gross profit from consulting, maintenance and other services decreased 12.3% to \$9.3 million in 2002 from \$10.6 million in 2001 which was an increase of 30.9% from \$8.1 million in 2000. At the same time, gross margin from consulting, maintenance and other services improved 13.4% in 2002 to 40.8% from 35.9% in 2001 after a 27.3% increase from 28.2% in 2000, mainly due to improved utilization of our professional resources and replacement of low margin consulting services with those that have higher margins. Improved efficiencies and better utilization of our maintenance professionals also contributed to the improvement in gross margin from our maintenance services.

**Research and Development, net.** Research and development (“R&D”) costs are mainly comprised of labor costs and depreciation of fixed assets net of grants from the OCS. Net research and development expenditures increased 9.1% in 2002 to \$6.0 million from \$5.5 million in 2001 after decreasing 46.6% from \$10.3 million in 2000. The increased spending on R&D recorded in 2002 as compared with the previous year, as well as the increased dedication of company resources to new product development, reflect our efforts to accelerate development of specially-designed products for the insurance industry such as Policy INSIGHT, Closed Books INSIGHT and Claims INSIGHT. A portion of our R&D expenditures is funded by the OCS pursuant to programs entitling the Government to receive royalties on sales of products developed as a result of R&D projects so funded. The net R&D expenditure in 2002 and 2001 benefited from OCS funding in the amounts of \$0.7 million and \$1.6 million, respectively. Due to the late approval of the R&D grant in the year 2000, the Company did not record any R&D funding in 2000. See information regarding capitalized software development costs under “Costs of Revenues” above.

**Selling, Marketing, General and Administrative expenses, net.** Selling, marketing, general and administrative expenses consist primarily of salaries and other personnel-related expenses. In addition, selling and marketing expenses also include

commission and other costs associated with our sales and marketing efforts while general and administrative expenses also include facilities, communications and external consultants. Selling and marketing, general and administrative, net (“SG&A”) expenses in 2002 decreased 17.1% to \$23.8 million from \$28.7 million in 2001, a decrease of 38.5% from \$46.7 million in 2000. The decrease in SG&A expenses in 2002 is the result of continuing the aggressive cost efficiency program that management implemented beginning in 2001. The decrease from 2000 to 2001 is primarily due to a decrease in payroll and headcount-related expenses, mainly in general and administrative (which accounted for \$10.4 million of the decrease) and a \$7.6 million decrease in facilities and other infrastructure expenses. The decrease from 2001 to 2002 is due to an additional decrease in payroll and headcount related expenses resulting from additional headcount reduction (which accounted for \$1.2 million of the decrease) and a \$3.7 million decrease in expenses related to other operating expenses. At the same time, marketing, promotional activity and related expenses were maintained in 2002 in order to support and accelerate the implementation of the Company’s strategy of penetrating the insurance industry as a targeted market. Expressed as a percent of total revenues, SG&A expenses decreased to 36.7% in 2002 from 45.3% in 2001 and 64.2% in 2000, representing a significant factor in our improving overall operating margins over that period.

**Restructuring expenses.** On December 31, 2002 we recorded a restructuring charge in the amount of \$0.5 million, compared to no such charge in 2001 and a charge of \$2.6 million in 2000. The restructuring charge in 2002 represented involuntary termination benefits for approximately 40 employees as part of our recovery plan for the year 2002. As part of the plan, the employment of 33 additional employees was terminated with no related restructuring charge. The restructuring plan was aimed at streamlining the Company by improving gross margins performance and realignment of SG&A organization and costs in order to better support the needs of our market and customers.

**Taxes on Income.** The tax expenses in 2002 were \$1.4 million, an increase of 100% compared with tax expenses of \$0.7 million in 2001, which in turn

represented an increase of 136.8% over a net tax benefit of \$1.9 million in 2000. The increase in 2002 is due primarily to the agreement with the Israel tax authorities described in the next paragraph. The Company’s entire provision for taxes on income relates to operations in jurisdictions other than the Netherlands Antilles. The effective income tax rate varies from period to period as the result of the various jurisdictions in which the Company operates and where each one has its own system of taxation (not only with respect to the nominal rate, but also with respect to the allowance of deductions, credits and other benefits). The Company records a valuation allowance to reduce its deferred tax assets to the amount that is more likely than not to be realized. The Company did not recognize a majority of the deferred tax assets relating to the net operating losses of the Company’s subsidiaries worldwide due to the uncertainty of the realization of such tax benefits.

In December 2001, Sapiens Technologies Ltd. (“Technologies”), Sapiens Israel Software Systems Ltd., Sapiens International Corporation N.V. and Sapiens International Corporation B.V. entered into an agreement with the Israeli Tax Authorities (“the ITA”) following a tax audit. In accordance with this agreement’s provisions, the Company agreed to pay in installments an amount of approximately \$1 million for the tax years through 1999. These payments were completed in November 2002. In addition, this agreement provided that the Company would have a contingent tax liability to pay an additional amount (the “additional amount”). The payment of the additional amount was contingent on Technologies obtaining certain approvals from the Investment Center regarding the status of the Approved Enterprise under the Encouragement of Investments Law. In July 2002, an agreement was reached between Technologies and the ITA, according to which the additional amount was determined to be \$580,000. This additional amount is payable in 11 installments ending in October 2003.

**Net Income/Loss.** Net loss for 2002 was \$5.2 million, a decrease of 71.1% compared with a loss of \$18.0 million, which in turn represented a decrease of 52.9% from \$38.2 million in 2000. The decrease in loss in 2002 was primarily due to improved gross

profit margins and lower operating and financial expenses.

### **Liquidity and Capital Resources**

Cash, cash equivalents, marketable securities and short term investments at the end of 2002 were \$23.7 million compared with \$16.1 million at the end of 2001 and \$10.9 at the end of 2000.

Net cash provided by operations was \$5.0 million in 2002 compared with \$2.6 million net cash used in operations in 2001 and \$21.1 net cash used in operations in 2000. The material improvement in 2002 versus 2001 and 2000 was due primarily to two factors: the improved operating results based on aggressive reduction of costs and increased efficiency throughout the Company's operations; and a decrease of 40.9% in trade receivables due to successful deliveries resulting in efficient collection efforts (\$10.4 million as at December 31, 2002 compared to \$17.6 million as at December 31, 2001). Net cash used in investing activities was \$3.7 million in 2002, compared with \$4.3 million in 2001 and \$3.7 million in 2000. The principal uses of cash were the purchase of property and equipment, capitalized software development costs and the purchase of short-term deposits and marketable securities.

Net cash provided by financing activities totaled \$4.3 million, compared with \$6.4 million net cash provided by financing activities in 2001 and \$33.4 million in 2000. The sources of cash provided by financing activities were the investment by Formula Systems (1985) Ltd. ("Formula") of \$10 million and a decrease of \$10.6 million in short-term bank debt, of which \$7.5 million was the result of reclassification to long-term debt through agreements with the Company's lender banks.

In June 2003, the Company received approval from its lender banks to extend its existing credit lines in the amount of \$24 million, of which \$16.1 million will be available until March 31, 2004 and \$7.9 million will be available until March 31, 2005.

In December 2002, Formula invested an additional \$10 million in the Company by exercising an existing option to purchase Common Shares.

Management believes that available working capital and credit lines will be sufficient for the next 12 months to support the Company's operating requirements. The Company may consider other financing alternatives to finance strategic goals and future growth.

### **Risk Factors**

We operate globally in a dynamic and rapidly changing environment that involves numerous risks and uncertainties. The following section lists some, but not all, of those risks and uncertainties that may have a material adverse effect on our business, financial condition or results of operations.

***Continuing adverse conditions in the market for information technology solutions may lead to decreased demand for our products and services and could harm our business and results of operations, as well as the price of our shares.***

Sapiens products and services are generally used by organizations with large information technology budgets and needs. The economic slowdown that has affected the markets in which we operate has had a particularly significant impact on the information technology sector. In response to this difficult economic environment, a number of our customers and potential customers have reduced their information technology budgets, leading to a decline in demand for our products. We believe that these adverse market conditions, and the response of certain of our customers and potential customers to these recent developments, have had a negative impact on our revenues and on the price of our shares. Should these market conditions persist, our business and results of operations could suffer further and the price of our shares could be harmed.

***If we fail to remain technologically competitive, we could lose customers or market share.***

The market for the Company's solutions is characterized by rapidly changing business conditions and customer requirements. The introduction of solutions embodying new technology and the emergence of new customer requirements can render existing technology obsolete and unmarketable. The Company's ability to anticipate changes in technology and customer requirements

and to successfully develop and introduce new and enhanced solutions on a timely basis will be significant factors in the Company's ability to grow and to remain competitive. Substantial expenditures are required for research and development and new product introduction. There can be no assurance that the Company will have sufficient resources to make such investments, or that these investments will bring the full advantages or any advantage as planned. If the Company is unable, for technological or other reasons, to develop solutions on a timely basis in response to the changing demands of its industry, the Company's business and financial results could be materially adversely affected. The Company has in the past experienced limited delays introducing its technology and enhancements, and there can be no assurance that it will not encounter technical or other difficulties that could delay introduction of new technologies or enhancements in the future. There can be no assurance that the Company will be successful in developing and marketing enhancements that incorporate new technology on a timely basis, or that its new solutions will adequately address the changing needs of the marketplace, which could have a material adverse effect on our results of operations and financial condition.

***Implementing our new strategy of focusing on the market for software solutions in the insurance and financial services industries could take longer than anticipated or could fail, which could have a material adverse affect on our long-term growth.***

In October 2001, we announced a new strategic initiative focusing on the insurance and financial services industries. Our goal is to rise to a position of global leadership in delivering strategic business software solutions to this market. Implementing this new strategy requires us, among other things, to design appropriate software solutions, maintain sufficient sales and marketing resources, recruit, train and hire sufficient professional services personnel and face intense competition. Our failure to meet any one or more of these challenges may lead to delays in, or to the failure of, our new strategy, which could have a material adverse affect on our short and medium term results and on our capability to grow and achieve our long-term goals.

***The software solutions market we address is expected to evolve rapidly, and if we are not able to accurately predict and respond to market developments or customer needs, our competitive position will be impaired.***

The market for the solutions we provide is expected to evolve rapidly. However, estimates of our market's expected growth are inherently uncertain and are subject to many risks and assumptions. Moreover, many of our customers operate in markets characterized by rapidly changing technologies and business plans. Rapid changes in the needs of these customers and changing technologies make it difficult for us to predict their demands. We are particularly susceptible to those changes since our software is used in a wide array of operating environments, which are constantly evolving. As a result, we may not be able to develop, on a timely basis or at all, solutions that meet our customers' needs or desires. In addition, various sectors of our market are served by competitors who may respond more effectively to market developments and customer needs. We cannot assure you that the market for our solutions will grow or that we will be able to respond to changes in the market, evolving customer needs or our competition. If the market for our solutions does not develop as we expect or if we fail to respond to market and competitive developments, our business prospects and competitive position will be impaired.

***The failure of our new solutions to achieve market acceptance or delays in our current or future efforts to develop software solutions could erode our competitive position.***

The failure to successfully develop, enhance or modify our software solutions, or the failure to do so on a timely basis, could limit our revenue growth and competitive position. We may need to rapidly develop and introduce additional software and enhancements to our existing solutions to satisfy our current customers and maintain our competitive position in the marketplace. We may also need to modify our software so that it can operate with new or enhanced software introduced by other software vendors. The failure to introduce new, enhanced or modified software on a timely basis could prevent our solutions from achieving market acceptance. We have experienced in the past, and may

experience in the future, delays in the timing of the introduction of new solutions. To support our software development, enhancement or modification, we may find it necessary to license or acquire new technologies, which may not be available to us on acceptable terms, if at all.

***We are dependent on the success of our two main subsidiaries in the U.S. and U.K.***

Our two main subsidiaries, which are located in Cary, North Carolina and London, England, account for more than 70% of annual revenues. While we are committed to the continued growth of these operations, as well as our operations in France, Germany, Japan Switzerland and Israel, there can be no assurance that our main operations will continue to perform at their current level. Furthermore, a significant downturn in the business of either of our two main subsidiaries would have a material adverse impact on our financial results.

***We compete against companies with significantly greater resources than our own.***

The market for software solutions and related services, and for business solutions for the insurance industry, in particular, is highly competitive. Our principal competitors generally have significantly greater resources than our own. Price reductions or declines in demand for our solutions and services, whether as a result of competition, technological change, changes in the level of application development, reengineering or maintenance performed internally by our customers or potential customers would have a material adverse effect on our results of operations and financial position. Additional factors that may cause actual results to differ materially from our expectations include industry specific factors; our ability to continuously develop, introduce and deliver commercially viable solutions and technologies, and the market's rate of acceptance of the solutions we offer; our ability to keep pace with market and technology changes and to compete successfully; and our ability to manage the competitive risks associated with the strategic alliances that we have entered into.

