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BOS BETTER ONLINE SOLUTIONS LTD

Form 20-F/A

January 06, 2005

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

AMENDMENT NO. 1  
TO

FORM 20-F/A

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

OR

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

For the fiscal year ended DECEMBER 31, 2003

OR

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

Commission file number 001-14184

B.O.S BETTER ON LINE SOLUTIONS LTD.  
(Exact name of Registrant as specified in its charter)

ISRAEL  
(Jurisdiction of incorporation or organization)

BEIT RABIN, 100 BOS ROAD, TERADYON INDUSTRIAL PARK, MISGAV, 20179, ISRAEL  
(Address of principal executive offices)

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

NONE  
(Title of each class)

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

ORDINARY SHARES, PAR VALUE NIS 4.00 PER SHARE  
(Title of Class)

Securities for which there is a reporting obligation pursuant to Section 15(d)  
of the Act:

NONE  
(Title of Class)

Indicate the number of outstanding shares of each of the issuer's classes of  
capital or common stock as of the close of the period covered by the annual  
report:

4,167,509 ORDINARY SHARES, NIS 4.00 PAR VALUE PER SHARE, AS OF DECEMBER 31, 2003

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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  No

Indicate by check mark which financial statement item the registrant has elected to follow:

Item 17  Item 18

## EXPLANATORY NOTE

This Amendment no. 1 to the Annual Report on Form 20-F for the year ended December 31, 2003, of B.O.S Better On-Line Solutions Ltd. (the "Company") includes restated consolidated financial statements and related information that reflect the accounting for the Company's investment in Surf Communications Solutions Ltd. ("Surf") according to the equity method rather than the cost method. As a result of the acquisition of additional voting securities of Surf in 2003, which resulted in the Company's owning securities representing more than 20% of the voting rights of Surf, the Company has the ability to exercise significant influence over Surf. In order to present financial statements in accordance with accounting principles generally accepted in the United States, the Company has restated its financial statements with respect to its investment in Surf which was previously accounted for based on the cost method, to accounting for it based on the equity method of accounting. Additionally, this Amendment includes the consolidated financial statements of Surf for the year ended December 31, 2003 in accordance with item 3.09 of Regulation S-X.

This Amendment no. 1 contains the following affected items only: 3A, 4A, 5, 8, 18 and 19. Other items remain unchanged.

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### ITEM 3: KEY INFORMATION REGARDING B.O.S.

Unless the context in which such terms are used would require a different meaning, all references to "BOS", "we" or "our" or the "Company" refer to B.O.S. Better On-Line Solutions Ltd.

#### 3A. SELECTED CONSOLIDATED FINANCIAL DATA

The consolidated statement of operations data for B.O.S Better On-Line Solutions Ltd. set forth below with respect to the years ended December 31, 2003, 2002 and 2001, and the consolidated balance sheet data as of December 31, 2003 and 2002, have been derived from the Consolidated Financial Statements listed in Item 18, which have been prepared in accordance with generally accepted accounting principles ("GAAP") in the United States. The consolidated statement of operations data set forth below with respect to the years ended December 31,

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2000 and 1999, and the consolidated balance sheet data as of December 31, 2001, 2000 and 1999, have been derived from other consolidated financial statements not included herein and have been prepared in accordance with U.S. GAAP. The financial statements for the years ended December 31, 2001, 2002 and 2003 were audited by Kost, Forer Gabbay & Kasierer, independent certified public accountants in Israel and a member of Ernst & Young Global, while the financial statements for the years ended December 31, 1999 and 2000 were audited by Somekh Chaikin, independent certified public accountants in Israel and members of KPMG International. The selected consolidated financial data presented below should be read in conjunction with Item 5: "Operating and Financial Review and Prospects" and the Notes to the Financial Statements included in this Form 20-F.

On May 29, 2003, the Company effected a one-for-four reverse stock split. All share and per share numbers herein reflect adjustments resulting from this reverse stock split.

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Statement of Operations Data: (In US thousands of dollars with the exception of per share data)

YEAR ENDED DECEMBER 31:

	2003*	2002*	2001*	2000	1999
	-----	-----	-----	-----	-----
Revenues	5,728	9,441	6,042	7,294	6,720
Cost of revenues	1,455	2,300	2,703	2,399	1,936
	-----	-----	-----	-----	-----
GROSS PROFIT	4,273	7,141	3,339	4,895	4,784
OPERATING EXPENSES:					
Research and development, net	1,846	2,182	1,757	2,177	1,486
Selling and marketing	2,178	3,705	4,811	4,185	3,024
General and administrative	1,317	1,697	1,425	2,279	2,181
Restructuring costs	678	-	132	83	-
	-----	-----	-----	-----	-----
TOTAL OPERATING EXPENSES	6,019	7,584	8,125	8,724	6,691
OPERATING LOSS:	(1,746)	(443)	(4,786)	(3,829)	(1,907)
Financial income (expense), net	109	295	427	639	(91)
Other income (expenses)	45	(95)	(298)	(479)	2,150
	-----	-----	-----	-----	-----
EARNING (LOSS) BEFORE EQUITY IN LOSSES OF AN AFFILIATED COMPANY	(1,592)	(243)	(4,657)	(3,669)	152
Equity in losses of an affiliated company	(465)	(570)	(137)	(1,283)	(696)
	-----	-----	-----	-----	-----
NET LOSS FROM CONTINUING OPERATIONS	(2,057)	(813)	(4,794)	(4,952)	(544)
Net earning (loss) related to discontinued operations	2,036	(7,674)	(8,313)	(2,743)	(522)

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NET LOSS	----- (21) =====	----- (8,487) =====	----- (13,107) =====	----- (7,695) =====	----- (1,066) =====
Basic and diluted net loss per share from continuing operations	\$ (0.56) =====	\$ (0.26) =====	\$ (1.55) =====	\$ (1.66) =====	\$ (0.23) =====
Basic and diluted net earning (loss) per share related to discontinued operations	\$ 0.55 =====	\$ (2.46) =====	\$ (2.68) =====	\$ (0.92) =====	\$ (0.22) =====
Basic and diluted net loss per share	\$ (0.01) =====	\$ (2.72) =====	\$ (4.23) =====	\$ (2.58) =====	\$ (0.45) =====
Weighted average number of shares used in computing basic and diluted net earning (loss) per share	3,683 =====	3,117 =====	3,102 =====	2,982 =====	2,388 =====

\*) Restated

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YEAR ENDED DECEMBER 31:

BALANCE SHEET HIGHLIGHTED DATA:	2003*	2002*	2001*	2000	1999
-----	-----	-----	-----	-----	-----
CASH AND CASH EQUIVALENTS	3,872	5,246	8,325	16,470	261
Working Capital (*)	5,082	5,980	7,008	17,378	290
Total Assets	14,023	16,485	31,144	46,128	33,637
Short-term bank credit and current maturities of long-term debt	-	-	286	429	421
Long-term debt	951	794	794	1,049	1,542
Shareholders equity	10,541	8,015	16,341	29,444	13,675
(*)Working capital comprises of:					
Current assets	7,239	9,525	10,677	20,795	3,411

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Less: current liabilities	2,157	3,545	3,669	3,417	3,121
	-----	-----	-----	-----	-----
	5,082	5,980	7,008	17,378	290
	=====	=====	=====	=====	=====

\*) RESTATED

### ITEM 4: INFORMATION ON THE COMPANY

#### 4A. HISTORY AND DEVELOPMENT OF THE COMPANY

We were incorporated in Israel in 1990 as a private corporation under the Israeli Companies Ordinance, 1983. Our headquarters and manufacturing facilities are located at 100 Bos Road, Teradyon Industrial Zone, Misgav 20179 Israel. Our telephone number is 972-4-990-7555.

In January 2002, the Company changed its organizational structure. As part of this change, the Company 's marketing, development, production and support activities were sold to Lynk, a B.O.S. subsidiary founded in 1995, to develop and market high-quality data access convergence and remote access solutions, and later VOIP hardware and software telephony, for the corporate market. Following the reorganization, Lynk changed its name to BOScom Ltd.

On May 24, 2002, the Company announced its intention to sell PacInfoSystems (see Risk Factors and Note 1c to the Consolidated Financial Statements) due to a change in the Company's business strategy. PacInfoSystems was the Company's wholly-owned U.S. subsidiary that resold, installed and provided computer networking products to various business entities. Management formulated a new strategic plan that provided for the discontinuation of the computer networking business. As a result, the Company decided in May 2002 to sell PacInfoSystems and to write-off amortized goodwill associated with PacInfoSystems in the amount of \$3.9 million.

