

ISG INTERNATIONAL SOFTWARE GROUP LTD.

CONSOLIDATED FINANCIAL STATEMENTS

AS OF DECEMBER 31, 1999

IN U.S. DOLLARS

INDEX

	<u>Page</u>
Report of Independent Auditors	F-2
Consolidated Balance Sheets	F-3 - F-4
Consolidated Statements of Operations	F-5
Statements of Changes in Shareholders' Equity	F-6
Consolidated Statements of Cash Flows	F-7 - F-8
Notes to Consolidated Financial Statements	F-9 - F-26

REPORT OF INDEPENDENT AUDITORS

To the Shareholders of

ISG INTERNATIONAL SOFTWARE GROUP LTD.

We have audited the consolidated balance sheets of ISG International Software Group Ltd. and its subsidiaries ("the Company") as of December 31, 1998 and 1999, 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, 1999. 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 generally accepted auditing standards in the United states. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in financial statements. An audit also includes assessing the accounting principles used and significant estimates made by the Company's management, as well as evaluating the overall financial 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, 1998 and 1999, and the consolidated results of their operations, and cash flows for each of the three years in the period ended December 31, 1999, in conformity with generally accepted accounting principles in United States.

Tel-Aviv, Israel
March 28, 2000**KOST FORER & GABBAY**
A Member of Ernst & Young
International

ISG INTERNATIONAL SOFTWARE GROUP LTD.**CONSOLIDATED BALANCE SHEETS**

U.S. dollars in thousands

	December 31,	
	1998	1999
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 4,919	\$ 4,272
Restricted cash (Note 1b)	2,297	-
Marketable securities	847	1,115
Trade receivables, net of allowance for doubtful accounts (1998 - \$ 114, 1999 - \$ 634)	5,274	7,194
Other accounts receivable and prepaid expenses (Note 3)	1,502	1,345
Total current assets	14,839	13,926
SEVERANCE PAY FUND	697	1,102
PROPERTY AND EQUIPMENT, NET (Note 4)	1,765	1,420
OTHER ASSETS:		
Computer software costs, net of accumulated amortization (1998 - \$ 5,066, 1999 - \$ 5,747,)	7,597	8,916
Goodwill, net of accumulated amortization (1998 - \$ 680, 1999 - \$ 908)	2,073	1,845
	9,670	10,761
	\$ 26,971	\$ 27,209

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

**ISG INTERNATIONAL SOFTWARE GROUP LTD.
CONSOLIDATED BALANCE SHEETS**

U.S. dollars in thousands

	December 31,	
	1998	1999
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Short-term bank debt (Note 5)	\$ 481	\$ 22
Current maturities of long-term debt	126	118
Trade payables	1,115	1,368
Deferred revenues	2,056	2,223
Employees and payroll accruals	1,497	1,167
Accrued expenses and other liabilities (Note 6)	936	1,392
Notes payable with respect to acquisition (Note 1b)	2,046	-
Total current liabilities	<u>8,257</u>	<u>6,290</u>
LONG-TERM LIABILITIES:		
Long-term debt (Note 7)	96	93
Accrued severance pay	883	1,310
Total long-term liabilities	<u>979</u>	<u>1,403</u>
SHAREHOLDERS' EQUITY:		
Share capital (Note 10) - Authorized: 10,000,000 Ordinary shares of NIS 0.1 par value; Issued and outstanding: 8,167,862 shares at December 31, 1998 and 8,531,778 shares at December 31, 1999	371	379
Additional paid-in capital	44,214	46,742
Accumulated other comprehensive loss	(333)	(692)
Accumulated deficit	(26,517)	(26,913)
Total shareholders' equity	<u>17,735</u>	<u>19,516</u>
	<u>\$ 26,971</u>	<u>\$ 27,209</u>

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

ISG INTERNATIONAL SOFTWARE GROUP LTD.

CONSOLIDATED STATEMENTS OF OPERATIONS

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

	Year ended December 31,		
	1997	1998	1999
Revenues (Note 12a):			
Products and maintenance	\$ 8,717	\$ 9,091	\$ 12,323
Services	3,102	5,809	8,184
	<u>11,819</u>	<u>14,900</u>	<u>20,507</u>
Cost of revenues:			
Products and maintenance	1,936	2,554	2,294
Services	1,651	2,778	5,028
	<u>3,587</u>	<u>5,332</u>	<u>7,322</u>
Gross profit	8,232	9,568	13,185
Operating expenses:			
Research and development, net (Note 12b)	2,059	2,272	2,476
Selling and marketing	5,202	7,012	8,544
General and administrative	1,346	1,960	2,533
Operating loss	(375)	(1,676)	(368)
Financial income, net (Note 12c)	557	252	160
Income taxes	-	-	188
Net income (loss)	<u>\$ 182</u>	<u>\$ (1,424)</u>	<u>\$ (396)</u>
Basic and diluted earnings (loss) per share (Note 12d)	<u>\$ 0.02</u>	<u>\$ (0.17)</u>	<u>\$ (0.05)</u>

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

ISG INTERNATIONAL SOFTWARE GROUP LTD.

STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

U.S. dollars in thousands

	<u>Share capital</u>	<u>Additional paid-in capital</u>	<u>Accumulated other comprehensive loss</u>	<u>Accumulated deficit</u>	<u>Total shareholders' equity</u>
Balance as of January 1, 1997	\$ 363	\$ 42,133	\$ (230)	\$ (25,275)	\$ 16,991
Comprehensive income:					
Net income	-	-	-	182	182
Other comprehensive income:					
Foreign currency translation adjustments	-	-	58	-	<u>58</u>
Total comprehensive income					<u>\$ 240</u>
Exercise of stock options and warrants	<u>6</u>	<u>1,949</u>	<u>-</u>	<u>-</u>	<u>1,955</u>
Balance as of December 31, 1997	369	44,082	(172)	(25,093)	19,186
Comprehensive loss:					
Net loss	-	-	-	(1,424)	(1,424)
Other comprehensive loss:					
Foreign currency translation adjustments	-	-	(161)	-	<u>(161)</u>
Total comprehensive loss					<u>\$ (1,585)</u>
Exercise of stock options and warrants	<u>2</u>	<u>132</u>	<u>-</u>	<u>-</u>	<u>134</u>
Balance as of December 31, 1998	371	44,214	(333)	(26,517)	17,735
Comprehensive loss:					
Net loss			-	(396)	(396)
Other comprehensive loss:					
Foreign currency translation adjustments			(359)	-	<u>(359)</u>
Total comprehensive loss					<u>\$ (755)</u>
Issuance of shares upon conversion of convertible notes	3	1,484	-	-	1,487
Exercise of stock options and warrants	<u>5</u>	<u>1,044</u>	<u>-</u>	<u>-</u>	<u>1,049</u>
Balance as of December 31, 1999	<u>\$ 379</u>	<u>\$ 46,742</u>	<u>\$ (692)</u>	<u>\$ (26,913)</u>	<u>\$ 19,516</u>

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

ISG INTERNATIONAL SOFTWARE GROUP LTD.

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

	Year ended December 31,		
	1997	1998	1999
Cash flows from operating activities:			
Net income (loss)	\$ 182	\$ (1,424)	\$ (396)
Adjustments to reconcile net income (loss) to net cash used in operating activities:			
Depreciation and amortization	1,166	1,471	1,636
Loss on sale of property and equipment	-	23	3
Decrease (increase) in marketable securities	-	7	(411)
Increase in trade receivables	(1,455)	(700)	(2,140)
Decrease (increase) in other accounts receivable and prepaid expenses	(351)	(42)	340
Increase (decrease) in trade payables	(538)	216	313
Increase (decrease) in deferred revenues	(485)	(8)	274
Increase (decrease) in accrued expenses and other liabilities	228	(289)	134
Increase in severance pay, net	28	75	22
Net cash used in operating activities	<u>(1,225)</u>	<u>(671)</u>	<u>(225)</u>
Cash flows from investing activities:			
Restricted cash	-	(2,048)	2,018
Capitalization of computer software costs	(1,905)	(2,093)	(2,000)
Purchase of property and equipment	(788)	(940)	(434)
Proceeds from sale of property and equipment	170	149	34
Decrease (increase) in long-term receivables	171	-	(618)
Investment in Infocom and Infopar, net of cash acquired (1)	-	(752)	-
Net cash used in investing activities	<u>(2,352)</u>	<u>(5,684)</u>	<u>(1,000)</u>

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

ISG INTERNATIONAL SOFTWARE GROUP LTD.

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

	Year ended December 31,		
	1997	1998	1999
Cash flows from financing activities:			
Proceeds from exercise of stock options and warrants	1,955	134	1,049
Revolving credit, net	(189)	158	(453)
Proceeds from short-term bank loans	288	123	139
Payments of short-term bank loans	(165)	(241)	-
Principal payment of long-term debt	(252)	(96)	(148)
Net cash provided by financing activities	<u>1,637</u>	<u>78</u>	<u>587</u>
Effect of exchange rate changes on cash and cash equivalents	<u>87</u>	<u>(106)</u>	<u>(9)</u>
Increase (decrease) in cash and cash equivalents	(1,853)	(6,383)	(647)
Cash and cash equivalents at the beginning of the year	<u>13,155</u>	<u>11,302</u>	<u>4,919</u>
Cash and cash equivalents at the end of the year	<u>\$ 11,302</u>	<u>\$ 4,919</u>	<u>\$ 4,272</u>
Non-cash transactions:			
Ordinary shares issued to affiliate upon conversion of long-term debt	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 1,487</u>
(1) The fair value of net assets acquired from the shareholders of Infocom and Infopar (see Note 1b) was as follows:			
Working capital, excluding cash and cash equivalents	\$ -	\$ 887	\$ -
Property and equipment	-	43	-
Excess of cost over net fair values upon acquisition	<u>-</u>	<u>1,860</u>	<u>-</u>
	-	2,790	-
Less - amount financed by notes payable	<u>-</u>	<u>(2,038)</u>	<u>-</u>
	<u>\$ -</u>	<u>\$ 752</u>	<u>\$ -</u>
Supplemental disclosure of cash flow activities:			
Cash paid during the year for:			
Interest	<u>\$ 59</u>	<u>\$ 81</u>	<u>\$ 99</u>
Income taxes	<u>\$ 6</u>	<u>\$ -</u>	<u>\$ 115</u>