***Our business involves long-term, large projects, some of them fixed-price projects that involve***

***uncertainties, such as estimated project costs and profit margins.***

Our business is characterized by relatively large projects or engagements that can have a significant impact on our total revenue and cost of revenue from quarter to quarter. A high percentage of our expenses, particularly employee compensation, is relatively fixed. Therefore, a variation in the timing of the initiation, progress or completion of projects or engagements, especially at or near the end of any quarter, can cause significant variations in operating results from quarter to quarter.

Some of our solutions are sold as fixed-price projects with delivery requirements spanning more than one year. If our actual cost-to-completion of these projects differs significantly from the estimated costs, there could be a material adverse effect on our results of operations and financial position. Similarly, delays in executing client contracts may affect our revenue and cause our operating results to vary widely. Some of our solutions may be priced in excess of \$1 million and are delivered over periods of time ranging from several months to a few years. Payment terms are generally based on periodic payments or on the achievement of milestones. Any delays in payment or in the achievement of milestones may have a material adverse impact on our financial position.

The sales cycle for our solutions is long and variable, typically ranging between six months to twelve months from initial contact with the potential client to the signing of a contract. Occasionally, sales require substantially more time. This variability may adversely affect our operating results in any particular quarter.

***Our business involves business-critical solutions which expose us to potential liability claims.***

Our products focus on organizations' business-critical applications including those related to core business solutions for the insurance and financial services industries and specialized redevelopment issues such as the adoption of the single European currency. Since our customers rely on our software to operate, monitor and improve the performance of their critical software applications, they are sensitive to potential disruptions that may be caused by the

use of, or any defects in, our software. As a result, we may be subject to claims for damages related to software errors in the future. Liability claims could require us to spend significant time and money in litigation or to pay significant damages. Regardless of whether we prevail, diversion of key employees' time and attention from the business, incurrence of substantial expenses and potential damage to our reputation might result. While the terms of our sales contracts typically limit our exposure to potential liability claims, and we carry errors and omissions insurance against such claims, there can be no assurance that such insurance will continue to be available on acceptable terms, if at all, or that such insurance will provide us with adequate protection against any such claims. A significant liability claim against us could have a material adverse effect on our results of operations and financial position.

***If existing customers do not make subsequent purchases from us or if our relationships with our largest customers are impaired, our revenue could be negatively affected.***

Our existing customers are a key asset of the Company, and we depend on repeat product and service revenues from our base of customers. There can be no assurance that our existing customers will enter into new project contracts with the Company or that they will continue using our enabling technologies. If our revenue stream from existing customers were to decline significantly, it would have a material adverse impact on our operating results.

The relationships with two large customers of our North American subsidiaries – OneBeacon Insurance Company and Computer Sciences Corporation – and two large customers of our subsidiary in the United Kingdom – Liverpool Victoria and EDS Credit Services – are the sources of a large portion of the revenues of each of those two subsidiaries. During 2002, revenues from sales to the American customers constituted 26% of the total revenues of the North American subsidiaries; and revenues from sales to the British customers constituted 33% of the total revenues of the UK subsidiary. If our sales to these customers were impaired, our revenue stream could be negatively affected. We expect that level of revenues from Computer Sciences Corporation will increase during

2003, thus increasing the possible effect of a subsequent decline in sales to that customer.

***Defects in our technology would harm our business and divert resources.***

The quality of our products, enhancements and new versions is critical to our success. Since our software solutions are complex, they may contain errors that can be detected at any point in its life cycle. Any errors or defects in our technology could result in:

- delayed or lost revenue;
- failure to attract new customers or achieve market acceptance;
- claims against us;
- diversion of development resources;
- increased service, warranty and insurance costs; and
- negative publicity resulting in damage to our reputation.

While we continually test our products for errors and work with customers to identify and correct them, errors in our technology may be found in the future. Testing for errors is complicated because it is difficult to simulate the breadth of operating systems, user applications and computing environments that our customers use and because our software is becoming increasingly complex itself. The costs we may incur in addressing technology errors could be substantial and could impair our results of operations.

***Our quarterly results may be impacted by seasonal trends and other short-term factors.***

The operating results of many software and services companies reflect seasonal trends, and we expect to be affected by such trends in the future. Although we have not experienced consistent seasonal fluctuations in operational results to date, to the extent that our operations in Europe continue to generate a high percentage of our total revenues, we anticipate that we may experience relatively weak demand in the third quarter as a result of reduced activities in Europe during the summer months.

Variations in our revenue and operating results could occur as a result of a number of other factors, such as the budgeting and purchasing practices of our

customers, the length of the customer product evaluation process, the timing of our customers' system conversions, the timing and cost of new product introductions and product enhancements, and the timing of any acquisitions and associated costs. Employee hiring and utilization rates may also affect our revenues and results of operations.

***Our international operations involve inherent risks, such as foreign currency fluctuations and compliance with various regulatory and tax regimes.***

Most of the Company's revenues are derived from international operations that are conducted in local currencies as well as dollars. Changes in the value of such local currencies or the dollar relative to such local currencies will affect the Company's financial position. Gains and losses on translations to dollars of assets and liabilities will contribute to fluctuations in the Company's financial position. The Company engages in currency-hedging transactions intended to reduce the effect of fluctuations in foreign currency exchange rates on the Company's financial position. However, there can be no assurance that any such hedging transaction, if entered into, will materially reduce the effect of fluctuation in foreign currency exchange rates on such results or on the dollar price at which the Common Shares are publicly traded. In addition, if for any reason exchange or price controls or other restrictions on the conversion of foreign currencies were imposed, the Company's financial position could be adversely affected.

Other potential risks that may impact the Company's international business activities include longer accounts receivable payment cycles, the burdens of complying with a wide variety of foreign laws and changes in regulatory requirements, although such factors have not had a material adverse effect on the Company's financial position to date.

***We have implemented a 1-for-5 reverse stock split to maintain our Nasdaq listing, which could damage our liquidity and investor confidence in our common stock, and we may again fail to meet Nasdaq's minimum bid requirement.***

The Company implemented a 1-for-5 reverse stock split of its common stock on June 16, 2003, to meet

the listing requirements of Nasdaq. In January 2003, Nasdaq informed the Company that its Common Shares would be delisted from the Nasdaq National Market (the "National Market") due to the Company's failure to maintain compliance with the \$1.00 minimum bid price requirement for continued listing on the National Market (the "Minimum Bid Price Requirement"). In March 2003, Nasdaq approved the Company's plan to implement the reverse stock split in order to regain compliance with the Minimum Bid Requirement. Nasdaq notified the Company that its common stock would continue to be traded on the National Market provided that the Company regained compliance with the Minimum Bid Price Requirement by June 16, 2003 and maintained compliance for at least ten consecutive days thereafter.

As a result of the reverse stock split, on June 16, 2003 the Common Shares began trading on the National Market in compliance with the Minimum Bid Price Requirement. Compliance was maintained for nine consecutive days before the filing of this report. The implementation of the reverse stock split could have a negative impact on the value of our common stock by allowing additional downward pressure on the stock price as its relative value becomes greater following the reverse stock split. In addition, liquidity of our Common Shares could be adversely affected by the reduced number of shares that would be outstanding after the reverse stock split. It is our intent to comply with and meet the requirements for continued National Market listing. However, there can be no assurance that the Company will maintain long-term compliance with the Minimum Bid Price Requirement. If we fail to maintain such compliance, our Common Shares could be delisted, which could have a material adverse effect on our standing with current and future investors. There can be no assurance that the Panel will decide to allow us to remain listed or that our actions will prevent the delisting of our common stock from the National Market.

***If we fail to meet other standards for continued listing of our common stock on the Nasdaq National Market, the common stock could be delisted from the National Market.***

In addition to maintaining compliance with the Minimum Bid Price Requirement, a company must

continue to comply with other requirements in order to remain listed on the National Market. There can be no assurance that we will continue to meet all such requirements, one of which could be maintaining a required minimum shareholders' equity of at least \$10 million. As at December 31, 2002, the Company's shareholders' equity was \$15.9 million, while as at March 31, 2003, shareholders' equity decreased to \$13.9 million. There can be no assurance that the Company's shareholders' equity will be maintained above \$10 million or, if not so maintained, that the Company will meet an alternative continued listing standard. Failure to meet one of Nasdaq's continued listing standards could result in the delisting of our common stock from the National Market.

***We have a history of losses, and we anticipate that our expenses will increase in the foreseeable future as a result of planned expansion of our marketing efforts and research and development activities***

We incurred net losses of approximately \$18 million and \$5.2 million for the years ended December 31, 2001 and December 31, 2002, respectively. We cannot predict the extent of our future losses and when, or if, we may become profitable on a sustained basis. We anticipate that our expenses may increase substantially in the foreseeable future as we seek to increase our sales and marketing activities, and to continue to develop our technology and introduce new solutions. These efforts may prove more costly than we currently anticipate and we may not succeed in increasing our revenues sufficiently to offset these higher expenses. If we fail to increase our revenues at a greater rate than our expenses, we will not be able to achieve profits.

***The terms of our bank debt include a number of restrictive covenants which, if breached, could result in acceleration of our obligation to repay our debt.***

Our loan agreements contain a number of conditions and limitations on the way in which we can operate our business, including limitations on our ability to raise debt, sell or acquire assets and pay dividends. Our loan agreements also contain various covenants which require the Company to maintain certain financial ratios related to shareholders' equity and operating results that are customary for companies

of comparable size. These limitations and covenants may force us to pursue less than optimal business strategies or forego business arrangements which could have been financially advantageous to us or our shareholders. There can be no assurance that we will continue to fulfill these conditions and covenants.

Our failure to comply with the covenants and restrictions contained in our loan agreements could lead to a default under the terms of these agreements. If a default occurs and we are unable to renegotiate the terms of the debt, the lenders could declare all amounts borrowed and all amounts due to them under the agreements due and payable. If we are unable to repay the debt, the lenders could foreclose on our assets that are subject to liens and sell our assets to satisfy the debt. As a result of negotiations regarding the extension of our loan agreements, the assets of our subsidiaries in the United States and United Kingdom are subject to floating liens. Foreclosure on these assets could have a material adverse effect on our results of operations and financial condition.

***Our liquidity may be negatively affected and the holdings of current shareholders may be diluted due to outstanding obligations to investors in the discontinued operations of a subsidiary.***

In February 2001, management decided to discontinue the operation of the subsidiary eZoneXchange.com, Inc. ("eZone"), held by Sapiens and other investors. The private placement to such investors in April 2000 was accompanied by a Put/Call Agreement giving the investors a put option on Sapiens shares as an exchange for its shares in eZone. Following the discontinuation of eZone's operation, Sapiens and the investors amended the Put/Call Agreement. As a result of the amended agreement, if the market price of our Common Shares reaches \$10, the investors will have the right to have the Company repurchase a portion of their shares in eZone in exchange for approximately 363,000 Common Shares of the Company. In addition, as provided in the original Put/Call Agreement, during the period from May 4, 2004 through May 3, 2005, the investors will have the right to put some or all of their remaining shares in eZone to the Company in return for both cash (approximately \$3) and Common Shares of the

Company (at a value of approximately \$2.5 million). If the investors fully exercise their put rights, the Company's liquidity would be negatively affected due to the reduction in our cash reserves and the holdings of current shareholders would be diluted by at least 3.4%.

***Although we protect our intellectual property rights vigorously, there can be no assurance that these measures will be successful.***

In accordance with industry practice, the Company relies upon a combination of contractual provisions and intellectual property law to protect its proprietary technology. The Company believes that because of the dynamic nature of the computer and software industries, copyright protection is less significant than factors such as the knowledge and experience of the Company's management and personnel. The Company seeks to protect the source code of its products as trade secret information and as an unpublished copyright work. The Company also relies on security and copy protection features in its proprietary software. The Company distributes its products under software license agreements which grant customers a personal, non-transferable license to use the Company's products and contain terms and conditions prohibiting the unauthorized reproduction or transfer of the Company's products. In addition, the Company attempts to protect trade secrets and other proprietary information through agreements with employees, consultants, and distributors. Although the Company intends to protect its rights vigorously, there can be no assurance that these measures will be successful. If we fail to protect our rights, and others are able to improperly use our products without licensing them from us, this failure may have a material adverse effect on our results of operations and financial condition.

***We depend upon key personnel, the loss of whom would harm our operations.***

Our success depends, to a significant extent, upon the continued performance and services of our executive officers and other key sales, marketing, software engineers and support personnel. The loss of the services of any of our executive officers, for example, Yitzhak Sharir, our President and Chief Executive Officer, or key personnel, would be

disruptive to our operations. It would be difficult and time consuming to replace them. We do not maintain key person life insurance policies on any of our officers. Any of these individuals may voluntarily terminate his employment with Sapiens. Our inability to retain executive officers or key employees could have a material adverse affect on our results of operations and financial condition.