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However, the Company's efforts to sell PacInfoSystems, whose financial situation was deteriorating, were not successful. Further developments, such as an arbitration judgment rendered against PacInfoSystem in the sum of approximately \$650,000, continuation of poor sales results, termination of line of credit, as well as the loss of some key employees and members of the sales force, left the Company with little choice but to wind up the business. PacInfoSystems has already settled with a majority of its creditors, however, there can be no assurance that such a settlement will be reached with the remainder of the creditors.

Our U.S. subsidiaries are Lynk USA, Inc., and its subsidiary PacInfoSystems, Inc. (into which our U.S. subsidiary, Better On-Line Solutions Inc. was merged in early 2001). Both are non-operational and commencing the beginning of year 2003 we market our products in the U.S. through one Master Distributor.

Our other subsidiaries are BOScom Ltd., in Israel, and its subsidiaries - Better On-Line Solutions Ltd. in the U.K; Better On-Line Solutions S.A.S. in France; and BOSDelaware, Inc., in the US. During 2003, the operation of the BOScom subsidiaries was ceased (although all subsidiaries still exist except for the French one) and the sales and marketing in Europe and USA have since been conducted through master distributors.

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In addition, we have an interest in Surf Communications Solutions Ltd. ("Surf"), the leading supplier of embedded network convergence software that lends flexibility and scalability to network products handling data modem, fax, and voice transmissions. In March 2003, the Company purchased from Catalyst Investors L.P. ("Catalyst") most of the Surf shares held by Catalyst. Under the terms of the transaction, the Company purchased 191,548 of Catalyst's Preferred C shares in Surf, and a pro rata share of the Surf Preferred C warrants held by Catalyst, and in exchange it issued to Catalyst 2,529,100 ordinary shares of the Company (representing 19.9% of its current outstanding shares pre-issuance, as a result of which Catalyst held 16.6% of the outstanding Company shares, after the issuance). The Company has an option to purchase the remaining Catalyst Preferred C shares in Surf by January 31, 2006, and until such purchase has voting rights in these Surf shares, in addition to being entitled to profits resulting from the sale of these shares to a third party. In February 2004, these voting rights were assigned to Mr. Yair Shamir, one of the Company's directors. Thus, the Company now holds 19.8% in Surf, and 15.3% on a fully diluted basis (assuming the Company does not exercise its option to purchase the additional shares from Catalyst). Yair Shamir holds 0.2% in Surf (and 0.2% on a fully diluted basis), in addition to his holdings of 2.8% of the voting rights in Surf (2.3% on a fully diluted basis) assigned to him by the Company.

As a result of the Catalyst transaction, the Company has the ability to exercise significant influence over Surf and therefore applied the equity method of accounting with respect to its investment in Surf. In order to present financial statements in accordance with accounting principles generally accepted in the United States, the Company has restated its financial statements as detailed below, with respect to its investment in Surf which was previously accounted for based on the cost method, to account for it based on the equity method of accounting.

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Consequently the investment, results of operations (current and prior periods presented), and retained earnings of the Company were adjusted retroactively in a manner consistent with the accounting for a step-by-step acquisition of a subsidiary. Since its investment in Common stock was reduced to zero in prior years, the Company recognized equity losses only with respect to its share in the Preferred C shares (8.4% since November 2001 through March 2003 and thereafter 15.7%). As a result, the Company recorded equity losses in the total amount of \$ 1,172 thousands for the years 2001 through 2003 and reversed the impairment expenses of \$ 840 thousands recorded in 2003 due to the fact that the equity losses recorded, reduced the book value of the investment in Surf below its fair value. The accumulated equity losses net of the impairment expenses were \$ 332 thousands.

We design, integrate and test our products in our facilities in northern Israel. In early 1996, we moved into a new facility, which resulted in the expansion of our production capabilities and has allowed us to continue to benefit from substantial Israeli tax incentives.

### ITEM 5: OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The following management's discussion and analysis of financial condition and results of operations should be read in conjunction with our financial statements and notes thereto. Certain matters discussed below and throughout this annual report are forward-looking statements that are based on our beliefs and assumptions as well as information currently available to us. Such

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forward-looking statements may be identified by the use of the words "anticipate", "believe", "estimate", "expect", "plan" and similar expressions. Such statements reflect our current views with respect to future events and are subject to certain risks and uncertainties. While we believe such forward-looking statements are based on reasonable assumptions, should one or more of the underlying assumptions prove incorrect, or these risks or uncertainties materialize, our actual results may differ materially from those described herein. Please read the section below entitled "Factors That May Affect Future Results" to review conditions that we believe could cause actual results to differ materially from those contemplated by the forward-looking statements.

The Company's discussion and analysis of its financial condition and result of operations is based upon the Company's consolidated financial statements which have been prepared in accordance with generally accepted accounting principles ("GAAP ") in the United States of America. Prior to 2003, the consolidated financial statements were prepared in accordance with Israeli GAAP with reconciliation to U.S.GAAP. The Company believes that investors and other users of its financial statements would benefit if the primary financial statements were prepared in accordance with U.S., rather than Israeli, GAAP.

### CRITICAL ACCOUNTING POLICIES

The preparation of these financial statements required the Company to make estimations and judgments, in accordance with U.S. GAAP, that affect the reporting amounts of assets, liabilities, revenues and expenses and related disclosure of contingent assets and liabilities. On an ongoing basis, the Company evaluates its estimates, including those related to revenue recognition, bad debts, inventories and legal contingencies. The Company based its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis of making judgments about the values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

For a review of the accounting policies that form the basis of the above-referenced estimates and judgments that the Company made in preparing its consolidated financial statements, please see Note 2 (Significant Accounting Policies) to the Consolidated Financial Statements. The following accounting policies had the most significant impact on the Financial Statements for the year ended December 31, 2003.

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### REVENUE RECOGNITION

We recognize revenues from sales of product and services in accordance with Staff Accounting Bulletin No. 101 "Revenue Recognition in Financial Statements" ("SAB 101"), Staff Accounting Bulletin No. 104 "Revenue Recognition in Financial Statements" ("SAB 104") and Statement of Position No. 97-2 "Software Revenue Recognition" ("SOP 97-2") when delivery has occurred, persuasive evidence of an arrangement exists, the vendor's fee is fixed or determinable, no further obligation exists, and collection is reasonably assured. When a right of return exists, the Company defers revenues until the right of return expires. Determination of the probability of collection is based on management's judgments regarding the payment of fees for services rendered and products delivered. This determination is based on management's periodic assessment of the credit worthiness and other known factors of its customers and distributors.

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If this assessment will not properly reflect the actual collection, revenue recognized for any reporting period could be adversely affected.

### ALLOWANCE FOR DOUBTFUL ACCOUNTS

The Company maintains an allowance for doubtful accounts for estimated losses, which may result from the inability of its customers to make required payments. Management exercises judgment as to its ability to collect outstanding receivables. Allowances for doubtful accounts are made based upon a specific review of all significant outstanding invoices. For those invoices not specifically reviewed, allowances for doubtful accounts are made based upon the age of the receivable. In determining the allowance, the Company analyzes its historical collection experience and current economic trends. If the historical data used to calculate the allowances for doubtful accounts do not reflect the future ability to collect outstanding receivables, additional allowances for doubtful accounts may be needed and the future results of operations could be materially affected.

### INVENTORIES

Inventories are valued at the lower of cost or market value. Cost is determined as follows:

Raw and packaging materials	- Moving Average Cost Method
Products in progress and finished products	- On the production costs basis with the addition of allocable indirect manufacturing costs

If actual market conditions prove less favorable than those projected by management, additional inventory write-downs may be required. Inventories are written down for estimated obsolescence based upon assumptions about future demand and market conditions. Likewise, favorable future demand and market conditions could positively impact future operating results if inventory that has been written down is sold. As of December 31, 2003, inventory is presented net of \$300,000 general provision for technological obsolescence and slow moving items (see also Note 5 to the Consolidated Financial Statements).

### LEGAL CONTINGENCIES

The Company has been a party to various legal proceedings in the normal course of its business (see Item 8A for more details). The results of legal proceedings are difficult to predict and an unfavorable resolution of a lawsuit or proceeding may occur. Management believes that the prospects of these proceedings to prevail and recover a significant amount, seem remote, and accordingly no provision was recorded. As additional information becomes available, management will reassess the potential liability related to these legal proceedings and may revise its estimate of the probable cost of this proceedings. Such revisions in the estimates of the probable cost could have a material adverse effect on the Company's future results of operations and financial position.



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### 5A. RESULTS OF OPERATIONS

On May 29, 2003 we effected a 1:4 reverse stock split. All share and per share data for periods prior to that date have been retroactively adjusted to reflect this reverse stock split.

#### COMPARISON OF 2003 AND 2002

Year 2003 results of operation reflected the reorganization made in the sales and marketing organization. In the United States, up until the fourth quarter of 2002, we marketed our BOScom products through a US subsidiary (the BOS US division of PacInfoSystems). Currently, we market our products through one Master Distributor (Bosanova, Inc.)