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

NOTE 1:- GENERAL

- a. ISG International Software Group Ltd. and its subsidiaries ("ISG" or "the Company") develop, market and support computer software integration tools and application development tools. A portion of the Company's revenues derive from consulting, maintenance and other related services. The Company's products and services are sold throughout the world through both direct and indirect channels, including distributors and value-added resellers ("VARs").

The Company's main product is ISG Navigator, an Enterprise Information Infrastructure product, which is available on multiple platforms and provides database-independent access to many databases and file systems. The ISG Navigator standardizes the interaction between data sources and application programs utilizing various universally accepted standards.

The Company's principal application development tools are CorVision, an application generator, and APTuser, a database retrieval and production report generator. The Company also develops, markets and supports through its Israeli subsidiary Meyad, "Mancal 2000", a logistics and financial application software package.

- b. Acquisition of companies:

(1) In September 1998, the Company consummated the acquisition of all the outstanding shares of Infocom, S.A. and Infopar S.A.R.L, two privately-held, French based, software distributor companies under common control ("Infocom" and "Infopar") in consideration for \$2,790, including \$77 of costs related to the acquisition. Pursuant to the agreement, an amount of approximately \$752 was paid by the Company upon the closing of the transaction, and an amount of approximately \$680 was paid to the selling shareholders of Infocom and Infopar (the "Selling Shareholders") in the form of promissory notes payable on or before August 31, 1999. In addition, the Company issued to the selling shareholders convertible promissory notes ("Convertible Notes") for the remaining purchase price in the amount of approximately \$1,358 payable on or before December 31, 1999. The Company issued 140,000 Ordinary shares in exchange for the convertible notes in June 1999.

The Infocom and Infopar acquisition has been accounted for using the purchase method of accounting, and accordingly, the purchase price has been allocated to the assets acquired and liabilities assumed based upon the related fair values on the date of the acquisition. The excess of the purchase price over the fair value of the net tangible assets acquired has been attributed to goodwill as follows:

Net tangible assets of Infocom and Infopar (1)	\$ 90
Goodwill (2)	<u>1,890</u>
	<u>\$ 2,790</u>

- (1) After deducting an amount of \$249 from the fair value of the net tangible assets of Infocom due to cash held in a restricted account, bearing interest, which is subject to an ongoing dispute with the French Tax Authorities.

To the extent that Infocom is successful in the tax litigation and is allowed by law to release the restricted funds, the Company shall pay the shareholders of Infocom and Infopar such amount including any related interest. As of December 31, 1999, the accrued expenses and other liabilities include an accrual in the amount of \$215, with respect to such payment.

(2) Goodwill is amortized over its useful life which is estimated at ten years.

As a result of the acquisition, the Company consolidated the balance sheets of Infocom and Infopar as of December 31, 1998 and their statements of operations for the three months then ended.

Pro-Forma information:

The following are pro forma unaudited results of operations for the years ended December 31, 1997 and 1998 representing the combined results of operations as if the Infocom and Infopar acquisition had been completed on January 1, 1997 and 1998 as follows:

	Year ended December 31,	
	1997	1998
Revenues	<u>\$ 15,045</u>	<u>\$ 17,621</u>
Net income (loss)	<u>\$ 115</u>	<u>\$ (913)</u>
Basic and diluted earnings (loss) per share	<u>\$ 0.01</u>	<u>\$ (0.11)</u>

c. In February 2000, the Company signed an agreement to acquire Bridges for Islands Ltd., an Israeli privately held company, a provider of B2B integration solutions ("BFI") in consideration of \$ 18,000, of which \$ 4,000 will be paid in cash and the remaining balance by the issuance of 875 thousand common stock of ISG aggregating to a value of \$ 14,000. The Company has entered into a share price protection guarantee with the shareholders of BFI pertaining to the shares to be issued to them at \$ 16 per share for a one year period from the registration date with the SEC ("Securities and Exchange Commission") of the abovementioned shares.

In March 2000, the Company signed a letter of intent to acquire two Israeli privately held companies under common control - 100% of Medatech Information Technology Ltd. ("Medatech") a company that provides software system integration services and 70% of Insol Ltd. ("Insol"), a provider of B2B system integration services in consideration of \$ 7,800 to be paid in the form of the issuance of 300,000 of the Company's common stock.