***Any acquisitions or attempted acquisitions will divert management attention and financial resources and may harm our results of operations and financial condition.***

As part of our growth strategy, we intend to consider acquiring complementary technologies, products and businesses. Attempted acquisitions may divert management, operational and financial resources from the conduct of our core business. As a result, if we pursue this growth strategy, the efforts of management will be diverted from their other operational responsibilities, and we may not complete any attempted acquisition. If we use capital stock, our existing shareholders may experience dilution. If we use cash or debt financing, our financial liquidity will be reduced, the holders of our debt would have claims on our assets ahead of holders of our ordinary shares and our business operations may be restricted by the terms of any debt, including restrictions on our ability to pay dividends on our ordinary shares. In addition, an acquisition may involve nonrecurring charges or amortization of significant amounts of goodwill and other intangible assets, which would adversely affect our ability to achieve and maintain profitability.

***We intend to rely upon tax benefits from the State of Israel, but those tax benefits may not be available to us as anticipated.***

Our subsidiary, Sapiens Technologies Ltd., which is incorporated in Israel, was granted "Approved Enterprise" status by the Israeli government for six investment programs in 1984, 1991, 1993, 1995, 1998 and 2000 under the Law for Encouragement of Capital Investments, 1959. We are eligible for certain tax benefits based on this status. In order to receive these tax benefits, the Company must comply with two material conditions: (a) it must invest a certain amount in fixed assets and (b) it must finance a certain portion of these investments

out of equity capital. We believe that the Company has complied with these conditions. However, confirmation that we have complied with these conditions from the Israeli government's Investment Center with respect to the 2000 program has not yet been received.

If the Investment Center determines that we failed to comply with these conditions, these past benefits may be canceled, reduced or rendered unavailable to us, which could have a material adverse effect on our results of operations and financial condition.

***Conducting business in Israel entails certain inherent risks that could harm our business.***

We have offices and research and development facilities in the State of Israel. Political, economic and military conditions in Israel directly affect our operations. We could be adversely affected by any major hostilities involving Israel, the interruption or curtailment of trade between Israel and its trading partners or a significant downturn in the economic or financial condition of Israel. The future of the peace process is uncertain and has deteriorated due to recent violence between Israelis and Palestinians. In addition, several countries still restrict business with Israel and with companies doing business in Israel. We could be adversely affected by adverse developments in the peace process or by restrictive laws or policies directed towards Israel or Israeli businesses.

All male permanent residents of Israel between the ages of 18 and 48 are, unless exempt, obligated to perform reserve duty in the Israeli Defense Forces, currently consisting of approximately 30 days of service annually. Additionally, all such residents are subject to being called to active duty at any time upon the outbreak of hostilities. Many of the Company's employees are currently obligated to perform annual reserve duty. While the Company has operated effectively under these requirements since its establishment, no assessment can be made as to the full impact of such requirements on the Company's business or work force and no prediction can be made as to the effect on the Company of any expansion of such obligations.

***Formula Systems (1985) Ltd. may exercise control and influence corporate actions that are potentially in conflict with the Company's other public shareholders***

Formula Systems (1985) Ltd. ("Formula"), whose shares trade on The Nasdaq National Market and the Tel Aviv Stock Exchange, directly owns 5,491,677 or 50% of our currently outstanding Common Shares. Formula is and may continue to be in a position to exercise control over most matters requiring shareholder approval. Formula may use its share ownership or representation on the Company's board of directors to substantially influence corporate actions that conflict with the interests of the Company's other public shareholders including, without limitation, changing the size and composition of the board of directors and committees of the Company's board of directors, causing the issuance of further securities of the Company, amending the Company's governing documents or otherwise controlling the outcome of shareholder votes. Further, actions by Formula with respect to the disposition of the shares they beneficially own, or the perception that such actions may occur, may adversely affect the trading price of the shares on the Nasdaq National Market.



## REPORT OF INDEPENDENT AUDITORS

To the Shareholders of

**SAPIENS INTERNATIONAL CORPORATION N.V.**

We have audited the consolidated balance sheets of Sapiens International Corporation N.V. ("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. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above, present fairly, in all material respects, the consolidated financial position of the Company and its subsidiaries as of December 31, 2001 and 2002, and the 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.

/s/ KOST FORER & GABBAY

Tel-Aviv, Israel  
February 26, 2003

KOST FORER & GABBAY  
A Member of Ernst & Young Global

**SAPIENS INTERNATIONAL CORPORATION N.V.  
AND ITS SUBSIDIARIES**

**CONSOLIDATED BALANCE SHEETS**

**U.S. dollars in thousands**

	<b>December 31,</b>	
	<b>2001</b>	<b>2002</b>
<b>ASSETS</b>		
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents	\$ 16,087	\$ 22,001
Restricted cash deposits (Note 3)	2,500	-
Marketable securities and short-term deposits (Note 4)	50	1,652
Trade receivables (net of allowance for doubtful accounts of \$ 4,599 and \$4,001 as of December 31, 2001 and 2002, respectively) (Note 5)	17,563	10,405
Other receivables and prepaid expenses (Note 6)	5,534	5,842
Total current assets	41,734	39,900
PROPERTY AND EQUIPMENT, NET (Note 7)	4,097	3,426
<b>OTHER ASSETS:</b>		
Capitalized software development costs, net of accumulated amortization of \$ 20,719 and \$ 21,072 as of December 31, 2001 and 2002, respectively (Note 8a)	8,911	8,170
Goodwill (Note 8)	7,579	8,621
Other, net (Note 9)	6,059	5,035
Total other assets	22,549	21,826
Total assets	\$ 68,380	\$ 65,152

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

**SAPIENS INTERNATIONAL CORPORATION N.V.  
AND ITS SUBSIDIARIES**

**CONSOLIDATED BALANCE SHEETS**

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

	<b>December 31,</b>	
	<b>2001</b>	<b>2002</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>CURRENT LIABILITIES:</b>		
Short-term bank credit (Note 11a)	\$ 16,209	\$ 5,006
Current maturities of long-term debt (Note 11b)	245	4,477
Trade payables	3,242	2,578
Deferred revenues	1,633	3,683
Other liabilities and accrued expenses (Note 10)	18,768	14,541
Total current liabilities	40,097	30,285
<b>LONG-TERM LIABILITIES:</b>		
Convertible subordinated notes and other long-term liabilities (Note 11b)	7,365	7,787
<b>REDEEMABLE SHARES IN A SUBSIDIARY (Note 1c)</b>	10,711	11,185
<b>COMMITMENT AND CONTINGENT LIABILITIES (Note 12)</b>		
<b>SHAREHOLDERS' EQUITY (Note 15):</b>		
Share capital:		
Convertible Preferred shares: Authorized - 20,000 and 0 of €81 par value at December 31, 2001 and 2002, respectively; Issued and outstanding 10,000 and 0 at December 31, 2001 and 2002, respectively; Aggregate liquidation preference of approximately \$ 15,000 and \$ 0 as of December 31, 2001 and 2002, respectively.	6,361	-
Common shares: Authorized 14,000,000 and 20,000,000 of €2.30 par value at December 31, 2001 and 2002, respectively; Issued: 4,942,932 and 11,028,909 at December 31, 2001 and 2002, respectively; Outstanding: 4,901,138 and 10,987,115 at December 31, 2001 and 2002, respectively.	10,020	23,773
Additional paid-in capital	80,514	82,648
Deferred stock compensation	(68)	(21)
Treasury shares	(2,423)	(2,423)
Note receivable from a related party shareholder	(975)	(975)
Accumulated other comprehensive loss	(5,088)	(3,820)
Accumulated deficit	(78,134)	(83,287)
Total shareholders' equity	10,207	15,895
Total liabilities and shareholders' equity	\$ 68,380	\$ 65,152

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

**SAPIENS INTERNATIONAL CORPORATION N.V.  
AND ITS SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF OPERATIONS**

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

	<b>Year ended December 31,</b>		
	<b>2000</b>	<b>2001</b>	<b>2002</b>
Revenues (Note 16b):			
Products	\$ 43,995	\$ 33,924	\$ 42,008
Consulting and other services	28,749	29,511	22,820
Total revenues	<u>72,744</u>	<u>63,435</u>	<u>64,828</u>
Cost of revenues:			
Products	30,283	23,711	22,567
Consulting and other services	20,652	18,902	13,543
Total cost of revenues	<u>50,935</u>	<u>42,613</u>	<u>36,110</u>
Gross profit	<u>21,809</u>	<u>20,822</u>	<u>28,718</u>
Operating expenses:			
Research and development, net (Note 17a)	10,317	5,458	6,017
Selling, marketing, general and administrative, net	46,682	28,725	23,782
Aborted merger costs	1,252	-	-
Restructuring costs (Note 1b)	2,558	-	481
Total operating expenses	<u>60,809</u>	<u>34,183</u>	<u>30,280</u>
Operating loss	39,000	13,361	1,562
Financial expenses, net (Note 17b)	632	3,187	971
Other expenses, net	403	665	1,173
Loss before taxes on income	40,035	17,213	3,706
Taxes on income (benefit) (Note 14)	<u>(1,949)</u>	<u>726</u>	<u>1,408</u>
	38,086	17,939	5,114
Minority interest in earnings of a subsidiary	<u>-</u>	<u>31</u>	<u>39</u>
Net loss	<u>38,086</u>	<u>17,970</u>	<u>5,153</u>
Dividends on Preferred shares (Note 15g)	<u>107</u>	<u>-</u>	<u>-</u>
Net loss to shareholders of Common shares	<u>\$ 38,193</u>	<u>\$ 17,970</u>	<u>\$ 5,153</u>
Basic and diluted net loss per share (Note 17c)	<u>\$ 8.46</u>	<u>\$ 3.91</u>	<u>\$ 1.03</u>

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

**SAPIENS INTERNATIONAL CORPORATION N.V.  
AND ITS SUBSIDIARIES**

**STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY**

**U.S. dollars in thousands**

	preferred shares	common shares	Additional paid-in capital	Deferred stock compensation	Proceeds on account of shares	Treasury shares	Common shares accrued as dividends	Accumulated other comprehensive loss	Accumulated deficit	Total
Balance as of January 1, 2000	\$ 4	\$ 8,694	\$ 69,593	\$ -	\$ -	\$ (2,423)	\$ 967	\$ (3,450)	\$(21,971)	\$ 51,414
Comprehensive loss:										
Net loss	-	-	-	-	-	-	-	-	(38,086)	(38,086)
Other comprehensive loss:										
Unrealized losses on available-for-sale marketable securities, net	-	-	-	-	-	-	-	-	-	(58)
Foreign currency translation adjustments	-	-	-	-	-	-	-	-	-	(1,143)
Other comprehensive loss	-	-	-	-	-	-	-	(1,201)	-	(1,201)
Total comprehensive loss										(39,287)
Conversion of Preferred shares to Common shares:										
Series "D <sub>1</sub> "	(1)	131	(130)	-	-	-	-	-	-	-
Series "E"	(2)	169	(167)	-	-	-	-	-	-	-
Series "D <sub>2</sub> "	(1)	104	(103)	-	-	-	-	-	-	-
Employee stock options exercised	-	166	832	-	-	-	-	-	-	998
Warrants exercised	-	2	6	-	-	-	-	-	-	8
Compensation expense related to issuance of warrants to service providers	-	-	78	-	-	-	-	-	-	78
Deferred stock compensation related to options repriced	-	-	628	(628)	-	-	-	-	-	-
Amortization expense on re-priced options	-	-	-	453	-	-	-	-	-	453
Deferred tax benefit on exercised options	-	-	547	-	-	-	-	-	-	547
Common shares accrued as dividends on Preferred shares	-	-	-	-	-	-	107	-	(107)	-
Common shares issued as dividends on Preferred shares										
Series "D <sub>1</sub> "	-	31	326	-	-	-	(357)	-	-	-
Series "E"	-	40	366	-	-	-	(406)	-	-	-
Series "D <sub>2</sub> "	-	25	286	-	-	-	(311)	-	-	-
Shares issued as payment in respect of acquisitions adjustments of SAIC, Syspart and Sapiens Japan	-	2	(317)	-	-	-	-	-	-	(315)
Proceeds on account of shares	-	-	-	-	5,000	-	-	-	-	5,000
Balance as of December 31, 2000	\$ -	\$ 9,364	\$ 71,945	\$ (175)	\$ 5,000	\$ (2,423)	\$ -	\$ (4,651)	\$(60,164)	\$ 18,896