In Europe, up until the second quarter of 2003, we marketed our BOScom products through subsidiaries in the U.K. and France. Currently, we market our products through local distributors that provide pre and post sales support. Products sold in the rest of the world are serviced from our headquarters in Israel.

As a result of the above reorganization, the Company experienced a significant decrease in revenues in 2003, due to the distributors' margin, which was only partially compensated for by the decrease in sales and marketing expenses. Furthermore, as a result of the reorganization, in 2003 the Company recorded a restructuring cost of \$680,000.

Consolidated revenues for 2003 were \$5,728,000 compared with \$9,441,000 in 2002, a 39% decrease.

The major reasons for the decrease were: (a) sales through master distributors in year 2003 compared to sales through subsidiaries in year 2002, as the margins of the master distributors decreased revenues; and (b) slowdown in sales due to global slowdown in the telecommunications industry.

Gross profit in 2003 totaled \$4,273,000, representing 75% of revenues, compared with \$7,141,000, constituting 76% of revenues in 2002. Cost of revenues of year 2003 includes income of \$339,000 due to a reversal of a non-recurring royalty for the Office of the Chief Scientist (see also Note 14a to the Consolidated Financial Statements). Excluding such income, the gross profit for year 2003 represented 69% of revenues compared to 76% in year 2002, the major reasons for the decrease being (a) sales through master distributors in year 2003 compared to sales through subsidiaries in year 2002 which caused a decrease in the sale price while the cost of revenue remained virtually the same; and (b) revenues of BOSANOVA PrintBoss in year 2003 decreased to \$448,000 compared to \$1,387,000 in year 2002. Since the BOSANOVA PrintBoss is a software product with a relatively low cost of production, the decrease in its revenues in year 2003 compared to year 2002 significantly affected the gross profit.

Net research and development costs in 2003 decreased by 15% to \$1,846,000 compared to \$2,182,000 in 2002. The expenses in 2003 included \$283,000 funding that the Company received from the Office of the Chief Scientist. In 2002 the company did not receive such funding. Excluding the effect of the funds received from the Office of the Chief Scientist in 2003, the research and development costs in 2003 remained virtually the same as in year 2002.

Selling and marketing expenses in year 2003 decreased by 41% to \$2,178,000, compared to \$3,705,000 in 2002. The major reason for such decrease was sales through subsidiaries in 2002, as opposed to sales through distributors in year 2003 after the operation of the subsidiaries was ceased.

General and administrative expenses in year 2003 decreased by 22% to \$1,317,000 compared to \$1,697,000 in 2002. The major reason was the reduction in payroll of employees and directors, by 17%, effected July 2003.

Restructuring costs in year 2003 amounted to \$678,000 which resulted from ceasing the operation of the Company's subsidiaries in Europe.

As a result of the foregoing, our operating loss in 2003 was \$1,746,000 compared to an operating loss of \$443,000 in 2002.

The Company had net financial income of \$109,000 in 2003 compared with net financial income of \$295,000 in 2002. The decrease in the financial income is related to the decrease in cash and investment balances during 2003 and to decrease of financial income from translation of foreign currency into dollar.

Equity in losses of an affiliated company refers to the Company's investment in Surf which amounted to \$465,000 in 2003 compared to \$570,000 in 2002. The investment in Surf is accounted for using the equity method, since the Company has the ability to exercise significant influence over Surf (through the Company's ownership of voting securities representing more than 20% of the voting rights of Surf) and therefore applied the equity method. In order to present financial statements in accordance with accounting principles generally accepted in the United States, the Company has restated its financial statements as detailed below, with respect to its investments in Surf which was previously accounted for based on the cost method, to accounting for it according to the equity method of accounting (see Item 4A).

As a result, net loss from the continuing operations for 2003 amounted to \$2,057,000 compared with \$813,000 in 2002. On a per share basis, the net loss from the continuing operations in 2003 was \$0.56 per share compared with a \$0.26 net loss per share in 2002. (For details regarding computation of net loss per share, see Note 14d to the Consolidated Financial Statements.)

The net earnings related to the discontinuing operations for 2003 was \$2,036,000 compared with a loss of \$7,674,000 in 2002. The earnings of 2003 resulted from debt settlement with more than 95% of PacInfoSystems' external creditors for an amount which was significantly lower than the face value of the debt.

The total net loss for 2003 was \$21,000, compared with \$8,487,000 in 2002. On a per share basis, the net loss in 2003 was \$0.01 per share compared with a \$2.72 net loss per share in 2002.

#### COMPARISON OF 2002 AND 2001

Consolidated revenues for 2002 were \$9,441,000, compared with \$6,042,000 in 2001, a 56% increase.

During 2002 we focused our sales on our core business products. The S&M activity was aimed to expand our customer base and distribution channels.

During 2002 we succeeded in closing a software deal with one customer which represented about 13% of the total revenues.

Gross profit in 2002 totaled \$7,141,000, representing 76% of revenues, compared with \$3,339,000, constituting 55% of revenues in 2001. The difference is related mainly to high provisions for slow inventory that the company made in 2001 relating to its IP old product line.

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Net research and development costs in 2002 increased 24% to \$2,182,000, compared with \$1,757,000 in 2001. The expenses in 2001 included \$989,000 funding that the Company received from the Office of the Chief Scientist. In 2002 the company did not receive such funding.

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Gross research and development costs in 2002 decreased 21% to \$2,182,000, compared with \$2,746,000 in 2001, mainly due to HR costs reduction. We improved the R&D staff by replacing some of our engineers with new ones, who are better skilled and more efficient but paid lower salaries.

In Europe we closed branches that were not economically efficient and made some personnel changes. These steps saved us \$500,000 in operational and other expenses compared to 2001. In addition, we reduced our operational costs in the US by \$550,000 compared to 2001.

Selling and marketing expenses decrease by 23% to \$3,705,000 in 2002 compared to \$4,811,000 in 2001 mainly due to the closing of branches in Europe and the reduction of operations in the US.

General and administrative expenses increased by 19% to \$1,697,000 in 2002, compared to \$1,425,000 in 2001. This increase is due to expenses related to 2002 reorganization of the US subsidiary and the closing of branches in Europe.

As a result of the foregoing, our operating loss in 2002 was \$443,000 compared with an operating loss of \$4,786,000 in 2001.

The Company had net financial income of \$295,000 in 2002 compared with net financial income of \$427,000 in 2001. The decrease in the financial income is related to a decrease in cash and investment balances during 2002.

Other expenses for 2002 were \$95,000, compared with other expenses of \$298,000 in 2001. (For more details regarding other expenses, see Note 14c to the Consolidated Financial Statements).

Equity in losses of an affiliated company refers to investment in Surf which amounted to \$570,000 in 2002 compared to \$137,000 in 2001. The investment in a company is stated at equity method, since the Company has the ability to exercise significant influence over Surf and applied the equity method. In order to present financial statements in accordance with accounting principles generally accepted in the United States, the Company has restated its financial statements as detailed below, with respect to its investments in Surf which was previously accounted based on the cost method, to accounting for it according to the equity method of accounting (see Item 4A).

As a result of the foregoing, net loss from the continuing operations for 2002 amounted to \$813,000 compared with \$4,794,000 in 2001. On a per share basis, the net loss from continuing operations in 2002 was \$0.26 per share compared with a \$1.55 net loss per share in 2001.

The net loss related to the discontinuing operations for 2002 was \$7,674,000 compared with \$8,313,000 in 2001. On a per share basis, the net loss from the discontinuing operations in 2002 was \$2.46 per share compared with a \$2.68 net loss per share in 2001.

The total net loss for 2002 was \$8,487,000, compared with \$13,107,000 in 2001. On a per share basis, the net loss in 2002 was \$2.72 per share compared with a \$4.23 net loss per share in 2001.

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### VARIABILITY OF QUARTERLY OPERATING RESULTS

Our revenues and profitability may vary in any given year, and from quarter to quarter, depending on the number of products sold. In addition, due to potential competition, uncertain market acceptance and other factors, we may be required to reduce prices for our products in the future.

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Our future results will be affected by a number of factors including our ability to:

- o increase the number of products sold,
- o develop, introduce and deliver new products on a timely basis,
- o anticipate accurately customer demand patterns and
- o manage future inventory levels in line with anticipated demand.

These results may also be affected by currency exchange rate fluctuations and economic conditions in the geographical areas in which we operate. There can be no assurance that our historical trends will continue, or that revenues, gross profit and net income in any particular quarter will not be lower than those of the preceding quarters, including comparable quarters.

### IMPACT OF INFLATION AND CURRENCY FLUCTUATIONS

The US Dollar cost of our operations in Israel is influenced by the differential between the rate of inflation in Israel and any change in the value of the NIS relative to the Dollar.