The Company has entered into a share price protection guarantee with the shareholders of Medatech and Insol pertaining to the shares to be issued to them, at \$ 26 per share for a one year period from the registration date with the SEC (Securities and Exchange Commission) of the abovementioned shares.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES

a. Use of estimates:

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

b. Financial statements in U.S. dollars:

The majority of ISG Ltd.'s sales is made in U.S. dollars ("dollar"). In addition, a substantial portion of ISG Ltd.'s costs and finance is incurred in dollars. Since the dollar is the primary currency of the economic environment in which ISG Ltd. operates, the dollar is its functional and reporting currency. Israeli and non-U.S. subsidiaries of ISG Ltd. transact in their local currency only, and therefore, their functional and reporting currency is the related local currency.

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

Assets and liabilities of ISG Ltd.'s Israeli and other non-U.S. subsidiaries, whose functional currency is not the dollar, are translated at year-end exchange rates while the statement of operations items are translated at average exchange rates prevailing during the year. Such translation adjustments are recorded as a separate component of shareholders' equity.

c. Principles of consolidation:

The consolidated financial statements include the accounts of the Company and its over 50% owned subsidiaries. Significant intercompany balances and transactions have been eliminated in consolidation.

d. Cash equivalents:

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

e. Marketable securities:

The Company classifies its marketable securities as "trading securities" in accordance with Statement No. 115 of the FASB. Realized and unrealized holding gains and losses related to trading securities are included in financial income, net. All marketable securities are stated at their fair market value as of balance sheet date.

f. Property and equipment:

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

	<u>%</u>
Computers and peripheral equipment	20 - 33
Office furniture and equipment	10 - 20
Motor vehicles	15
Leasehold improvements	Over the related lease period

Assets acquired under a long-term capital lease agreement have been included in property and equipment and the related liabilities are reflected in the financial statements at present value of future minimum lease payments.

g. Research and development costs:

Research and development costs incurred in the process of software development before establishment of technological feasibility are charged to expenses as incurred. Costs of the production of a product master incurred subsequent to the establishment of technological feasibility are capitalized according to the principles set forth in Statement No. 86 of the FASB, and are included in other assets.

Capitalized software costs are amortized on a product by product basis commencing with general product release by the greater of the amount computed using the: (i) 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 product (three to five years), and are included in the cost of revenues.

At each balance sheet date, the Company compares the unamortized capitalized software costs to the net realizable value on a product by product basis. Should the amount of the unamortized capitalized costs of a computer software product exceed the net realizable value, these products will be written down by the excess amount.

Amortization of capitalized research and development costs for the years ended December 31, 1997, 1998 and 1999 were \$ 402, \$ 579 and \$ 681, respectively.

h. Goodwill:

Goodwill which reflects the excess of purchase price over net tangible assets acquired, is stated at cost and is amortized by a straight-line basis over periods of five to ten years.

The Company assesses the recoverability of this intangible asset by determining whether the amortization of the goodwill balance over its remaining life can be recovered through undiscounted future operating cash flows of the acquired operation and other considerations.

i. Income taxes:

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

j. Revenue recognition:

The Company generates revenues from licensing the rights to use its software products directly to end-users and indirectly through sub-license fees from distributors. The Company also generates revenues from sales of professional services, including consulting, implementation, project and training, and maintenance.

Revenues from software license agreements are recognized upon delivery of the software when collection is probable; all license payments are due within one year; the license fee is otherwise fixed or determinable; no significant obligations with regard to implementation remain; and persuasive evidence of an arrangement exists.

Revenue from maintenance arrangements is deferred and recognized on a straight-line basis over the life of the related agreement, which is typically one year. Consulting and training revenue is deferred and recognized when provided to the customer. Customer advances and billed amounts due from customers in excess of revenue recognized are recorded as deferred revenue.

The Company recognizes revenues from fixed price contracts relating to the modifications of the Mancal 2000 product according to specified milestones mentioned in the contracts. These milestones generally relate to the completion of the modifications of a module according to the contract. The Company provides for any anticipated losses in the process of the adaptation during the period when such losses are incurred.

The Company adopted the American Institute of Certified Public Accountants ("AICPA") Statement of Position 97-2, "Software Revenue Recognition" (SOP 97-2"), and Statement of Position 98-4, "Deferral of the Effective Date of a Provision of SOP 97-2, Software Revenue Recognition" ("SOP 98-4"), as of January 1, 1998. SOP 97-2 and SOP 98-4 provide guidance for recognizing revenue on software transactions and supersede Statement of Position 91-1. The adoption of SOP 97-2 and SOP 98-4 did not have a material impact on the Company's financial results.

