BACKWEB TECHNOLOGIES LTD
Form 10-K
March 31, 2006

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

Form 10-K

þ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the Fiscal Year Ended December 31, 2005

or

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from to

Commission file number 0-26241

BackWeb Technologies Ltd.
(Exact name of registrant as specified in its charter)

Israel	**51-2198508**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification Number)*
10 Ha amal Street, Park Afek, Rosh Ha ayin, Israel	**48092**
(Address of principal executive offices)	*(Zip Code)*

(972) 3-6118800
(Registrant s Telephone Number, Including Area Code)

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	**Name of Each Exchange on Which Registered**
None	None

Securities registered pursuant to Section 12(g) of the Act:

Ordinary Shares, NIS 0.03 par value
(Title of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act: Yes o No þ

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934: Yes o No þ

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

Indicate by check mark if the disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer o Accelerated filer o Non-accelerated filer þ

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No þ

As of June 30, 2005, based on the closing sales price of the registrant s Ordinary Shares as quoted by the Nasdaq Capital Market, 26.3 million Ordinary Shares, having an aggregate market value of approximately $12.1 million, were held by non-affiliates. For purposes of the above statement only, all directors and executive officers of the registrant and 5% holders of Ordinary Shares are deemed to be affiliates.

As of March 4, 2006, the registrant had 41,225,846 Ordinary Shares outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

None.

BACKWEB TECHNOLOGIES LTD.

ANNUAL REPORT ON FORM 10-K
Year Ended December 31, 2005

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BackWeb Technologies Ltd. was incorporated in the State of Israel in 1995. Our principal executive offices are located at 10 Ha amal Street, Park Afek, Rosh Ha ayin, Israel, 48092. In the United States, our principal executive offices are located at 2077 Gateway Place, Suite 500, San Jose, California 95110. Our website may be accessed at

www.backweb.com; however, the information in, or that can be accessed through, our website is not part of this Annual Report on Form 10-K.

BackWeb, the BackWeb logo, ProactivePortal, Polite, Polite Agent, Polite Neighborcast, Polite Proxy, and Polite Upstream are our registered trademarks and Offline Access Server, e-Accelerator, Polite Sync Server, and Foundation are trademarks of ours that appear in this Annual Report. All other trademarks or trade names appearing elsewhere in this Annual Report are the property of their respective owners.

The terms BackWeb, Company, we, us, and our as used in this Annual Report refer to BackWeb Technologies I and its subsidiaries as a combined entity, except where it is made clear that such term means only the parent company.

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Cautionary Statement Regarding Forward-Looking Statements

This Annual Report on Form 10-K contains express or implied forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Forward-looking statements are those that predict or describe future events or trends and that do not relate solely to historical matters. The words believes, expects, anticipates, intends, forecasts, projects, plans, estimates, anticipates, o expressions may identify forward-looking statements. Readers are cautioned not to place undue reliance on our forward-looking statements, as they involve many risks and uncertainties. Our actual results may differ materially from such statements. Factors that may cause or contribute to such differences include those discussed in this Annual Report under the caption Risk Factors and elsewhere in this Annual Report. Although we believe that the assumptions underlying our forward-looking statements are reasonable, any of the assumptions could prove inaccurate, and, therefore, we cannot assure you that the results contemplated in such forward-looking statements will be realized. The inclusion of such forward-looking information should not be regarded as a representation by us, or any other person, that the future events, plans or expectations contemplated by us will be achieved. Forward-looking statements reflect our current views with respect to future events and financial performance or operations and speak only as of the date of this report. We undertake no obligation to issue any updates or revisions to any forward-looking statements to reflect any change in our expectations with regard thereto or any change in events, conditions, or circumstances on which any such statements are based.

PART I

Item 1. *Business*

Overview

BackWeb competes in the mobility and mobile applications market and offers a solution allowing users of enterprise Web applications to synchronize those Web applications to their PCs for use while disconnected from the network. Our enabling software is designed to integrate with web applications in a loosely-coupled way that requires no changes in a company s enterprise web architecture and applications. This approach has the potential to bring mobile functionality to enterprise web applications quickly and with low total cost of ownership. Our products address the need of mobile users who spend important parts of their work time in situations in which fixed or wireless network connectivity is not practical. This includes mobile workers engaged in field sales, services, consulting and operational roles. Many of these people must frequently disconnect from and reconnect to the network but require consistent access to their important web-based business applications. Examples of such critical business applications include sales tools, customer relationship management, or CRM, systems, service management systems, service document repositories, training and e-learning applications, human resources, or HR, applications, service repair guides, expense report updates, pricing data, time sheets, work orders, and other essential documents and information. Our products are designed to capitalize on the potential business and return on investment benefits of mobile applications, including improved productivity of mobile workforces, faster completion of company workflows and increased levels of sales and customer satisfaction. They are also designed to reduce the cost of distributing information to field personnel and to minimize the impact and costs on enterprise networks to support mobile users.

The BackWeb Offline Access Server (OAS) integrates with Web applications in any web-based architecture, including portal frameworks, intranets, and websites, so the applications may be used by users who are frequently disconnected from the network. Its two-way synchronization capability enables people to access content from, publish to and conduct transactions on web applications while disconnected, enabling the productive combination of fully-featured enterprise applications and mobile use cases. This can be less expensive and easier to implement than the alternative of writing special client-server applications for use by mobile personnel.

Using HTML-type tags (called Offline Tagging Markup Language, or OTML), our customers can offline-enable their websites and portals without rewriting code, creating an offline end-user experience that is essentially the same as the online user experience. The BackWeb Polite Sync Server, formerly known as BackWeb Foundation, uses network-sensitive background content delivery that can deliver large amounts of data without impacting the performance of other network applications. This allows organizations to efficiently target and deliver sizeable

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digital data to users desktops throughout the extended enterprise. The Polite Sync Server utilizes our patented polite synchronization technology that is designed to distribute large amounts of data over very good or very low quality network connections.

BackWeb Technology and Products

We develop, market, and support mobile and offline web synchronization software that enables companies to extend the reach of their Web applications and content to their mobile community of customers, partners and employees. Our software enables mobile users to access and transact with a company s critical Web content and applications by enabling offline users to work with synchronized, thin-client versions of those enterprise Web applications on their desktop. Mobile users can then use their enterprise Web applications wherever they go and perform transactions when disconnected from the network.

Our products and technology are designed to provide the benefits of:

Improved mobile user productivity by making it possible for mobile and field employees to use their applications when and where they are needed, and allowing them to make use of disconnected time that would otherwise be unproductive due to the lack of access to their applications;

Acceleration of business processes by allowing offline data entry submission for items such as service orders, expense reports, sales forecasts, time sheets and collaboration sessions, enabling users to productively use forced down time while traveling;

Increased customer satisfaction by providing our customers field workforce access to important business information when servicing a customer in the field, enabling them to respond to their customers more quickly and effectively;

Decreased costs through the reduction of the costs incurred in manually distributing information, and the costs associated with unnecessary repeat service calls resulting from the inability of users to access service data;

Elimination of costly development projects because BackWeb can enable existing web applications for mobile use and eliminate the need for projects to develop special mobilized versions of those applications;

Improved Web and portal effectiveness through tracking and reporting offline interactions, to analyze what content, information, and applications mobile users need most often; and

Leveraging current information technology, or IT, investments and lower total cost of ownership by deploying in a matter of weeks, and integrating with a customer s existing portal environment to maintain the existing Web user interface and eliminate the need to rewrite code.

Technology

Our infrastructure software platform is powered by two proprietary core technologies: Polite Synchronization and OTML Offline Web Integration.

Polite Synchronization

Polite Synchronization enables the transmission of significant volumes of digital data from BackWeb Polite Sync Servers to BackWeb plug-ins on personal computers through existing networks without interfering with normal

network applications and traffic. Polite Synchronization enables companies to provide users with rapid communication of bandwidth-intensive data, regardless of whether they utilize high-speed or low-speed data access services. Polite Synchronization is designed to improve the efficiency of transmission by reducing the amount of data to be transmitted through various techniques, including the compression of data, updating only the information which has changed since the user s previous download and by eliminating the need to re-send an interrupted

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transmission by progressively resuming the transmission at the point where it was interrupted. This bandwidth-sensitive delivery is accomplished through the use of various components, including the following:

Polite Agent monitors the network activity of the plug-in and communicates with BackWeb Polite Sync Servers only when the connection is idle. It is able to interrupt BackWeb communications when other applications request use of the user s network connection.

Polite Proxy allows communication between the BackWeb proxy server and BackWeb Polite Sync Servers only when wide area network, or WAN, bandwidth utilization is below a specified threshold. It achieves this by monitoring the WAN.

Polite Neighborcast enables the automatic transmission of digital data from one BackWeb plug-in to others on the same local area network, or LAN, eliminating the need for transmission of the data from the server to each BackWeb plug-in. The transmission from BackWeb plug-in to BackWeb plug-in on the same LAN enables fast, efficient and cost-effective transmission of data.

Polite Upstream enables the automatic transmission of digital data from BackWeb plug-ins to the BackWeb Polite Sync Server when the network connection is idle.

OTML Offline Web Integration

BackWeb has developed a set of HTML tags, referred to as OTML, that extends HTML to support offline browsing. OTML tags are instructions which tell the BackWeb Content Acquisition Server which parts of the enterprise web application to crawl and package for synchronization to users PCs. These OTML tags can be applied by script files on the BackWeb server or embedded within online HTML pages. They control the transformation of the online HTML pages into pages that a browser, enhanced with the BackWeb plug-in, can display offline. OTML is designed to preserve the personalization of the website or portal, including layout and data preferences. OTML tags also control the transformation of HTML data entry forms, allowing end users to perform transactions while offline. Offline transactions are queued while the user is offline and sent to the server when the user connects to the network. The server applies the transaction to the online Web environment and reports back to the plug-in the results of the submission. A Content Acquisition Server, or CAS, is a high performance OTML processor that retrieves content from the target portal or website and processes content for offline use. The CAS transforms online HTML pages into their offline equivalent based on OTML tags and can process OTML tags that are applied to the HTML in run time (known as scripted OTML) or can process OTML tags that already exist in the HTML (known as embedded OTML). The CAS can be clustered to increase scalability and is responsible for content acquisition scheduling through automated or on-demand synchronization.

Products

BackWeb Offline Access Server

In September 2001, we introduced the BackWeb Offline Access Server (OAS), then known as the BackWeb ProactivePortal Server, which enables mobile users to access Web applications and content, including portal environments, when a user is disconnected or poorly connected to a network. The BackWeb OAS is comprised of two major components: the Web Integration Server and the BackWeb Polite Sync Server.

The Web Integration Server, which is also known as Content Acquisition Server, is a component of the OAS that is designed for highly scalable Web content acquisition from corporate portal, intranet, and Web applications. On an ongoing basis, the OAS logs into the portal, intranet or Web application as if it were an

individual user and retrieves HTML pages using standard HTTP or HTTPS protocols (either secure or non-secure). Each page links to additional Web pages or documents that are retrieved once the links are identified. Content transformation and OTML tags parse the HTML pages and create an offline equivalent of the page that is sent to users. The Content Acquisition Server retrieves additional pages when it identifies links to additional portal pages, external documents or Web pages. Since the presentation of content sometimes changes, it is necessary to keep the content transformation correct regardless of visual presentation changes. Content transformation is accomplished by embedding OTML tags into the portal, intranet, or Web application page, which tags control the optimized transformation of the pages for offline viewing.

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OTML is an extension to HTML and applications other than OAS software, such as the browser, will ignore the HTML tags. Although portals, for example, include both personalized and non-personalized content, our OAS acquires content in the context of individual users and creates a single personalized information package for each user. Because a large portion of the content is shared among many users and because that content may be very large, it is necessary to consolidate shared information so that it can be retrieved and stored once for all targeted users. The OAS stores content, including documents and Web pages, in separate information packages that are sent to more than one user. Once content has been acquired, transformed and consolidated, it is packaged for offline delivery into units called InfoPaks. Such packaging includes the creation of database records for targeting, delivery tracking, user interaction reporting and version control of the content, calculating byte-level differences between versions of the content, which is critical when only a small portion of a document is modified, and optimized storage and communication with users plug-ins.

The BackWeb Polite Sync Server, which is also available as a separate product as described below, is a highly scalable content delivery engine for desktops and laptops that enables offline access to Web content via BackWeb plug-ins. The BackWeb Polite Sync Server is designed to manage the delivery of thousands of gigabytes of data every day to end users. The server consults the BackWeb OAS database to find out whether there is new content relevant to the corresponding user. The BackWeb plug-in then begins downloading InfoPaks incrementally via the Polite Sync Server to enable scalable content delivery. The Polite Sync Server includes several key features:

Interruptible content delivery activates only when the network connection is idle;

Byte-level differentiation determines which content has been modified based on the content already stored on the user s computer and ensures the delivery of only the changes rather than the entire content item; and

Polite Neighborcast distributes content over a LAN using the distributed client-based caching system, thereby reducing the amount of WAN traffic.

BackWeb Polite Sync Server

Our infrastructure software platform, the BackWeb Polite Sync Server, formerly known as BackWeb Foundation, is based on a set of flexible components that enable an organization to capture information from most data sources, including websites, file servers, databases, applications and legacy systems, and efficiently and reliably deliver the information throughout its extended enterprise. The Polite Sync Server automatically distributes that data to BackWeb plug-ins. The BackWeb Polite Sync Server is highly scalable and designed to support a large number of plug-ins concurrently. BackWeb Development Tools are used to customize the BackWeb Polite Sync Server solution. Components of BackWeb Development Tools include: the BackWeb Server Extension API, which is an application programming interface that allows companies to integrate the BackWeb Polite Sync Server with any digital data source, enabling automated publishing of content or files from any source to the BackWeb Polite Sync Server; the BackWeb Automation SDK and Automation Editor, which includes application programming interfaces and a library of BackWeb supplied programs that perform tasks between the BackWeb Polite Sync Server and external data source; our BackWeb Authoring Language Interface, or BALI, Editor that is used by companies to create and modify Flash Alerts; and our BackWeb plug-in, our software program operating on personal computers or workstations, which operates in the background and communicates with designated BackWeb Polite Sync Servers during the idle time of a user s network connection, enabling the user to receive data transparently and without disruption while using other applications.

Customers

We sell our products to customers from a variety of industries. Our customers include industry leaders, such as BAE Systems, Boehringer Ingelheim, Bristol Myers Squibb, British Telecommunications PLC, Centocor, Inc., Eastman Kodak Company, General Electric Medical Systems, Guidant Corporation, Hewlett-Packard Company, International Business Machines Corporation, or IBM, Johnson & Johnson, KLA Tencor Corporation, Lam Research Corp., Logitech International S.A., Nalco Chemical Company, Ortho Biotech, Inc., Pfizer Inc., and Siemens AG, as well as the United States Social Security Administration.

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For a discussion of customer transactions by geography, please refer to Note 13 of the Notes to Consolidated Financial Statements appearing elsewhere in this Annual Report.

Sales and Marketing

Sales

We currently market our software and services primarily through a direct sales organization complemented by indirect sales channels and channel partners. Our direct sales force is located in the United States and Europe. Our sales force consists of direct sales representatives and field application engineers. During 2005, most of our revenue was attributable to the efforts of this direct sales force and, although we expect to generate increased sales from indirect channels in the future, we expect direct sales to continue to account for the majority of our revenue for the foreseeable future.

In an effort to accelerate the acceptance of our products, we have developed cooperative alliances and entered into reseller and remarketing agreements with leading enterprise software vendors, original equipment manufacturers, or OEMs, and system integrators, including Oracle Corporation and SAP AG. We believe these alliances have the potential to provide additional marketing and sales channels for our products, help enable us to raise awareness of BackWeb among enterprise customers and facilitate broad market acceptance for our products. These partnerships accounted for a material part of our 2005 license revenue and the partner-assisted percentage of our sales could grow as these partnerships continue to be productive. We typically have very little backlog and, accordingly, generate substantially all of our revenue for a given quarter in that quarter.

Marketing

In 2005, our marketing efforts were focused on web-based business applications that are typically used by audiences whose work day necessarily includes frequent disconnecting from the network. Our most productive sales efforts are those centered on business users and key business applications where BackWeb s software is viewed as an extension of the application. We are less productive in sales efforts centered on IT infrastructure. We work to identify customer and application market segments that will have a recurring need for our capabilities. We work closely with our partners to leverage their sales and marketing efforts and installed base. We also educate industry analysts, application software vendors and system integrators, and enterprise customers about our technology and its competitive advantages.

Our marketing strategy is designed to identify in enterprises the web applications used by mobile employees for important business processes and to position BackWeb as the fastest and most cost-effective way to mobilize the web application. We believe the trend to web-enable enterprise applications, now more than seven years old, is beginning to result in an increasing number of mature, valuable web applications. Furthermore, we believe enterprises are focused on top-line revenue growth and are investing in cost-effective ways to make their revenue producing employees more productive. Our marketing efforts are directed at creating market awareness and generating leads for our OAS technology. Marketing activities include: inside sales, Web seminars, online advertising and opportunity generation prospecting activities. In addition, our public relations programs are designed to build market awareness by establishing and maintaining relationships with key trade press, business press, and industry analysts.

Customer Service and Support

We have a comprehensive service and support organization designed to ensure that customers receive high quality service. Our services are primarily comprised of maintenance, consulting, and training. Our technical support group provides post-sales support through renewable annual maintenance contracts. Our support contracts provide for technical and emergency support as well as software upgrades, on an if and when available basis. When our technical

support organization is unable to solve a problem, our engineers and product developers work with the support personnel to resolve the problem. We believe that a strong customer support organization is crucial to both the initial marketing of our products and maintaining customer satisfaction, which in turn can enhance our reputation and generate repeat orders. In addition, we believe that the customer interaction and feedback involved in

our ongoing support functions provide us with information on market trends and customer requirements that is critical to future product development efforts.

Our professional services organization provides consulting, training, and on-site implementation services, offering our customers the expertise, knowledge, and practices to help implement successfully an enterprise-wide IT strategy. We expect to expand our range of services, both directly and through third-party relationships, in order to meet the growing needs of our customers.

Research and Development

Since our inception in 1995, we have made substantial investments in research and product development. We believe that strong product development capabilities are essential to enhancing our core technology, developing additional applications, and maintaining the competitiveness of our product and service offerings. We have invested significant time and resources in creating a structured process for undertaking all product development projects.

Our research and development group is located in Rosh Ha ayin, Israel. We believe that performing research and development in Israel offers a number of strategic advantages because Israel offers a pool of highly qualified technology engineers, as well as a lower cost structure than the U.S. Operating in Israel has also allowed us to enjoy tax incentives from the government of Israel. Our Israeli engineers typically hold advanced degrees in computer-related disciplines. We have complemented these individuals by hiring senior management with backgrounds in the commercial software development industries. Our research and development expenses were $2.2 million, $3.3 million, and $4.5 million for the years ended December 31, 2005, 2004, and 2003, respectively. To date, all research and development costs have been expensed as incurred.

Competition

We compete in markets that are new, intensely competitive, highly fragmented and rapidly changing. We have experienced, and expect to continue to experience, intense competition from current and potential competitors. Many of our competitors have greater name recognition, longer operating histories, larger customer bases and significantly greater financial, technical, marketing, public relations, sales, distribution and other resources. In addition, some of our potential competitors are among the largest and most well capitalized software companies in the world. We expect to face competition from these and other competitors, including:

- small companies attempting to address the needs of mobile or disconnected Web users such as iOra;
- large enterprise software companies attempting to address the needs of mobile or disconnected Web users that have announced or may have plans to develop mobile technology, such as IBM, Microsoft, and SAP;
- mobile middleware vendors such as Everypath and Sybase iAnywhere; and
- wireless data networking solutions such as wireless fidelity, or WiFi, and cellular data services such as Sprint EVDO.

Additional competition could come from operating system vendors, online service providers, plug-in or server applications and tools vendors, multimedia companies, document management companies and network management vendors. If any of our competitors were to become the industry standard or were to enter into or expand relationships with significantly larger companies through mergers, acquisitions or otherwise, our business and operating results could be seriously harmed. In addition, potential competitors may bundle their products or incorporate functionality into existing products in a manner that discourages users from purchasing our products.

Many of our existing and potential customers evaluate on an ongoing basis whether to develop their own software or purchase it from outside suppliers. In addition, our partners have significant research and development capabilities and are continually evaluating the efficacy of internal software development. As a result, we must, on an ongoing basis, educate existing and potential customers on the advantages of our software over our competitors products and capabilities enterprises could develop internally. However, we cannot assure you that our potential customers or partners will not internally develop products similar to our own.

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Our existing and potential customers often have a predetermined budget for which we compete. We currently compete primarily on the basis of the following factors: functionality; product features and effectiveness; ease of installation and use; and total cost of ownership. We believe that we currently compete favorably with respect to each of these factors. However, the market for our products is still rapidly evolving, and we may not be able to compete successfully against present or future competitors, which could harm our operating results.

Emerging wireless technologies, such as WiFi and cellular data networks, may pose a competitive challenge as an alternative to BackWeb s capabilities or they may be a source of growth to BackWeb as they raise awareness of the benefits of mobility and potentially highlight increased needs for solutions like BackWeb. While we believe that many customer mobile business needs will not be met by wireless networking for the foreseeable future, the reality and promise of wireless connectivity will make it necessary for BackWeb to target and educate its prospects intelligently.