A devaluation of the NIS in relation to the US Dollar will have the effect of decreasing the costs in NIS and a converse effect in case of devaluation of the US Dollar in relation to the NIS.

A devaluation of the NIS in relation to the US Dollar will have the effect of decreasing the Dollar value of any of our assets which consist of NIS (unless such asset is linked to the Dollar). Such a devaluation would also have the effect of reducing the Dollar amount of any of our liabilities which are payable in NIS (unless such payables are linked to the Dollar). Conversely, any increase in the value of the NIS in relation to the Dollar will have the effect of increasing the Dollar value of our assets which consist of NIS (unless such asset is linked to the Dollar). Such an increase would also have the effect of increasing the Dollar amount of any of our liabilities which are payable in NIS (unless such payables are linked to the Dollar).

In the years ended December 31 2003, 2002, 2001, 2000 and 1999, the annual inflation rate in Israel as adjusted for the devaluation of the Israeli currency in relation to the Dollar was 5.7% (0.8)%, (7.8)%, 2.7% and 1.5%, respectively. The closing representative exchange rate of the Dollar at the end of each such period, as reported by the Bank of Israel, was NIS 4.379 NIS 4.737, NIS 4.416, NIS 4.041 and NIS 4.153, respectively. As a result, the Company experienced increases in the Dollar costs of operations in Israel in 1999, 2000 and 2003, and decreases in 2001 and 2002.

### EFFECTIVE CORPORATE TAX RATE

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The Israeli regular tax rate imposed on companies is 36%, however, the effective tax rate payable by a company (such as ours) which derives income from an "Approved Enterprise," may be considerably less. See Note 13 to the Consolidated Financial Statements and Item 10E ahead. Subject to relevant tax treaties, dividends or interest received by an Israeli corporation from subsidiaries are generally subject to tax (unless the subsidiary's income is subject to Israeli corporate tax) regardless of its status as an Approved Enterprise. We anticipate that most of our taxable income over the next several years will be tax exempt in Israel. Our U.S. and U.K. subsidiaries, however, will be subject to U.S. and U.K. corporate income taxes, respectively, on their taxable income.

On January 1, 2003, a comprehensive tax reform took effect in Israel. Pursuant to the reform, resident companies are subject to Israeli tax on income accrued or derived in Israel or abroad. In addition, the concept of "controlled foreign corporations" was introduced, according to which an Israeli company may become subject to Israeli taxes on certain income of a non-Israeli subsidiary if the subsidiary's primary source of income is passive income (such as interest, dividends, royalties, rental income or capital gains). The tax reform also substantially changed the system of taxation of capital gains.

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### GRANTS AND PARTICIPATION

Under the Law for the Encouragement of Industrial Research and Development, 1984 (the "Research Law"), research and development programs approved by a research committee appointed by the Israeli Government are eligible for grants in exchange for payment to the Government of royalties from the sale of products developed in accordance with the Program. Regulations issued under the Research Law generally provide for the payment of royalties to the Office of the Chief Scientist of 3.5% on sales of products developed as a result of a research project so funded until 100% of the dollar-linked grant is repaid. Royalties payable with respect to grants received under programs approved by the OCS after January 1, 1999, are subject to interest on the U.S. dollar-linked value of the total grants received at the annual rate of LIBOR applicable to U.S. dollar deposits at the date the grants received.

The Research Law requires that the manufacture of any product developed as a result of research and development funded by the Israeli Government take place in Israel. It also provides that know-how from the research may not be transferred to third parties without the approval of the Israeli Office of the Chief Scientist in the Ministry of Industry and Trade. As of December 31, 2003, the total amount of grants which we received from the Office of the Chief Scientist, net of royalties paid or accrued, accumulated interest and net of non-recurring royalty reversal recorded in year 2003 in the amount of \$339,000, totaled \$5,621,000, compared with \$ 5,875,000 as of December 31, 2002. We are committed to paying royalties to the Fund for the Encouragement of Exports for its participation, by way of grants, in our marketing expenses outside of Israel. Royalties payable are 3% of the growth in exports, from the year we received the grant, up to 100% of the dollar-linked amount of the grant received at the date the grants received.

The total amount of the grants we received from the Fund, net of royalties paid or accrued, was \$144,000 on December 31, 2003, compared with \$225,000 on December 31, 2002.

### CONDITIONS IN ISRAEL

We are incorporated under the laws of Israel. Our offices and product

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development and manufacturing facilities are located in Israel. As a consequence, we are directly affected by political, economic and military conditions in Israel. Our operations would be substantially impaired if major hostilities involving Israel should occur or if trade between Israel and its present trading partners should be curtailed. See also Item 3D - Risk Factors.

### POLITICAL AND ECONOMIC CONDITIONS

Since the establishment of the State of Israel in 1948, a number of armed conflicts have taken place between Israel and its Arab neighbors and a state of hostility, varying from time to time in intensity and degree, has led to security and economic problems for Israel. A peace agreement between Israel and Egypt was signed in 1979. However, economic relations have been limited.

Since 1993, a joint Israeli - Palestinian Declaration of Principles and several agreements between Israel and Palestinian representatives have been signed outlining interim self-government arrangements. Israel has since transferred the civil administration of the Gaza Strip and several major towns and villages in the West Bank to the Palestinian Authority.

In addition, Israel and several other Arab States announced their intention to establish trade and other relations and are discussing certain projects. As of the date hereof, Israel has not entered into any peace agreement with Syria or Lebanon. There is substantial uncertainty with regard to how the "peace process" will develop or what effect it may have on us.

Furthermore, full diplomatic ties between Israel and Jordan were created following a peace treaty signed in 1994. The treaty expressed a mutual desire for full economic cooperation, the lifting of economic barriers and a strive towards the lifting of any economic boycotts by third parties.

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Despite the progress towards peace between Israel, its Arab neighbors and the Palestinians, certain countries, companies and organizations continue to participate in a boycott of Israeli firms. We do not believe that the boycott has had a material adverse effect on us, but there can be no assurance that restrictive laws, policies or practices directed towards Israel or Israeli businesses will not have an adverse impact on our business or financial condition in the future.

Some of our employees are obligated to perform annual reserve duty in the Israel Defense Forces and may, at any time, be called for active military duty. While we have operated effectively under those and similar requirements in the past, no assessment can be made of the full impact of such requirements on us in the future, particularly if emergency circumstances occur.

Israel's economy has been subject to many destabilizing factors including a period of high inflation in the early to mid-1980s. It has also been subject to low foreign exchange reserves, fluctuations in world commodity prices, military conflicts and civil unrest. The Government of Israel has intervened in several sectors of the economy, employing among other means, fiscal and monetary policies, import duties, foreign currency restrictions and control of wages, as well as prices and foreign currency exchange rates.

In 1998, the Israeli currency control regulations were liberalized dramatically. As a result, Israeli citizens can generally freely purchase and sell Israeli currency and assets. The Government of Israel has periodically changed its policies in these areas. There are currently no Israeli currency control

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restrictions on remittances of dividends on ordinary shares or proceeds from the sale of ordinary shares; however, legislation remains in effect pursuant to which currency controls can be imposed by administrative action at any time.

The costs of our operations in Israel are generally incurred in New Israeli Shekels ("NIS"). If the inflation rate in Israel exceeds the rate of devaluation of the NIS against the US Dollar in any period, the costs of our Israeli operations, as measured in US Dollars, could increase. Israel's economy has, at various times in the past, experienced high rates of inflation.

Like many Israeli companies, we receive grants and tax benefits from the Israeli Government. We also participate in programs sponsored by the Israeli Government. The reduction or termination of any such grants, programs or tax benefits, especially those benefits available as a result of the "Approved Enterprise" status of certain facilities in Israel, could have a materially adverse effect on future investments by us in Israel.

### TRADE AGREEMENTS

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

Israel and the European Union signed a Free Trade Agreement, which became effective on July 1, 1975, that confers certain advantages with respect to Israeli exports to most European countries and obligates Israel to lower its tariffs with respect to imports from these countries over a number of years. In 1985, Israel and the United States entered into an agreement to establish a Free Trade Area ("FTA"). The FTA has eliminated all tariff and certain non-tariff barriers on most trade between the two countries.

On January 1, 1993, Israel and the European Free Trade Association ("EFTA"), entered into an agreement establishing a free-trade zone between Israel and the EFTA nations. In recent years, Israel has established commercial and trade relations with a number of other nations, including Russia, the People's Republic of China, India and the nations of Eastern Europe, with which Israel had not previously had such relations.

### 5B. LIQUIDITY AND CAPITAL RESOURCES

We finance our activities by different means, including proceeds of equity financing, long-term loans, grants from the Office of the Chief Scientist in Israel and income from operating activities.