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

**SAPIENS INTERNATIONAL CORPORATION N.V.  
AND ITS SUBSIDIARIES**

**STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY**

**U.S. dollars in thousands**

	Convertible preferred shares	common shares	Additional paid-in capital	Deferred stock compensation	Proceeds on account of shares	Treasury shares	Note receivable from a shareholder	Accumulated other comprehensive loss	Accumulated deficit	Total
Balance as of January 1, 2001	\$ -	\$ 9,364	\$ 71,945	\$ (175)	\$ 5,000	\$ (2,423)	\$ -	\$ (4,651)	\$ (60,164)	\$ 18,896
Total comprehensive loss:										
Net loss	-	-	-	-	-	-	-	-	(17,970)	(17,970)
Other comprehensive loss:										
Unrealized losses on available- for-sale marketable securities, net	-	-	-	-	-	-	-	-	-	(30)
Foreign currency translation adjustments	-	-	-	-	-	-	-	-	-	(407)
Other comprehensive loss	-	-	-	-	-	-	-	(437)	-	(437)
Total comprehensive loss	-	-	-	-	-	-	-	-	-	(18,407)
Employee stock options exercised	-	1	(1)	-	-	-	-	-	-	-
Compensation expense related to issuance of warrants to banks	-	-	203	-	-	-	-	-	-	203
Amortization expense on re-priced ptions	-	-	-	107	-	-	-	-	-	107
Issuance of Series "F" convertible Preferred shares and warrants, net	6,361	-	8,518	-	(5,000)	-	-	-	-	9,879
Common shares issued for a note to a related party	-	655	320	-	-	-	(975)	-	-	-
Payment in respect of acquisition adjustment of Syspart	-	-	(471)	-	-	-	-	-	-	(471)
Balance as of December 31, 2001	<u>\$ 6,361</u>	<u>\$ 10,020</u>	<u>\$ 80,514</u>	<u>\$ (68)</u>	<u>\$ -</u>	<u>\$ (2,423)</u>	<u>\$ (975)</u>	<u>\$ (5,088)</u>	<u>\$ (78,134)</u>	<u>\$ 10,207</u>

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

**SAPIENS INTERNATIONAL CORPORATION N.V.  
AND ITS SUBSIDIARIES**

**STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY**

**U.S. dollars in thousands**

	Convertible preferred shares	common shares	Additional paid-in capital	Deferred stock compensation	Treasury shares	Note receivable from a shareholder	Accumulated other comprehensive loss	Accumulated deficit	Total
Balance as of January 1, 2002	\$ 6,361	\$ 10,020	\$ 80,514	\$ (68)	\$ (2,423)	\$ (975)	\$ (5,088)	\$ (78,134)	\$ 10,207
Total comprehensive loss:									
Net loss	-	-	-	-	-	-	-	(5,153)	(5,153)
Other comprehensive loss:	-	-	-	-	-	-	-	-	-
Unrealized losses on available-for-sale marketable securities, net	-	-	-	-	-	-	-	-	(5)
Foreign currency translation adjustments	-	-	-	-	-	-	-	-	1,273
Other comprehensive loss	-	-	-	-	-	-	1,268	-	1,268
Total Comprehensive loss	-	-	-	-	-	-	-	-	(3,885)
Employee stock options exercised	-	117	(105)	-	-	-	-	-	12
Amortization expense on re-priced options	-	-	-	47	-	-	-	-	47
Conversion of Series F Preferred shares and exercise of warrants	(6,361)	13,636	2,725	-	-	-	-	-	10,000
Payment in respect of acquisition adjustment of Syspart	-	-	(486)	-	-	-	-	-	(486)
Balance as of December 31, 2002	<u>\$ -</u>	<u>\$ 23,773</u>	<u>\$ 82,648</u>	<u>\$ (21)</u>	<u>\$ (2,423)</u>	<u>\$ (975)</u>	<u>\$ (3,820)</u>	<u>\$ (83,287)</u>	<u>\$ 15,895</u>
Accumulated unrealized gain from available- for-sale marketable securities							\$ 18		
Accumulated foreign currency translation adjustments							(3,838)		
Accumulated other comprehensive loss							<u>\$ (3,820)</u>		

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

**SAPIENS INTERNATIONAL CORPORATION N.V.  
AND ITS SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

U.S. dollars in thousands

	<b>Year ended December 31,</b>		
	<b>2000</b>	<b>2001</b>	<b>2002</b>
Cash flows from operating activities:			
Net loss	\$ (38,086)	\$ (17,970)	\$ (5,153)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:			
Depreciation, amortization and impairment	6,984	9,555	4,818
Amortization of deferred gain on sale - leaseback transaction	(226)	(3)	-
Gain on marketable securities	(91)	(124)	-
Loss (gain) on disposal of property and equipment	(8)	417	24
Amortization of compensation expenses related to issuance of warrants to service providers	78	-	-
Amortization expense on re-priced options	453	107	47
Decrease (increase) in trade receivables	(873)	13,372	8,190
Decrease (increase) in other receivables and prepaid expenses	(251)	(82)	180
Decrease (increase) in deferred income taxes, net	(2,636)	50	407
Reduction of income taxes related to employee stock option exercised	547	-	-
Increase (decrease) in trade payables	2,702	(2,664)	(960)
Increase (decrease) in deferred revenues	942	(1,347)	1,805
Increase (decrease) in other liabilities and accrued expenses	9,332	(4,230)	(4,509)
Accrued interest on redeemable shares in a subsidiary	-	270	474
Gain on payment of convertible subordinated notes	-	-	(409)
Minority interests in earnings of a subsidiary	-	31	39
Net cash provided by (used in) operating activities	<u>(21,133)</u>	<u>(2,618)</u>	<u>4,953</u>
Cash flows from investing activities:			
Purchase of property and equipment	(3,663)	(508)	(1,011)
Increase in capitalized software development costs	(4,250)	(3,967)	(2,732)
Decrease (increase) in restricted cash	-	(2,500)	2,500
Purchase of short-term deposits and marketable securities	(6,763)	(2,883)	(1,618)
Proceeds from sale of marketable securities	12,078	5,573	-
Proceeds from sale of property and equipment	38	96	128
Purchase of other assets	(321)	-	-
Payment for acquisition of IMA	(275)	(66)	-
Payment for acquisition of Syspart	(164)	-	(957)
Payment for acquisition of SAIC	(401)	(41)	-
Net cash used in investing activities	<u>(3,721)</u>	<u>(4,296)</u>	<u>(3,690)</u>

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

**SAPIENS INTERNATIONAL CORPORATION N.V.  
AND ITS SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

**U.S. dollars in thousands**

	<b>Year ended December 31,</b>		
	<b>2000</b>	<b>2001</b>	<b>2002</b>
Cash flows from financing activities:			
Proceeds from issuance of redeemable shares in a subsidiary	14,675	-	-
Redemption of redeemable shares in subsidiary	-	(4,234)	-
Proceeds from issuance of Series "F" convertible Preferred shares and warrants, net	-	9,879	-
Proceeds from exercise of Series "F" convertible Preferred share warrants			10,000
Proceeds from exercise of options and warrants	819	-	12
Proceeds on account of shares	5,000	-	-
Increase (decrease) in short-term bank debt, net	13,204	772	(10,621)
Payment of convertible subordinated notes	-	-	(2,316)
Principal payment of long-term liabilities	(255)	(202)	(260)
Proceeds from long-term bank loans	-	211	7,500
Net cash provided by financing activities	<u>33,443</u>	<u>6,426</u>	<u>4,315</u>
Effect of exchange rate changes on cash and cash equivalents	<u>(286)</u>	<u>(463)</u>	<u>336</u>
Increase (decrease) in cash and cash equivalents	8,303	(951)	5,914
Cash and cash equivalents at the beginning of year	<u>8,735</u>	<u>17,038</u>	<u>16,087</u>
Cash and cash equivalents at the end of year	<u>\$ 17,038</u>	<u>\$ 16,087</u>	<u>\$ 22,001</u>
Supplemental cash flow activities:			
Cash paid during the year for:			
Interest	<u>\$ 1,305</u>	<u>\$ 1,440</u>	<u>\$ 820</u>
Income taxes	<u>\$ 337</u>	<u>\$ 471</u>	<u>\$ 1,235</u>
Non-cash transactions:			
Common shares accrued as dividends on Preferred shares	<u>\$ 107</u>	<u>\$ -</u>	<u>\$ -</u>
Common shares issued as dividends on Preferred shares	<u>\$ 1,074</u>	<u>\$ -</u>	<u>\$ -</u>
Revaluation of Syspart acquisition against liability	<u>\$ -</u>	<u>\$ 471</u>	<u>\$ -</u>

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

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**NOTE 1: BUSINESS AND ORGANIZATION**

a. General:

Sapiens International Corporation N.V. ("the Company"), which operates through its worldwide subsidiaries, is a provider of rapidly deployed business software solutions that support its clients' core business processes, such as insurance claims processing, loan/mortgage management and other key business solutions. These solutions, which are based on the Sapiens eMerge technology, consist primarily of rapid application development ("RAD"), integration of legacy systems into new applications and technologies, mapping and management of enterprise IT assets, and reengineering services.

The Company focuses on the insurance industry, and is in the process of developing customizable component-based solutions for insurance claim processing, closed-books administration, policy administration and multi-channel connectivity. The Company also provides a specialized solution for the migration of European IT systems to the Euro currency.

b. Restructuring costs:

In 2000, the Company recorded restructuring charges of approximately \$ 2.6 million which was accrued as a short-term liability as of December 31, 2000 and were paid in 2001. The restructuring costs consist of employee termination benefits associated with involuntary terminations of approximately 250 employees. The terminations resulted from the Company's strategy to reduce costs and restore profitability.

In 2002, the Company recorded restructuring charges at approximately \$ 0.5 million, all of which was paid in 2002. The restructuring costs consist of employee termination benefits associated with the involuntary termination of approximately 40 employees, accounted for in accordance with EITF 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") and SAB 100, "Restructuring and Impairment Charges" ("SAB 100"). The terminations resulted from the Company's strategy to reduce costs and restore profitability.

c. Investment in eZoneXchange:

In April 2000, the Company completed a private placement of 600,000 shares of Common stock ("investor's shares") of its wholly-owned subsidiary, eZoneXchange.com, Inc. ("eZoneXchange"), for \$ 15 million. The investor also received a warrant to purchase an additional 2.25% of the Common stock of eZoneXchange at the same private placement share price of \$ 25 per share. As part of the transaction, the Company entered into a Put and Call Option agreement pursuant to which the investors were granted the right (exercisable in whole or in part) to cause the Company during the put option exercise period (May 4, 2004 through May 3, 2005) to repurchase the investors' shares at the principal amount of the investor's investment plus 5% annual interest accrued thereon from May 4, 2000.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**NOTE 1: BUSINESS AND ORGANIZATION (Cont.)**

The Put and Call agreement provides that 50% of the consideration for the investors' shares will be paid in cash and 50% in Sapiens' Common shares to be valued according to the average closing market price of Sapiens' Common share over the 14 day trading period preceding the date of issuance of the Put consideration. The agreement also included a call option which grants the Company the option to purchase the investor's shares at a price of \$ 30 million in the first two years after the investment date, \$ 37.5 million in the third year, and \$ 45 million in the fourth year. The purchase price will be multiplied by the percentage of shares purchased. The exercise period will last until the earlier of the fourth anniversary of the investment, an acquisition of, or an IPO of eZoneXchange.

The amount of \$15 million was accounted for as a mezzanine item under redeemable shares in a subsidiary, net of issuance expenses.

During February 2001, the Company decided to close the operations of eZoneXchange.com Inc. In February 2001, the Company repurchased 173,100 of the investors' shares with a cash repayment of \$ 4.5 million for principal and interest, according to an amendment to the Put and Call Option agreement. As a result, the amount of the principal portion of the redeemable shares in a subsidiary to be repaid in cash was decreased by \$ 4.2 million, net of expenses. In addition, in accordance with the amendment, if the market price of Sapiens' Common share reaches \$ 10 per share, the investors will have the right to put 192,333 shares of its eZoneXchange stock in return for 363,776 Sapiens' Common shares at a price of \$ 13.75 per share. No interest is accrued for the amended portion of the investment. The remaining portion of the investment to be repaid in shares (approximately \$ 2.5 million) and the portion to be paid in cash (approximately \$ 3 million) will continue to be subject to the original terms of the Put and Call Option agreement.

The results of eZoneXchange were consolidated with the results of the Company starting from April 2000.

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

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**NOTE 2: SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

b. Financial statements in U.S. dollars:

A substantial portion of the Company's financing is made in U.S. dollars ("dollar"). In addition, a substantial portion of the Company's and certain of its subsidiaries' costs is incurred in dollars. A majority of the revenues of the Company and certain of its subsidiaries is generated in dollars. Company's management believes that the dollar is the primary currency of the economic environment in which the Company and those subsidiaries operate. Thus, the functional and reporting currency of the Company and its subsidiaries is the dollar.