We expect that competition will increase in the near term and increased competition could result in price reductions, fewer customer orders, reduced gross margin and loss of market share, any of which could cause our business to suffer.

Intellectual Property and Proprietary Rights

Our success and ability to compete are dependent on our ability to develop, maintain and protect the proprietary aspects of our technology. We rely on a combination of patent, trademark, trade secret and copyright laws and contractual restrictions to protect the proprietary aspects of our technology.

We have been issued several U.S. patents with respect to certain aspects of our products. In addition, we have filed other U.S. and foreign patent applications on various elements of our products. Our policy is to apply for patents or for other appropriate statutory protection when we develop valuable new or improved technology. The status of any patent involves complex legal and factual questions, and the breadth of claims that may be allowed is uncertain. Accordingly, we cannot assure you that any patent application filed by us will result in a patent being issued, or that our patents, and any patents that may be issued in the future, will afford adequate protection against competitors with similar technology, nor can we assure you that patents issued to us will not be infringed or designed around by others.

We have been issued registered trademarks in the U.S. covering certain goods or services for BackWeb, the BackWeb logo design, Polite, Polite Agent, Polite Neighborcast, Polite Proxy, Polite Upstream, and ProactivePortal. In the trademark BackWeb is registered in Australia, the European Community, and Japan.

We seek to protect our source code for our software, documentation and other written materials under trade secret and copyright law. We license our software to our customers under signed license agreements and under electronic (shrink-wrap) agreements that restrict the customer s use of our software to its own business operations and prohibit disclosure to third parties. The enforceability of shrink-wrap licenses is unproven in certain jurisdictions. Finally, we seek to avoid disclosure of our intellectual property by requiring employees and consultants with access to our proprietary information to execute confidentiality and assignment of invention agreements with us and by restricting access to our source code. However, we have not signed confidentiality agreements in every case.

Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy or otherwise obtain and use our products or technology. Policing unauthorized use of our products is difficult, and the steps we have taken might not prevent misappropriation of our technology, particularly in foreign countries where the laws may not protect our proprietary rights as fully as do the laws of the U.S.

Thus, while we rely on patent, copyright, trade secret and trademark law to protect our technology, we believe that factors such as the technological and creative skills of our personnel, new product developments, frequent product

enhancements and reliable product maintenance are more essential to establishing and maintaining a technology leadership position. Others may develop technologies that are similar or superior to our technology.

Our products and services operate in part by making copies of material available on the Internet and other networks and making this material available to end-users from a central location. This creates the potential for claims to be made against us, either directly or through contractual indemnification provisions with customers, including defamation, negligence, copyright or trademark infringement, personal injury, invasion of privacy or other legal theories based on the nature, content or copying of such materials. In the past, these claims have been brought, and sometimes successfully pressed against, companies such as online service providers. It is also possible that if any such information, or information that is copied and stored by customers that have deployed our products, contains errors, third parties could make claims against us for losses incurred in reliance on such information. Although we carry general liability and directors and officers insurance, our insurance may not cover potential claims of this type or may not be adequate to indemnify us for all liability that may be imposed.

Substantial litigation regarding intellectual property rights exists in the software industry. We expect that software products may be increasingly subject to third-party infringement claims as the number of competitors in our industry segments grows and the functionality of products in different industry segments overlaps. We believe that many of our competitors have filed or intend to file patent applications covering aspects of their technology that they may claim our technology infringes. Third parties may claim infringement by us with respect to our products and technology. Any such claims, with or without merit, could:

- be time-consuming to defend;
- result in costly litigation;
- divert management s attention and resources;
- cause product shipment delays; or
- require us to enter into royalty or licensing agreements.

Royalty or licensing agreements, if required, may not be available on acceptable terms, if at all. A successful claim of product infringement against us and our failure or inability to license the infringed or similar technology could harm our business.

Employees

As of December 31, 2005, we had a total of 46 employees, of whom 17 were engaged in research and development, 10 in sales, marketing and business development, 13 in professional services and technical support, and 6 in finance, administration, and operations. Our future performance depends in part upon the continued service of our key technical, sales and senior management personnel, none of whom is bound by an employment agreement requiring service for any defined period of time. The loss of the services of one or more of our key employees could have a material adverse effect on our business, financial condition and results of operations. Our future success also depends on our continuing ability to attract, train and retain highly qualified technical, sales and managerial personnel. Competition for such personnel is intense, and we may not be able to retain our key personnel in the future. None of our employees are represented by a labor union. We have not experienced any work stoppages and consider our overall relations with our employees to be good.

We have 22 of our 46 employees located in Israel. Israeli law and certain provisions of the nationwide collective bargaining agreements between the Histadrut, which is the General Federation of Labor in Israel, and the Coordinating Bureau of Economic Organization, which is the Israeli federation of employers organizations, apply to our Israeli employees. These provisions principally concern the maximum length of the work day and the work week,

minimum wages, contributions to a pension fund, insurance for work-related accidents, procedures for dismissing employees, determination of severance pay and other conditions of employment. Furthermore, pursuant to such provisions, the wages of most of our employees are subject to cost of living adjustments, based on changes in the Israeli Consumer Price Index. The amounts and frequency of such adjustments are modified from time to time. Israeli law generally requires the payment of severance pay upon the retirement or death of an employee or upon termination of employment by the employer or, in certain circumstances, by the employee. We currently fund our ongoing severance obligations for our Israeli employees by making monthly payments for insurance policies to cover these obligations.

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Item 1A. *Risk Factors*

You should consider the following factors, as well as other information set forth in this Annual Report, in connection with any investment in our Ordinary Shares. If any of the risks described below occurs, our business, results of operations and financial condition could be adversely affected. In such cases, the price of our Ordinary Shares could decline, and you could lose part or all of your investment.

Risks Relating to Our Business

We have a history of losses and we expect future losses.

Since our inception, we have not achieved profitability and we expect to continue to incur net losses for the foreseeable future. We incurred a net loss of approximately $1.0 million in the year ended December 31, 2005. As of December 31, 2005, we had an accumulated deficit of $144.7 million. We expect to continue to incur significant sales and marketing, research and development, and general and administrative expenses through the remainder of 2006 and into 2007. As a result, we will need to generate significant revenue to achieve and maintain profitability, and we may not be able to do so. Failure to achieve profitability or achieve and sustain the level of profitability expected by investors and securities analysts may adversely affect the market price of our common stock.

Our business strategy requires that we derive a significant amount of license revenue from our OAS product. If demand for OAS does not increase, our total revenue will not increase and our business will suffer.

Our business strategy requires that we derive a significant amount of license revenue from licensing our OAS product and derive additional related revenue through providing related consulting and maintenance services. Accordingly, our future operating results will depend on the demand for OAS by future customers. While our OAS revenue accounted for the majority of our license revenue for the first time in 2005, we need to realize additional growth in 2006 or our operating results will be negatively impacted. If our competitors release products that are superior to OAS in performance or price, OAS is not widely accepted by the market, or we fail to enhance OAS and introduce new versions in a timely manner, we may never generate significant license revenue from this product. If demand for our OAS product does not significantly increase, as a result of competition, technological change or other factors, it would significantly and adversely affect our business, financial condition, and operating results.

Wireless networking technology and geographic coverage could limit our market.

Emerging wireless technologies, such as wireless fidelity, or WiFi, and cellular data networks, may pose a competitive challenge as an alternative to BackWeb s capabilities or they may be a source of growth to BackWeb as they raise awareness of the benefits of mobility and potentially highlight increased needs for solutions like BackWeb. While we believe that many of our potential mobile business customers needs will not be met by wireless networking for the foreseeable future, the reality and promise of wireless connectivity will make it necessary for BackWeb to target and educate its prospects intelligently. If we fail to successfully target those market segments which are not served by wireless networking, then our operating results could suffer.

Rapid technological changes could cause our products to become obsolete.

The Internet communications market is characterized by rapid technological change, frequent new product introductions, changes in customer requirements and evolving industry standards. If we are unable to develop and introduce products or enhancements in a timely manner to meet these technological changes, we may not be able to

successfully compete. In addition, our products may become obsolete, in which event we may not remain a viable business.

Our market is susceptible to rapid changes due to technology innovation, evolving industry standards, and frequent new service and product introductions. New services and products based on new technologies or new industry standards expose us to risks of technical or product obsolescence. For example, emerging technologies, such as WiFi, that take a different approach to the challenge of offline Web access by, for example, re-engineering platforms and applications, pose a competitive challenge. In addition, other companies, including some of our partners, also approach the issue of offline Web architecture differently than we do in some cases, and such

approaches may achieve a greater degree of market acceptance. If we do not use leading technologies effectively, meet the challenges posed by emerging technologies or other architectures, continue to develop our technical expertise and enhance our existing products on a timely basis, we may be unable to compete successfully in this industry, which would adversely affect our business and results of operations.

If we require additional financing for our future capital needs but are not able to obtain it, we may be unable to develop or enhance our products, expand operations or respond to competitive pressures.

Our cash, cash equivalents and short-term investments balances have declined from $10.3 million as of December 31, 2004 to $7.8 million as of December 31, 2005, and we expect to continue to use cash in our operations for the foreseeable future. As a result, we might need to raise additional capital to fund expansion, product development, acquisitions or working capital. This need may arise sooner than we anticipate if our revenue does not grow in line with our expectations, particularly revenue from licensing our OAS product, if our costs are higher than we expect or if we change our strategic plans. If we were required to raise additional funds, it could be difficult to obtain additional financing on favorable terms, or at all, due to our financial condition. In the event that we obtain additional financing by issuing Ordinary Shares or securities that are convertible into Ordinary Shares, the interests of existing shareholders would be diluted. If we cannot raise needed funds on acceptable terms, or at all, we may not be able to develop or enhance our products, respond to competitive pressures or grow our business or we may be required to further reduce our expenditures, any of which could harm our business.

We have restructured our company, which could make it more difficult for us to achieve our business objectives or could result in further restructurings if we don t meet the goals of the restructuring.

In October 2004, we restructured in order to reduce management and administrative costs and bring our sales and marketing operations in line with our current sales level. While the restructuring has reduced cash operating expenses, our ability to adequately reduce cash used in operations, and ultimately generate profitable results from operations, depends upon successful execution of our business plan and obtaining new customers. As a result of the reduction in personnel, however, we may not have sufficient resources to execute our refocused sales strategy, particularly with respect to our OAS product, which could adversely affect our revenues and operating results. If we do not meet our restructuring objectives, we may have to implement additional restructuring plans, which could impact our long-term viability. Further, these plans may not achieve our desired goals due to such factors as significant costs or restrictions that may be imposed in some international locales on workforce reductions and a potential adverse affect on employee morale that could harm our efficiency and our ability to act quickly and effectively in the rapidly changing technology markets in which we sell our products.

Our quarterly license revenue typically depends on a small number of large orders, and any failure to complete one or more substantial license sales in a quarter could materially and adversely affect our operating results.

We typically derive a significant portion of our license revenue in each quarter from a small number of relatively large orders. For example, for the year ended December 31, 2005, we derived approximately 35% of our license revenue from licenses sold to two existing customers. Our operating results for a particular fiscal quarter could be materially and adversely affected if we are unable to complete one or more substantial license sales forecasted for that quarter. Additionally, we also offer volume-based pricing, which may adversely affect our operating margins. We typically have very little backlog and, accordingly, generate substantially all of our revenue for a given quarter in that quarter.

The economic outlook has adversely affected, and may continue to adversely affect, the demand for our current products and our results of operations.

General economic indicators suggest continued uncertain economic conditions for the near future. Weak or uncertain economic conditions may continue to cause a reduction in or irregular information technology spending generally. In addition, some of our customers continue to operate Internet-centric businesses, and these companies have been more acutely affected by uncertain economic conditions and have encountered significant difficulties in raising additional capital. If our customers experience financial difficulties, it could have an adverse impact on the

demand for our products, which would adversely affect our results of operations. In addition, predictions regarding economic conditions have a low degree of certainty, and further predicting the effects of the changing economy is even more difficult. We may not accurately gauge the effect of the general economy on our business. As a result, we may not react to changing conditions in a timely manner, which could adversely impact our business and results of operations and cause the price of our Ordinary Shares to decline.

Our business is difficult to evaluate because our operating history is limited, and we have changed our strategic focus and repositioned our product line.

We have a limited operating history generally and an even more limited history operating our business in our current markets. We cannot be certain that our business strategy will be successful. We were incorporated on August 31, 1995, and did not begin generating revenue until December 1996. In early 1998, we changed our strategic focus from a consumer-oriented to an enterprise-oriented Internet communications company. In 2001, we again re-positioned our products to focus on the portal market. During 2003, we expanded our market focus to include corporate intranets and other Web-based applications. During 2004, we realigned our sales strategy to focus on selling to the line of business owner as opposed to the IT department. These changes required us to adjust our business processes and make a number of significant personnel changes. To date, we have only generated limited revenue from our new strategic focus, and we do not know if we will ever generate significant revenue from our new products. To the extent we do not succeed in generating significant revenue from licensing our new products, particularly our OAS product, our business, operating results and financial conditions will suffer.

We are increasingly relying on sales and marketing partnerships, rather than direct sales and marketing, for revenue generation and failure to establish successful partnerships could negatively affect our revenues.

Although the majority of our revenue is generated by our direct sales force, we believe our greatest opportunity for growth is with our sales and marketing partners. 2005 was the first recent year in which we realized significant contributions from these partnerships and we must continue to successfully manage our existing partnerships and enter into new partnerships in order to realize our expectations for the growth of our business. Failure to do so could negatively impact our operating results.

Our long and unpredictable sales cycle depends on factors outside our control and may cause our license revenue to vary significantly.

To date, our average engagement with our customers have typically taken between 3 and 12 months for them to evaluate our products before making their purchasing decisions. The long, and often unpredictable, sales and implementation cycles for our products have caused, and may continue to cause, our license revenue and operating results to vary significantly from period to period. Sales of licenses and implementation schedules are subject to a number of risks over which we have little or no control, including customer budgetary constraints, customer internal acceptance reviews, the success and continued internal support of customers own development efforts, the sales and implementation efforts of businesses with which we have relationships, the nature, size and specific needs of a customer and the possibility of cancellation of projects by customers. Along with our distributors, we spend significant time educating and providing information to our prospective customers regarding the use and benefits of our products with no guarantee that such investment will result in a sale. In addition, our customers often begin by purchasing our products on a pilot basis before they decide whether or not to purchase additional licenses for full deployment. For example, even after purchase, our customers tend to deploy our OAS solution slowly, depending upon the skill set of the customer, the size of the deployment, the stage of the customer s deployment of a portal, the complexity of the customer s network environment and the quantity of hardware and the degree of hardware configuration necessary to deploy the products.

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Our quarterly operating results are subject to fluctuations.

Our operating results are difficult to predict. Our revenue and operating results have fluctuated in the past and may, in the future, vary significantly from quarter to quarter due to a number of factors, including:

- demand for our products and services;
- internal budget constraints and the approval processes of our current and prospective customers;
- the timing and mix of revenue generated by product licenses and professional services;
- the length and unpredictability of our sales cycle;
- loss of customers;
- new product introductions or internal development efforts by competitors or partners;
- costs related to acquisitions of technology or businesses; and
- economic conditions generally, as well as those specific to the Internet and related industries.

Due to the foregoing factors, we believe that quarter-to-quarter comparisons of our operating results are not necessarily a good indication of our future performance. We incur expenses based predominantly on operating plans and estimates of future revenue. Our expenses are to a large extent fixed and we may not be able to adjust them quickly to meet a shortfall in revenue during any particular quarter. Any significant shortfall in revenue in relation to our expenses would decrease our net income or increase our operating losses and would also harm our financial condition. In some recent quarters our operating results have been below the expectations of public market analysts and investors. It is likely that in some future quarters, our operating results may also be below such expectations, which would likely cause our stock price to decline.

If we lose a major customer, our revenue could suffer because of our customer concentration.

We have historically generated a substantial portion of our revenue from a limited number of customers, and we expect this to continue for the foreseeable future. For example, in 2005, our three largest customers represented approximately 45% of our total revenue, in 2004, our three largest customers represented approximately 34% of our total revenue, and in 2003, our three largest customers represented approximately 28% of our total revenue. As a result, if we lose a major customer, or if there is a decline in the use of our products within our existing customers organizations, our revenue would be adversely affected.

Failure to successfully develop versions and updates of our products that run on the operating systems used by our current and prospective customers could reduce our sales.

Many of our products run on the Microsoft Windows NT, Microsoft Windows 2000 or certain versions of the Sun Solaris Unix operating systems, and some require the use of third party software. Any change to our customers operating systems could require us to modify our products and could cause us to delay product releases. In addition, any decline in the market acceptance of these operating systems we support may require us to ensure that all of our products and services are compatible with other operating systems to meet the demands of our customers. If potential customers do not want to use the Microsoft or Sun Solaris operating systems we support, we will need to develop more products that run on other operating systems adopted by our customers. If we cannot successfully develop these

products in response to customer demands, our business could be adversely impacted. The development of new products in response to these risks would require us to commit a substantial investment of resources, and we might not be able to develop or introduce new products on a timely or cost-effective basis, or at all, which could lead potential customers to choose alternative products.

In addition, our products may face competition from operating system software providers, which may elect to incorporate similar technology into their own products.

We depend on increased business from new customers, as well as additional business from existing customers, and if we fail to grow our customer base or generate repeat business, our operating results could be harmed.

Our business model generally depends on the sale of our products to new customers as well as expanded use of our products within our existing customers organizations. If we fail to grow our customer base or to generate repeat and expanded business from our current and future customers, our business and operating results will be seriously harmed. In some cases, our customers initially make a limited purchase of our products and services for trials, pilot or proof of concept programs. These customers might not choose to acquire additional licenses to expand their use of our products.

In addition, as we have introduced new versions of our products or new products, such as our OAS, we have experienced a decline in licensing revenue generated from our older products, such as Polite Sync Server and e-Accelerator, and we anticipate future declines in licensing revenue from these products. However, it is also possible that our current customers might not require the functionality of our new products and might not ultimately license these products. Because the total amount of maintenance and support fees we receive in any period depends, in large part, on the size and number of licenses that we have previously sold, any downturn in our software license revenue would negatively affect our future maintenance and support revenue. In addition, if customers elect not to renew their maintenance agreements, our services revenue will decline significantly. Further, some of our customers are telecommunications or information technology companies, which have been forced to significantly reduce their operations in light of limited access to sources of financing and the national and global economic uncertainty. If customers are unable to pay for their current products or are unwilling to purchase additional products, our revenue will decline, which would likely materially and adversely affect our revenue, operating results and stock price.

Factors outside our control may cause the timing of our license revenue to vary from quarter-to-quarter, possibly adversely affecting our operating results.

We recognize license revenue when persuasive evidence of an agreement exists, the product has been delivered, the license fee is fixed or determinable, and collection of the fee is probable. If an arrangement requires acceptance testing or specialized professional services, recognition of the associated license and service revenue would be delayed. The timing of the commencement and completion of these services is subject to factors that may be beyond our control, such as access to the customer s facilities and coordination with the customer s personnel after delivery of the software. If new or existing customers have difficulty deploying our products or require significant amounts of our professional services support for specialized features, our revenue recognition could be further delayed and our costs could increase, causing increased variability in our operating results.

Our inability to integrate our products with other third-party software could adversely affect market acceptance of our products.

Our ability to compete successfully depends on the continued compatibility and interoperability of our products with products and systems sold by various third parties, such as portal framework vendors. Currently, these vendors have open applications program interfaces, which facilitate our ability to integrate with their systems. These vendors have also been willing to license to us rights to build integrations to their products and use their development tools. If any one of them were to close their programs interfaces or fail to grant us necessary licenses, our ability to provide a close integration of our products could become more difficult and could delay or prevent our products integration with future systems.

Competition in the Internet communications market may reduce the demand for, or price of, our products.

The Internet communications market is intensely competitive and rapidly changing. We expect that competition will intensify in the near-term because there are very limited barriers to entry. Our primary long-term

competitors may not have entered the market yet because the Internet communications market is relatively new. Competition could impact us through price reductions, fewer customer orders, reduced gross margin and loss of market share, any of which could cause our business to suffer. Many of our current and potential competitors have greater name recognition, longer operating histories, larger customer bases and significantly greater financial, technical, marketing, public relations, sales, distribution and other resources than we do. Some of our potential competitors are among the largest and most well capitalized software companies in the world. For example, both Microsoft and IBM have announced product plans addressing the offline Web application market segment served by our OAS product. If such companies enter this market segment, we may not be able to compete successfully, and competitive pressures may harm our business.

The loss of our right to use software licensed to us by third parties could harm our business.

We license technology that is incorporated into our products from third parties, including security and encryption software. Any interruption in the supply or support of any licensed software could disrupt our operations and delay our sales, unless and until we can replace the functionality provided by this licensed software. Because our products incorporate software developed and maintained by third parties, we depend on these third parties to deliver and support reliable products, enhance their current products, develop new products on a timely and cost-effective basis and respond effectively to emerging industry standards and other technological changes.

Changes in existing financial accounting standards or practices or taxation rules or practices may adversely affect our results of operations.