In December 2003 we received net proceeds of \$928,000 from a private placement with two European private investors. We issued these investors 357,143 ordinary shares at a price per share of \$2.80. We also granted these investors certain incidental registration rights with respect to the ordinary shares they purchased.

On June 10, 2004 the Company entered into a Securities Purchase Agreement (the "Purchase Agreement"), with Laurus Master Fund Ltd. (the "Investor"), under

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which the Company issued and sold to the Investor in a private placement (i) a Secured Convertible Term Note of a \$2 million principal amount, due June 10, 2007 (the "Note") and (ii) a warrant to purchase 130,000 Ordinary Shares at an exercise price of \$4.04 per share (the "Warrant"). The Warrant is exercisable, in whole or in part, until June 10, 2011. The Note bears interest at a fluctuating interest rate equal at all times to the prime rate plus 3%, subject to reduction if the average closing price of the Registrant's Ordinary Shares exceeds certain benchmarks. The proceeds from the private placement will be used for general working capital purposes and/or mergers and acquisitions.

The Note is convertible into Ordinary Shares at a price of \$3.08 per share (subject to adjustment). The principal amount of the Note is repayable in monthly installments, commencing as of October 1, 2004, in the initial amount of \$20,000 eventually increasing to \$73,600, and may be paid in cash or, subject to certain conditions, in Ordinary Shares. Interest on the Note is payable monthly and may be paid in cash or, subject to certain conditions, in Ordinary Shares. The Note is secured by a security interest in certain assets of the Company.

The Company also entered into a Registration Rights agreement with the Investor pursuant to which the Company agreed to prepare and file with the Securities and Exchange Commission within 45 days a registration statement covering the resale of Ordinary Shares that is issuable upon conversion of the Note and/or exercise of the Warrants, and/or issuable in payment of principal and interest on the Note.

As of December 31, 2003, we had \$3,872,000 in cash and cash equivalents, \$2,876,000 in marketable securities, and positive working capital of \$5,082,000. Net cash used in operating activities of continuing operations in 2003 was \$1,937,000 compared to cash provided by operating activities in 2002 in the amount of \$127,000. The cash used in operating activities in year 2003 was adversely affected by a number of factors. First, a decrease in gross profit due to the sales through distributors instead of subsidiaries from mid 2003, which was not immediately compensated by decrease in the sales and marketing expenses in 2003. Second, the revenues of BOSANOVA PrintBoss in year 2003 amounted to \$448,000 compared to \$1,387,000 in year 2002. Since the BOSANOVA PrintBoss is a software product with a relatively low cost of production, the decrease in its revenues in year 2003 compared to year 2002 adversely affected the cash used in operating activities. Net cash provided by investing activities in 2003 was \$519,000 which was mainly due to realization of restricted cash into cash and cash equivalents.

The Company does not currently have borrowings from financial institutions.

Working capital and working capital requirements will vary from time-to-time and will depend on numerous factors, including but not limited to operating results, the level of resources devoted to research and development, new product introductions, grants from the Office of the Chief Scientist in Israel, marketing and acquisition activities.

We have in-balance sheet financial instruments and off-balance sheet contingent commitments. Our in-balance sheet financial instruments consist of our assets and liabilities. Our cash is invested in short-term (less than 3 months) U.S. dollars and NIS interest bearing deposits with banks. Our receivables' aging is between 60 to 70 days and our current liabilities' aging is approximately 60 days. The fair value of our financial instruments is similar to their book value. Our off-balance sheet contingent commitments consist of: (a) royalty commitments that are directly related to our future revenues, (b) lease



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commitments of our premises and vehicles, (c) directors and officers' indemnities, in excess of the proceeds received from liability insurance which we obtain and (d) legal proceeding.

We believe that cash resources are sufficient to meet our needs for at least 12 months following the date of this submission. However, it is our intention to engage in equity and loan financing to further feature-rich products of the Company and establish distribution channels in new markets. There is, however, no assurance that we shall be able to obtain such financing.

### 5C. RESEARCH AND DEVELOPMENT

We believe that our future growth will depend upon our ability to enhance our existing products and introduce new products on a timely basis. Since we commenced operations, we have conducted extensive research and development activities. In 2003, gross research and development costs totaled \$2,129,000, compared to \$2,182,000 in 2002 and \$2,746,000 in 2001.

Our research and development efforts have been focused on VOIP solutions, and our existing products for the IBM midrange market. We intend to finance our research and development activities with our own resources and grants from the Office of the Chief Scientist. Grants from the Chief Scientist totaled \$283,000 in 2003 and \$989,000 in 2001 (no grants were received for the year 2002).

### 5D. TREND INFORMATION

The global slowdown in the telecommunications industry has taken its toll on our company. The effect of a prolonged slowdown may continue to result in lower sales and lower gross margins as our products may be subject to price pressure due to reduced demand, write-downs and write-offs.

Over the past few years there has been a continuous global decrease in sales and revenues from the connectivity solutions sector (also known as the legacy family products) (see Item 4B). Although the Company's revenues in this sector have decreased as a result, in comparison to other players in this field, we have fared quite well.

Currently the Company's R&D focuses mainly on the company's VOIP line of products, that will successfully compete with Legacy telephony quality and reliability, and will allow special CTI (Computer Telephony Integration) features that are not available in Legacy telephony today. These products will allow seamless integration with legacy telephony systems, thus reducing the implementation price. In addition, the products will guaranty the quality of service and will allow the end users to use the telephone system in the same way that they used their non-IP-enabled system. Until now, complicated installation, non-transparent usage and inconsistent quality of service were the major issues that slowed-down the implementation of VOIP in the corporate market. With the new line of intelligent gateways, these hurdles are solved, thus opening new opportunities in this market. According to market research performed by professional market analysis firms such as Advanced Business Link, the revenues in this VOIP market are expected to grow for at least the next five years. Although the Company's business in this market has not fared well until now, we hope to overcome marketing and other hurdles, and become a significant player in this field, although there is no assurance that we will be able to do so.

### 5E. OFF-BALANCE SHEET ARRANGEMENTS

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In 1998, as part of PacInfoSystems' Share Purchase Agreement between the Company and Mr. Jacob Lee (the seller of PacInfoSystems who became a shareholder of the Company), certain actions involving PacInfoSystems, if occurring before the end of 2003, may trigger a tax event for Mr. Jacob Lee. In such event, the Company may be obligated, under the purchase agreement, to grant Mr. Lee a loan on a full recourse basis for certain tax payments Mr. Lee may be liable for, currently estimated at approximately \$1.5 million. The purchase agreement provides that the Company is to receive a security interest in shares of the Company that Mr. Lee holds at the time of the loan with a fair market value as of the date of the loan of at least 125% of the amount of the loan as security for the repayment of the loan. In addition, in the event the Company is required to loan such sum to Mr. Lee, the Company may also be required to reimburse Mr. Lee for certain interest on taxes that he may owe. It is possible that the windup of PacInfoSystems during 2002 and 2003 may have triggered such a tax event for Mr. Lee, which would result in an obligation by the Company to loan Mr. Lee such amount and to reimburse him for interest expenses incidental to the tax event.

### 5F. TABULAR DISCLOSURE OF CONTRACTUAL OBLIGATIONS

The following table summarizes our contractual obligations as of December 31, 2003:

	Payment due by period				
	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
Operating lease	\$471	\$286	\$185	-	-
Purchase obligation	\$415	\$415	-	-	-
Total	\$886	\$701	\$185	-	-

The above table does not include contingent obligations to pay royalties to the Office of the Chief Scientist and to the Overseas Marketing Fund since the total amount to be paid under the terms of those agreements are a function of future sales (see note 11(a)(1) of the Consolidated Financial Statements).

### ITEM 8: FINANCIAL INFORMATION.

#### 8A. CONSOLIDATED STATEMENTS AND OTHER FINANCIAL INFORMATION

##### CONSOLIDATED FINANCIAL STATEMENTS

See Item 18.