Accordingly, monetary accounts maintained in currencies other than the dollar are remeasured into U.S. dollars in accordance with Statement of the Financial Accounting Standard Board No. 52, "Foreign Currency Translation" ("SFAS No. 52"). All transaction gains and losses of the re-measurement of monetary balance sheet items are reflected in the statements of operations as financial income or expenses as appropriate.

The financial statements of foreign subsidiaries whose functional currency is not the U.S. dollar, have been translated into U.S. dollars. All balance sheet accounts have been translated using the exchange rates in effect at the balance sheet date. Statements of operations amounts have been translated using the average exchange rate for the period. The resulting translation adjustments are reported as accumulated other comprehensive income (loss), in shareholders' equity.

Foreign currency translation differences included in the financial income (loss) amounted to approximately \$ (210,000), \$ (1,549,000) and \$ 160,000 for 2000, 2001 and 2002, respectively.

c. Principles of consolidation:

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

d. Cash equivalents:

Cash equivalents consist of interest-bearing demand deposits, money market funds and highly liquid debt instruments originally purchased with a maturity of three months or less.

e. Short-term bank deposits:

Bank deposits with maturities of more than three months but less than one year are included in short-term bank deposits. Such bank deposits are stated at cost.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**NOTE 2: SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

f. Marketable securities:

Management determines the proper classification of investments in marketable debt and equity securities at the time of purchase and reevaluates such designations as of each balance sheet date. All securities covered by Statement of Financial Accounting Standard No. 115, "Accounting for Certain Investments in Debt and Equity Securities" ("SFAS No. 115"), were designated as available-for-sale. Accordingly, these securities are stated at fair value, with unrealized gains and losses reported in a separate component of shareholders' equity, accumulated other comprehensive loss. Realized gains and losses on sales of investments, as determined on a specific identification basis, are included in the consolidated statement of operations.

g. Property and equipment:

Property and equipment are stated at cost less accumulated depreciation and depreciated using the straight-line method over the estimated useful lives of the assets:

Equipment and furniture	4 - 15 years
Computer equipment and software	3 - 5 years
Motor vehicles	3 - 7 years
Leasehold improvements	(Over the shorter of the term of the lease or the estimated useful life of the asset)

The Company periodically 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. 144 "Accounting for the Impairment or Disposal of Long- Lived Assets" ("SFAS No. 144"). As of December 31, 2002, no impairment losses have been identified.

h. Impairment of long-lived assets:

The Company's long-lived assets and certain identifiable intangibles are reviewed for impairment in accordance with SFAS No. 144 "Accounting for the Impairment or Disposal of Long-Lived Assets" 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.

i. Capitalized software development costs:

Research and development costs incurred in the process of developing new products or product improvements, are charged to expense as incurred, net of participation by the Office of the Chief Scientist in Israel's Ministry of Industry and Trade ("the OCS").

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**NOTE 2: SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

Statement of Financial Accounting Standard No. 86 "Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed" ("SFAS No. 86"), requires capitalization of certain software development costs subsequent to the establishment of technological feasibility. Based on the Company's product development process, technological feasibility is established upon completion of a detailed program design.

Capitalized software costs are amortized by the greater of the amount computed using: (i) the ratio that current gross revenues from sales of the software bear to the total of current and anticipated future gross revenues from sales of that software, or (ii) the straight-line method over the estimated useful life of the software product (three to five years). The Company assesses the recoverability of this intangible asset on a regular basis by determining whether the amortization of the asset over its remaining life can be recovered through undiscounted future operating cash flows from the specific software product sold. Based on its most recent analyses, management believes that no impairment of capitalized software development costs exists as at December 31, 2002.

j. Goodwill:

Goodwill represents the excess of the costs over the net assets of businesses acquired. Goodwill that arose from acquisitions prior to July 1, 2001, was amortized until December 31, 2001, on a straight-line basis over 3.5 to 10 years. In accordance with SFAS No. 142, "Goodwill and Other Intangible Assets" ("SFAS No. 142") the Company ceased amortizing the goodwill as of January 1, 2002.

SFAS No. 142 requires goodwill to be tested for impairment on adoption and at least annually thereafter or between annual tests in certain circumstances, and written down when impaired, rather than being amortized as previous accounting standards required. Goodwill is tested for impairment by comparing the fair value of each of the Company's reporting units with its carrying value. Fair values are determined using discounted cash flows. Significant estimates used in the methodologies include estimates of future cash flows, future short-term and long-term growth rates, weighted average cost of capital and estimates of market multiples.

During 2001, prior to the adoption of SFAS No. 142 by the Company, an impairment of goodwill was recorded in accordance with SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of" ("SFAS No. 121") in the amount of \$204,000, which was included in the marketing, selling, general and administrative expenses.

k. Intangible assets:

Intangible assets that arose prior to July 1, 2001, and are stated at cost less accumulated amortization. Amortization is computed using the straight-line method as follows:

Prepaid royalties	15 years
Distribution rights	7 years
Technology, usage rights and other intangible assets	5-8 years

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**NOTE 2: SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

Before the adoption of SFAS No. 144 the Company evaluated the recoverability of long-lived assets annually and the appropriateness of the amortization period based on the estimated future undiscounted cash flows derived from the asset. In 2001, such impairments were indicated and the Company recognized impairment loss in the amount of \$519,000, which was included in the marketing, selling, general and administrative expenses

As of December 31, 2002, no impairment losses have been identified.

1. Revenue recognition:

Product revenues include implementation services contracts (which include the sale of software technology and services) and software license sales.

Revenues from implementation services contracts are recognized based on Statement of Opinion No. 81-1 "Accounting for Performance of Construction-Type and Certain Production -Type Contracts" ("SOP No. 81-1"), using contract accounting on a percentage of completion method based on the relationship of actual costs incurred to total costs estimated to be incurred over the duration of the contract. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are first determined, in the amount of the estimated loss on the entire contract. As of December 31, 2002, no such estimated losses were identified.

Revenues earned under software licensing agreements with end-users are recognized when all criteria outlined in Statement of Position No. 97-2 "Software Revenue Recognition" ("SOP No. 97-2") (as amended) are met. Revenues from license fees are recognized when persuasive evidence of an agreement exists, delivery of the product has occurred, no significant obligations with regard to implementation remain, the fee is fixed or determinable and collectibility is probable.

The Company and its subsidiaries do not grant rights of return.

Where software arrangements involve multiple elements, revenues are allocated to each element based on vendor specific objective evidence ("VSOE") of the relative fair values of each element in the arrangement, in accordance with the "residual method" prescribed by Statement of Opinion No. 98-9. "Modification of SOP 97-2, Software Revenue Recognition With Respect to Certain Transactions" ("SOP No. 98-9"). The Company's VSOE used to allocate the sales price to consulting, training and maintenance is based on the price charged when these elements are sold separately. License revenues are recorded based on the residual method.

Under the residual method, revenue is recognized for the delivered elements when (1) there is VSOE of the fair values of all the undelivered elements other than those accounted for using long-term contract accounting, and (2) all revenue recognition criteria of SOP 97-2, as amended, are satisfied.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**NOTE 2: SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

Consulting and other services revenues also include training and post-contract maintenance services. Revenues from consulting, maintenance and training services are recognized ratably over the contractual period or as services are performed.

Deferred revenues include amounts received from customers for which revenues have not yet been recognized.

m. Advertising expenses:

Advertising expenses are charged to the statement of operations as incurred.

n. Government grants:

Royalty-bearing grants from the Government of Israel for the funding of research and development projects are recognized at the time the Company is entitled to such grants on the basis of the related costs incurred, and are recorded as a reduction of research and development costs.

o. Income taxes:

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

p. Concentrations of credit risk:

Financial instruments that potentially subject the Company and certain of its subsidiaries to concentrations of credit risk consist principally of cash and cash equivalents, marketable securities, short-term deposits, and trade receivables. The Company's cash, cash equivalents and short-term deposits are invested in deposits with major international financial institutions. Such deposits in the United States may be in excess of insured limits and are not insured in other jurisdictions. Management believes that the financial institutions that hold the Company's investments are financially sound and, accordingly, minimal credit risk exists with respect to these investments.

The Company's trade receivables are derived from sales to large and solid organizations located mainly in Europe, North America and Israel. The Company performs ongoing credit evaluations of its customers and has established an allowance for doubtful accounts based upon factors surrounding the credit risk of specific customers and other information. In certain circumstances, the Company may require letters of credit, other collateral or additional guarantees.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**NOTE 2: SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

The Company's marketable securities include investments in debentures of non-U.S. Corporations. Management believes that those Corporations are financially sound, and accordingly, minimal credit risk exists with respect to these marketable securities.

q. Fair value of financial instruments:

The estimated fair value of financial instruments has been determined by the Company using available market information and valuation methodologies. Considerable judgment is required in estimating fair values. Accordingly, the estimates may not be indicative of the amounts the Company could realize in a current market exchange. The carrying amounts of cash and cash equivalents, short-term deposits, marketable securities, trade accounts receivables, short-term bank credit and trade accounts payable approximate their fair values due to the short-term maturity of such instruments.

The carrying amounts of the Company's long-term borrowings arrangements approximate their fair value. Fair values were estimated using discounted cash flow analyses, based on prevailing market borrowing rates.

r. Derivative and hedging:

The Company accounts for derivatives and hedging based on Financial Accounting Standards Board Statement No. 133, "Accounting for Derivative Instruments and Hedging Activities" as amended ("SFAS No. 133"). SFAS 133 requires companies to recognize all of its derivative instruments on the balance sheet at fair value. The accounting for changes in the fair value of a derivative instrument depends on whether it has been designated and qualifies as part of a hedging relationship and further, on the type of hedging relationship. For those derivative instruments that are designated and qualify as hedging instruments, a company must designate the hedging instrument, based upon the exposure being hedged, as a fair value hedge, cash flow hedge or a hedge of a net investment in a foreign operation.

For derivative instruments that are designated and qualify as a fair value hedge, the gain or loss on the derivative instrument as well as the offsetting loss or gain on the hedged item attributable to the hedged risk are recognized in the same line item associated with the hedged item in current earnings during the period of the change in fair values.

The Company enters into forward exchange contracts to hedge certain transactions denominated in foreign currencies. The purpose of the Company's foreign currency hedging activities is to protect the Company from risk that the eventual dollar cash flows from international activities will be adversely affected by changes in the exchange rates. The Company's forward contracts did not qualify as hedging instruments under SFAS No. 133. Changes in the fair value of forward contracts are reflected in the statement of operations as financial income or expense.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**NOTE 2: SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

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

Basic net earnings (loss) per share is calculated based on the weighted average number of Common shares outstanding during each year including contingent shares. Diluted net earnings per share is computed based on the weighted average number of Common shares outstanding during each year, plus dilutive potential Common shares considered outstanding during the year, in accordance with Statement of Financial Accounting Standard No. 128, "Earnings Per Share" ("SFAS No. 128").

In 2000, 2001 and 2002, all convertible Preferred shares, outstanding stock options, convertible subordinate notes and warrants have been excluded from the calculation of the diluted net loss per Common share because all such securities were anti-dilutive for the period presented. The total weighted average number of shares related to the outstanding convertible Preferred shares, options and warrants excluded from the calculations of diluted net loss per share was 1,510,658, 3,265,349 and 3,892,357 for the years ended December 31, 2000, 2001 and 2002, respectively.

t. Stock-based compensation:

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

Under Statement of Financial Accounting Standard No. 123 "Accounting for Stock-Based Compensation" ("SFAS No. 123"), pro forma information regarding net income (loss) and net earnings (losses) per share is required 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 the Black-Scholes option pricing model with the following weighted-average assumptions for 2000, 2001 and 2002: risk-free interest rates of 6.5% , 2.5% and 2% respectively, dividend yields of 0% for each year, volatility factors of the expected market price of the Company's Common shares of 0.867, 0.82 and 0.97 respectively and a weighted-average expected life of the options of 6 years for each year.

The weighted-average fair value of the options at their grant dates in 2000, 2001 and 2002 was \$ 7.15, \$ 3.45 and \$ 4.48, respectively. All options were granted at the fair market value at the date of grant.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 2: SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

Pro forma information under SFAS No. 123:

	Year ended December 31,		
	2000	2001	2002
	U.S. dollars in thousands		
Net loss to shareholders' of Common shares as reported	\$ 38,193	\$ 17,970	\$ 5,153
Pro forma net loss to shareholders' of Common shares	\$ 47,919	\$ 19,598	\$ 7,919
Pro forma basic and diluted net loss per share	\$ 10.62	\$ 4.26	\$ 1.58

The Company applies SFAS No. 123 and EITF 96-18 "Accounting for Equity Instruments that are Issued to Other than Employees for Acquiring, or in Conjunction with Selling, Goods or Services" ("EITF No. 96-18") with respect to warrants and options issued to non-employees. SFAS No. 123 requires use of an option valuation model to measure the fair value of the options at the grant date.

u. Employee rights upon retirement:

The Company has various defined contribution plans for employees of its subsidiaries around the world. Most of the plans are those required according to the laws of the country in which the subsidiary operates. Contributions made under the plans are invested with financial institutions. Benefits under the plans are based on contributions from employees and the Company and earnings on insurance contracts or other investment instruments in which the contributions are invested.