Changes in existing accounting or taxation rules or practices, new accounting pronouncements or taxation rules, or varying interpretations of current accounting pronouncements or taxation practice could have a significant adverse effect on our results of operations or the manner in which we conduct our business. Further, such changes could potentially affect our reporting of transactions completed before such changes are effective. For example, in December 2004, the Financial Accounting Standards Board (FASB) enacted Statement of Financial Accounting Standards 123 Revised 2004 (SFAS 123R), *Share-Based Payment,* which replaces Statement of Financial Accounting Standards No. 123 (SFAS 123), *Accounting for Stock-Based Compensation,* and supersedes APB Opinion No. 25 (APB 25), *Accounting for Stock Issued to Employees.* SFAS 123R requires the measurement of all share-based payments to employees, including grants of employee stock options, using a fair-value-based method and the recording of such compensation expense in our statements of income. We are required to adopt SFAS 123R in the first quarter of fiscal year 2006. The pro forma disclosures, previously permitted under SFAS 123 and adopted by us, no longer will be an alternative to financial statement recognition. Although we have not yet determined whether the adoption of SFAS 123R will result in amounts that are similar to the current pro forma disclosures under SFAS 123, we expect the adoption to increase our cost of revenues and operating expenses, and the adoption of SFAS 123R could make our net income less predictable in any given reporting period, and could change the way we compensate our employees.

Our growth may suffer because of the complexities involved in implementing our products.

The use of our products by our customers often requires implementation services, and our growth will be limited in the event we are unable to expand our implementation services personnel or subcontract these services to qualified third parties. In addition, customers could delay product implementations. As the number of deployments of our OAS solution grows, that solution is being subjected to actual commercial use and implementation. Initial implementation typically involves working with sophisticated software, computers and communications systems. If we experience difficulties with implementation or do not meet project milestones in a timely manner, we could be obligated to devote more customer support, engineering and other resources to a particular project at the expense of other projects.

Our business will suffer if the Internet infrastructure cannot support the demands placed on it.

Our future revenue and profits, if any, depend upon the widespread acceptance and use of the Internet as an effective medium of business and communication by our customers. Rapid growth in the use of, and interest in, the Internet has placed increased demands on its infrastructure. Our success will depend, in large part, on the

acceptance of the Internet in the commercial marketplace and on the ability of third parties to provide a reliable Internet infrastructure network with the speed, data capacity, security and hardware necessary for reliable Internet access and services. To the extent that the Internet continues to experience increased numbers of users, increased frequency of use or increased bandwidth requirements, the Internet infrastructure may not be able to support the demands placed on it and the performance or reliability of the Internet could suffer.

We may experience tax liabilities in connection with the liquidation of wholly owned subsidiaries that have ceased operations.

As a result of the restructuring plans we announced on July 1, 2001 and September 30, 2002, we ceased commercial operations of the following subsidiaries: BackWeb Technologies B.V., BackWeb Technologies (U.K.) Ltd., BackWeb Technologies S.a.r.l., BackWeb Technologies A.B., BackWeb Canada Inc., and BackWeb K.K. Ltd. We decided to liquidate these companies in order to further streamline our operations and to simplify our legal entity structure. We cannot assure you that we will not have any termination liability issues with the appropriate tax authorities in each jurisdiction. If such termination liability issues were to arise and we did not prevail, we might be required to pay significant taxes and penalties, which could adversely affect our cash balances and results of operations.

We may experience difficulties managing our expected growth and geographic dispersion.

Our ability to successfully offer products and services and to implement our business plan in the rapidly evolving Internet communications market requires an effective planning and management process. These factors, together with our anticipated future operations and geographic dispersion, will continue to place a significant strain on our management systems and resources. We expect that we will need to continue to improve our financial and managerial controls and reporting systems and procedures, and expand, train and manage our work force worldwide.

Our international operations are subject to additional risks.

Revenue from customers outside the United States represented approximately $2.9 million, or 41%, of our total revenue for the year ended December 31, 2005, and $962,000, or 18%, of our total revenue, for the year ended December 31, 2004. Our international operations will continue to be subject to a number of risks, including, but not limited to:

- laws and business practices favoring local competition;
- compliance with multiple, conflicting and changing laws and regulations;
- longer sales cycles;
- greater difficulty or delay in accounts receivable collection;
- import and export restrictions and tariffs;
- difficulties in staffing and managing foreign operations;
- difficulties in investing in foreign operations at appropriate levels to compete effectively; and
- political and economic instability.

Our international operations also face foreign-currency-related risks. To date, substantially all of our revenue has been denominated in U.S. dollars, but we believe that, in the future, an increasing portion of our revenue may be denominated in foreign currencies, including the Euro and the British Pound. Fluctuations in the value of foreign currencies may cause further volatility in our operating results, reduce the accuracy of our financial forecasts and could have a material adverse effect on our business, operating results and financial condition.

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Our efforts to protect our proprietary rights may be inadequate.

To protect our proprietary rights, we rely primarily on a combination of patent, copyright, trade secret and trademark laws, confidentiality agreements with employees and third parties, and protective contractual provisions such as those contained in license agreements with customers, consultants and vendors. However, these parties could breach such confidentiality agreements and other protective contracts. In addition, we have not signed confidentiality agreements in every case. Despite our efforts to protect our proprietary rights, unauthorized parties may copy aspects of our products and obtain and use information that we regard as proprietary. We may not become aware of, or have adequate remedies in the event of, such breaches.

We pursue the registration of some of our trademarks and service marks in the United States and in certain other countries, but we have not secured registration of all our marks. We license certain trademark rights to third parties. Such licensees may not abide by compliance and quality control guidelines with respect to such trademark rights and may take actions that would adversely affect our trademarks.

We do not conduct comprehensive patent searches to determine whether the technology used in our products infringes patents held by third parties. Product development is inherently uncertain in a rapidly evolving technological environment in which there may be numerous patent applications pending, which are confidential when filed, with regard to potentially similar technologies. We expect that software products may be increasingly subject to third-party infringement claims as the number of competitors in our industry segment grows and the functionality of products in different industry segments overlaps. Although we believe that our products do not infringe the proprietary rights of any third parties, third parties could assert infringement claims against us in the future. The defense of any such claims would require us to incur substantial costs and would divert management s attention and resources, which could materially and adversely affect our financial condition and operations. If a party succeeded in making such a claim, we could be liable for substantial damages, as well as injunctive or equitable relief that could effectively block our ability to sell our products and services. Royalty or licensing agreements, if required, may not be available on acceptable terms, if at all. Any such outcome could have a material adverse effect on our business, financial condition, operating results and stock price.

Our products may be used in an unintended and negative manner.

Our products are used to transmit information through the Internet. A BackWeb customer could potentially use our products to transmit harmful applications, negative messages, unauthorized reproduction of copyrighted material, inaccurate data, or computer viruses to end users in the course of delivery. Any such transmission could damage our reputation or could give rise to legal claims against us. We have received emails from certain of our customers end users claiming that our technology is a form of spyware, and we are actively engaged in challenging such accusations. In the event such allegations result in litigation, we could spend a significant amount of time and money pursuing or defending legal claims, which could have a material adverse effect on our business.

We may not have sufficient insurance to cover all potential product liability and warranty claims.

Our products are integrated into our customers networks. The sale and support of our products may entail the risk of product liability or warranty claims based on damage to these networks. In addition, the failure of our products to perform to customer expectations could give rise to warranty claims. Although we carry general commercial liability insurance, our insurance may not cover potential claims of this type or may not be adequate to protect us from all liability that may be imposed.

Our financial performance and workforce reductions may adversely affect the morale and performance of our personnel and our ability to hire new personnel.

In connection with the evolution of our business model and in order to reduce our cash expenses, we have adopted a number of changes in personnel, including significant workforce reductions. The changes in personnel may adversely affect morale and our ability to attract and retain key personnel. In addition, recent trading levels of our common stock have decreased the value of the stock options granted to employees pursuant to our stock option plan. As a result of these factors, our remaining personnel may seek employment with larger, more established companies or companies they perceive to have better prospects. If this were to occur, our revenue could decline and

our operations in general could be impacted. None of our officers or key employees is bound by an employment agreement for any specific term. Our relationships with these officers and key employees are at will. Moreover, we do not have key person life insurance policies covering any of our employees.

Legislation and regulatory changes may cause us to incur increased costs, limit our ability to obtain director and officer liability insurance, and make it more difficult for us to attract and retain qualified officers and directors.

Changes in the laws and regulations affecting public companies, including the provisions of the Sarbanes-Oxley Act of 2002 and rules adopted by the SEC and Nasdaq, have required changes in some of our corporate governance and accounting practices. We expect these laws, rules, and regulations to increase our legal and financial compliance costs and to make some activities more difficult, time consuming and costly. The new rules could also make it more difficult for us to obtain certain types of insurance, including director and officer liability insurance, and we may be forced to accept reduced policy limits and coverage or incur substantially higher costs to obtain the same or similar coverage. The impact of these events could also make it more difficult for us to attract and retain qualified persons to serve on our board of directors, particularly on our audit committee, or as executive officers.

Risks Relating to Our Location in Israel

Any major developments in the political or economic conditions in Israel could cause our business to suffer because we are incorporated in Israel and have important facilities and resources located in Israel.

We are incorporated under the laws of the State of Israel. Our research and development facilities, as well as one of our executive offices, are located in Israel. Although substantial portions of our sales are currently made to customers outside of Israel, any major hostilities involving Israel or the interruption or curtailment of trade between Israel and its present trading partners could significantly harm our business. Since September 2000, a continuous armed conflict with the Palestinian Authority has been taking place. We cannot predict the effect on BackWeb of an increase in the degree of violence in Israel or of any possible military action elsewhere in the Middle East. We incur a large portion of our costs from operations in Israel in NIS. If Israel s economy is impaired by a high inflation rate or if the timing of the devaluation of the NIS against the U.S. dollar were to lag considerably behind inflation, our operations and financial condition may be negatively impacted to the extent that the inflation rate exceeds the rate of devaluation of the NIS against the U.S. dollar.

Any future profitability may be diminished if tax benefits from the State of Israel are reduced or withheld.

Pursuant to the Law for the Encouragement of Capital Investments, the Israeli Government has granted Approved Enterprise status to our existing capital investment programs. Consequently, we are eligible for tax benefits for the first several years in which we generate taxable income. Our future profitability may be diminished if all or portions of these tax benefits are reduced or eliminated. These tax benefits may be cancelled if we fail to comply with requisite conditions and criteria. Currently the most significant conditions that we must continue to meet include making specified investments in fixed assets, financing at least 30% of these investments through the issuance of capital stock, and maintaining the development and production nature of our facilities. Company Management believes that the Company is in compliance with the aforesaid conditions.

We have two investment programs. On June 30, 2005, we completed the investments for our second program. We cannot assure you that new benefits will be available after June 30, 2005 or that the benefits will be continued in the future at their current levels or at any level.

Israeli regulations may limit our ability to engage encryption research and development and export our products that incorporate encryption.

Under Israeli law, we are required to obtain an Israeli government license to engage in research and development and the export of the encryption technology incorporated in our products. Our current government license to engage in these activities expires in May 2006. Our research and development activities in Israel, together

with our ability to export our products out of Israel, would be limited if the Israeli government revokes our current license, our current license is not renewed, our license fails to cover the scope of the technology in our products, or Israeli law regarding research and development or export of encryption technologies were to change.

Israeli courts might not enforce judgments rendered outside of Israel that may make it difficult to collect on judgments rendered against us.

Some of our directors and executive officers are not residents of the United States and some of their assets and our assets are located outside the United States. Service of process upon these directors and executive officers, and enforcement of judgments obtained in the United States against us, and these directors and executive officers, may be difficult to obtain within the United States. BackWeb Technologies, Inc., our U.S. subsidiary, is the U.S. agent authorized to receive service of process in any action against us in any federal or state court arising out of our initial public offering or any related purchase or sale of securities. We have not given consent for this agent to accept service of process in connection with any other claim.

We have been informed by our legal counsel in Israel, Naschitz, Brandes & Co., that there is doubt as to the enforceability of civil liabilities under U.S. securities laws in original actions instituted in Israel. However, subject to certain time limitations, an Israeli court may declare a foreign civil judgment enforceable if it finds that:

- the judgment was rendered by a court that was, according to the laws of the state of the court, competent to render the judgment;
- the judgment is no longer able to be appealed;
- the obligation imposed by the judgment is enforceable according to the rules relating to the enforceability of judgments in Israel and the substance of the judgment is not contrary to public policy; and
- the judgment is executory in the state in which it was given.

Even if the above conditions are satisfied, an Israeli court will not enforce a foreign judgment if it was given in a state whose laws do not provide for the enforcement of judgments of Israeli courts (subject to exceptional cases) or if its enforcement is likely to prejudice the sovereignty or security of the State of Israel. An Israeli court also will not declare a foreign judgment enforceable if:

- the judgment was obtained by fraud;
- there was no due process;
- the judgment was rendered by a court not competent to render it according to the laws of private international law in Israel;
- the judgment is at variance with another judgment that was given in the same matter between the same parties and which is still valid; or
- at the time the action was brought in the foreign court a suit in the same matter and between the same parties was pending before a court or tribunal in Israel.

If a foreign judgment is enforced by an Israeli court, it generally will be payable in NIS, which can then be converted into non-Israeli currency and transferred out of Israel. The usual practice in an action to recover an amount in

non-Israeli currency is for the Israeli court to render judgment for the equivalent amount in NIS at the rate of exchange on the date of payment, but the judgment debtor also may make payment in non-Israeli currency. Pending collection, the amount of the judgment of an Israeli court stated in NIS ordinarily will be linked to the Israel consumer price index plus interest at the annual rate (set by Israeli law) prevailing at that time. Judgment creditors bear the risk of unfavorable exchange rates.

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We have adopted anti-takeover provisions that could delay or prevent an acquisition of BackWeb, even if an acquisition would be beneficial to our shareholders.

Provisions of Israel corporate and tax law and of our articles of association, such as our staggered Board, may have the effect of delaying, preventing or making more difficult a merger or other acquisition of BackWeb, even if an acquisition would be beneficial to our shareholders.

Israeli corporate law regulates acquisitions of shares through tender offers, requires special approvals for transactions involving significant shareholders and regulates other matters that may be relevant to these types of transactions. Furthermore, Israeli tax considerations may make potential transactions unappealing to us or to some of our shareholders. In addition, our articles of association provide for a staggered board of directors.

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

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

Risks Relating to Our Ordinary Shares

Our stock price has been volatile and could fluctuate in the future.

The market price of our Ordinary Shares has been volatile. We expect our stock price to continue to fluctuate:

- in response to quarterly variations in operating results;
- in response to announcements of technological innovations or new products by us or our competitors or partners;
- because of market conditions in the enterprise software or portal industry;
- in reaction to changes in financial estimates by securities analysts, and our failure to meet or exceed the expectations of analysts or investors;
- in response to our announcements of strategic relationships or joint ventures; and
- in response to sales of our Ordinary Shares.

In the past, following periods of volatility in the market price of a particular company s securities, securities class action litigation has often been brought against that company. We are currently subject to a securities class action described in Part I, Item 3 Legal Proceedings of this Annual Report, and the volatility of our stock price could make us a target for additional suits. Securities class action litigation could result in substantial costs and a diversion of our management s attention and resources, which could seriously harm our business and results of operations.

Our stock is listed on the Nasdaq Capital Market and our continued listing on the Nasdaq Capital Market listing is not assured.

Effective on September 23, 2002, we transferred the listing of our Ordinary Shares from the Nasdaq National Market System and began trading on the Nasdaq Capital Market. We will remain eligible to be quoted on the Nasdaq Capital Market, subject to our compliance with the applicable continued listing requirements which require, among other things, that (i) we have shareholders equity of $2.5 million, (ii) we have $500,000 in net income, or (iii) the market value of our publicly held shares be $35 million or more. At December 31, 2005, we met the shareholder equity test and were eligible for continued listing. However, we cannot assure you that we will be able to maintain the continued listing requirements, and, as a result, may be delisted from trading on the Nasdaq Capital Market. If

our Ordinary Shares are delisted from trading on the Nasdaq Capital Market, then the trading market for our Ordinary Shares, and the ability of our shareholders to trade our shares and obtain liquidity for their shares, may be significantly impaired and the market price of our Ordinary Shares may decline significantly.

Holders of our Ordinary Shares who are United States residents face income tax risks.

We believe that we will be classified as a passive foreign investment company, or PFIC, for U.S. federal income tax purposes. Our treatment as a PFIC could result in a reduction in the after-tax return to the holders of our Ordinary Shares and may cause a reduction in the value of such shares. For U.S. federal income tax purposes, we will be classified as a PFIC for any taxable year in which either (i) 75% or more of our gross income is passive income, or (ii) at least 50% of the average value of all of our assets for the taxable year produce or are held for the production of passive income. For this purpose, cash is considered to be an asset, which produces passive income. Passive income also includes dividends, interest, royalties, rents, annuities and the excess of gains over losses from the disposition of assets, which produce passive income. As a result of our cash position and the decline in the value of our stock, we might be considered a PFIC under a literal application of the asset test that looks solely to market value. If we are a PFIC for U.S. federal income tax purposes, holders of our Ordinary Shares who are residents of the United States (U.S. Holders) would be required, in certain circumstances, to pay an interest charge together with tax calculated at maximum rates on certain excess distributions, including any gain on the sale of Ordinary Shares.

The consequences described above can be mitigated if the U.S. Holder makes an election to treat us as a qualified electing fund, or QEF. A shareholder making the QEF election is required for each taxable year to include in income a pro rata share of the net capital gain of the QEF as long-term capital gain, subject to a separate election to defer payment of taxes, which deferral is subject to an interest charge. We have agreed to supply U.S. Holders with the information needed to report income and gain pursuant to a QEF election. The QEF election is made on a shareholder-by-shareholder basis and can be revoked only with the consent of the Internal Revenue Service, or IRS.

As an alternative to making the QEF election, the U.S. Holder of PFIC stock which is publicly traded could mitigate the consequences of the PFIC rules by electing to mark the stock to market annually, recognizing as ordinary income or loss each year an amount equal to the difference as of the close of the taxable year between the fair market value of the PFIC stock and the U.S. Holder s adjusted tax basis in the PFIC stock. Losses would be allowed only to the extent of net mark-to-market gain previously included by the U.S. Holder under the election for prior taxable years.

All U.S. Holders are advised to consult their own tax advisers about the PFIC rules generally and about the advisability, procedures and timing of their making any of the available tax elections, including the QEF or mark-to-market elections.

Our officers, directors and affiliated entities own a large percentage of BackWeb and could significantly influence the outcome of actions.

Our executive officers, directors and entities affiliated with them, in the aggregate, beneficially owned approximately 27% of our outstanding Ordinary Shares as of December 31, 2005. These shareholders, if acting together, would be able to significantly influence all matters requiring approval by our shareholders, including the election of directors and the approval of mergers or other business combination transactions.

Item 1B. ***Unresolved Staff Comments***

None.

Item 2. ***Properties***

As of December 31, 2005, BackWeb leased approximately 3,234 square feet in a single office building located in Rosh Ha ayin, Israel, and approximately 17,600 square feet in a single office building located in San Jose, California. The office space in Rosh Ha ayin, Israel is leased pursuant to a lease that terminates in June 2006. We are currently in negotiations to extend this lease. The office space in San Jose, California is leased pursuant to a lease that expires in January 2007. In addition to these facilities, as of December 31, 2005, BackWeb also leased small

field sales and support offices in New York, New York, and Hamburg, Germany. Lease terms on these offices are month-to-month. We believe that our current facilities will be adequate to meet our needs for the foreseeable future. Please refer to Note 7 of the Notes to Consolidated Financial Statements for further information regarding leases.

For a more complete discussion of our lease obligations, please refer to Note 9 of the Notes to Consolidated Financial Statements found elsewhere in this Annual Report.

Item 3. *Legal Proceedings*

On November 13, 2001, BackWeb, six of our officers and directors, and various underwriters for our initial public offering were named as defendants in a consolidated action captioned In re BackWeb Technologies Ltd. Initial Public Offering Securities Litigation, Case No. 01-CV-10000, a purported securities class action lawsuit filed in the United States District Court, Southern District of New York. Similar cases have been filed alleging violations of the federal securities laws in the initial public offerings of more than 300 other companies, and these cases have been coordinated for pretrial proceedings as In re Initial Public Offering Securities Litigation, 21 MC 92. A consolidated amended complaint filed in the BackWeb case asserts that the prospectus from our June 8, 1999 initial public offering failed to disclose certain alleged improper actions by the underwriters for the offering, including the receipt of excessive brokerage commissions and agreements with customers regarding aftermarket purchases of shares of our stock. The complaint alleges violations of Sections 11 and 15 of the Securities Act of 1933, Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, and Rule 10b-5 promulgated under the Securities Exchange Act of 1934. On or about July 15, 2002, an omnibus motion to dismiss was filed in the coordinated litigation on behalf of defendants, including BackWeb, on common pleadings issues. In October 2002, the Court dismissed all six individual defendants from the litigation without prejudice, pursuant to a stipulation. On February 19, 2003, the Court denied the motion to dismiss with respect to the claims against BackWeb. No trial date has yet been set.