##### SALES OUTSIDE ISRAEL

The total amount of export sales of the Company has been as follows:

2003- \$4,173,000 (totaling 73% of all revenues); 2002 - \$7,147,000 (totaling 76% of all revenues); 2001 - \$4,787,000 (totaling 79% of all revenues);

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### LEGAL PROCEEDINGS

In 2001, our US subsidiary, PacInfoSystems acquired 100% of Dean Tech. The effective date of the acquisition was January 1, 2001. The total purchase price, including acquisition costs, consisted of \$275,000 in cash plus Dean Tech's total amount of cash and accounts receivables, less accounts payable, and plus payments to the sellers of certain annual earn-out payments until April 15, 2004. During the second quarter of 2002, the sellers of Dean Tech disputed the financial audit and earnings calculations of Dean Tech for the year ended 2001, which directly affected their earn-out payment for that year. Their dispute was submitted to the American Arbitration Association ("AAA") and contained a claim for an earn-out payment in the amount of \$900,000 against PacInfoSystems. In October 2002, the AAA resolved that PacInfoSystems should pay the sellers of Dean Tech \$618,000 plus \$29,000 arbitration costs. In July 2003 BOS entered into an Agreement and Assignment of the AAA Judgment with the sellers of Dean Tech, and negotiated a final payment of \$324,000, made by BOS to the sellers of Dean Tech

PacInfoSystems is responsible for collecting sales taxes on sales of products to customers in various states. Between 1999 and 2001 PacInfoSystems had not remitted collected sales taxes to several states on a timely basis. As of December 31, 2001, the financial statements included a liability for taxes, interest and estimated penalties amounting to \$1,392,000. During 2002, PacInfoSystems paid its unpaid sales taxes according to certain amnesties with state authorities in the amount of \$772,000. As a result, PacInfoSystems reversed the provision for interests and penalties in the amount of \$568,000. During year 2003 the Company reached a final settlement with the tax authorities, which resulted in additional sales tax expenses in year 2003 in the amount of \$28,000. As of December 31, 2003 there is no sales tax debt.

In July 2002, Operate Lease, Ltd., a company from which the Company leased cars for its employees, claimed that the Company's termination notice of the leasing agreement in March 2002 constituted a breach of the agreement and Operate Lease demanded compensation in the amount of NIS 1,278,968 (the nominal sum of the claim is equivalent to approximately \$292,000, as of December 31, 2003). The Company denied the claim and to date, no legal proceeding has been filed. The Company does not believe that the chances of Operate Lease prevailing and recovering a significant amount, are high, and therefore no provision was recorded.

On the basis of an audit conducted by the Office of the Chief Scientist in October 2002, the Company was required to pay royalties in the sum of \$473,200 for the years 1991-1999 (in excess of royalties already paid for this period). The Company paid \$23,367 and appealed with respect of the remainder of the sum claimed. In July 2003 the company entered into an agreement with the Chief Scientist pursuant to which the required royalties for the years 1991-1999 were reduced from \$473,200 to \$247,000. The Company has recorded a provision for the reduced amount.

### DIVIDEND POLICY

We intend to reinvest our earnings and therefore do not anticipate paying any cash dividends in the foreseeable future. The declaration and payment of any cash dividends in the future will be determined by the Board of Directors in light of the conditions existing at the time. This will include our earnings and financial condition. We may only pay cash dividends in any fiscal year out of "profits," as determined under Israeli statutory standards. Any dividends paid out of Approved Enterprise earnings (i.e. tax exempt income) will be liable to tax. As we do not intend to distribute these earnings, no provision has been

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made for this additional tax in our Financial Statements.

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### 8B. SIGNIFICANT CHANGES

Not applicable.

### ITEM 18: FINANCIAL STATEMENTS

The following restated financial statements are filed as part of this Annual Report:

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	----
Report of Independent Auditors	F-2
Consolidated Balance Sheets	F-3 - F-4
Consolidated Statements of Operations	F-5
Statement of Changes in Shareholders' Equity	F-6
Statements of Cash Flows	F-7 - F-8
Notes to Consolidated Financial Statements	F-9 - F-33

The consolidated financial statements of Surf Communications Solutions Ltd., are also filed as part of this Annual Report.

### ITEM 19: EXHIBITS

The following exhibits are filed as part of this Annual Report:

- 1.1 Memorandum of Association, as amended (incorporated by reference to the Company's Annual Report on Form 20-F filed on June 27, 2003).
- 1.2 Articles of Association, as amended (incorporated by reference to the Company's Annual Report on Form 20-F filed on June 27, 2003).
- 4.1 Form of Indemnification Agreement between the Company and its officers and directors (incorporated by reference to the Company's Current Report on Form 6-K filed on January 17, 2003).
- 4.2\* Share Purchase Agreement, dated as of February 23, 2003, and Option Agreement and Registration Rights Agreement, dated as of March 30, 2003, by and between Catalyst Investments L.P. and the Registrant.
- 4.3\* Share Purchase Agreement and Registration Rights Agreement, dated as of December 14, 2003, by and between Hillswood Holdings Limited and Vamos Inc. and the Registrant.
- 4.4\* Services Agreement, dated as of April 15, 2003, between Cukierman & Co. Investment House Ltd., BOScom Ltd. and the Registrant.
- 4.5\* Management Agreement between Signum Ltd., Adiv Baruch and the Registrant, dated as of January 1, 2004.
- 4.6\* Securities Purchase Agreement, Master Security Agreement and Registration Rights Agreement, dated as of June 10, 2004, by and between Laurus Master

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Fund Ltd. and the Registrant.

- 4.7 Distribution Agreement, dated as of January 15, 2003, by and between Boscom Ltd. and Bosanova Inc.
- 8.1 List of subsidiaries (incorporated by reference to Item 4C of this Annual Report on Form 20-F).
- 10.1 Consent of Kost Forer Gabbay & Kasierer, a member of Ernst &Young Global.

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- 31.1 Certification by Chief Executive Officer pursuant to Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934.
- 31.2 Certification by Chief Financial Officer pursuant to Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934.
- 32.1 Certification by Chief Executive Officer and Chief Financial Officer pursuant to Rule 13a-14(b) or Rule 15d-14(b) of the Securities Exchange Act of 1934.

\* previously filed

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SIGNATURES

The Registrant hereby certifies that it meets all of the requirements for filing on Form 20-F and that it has duly caused and authorized the undersigned to sign this Amendment No. 1 to its annual report on its behalf.

B.O.S. Better On-Line Solutions, Ltd.

/s/ Adiv Baruch  
-----  
Adiv Baruch  
President and Chief Executive Officer

/s/ Nehemia Kaufman  
-----  
Nehemia Kaufman  
Chief Financial Officer

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Date: January 6, 2005

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B.O.S. BETTER ONLINE SOLUTIONS LTD.  
AND ITS SUBSIDIARIES  
CONSOLIDATED FINANCIAL STATEMENTS  
AS OF DECEMBER 31, 2003  
IN U.S. DOLLARS

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STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY	F6
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REPORT OF INDEPENDENT AUDITORS

THE BOARD OF DIRECTORS AND SHAREHOLDERS OF

B.O.S. BETTER ONLINE SOLUTIONS LTD. AND SUBSIDIARIES

We have audited the accompanying consolidated balance sheets of B.O.S Better OnLine Solution Ltd. ("the Company") and subsidiaries as of December 31, 2003 and 2002, and the related consolidated statements of operations, changes in shareholders' equity and cash flows for each of the three years in the period

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ended December 31, 2003. 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. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company and subsidiaries at December 31, 2003 and 2002, and the consolidated results of their operations and cash flows for each of the three years in the period ended December 31, 2003, in conformity with U.S. generally accepted accounting principles.

As described in Note 1e of the notes to the consolidated financial statements, the accompanying financial statements have been restated to correct amounts with respect to the Company's investment in an affiliated company.

As discussed in the notes to the consolidated financial statements, effective January 1, 2002 the Company changed its method of accounting for goodwill to conform with Statement of Financial Accounting Standards No.142, "Goodwill and Other Intangible Assets" see Note 2(k).

Tel-Aviv, Israel  
 March 22, 2004, Except for note 1e, as to  
 which the date is January 6,  
 2005

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

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B.O.S. BETTER ONLINE SOLUTIONS LTD.  
 AND ITS SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

U.S. DOLLARS IN THOUSANDS

	DECEMBER 31, 2003*)
ASSETS	
CURRENT ASSETS	
Cash and cash equivalents	\$ 3,872
Restricted cash (Note 3)	-

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Marketable securities (Note 6)	1,014
Trade receivables (net of allowance for doubtful accounts of \$ 171 in 2003 and \$ 347 in 2002)	1,075
Other accounts receivable and prepaid expenses (Note 4)	317
Inventories (Note 5)	961
	-----
	7,239
	-----
LONG-TERM INVESTMENTS:	
Long-term marketable securities (Note 6)	1,862
Long-term prepaid expenses	-
Severance pay funds	684
Investment in an affiliated company (Note 7)	2,780
	-----
Total long-term investments	5,326
	-----
PROPERTY AND EQUIPMENT, NET (Note 8)	598
	-----
GOODWILL (Note 9)	741
	-----
ASSETS RELATED TO DISCONTINUED OPERATIONS (Note 1c)	119
	-----
	\$14,023
	=====

\*) Restated, see Note 1e.