In December 1998, the AICPA issued Statement of Position 98-9, "Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions" ("SOP 98-9"). SOP 98-9 amends SOP 98-4 to extend the deferral of the application of certain passages of SOP 97-2 provided by SOP 98-4 through fiscal years beginning on or before March 15, 1999. All other provisions of SOP 98-9 are effective for transactions entered into in fiscal years beginning after March 15, 1999. The Company has not yet determined the effect of the final adoption of SOP 98-9 on its financial condition or results of operations.

k. Royalty-bearing grants:

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

l. Concentrations of credit risks:

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

The Company's cash and cash equivalents and restricted cash are invested in deposits with major Israeli and U.S. banks and the Company's marketable securities are held in major French banks. 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 receivables are derived from sales to customers located primarily in the U.S., Europe and Israel. The Company performs ongoing credit evaluations of its customers and to date has not experienced any material losses. The allowance for doubtful accounts is determined with respect to specific debts that are doubtful of collection.

m. Basic and diluted earnings (loss) per share:

Basic earnings (loss) per share is computed based on the weighted average number of Ordinary shares outstanding during each year. Diluted earnings per share is computed based on the weighted average number of Ordinary shares outstanding during each year, plus dilutive potential Ordinary shares considered outstanding during the year, in accordance with FASB Statement No. 128. "Earnings Per Share".

All outstanding stock options, and warrants have been excluded from the calculation of the diluted loss per share because all such securities are antidilutive for the years ended December 31, 1998 and 1999. The total number of shares related to the outstanding stock options and warrants excluded from the calculations of diluted net loss per share were 924,090 and 1,040,996 for the years ended December 31, 1998 and 1999, respectively.

n. Accounting for stock-based compensation:

The Company has elected to follow Accounting Principles Board Opinion No. 25, "Accounting for Stock Options Issued to Employees" ("APB 25"), and related interpretations in accounting for its employee stock options. Under APB 25, when the exercise price of the Company's employee stock options equals or is above the market price of the underlying Ordinary shares on the date of grant, no compensation expense is recognized.

The Company has accounted for warrants issued to non-employees according to the terms of Statement No. 123, "Accounting for Stock Based Compensation" ("SFAS 123"). See proforma disclosures of the application of SFAS 123 in Note 10b.

o. Severance pay:

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

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

p. Fair value of financial instruments:

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

- The carrying amount of cash and cash equivalents, restricted cash, marketable securities, short-term bank credit and promissory notes approximates their fair value due to the short-term maturities of these instruments.
- The carrying amount of the Company's long-term debt, approximates its fair value. The fair value was estimated using discounted cash flow analyses, based on the Company's current incremental borrowing rates for similar types of borrowing arrangements.

q. Impact of recently issued accounting standards:

In June 1998, the FASB issued Statement No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("SFAS 133"). The Company is required to adopt SFAS 133 for the year ending December 31, 2000. SFAS 133 establishes methods of accounting for derivative financial instruments and hedging activities. Because the Company currently holds no derivative financial instruments as defined by SFAS 133 and does not currently engage in hedging activities, adoption of SFAS 133 is expected to have no material effect on the Company's financial condition and results of operations.

NOTE 3:- OTHER ACCOUNTS RECEIVABLE AND PREPAID EXPENSES

	December 31,	
	1998	1999
Prepaid expenses	\$ 584	\$ 455
Government grants receivable		
Government authorities		
Employees		
Notes receivable		
Other		
	<u>\$ 1,502</u>	<u>\$ 1,345</u>

NOTE 4:- PROPERTY AND EQUIPMENT

	Cost:	
Computers and peripheral equipment (1)	\$ 2,261	\$ 2,441
Office furniture and equipment	2	2
Motor vehicles (1)		
Leasehold improvements		
	<u>5</u>	<u>5</u>
	Accumulated depreciation:	
Computers and peripheral equipment (1)	1	2
Office furniture and equipment	1	1
Motor vehicles (1)		
Leasehold improvements		
	<u>3</u>	<u>4</u>
Depreciated cost	<u>\$ 1,706</u>	<u>\$ 1,421</u>
(1) Including assets acquired under long-term lease:		
Cost	<u>\$ 1</u>	<u>\$ 1</u>
Accumulated depreciation	<u>\$</u>	<u>\$ 1</u>

Depreciation expenses for the years ended December 31, 1997, 1998 and 1999 are \$ 696, \$ 731 and \$ 727, respectively.

For charges on the Company's assets, see Note 8.

NOTE 5:- SHORT-TERM BANK DEBT

As of December 31, 1999, the Company has an authorized line of credit in the amount of \$ 420 which was partially utilized. The credit line generally bears interest at an annual rate between Prime-2% to Prime + 3%. Short-term bank debt utilized by the Company consists of the following:

	December 31,	
	1998	1999
Revolving credit unlinked (in NIS and £ Sterling) + 7.5% to 16.3% interest	\$ 3.	\$
Loans linked to the Israeli CPI and unlinked (in NIS) + 6% to 15.5% interest		
	<u>\$ 481</u>	<u>\$</u>

Weighted average interest rate at December 31, 1998 and 1999 was 12.6% and 16.3%, respectively.