A proposal was made in 2003 for the settlement and for the release of claims against the issuer defendants, including BackWeb, has been submitted to the Court. We have agreed to the proposal. The settlement is subject to a number of conditions, including approval by the proposed settling parties and the court.

If the settlement does not occur, and litigation against us continues, we believe we have meritorious defenses and intend to defend the case vigorously. However, the results of any litigation are inherently uncertain and can require significant management attention, and we could be forced to incur substantial expenditures, even if we ultimately prevail. In the event there were an adverse outcome, our business could be harmed. Thus, we cannot assure you that this lawsuit will not materially and adversely affect our business, results of operations, or the price of our Ordinary Shares.

Additionally, we were named in a judgment during September 2005 for approximately $500,000 related to a claim against our dormant French subsidiary. The judgment is related to a dispute between a former French distributor of ours and one of the distributor s end user customers. While we believe we have additional defenses against the claim and will ultimately not be responsible for payments under the judgment, we accrued approximately $250,000, or approximately one-half of the total judgment against us and the former distributor, in the September 2005 quarter.

From time to time, we are involved in litigation incidental to the conduct of our business. Apart from the litigation described above, we are not party to any lawsuit or proceeding that, in our opinion, is likely to seriously harm our business.

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Item 4. ***Submission of Matters to a Vote of Security Holders***

On December 29, 2005, we held our Annual General Meeting of Shareholders at which our shareholders voted on and approved the following matters:

1. To re-elect Eli Barkat as a Class III director to serve for a term of three years, expiring upon the 2008 Annual General Meeting of Shareholders, or until his successor is elected;

For	20,885,626
Withhold Authority	24,662

2. To elect Kara Andersen to serve as an Outside Director under Israel s Companies Law for a term of three years;

For	20,927,546
Withhold Authority	40,855

3. To approve an amendment to our Articles of Association regarding director and officer insurance, indemnification and exculpation;

For	20,873,149
Against	93,849
Abstain	4,548
Broker Non-Votes	20,163,994

4. To approve insurance, indemnification and exculpation agreements with each of our directors; and

For	20,869,879
Against	97,229
Abstain	4,438
Broker Non-Votes	20,163,994

5. To (i) ratify the appointment of Grant Thornton LLP as our independent registered public accounting firm for the fiscal year ending December 31, 2005 and (ii) authorize our Audit Committee to enter into an agreement to pay the fees of Grant Thornton on customary terms.

For	20,930,054
Against	39,719
Abstain	1,773
Broker Non-Votes	20,163,994

PART II

Item 5. ***Market for Our Common Stock and Related Stockholder Matters***

Our Ordinary Shares are traded on the Nasdaq Capital Market under the symbol BWEB. The following table presents the high and low intra-day sales prices per share of our Ordinary Shares as reported on the Nasdaq Capital Market during the quarters indicated below:

	High	Low
2004		
First Quarter	$ 1.77	$ 0.84
Second Quarter	$ 1.24	$ 0.62
Third Quarter	$ 0.84	$ 0.30
Fourth Quarter	$ 0.88	$ 0.32

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	High	Low
2005		
First Quarter	$ 0.84	$ 0.44
Second Quarter	$ 0.57	$ 0.41
Third Quarter	$ 0.63	$ 0.45
Fourth Quarter	$ 0.74	$ 0.37

According to the records of our transfer agent, American Stock Transfer & Trust Company, we had approximately 182 shareholders of record as of March 4, 2006. Because many of our Ordinary Shares are held by brokers and other institutions on behalf of shareholders, we are unable to estimate the total number of shareholders represented by these record holders.

Our policy is to reinvest earnings to fund future operations. Accordingly, we have never declared a dividend and do not anticipate declaring or paying any dividends in the foreseeable future.

If we were to distribute cash dividends out of income that had been exempt from tax because of our investment program s Approved Enterprise status (for description of such status please refer to the section entitled Effective Corporate Tax Rate in Management s Discussion and Analysis of Financial Condition and Results of Operations below) such income would become subject to Israeli corporate tax.

If we were to declare dividends in the future, we would declare those dividends in NIS but pay those dividends to our non-Israeli shareholders in U.S. dollars. Because exchange rates between NIS and the dollar fluctuate continuously, a U.S. shareholder would be subject to currency fluctuation between the date when the dividends were declared and the date the dividends were paid.

In 1998, the Israeli currency control regulations were liberalized significantly, and, since January 1, 2003, all exchange control restrictions have been removed, although there are still reporting requirements for foreign currency transactions. There are no longer Israeli currency control restrictions on remittances of dividends on the Ordinary Shares (after deduction of withholding tax) or the proceeds from the sale of the Ordinary Shares, and shareholders may freely convert these amounts into non-Israeli currencies and remit these amounts abroad. However, legislation remains in effect, pursuant to which currency controls can be imposed by administrative action at any time.

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Item 6. ***Selected Consolidated Financial Data***

The selected consolidated financial data set forth below should be read in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations, our Consolidated Financial Statements and Notes thereto, and other financial information included elsewhere in this report. Historical results are not necessarily indicative of the results to be expected in the future.

	Years Ended December 31, (In thousands, except per share data)				
	2005	**2004**	**2003**	**2002**	**2001**
Consolidated Statements of Operations					
Revenue:					
License	$ 3,312	$ 1,593	$ 3,232	$ 2,119	$ 13,807
Service	3,599	3,906	3,270	4,228	6,831
Total revenue	6,911	5,499	6,502	6,347	20,638
Cost of revenue:					
License	51	72	128	213	443
Service	684	1,170	1,057	3,050	5,238
Total cost of revenue	735	1,242	1,185	3,263	5,681
Gross profit	6,176	4,257	5,317	3,084	14,957
Operating expenses:					
Research and development	2,178	3,298	4,487	6,059	9,230
Sales and marketing	3,452	4,071	6,272	10,298	22,882
General and administrative	1,787	1,958	3,939	4,557	10,494
Restructuring charges	(105)	469	443	4,678	2,825
Write-off and amortization of intellectual property, other intangibles and deferred stock compensation				3,546	3,806
Total operating expenses	7,312	9,796	15,141	29,138	49,237
Loss from operations	(1,136)	(5,539)	(9,824)	(26,054)	(34,280)
Interest and other income, net	103	396	98	1,172	2,037
Write down of equity investments			(1,000)		(2,500)
Net loss	$ (1,033)	$ (5,143)	$ (10,726)	$ (24,882)	$ (34,743)
Basic and diluted net loss per share	$ (0.03)	$ (0.13)	$ (0.27)	$ (0.63)	$ (0.91)
Weighted average number of shares used in computing basic and diluted net loss per	41,011	40,711	40,000	39,284	38,225

share(1)

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	As of December 31,				
	2005	2004	2003	2002	2001
	(In thousands)				
Consolidated Balance Sheets Data:					
Cash, cash equivalents and short-term investments	$ 7,876	$ 10,320	$ 14,457	$ 23,757	$ 41,824
Working capital	6,801	7,903	12,301	20,334	37,905
Total assets	10,003	12,555	18,515	29,409	56,512
Total shareholders equity	$ 7,041	$ 7,938	$ 12,961	$ 22,521	$ 46,581

(1) For the calculation of the weighted average number of shares used to calculated basic and diluted net loss per share, please see Note 2 of the Notes to Consolidated Financial Statements, Net Loss Per Share.

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Item 7. *Management s Discussion and Analysis of Financial Condition and Results of Operations*

The following discussion and analysis should be read in conjunction with, and is qualified by, the Selected Consolidated Financial Data and our consolidated financial statements and notes thereto included elsewhere in this report, as well as Risk Factors . In addition, this discussion contains forward-looking statements and is, therefore, subject to the overall qualification on forward-looking statements that appears at the beginning of this report.

We compete in the mobility and mobile applications market and offer a solution allowing users of enterprise Web applications to synchronize those Web applications to their PCs for use while disconnected from the network. Our enabling software is designed to integrate with web applications in a loosely-coupled way that requires no changes in a company s enterprise web architecture and applications. This approach has the potential to bring mobile functionality to enterprise web applications quickly and with low total cost of ownership. Our products address the need of mobile users who spend important parts of their work time in situations in which fixed or wireless network connectivity is not practical. This includes mobile workers engaged in field sales, services, consulting and operational roles. Many of these people must frequently disconnect from and reconnect to the network but require consistent access to their important web-based business applications. Examples of such critical business applications include customer relationship management, or CRM, systems, service management systems, service document repositories, training and e-learning applications, human resources, or HR, applications, service repair guides, expense report updates, pricing data, time sheets, work orders, and other essential documents and information. Our products are designed to capitalize on the potential business and return on investment benefits of mobile applications, including improved productivity of mobile workforces, faster completion of company workflows and increased levels of sales and customer satisfaction. They are also designed to reduce the cost of distributing information to field personnel and to minimize the impact and costs on enterprise networks to support mobile users.

The BackWeb Offline Access Server (OAS) integrates with Web applications in any web-based architecture, including portal frameworks, intranets, and websites, so the applications may be used by users who are frequently disconnected from the network. Its two-way synchronization capability enables people to access content from, publish to and conduct transactions on web applications while disconnected, enabling the productive combination of fully-featured enterprise applications and mobile use cases. This can be less expensive and easier to implement than the alternative of writing special client-server applications for use by mobile personnel.

Using HTML-type tags (called Offline Tagging Markup Language, or OTML), our customers can offline-enable their websites and portals without rewriting code, creating an offline end-user experience that is essentially the same as the online user experience. The BackWeb Polite Sync Server, formerly known as BackWeb Foundation, uses network-sensitive background content delivery that can deliver large amounts of data without impacting the performance of other network applications. This allows organizations to efficiently target and deliver sizeable digital data to users desktops throughout the extended enterprise. The Polite Sync Server utilizes our patented polite synchronization technology that is designed to distribute large amounts of data over very good or very low quality network connections.

We derive revenue from licensing our products and from maintenance, consulting and training services. Our products are marketed worldwide primarily through our direct sales force. We also have generated revenue through business partners via our reseller, OEM and co-sales/marketing partners. Since 2002, our direct sales force has accounted for a significant majority of our revenue. However, the revenue from partner activities increased in 2005 and we believe it could continue to increase in absolute dollars and in percentage of overall revenue.

For the year ended December 31, 2005, certain adjustments were made to the consolidated financial statements after the press release reporting our financial results for the fourth quarter of 2005 was issued and before the conclusion of the financial statement audit. The impact of these adjustments resulted in approximately $40,000 of additional operating expense and an additional $0.01 of loss to net loss per share, from $0.02 as per the press release to $0.03 as reported herein.

Business Overview

2005 was an important stabilization year for us, marked with some key successes. We had our highest revenue total since 2001, and our lowest net loss since our initial public offering in 1999. While there is still great challenge for us to define our market, identify and enter into additional partnerships, and increase our sales through our growing number of distribution partners, we are encouraged by the growth rate we achieved in 2005 within our core product, Offline Access Server (OAS), and the new customer acquisitions we were able to secure during the year. For the first time in our history, our OAS product accounted for the majority of our license revenue in 2005. We believe this is due to our ability to demonstrate improved employee productivity and accelerate corporate workflows for remote or occasionally connected workforces. During the year, we launched new partnerships with system integrators in key industries and initiated partner activity with Oracle. These partnerships made important contributions to our revenues in 2005 and we look to expand upon that trend in 2006. Our recent investments in sales and marketing are aimed at increasing the number of partnerships and expanding our sales coverage. We believe enterprises will continue to focus on web applications and mobile solutions to help their people become more productive. As they invest in mobile web productivity, we believe we are positioned to capitalize on this trend, as was evidenced in 2005 by our new customer signings and by existing customers who expanded their use of our software.

We experienced increases in our key revenue streams during 2005. We view license revenue as a key indicator of our business as it drives the need for both service and maintenance services within our installed base. License revenues in 2005 increased 108% from 2004, and increased 188% excluding license revenue from large license sales of our older product lines, including a $1.5 million sale to F-Secure. 40% of our license revenue in 2005 was derived from two customers, including $1.4 million that was recognized from F-Secure pursuant to a license that we sold in the fourth quarter of 2004 and which was recognized ratably through the fourth quarter of 2005. We will no longer recognize any revenue from the F-Secure license sale and must replace this revenue with new license sales in order to continue to grow our licensing revenues. In 2005, we also focused on increasing our sales outreach through the combination of our technology and size of our partners sales forces and, to that end, sold and deployed our first sales through our relationship with Oracle. During 2005 we secured our first relationship with Oracle and their Human Capital Management suite of products. We plan to expand the number of product offerings we market jointly with Oracle in the coming years.

Service revenues in 2005 remained relatively consistent from 2004 levels. Our consulting services revenues tend to trail license revenues of previous quarters. Accordingly, our consulting services revenues decreased in 2005 from 2004 due to the fact that we had fewer license deployments in 2004 than in 2003. 2005 maintenance revenue remained relatively flat with 2004 as we experienced better than expected maintenance renewals within our installed base of customers.

During 2005, we realized benefits from our cost control measures taken in prior years. Our operating expenses in 2005 decreased approximately $1 million per quarter in 2005 compared with 2004 as a result of these actions. Our overall decrease in operating expenses was approximately $2.5 million or 26% primarily due to these reductions, partially offset by investments in sales and marketing towards the end of 2005. As a result, we were able to reduce our net loss per share in 2005 by $0.10 compared to 2004. While we are focused on achieving profitability, we believe the best way to accomplish that is by making modest investments in our business in order to better position us to achieve growth in our revenue. We hope to use these modest investments to expand our sales coverage and to expand our depth and number of sales and marketing partnerships. We believe these investments are merited given our experience in 2005 in which we saw some of our existing sales territories and our new partnerships become productive. However, unless and until our new investments pay off, these investments will likely lead to future losses in the near term.

Critical Accounting Policies

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States requires us to make judgments, assumptions and estimates that affect the amounts reported in the Consolidated Financial Statements and accompanying notes. We consider the accounting polices described below to be our critical accounting polices. These critical accounting policies are impacted

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significantly by judgments, assumptions and estimates used in the preparation of the Consolidated Financial Statements and actual results could differ materially from the amounts reported based on these policies.

Our critical accounting policies are as follows:

- revenue recognition; and
- estimating valuation allowances and accrued liabilities, specifically the trade receivable allowances for doubtful accounts.

Revenue Recognition

We derive revenue primarily from software license fees, maintenance service fees, and consulting services paid to us directly by corporate customers and resellers and, to a lesser extent, from royalty fees from OEMs. Revenue derived from resellers is not recognized until the software is sold through to the end user. Royalty revenue is recognized when reported to us by the OEM after delivery of the applicable products. In addition, royalty revenue can arise from the right of OEMs and other distributors to use our products. As described below, management estimates must be made and used in connection with the revenue we recognize in any accounting period.

We recognize software license revenue in accordance with Statement of Position 97-2 Software Revenue Recognition (SOP 97-2), as amended, and SOP 98-9, Modification of SOP 97-2, Software Revenue Recognition with Respect to Certain Transactions (SOP 98-9). SOP 98-9 requires that revenue be recognized under the Residual Method when vendor specific objective evidence (VSOE) of fair value exists for all undelivered elements and no VSOE exists for the delivered elements. Under the Residual Method, any discounts in the arrangement are allocated to the delivered elements.

When contracts contain multiple elements wherein VSOE of fair value exists for all undelivered elements, we account for the delivered elements in accordance with the Residual Method prescribed by SOP 98-9. Maintenance revenue included in these arrangements is deferred and recognized on a straight-line basis over the term of the maintenance agreement. The VSOE of fair value of the undelivered elements (maintenance, training, and consulting services) is determined based on the price charged for the undelivered element when sold separately.

Revenue from software license agreements is recognized when all of the following criteria are met as set forth in SOP 97-2: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred; (3) the fee is fixed or determinable; and (4) collectibility is probable. We do not generally grant a right of return to our customers. When a right of return exists, we defer revenue until the right of return expires, at which time revenue is recognized provided that all other revenue recognition criteria have been met. If the fee is not fixed or determinable, revenue is recognized as payments become due from the customer provided that all other revenue recognition criteria have been met.

We license our products on a perpetual and on a term basis. We recognize license revenue arising from perpetual licenses and multi-year term licenses in the accounting period that all revenue recognition criteria have been met, which is generally upon delivery of the software to the end user. For term licenses with a contract period of less than two years, revenue is recognized on a monthly basis.

At the time of each transaction, we assess whether the fee associated with our license sale is fixed or determinable. If the fee is not fixed or determinable, we recognize revenue as payments become due from the customer provided that all other revenue recognition criteria have been met. In determining whether the fee is fixed or determinable, we compare the payment terms of the transaction to our normal payment terms. We assess the likelihood of collection based on a number of factors, including past transaction history, the credit worthiness of the customer and, in some

instances, a review of the customer s financial statements. We do not request collateral from our customers. If credit worthiness cannot be established, we defer the fee and recognize revenue at the time collection becomes reasonably assured, which is generally upon the receipt of cash.

Service revenue is primarily comprised of revenue from standard maintenance agreements and consulting services. Customers licensing products generally purchase the standard annual maintenance agreement for the products. We recognize revenue from maintenance over the contractual period of the maintenance agreement, which is generally one year. Maintenance is priced as a percentage of the license revenue. For those agreements

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where the maintenance and license is quoted as one fee, we value the maintenance as an undelivered element at standard rates and recognize this revenue over the contractual maintenance period. Consulting services are billed at an agreed-upon rate, plus out-of-pocket expenses. We generally charge for our consulting services on a time and materials basis and recognize revenue from such services as they are provided to the customer. We account for fixed fee service arrangements in a similar manner to an agreement containing an acceptance clause. Our arrangements do not generally include acceptance clauses. However if an acceptance provision exists, then we defer revenue recognition until we receive written acceptance of the product from the customer.

Deferred revenue includes amounts billed to customers and cash received from customers for which revenue has not been recognized.

Estimating Valuation Allowances and Accrued Liabilities, Including the Allowance for Doubtful Accounts

Management continually reviews the collectibility of trade accounts receivable and the adequacy of the allowance for doubtful accounts against the trade accounts receivable. Management specifically analyzes customer accounts, account receivable aging reports, history of bad debts, the business or industry sector to which the customer belongs, customer concentrations, customer credit-worthiness, current economic trends, and any other pertinent factors. Generally, we make a provision for doubtful accounts when a trade receivable becomes 180 days past due. In exceptional cases, we will waive a provision after a trade receivable is 180 days or more past due when, in the judgment of management, after conducting due diligence with the management of the customer, the receivable is still collectible and the customer has demonstrated that payment is imminent. During 2005, management s review of the allowance for doubtful accounts resulted in a write offs during the year of $364,000 related to past due accounts, primarily from amounts recorded in prior years.

Management believes that it is able to make reasonably objective judgments on the adequacy of other provisions relating to trade accruals. We have not made any provision for contingent liabilities which has involved significant management judgment that either we will prevail in the case of material litigation or that we have sufficient insurance to cover any adverse outcome. A discussion of our outstanding material litigation is contained in Part I, Item 3 Legal Proceedings of this Form 10-K.

For the year ended December 31, 2005, certain adjustments were made to the consolidated financial statements after the press release reporting our financial results for the fourth quarter of 2005 was issued and before the conclusion of the financial statement audit. The impact of these adjustments resulted in approximately $40,000 of additional operating expense and an additional $0.01 of loss to net loss per share, from $0.02 as per the press release to $0.03 as reported herein.

Results of Operations

The following table sets forth the results of operations, for the periods indicated, expressed as a percentage of total revenue.

	Year Ended December 31,		
	2005	**2004**	**2003**
Revenue:			
License	48%	29%	50%
Service	52	71	50

Total revenue	100	100	100
Cost of revenue:			
License	0	1	2
Service	10	22	16
Total cost of revenue	10	23	18
Gross profit	90	77	82

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	Year Ended December 31,		
	2005	2004	2003
Operating expenses:			
Research and development	32	60	69
Sales and marketing	50	74	96
General and administrative	26	36	61
Restructuring charges	(2)	8	7
Total operating expenses	106	178	233
Loss from operations	(16)	(101)	(151)
Interest and other income, net	2	7	2
Write down of equity investments			(15)
Net loss	(14)%	(94)%	(164)%

Revenue

	December 31,						
		Change			Change		
	2005	$	%	2004	$	%	2003
	(In thousands, except percentages)						
Total revenue	$ 6,911	$ 1,412	25.7%	$ 5,499	$ (1,003)	(15.4)%	$ 6,502

We derive revenue from licensing and providing maintenance and consulting services for our BackWeb Offline Access Server (OAS), BackWeb Polite Sync Server, and BackWeb e-Accelerator products. The increase in total revenue in 2005 as compared to 2004 was due in part to a $1.5 million license transaction for our older Polite Sync product that we completed with F-Secure in the fourth quarter of 2004, of which $1.4 million was recognized in 2005. While we realized growth from our current OAS product line in 2005, we will need to see additional growth from that product line in 2006 to offset the fact that we will no longer be recognizing any revenue from the F-Secure license transaction. The decrease in total revenue in 2004 from 2003 was due to a $1.6 million decrease in license revenue, partially offset by an increase in consulting service revenue of approximately $640,000. 2005 was a stabilization year for us with little turnover in the sales force and a consistent message to the market, which we believe led to the increase in total revenue despite a substantially smaller sales and marketing team. Further discussion of the changes in the components of total revenue is included in the sections below. We have limited visibility to forecast revenue for 2006 and therefore we are unable to quantify future overall trends in our total revenue. However, in the sections below we discuss expected trends in the individual components of our total revenue and in our product revenue mix.