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

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B.O.S. BETTER ONLINE SOLUTIONS LTD.  
AND ITS SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

-----  
U.S. DOLLARS IN THOUSANDS, EXCEPT SHARE DATA

LIABILITIES AND SHAREHOLDERS' EQUITY

CURRENT LIABILITIES:

DE  
-----  
2003\*)  
-----



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Trade payables	\$ 464
Employee and payroll accruals	404
Deferred revenues	378
Accrued expenses and other liabilities (Note 10)	911
	-----
Total current liabilities	2,157
	-----
ACCRUED SEVERANCE PAY	951
	-----
LIABILITIES RELATED TO DISCONTINUED OPERATIONS (Note 1c)	374
	-----
COMMITMENTS AND CONTINGENT LIABILITIES (Note 11)	
SHAREHOLDERS' EQUITY:	
Share capital (Note 12)-	
Ordinary shares of NIS 4.00 par value: Authorized: 8,750,000 shares at December 31, 2003 and 2002; Issued 4,167,509 and 3,177,264 shares at December 2003 and 2002, respectively; Outstanding: 4,162,126 and 3,171,881 shares at December 2003 and 2002, respectively	4,309
Additional paid-in capital	43,247
Treasury shares (5,383 Ordinary shares at December 31, 2003 and 2002)	(150)
Accumulated deficit	(36,865)
	-----
	10,541
	-----
	\$ 14,023
	=====

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

\*) Restated, see Note 1e.

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B.O.S. BETTER ONLINE SOLUTIONS LTD.  
AND ITS SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

U.S. DOLLARS IN THOUSANDS, EXCEPT PER SHARE DATA

	YEAR ENDED	
	2003*)	2002*
	-----	-----
Revenues	\$ 5,728	\$ 9,4
Cost of revenues	1,794	2,3
Non recurring royalty reversal (Note 14a)	(339)	

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Gross profit	4,273	7,1
Operating costs and expenses:		
Research and development	2,129	2,1
Less - grants and participation	(283)	
Sales and marketing	2,178	3,7
General and administrative	1,317	1,6
Restructuring and related costs	678	
Total operating costs and expenses	6,019	7,5
Operating loss	(1,746)	(4
Financial income, net (Note 14b)	109	2
Other income (expenses) (Note 14c)	45	(
Loss before equity in losses of an affiliated company	(1,592)	(2
Equity in losses of an affiliated company	465	5
Net loss from continuing operations	(2,057)	(8
Net income (loss) related to discontinued operations (Note 1c)	2,036	(7,6
Net loss	\$ (21)	\$ (8,4
Basic and diluted net loss per share from continuing operations (Note 14d)	\$ (0.56)	\$ (0.
Basic and diluted net income (loss) per share from discontinued operations (Note 14d)	\$ 0.55	\$ (2.
Basic and diluted net loss per share NIS 4.00 par value (Note 14d)	\$ (0.01)	\$ (2.

\*) Restated, see Note 1e.

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

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B.O.S. BETTER ONLINE SOLUTIONS LTD.  
AND ITS SUBSIDIARIES

STATEMENTS OF SHAREHOLDERS' EQUITY

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U.S. DOLLARS IN THOUSANDS, EXCEPT SHARE DATA

	NUMBER OF ORDINARY SHARES	SHARE CAPITAL	ADDITIONAL PAID-IN CAPITAL	ACCUM DEFI
Balance at January 1, 2001	3,102,264	\$ 3,628	\$ 41,216	\$ (1
Stock based compensation	-	-	4	
Net loss	-	-	-	(1
Balance at December 31, 2001	3,102,264	3,628	41,220	(2
Issuance of shares	3,750	3	27	
Issuance of shares related to the private placement in 2000	71,250	59	(1)	
Reversal of accrued issuance expenses	-	-	66	
Stock based compensation related to warrants issued to service providers	-	-	7	
Net loss	-	-	-	(
Balance at December 31, 2002	3,177,264	3,690	41,319	(3
Issuance of shares related to share swap transaction	633,102	537	1,059	
Issuance of shares related to the private placement in 2003	357,143	82	846	
Stock based compensation related to warrants issued to service providers	-	-	23	
Net loss	-	-	-	
Balance at December 31, 2003	4,167,509	\$ 4,309	\$ 43,247	\$ (3

\*) Restated, see Note 1e.

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

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B.O.S. BETTER ONLINE SOLUTIONS LTD.  
AND ITS SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. DOLLARS IN THOUSANDS

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	YEAR ENDED DECEMBER 31, 2003 *) -----	YEAR ENDED DECEMBER 31, 20 -----
CASH FLOWS FROM OPERATING ACTIVITIES		
Net loss	\$ (21)	\$ (8,
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Net loss (income) from discontinuing operations	(2,036)	7,
Depreciation and amortization	307	
Impairment of property and equipment	110	
Accrued severance pay, net	36	
Amortization of premium on marketable securities	101	
Interest on investment in affiliate	-	
Equity in losses of an affiliated company	465	
Capital loss from sale of property and equipment	6	
Gain on sale of marketable securities	(13)	
Stock based compensation related to warrants issued to service providers	23	
Decrease (increase) in trade receivables	448	
Decrease in other accounts receivable and prepaid expenses	131	
Decrease (increase) in inventories	(106)	
Increase (decrease) in trade payables	(580)	
Increase (decrease) in employees and payroll accruals, deferred revenues, accrued expenses and other liabilities	(808)	
	-----	-----
Net cash flows provided by (used in) continuing operations	(1,937)	
Net cash provided by (used in) operating activities from discontinuing operations	(1,032)	
	-----	-----
Net cash provided by (used in) operating activities	(2,969)	
	-----	-----
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of property and equipment	(64)	
Proceeds from sale of property and equipment	8	
Purchase of other assets	-	
Investment in long-term marketable securities	(971)	
Investment in an affiliated company	(155)	
Realization of (investment in) restricted cash	700	
Proceeds from sale of marketable securities	1,001	
	-----	-----
Net cash provided by (used in) investing activities from continuing operations	519	(1,
Net cash used in investing activities from discontinuing operations	-	(
	-----	-----
Net cash provided by (used in) investing activities	519	(1,
	-----	-----
CASH FLOWS FROM FINANCING ACTIVITIES:		
Repayment of long-term loan	-	
Proceeds from issuance of shares	928	
Payment for acquisition of a subsidiary	-	
Issuance expenses related to investment in an affiliated company	(159)	
	-----	-----
Net cash provided by (used in) financing activities from		

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continuing operations	769	(
Net cash used in financing activities from discontinuing operations	(47)	(3,
	-----	-----
Net cash provided by (used in) financing activities	722	(3,
	-----	-----
Decrease in cash and cash equivalents	(1,728)	(3,
Decrease (increase) in cash and cash equivalents of discontinuing operations	354	
Cash and cash equivalents at the beginning of the year	5,246	8,
	-----	-----
Cash and cash equivalents at the end of the year	\$ 3,872	\$ 5,
	=====	=====

\*) Restated, see Note 1e.

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

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B.O.S. BETTER ONLINE SOLUTIONS LTD.  
AND ITS SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. DOLLARS IN THOUSANDS

	YEAR ENDED DECEMBER 31, 2003 *)	YEAR DECEMBER 200
	-----	-----
Supplemental disclosure of cash flow activities:		
(i) Net cash paid during the year for:		
Interest	\$ 1	\$
	=====	=
(ii) Non-cash activities:		
Investment in an affiliated company against issuance of shares	\$ 1,755	\$
	=====	=
Reversal of issuance expenses payable	\$ -	\$
	=====	=

\*) Restated, see Note 1e.

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

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B.O.S. BETTER ONLINE SOLUTIONS LTD.  
AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## Edgar Filing: BOS BETTER ONLINE SOLUTIONS LTD - Form 20-F/A

-----  
U.S. DOLLARS IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA

### NOTE 1:- GENERAL

B.O.S. Better Online Solutions Ltd. is an Israeli corporation together with its subsidiaries (hereinafter "the Company" or "BOS"):

- a. Since January 2002, the Company's structure was re organized by transforming the Company into a holding company specializing in high tech investments and by merging the Company's connectivity operations into BOScom. As such, on January 1, 2002, the net assets pertaining to the connectivity operations were transferred to BOScom.

The Company's wholly owned subsidiary, "BOScom" operates in connectivity, software utilities and communication solution product lines.

Connectivity - A solutions for seamless integration of personal computers and Local Area Networks into the midrange host environment. "BOScom" also design, integrate, test, market and support superior products that provide efficient solutions to personnel connecting personal computers to IBM midrange hosts.

Software Utilities - Powerful solutions for document design, distribution and management solutions for a wide range of operating systems, including mainframe and UNIX.

Communication Solutions - BOScom developed a series of Voice over Internet protocol (" VOIP ") communication products designed for the corporate market. The gateways enable enterprises to reduce or eliminate inter-office communication costs or bypass long-distance costs using their private Intranet or the public Internet to carry telephone calls. They also provide a powerful means to extend Private Branch Exchange ("PBX") functionality to the enterprise's branch offices.