NOTE 6:- ACCRUED EXPENSES AND OTHER LIABILITIES

Government authorities	\$ 10	\$ 35
Accrued expenses - mainly professional fees, commissions and rent		
Royalties to government institutions		
Accrued expenses with respect to acquisition (See Note 1b)		
Other		
	<u>\$ 93</u>	<u>\$ 1,39</u>

NOTE 7:- LONG-TERM DEBT

The Company's long-term debt consists of the following:

	December 31,	
	1998	1999
Capital lease obligations, linked to the U.S. dollar +10.3% interest	\$ 16	\$ 11
Others loans, linked to the Israeli CPI +5.5% to 6.85% interest		
Capital lease obligations, linked to the U.S. dollar + 2.25%		
Less - current maturities		
	<u>\$</u>	<u>\$</u>

Maturities of outstanding long-term debt for the three years subsequent to December 31, 1999, are \$118, \$ 49, \$ 31 and \$ 13 in 2000, 2001, 2002 and 2003, respectively.

NOTE 8:- CHARGES (ASSETS PLEDGED)

- a. As collateral for certain liabilities of the Company and its subsidiaries to banks and others, fixed charges have been placed on certain assets of the Company and its subsidiaries.
- b. The balances of collateralized liabilities as of December 31, 1999, are as follows:

Short-term	\$ 1
Long-term	\$ 1

NOTE 9:- COMMITMENTS AND CONTINGENT LIABILITIES

- a. Lease commitments:

The Company leases its operating facilities and other equipment under non-cancelable operating lease agreements. The Company also leases certain equipment under non-cancelable capital lease agreements. Future minimum commitments under these leases as of December 31, 1999, are as follows:

Year ending December 31,	<u>Operating leases</u>	<u>Capital leases</u>
2000	\$ 1	
2001		
2002		
2003		
2004		
	<u>\$ 1,4</u>	
Less - amount representing interest		
Present value of minimum lease payments		
Less - current portion of capital lease obligations		
		<u>\$</u>

Rent expense under operating leases for the years ended December 31, 1997, 1998 and 1999 was \$556, \$713 and \$659, respectively.

b. Royalties:

Royalties are due to participants in the financing of the development of certain products mainly to the Chief Scientist of the Ministry of Industry and Trade. Under the Company's research and development agreements with the Chief Scientist and pursuant to applicable law, the Company is required to pay royalties at the rate of 2%-5% of sales of products developed with funds provided by the Chief Scientist, up to an amount equal to 100%-150% of the Chief Scientist's research and development grants (dollar linked) related to such projects.

For the years ended December 31, 1997, 1998 and 1999, the Company recognized grants in the amounts of \$ 260, \$ 557 and \$ 26, respectively, which are presented in the financial statements as an offset to research and development costs. Royalties expenses for the three years ended December 31, 1997, 1998 and 1999 are \$ 87, \$ 154 and \$ 229, respectively.

As of December 31, 1999, the Company has a contingent liability to pay royalties in the amount of \$ 1,898.

NOTE 10:- SHARE CAPITAL

a. The Ordinary shares of the Company are quoted on NASDAQ.

b. Stock Option Plan:

Under the Company's Stock Option Plans (the "Plans"), options may be granted to employees, officers, directors and consultants of the Company or any of its subsidiaries. The exercise price of options granted under the Plan may not be less than 75% of the fair market value of the Company's Ordinary shares on the date of the grant. Each option granted under the Plans may expire not later than ten years from the date of the grant. Options granted under the Plans are generally exercisable in installments during the option term.

Under the Plans, 1,500,000 Ordinary shares of the Company were reserved for issuance. Any options which are canceled or not exercised within the option period become available for future grants.

Summary of the Company's stock option activity, and related information:

	Year ended December 31					
	1997		1998		1998	
	Amount In thousands	Weighted average exercise price	Amount In thousands	Weighted average exercise price	Amount In thousands	Weighted average exercise price
Outstanding at the beginning of the year	630	\$ 5.6	643	\$ 7.00	891	\$ 7.55
Granted	154	9.57	338	8.54	463	8.28
Exercised	(108)	3.73	(42)	3.14	(154)	5.62
Forfeited	(33)	3.17	(48)	10.94	(132)	8.59
Outstanding at the end of the year	<u>643</u>	<u>\$ 7.00</u>	<u>891</u>	<u>\$ 7.55</u>	<u>1,068</u>	<u>\$ 8.02</u>

The number of options exercisable as of December 31, 1997, 1998 and 1999 was 184, 351 and 387, respectively.

The weighted average exercise price of the options exercisable at December 31, 1997, 1998 and 1999 was \$ 5.32, \$ 6.84 and \$ 7.44, respectively.