Customers outside of the United States accounted for 41.8%, 15.8% and 24.0% of our total revenue in the years ended December 31, 2005, 2004 and 2003, respectively. The variations in the mix of revenue generated in the United States as compared to the revenue generated outside of the United States is partially due to the small number of deals closed in these periods, as each individual deal had a greater impact on the composition of our revenue and the significant variability in the value of these deals.

F-Secure accounted for approximately 25% and Pfizer accounted for approximately 15% of our total revenue in 2005. CABC/Ignite accounted for approximately 16% of our revenue in 2004. Hewlett-Packard accounted for approximately 15% of our revenue in 2003. We expect that a small number of customers will continue to account for a substantial portion of our total revenue for the foreseeable future and revenue from one or more of these customers may represent more than 10% of our total revenue in future years.

License Revenue

	December 31,						
		Change			Change		
	2005	$	%	2004	$	%	2003
	(In thousands, except percentages)						
License revenue	$ 3,312	$ 1,719	107.9%	$ 1,593	$ (1,639)	(50.7)%	$ 3,232
As a percentage of total revenue	47.9%			29.0%			49.7%

License revenue increased significantly in 2005 as compared to 2004, primarily due to a license sale of our older Polite Sync Server product to F-Secure in the fourth quarter of 2004, of which $1.4 million was recognized during 2005. This recognition coupled with an increase in our core OAS product license sales led to the increase in license revenue. License revenue decreased significantly in 2004 as compared to 2003 primarily due to a $1.6 million decrease in license revenue generated from our OAS product offering. We released the OAS product at the end of 2002, and the demand that had been generated prior to its release led to increased license revenues in the first half of 2003. These revenues gradually decreased towards the end of 2003, a trend that continued into 2004. These decreases were partially offset by an $800,000 license of our source code to an existing customer in the first quarter of 2004 recognized ratably throughout 2004.

During 2006 we expect license revenue from our OAS product offering to increase in absolute dollars. We expect to continue to generate license revenue from our older products, in particular the BackWeb Polite Sync Server product, but we expect this to continue to decrease as a percentage of overall license revenue.

Service Revenue

	December 31,						
		Change			Change		
	2005	$	%	2004	$	%	2003
	(In thousands, except percentages)						
Service revenue	$ 3,599	$ (307)	(7.9)%	$ 3,906	$ 634	19.4%	$ 3,270
As a percentage of total revenue	71.0%			71.0%			50.3%

Service revenue consists of maintenance, consulting and training services. In general, we experience an increase in consulting revenues in the quarters following license sales, and the vast majority of consulting revenue was related to the deployments of our OAS product. The decrease in services revenue in 2005 as compared to 2004 was primarily related to the decrease in license sales in 2004. The increase in service revenue in 2004 was primarily attributable to the consulting revenue generated from the increased license sales during 2003. Maintenance revenue in 2005 compared to 2004 and in 2004 compared to 2003 was relatively flat, as maintenance contracts related to new product sales replaced cancelled maintenance contracts related to our older product lines.

During 2006, we expect service revenue to increase slightly as compared to 2005. We expect that maintenance revenue associated with our older products will continue to decrease, offset by an increase in maintenance revenue associated with our OAS product offering. Any increase in maintenance revenue from our OAS product offering,

however, is dependent upon an absolute dollar level increase in license revenue from that product, which cannot be assured. Further, while we expect consulting revenue to increase slightly as compared with the prior year, this too is dependent on increased licenses of our OAS product offering.

Cost of Revenue

	December 31,						
		Change			Change		
	2005	$	%	2004	$	%	2003
	(In thousands, except percentages)						
Cost of revenue	$ 735	$ (507)	(40.8)%	$ 1,242	$ 57	4.8%	$ 1,185
As a percentage of total revenue	10.6%		12.0%	22.6%		4.4%	18.2%

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Cost of revenue decreased as a percentage of revenue during 2005 as compared to 2004 primarily due to higher professional services costs in 2004, including the use of more senior consultants on our professional services engagements, which has a higher cost of revenue than license revenue. Cost of revenue remained relatively flat in 2004 as compared to 2003 both in absolute dollars and as a percentage of total revenue, reflecting the cost reductions we implemented in prior years. In the sections below we discuss expected trends in the individual components of our cost of revenue.

Cost of License Revenue

Cost of license revenue consists primarily of expenses related to media duplication, packaging of products, and royalty payables to OEM vendors.

	December 31,						
		Change			Change		
	2005	$	%	2004	$	%	2003
	(In thousands, except percentages)						
Cost of license revenue	$ 51	$ (21)	(29.2)%	$ 72	$ (56)	(43.8)%	$ 128
As a percentage of license revenue	1.5%		(5.0)%	6.5%		2.5%	4.0%
As a percentage of total revenue	0.7%		(0.6)%	1.3%		(0.7)%	2.0%

Cost of license revenue decreased in absolute dollars in 2005 as compared to 2004 due to our conscious effort to reduce the use of costly external consultants to produce artwork, technical writing and other cost of license revenue during 2005. Cost of license revenue decreased in absolute dollars in 2004 as compared to 2003 due to a decrease in the amount of media duplication required to distribute our products as well as a decrease in license revenue.

During 2006, we expect our cost of license revenue as a percentage of license revenue to remain at approximately the same levels as 2005.

Cost of Service Revenue

Cost of service revenue consists primarily of personnel and overhead related expenses of our customer support and professional service organizations, including related expenses of BackWeb consultants, third party consultants, and contractors.

	December 31,						
		Change			Change		
	2005	$	%	2004	$	%	2003
	(In thousands, except percentages)						
Cost of service revenue	$ 684	$ (486)	(41.5)%	$ 1,170	$ 113	10.7%	$ 1,057
As a percentage of service revenue	19.0%		(11.0)%	30.0%		(2.3)%	32.3%
As a percentage of total revenue	9.9%		(11.4)%	21.3%		5.0%	16.3%

Cost of service revenue decreased during 2005 as compared to 2004 due primarily to a reduction in costs within the services organization through reductions in services personnel. The increase in absolute dollars of cost of service revenue in 2004 as compared to 2003 was primarily due to the increase in consulting services revenue, and the use of more senior consultants on our professional services engagements in 2004, which increased the related cost of delivering the service revenue. These increases were partially offset by a reduced level of payroll and related expenses together with a reduction in the associated overhead expenses that resulted from the reorganizations that occurred in October 2004, October 2002 and July 2001, and continuing cost containment and reduction programs applied throughout 2003 and 2004. The decrease in cost of service revenue as a percentage of service revenue in all periods presented was primarily a result of a reduction in infrastructure and overhead expenses associated with both our support and professional services departments, primarily stemming from the reorganizations in 2004 and 2002.

We expect cost of service revenue to increase marginally and remain relatively constant as a percentage of service revenue during 2006.

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Operating Expenses

Research and Development

Research and development expenses consist of personnel, equipment and supply costs for our development efforts. We charge these expenses to operations as they are incurred. Our research and development facilities are located in Israel.

	December 31,						
		Change			Change		
	2005	$	%	2004	$	%	2003
	(In thousands, except percentages)						
Research and development	$ 2,178	$ (1,120)	(34.0)%	$ 3,298	$ (1,189)	(26.5)%	$ 4,487
As a percentage of total revenue	31.5%		(28.4)%	59.9%		(9.1)%	69.0%

The decrease in research and development expenses during 2005 as compared to 2004 was primarily related to realizing the full effects of the personnel reductions in 2004. Personnel and related costs decreased approximately $824,000 in 2005 as compared to 2004. The decrease in research and development expenses during 2004 was primarily due to lower personnel and third party contractor costs and a reduction in associated travel and other related expenses. During 2004, we reduced our headcount across all departments, including a reduction of full-time employees in the research and development department from 30 in 2003 to 17 in 2004.

We believe that continued investment in research and development is important in order to attain our strategic objectives. However, we intend to continually monitor expenses across the organization and continually strive for cost reductions in areas such as facilities, travel and entertainment, and telecommunications expenses. As a result, we expect that research and development expenses will remain relatively consistent with 2005 levels during 2006.

Sales and Marketing

Sales and marketing expenses consist of personnel and related costs for our direct sales force and our product management, marketing, business development, and operations management employees, together with the costs of marketing programs, including trade shows and other related direct expenses and general overhead.

	December 31,						
		Change			Change		
	2005	$	%	2004	$	%	2003
	(In thousands, except percentages)						
Sales and marketing	$ 3,452	$ (619)	(15.2)%	$ 4,071	$ (2,201)	(35.1)%	$ 6,272
As a percentage of total revenue	50.0%		(24.0)%	74.0%		(22.5)%	96.5%

The decrease in sales and marketing expenses during 2005 as compared to 2004 was primarily related to realizing the full effects of the personnel reductions in 2004, partially offset by increases in the use of outside services and other

consulting costs. Personnel and related costs decreased approximately $900,000 in 2005 as compared to 2004, while outside services and other consulting costs increased approximately $200,000 for the same period. The decrease in sales and marketing expenses during 2004 as compared to 2003 resulted primarily from further reductions in personnel related costs and facilities expenses. Personnel related costs decreased $1.0 million as compared to 2003. Reductions in travel and entertainment expenses resulted in a savings in 2004 of approximately $300,000.

We consider maintaining a marketing presence and an effective sales organization to be vital to the achievement of our strategic objectives. Though we intend to continually monitor expenses across the organization and continually strive for cost reductions, we expect to selectively increase our sales organization when and where appropriate. We expect sales and marketing expenses will remain relatively consistent with the levels in 2005 during 2006.

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General and Administrative

General and administrative expenses consist primarily of personnel and related costs and outside services for general corporate functions, including finance, accounting, general management, human resources, information services, and legal, as well as the provision for bad debts.

	December 31,						
		Change			Change		
	2005	$	%	2004	$	%	2003
	(In thousands, except percentages)						
General and administrative	$ 1,787	$ (171)	(8.7)%	$ 1,958	$ (1,981)	(50.3)%	$ 3,939
As a percentage of total revenue	25.9%		(9.7)%	35.6%		(25.0)%	60.6%

During 2005 as compared to 2004, the decrease in general and administrative expenses was primarily due to realizing the full effect of the reduction in accounting and legal personnel in the reorganization we implemented in October 2004, partially offset by an increase in accounting and legal service fees from outside service providers. Personnel and related costs decreased approximately $1.3 million in 2005 as compared to 2004, while accounting and legal service fees increased approximately $600,000 for the same period. The increase in the accounting and legal service expense is primarily related to an accrual of an unfavorable judgment we received with respect to French subsidiary. During 2004 as compared to 2003, the decrease in general and administrative expenses was primarily due to a reduction in accounting and legal services, insurance costs and facilities expenses due in large part to the reorganization we implemented in October 2002. The reduction in accounting, legal and other outside service expenses was approximately $2.3 million in 2004 as compared to 2003 primarily due to a change in our external accounting firm, a concerted effort to reduce legal expenses, and the discontinuation of the use of certain external consultants. In addition, the restructuring and renegotiation of our insurance programs, particularly the rates related to our directors and officers insurance, resulted in savings in 2004 of approximately $400,000 as compared to 2003. These reductions were offset in part by an increase in expenses related to facilities and bad debt expense.

We expect general and administrative expenses will remain relatively consistent with the levels in 2005 during 2006.

Restructuring Charges

	December 31,						
		Change			Change		
	2005	$	%	2004	$	%	2003
	(In thousands, except percentages)						
Restructuring and other charges	$ (105)	$ (574)	(122.4)%	$ 469	$ 26	5.9%	$ 443
As a percentage of total revenue	(1.5)%		(10.0)%	8.5%		1.7%	6.8%

In November 2003, we accrued a charge of approximately $443,000, of which approximately $289,000 related to the impairment of leased facilities in Canada, $120,000 related to a charge for settlement of leased space in San Jose, California, and approximately $34,000 related to other office lease impairment charges. During the fourth quarter of 2004, we recorded a charge of approximately $469,000 related to the termination of 19 employees throughout

BackWeb, including our Chief Executive Officer and Chief Financial Officer. All amounts related to this action were expensed in 2004, and at December 31, 2005, all amounts related to severance and other payments had been distributed or reversed. For further information related to this restructuring, see Note 8 of the Notes to the Consolidated Financial Statements.

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Interest and Other Income, Net

Interest and other income, net includes interest income earned on our cash, cash equivalents and short-term investments, offset by interest expense and the effects of exchange gains and losses arising from the re-measurement of transactions in foreign currencies.

	December 31,						
		Change			Change		
	2005	$	%	2004	$	%	2003
	(In thousands, except percentages)						
Interest and other income, net	$ 103	$ (293)	74.0%	$ 396	$ 298	304%	$ 98
As a percentage of total revenue	1.5%		(5.7)%	7.2%		5.5%	1.7%

The decrease in interest and other income, net during 2005 as compared to 2004 was due to the decrease in our cash, cash equivalents and short-term investments due to our operating losses and reduced interest rates. The increase in interest and other income, net during 2004 as compared to 2003 was primarily due to an accrual reversal of $270,000 related to a provision for foreign taxes not expected to be remitted as of December 31, 2004. We expect interest and other income, net to continue to decrease slightly during 2006 as we anticipate we will continue to use cash during 2006 and, as a result, we expect to earn less investment and interest income.

Write-Down of Equity Investments

	December 31,						
		Change			Change		
	2005	$	%	2004	$	%	2003
	(In thousands, except percentages)						
Write-down of equity investments	$	$	%	$	$ (1,000)	(100)%	$ 1,000
As a percentage of total revenue	%		%	%		(15.4)%	15.4%

In 2000, we invested in certain development-stage companies operating Internet-centric businesses which we believed had a significant strategic interest. Due to the economic slowdown and the significant decline in capital available to, and in the valuations of, the privately funded Internet-centric businesses, management determined that one of our investments had become impaired. Accordingly, in 2001, we recorded a charge of $2.5 million to reflect impairment of this asset below its recorded cost to represent what management considered to be fair value. No impairment charge was recorded during the year ended December 31, 2002. During September 2003, we determined our one remaining investment was fully impaired primarily due to continuing difficulties in the economy, and recorded a charge for the full remaining carrying value of that investment, or $1.0 million.

Income Taxes

There is no provision for income taxes because we have incurred operating losses since our inception. As of December 31, 2005, we had approximately $102.0 million of Israeli net operating loss carry forwards and $6.3 million and $2.2 million of U.S. federal and state net operating losses carry forwards, respectively, available to offset future taxable income. The U.S. federal and state net operating loss carry forwards expire in varying amounts between the years 2007 and 2025. The Israeli net operating loss carry forwards have no expiration date.

Off-Balance Sheet Financings and Liabilities

Off-Balance Sheet Arrangement. We provide indemnifications of varying scope and size to certain customers against claims of intellectual property infringement made by third parties arising from the use of our products. Management evaluates estimated losses for such indemnifications under SFAS No. 5, Accounting for Contingencies, as interpreted by FASB Interpretation No. 45, Guarantor s Accounting and Disclosure Requirements for Guarantees. Management considers such factors as the degree of probability of an unfavorable outcome and the ability to make a reasonable estimate of the amount of the loss. As of December 31, 2005, we had not encountered material costs as a result of such obligations and had not accrued any liabilities related to such indemnifications in our consolidated financial statements.

Liquidity and Capital Resources

As of December 31, 2005, we had $7.8 million of cash, cash equivalents and short-term investments as compared to $10.3 million as of December 31, 2004.

Net cash used in operating activities was $2.4 million and $4.4 million for the years ended December 31, 2005 and 2004, respectively, and was primarily used to fund our ongoing operational needs. The decrease in cash used in operating activities reflects the restructurings that we implemented in 2004, which resulted in significant headcount and other operational cost reductions throughout 2004 and 2005, as well as an increase in total revenues. Cash used by investment activities was $1.4 million for the year ended December 31 2005, which primarily reflects the amount of cash transferred to our investment account from operations during the year. Cash provided by investing activities was $5.5 million for the year ended December 31, 2004 and primarily represents the net proceeds from the purchases and sales of short-term investments to fund operational needs. Cash provided by financing activities was $136,000 and $121,000 for the years ended December 31, 2005 and 2004, respectively, and consisted primarily of proceeds from the issuance of Ordinary Shares under our employee stock purchase plan and issuances related to the exercise of stock options.

In May 2004, we entered into a $1.5 million line of credit with Silicon Valley Bank. The amount of borrowings available under the line of credit is based on a formula using accounts receivable. The line of credit has a stated maturity date of January 31, 2007 and provides that the lender may demand payment in full of the entire outstanding balance of the loan at any time. The line of credit is secured by substantially all of our assets. The line requires that we meet certain financial covenants, provides payment penalties for noncompliance and prepayment, limits the amount of other debt we can incur, and limits the amount of spending on fixed assets. During the third quarter of 2004, we moved the $500,000 deposit related to our lease space in San Jose, California under the line of credit. In June 2005, we amended the line of credit down from a borrowing capacity of $1.5 million to $500,000. At December 31, 2005, we had no unused borrowing capacity. We do not expect to renew this line of credit beyond the maturity date as it is primarily used to support the lease deposit commitment and has the same expiration date as the building lease it supports. We also do not intend to extend the credit facility nor draw further upon it. At the termination of the underlying office lease, we expect the lease deposit of the same space or a new space to be substantially reduced to reflect the current market rates for our lease space requirements. We expect to provide for the revised lease deposit with cash security.

As of December 31, 2005, we had no material commitments for capital expenditures. Our capital requirements depend on numerous factors, including market acceptance of our products, the resources we devote to developing, marketing, selling and supporting our products and the timing and extent of establishing additional operations. As a result of the restructuring we implemented in October 2004, we believe that our current cash, cash equivalents, and short term investment balances will be sufficient to fund our operations for at least the next 12 months. However, we might need to raise additional funds prior to the expiration of this period to fund expansion, product development, acquisitions or working capital. This need may arise sooner than we anticipate if our revenue does not grow in line with our expectations, particularly revenue from licensing our OAS product, if our costs are higher than we expect or if we change our strategic plans. If we were required to raise additional funds, it could be difficult to obtain additional financing on favorable terms, or at all, due to our financial condition. We may try to obtain additional financing by issuing Ordinary Shares or convertible debt securities, which would dilute our existing shareholders. If we cannot raise needed funds on acceptable terms, or at all, we may not be able to develop or enhance our products, respond to competitive pressures or grow our business, or we may be required to further reduce our expenditures, any of which could harm our business.

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Contractual Obligations

The following table summarizes our contractual obligations at December 31, 2005, and the effect such obligations are expected to have on our liquidity and cash flows in future periods (in thousands). We did not have long-term debt obligations, capital lease obligations, or purchase obligations as of such date.

	Payments Due by Period				
	Total	Less Than 1 Year	1-3 Years	3-5 Years	After 5 Years
Operating lease obligations	$ 908	$ 844	$ 64	$	$

Effective Corporate Tax Rates

Our tax rate reflects a mix of the U.S. statutory tax rate on our U.S. income, European country tax rates on our individual European country income and the Israeli tax rate discussed below. We expect that most of our future taxable income will be generated in Israel. Israeli companies were generally subject to corporate tax at the rate of 34% of their taxable income in 2005. Pursuant to tax reform legislation that came into effect in 2003, the corporate tax rate is to undergo further staged reductions to 25% by the year 2010. In order to implement these reductions, the corporate tax rate is scheduled to decline to 31% in 2006, 29% in 2007, 27% in 2008, and 26% in 2009. However, the rate is effectively reduced for income derived from an Approved Enterprise. The majority of our income is derived from our capital investment program with Approved Enterprise status under the Law for the Encouragement of Capital Investments, and is eligible therefore for tax benefits. As a result of these benefits, we expect to have a tax exemption on income derived during the first two years in which this investment program produces taxable income, provided that we do not distribute such income as a dividend, and a reduced tax rate of 10% to 25% for the following 5 to 8 years, depending upon the proportion of foreign ownership of BackWeb.

On April 1, 2005, an amendment to the Law for the Encouragement of Capital Investments in Israel came into effect, which revised the criteria for investments qualified to receive tax benefits. An eligible investment program under the amendment will qualify for benefits as a Privileged Enterprise (rather than the previous terminology of Approved Enterprise). Among other things, the amendment provides tax benefits to both local and foreign investors and simplifies the approval process. The amendment does not apply to investment programs approved prior to December 31, 2004. The new tax regime will apply to new investment programs only.

As a result of the amendment, tax-exempt income generated under the provisions of the new law will subject us to taxes upon distribution or liquidation and we may be required to record deferred tax liability with respect to such tax-exempt income. We are currently evaluating the impact the amendment will have on us. Based on our preliminary analysis, it will not adversely affect our 2006 financial statements.

All of these tax benefits are subject to various conditions and restrictions. See Note 12 Income Taxes Israeli Income Taxes Tax Benefits under the Law for the Encouragement of Capital Investments, 1959, of Notes to the Consolidated Financial Statements elsewhere in this report. We cannot assure you that we will obtain approval for additional Approved Enterprise Programs, or that the provisions of the law will not change.