Expense for contributions made to these plans was \$ 1,408,000, \$ 1,346,000 and \$ 1,243,000 for 2000, 2001 and 2002, respectively.

v. Impact of recently issued accounting standards:

In April 2002, the FASB issued SFAS No. 145, "Rescission of SFAS No. 4, 44 and 64, Amendment of SFAS No. 13, and Technical Corrections," ("SFAS No. 145") which rescinds SFAS No. 4, "Reporting Gains and Losses from Extinguishment of Debt," and an amendment of that Statement, and SFAS No. 64, "Extinguishments of Debt Made to Satisfy Sinking-Fund Requirements." SFAS No. 145 amends SFAS No. 44, "Accounting for Intangible Assets for Motor Carriers." SFAS No. 145 amends SFAS No. 13, "Accounting for Leases," to eliminate an inconsistency between the required accounting for sale-leaseback transactions and the required accounting for certain lease modifications that have economic effects that are similar to sale-leaseback transactions. SFAS No. 145 also amends other existing authoritative pronouncements to make various technical corrections, clarify meanings, or describe their applicability under changed conditions. SFAS No. 145 is effective for fiscal years beginning May 15, 2002. The Company does not expect the adoption of SFAS 145 to have a material impact on the Company's results of operation or financial position.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**NOTE 2: SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

In June 2002, the FASB issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities," ("SFAS No. 146") which addresses significant issues regarding the recognition, measurement and reporting of costs associated with exit and disposal activities, including restructuring activities. SFAS No. 146 requires that costs associated with exit or disposal activities be recognized when they are incurred rather than at the date of a commitment to an exit or disposal plan. SFAS No. 146 is effective for all exit or disposal activities initiated after December 31, 2002. The Company does not expect the adoption of SFAS No. 146 to have a material impact on the Company's results of operations or financial position.

In November 2002, the FASB issued Interpretation No. 45 ("FIN No. 45"), "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, an interpretation of SFAS No. 5, 57 and 107 and Rescission of FASB Interpretation No. 34 ("FIN No. 34)." FIN No. 45 elaborates on the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under certain guarantees that it has issued. It also clarifies that a guarantor is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. FIN No. 45 does not prescribe a specific approach for subsequently measuring the guarantor's recognized liability over the term of the related guarantee. It also incorporates, without change, the guidance in FIN No. 34, "Disclosure of Indirect Guarantees of Indebtedness to Others," which is being superseded. The disclosure provisions of FIN No. 45 are effective for financial statements of interim or annual periods that end after December 31, 2002 and the provisions for initial recognition and measurement are effective on a prospective basis for guarantees that are issued or modified after December 31, 2002, irrespective of a guarantor's year-end. The Company does not expect the adoption of FIN No. 45 to have a material impact on its results of operations or financial position

In January 2003, the FASB issued Interpretation No. 46 (or FIN 46), "Consolidation of Variable Interest Entities." 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. A variable interest entity is a corporation, partnership, trust, or any other legal structures 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. A variable interest entity often holds financial assets, including loans or receivables, real estate or other property. A variable interest entity may be essentially passive or it may engage in research and development or other activities on behalf of another company. 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 to all financial statements issued after January 31, 2003, regardless of when the variable interest entity was established. The Company is evaluating the possible impact of the new interpretation and does not expect it to have a material effect on its financial position or result of operations.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**NOTE 2: SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

w. Reclassification:

Certain 2000 and 2001 figures have been reclassified in order to conform with the 2002 presentation.

**NOTE 3: RESTRICTED CASH DEPOSITS**

Restricted cash deposits are maintained with banks as security for the Company's revolving credit line. In 2001, the Company was restricted from withdrawing any portion of the secured balances until repayment of the credit line. In 2002, the restriction was eliminated as part of the decrease in the credit line.

Such restricted cash deposits are recorded at cost.

**NOTE 4: MARKETABLE SECURITIES AND SHORT-TERM DEPOSITS**

At December 31, 2001 and 2002, the Company's short-term investments were classified as available-for-sale securities and were carried at fair value. Gross realized gains on sales of these securities included in earnings in 2000, 2001 and 2002 totaled \$ 163,000, \$ 124,000 and \$ 0, respectively. Gross realized losses on sales of these securities included in earnings in 2000, 2001 and 2002 totaled \$ 49,000, \$ 0 and \$ 0, respectively. As of December 31, 2002, the Company has short-term deposits of \$ 1,618,000 and marketable securities of \$34,000.

As for pledges see Note 13.

**NOTE 5:- TRADE RECEIVABLES**

The Company's trade receivables are composed of accounts receivable in the amounts of \$ 11.6 million and \$ 9.9 million as of December 31, 2001 and 2002, respectively and unbilled receivables in the amounts of \$ 6 million and \$ 0.5 million as of December 31, 2001 and 2002, respectively.

**NOTE 6: OTHER RECEIVABLES AND PREPAID EXPENSES**

	<b>December 31,</b>	
	<b>2001</b>	<b>2002</b>
	<b>U.S. dollars in thousands</b>	
Sales and other taxes receivable	\$ 2,068	\$ 2,290
Prepaid expenses	896	1,332
Deferred income taxes	655	860
Government grants	1,018	742
Other	897	618
	\$ 5,534	\$ 5,842

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 7: PROPERTY AND EQUIPMENT, NET**

	Cost		Accumulated Depreciation	
	December 31		December 31	
	2001	2002	2001	2002
	U.S. dollars in thousands			
Equipment and furniture	\$ 2,532	\$ 2,231	\$ 1,411	\$ 1,323
Computer equipment and software	10,560	10,447	8,792	9,042
Motor vehicles	139	198	66	112
Leasehold improvements	1,974	1,989	839	962
	\$ 15,205	\$ 14,865	\$ 11,108	\$ 11,439

Depreciation expense totaled \$ 2,213,000, \$ 2,318,000 and \$ 1,592,000 for the years ended December 31, 2000, 2001 and 2002, respectively.

As for pledges see Note 13.

**NOTE 8: GOODWILL**

- a. Goodwill amortization amounted to \$ 1,106,000, \$ 1,345,000 and \$ 0 for 2000, 2001 and 2002, respectively.
- b. The unaudited results of operations presented below for the three years ended December 31, 2000, 2001 and 2002, respectively, reflect the impact on results of operations had the Company adopted the non-amortization provisions of SFAS No. 142 effective January 1, 2000:

	Year ended December 31,		
	2000	2001	2002
	U.S. dollars in thousands		
Reported net loss	\$ 38,193	\$ 17,970	\$ 5,153
Goodwill amortization	1,106	1,345	-
Adjusted net loss	\$ 37,087	\$ 16,625	\$ 5,153
Basic and diluted loss per share:			
Reported loss per-share	\$ 8.46	\$ 3.91	\$ 1.03
Goodwill amortization	\$ 0.24	\$ 0.29	\$ -
Adjusted net loss per-share	\$ 8.22	\$ 3.62	\$ 1.03

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 9: OTHER ASSETS**

- a. Amortization expenses for capitalized software development costs for 2000, 2001 and 2002 were \$ 3,176,000, \$ 4,606,000 and \$ 2,858,000 respectively. Amortization expenses are included in cost of products.
- b. Other assets, net of amortization, are comprised of the following:

	Cost		Accumulated amortization	
	December 31		December 31	
	2001	2002	2001	2002
	<b>U.S. dollars in thousands</b>			
Prepaid royalties	\$ 2,083	\$ 2,083	\$ 1,239	\$ 1,371
Technology and usage rights	895	863	716	735
Other intangible assets	370	335	146	147
Distribution rights	1,070	1,070	742	935
Long-term deferred income taxes	4,484	3,872	-	-
	\$ 8,902	\$ 8,223	\$ 2,843	\$ 3,188

Amortization of other assets charged to expenses was \$ 489,000, \$ 563,000 and \$ 368,000 for 2000, 2001 and 2002, respectively.

As for impairments see Note 2h.

- c. Estimated amortization expense for the years ended:

	December 31,
2003	\$ 309
2004	170
2005	165
2006	148
2007 and thereafter	190
	\$ 982

**NOTE 10: OTHER LIABILITIES AND ACCRUED EXPENSES**

	December 31,	
	2001	2002
	U.S. dollars in thousands	
Employee and related payroll accruals	\$ 5,402	\$ 4,035
Sales and other taxes payable	3,962	2,915
Accrued royalties to the OCS (Note 12a)	2,105	2,776
Accrued expenses	7,299	4,815
	\$ 18,768	\$ 14,541

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 11: DEBT**

a. Short-term debt:

The Company has available unsecured revolving credit line facilities for borrowings of up to a total of \$ 24 million as of December 31, 2002, of which \$ 16.5 million is available until March 31, 2003 and \$ 7.5 million is available until March 31, 2005. (As for the renewal of the credit lines see Note 18). Under the terms of these credit line agreements, the Company and several of its subsidiaries granted floating charges to the banks and issued cross guaranties in support of the credit facilities. Additionally, the Company is required to maintain certain financial ratios. As of December 31, 2002, the Company maintained these financial ratios. Borrowings under these agreements in Euro and U.S. dollars bear interest at rates ranging between the London Interbank Offered Rate ("LIBOR") plus 0.75% to plus 1.95% and borrowings in new israeli shekel ("NIS") bear interest at the prime rate of interest in Israel plus 2%. The Company had an unused credit facility in the amount of approximately \$12.5 million as of December 31, 2002. As for warrants granted under the credit line agreement, see Note 15j.

A portion of the Company's short-term loans require that the Company pledge cash or short-term investments and record a floating charge as collateral for its borrowings (Note 13).

	Linkage	Weighted average interest		December 31,	
		December 31,		December 31,	
		2001	2002	2001	2002
		%	%	U.S. dollars in thousands	
Credit lines	New Israeli shekel *)	5.46	-	\$ 10,180	\$ -
	Euro **)	-	5	-	1,146
Short-term loans	U.S. dollar *)	3.73	3.5	6,029	2,275
	British Pound	-	5.5	-	1,585
				<u>\$ 16,209</u>	<u>\$ 5,006</u>

\*) Including non-material amounts linked to the Euro.

\*\*\*) Including non-material amounts linked to the U.S. dollar and to the British Pound.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 11: DEBT (Cont.)**

b. Convertible subordinated notes and other long-term liabilities:

	<u>Linkage</u>	<u>Rate of interest</u>	<u>Maturity</u>	<u>December 31,</u>	
				<u>2001</u>	<u>2002</u>
				<u>U.S. dollars in thousands</u>	
		<u>%</u>			
Convertible subordinated notes ("Old Notes" - conversion price \$ 160 per Common share)	US Dollar	5	September 2003 June 2004 through March 2005	\$ 6,930	\$ 4,205
Long- term loans	US Dollar	3.75	March 2005	-	7,500
Capital lease obligations (Note 12b)	Euro	5	August 2005	167	150
Other long-term debts *)	Japanese Yen	1.8 - 3.15	February 2006	484	324
				<u>7,581</u>	<u>12,179</u>
Less - current maturities				<u>(245)</u>	<u>(4,477)</u>
				7,336	7,702
Minority interest				<u>29</u>	<u>85</u>
				<u>\$ 7,365</u>	<u>\$ 7,787</u>

\*) Including non-material amounts linked to other currencies.

In 2002, the Company executed an early redemption of some of the convertible subordinated notes in the amount of approximately \$ 2.7 million, which resulted in a gain of \$409,000 recorded as other income.

Long-term debt maturities after December 31, 2002 are as follows (U.S. dollars in thousands):

2003	\$ 4,477
2004	1,610
2005	6,084
2006	<u>8</u>
	<u>\$ 12,179</u>

Interest expense was \$ 0.4 million, \$ 1.3 million and \$ 1.0 million for 2000, 2001 and 2002, respectively.

**NOTE 12: COMMITMENTS AND CONTINGENT LIABILITIES**

a. Sapiens Technologies Ltd. (hereafter - "Technologies") a subsidiary incorporated in Israel partially finances its research and development expenditures under programs sponsored by the OCS of Israel for the support of research and development activities conducted in Israel.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**NOTE 12: COMMITMENTS AND CONTINGENT LIABILITIES (Cont.)**

In exchange for participation in the programs by the OCS, the Company agreed to pay 3%-3.5% of total net consolidated sales of software developed within the framework of these programs. The royalties will be paid up to a maximum amount equaling 100%-150% of the grant provided by the OCS, linked to the dollar and for grants received after January 1, 1999 bear annual interest at a rate based on LIBOR. Repayment of such grants is not required in the event that there are no sales of products developed within the framework of such funded programs.