The options outstanding as of December 31, 1999 have been separated into ranges of exercise price as follows:

Range of exercise prices	Outstanding at December 31, 1999	Weighted average remaining contractual life	Weighted average exercise price	Exercisable at December 31, 1999	Weighted average exercise price
	In thousands	Years		In thousands	
1.125 - 3					
4.875 - 9.812				2	
10 - 16.625			1		1
				3	

Under FAS - 123, "Accounting for Stock-Based Compensation", pro-forma information regarding net income and earnings (loss) per share is required (for grants issued after December 1994), and has been determined as if the Company had accounted for its employee stock option under the fair value method of that Statement. The fair value for these options was estimated at the date of grant using a Black-Scholes option valuation pricing model, with the following weighted-average assumptions for 1997, 1998 and 1999: risk-free interest rates of 6%, dividend yields of 0%, volatility factors of the expected market price of the Company's Ordinary shares of 114%, 74% and 68% in 1997, 1998 and 1999 respectively, and a weighted-average expected life of the options of six years.

The Black-Scholes option pricing model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions, including the expected stock price volatility. Because the Company's employee stock options have characteristics significantly different from those traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options. The weighted-average fair value of the options at their grant dates in 1997, 1998 and 1999 was \$ 8.1, \$ 6.2 and \$ 5.3, respectively.

Pro-forma information under SFAS-123 is as follows:

	Year ended December 31,		
	1997	1998	1999
Net income (loss) as reported	\$ 182	\$ (1,424)	\$ (39)
Pro-forma net loss	\$ (348)	\$ (2,712)	\$ (1,876)
Pro-forma basic and diluted net loss per share	\$ (0.04)	\$ (0.33)	\$ (0.22)

c. Stock warrants:

The Company has issued warrants, as follows:

	Outstanding as of December 31, 1998	Price per share	Exercised during 1999	Granted in 1999	Outstanding as of December 31, 1999
September 1996 (1)	90,0	\$3.00	(45,000)		45,0
October 1997 (2)	60,0	\$8.00 - \$19.20			60,0
November 1999 (3)	_____	\$14	_____	10,000	10,0
	<u>150,00</u>		<u>(45,000)</u>	<u>10,000</u>	<u>115,00</u>

- (1) Issued to the underwriters of the September 1995 private placement, investors and consultants, at prices above the offering price.
- (2) Issued to investors of the October 1996 private placement at a price equal to 120% of the offering price.
- (3) Issued to consultants 5,000 warrants per month in respect to consulting investing services to the Company to be performed on a continuing basis.

In February 2000, the agreement was terminated and the Company issued an additional 10,000 in the year 2000.

- d. In March 2000, the Company issued 850,000 Ordinary shares and 340,000 warrants in consideration of approximately \$ 13,000 in a private placement. The exercise price of the warrants ranges between \$ 21.25 and \$ 25.5 warrants.

NOTE 11:- INCOME TAXES

- a. Tax benefits under the Law for the Encouragement of Capital Investments, 1959 ("Law") are as follows:

The production facilities of ISG Ltd. (the parent company) and its subsidiary Meyad Systems (1988) Ltd., have been granted the status of an "Approved Enterprise" under the Law.

In December 1997, ISG Ltd. (the parent company) filed an application for a third investment program which was approved by the Investment Center of the Government of Israel in December 1998. The first two investment programs, which ended in June 1994 and December 1997, received final approval during 1998.

Meyad Systems (1988) Ltd. finalized its investment programs through December 1995, but has not yet received final approval for such programs.

According to the provisions of the Law, ISG Ltd. and its subsidiary have elected to enjoy "alternative benefits" - waiver of grants in return for tax exemption - and, accordingly, their income from the "Approved Enterprise" will be tax-exempt for a period of two - four years commencing with the year it first earns taxable income, and will be taxed at 10% to 25%, based upon the percentage of foreign investment in the Company, for an additional period of three-eight years. The period of tax benefits, detailed above, is subject to limits of the earlier of 12 years from the commencement of production, or 14 years from the date of approval.

If a dividend is distributed out of the tax-exempt profits, as detailed above, the Company and its subsidiary will be required to pay tax at the rate of 10%-25% in respect of the amount distributed.

The Company's decision is not to distribute dividends, other than upon the liquidation of the Company.

The subsidiary, Meyad has been granted the status of an "Approved Enterprise" whereby it has elected to receive government grants and to enjoy the benefit of a reduced tax rate of 25% during a period of seven years commencing with the year it first earns taxable income.

Should ISG or its subsidiary derive income from sources other than the approved enterprise during the periods of benefits, such income shall be taxable at regular corporate tax rate (36% in 1996 and thereafter).

b. Measurement of results for tax purposes:

The Company and its Israeli subsidiaries results for tax purposes are measured in terms of earnings in NIS after certain adjustments for increases in the Israeli Consumer Price Index ("CPI"). In accordance with paragraph 9(f) of SFAS No. 109, the Company has not provided for deferred income taxes on the difference between the reporting currency and the tax bases of assets and liabilities.

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

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

d. Tax assessments:

ISG is currently in dispute with the Israeli Tax Authorities regarding its tax assessments for the years 1992-1994. The main issue in dispute is the deduction of public offering expenses. The outcome could be a reduction in net operating loss carryforward of approximately \$ 2.4 million. At this point, the outcome of such dispute cannot be reasonably estimated and therefore no accrual has been provided.