Since we have incurred tax losses through December 31, 2005, we have not yet used the tax benefits for which we are eligible. See Risk Factors Any future profitability may be diminished if tax benefits from the State of Israel are reduced or withheld.

Impact of Inflation and Currency Fluctuations

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

exchange rate to the major European currencies due to the fact that we do business in Europe. To date these fluctuations have not been material.

Recently Issued Accounting Pronouncements

In July 2005, the FASB issued an Exposure Draft of a proposed interpretation, Accounting for Uncertain Tax Positions an interpretation of FASB Statement No. 109. This proposal seeks to reduce the diversity in practice associated with certain aspects of the recognition and measurement requirements related to accounting for income taxes. Specifically, the interpretation requires that an enterprise recognize in its financial statements, the best estimate of the impact of a tax position only if that position is probable of being sustained on audit based solely on the technical merits of the position. In evaluating whether the probable recognition threshold has been met, this proposed interpretation would require the presumption that the tax position will be evaluated during an audit by taxing authorities. The Exposure Draft is scheduled to be finalized in the first quarter of calendar year 2006. We are currently reviewing the provisions in the Exposure Draft to determine the impact to our consolidated financial statements.

In November 2005, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) Nos. FAS 115-1 and FAS 124-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments. This FSP addresses the determination as to when an investment is considered impaired, whether that impairment is other than temporary, and the measurement of an impairment loss. This FSP also includes accounting considerations subsequent to the recognition of other-than-temporary impairments. The guidance in this FSP will be applied to reporting periods beginning after December 15, 2005. The adoption of this FSP is not expected to have a significant impact on our financial position and results of operations.

In June 2005, the Emerging Issues Task Force (EITF) issued No. 05-06, Determining the Amortization Period for Leasehold Improvements (EITF 05-6). The pronouncement requires that leasehold improvements acquired in a business combination or purchase, subsequent to the inception of the lease, be amortized over the lesser of the useful life of the asset or the lease term that includes reasonably assured lease renewals as determined on the date of the acquisition of the leasehold improvement. This pronouncement is effective for leasehold improvements that are purchased or acquired in reporting periods beginning after June 29, 2005. The adoption of EITF 05-6 has not had a significant impact on our financial position and results of operations.

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections (SFAS 154). This new standard replaces APB Opinion No. 20, Accounting Changes in Interim Financial Statements , and SFAS No. 3, Reporting Accounting Changes in Interim Financial Statements , and represents another step in the FASB s goal to converge its standards with those issued by the International Accounting Standards Board (IASB). Among other changes, SFAS 154 requires retrospective application to prior periods financial statements of a voluntary change in accounting principle unless it is impracticable. SFAS 154 also provides that (1) a change in method of depreciating or amortizing a long-lived nonfinancial asset be accounted for as a change in estimate (prospectively) that was effected by a change in accounting principle, and (2) correction of errors in previously issued financial statements should be termed a restatement. The new standard is effective for accounting changes and correction of errors made in fiscal years beginning after December 15, 2005. Early adoption of this standard is permitted for accounting changes and correction of errors made in fiscal years beginning after June 1, 2005. Management does not expect the adoption of SFAS 154 to have a material effect on our consolidated financial statements.

In March 2005, the SEC released SEC Staff Accounting Bulletin No. 107 (SAB 107). SAB 107 provides the SEC staff position regarding the application of SFAS 123R Share-Based Payment. SAB 107 contains interpretive guidance relating to the interaction between SFAS 123R and certain SEC rules and regulations, as well as the SEC staff s views regarding the valuation of share-based payment arrangements for public companies. SAB 107 also highlights the importance of disclosures made related to the accounting for share-based payment transactions. We are currently

evaluating SAB 107 and will be incorporating it as part of our adoption of SFAS 123R in the first quarter of 2006.

In December 2004, the FASB issued SFAS No. 123R, Share-Based Payment, a revision of SFAS No. 123, Accounting for Stock-Based Compensation which supersedes APB Opinion No. 25, Accounting for Stock

Issued to Employees.   SFAS No. 123R requires us to expense grants made under our stock option program. That cost will be recognized over the vesting period of the plans. SFAS No. 123R is effective for interim periods beginning after June 15, 2005. Upon adoption of SFAS No. 123R, amounts previously disclosed under SFAS No. 123 will be recorded in our statements of operations. We are evaluating the alternatives allowed under the standard, which we are required to adopt effective for our first quarter of fiscal 2006. We expect the adoption of SFAS No. 123 to have a material effect on our financial position or results of operations.

In December 2004, the FASB issued Staff Position SFAS No. 109-1, *Application of FASB Statement No. 109, Accounting for Income Taxes* (FSP No. 109-1) to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004 which was signed into law by the President of the United States on October 22, 2004. Companies that qualify for the recent tax law s deduction for domestic production activities must account for it as a special deduction under SFAS No. 109 and reduce their tax expense in the period or periods the amounts are deductible, according to FSP No. 109-1, effective for us in its fiscal year 2006. The FASB s guidance is not expected to have a material impact to our financial results.

In December 2004, the FASB also issued Staff Position SFAS No. 109-2, *Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision* (FSP No. 109-2) within the American Jobs Creation Act of 2004. The Act provides for a one-time deduction of 85 percent of certain foreign earnings that are repatriated in either an enterprise s last tax year that began before the date of enactment, or the first tax year that begins during the one-year period beginning on the date of enactment. FSP No. 109-2 allows companies additional time to evaluate whether foreign earnings will be repatriated under the repatriation provisions of the new tax law and requires specified disclosures for companies needing the additional time to complete the evaluation. We are currently evaluating the repatriation provisions of the Act and shall complete its evaluation once guidance has been issued by the Treasury Department on the repatriation provision, which is expected sometime in 2006.

In December 2003, the Financial Accounting Standards Board (FASB) issued a proposed amendment to Statement of Financial Accounting Standards (SFAS) 128, *Earnings per Share*, to make it consistent with International Accounting Standard 33, *Earnings per Share*, so as to make earnings per share computations comparable on a global basis. As currently drafted, the amendment would require companies to use the year-to-date average stock price to compute the number of treasury shares that could theoretically be purchased with the proceeds from exercise of share contracts such as options or warrants. The current method of calculating earnings per share requires companies to calculate an average of the potential incremental common shares computed for each quarter when computing year-to-date incremental shares. The proposed amendment would also change other aspects of SFAS 128 that would not impact the Company s earnings per share calculations. The proposed amendment is currently expected to be effective for interim and annual periods ending after June 15, 2006 and, once effective, will require retrospective application for all prior periods presented. If the proposed amendment is finalized in its current form (including the proposed effective date), its adoption is not expected to have a material impact on our financial condition or results of operations.

Item 7A. ***Quantitative and Qualitative Disclosures About Market Risk***

We develop products in Israel and sell them in the U.S., Canada, Europe and Israel. As a result, our financial results could be affected by factors such as changes in foreign currency exchange rates or weak economic conditions in foreign markets. As most of our sales are currently made in U.S. dollars, a strengthening of the dollar could make our products less competitive in foreign markets. Our interest income is sensitive to changes in the general level of U.S. interest rates, particularly since the majority of our investments are in short-term instruments. We regularly assess these risks and have established policies and business practices to protect against the adverse effects of these and other potential exposures. As a result, we do not anticipate material losses in these areas. Due to the nature of our short-term investments, we have concluded that there is no material market risk exposure.

Item 8. ***Financial Statements and Supplementary Data***

The following are summaries of consolidated quarterly financial data for the years ended December 31, 2005 and 2004:

	First Qtr	Second Qtr	Third Qtr	Fourth Qtr
	Unaudited (In thousands, except per share data)			
2005				
Total revenue	$ 1,657	$ 1,718	$ 1,782	$ 1,754
Gross profit	1,493	1,518	1,585	1,580
Net loss	(249)	(233)	(208)	(343)
Basic and diluted net loss per share	(0.01)	(0.01)	(0.01)	(0.01)
2004				
Total revenue	$ 1,638	$ 1,147	$ 1,181	$ 1,533
Gross profit	1,221	910	822	1,304
Net loss	(1,371)	(1,323)	(1,537)	(912)
Basic and diluted net loss per share	(0.03)	(0.03)	(0.04)	(0.02)

(b) Financial Statements

The following consolidated financial statements and the related notes thereto of BackWeb Technologies Ltd. and the Report of Independent Auditors are filed as a part of this Annual Report on Form 10-K.

Report of Grant Thornton LLP, Independent Registered Public Accounting Firm	41
Report of Ernst & Young LLP, Independent Registered Public Accounting Firm	42
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Report of Independent Registered Public Accounting Firm

To the Board of Directors and
Shareholders of BackWeb Technologies Ltd.

We have audited the accompanying consolidated balance sheets of BackWeb Technologies Ltd. (the Company) and its subsidiaries as of December 31, 2005 and 2004, and the related consolidated statements of operations, shareholders equity and cash flows for each of the years then ended. 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 the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company s internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, 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 financial statements referred to above present fairly, in all material respects, the consolidated financial position of BackWeb Technologies Ltd. and its subsidiaries as of December 31, 2005 and 2004 and the consolidated results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. Schedule II is presented for purposes of additional analysis and is not a required part of the basic financial statements. This schedule has been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

/s/ GRANT THORNTON LLP

San Jose, CA
March 6, 2006

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Report of Independent Registered Public Accounting Firm

To the Shareholders of
BackWeb Technologies Ltd.

We have audited the accompanying consolidated balance sheet of BackWeb Technologies Ltd. (the Company) and its subsidiaries as of December 31, 2003, and the related consolidated statement of operations, shareholders equity and cash flows for the year then ended. Our audit also included the financial statement schedule listed at Item 15(a) 2. These financial statements and schedule are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements and schedule based on our audit.

We conducted our audit 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. We were not engaged to perform an audit of the Company s internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company s internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audit provides 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 BackWeb Technologies Ltd. and its subsidiaries as of December 31, 2003 and the consolidated results of their operations and cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, present fairly in all material respects the information set forth therein.

/s/ ERNST & YOUNG LLP

Palo Alto, CA
January 27, 2004

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BACKWEB TECHNOLOGIES LTD.

CONSOLIDATED BALANCE SHEETS

	December 31, 2005	December 31, 2004
	(In thousands, except share and per share data)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 1,583	$ 5,213
Short-term investments	6,293	5,107
Trade accounts receivable, net of allowance for doubtful accounts of $279 and $643 at December 31, 2005 and 2004, respectively	1,554	1,677
Other accounts receivable and prepaid expenses	325	378
Total current assets	9,755	12,375
Long-term investments and other long term assets	35	26
Property and equipment, net	213	154
Total assets	$ 10,003	$ 12,555
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 247	$ 175
Accrued liabilities	1,731	1,625
Deferred revenue	976	2,672
Total current liabilities	2,954	4,472
Accrued severance pay, net		85
Long-term deferred revenue	8	60
Commitments and contingencies		
Shareholders equity:		
Preferred Shares, nominal value NIS 0.01 per share; 50,000,000 shares authorized and zero outstanding at December 31, 2005 and December 31, 2004, Series E Preferred Shares, nominal value NIS 0.01 per share; zero and one share authorized and issued and outstanding at December 31, 2005 and December 31, 2004, respectively		
Ordinary Shares, nominal value NIS 0.03 per share; 150,067,829 shares authorized at December 31, 2005 and 2004; 41,140,813 and 40,832,116 shares issued and outstanding at December 31, 2005 and 2004, respectively	151,763	151,644
Accumulated other comprehensive loss	(2)	(19)
Accumulated deficit	(144,720)	(143,687)
Total shareholders equity	7,041	7,938

Total liabilities and shareholders equity	$	10,003	$	12,555

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

BACKWEB TECHNOLOGIES LTD.

CONSOLIDATED STATEMENTS OF OPERATIONS

	Year Ended December 31,		
	2005	2004	2003
	(In thousands, except per share data)		
Revenue:			
License	$ 3,312	$ 1,593	$ 3,232
Service	3,599	3,906	3,270
Total revenue	6,911	5,499	6,502
Cost of revenue:			
License	51	72	128
Service	684	1,170	1,057
Total cost of revenue	735	1,242	1,185
Gross profit	6,176	4,257	5,317
Operating expenses:			
Research and development	2,178	3,298	4,487
Sales and marketing	3,452	4,071	6,272
General and administrative	1,787	1,958	3,939
Restructuring and other charges	(105)	469	443
Total operating expenses	7,312	9,796	15,141
Loss from operations	(1,136)	(5,539)	(9,824)
Interest and other income, net	103	396	98
Write down of equity investments			(1,000)
Net loss	$ (1,033)	$ (5,143)	$ (10,726)
Basic and diluted net loss per share	$ (0.03)	$ (0.13)	$ (0.27)
Weighted average number of shares used in computing basic and diluted net loss per share	41,011	40,711	40,000

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

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BACKWEB TECHNOLOGIES LTD.

CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

	Series E Preferred Shares		Ordinary Shares		Shareholders Equity				
					Notes Receivable from Shareholders	Accumulated Other Comprehensive Income/(Loss)	Accumulated Deficit	Comprehensive Income/(Loss)	Total Shareholders Equity
	Shares	Amount	Shares	Amount					
	(In thousands, except share data)								
Balance at December 31, 2002			39,772,254	150,867	(506)	(22)	(127,818)		22,521
Issuance of Ordinary Shares pursuant to options exercised, ESPP purchases and exchange of Series E preferred shares, net			787,928	629					629
Repayment of notes receivable from shareholders					506				506
Comprehensive loss:									
Net loss							(10,726)	(10,726)	(10,726)
Unrealized income on available for sale marketable securities						31		31	31
Total comprehensive loss								$ (10,695)	
Balance at December 31, 2003		$	40,560,182	$ 151,496	$	$ 9	$ (138,544)		$ 12,961
Issuance of Ordinary Shares pursuant to options exercised, ESPP purchases and exchange of Series E preferred shares, net			271,934	148					148
Comprehensive loss:									
Net loss							(5,143)	(5,143)	(5,143)
Unrealized income on available for sale marketable securities						(28)		(28)	(28)
								$ (5,171)	

Total comprehensive loss							
Balance at December 31, 2004	$ 40,832,116	$ 151,644	$	$ (19)	$ (143,687)		$ 7,938
Issuance of Ordinary Shares pursuant to options exercised, ESPP purchases and exchange of Series E preferred shares, net	308,697	119					119
Comprehensive loss:							
Net loss					(1,033)	(1,033)	(1,033)
Unrealized income on available for sale marketable securities				17		17	17
Total comprehensive loss						(1,016)	
Balance at December 31, 2005	$ 41,140,813	$ 151,763	$	$ (2)	$ (144,720)		$ 7,041

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

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BACKWEB TECHNOLOGIES LTD.

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year Ended December 31,		
	2005	2004	2003
	(In thousands)		
Operating activities			
Net loss	$ (1,033)	$ (5,143)	$ (10,726)
Adjustments to reconcile net loss to net cash used in operating activities:			
Provision for bad and doubtful debts			104
Depreciation	140	252	878
Gain on disposal of property and equipment		(260)	
Write down of an equity investment			1,000
Changes in operating assets and liabilities:			
Trade accounts receivable	123	726	(848)
Other accounts receivable, prepaid expenses and other long-term assets	44	950	556
Accounts payable and accrued liabilities	93	(2,439)	(1,130)
Deferred revenue	(1,748)	1,501	(204)
Net cash used in operating activities	(2,381)	(4,413)	(10,370)
Investing activities			
Purchases of property and equipment	(199)	(105)	(96)
Proceeds from disposals of property and equipment		260	
Purchases of short-term investments	(1,186)		
Proceeds from sales of short-term investments		5,324	8,575
Net cash provided by (used in) investing activities	(1,385)	5,479	8,479
Financing activities			
Proceeds from repayment of shareholders notes receivable			506
Proceeds from issuance of Ordinary Shares pursuant to options exercised and ESPP purchases	136	121	629
Net cash provided by financing activities	136	121	1,135
Net increase (decrease) in cash and cash equivalents	(3,630)	1,187	(756)
Cash and cash equivalents at beginning of the year	5,213	4,026	4,782
Cash and cash equivalents at end of the year	$ 1,583	$ 5,213	$ 4,026
Supplemental disclosure of non-cash investing and financing transactions			
Taxes paid	$ 16	$ 59	$ 78

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

BACKWEB TECHNOLOGIES LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Organization and Basis of Presentation

BackWeb Technologies Ltd. was incorporated under the laws of Israel in August 1995 and commenced operations in November 1995. BackWeb Technologies Ltd. and its subsidiaries (collectively, BackWeb, or the Company) is a provider of offline Web infrastructure and application-specific software that enables companies to extend the reach of their Web assets to the mobile community of their customers, partners and employees. The Company s products address the need of mobile users who are disconnected from a network to access and transact with critical enterprise Web content, such as sales tools, forecast management, contact lists, service repair guides, expense report updates, pricing data, time sheets, collaboration sessions, work orders and other essential document and applications offline. The Company s products are designed to reduce network costs and improve the productivity of increasingly mobile workforces. The Company sells its products primarily to end users from a variety of industries, including the telecommunications, financial and computer industries, through its direct sales force, resellers, OEMs and sales/marketing partners.

The BackWeb group of companies consists of wholly owned subsidiaries operating as follows: BackWeb Technologies, Inc., a U.S. corporation; BackWeb Canada, Inc., a Canadian corporation; BackWeb Technologies GmbH, a German corporation; and BackWeb Technologies Europe Limited, a United Kingdom corporation.

Other subsidiaries ceased commercial operations in January 2002 but continue to be wholly owned subsidiaries. These subsidiaries are registered as BackWeb Technologies (U.K.) Ltd., a United Kingdom corporation, and BackWeb Technologies S.a.r.l., a French corporation. Other subsidiaries ceased commercial operations in September 2001 and were formally dissolved during 2004. These subsidiaries are registered as BackWeb Technologies B.V., a Netherlands corporation, BackWeb Technologies A.B., a Swedish corporation, and BackWeb K.K. Ltd., a Japanese corporation.

The Company believes that its existing cash balances and anticipated cash flows from operations will be sufficient to meet its anticipated capital requirements for the next 12 months. If the Company has a need for additional capital resources, it may be required to sell additional equity or debt securities, secure additional lines of credit or obtain other third party financing. The timing and amount of such capital requirements cannot be determined at this time and will depend on a number of factors, including demand for the Company s existing and new products, if any, and changes in technology in the software industry. There can be no assurance that such additional financing will be available on satisfactory terms when needed, if at all. Failure to raise such additional financing, if needed, may result in the Company not being able to achieve its long-term business objectives.

The consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles.

2. Summary of Significant Accounting Policies

The significant accounting policies followed in the preparation of the consolidated financial statements, applied on a consistent basis, are:

Use of Estimates

The preparation of consolidated financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial

statements and accompanying notes. Estimates are based on historical experience, input from sources outside of the Company, and other relevant facts and circumstances. Actual results could differ from these estimates.

BACKWEB TECHNOLOGIES LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Financial Statements in U.S. Dollars

The Company prepares its financial statements in U.S. dollars, which is also its functional currency. Most of the revenue generated is in U.S. dollars. A significant portion of the Company s research and development expenses is incurred in New Israeli Shekels (NIS). However, most of the expenses are denominated and determined in U.S. dollars. Since the U.S. dollar is the primary currency in the economic environment in which BackWeb conducts its operations, the U.S. dollar is the functional and reporting currency of BackWeb Technologies Ltd. and its subsidiaries.

Monetary accounts maintained in currencies other than the U.S. dollar are re-measured using the foreign exchange rate at the balance sheet date in accordance with Statement of Financial Accounting Standard No. 52, Foreign Currency Translations. Operational accounts and non-monetary balance sheet accounts are measured and recorded in current operations at the rate in effect at the date of the transaction. The foreign currency re-measurement effect included in interest and other income, net for the years ended December 31, 2005, 2004, and 2003 was a loss of $88,549, a gain of $115,892, and a loss of $13,000, respectively.

Principles of Consolidation

The consolidated financial statements include the accounts of BackWeb Technologies Ltd. and its wholly owned subsidiaries. Intercompany balances and transactions have been eliminated in consolidation.

Cash Equivalents

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

Short-Term Investments

The Company accounts for investments in debt and equity securities in accordance with Statement of Financial Accounting Standard No. 115, Accounting for Certain Investments in Debt and Equity Securities.

Management determines the appropriate classification of marketable debt and equity securities at the time of purchase and evaluates such designation as of each balance sheet date. To date, all debt securities have been classified as available-for-sale and are carried at fair market value, based on quoted market prices, with all unrealized gains and losses reported in comprehensive income/loss, a separate component of shareholders equity. Realized gains and losses, declines in value of securities judged to be other than temporary and amortization of premium are included in interest and other income, net. Realized gains and losses and declines in value of securities judged to be other than temporary have not been material. The cost of securities sold is based on the specific identification method.

Long-Term Investments

Investments in non-marketable securities in which the Company holds less than 20% of the capital stock of the entity are recorded at the lower of cost or estimated fair value, since the Company does not have the ability to exercise significant influence over operating and financial policies of the investee.

The Company periodically assesses the recoverability of the carrying amount of long-term investments and provide for any possible impairment loss based upon the difference between the carrying amount and fair value of such assets. During 2003, based on a review of its investments, the Company recorded a non-cash charge of $1.0 million to write-down an equity investment.