Royalties paid or accrued amounted to \$ 1,257,000, \$ 1,523,000 and \$ 1,569,000 in 2000, 2001 and 2002, respectively.

As of December 31, 2002, the Company had a contingent liability to pay royalties of approximately \$ 12 million.

- b. The Company and its subsidiaries lease various office equipment, office space, and motor vehicles through operating and capital leases. Future minimum lease payments for the next five years and thereafter are as follows:

	<b>Operating leases</b>	<b>Capital leases</b>
	<b>U.S. dollars in thousands</b>	
2003	\$ 2,920	\$ 57
2004	2,673	83
2005	1,234	10
2006	1,101	-
2007 and thereafter	1,350	-
Total future minimum lease payments	\$ 9,278	\$ 150

Rent expense for the years ended December 31, 2000, 2001 and 2002 was \$ 2,892,000, \$ 2,631,000 and \$ 2,489,000, respectively.

- c. In 2000, the Company filed a lawsuit against GIE AGF Systems D'Information (hereinafter - "AGF SI"), a customer, regarding an unpaid balance related to a year 2000 project performed during 1998 and 1999. The Company's claim was in respect of a dispute over the implementation of contracts signed between the parties regarding the above project. While the Company, based on the advice of its legal counsel, believed that the court would rule in its favor and the amounts recorded would be collected, on February 14, 2001 the French court ruled that AGF SI must pay the Company the sum of approximately \$3 million. In accordance with SFAS No. 5 "Accounting for Contingencies", as a result of the ruling, the Company recorded a provision of \$2.4 million for selling, marketing, general and administrative expenses in the fourth quarter of 2000.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**NOTE 12: COMMITMENTS AND CONTINGENT LIABILITIES (Cont.)**

Following the French court ruling, AGF SI has filed an appeal to the Court of Appeals of Paris. On January 26, 2002, the Company has filed a counter appeal in reply rejecting the claims presented by AGF SI and claiming an additional amount of approximately \$3.5 million in respect with the contract signed between the parties. The Company, based on the advice of its legal counsel, believes that the court will not accept AGF SI's appeal, therefore the Company did not accrue for such potential liability.

- d. The Company is party to various other legal proceeding and claims that arise in the ordinary course of business in the total amount aggregating to approximately \$ 1 million. The Company based on the advise of its legal counsel, has accrued for the expected implication of these proceedings and claims an amount of \$ 0.2 million, in accordance with SFAS No. 5.
- e. As for tax assessments, see Note 14c.

**NOTE 13: SECURITY INTERESTS AND PLEDGES**

The Company and several of its subsidiaries granted floating charges to the banks and issued cross guaranties in support of the credit facilities.

All of the Company's leased assets are pledged to the finance companies that provided the lease financing and the banks providing credit lines.

The Company pledged bank guarantees in the amount of \$ 0.5 million as security for the rent of its offices in Israel.

**NOTE 14: TAXES ON INCOME**

- a. Net operating losses carryforward:

At December 31, 2002, the Company had net operating loss carryforwards for U.S. federal income tax purposes of approximately \$ 7 million and tax credits of \$ 0.2 million, which are available to offset future federal taxable income and expire in 2009 to 2020.

Utilization of U.S. net operating losses may be subject to substantial annual limitation due to the "change in ownership" provisions of the Internal Revenue Code of 1986 and similar state provisions. The annual limitations may result in the expiration of net operating losses before utilization.

In addition, the Company had a net operating loss carryforwards relating to non-U.S. subsidiaries totaling approximately \$ 49.1 million, which are available to offset future taxable income. Generally, a majority of such amounts have no expiration date. However, in some cases, amounts expire in the years 2003 to 2008.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**NOTE 14: TAXES ON INCOME (Cont.)**

b. Israeli income tax:

Sapiens Technologies Ltd. (hereafter-"Technologies"), has been granted "Approved Enterprise" status for six investment programs approved in 1984, 1991, 1993, 1995, 1998 and 2000, by the Israeli Government under the Law for Encouragement of Capital Investments, 1959 ("the Law").

Undistributed Israeli income derived from the "Approved Enterprise" programs entitle Technologies to a tax exemption for a period of two to four years and to a reduced tax rate of 10% - 25% for an additional period of three to eight years (depending on the level of foreign-investment in Technologies). These tax benefits are subject to a limitation of the earlier of twelve years from commencement of operations, or fourteen years from receipt of the approval. Technologies completed the implementation of 1984, 1991, 1993, 1995 and 1998 investment programs. As of December 31, 2002 the Investment Center has granted final approval to the implementation of the 1995 and 1998 plans. Technologies has used all the tax benefits under the 1984 plan and is entitled for additional benefits under the 1991 plan which commenced in 1992 and will expire in 2002, under the 1993 plan the benefits period commenced in 1998 and will expire in 2006 and under the 1995 plan the benefits period commenced in 1998 and will expire in 2008. The benefits have not yet commenced for the 1998 and the 2000 plans.

The law also grants entitlement to claim accelerated depreciation on machinery and equipment used by the "Approved Enterprise", during the first five years.

The tax-exempt profits that will be earned by Technologies' "Approved Enterprises" can be distributed to shareholders, without imposing tax liability to Technologies only upon the complete liquidation of Technologies. If these retained tax-exempt profits are distributed in a manner other than in the complete liquidation of Technologies they would be taxed at the corporate tax rate applicable to such profits as if Technologies had not elected the alternative system of benefits (depending on the level of foreign - investment in Technologies) for an "Approved Enterprise". Technologies has decided not to declare dividends out of such tax-exempt earnings. Accordingly, no deferred income taxes have been provided on earnings attributable to the Technologies' "Approved Enterprise".

Income from sources other than the "Approved Enterprise" during the benefit period is subject to tax at the regular corporate tax rate of 36%.

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 Enterprise". 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.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 14: TAXES ON INCOME (Cont.)**

Results of the Company's Israeli subsidiaries for tax purposes are measured and reflected in real terms in accordance with the changes in the Israeli Customer Price Index (CPI). As explained in Note 2b, the financial statements are presented in U.S. dollars. The difference between the change in the Israel CPI and in the NIS\U.S. dollar exchange rate causes a difference between taxable income or loss and the income or loss reflected in the financial statements. In accordance with paragraph 9(f) of SFAS 109, the Israeli subsidiaries have not provided deferred income taxes on this difference between the reporting currency and the tax bases of assets and liabilities.

c. Tax assessments

In December 2001, Sapiens Technologies Ltd. and some of the Company's group entities, have reached an agreement with the Israeli Tax Authorities ("the ITA") as a result of a tax assessment. In accordance with the agreement's provisions, the tax liability for the tax years through 1999 will be increased by approximately \$1 million, which was paid in 12 equal monthly payments, commencing with the agreement date.

In addition, based on the provisions of the abovementioned agreement, the Company had a contingent tax liability to pay an additional amount ("the additional amount") conditioned by obtaining certain approvals from the "Investment Center" regarding the status of the "Approved Enterprise", under the "Law for Encouragement of Capital Investment, 1959" to some of its plans. In July 2002, a second agreement with the ITA was reached, and the additional amount was set to be \$ 580,000, payable in 11 payments ending October 2003. This amount completes Technologies' tax liability for the tax years through 1999, and is included in the current liabilities.

d. 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 and its subsidiaries' deferred tax liabilities and assets are as follows:

	December 31, 2001		December 31, 2002	
	Current	Non-current	Current	Non-current
	U.S. dollars in thousands			
Gross deferred tax assets	2,478	16,034	3,456	10,904
Less - valuation allowance	(1,823)	(11,550)	(2,596)	(7,032)
Net deferred tax asset	\$ 655	\$ 4,484	\$ 860	\$ 3,872

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**NOTE 14: TAXES ON INCOME (Cont.)**

As of December 31, 2002, the Company and its subsidiaries have decreased the deferred income taxes assets resulting from tax loss carryforwards and other tax credits and the related valuation by \$ 4.2 million and \$ 3.7 million, respectively. Management currently believes that it is more likely than not that the deferred income taxes regarding the loss carryforwards and other temporary differences, on which a valuation allowance has been provided, will not be realized in the foreseeable future.

Provisions for income tax expense are comprised of the following:

	<b>Year ended December 31,</b>		
	<b>2000</b>	<b>2001</b>	<b>2002</b>
	<b>U.S. dollars in thousands</b>		
Current (foreign)	\$ 383	\$ 676	\$ 1,001
Deferred (foreign)	(2,332)	50	407
	\$ (1,949)	\$ 726	\$ 1,408

The Company's entire provision for taxes on income relates to operations in jurisdictions other than the Netherlands Antilles. The effective income tax rate varies from period to period because each jurisdiction in which the Company operates has its own system of taxation (not only with respect to the nominal rate, but also with respect to the allowance of deductions, credits and other benefits). In addition, the provision for income taxes for the fiscal years ended December 31, 2000, 2001 and 2002, does not include the recognition of a majority of the deferred tax assets relating to the net operating losses of the Company's subsidiaries worldwide. The main reconciling item from the statutory tax rate of the Company to the effective tax rate is the non-recognition of tax benefits from accumulated net operating losses carryforward among the various subsidiaries worldwide due to the uncertainty of the realization of such tax benefits.

e. Israeli tax reform:

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

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**NOTE 15: SHAREHOLDERS' EQUITY**

- a. In June 2003, the Company's shareholders approved a 1-for-5 reverse stock split of the Company's Common shares. Accordingly, all share and per share data shown in these financial statements has been retroactively adjusted to reflect the reverse stock split.
- b. In December 2000, the Company entered a memorandum of understanding with Yarnfield International Limited, an affiliate of Magnum Technologies Fund ("Magnum"), and Formula Systems Ltd., for a \$ 15 million investment in exchange for issuance of Series F convertible Preferred shares. On December 25, 2000 the Company received a \$5 million nonrefundable

deposit, for which it would have issued 5 million Common shares if the agreement would not be approved by shareholders, or Series F Preferred shares if it would have been approved. The Company recorded the \$5 million cash received as proceeds on account of shares within the shareholders' equity as of December 31, 2000.

The Series F convertible Preferred shares were convertible into Common shares of the Company at any time at a ratio of \$ 7.5 per Common share. In accordance with an anti dilution clause, the conversion ratio will be adjusted in two stated dates, but will never increase, to 110% of the average closing sale price of the Company's Common shares for the 10 trading days following August 15, 2001 and March 1, 2002. The conversion ratio shall not be adjusted to be less than \$ 5.00 per Common share. At maturity, three years from the date of investment, the Company will redeem all of the remaining outstanding Series F convertible Preferred shares through payment of cash or delivery of Common shares, at the Company's election. If Common shares are issued, the redemption price will be the average closing sale price of the Company's Common share for the 30 trading days preceding maturity. The Company's intention was to redeem the investment in shares.

The investors were also granted warrants to acquire from the Company additional 10,000 Series F Preferred shares at any time before December 25, 2003, at an exercise price of \$ 7.50 per share or as adjusted in accordance with the provisions described above.

The warrant fair value was measured using the Black-Scholes Option Pricing Model with the following assumptions: risk-free interest rate of 4% dividend yields of 0%, volatility factors of the expected market price of the Company's Common shares of 0.7 and expected life of the warrant of 2.5 year.

In February 2001, the Company's shareholders approved the share purchase agreement, which was signed on January 24, 2001, and the Company issued to the investors an aggregate of 10,000 Series F Preferred shares par value €681 per share, each of which may be converted into 200 Common shares, subject to adjustment, at a cash price of \$ 1,500 per Series F share.

The Series F Preferred shares have all the rights of Common shares in addition to liquidation preference and conversion rights.

In addition, the investors have the right for "demand registrations" of an under written public offering of Common shares with unlimited piggyback rights.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**NOTE 15: SHAREHOLDERS' EQUITY (Cont.)**

In determining whether an instrument includes a beneficial conversion option in accordance with EITF 98-5 "Accounting for Convertible Securities with Beneficial Conversion Features or Continently Adjustable Conversion Ratios" ("EITF No. 98-5") and EITF 00-27 "Application of Issue No. 98-5 to Certain Convertible Instruments" ("EITF No. 00-27"), the total proceeds were allocated to the Preferred shares and the detachable warrants based on their fair values. As of December 31, 2001, no beneficial conversion feature value was accounted in respect of the Preferred share.

On August 15, 2001 the conversion ratio was adjusted to \$ 1,139 per Series F Preferred share. Following the adjustment, and in accordance with the provisions of EITF No. 00-27, no beneficial conversion feature was recorded, due to immateriality.