All the Israeli subsidiaries received final tax assessments through 1993, and the non-Israeli subsidiaries received final tax assessments through 1994.

e. Tax loss carryforwards:

Net operating loss carryforwards as of December 31, 1999 are as follows:

Israel	\$ 16,300
United States *)	12,000
Far East	
Europe	_____
	<u>\$ 29,960</u>

Net operating losses in Israel may be carried forward indefinitely and in the U.S. they are available through 2019.

*) These losses may be subject to certain limitations when an "ownership change" occurs, as defined, under Section 382 of the Internal Revenue Code.

- f. The significant components of deferred tax assets and liabilities are as follows:

	<u>December 31,</u>	
	<u>1998</u>	<u>1999</u>
Net operating loss carryforwards	\$ 12,81	\$ 10,58
Other	13,4	11,4
Less - valuation allowance	<u>(13,02</u>	<u>(11,02</u>
	<u>\$</u>	<u>\$</u>

The Company has valuation allowances against the full amount of the tax benefits related to carryforwards in the accompanying consolidated financial statements due to uncertainty as to when these benefits will be utilized.

- g. A reconciliation of the theoretical tax expense, assuming all income is taxes at the statutory rate applicable to income of the Company and the actual tax expense, is as follows:

	<u>Year ended December 31,</u>		
	<u>1997</u>	<u>1998</u>	<u>1999</u>
Theoretical tax expense (income tax benefit) computed at the rate applicable to the Company (1)	\$ 6	\$ (51)	\$ (14)
Tax adjustments in respect of inflation in Israel and effect of different tax rates for foreign subsidiaries	(
Losses for which valuation allowance was provided			
Non-deductible expenses			
	<u>\$</u>	<u>\$</u>	<u>\$ 18</u>
(1) Statutory rate applicable to the Company			

- h. Income (loss) before income taxes is comprised as follows:

Domestic	\$ 1	\$ (745)	\$ (30)
Foreign	<u>(</u>	<u>(</u>	<u>(</u>
	<u>\$ 18</u>	<u>\$ (1,424)</u>	<u>\$ (20)</u>

NOTE 12:- SELECTED STATEMENTS OF OPERATIONS DATA

a. Geographic information:

The Company manages its business on the basis of one reportable segment and attributes revenues based on the customers' location, as follows:

	Year ended December 31,		
	1997	1998	1999
Israel	\$ 3,122	\$ 3,272	\$ 4,366
United States	4,970	6,126	8,434
Europe	1,451	3,409	5,920
Far East	1,674	1,631	1,288
Other	602	462	499
Total	\$ 11,819	\$ 14,900	\$ 20,507

The Company's long lived assets as of December 31, are as follows:

	December 31,		
	1997	1998	1999
Israel	\$ 8,275	\$ 11,627	\$ 12,918
United States	281	257	107
Other	109	248	258
	\$ 8,665	\$ 12,132	\$ 13,283

b. Research and development costs, net:

	Year ended December 31,		
	1997	1998	1999
Total costs	\$ 4,224	\$ 4,922	\$ 4,502
Less - royalty-bearing grants	(260)	(557)	(26)
Less - capitalized computer software development costs	(1,905)	(2,093)	(2,000)
	\$ 2,059	\$ 2,272	\$ 2,476

c. Financial income, net:

	Year ended December 31,		
	1997	1998	1999
Financial income:			
Gain on marketable securities	\$ -	\$ 19	\$ 111
Interest and other income	608	442	191
Foreign currency translation differences	460	406	2
	<u>1,068</u>	<u>867</u>	<u>304</u>
Financial expenses:			
Interest	244	175	92
Foreign currency translation differences and other	267	440	52
	<u>511</u>	<u>615</u>	<u>144</u>
	<u>\$ 557</u>	<u>\$ 252</u>	<u>\$ 160</u>

d. The following table sets forth the computation of basic and diluted earnings (loss) per share:

	Year ended December 31,		
	1997	1998	1999
Numerator:			
Net income (loss) to shareholders of Ordinary shares	<u>\$ 182</u>	<u>\$ (1,424)</u>	<u>\$ (396)</u>
Numerator for diluted earnings per share - income (loss) available to shareholders of Ordinary shares	<u>\$ 182</u>	<u>\$ (1,424)</u>	<u>\$ (396)</u>
Denominator:			
Denominator for basic earnings (loss) per share - weighted average shares	8,088	8,157	8,365
Effect of dilutive securities:			
Employee stock options and warrants*)	<u>467</u>	<u>-</u>	<u>-</u>
Denominator for diluted earnings (loss) per share - adjusted weighted average shares and assumed conversions	<u>8,555</u>	<u>8,157</u>	<u>8,365</u>

*) The effect of the inclusion of the dilutive securities in 1998 and 1996 is antidilutive.