BACKWEB TECHNOLOGIES LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Other Long-Term Assets

Other long-term assets are primarily comprised of security deposits related to leased facilities which are recorded at cost.

Property and Equipment, Net

Property and equipment are stated at cost, net of accumulated depreciation. Property and equipment are depreciated on a straight-line basis over the estimated useful lives of the assets, as follows:

	Years
Computer and peripheral equipment	2-3
Office furniture and equipment	3
Leasehold improvements	Over the shorter of term of lease or estimated life

The Company s property and equipment are reviewed for impairment in accordance with Statement of Financial Accounting Standard (SFAS) No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets (SFAS No. 144) whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Impairment of assets to be held and used is assessed by a comparison of the carrying amount of the asset group 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.

Intellectual Property and Other Purchased Intangible Assets

Intellectual property and other purchased intangible assets subject to amortization that arose from acquisitions prior to July 1, 2001 were amortized on a straight-line basis over their useful lives of two to three years in accordance with APB Opinion No. 17 Intangible Assets.

The Company s intellectual property and other purchased intangible assets are reviewed for impairment in accordance with SFAS No. 144 at least annually and whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Impairment of assets to be held and used is assessed by a comparison of the carrying amount of the asset group 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. Based on SFAS No. 144, the Company s intangible assets carrying value of $1.8 million was in excess of its fair value of zero. Therefore, the Company wrote-off the $1.8 million remaining carrying value of the Company s intangibles during the year ended December 31, 2002. As of December 31, 2005, 2004 and 2003, the carrying value of the intellectual property and other purchased intangible assets was zero.

Revenue Recognition

The Company derives revenue primarily from software license fees, maintenance service fees, and consulting services paid directly by corporate customers and resellers and, to a lesser extent, from royalty fees from OEMs. Revenue derived from resellers is not recognized until the software is sold through to the end user. Royalty revenue is recognized when reported to the Company by the OEM after delivery of the applicable products. In addition, royalty revenue can arise from the right to use the Company s products. As described below, management estimates must be made and used in connection with the revenue the Company recognizes in any accounting period.

The Company recognizes software license revenue in accordance with Statement of Position 97-2, Software Revenue Recognition (SOP 97-2), as amended, by SOP 98-9, Modification of SOP 97-2, Software Revenue

BACKWEB TECHNOLOGIES LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Recognition with Respect to Certain Transactions (SOP 98-9). SOP 98-9 requires that revenue be recognized under the Residual Method when vendor specific objective evidence (VSOE) of fair value exists for all undelivered elements and no VSOE exists for the delivered elements. Under the Residual Method, any discounts in the arrangement are allocated to the delivered element.

When contracts contain multiple elements wherein VSOE of fair value exists for all undelivered elements, the Company accounts for the delivered elements in accordance with the Residual Method prescribed by SOP 98-9. Maintenance revenue included in these arrangements is deferred and recognized on a straight-line basis over the term of the maintenance agreement. The VSOE of fair value of the undelivered elements (maintenance, training, and consulting services) is determined based on the price charged for the undelivered element when sold separately.

Revenue from software license agreements is recognized when all of the following criteria are met as set forth in SOP 97-2: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred; (3) the fee is fixed or determinable; and (4) collectibility is reasonably assured. The Company does not generally grant a right of return to its customers. When a right of return exists, the Company defers revenue until the right of return expires, at which time revenue is recognized provided that all other revenue recognition criteria have been met. If the fee is not fixed or determinable, revenue is recognized as payments become due from the customer provided that all other revenue recognition criteria have been met.

The Company licenses its products on a perpetual and on a term basis. It recognizes license revenue arising from perpetual licenses and multi-year term licenses in the accounting period that all revenue recognition criteria have been met, which is generally upon delivery of the software to the end user. For term licenses with a contract period of one year or less, revenue is recognized on a monthly basis.

At the time of each transaction, the Company assesses whether the fee associated with its license sale is fixed and determinable. If the fee is not fixed or determinable, the Company recognizes revenue as payments become due from the customer provided that all other revenue recognition criteria have been met. In determining whether the fee is fixed or determinable, the Company compares the payment terms of the transaction to its normal payment terms. The Company assesses the likelihood of collection based on a number of factors, including past transaction history, the credit worthiness of the customer and, in some instances, a review of the customer s financial statements. The Company does not request collateral from its customers. If credit worthiness cannot be established, the Company defers the fee and recognizes revenue at the time collection becomes reasonably assured, which is generally upon the receipt of cash.

Service revenue is comprised primarily of revenue from standard maintenance agreements and consulting services. Customers licensing products generally purchase the standard annual maintenance agreement for the products. The Company recognizes revenue from maintenance over the contractual period of the maintenance agreement, which is generally one year. Maintenance is priced as a percentage of the license revenue. For those agreements where the maintenance and license is quoted as one fee, the Company values the maintenance as an undelivered element at standard rates and recognizes this revenue over the contractual maintenance period. Consulting services are billed at an agreed-upon rate, plus out-of-pocket expenses. The Company generally charges for consulting services on a time and materials basis and recognize revenue from such services as they are provided to the customer. The Company accounts for fixed fee service arrangements in a similar manner to an agreement containing an acceptance clause. The Company s arrangements do not generally include acceptance clauses. However, if an acceptance provision exists, then the Company defers revenue recognition until written acceptance of the product from the customer is received.

Deferred revenue includes amounts billed to customers and cash received from customers for which revenue has not been recognized.

BACKWEB TECHNOLOGIES LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Research and Development

Research and development expenditures are charged to operations as incurred. SFAS No. 86, Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed, requires capitalization of certain software development costs subsequent to the establishment of technological feasibility. Based on the Company s product development process, technological feasibility is established upon the completion of a working model. The Company generally does not incur any significant costs between the completion of the working model and the point at which the product is ready for general release. Through December 31, 2005, the Company had recognized all software development costs as research and development expense in the period incurred.

Advertising Costs

The Company accounts for advertising costs as an expense in the period in which the costs are incurred. Advertising expense for the years ended December 31, 2005, 2004 and 2003 was approximately $1,000, $4,000 and $2,000, respectively.

Income Taxes

The Company accounts for income taxes in accordance with SFAS 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 differences between the financial reporting and tax bases of assets and liabilities and are measured using 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.

Forward Exchange Contracts

The Company accounts for derivatives and hedging based on SFAS No. 133 Accounting for Derivative Instruments and Hedging Activities (SFAS No. 133), which requires that all derivatives be recorded on the balance sheet at fair value. If the derivative meets the definition of a hedge and is so designated, changes in the fair value of the derivatives will either be offset against the change in fair value of the hedged assets, liabilities or firm commitments through earnings or recognized in other comprehensive income or loss until the hedged item is recognized in earnings. The ineffective portion of a derivative change in fair value is recognized in earnings. For all periods reported herein, gains or losses related to hedge ineffectiveness were immaterial and there were no hedge contracts placed in 2005. Changes in the fair value of derivatives that are not designated, or are not effective as hedges, must be recognized in earnings.

The Company conducts its business and sells its products directly to customers primarily in North America and Europe. In the normal course of business, the Company s financial position is routinely subject to market risks associated with foreign currency rate fluctuations due to balance sheet positions in other local foreign currencies. The Company s policy is to ensure that business exposures to foreign exchange risks are identified, measured and minimized using foreign currency forward contracts to reduce such risks. The foreign currency forward contracts generally expire within 90 days. The change in fair value of these forward contracts is recorded as income/loss in the Company s Consolidated Statements of Operations as a component of interest and other income, net. During 2004, the Company determined that the cost of the forward contracts were greater than the benefit they provided, and as such

the Company suspended its practice of using forward contracts.

Concentration of Credit Risk

Financial instruments that potentially subject the Company to concentrations of credit risk consist of cash, cash equivalents, short-term investments, forward exchange contracts and trade accounts receivable. The Company s cash and cash equivalents and short-term investments generally consist of money market funds with high credit

BACKWEB TECHNOLOGIES LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

quality financial institutions and corporate securities of corporations, which management believes are financially sound and are managed by major banks in the United States. Such investments in the United States may be in excess of insured limits and are not insured in other jurisdictions. Management believes that the financial institutions that hold the Company s investments are financially sound and, accordingly, minimal credit risk exists with respect to these investments. The Company has established guidelines relative to credit ratings, diversification and maturity that seek to maintain safety and liquidity. At December 31, 2005, the Company did not have any outstanding forward exchange contracts, and, accordingly, there was no credit risk associated with such investments. At December 31, 2005, the Company had no significant off-balance-sheet concentration of credit risk such as option contracts or other foreign hedging arrangements.

The Company sells its products to customers primarily in North America and Europe. The Company performs ongoing credit reviews of its customers financial condition and generally does not require collateral. The Company maintains reserves to provide for estimated credit losses. An allowance for doubtful accounts is determined with respect to those amounts that the Company has determined to be doubtful of collection. Provision for bad debts in the years ended December 31, 2005, 2004, and 2003 was $279,000, $643,000, and $104,000, respectively. Bad debt write-offs of accounts in the years ended December 31, 2005, 2004, and 2003 totaled $364,000, $1.5 million and $0, respectively.

Net Loss Per Share

Basic net loss per share is comprised of the weighted average number of Ordinary Shares outstanding each year. Diluted net loss per share is computed based on the weighted average number of Ordinary Shares outstanding during the year plus dilutive potential Ordinary Shares considered outstanding during the year in accordance with SFAS No. 128, Earnings per Share.

The following table presents the calculation of the basic and diluted net loss per Ordinary Share (in thousands, except per share data):

	Year Ended December 31,		
	2005	**2004**	**2003**
Net loss	$ (1,033)	$ (5,143)	$ (10,726)
Basic and diluted:			
Weighted-average shares	41,625	41,144	40,299
Less weighted-average shares subject to repurchase	(614)	(433)	(299)
Shares used in computing basic and diluted net loss per share	41,011	40,711	40,000
Basic and diluted net loss per share	$ (0.03)	$ (0.13)	$ (0.27)

All preferred stock, outstanding stock options and warrants have been excluded from the calculation of the diluted net loss per share because all such securities are considered to be anti-dilutive for all periods presented in the statements

of operations. The total number of Ordinary Shares related to preferred stock, outstanding options and warrants excluded from the calculations of diluted net loss per share were 6,323,840, 8,082,485 and 6,791,080 for the years ended December 31, 2005, 2004 and 2003, respectively.

Accounting for Stock-Based Compensation

The Company has elected to follow Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25), and FASB Interpretation No. 44 Accounting for Certain Transactions Involving Stock Compensation, in accounting for its employee stock options and shares issued under its 1999 Employee Stock Purchase Plan. Under APB 25, when the exercise price of the Company s stock options or shares is less than the market price of the underlying shares on the date of grant, compensation expense is recognized.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Pro forma information regarding the Company s net loss and net loss per share is required by SFAS No. 123, Accounting for Stock Based Compensation (SFAS No. 123), and has been determined as if the Company had accounted for its employee stock options or shares under the fair value method prescribed by SFAS No. 123.

The Company calculated the fair market value of each option grant on the date of grant using the Black-Scholes option-pricing model as prescribed by SFAS No. 123 based on the following assumptions:

	Year Ended December 31,		
Stock Options	**2005**	**2004**	**2003**
Risk-free interest rates	4.4%	3.6%	3.3%
Expected lives (in years)	5	5	5
Dividend yield	0%	0%	0%
Expected volatility	70%	124%	123%

	Year Ended December 31,		
Stock Purchase Shares	**2005**	**2004**	**2003**
Risk-free interest rates	4.4%	3.6%	3.3%
Expected lives (in years)	0.5	0.5	0.5
Dividend yield	0%	0%	0%
Expected volatility	70%	124%	123%

Pro forma information under SFAS No. 123 is as follows:

	December 31,		
	2005	**2004**	**2003**
	(In thousands, except per share data)		
Net loss as reported	$ (1,033)	$ (5,143)	$ (10,726)
Add stock based expense reported in net loss			
Less stock based compensation expense determined under the fair value method	(645)	(907)	(2,155)
Pro forma net loss	$ (1,678)	$ (6,050)	$ (12,881)
Pro forma basic and diluted net loss per share	$ (0.04)	$ (0.15)	$ (0.32)

Basic and diluted net loss per share	$	(0.03)	$	(0.13)	$	(0.27)

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

For the year ended December 31, 2005, certain adjustments were made to the consolidated financial statements after the press release reporting the Company s financial results for the fourth quarter of 2005 was issued and before the conclusion of the financial statement audit. The impact of these adjustments resulted in approximately $40,000 of additional operating expense and an additional $0.01 of loss to net loss per share, from $0.02 as per the press release to $0.03 as reported herein.

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 the balance sheet date.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Israeli employees are entitled to one month s salary for each year of employment or a proportional part thereof for a partial year of employment, after the first year of employment. The Company s liability for all of its Israeli employees is fully provided by monthly deposits with insurance policies and by an accrual for severance pay.

The funds deposited include profits accumulated up to the balance sheet date. The deposited funds may be withdrawn only upon 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.

Severance expenses relating to Israeli employees for the years ended December 31, 2005, 2004 and 2003 amounted to approximately $84,000, $121,000 and $456,000, respectively.

Fair Value of Financial Instruments

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

The carrying amounts of cash and cash equivalents, trade accounts receivable and trade accounts payable approximate their fair value due to the short-term maturity of such instruments.

The fair value for marketable securities is based on quoted market prices (See Note 3).

Accumulated Other Comprehensive Loss

Accumulated other comprehensive income/loss presented in the accompanying consolidated balance sheets and consolidated statements of stockholder s equity consists of net unrealized gains and losses on short-term investments and net unrealized gains and losses on foreign currency forward contracts.

The following are the components of accumulated other comprehensive loss (in thousands):

	December 31,	
	2005	2004
Beginning balance	$ (19)	$ 9
Unrealized gain/(loss) on available-for-sale investments	17	(28)
Total accumulated other comprehensive (loss)	$ (2)	$ (19)

Recently Issued Accounting Pronouncements

In July 2005, the FASB issued an Exposure Draft of a proposed interpretation, Accounting for Uncertain Tax Positions an interpretation of FASB Statement No. 109. This proposal seeks to reduce the diversity in practice associated with certain aspects of the recognition and measurement requirements related to accounting for income

taxes. Specifically, the interpretation requires that an enterprise recognize in its financial statements, the best estimate of the impact of a tax position only if that position is probable of being sustained on audit based solely on the technical merits of the position. In evaluating whether the probable recognition threshold has been met, this proposed interpretation would require the presumption that the tax position will be evaluated during an audit by taxing authorities. The Exposure Draft is scheduled to be finalized in the first quarter of calendar year 2006. The Company is currently reviewing the provisions in the Exposure Draft to determine its impact to its consolidated financial statements.

In November 2005, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) Nos. FAS 115-1 and FAS 124-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments. This FSP addresses the determination as to when an investment is considered impaired, whether that impairment is other than temporary, and the measurement of an impairment loss. This FSP also includes accounting considerations subsequent to the recognition of other-than-temporary impairments. The

BACKWEB TECHNOLOGIES LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

guidance in this FSP will be applied to reporting periods beginning after December 15, 2005. The adoption of this FSP is not expected to have a significant impact on the Company s financial position and results of operations.

In June 2005, the Emerging Issues Task Force (EITF) issued No. 05-06, Determining the Amortization Period for Leasehold Improvements (EITF 05-6). The pronouncement requires that leasehold improvements acquired in a business combination or purchase, subsequent to the inception of the lease, be amortized over the lesser of the useful life of the asset or the lease term that includes reasonably assured lease renewals as determined on the date of the acquisition of the leasehold improvement. This pronouncement is effective for leasehold improvements that are purchased or acquired in reporting periods beginning after June 29, 2005. The adoption of EITF 05-6 has not had a significant impact on the Company s financial position and results of operations.

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections (SFAS 154). This new standard replaces APB Opinion No. 20, Accounting Changes in Interim Financial Statements , and SFAS No. 3, Reporting Accounting Changes in Interim Financial Statements , and represents another step in the FASB s goal to converge its standards with those issued by the International Accounting Standards Board (IASB). Among other changes, SFAS 154 requires retrospective application to prior periods financial statements of a voluntary change in accounting principle unless it is impracticable. SFAS 154 also provides that (1) a change in method of depreciating or amortizing a long-lived nonfinancial asset be accounted for as a change in estimate (prospectively) that was effected by a change in accounting principle, and (2) correction of errors in previously issued financial statements should be termed a restatement. The new standard is effective for accounting changes and correction of errors made in fiscal years beginning after December 15, 2005. Early adoption of this standard is permitted for accounting changes and correction of errors made in fiscal years beginning after June 1, 2005. Management does not expect the adoption of SFAS 154 to have a material effect on the Company s consolidated financial statements.

In March 2005, the SEC released SEC Staff Accounting Bulletin No. 107 (SAB 107). SAB 107 provides the SEC staff position regarding the application of SFAS 123R Share-Based Payment. SAB 107 contains interpretive guidance relating to the interaction between SFAS 123R and certain SEC rules and regulations, as well as the SEC staff s views regarding the valuation of share-based payment arrangements for public companies. SAB 107 also highlights the importance of disclosures made related to the accounting for share-based payment transactions. The Company currently evaluating SAB 107 and will be incorporating it as part of its adoption of SFAS 123R in the first quarter of 2006.

In December 2004, the FASB issued SFAS No. 123R, Share-Based Payment, a revision of SFAS No. 123, Accounting for Stock-Based Compensation which supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees. SFAS No. 123R requires us to expense grants made under our stock option program. That cost will be recognized over the vesting period of the plans. SFAS No. 123R is effective for interim periods beginning after June 15, 2005. Upon adoption of SFAS No. 123R, amounts previously disclosed under SFAS No. 123 will be recorded in our statements of operations. The Company is evaluating the alternatives allowed under the standard, which it is required to adopt effective for its first quarter of fiscal 2006. The Company expects the adoption of SFAS No. 123 to have a material effect on its financial position or results of operations.

In December 2004, the FASB issued Staff Position SFAS No. 109-1, *Application of FASB Statement No. 109, Accounting for Income Taxes* (FSP No. 109-1) to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004 which was signed into law by the President of the United States on October 22, 2004. Companies that qualify for the recent tax law s deduction for domestic production activities must

account for it as a special deduction under SFAS No. 109 and reduce their tax expense in the period or periods the amounts are deductible, according to FSP No. 109-1, effective for the Company in its fiscal year 2006. The FASB s guidance is not expected to have a material impact to the Company s financial results.

In December 2004, the FASB also issued Staff Position SFAS No. 109-2, *Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision* (FSP No. 109-2) within the American Jobs Creation Act of 2004.

BACKWEB TECHNOLOGIES LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Act provides for a one-time deduction of 85 percent of certain foreign earnings that are repatriated in either an enterprise s last tax year that began before the date of enactment, or the first tax year that begins during the one-year period beginning on the date of enactment. FSP No. 109-2 allows companies additional time to evaluate whether foreign earnings will be repatriated under the repatriation provisions of the new tax law and requires specified disclosures for companies needing the additional time to complete the evaluation. The Company is currently evaluating the repatriation provisions of the Act and shall complete its evaluation once guidance has been issued by the Treasury Department on the repatriation provision, which is expected sometime in 2006.

In December 2003, the Financial Accounting Standards Board (FASB) issued a proposed amendment to Statement of Financial Accounting Standards (SFAS) 128, *Earnings per Share*, to make it consistent with International Accounting Standard 33, *Earnings per Share*, so as to make earnings per share computations comparable on a global basis. As currently drafted, the amendment would require companies to use the year-to-date average stock price to compute the number of treasury shares that could theoretically be purchased with the proceeds from exercise of share contracts such as options or warrants. The current method of calculating earnings per share requires companies to calculate an average of the potential incremental common shares computed for each quarter when computing year-to-date incremental shares. The proposed amendment would also change other aspects of SFAS 128 that would not impact the Company s earnings per share calculations. The proposed amendment is currently expected to be effective for interim and annual periods ending after June 15, 2006 and, once effective, will require retrospective application for all prior periods presented. If the proposed amendment is finalized in its current form (including the proposed effective date), its adoption is not expected to have a material impact on the Company s financial condition or results of operations.

3. Short-Term Investments

The following is a summary of the Company s available-for-sale marketable securities (in thousands):

	December 31,					
	2005			2004		
	Cost	Unrealized Losses	Estimated Fair Value	Cost	Unrealized Gains	Estimated Fair Value
Certificates of deposit	$ 331	$ (17)	$ 314	$ 2,738	$ (76)	$ 2,662
Money market	5,979		5,979	2,445		2,445
Totals	$ 6,310	$ (17)	$ 6,293	$ 5,183	$ (76)	$ 5,107

At December 31, 2005, the total amounts of investments due within one year and due after one year were approximately $300,000 and $6.0 million, respectively.

4. Property and Equipment, net

Property and equipment, net consists of the following (in thousands):

	December 31,	
	2005	2004
Computer and peripheral equipment	$ 3,417	$ 3,835
Office, furniture and equipment	190	2,487
Leasehold improvements	1,113	1,135
	4,720	7,457
Less: accumulated depreciation	(4,507)	(7,303)
Property and equipment, net	$ 213	$ 154

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BACKWEB TECHNOLOGIES LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Depreciation expense for the years ended December 31, 2005, 2004 and 2003 was $140,000, $252,000 and $878,000, respectively. See Note 8 regarding impairment of property and equipment.