In accordance with the share purchase agreement's provisions, the conversion price was not adjusted as a result of the average closing sale price of the Company's Common shares for the 10 trading days following March 1, 2002.

In December 2002 the Investors converted all of the outstanding Series F Preferred shares into Common shares at a reduced conversion service of \$ 4.15, and Formula invested an additional \$ 10 million in Common Shares by exercising its two thirds portion of the Investors' option to purchase Common Shares. The remaining unexercised one third portion of the Investors' existing option was assigned to Formula by Yarnfiled and it was agreed that such option would be exercisable at the reduced exercise price \$ 4.15 per Common Share. This transaction was accounted for in accordance with the guidelines of EITF D-42. "The Effect on the Calculation of Earnings Per Share for the Redemption or Induced Conversion of Preferred Stock". No deemed dividends were recorded as a result of the conversion of Series F Preferred shares and exercise of options due to immateriality.

Ron Zuckerman, Chairman of the Board of the Company, is an advisor to Magnum.

- c. On April 4, 2001, the Company entered into a share purchase and loan agreement with Red Coral Holdings, Inc. ("Red Coral"), owned by the Company's President and Chief Executive Officer. According to the terms of the agreement, Red Coral purchased 300,000 Common shares of the Company for a purchase price of \$ 975,000. As part of the agreement, the Company granted to Red Coral a loan in the amount of \$ 975,000 for the purpose of acquiring the Common shares. The term of the loan is six years with accrued interest at a rate of 4%, which is payable on January 15<sup>th</sup> of each calendar year. The interest amount is fully-recourse and fixed. To secure payment of the loan, Red Coral granted the Company a lien and security interest on all of the Common shares. To secure fulfillment of the terms of the agreement, the Common shares are being held in escrow by the General Counsel of the Company. The issuance of Common shares was accounted in the shareholders' equity and the loan amount was deducted from the shareholders' equity as a note receivable from a shareholder.

In accordance with EITF 95-16 "Accounting for Stock Compensation Arrangements with Employer Loan Features under APB Opinion No. 25", the transaction was accounted for as a fixed award.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**NOTE 15: SHAREHOLDERS' EQUITY (Cont.)**

- d. Common shares confer upon their holders voting rights, the right to receive cash dividends and the right to share in excess assets upon liquidation of the Company.
- e. During the first quarter of 2000, all of the remaining Series D<sub>1</sub>, and E referred shares, 1,500 and 1,700, respectively, were converted to Common shares at the conversion prices and, as a result, 58,394 and 75,555 Common shares were issued, respectively.

As of December 31, 2000, the remaining 1,300 Series D<sub>2</sub> Preferred shares had been converted to Common shares at the conversion price and, as a result, 50,608 Common shares were issued.

In 2000, 114,303 warrants to purchase Common shares were issued as part of the conversion of Preferred shares.

Upon conversion of all issued Series F Preferred shares, the remaining authorized Series F Preferred shares were eliminated.

- f. Dividends on Preferred shares:

In 2000, the Company accrued dividends to be paid out in the form of Common shares on its Series D<sub>1</sub>, D<sub>2</sub> and E Preferred shares, in the amount of \$ 107,000 thousand. In the course of the conversion of all of the company's Preferred stock (see Note 14d), all of the remaining accumulated dividends, \$1,074,000 thousand, were paid by the issuance of 44,049 Common shares.

- g. Stock option plan:

Stock options granted under the Company's 1992 Stock Option and Incentive Plan ("the Plan") to employees, directors and service providers are exercisable at the fair market value of the Company's Common shares on the date of grant and, subject to termination of employment, expire ten years from the date of grant and are generally exercisable in four equal annual installments commencing one year from the date of grant.

As of December 31, 2002, approximately 180,423 Common shares of the Company are still available for future grant. Any options which are forfeited or cancelled before expiration become available for future grant under the Plan.

In January 2000 and November 2000, the Company increased the number of shares available for grants by 400,000 and 800,000, respectively, and approved grants of such shares. In December 2000, 154,560 previously granted options with exercise price from \$ 11.25 to \$ 69.375 were repriced to \$ 0 resulting in a new measurement date in total compensation expense of \$ 628,000 of which \$ 453,000 was recognized in 2000 for the portion already vested and \$ 175,000 was deferred to be recognized over the remaining vesting period ending in 2004. During the years 2001 and 2002, \$ 107,000 and \$ 47,000 of the amount deferred was recognized, respectively.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 15: SHAREHOLDERS' EQUITY (Cont.)**

In December 2000, the Company granted 509,600 Time Accelerated Restricted Stock Award options (hereinafter - "TARSAP's") to employees. The TARSAP's include an acceleration feature, based on the Company's performance in the years 2001 and 2002. As of December 31, 2002, 410,400 of the options are outstanding, and 75% of the options were vested based on the 2001 and 2002 performance tests. No compensation expense was recorded, since the fair value was equal to the exercise price at the date of grant.

A summary of the stock options activities in 2000, 2001 and 2002 is as follows:

	Year ended December 31,					
	2000		2001		2002	
	Shares	Weighted average exercise price	Shares	Weighted average exercise price	Shares	Weighted average exercise price
Outstanding at January 1	868,553	\$ 27.50	*) 1,790,614	\$ 18.3	*) 1,569,698	\$ 12.5
Granted	1,087,150	\$ 15.50	61,700	\$ 4.6	274,300	\$ 4.7
Exercised	(74,650)	\$ 13.35	(560)	\$ 0	(55,080)	\$ 0.2
Cancelled and forfeited	(90,439)	\$ 49.45	(482,050)	\$ 29.75	(208,205)	\$ 15.7
Outstanding at December 31	*) 1,790,614	\$ 18.3	*) 1,569,698	\$ 12.5	*) 1,580,713	\$ 11.25
Exercisable options at December 31	424,833	\$ 16.55	745,647	\$ 12.3	908,784	\$ 12.85

\*) Including 154,560, 154,000 and 102,100 options repriced to zero, as of December 31, 2000, 2001 and 2002, respectively.

The options outstanding as of December 31, 2002, have been classified by range 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 of December 31, 2002	Weighted average exercise Price
\$ -	102,100	4.86	\$ -	102,100	\$ -
\$ 3.25 - \$ 3.75	189,170	9.22	\$ 3.55	33,845	\$ 3.30
\$ 4.065 - \$ 5.7	837,800	8.31	\$ 4.50	396,000	\$ 4.15
\$ 11.25 - \$ 16.875	185,825	3.32	\$ 12.00	185,825	\$ 12.00
\$ 19.375 - \$ 29.375	68,300	7.54	\$ 28.75	35,350	\$ 28.60
\$ 32.5 - \$ 47.5	143,608	6.07	\$ 38.30	128,204	\$ 37.55
\$ 61.25 - \$ 69.375	53,910	7.06	\$ 67.50	27,460	\$ 67.75
	<u>1,580,713</u>		<u>\$ 11.25</u>	<u>908,784</u>	<u>\$ 12.85</u>

h. Warrants:

In 1996, 1997 and 1999, warrants were granted to service providers. As of December 31, 2002, 225,086 warrants are outstanding.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**NOTE 15: SHAREHOLDERS' EQUITY (Cont.)**

- i. In 2001, the Company granted Bank Leumi Le Israel B.M., Bank Hapoalim Ltd., Mizrahi Bank Ltd. and Bank Discount Ltd. (collectively the "Banks") 81,000 warrants as part of a credit-line extension agreement (see Note 10a) at an exercise price ranging from \$ 4.4 to \$ 6.9 per share. As required by APB No. 14 "Accounting for Convertible Debt and Debt Issued with stock purchase warrants", these warrants were measured at fair value (according to the Black-Scholes option pricing model) with the following weighted-average assumptions for 2001: risk free interest rate of 5%, dividend yields of 0%, volatility factors of the expected market price of the Company's Common shares of 0.901 weighted-average expected life of the option of 2 years. Total compensation expense amounted to \$ 203,000, of which \$ 150,000 and \$ 53,000 were recognized as financial expense in 2001 and 2002, respectively, over the credit-line period.
- j. The Company does not intend to pay cash dividends in the foreseeable future.

**NOTE 16: GEOGRAPHIC INFORMATION**

- a. The Company operates in a single segment as a provider of software solutions. See Note 1 for brief description of the Company's business. The following data is presented in accordance with Statement of Financial Accounting Standard No. 131 "Disclosure About Segments of an Enterprise and Related Information" (SFAS No. 131).
- b. Geographic information:

The following is a summary of operations within geographic areas based on the end customers' location.

	<b>Year ended December 31,</b>		
	<b>2000</b>	<b>2001</b>	<b>2002</b>
	<b>U.S. dollars in thousands</b>		
1. Revenues:			
U.K.	\$ 17,744	\$ 21,275	\$ 25,438
North America	15,098	18,523	20,272
France	16,610	5,976	3,450
Germany	6,289	4,798	2,653
Israel	5,633	6,097	5,776
Other	11,370	6,766	7,239
	\$ 72,744	\$ 63,435	\$ 64,828
2. Long-lived assets:			
France	\$ 2,616	\$ 2,135	\$ 2,426
Dutch Antilles	1,662	1,275	936
Israel	14,043	11,722	10,213
Germany	5,218	4,287	4,988
Other	5,626	3,276	2,816
	\$ 29,165	\$ 22,695	\$ 21,379

**SAPIENS INTERNATIONAL CORPORATION N.V.  
AND ITS SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 17: SELECTED STATEMENTS OF OPERATIONS DATA**

a. Research and development costs:

	<b>Year ended December 31,</b>		
	<b>2000</b>	<b>2001</b>	<b>2002</b>
	<b>U.S. dollars in thousands</b>		
Total costs	\$ 14,567	\$ 11,006	\$ 9,448
Less - capitalized software development costs	(4,250)	(3,967)	(2,732)
Less - royalty-bearing grants	-	(1,581)	(699)
Research and development costs, net	\$ 10,317	\$ 5,458	\$ 6,017

b. Financial income (expenses):

Financial income:			
Interest	\$ 973	\$ 518	\$ 778
Foreign currency translation differences	3,904	3,728	6,511
Realized gain on sale of marketable securities	163	124	-
	5,040	4,370	7,289
Financial expenses:			
Interest	1,419	1,818	1,747
Foreign currency translation differences	4,114	5,277	6,351
Bank charges and others	139	462	162
	5,672	7,557	8,260
Financial expenses, net	\$ 632	\$ 3,187	\$ 971

c. Losses per share data:

The following table sets forth the calculation of basic and diluted net losses per share.

1. Numerator:

	<b>Year ended December 31,</b>		
	<b>2000</b>	<b>2001</b>	<b>2002</b>
	<b>U.S. dollars in thousands</b>		
Net loss to shareholders of Common shares	\$ 38,193	\$ 17,970	\$ 5,153
Effect of dilutive securities:			
Preferred share dividends	*) -	-	-
Numerator for diluted losses per share - loss available to shareholders of Common shares	\$ 38,193	\$ 17,970	\$ 5,153

\*) The effect of the inclusion of the convertible Preferred shares dividends in 2000 would be anti-dilutive.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 17: SELECTED STATEMENTS OF OPERATIONS DATA (Cont.)**

2. Denominator:

	Year ended December 31,		
	2000	2001	2002
	U.S. dollars in thousands		
Weighted average number of shares	4,508	4,600	4,999
Common shares to be issued as dividends	3	-	-
Denominator for net basic earnings per share	4,511	4,600	4,999
Effect of dilutive securities:			
Employee stock options	*) -	*) -	*) -
Warrants issued to third parties	*) -	*) -	*) -
Convertible Preferred shares	*) -	*) -	*) -
Redeemable shares in subsidiary	*) -	*) -	*) -
Convertible subordinated notes	*) -	*) -	*) -
Dilutive potential Common shares	-	-	-
Denominator for diluted net earnings per share - adjusted weighted average shares, assumed conversions and exercise of options and/or warrants	4,511	4,600	4,999

\*) Because of the loss in 2000, 2001 and 2002, the effect of the inclusion of the convertible Preferred shares, options, warrants, redeemable shares in subsidiary and convertible subordinated notes would be anti-dilutive.

**NOTE 18:- SUBSEQUENT EVENTS**

In June 2003, the Company extended its credit agreements with Bank Hapoalim Ltd., Bank Leumi Le Israel Ltd, Discount Bank Ltd. and Mizrahi Bank Ltd. regarding its existing credit lines in the total amount of \$ 25.5 million, of which \$ 18 million is available until March 31, 2004 and \$ 7.5 million is available until March 31, 2005. Under the terms of these credit line agreements, the Company and several of its subsidiaries recorded floating charges in favour of the banks and issued cross guarantees in support of the credit facilities. Additionally, the Company is required to maintain certain financial ratios.

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