5. Long-Term Investments

The Company was one of a group of lenders (collectively, the Lenders) that entered into a Convertible Loan Agreement, dated as of August 1, 2001, by and between Emony Ltd., now called Red Bend Ltd., an Israeli private company, and the Lenders pursuant to which the Lenders granted Emony a convertible loan in the aggregate amount of $2,150,000 (the Loan Amount) for working capital purposes. The Loan Amount bore interest at the LIBOR rate for 6 month loans as quoted by Bank Leumi Israel Ltd. plus 1.5% per annum, compounded monthly, and was repayable, unless converted, in full on September 20, 2002. The Loan Amount could not be prepaid in whole or in part without the Lenders consent. In the event that Emony closed a financing resulting in net aggregate cash proceeds of at least $5 million at a price of at least $1.34 per share, the outstanding portion of the Loan Amount would automatically convert into Series B1 Preferred Shares (the Preferred Shares) of Emony at a conversion price of $1.34 per share. In addition, until such an investment was received, any of the Lenders could demand through the exercise of a warrant granted pursuant to the Loan Agreement to convert its portion of the Loan Amount into such Preferred Shares. The Company s portion of the Loan Amount was $500,000, for which the Company received the warrant described above and a Promissory Note.

The first part of this two-part investment in Emony Ltd. occurred on November 1, 2000, when the Company acquired 483,600 shares of Series B Preferred Shares of Emony Ltd., representing approximately 7% of its share capital, in exchange for payment of $500,000 under the Share Purchase and Shareholders Agreement dated October 10, 2000 between Emony Ltd., the Company and various other investors. Further, under such Share Purchase and Shareholders Agreement, the Company was granted (a) a warrant to purchase Series B Preferred Shares of Emony Ltd. in an amount as maybe purchased in exchange for $500,000, based on a pre-exercise valuation of Emony Ltd. of $10,000,000 on a fully-diluted and as converted basis; and (b) a warrant to purchase Series B Preferred Shares of Emony Ltd. in an amount as may be purchased in exchange for $930,233, based on a pre-exercise valuation of Emony Ltd. of $15,000,000 on a fully-diluted and as converted basis.

On October 3, 2000, the Company acquired 1,197,679 shares of Series B Preferred Stock of 3Path, Inc. (formerly DeliverEx, Inc.), representing approximately 12% of its share capital, in exchange for payment of $2,500,000 under the Stock Purchase Agreement for Series B Convertible Preferred Stock dated February 2, 2000 between 3Path, Inc., BackWeb and various other investors.

In July 2002, in connection with an investment of $1,700,000 in Red Bend by certain existing shareholders of Red Bend, all Lenders agreed to exercise their warrants, agreeing to convert the Loan Amount into Series B Preferred Shares par value NIS 0.01 each, instead of Series B1 Preferred Shares par values NIS 0.01 each as originally provided under the Loan Agreement. As a result of this exercise and conversion, the Company received 1,339,997 shares of Series B Preferred Shares of Red Bend. In addition, the Company, along with other investors in Red Bend, agreed to cancel warrants it had received in connection with its earlier investment in Red Bend.

Long-term investments are reviewed for impairment whenever events or changes in circumstances indicate the carrying amount of such investments may not be recoverable. Accordingly, in 2001, the Company recorded a charge

of $2.5 million to reflect impairment of these assets below their recorded cost to represent what management considered to be fair value. No impairment charge was recorded during the year ended December 31, 2002. In March 2003, the Company determined the remaining investment was fully impaired primarily due to continuing difficulties in the economy, and recorded a charge for the full remaining investment balance of $1.0 million. There was no remaining balance as of December 31, 2005 or 2004.

BACKWEB TECHNOLOGIES LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

6. Accrued Liabilities

Accrued liabilities consist of the following (in thousands):

	December 31, 2005	December 31, 2004
Accrued employees compensation and related expense	$ 761	$ 765
Sales and marketing events		17
Restructuring accrual		119
Other	970	724
	$ 1,731	$ 1,625

7. Related Parties

Stock Options

Pursuant to the Founding Agreement, the Company granted to its Early Investors the right to grant stock options for up to 792,167 Ordinary Shares to any person or entity. Through December 31, 2002, all options had been granted. This pool of options was used by the Early Investors in granting options to employees and consultants of BRM Technologies Ltd. (BRM) and other related companies.

Certain shareholders and a director of the Company have a controlling interest in BRM.

8. Restructuring and Other Charges

On September 30, 2002, the Company announced a restructuring plan, which was implemented in the three months ended December 31, 2002. The restructuring plan included a reduction in workforce, vacating certain facilities, canceling of office service leases and impairment of fixed assets as a result of employee terminations and office consolidation. In accordance with EITF 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (Including Certain Costs in a Restructuring), and Staff Accounting Bulletin No. 100, Restructuring and Impairment Charges (SAB No. 100), the Company recorded a charge in 2002 of $4.7 million, which consisted of $1.6 million of severance and benefit costs, which included forgiveness of a $221,000 shareholder note receivable to one employee, $2.7 million of facility costs, $200,000 related to the write-down of fixed assets and $200,000 related to other related restructuring costs. The $1.6 million charge was related to severance and benefits to terminate 61 employees, representing approximately 44% of the Company s global workforce employed as of September 30, 2002. The $2.7 million charge represented early termination penalties, office restoration costs and an accrual of certain lease commitments. In November 2003, the Company accrued an additional charge of approximately $443,000 due to a change in estimate on its facilities costs, of which approximately $289,000 related to the impairment of lease space in its Canadian subsidiary, $120,000 related to an exchange of warrants to the landlord

as part of the final settlement of lease space at its headquarters in San Jose, California and approximately $34,000 of other office lease impairment charges.

During the second quarter of 2004, the Company settled a lease agreement related to its Canadian subsidiary for approximately $187,000. This settlement was more favorable than had been originally accrued for, resulting in a decrease in restructuring expense of approximately $184,000. During the third quarter of 2004, the Company determined that there would be no future cash requirements under the restructuring accrual, and reversed the accrual in full. During the fourth quarter of 2004, the Company recorded a charge of approximately $500,000 related to the termination of 19 employees throughout the Company, including the Company s Chief Executive Officer and Chief Financial Officer. All amounts related to this action were expensed in 2004, and at December 31, 2004 there was an accrual of approximately $119,000 for amounts yet to be distributed. At December 31, 2005, all amounts related to severance and other payments had been distributed or reversed.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table summarizes the costs and activities related to the 2002 and 2004 restructurings (in thousands):

	Involuntary Terminations	Facilities and Other	Total
Total charge 2002 restructuring	$ 1,600	$ 3,100	$ 4,700
Cash payments 2002 restructuring	(1,300)	(2,000)	(3,300)
Balance at December 31, 2002	300	(1,100)	(1,400)
Change in estimate 2002 restructuring		400	400
Cash payments 2002 restructuring	(300)	(1,000)	(1,300)
Balance at December 31, 2003		500	500
Change in estimate 2002 restructuring		(300)	(300)
Cash payments 2002 restructuring		(200)	(200)
Total charge 2004 restructuring	500		500
Cash payments 2004 restructuring	(400)		(400)
Balance at December 31, 2004	$ 100	$	$ 100
Cash payments 2005 restructuring	(100)		(100)
Balance at December 31, 2005	$	$	$

9. Commitments and Contingencies

Leases

The Company leases its office facilities under cancelable and non-cancelable operating leases. Future rental payments on a fiscal year basis under non-cancelable operating leases with initial terms in excess of one year are as follows:

2006	$ 844,000
2007	64,000
2008	
	$ 908,000

Rent expense, net approximated $839,000, $611,000 and $1.2 million for the years ended December 31, 2005, 2004 and 2003, respectively. The Company recognized approximately $77,000 of sublease income in 2005, which was

offset against rent expense.

Contingencies

From time to time, the Company may have certain contingent liabilities that arise in the ordinary course of its business activities. The Company accounts for contingent liabilities when it is probable that future expenditures will be made and such expenditures can be reasonably estimated.

On November 13, 2001, BackWeb, six of our officers and directors, and various underwriters for our initial public offering were named as defendants in a consolidated action captioned In re BackWeb Technologies Ltd. Initial Public Offering Securities Litigation, Case No. 01-CV-10000, a purported securities class action lawsuit filed in the United States District Court, Southern District of New York. Similar cases have been filed alleging violations of the federal securities laws in the initial public offerings of more than 300 other companies, and these cases have been coordinated for pretrial proceedings as In re Initial Public Offering Securities Litigation, 21 MC 92.

BACKWEB TECHNOLOGIES LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

A consolidated amended complaint filed in the BackWeb case asserts that the prospectus from our June 8, 1999 initial public offering failed to disclose certain alleged improper actions by the underwriters for the offering, including the receipt of excessive brokerage commissions and agreements with customers regarding aftermarket purchases of shares of our stock. The complaint alleges violations of Sections 11 and 15 of the Securities Act of 1933, Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, and Rule 10b-5 promulgated under the Securities Exchange Act of 1934. On or about July 15, 2002, an omnibus motion to dismiss was filed in the coordinated litigation on behalf of defendants, including BackWeb, on common pleadings issues. In October 2002, the Court dismissed all six individual defendants from the litigation without prejudice, pursuant to a stipulation. On February 19, 2003, the Court denied the motion to dismiss with respect to the claims against BackWeb. No trial date has yet been set.

A proposal was made in 2003 for the settlement and for the release of claims against the issuer defendants, including BackWeb, has been submitted to the Court. We have agreed to the proposal. The settlement is subject to a number of conditions, including approval by the proposed settling parties and the court.

If the settlement does not occur, and litigation against us continues, we believe we have meritorious defenses and intend to defend the case vigorously. However, the results of any litigation are inherently uncertain and can require significant management attention, and we could be forced to incur substantial expenditures, even if we ultimately prevail. In the event there were an adverse outcome, our business could be harmed. Thus, we cannot assure you that this lawsuit will not materially and adversely affect our business, results of operations, or the price of our Ordinary Shares.

Additionally, the Company was named in a judgment during September 2005 for approximately $500,000 related to a claim against its dormant French subsidiary. The judgment is related to a dispute between a former French distributor of the Company s and one of the distributor s end user customers. While the Company believes it has additional defenses against the claim and will ultimately not be responsible for payments under the judgment, against the Company accrued approximately $250,000, or approximately one-half of the total judgment against distributor, in the September 2005 quarter.

Letter of Credit

In February 2001, the Company signed a thirty-day revolving letter of credit of $300,000 in favor of Equity Office LLC (formerly Speiker Properties LLC). In conjunction with its lease renegotiation in San Jose, CA, the Company extended this letter of credit to a total of $500,000 in favor of Equity Office LLC in October 2003. The letter of credit extends to the end of the lease in January 2007.

Line of Credit

As of December 31, 2005, the Company had a $500,000 line of credit with a lender. The amount of borrowings available under the line of credit is based on a formula using accounts receivable. The line of credit has a stated maturity date of January 31, 2007 and provides that the lender may demand payment in full of the entire outstanding balance of the loan at any time. The line of credit is secured by substantially all of the Company s assets. The line requires that the Company meet certain financial covenants, provides payment penalties for noncompliance and prepayment, limits the amount of other debt the Company can incur, and limits the amount of spending on fixed assets. During the third quarter of 2004, the Company moved the $500,000 deposit related to its lease space in San Jose, California under the line of credit. At December 31, 2005, the Company had no unused borrowing capacity.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

10. Shareholders Equity

Ordinary Shares

Ordinary Shares reserved for future issuance are as follows:

	December 31,	
	2005	2004
Exercise of outstanding options	6,323,840	7,986,485
Ordinary Shares available for grant under stock option plans	11,277,654	9,444,026
	17,601,494	17,430,511

Holders of Ordinary Shares have one vote for each Ordinary Share held on all matters submitted to a vote of shareholders. Such voting rights may be affected by the grant of any special voting rights to the holders of a class of shares with preferential rights that may be authorized in the future. Under current Israeli law the Company cannot declare and pay a dividend unless the Company has a positive balance of retained earnings from which the dividend may be declared and paid. If the Company were to declare dividends in the future, the Company would declare those dividends in NIS but pay those dividends to its non-Israeli shareholders in U.S. dollars. Because exchange rates between NIS and the dollar fluctuate continuously, a U.S. shareholder would be subject to currency fluctuation between the date when the dividends were declared and the date the dividends were paid. The Company has not paid dividends in the past.

Preferred Stock

The Company is authorized to provide for the issuance of up to 50,000,000 shares of undesignated preferred stock, none of which had been issued at December 31, 2005.

Stock Option Plans

Under the 1996 Israel Stock Option Plan (the 1996 Israel Plan), the Company is authorized to grant options to purchase Ordinary Shares to its Israeli employees and other eligible participants. Options granted under the 1996 Israeli Plan expire seven years from the date of grant and terminate upon the termination of the option holder s employment or other relationship with BackWeb. The options under the 1996 Israel Plan will vest as determined by the plan administrator and generally vest over a four-year period. The 1996 Israel Plan does not have a termination date. Stock options cancelled or forfeited are credited back to the stock option pool.

Under the 1996 U.S. Stock Option Plan (the 1996 U.S. Plan), the Company is authorized to grant incentive stock options to employees and non-statutory stock options to employees, officers, directors and consultants at BackWeb or any other member of the BRM group. Options granted under the 1996 U.S. Plan expire no later than seven years from

the date of grant and generally vest over a four-year period. BackWeb is no longer granting options under the 1996 U.S. Plan. In the event of merger, sale or dissolution of the Company, all options will terminate immediately, except to the extent a successor corporation assumes the options.

Under the 1998 U.S. Option Plan (the 1998 U.S. Plan), the Company is authorized to grant incentive stock options to employees and non-statutory stock options and Share Purchase Rights to employees, directors and consultants. Options and share purchase rights under the 1998 U.S. Plan will vest as determined by the plan administrator and, if not assumed or substituted by a successor corporation will accelerate and become fully vested in the event of an acquisition of the Company. The exercise price of options and share purchase rights granted under the 1998 U.S. Plan will be as determined by the plan administrator, although the exercise price of incentive stock options must not be less than the fair market value of the underlying Ordinary Shares at the date of the grant. Options granted under the 1998 U.S. Plan generally vest over four years. Stock options cancelled or forfeited are credited back to the stock option pool. The plan administrator may amend, modify or terminate the 1998 U.S. Plan at any

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

time as long as such amendment, modification or termination does not impair vesting rights of 1998 U.S. Plan participants. The 1998 U.S. Plan will terminate in 2008, unless terminated earlier by the plan administrator.

Effective July 1, 2000, the Company amended the 1998 U.S. Plan and the 1996 Israel Plan (the Plans) to adopt an annual increase provision, commonly referred to as an evergreen provision, to each of the Plans. These amendments provide for an automatic increase on each anniversary beginning July 1, 2000 in the number of shares authorized for issuance under the Plans equal to the lesser of (a) an aggregate amount equal to 1,960,000 shares, (b) 5% of the outstanding shares on such date, or (c) an amount to be determined by the Board of Directors. The total annual increase will be allocated 70% to the 1998 U.S. Plan and 30% to the 1996 Israel Plan, unless the Board of Directors determines a different allocation. Therefore, for the 1996 Israel Plan, the amount of the increase would be equal to the lesser of 588,000 shares, or 1.5% of the outstanding shares on such date, unless the Board of Directors determines a different allocation between the Plans or decides on a lesser amount. Also, for the 1998 U.S. Plan the amount of the increase would be equal to the lesser of 1,372,000 shares or 3.5% of the outstanding shares on such date, unless the Board of Directors determines a different allocation between the Plans or decides on a lesser amount.

In addition to the automatic annual increase on July 1, 2000, the Company approved an additional increase in the shares available under the 1998 U.S. Plan and the 1996 Israel Plan to increase the shares available under the Plans by 1,894,622 shares as of June 30, 2000. The total amount of the increase was allocated 70% to the 1998 U.S. Plan and 30% to the 1996 Israel Plan, which was 1,326,235 shares for the 1998 U.S. Plan and 568,387 shares for the 1996 Israel Plan.

In addition to the automatic annual increase on July 1, 2001, the Company approved an additional increase in the Ordinary Shares available under the 1998 Plan and the 1996 Israel Plan to increase the total Ordinary Shares available under the Plans by an aggregate of 2,500,000 Ordinary Shares, as of June 30, 2001. The total amount of the increase was allocated 60% (1,500,000 Ordinary Shares) to the 1998 Plan and 40% (1,000,000 Ordinary Shares) to the 1996 Israel Plan. During the years ended 2003, 2004 and 2005, there were no increases beyond the automatic annual increase.

The Company introduced in 1999 an Employee Stock Purchase Plan, which was adopted by the Board of Directors in March 1999. The Company has reserved a total of 600,000 shares for issuance under the plan. The number of shares reserved under the plan is subject to an annual increase on each anniversary beginning July 1, 2000 equal to the lesser of 833,333 shares, 2% of the then outstanding shares or an amount determined by the Board of Directors. Eligible employees may purchase Ordinary Shares at 85% of the lesser of the fair market value of BackWeb s Ordinary Shares on the first day of the applicable offering period or the last day of the applicable purchase period. During 2005, 175,245 shares were issued at $0.43 per share. During 2004, 154,247 total shares were issued, of which 116,639 were issued at $0.65 per share and 37,608 were issued at $0.47 per share. During 2003, 196,691 total shares were issued all of which were issued at $0.20 share. As of December 31, 2005, 2,305,324 shares were available for grant under the Employee Stock Purchase Plan. The weighted average per share value of the shares at December 31, 2005, 2004 and 2003 was approximately $0.43, $0.61 and $0.20, respectively.

In 2003, the Company adopted an amendment to its 1996 Israel Plan. In accordance with the terms and conditions imposed by Section 102 of the Israel Income Tax Ordinance, grantees that receive options under the 2003 amendment to the 1996 Israel Plan are afforded certain tax benefits (excluding controlling shareholders of the Company or those who are not employees or directors of the Company). The Company has elected the benefits available under a capital gains alternative. There are various conditions that must be met in order to qualify for these benefits, including

registration of the options in the name of a trustee (the Trustee) for each of the employees who is granted options. Each option, and any Ordinary Shares acquired upon the exercise of the option, must be held by the Trustee for a period commencing on the date of grant and ending no earlier than 24 months after the end of the tax year in which the option was granted and deposited in trust with the Trustee.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

A summary of activity under the stock option plans is as follows:

	Shares Available For Grant	Options Outstanding	Exercise Price per Share	Weighted-Average Exercise Price	Weighted-Average Fair Value of Option Granted
Balance at December 31, 2002	7,711,094	8,772,774	$ 0.12-$19.00	$ 3.38	$ 0.71
Options granted	(1,271,388)	1,271,388	$ 0.23-$ 1.15	$ 0.90	
Options exercised		(591,235)	$ 0.12-$ 0.77	$ 0.70	
Options canceled	2,661,847	(2,661,847)	$ 0.24-$17.00	$ 2.26	
Balance at December 31, 2003	9,101,553	6,791,080	$ 0.12-$19.00	$ 3.62	$ 0.78
Options authorized	1,960,000				
Options granted	(3,352,500)	3,352,500	$ 0.37-$ 1.61	$ 0.47	
Options exercised		(117,687)	$ 0.23-$ 1.05	$ 0.70	
Options canceled	1,927,314	(1,927,314)	$ 0.23-$17.25	$ 1.90	
Balance at December 31, 2004	9,636,367	8,098,579	$ 0.24-$19.00	$ 2.77	$ 0.38
Options granted	(645,000)	645,000	$ 0.42-$ 0.57	$ 0.46	
Options exercised		(133,452)	$ 0.52-$ 0.75	$ 0.58	
Options canceled	2,286,687	(2,286,287)	$ 1.20-$12.50	$ 3.77	
Options Expired	(834)				
Balance at December 31, 2005	11,277,654	6,323,840	$ 2.85-$17.25	$ 0.58	$ 0.46

Exercise prices for options outstanding and exercisable as of December 31, 2005 and the weighted-average remaining contractual life are as follows:

Options Outstanding			Options Exercisable	
Number	Weighted Average	Weighted	Number	Weighted

Range of Exercise Prices	Outstanding as Of 12/31/05	Remaining Contractual Years	Average Exercise Price	Exercisable as of 12/31/05	Average Exercise Price
$ 0.26 - $ 0.37	42,500	4.99	$ 0.32	26,250	$ 0.29
$ 0.38 - $ 0.39	2,177,500	5.84	$ 0.39	997,332	$ 0.39
$ 0.40 - $ 0.57	782,500	7.03	$ 0.46	57,674	$ 0.45
$ 0.60 - $ 0.65	708,500	5.53	$ 0.61	359,841	$ 0.61
$ 0.72 - $ 1.15	769,773	3.14	$ 0.95	660,788	$ 0.92
$ 1.20 - $ 1.20	30,000	2.17	$ 1.20	30,000	$ 1.20
$ 1.32 - $ 1.32	725,000	6.00	$ 1.32	271,875	$ 1.32
$ 1.50 - $ 7.32	335,067	2.26	$ 5.03		