In 2003, the Company reorganized BOScom activity by ceasing the operation off all of its wholly owned marketing subsidiaries in the UK and France and began to sell its products directly through independent distributors. As a result, the Company reduced the total worldwide employees by approximately 49 employees and incurred \$ 678 thousand in restructuring costs in accordance with SFAS 146 "Accounting for Costs Associated with Exit or Disposal Activities". SFAS No.146 requires that a liability for a cost associated with an exit or disposal activity be recognized and measured, initially at fair value, only when the liability is incurred. The provisions of SFAS No.146 are effective for exit or disposal activities that are initiated after December 31, 2002.

- b. Accounting principles:

The consolidated financial statements for all years presented are prepared in accordance with generally accepted accounting principles ("GAAP ") in the United States of America. Prior to 2003, the consolidated financial statements were prepared in accordance with Israeli GAAP with reconciliation to U.S.GAAP.

- c. Discontinued operation:

On June 1, 1998, the Company acquired 100% of the share capital of Pacinfo ("Pacinfo"), a U.S. corporation. Pacinfo is a reseller of

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computer networking products. In April 2001, Pacinfo acquired Dean Technologies Associated LLC. ("DT") Texas limited Liability Company, which was also engaged in the computer-networking segment.

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B.O.S. BETTER ONLINE SOLUTIONS LTD.  
AND ITS SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA

#### NOTE 1:- GENERAL (CONT.)

In May 2002, the Board of Directors of the Company decided to sell all Pacinfo activity. During the fourth quarter of 2002, following unsuccessful efforts to sell Pacinfo and due to poor economic condition and continued operating losses together with a loss of key officers and employees, the Company initiated a plan to cease operations of Pacinfo and to proceed with a voluntary liquidation of the Company.

The results of operations including revenue, operating expenses and other income and expenses of Pacinfo for 2003, 2002 and 2001 have been reclassified in the accompanying statements of operations as discontinued operations.

The Company's balance sheets at December 31, 2003 and 2002 reflect the net liabilities of the Pacinfo as liabilities and assets related to discontinued operations within liabilities related to discontinuing operations and assets related to discontinuing operations.

The carrying amounts of the major classes of assets and liabilities included as part of the discontinued operation are:

	DECEMBER 31,	
	2003	2002
Cash	\$ 69	\$ 423
Trade receivables, other receivables and prepaid expenses	18	597
Property and equipment, net	32	95
	-----	-----
Assets of discontinued operation	\$ 119	\$1,115
	=====	=====
Trade payables	\$ 299	\$2,456
Accrued expenses and other liabilities	75	1,675
	-----	-----
Liabilities of discontinued operation	\$ 374	\$4,131
	=====	=====

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The results of operations, including revenues, cost of revenues and operating expenses of Pacinfo operation for 2003, 2002 and 2001 have been reclassified in the statements of operations. Taxes were not attributed to the discontinued operation due to utilization of losses from previous years, for which a valuation allowance was provided. Summarized selected financial information of the discontinued operation is as follows:

	YEAR ENDED DECEMBER 31,		
	2003	2002	2001
Revenues	\$ 25	\$ 32,912	\$ 53,168
Net income (loss)	\$ 2,036	\$ (7,674)	\$ (8,313)

- d. The Company had one major customer in 2003, which constituted 52 % of the revenues. This major customer is the Company's master distributor in the U.S. In the event that the Company encounters problems working with the master distributor, the Company may experience an interruption in sales until an alternative source of distribution can be found, which may have a material adverse effect on the financial statements.

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B.O.S. BETTER ONLINE SOLUTIONS LTD.  
AND ITS SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA

- e. Restatement of financial statements:

The Company has restated its financial statements for 2001, 2002 and 2003 to reflect revised accounting treatment in its investment in an affiliated company, Surf Communications Solution LTD. ("Surf") as a result of an additional investment in an affiliated company that occurred during 2003. Following the restatement the Company accounted for its investment in an affiliated company under the equity method of accounting, which was previously accounted based on the cost method.

In February 2003, the Company entered into an agreement with Catalyst Investors L.P. ("Catalyst") to issue Catalyst 633,102 Ordinary shares. In consideration for the issued shares, Catalyst granted 191,548 series C Preferred shares it held in Surf and additional voting rights of 124,936 Preferred C shares that increased the Company's voting rights from 10.7% to 23% of Surf. As a result of the Catalyst transaction, the Company has the ability to exercise significant influence over Surf. Consequently, the results of operations (current and prior periods presented), and retained earnings of the Company were adjusted retroactively in a manner consistent with the accounting



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for a step-by-step investment in an affiliated company. Since its investment in Common stock was reduced to zero in prior years, the Company recognized equity losses only with respect to its share in the Preferred C shares (8.4% since November 2001 through March 2003 and thereafter 15.7%), in accordance with EITF 99-10 "Percentage Used to Determine the Amount of Equity Method Losses"

To adjust the investment according to the equity method, the Company recorded equity losses in the amounts of \$ 465, \$ 570 and \$ 137 for the years 2003, 2002 and 2001 respectively. As a result, the Company reversed the impairment expense of \$ 840 recorded in 2003 due to the fact that the equity losses recorded, reduced the carrying amount of the investment in Surf below its fair value. The accumulated equity losses net of the impairment expenses were \$ 332.

THE FOLLOWING TABLE SHOWS THE RECONCILIATIONS OF ALL AMOUNTS AS PREVIOUSLY REPORTED AND AS RESTATED:

	YEAR ENDED DECEMBER 31, 2003		
	AS PREVIOUSLY REPORTED	RESTATEMENT	AS RESTATED
Operating loss	(1,746)	-	(1,746)
Other income	(795)	840	45
Loss before equity in losses of an affiliated company	(2,432)	840	(1,592)
Equity in losses of an affiliated company	-	(465)	(465)
Net loss from continuing operations	(2,432)	375	(2,057)
Net loss	(396)	375	(21)
Basic and diluted net income (loss) per share from continuing operations	(0.66)	0.10	(0.56)
Basic and diluted net loss per share	(0.11)	0.10	(0.01)

Accordingly as of December 31, 2003 the investment in surf was reduced by \$ 332.

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B.O.S. BETTER ONLINE SOLUTIONS LTD.  
AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA

NOTE 1:- GENERAL (CONT.)

YEAR ENDED  
DECEMBER 31, 2002

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	AS PREVIOUSLY REPORTED	RESTATEMENT	AS RESTATED
Operating loss	(443)	-	(443)
Equity in losses of an affiliated company	-	(570)	(570)
Net loss from continuing operations	(243)	(570)	(813)
Net loss	(7,917)	(570)	(8,487)
Basic and diluted net loss per share from continuing operations	(0.08)	(0.18)	(0.26)
Basic and diluted net loss per share	(2.54)	(0.18)	(2.72)

YEAR ENDED  
DECEMBER 31, 2001

	AS PREVIOUSLY REPORTED	RESTATEMENT	AS RESTATED
Operating loss	(4,786)	-	(4,786)
Equity in losses of an affiliated company	-	(137)	(137)
Net loss from continuing operations	(4,657)	(137)	(4,794)
Net loss	(12,970)	(137)	(13,107)
Basic and diluted net loss per share from continuing operations	(1.50)	(0.05)	(1.55)
Basic and diluted net loss per share	(4.18)	(0.05)	(4.23)

YEAR ENDED  
DECEMBER 31, 2003

	AS PREVIOUSLY REPORTED	RESTATEMENT	AS RESTATED
Cash flows from operating activities:			
Net loss	(396)	375	(21)
Equity in losses of an affiliated company	-	(465)	(465)
Impairment of investment in a company	840	(840)	-
Net cash flows used in continuing operations	(1,937)	-	(1,937)

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B.O.S. BETTER ONLINE SOLUTIONS LTD.  
AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS

NOTE 1:- GENERAL (CONT.)

	YEAR ENDED DECEMBER 31, 2002		
	AS PREVIOUSLY REPORTED	RESTATEMENT	AS RESTATED
Cash flows from operating activities:			
Net loss	(7,917)	(570)	(8,487)
Equity in losses of an affiliated company	-	(570)	(570)
Net cash flows provided by continuing operations	127	-	127

	YEAR ENDED DECEMBER 31, 2001		
	AS PREVIOUSLY REPORTED	RESTATEMENT	AS RESTATED
Cash flows from operating activities:			
Net loss	(12,970)	(137)	(13,107)
Equity in losses of an affiliated company	-	(137)	(137)
Net cash flows used in continuing operations	(1,670)	-	(1,670)

	DECEMBER 31, 2003		
	AS PREVIOUSLY REPORTED	RESTATEMENT	AS RESTATED
Investment in an affiliated company	3,112	(332)	2,780
Total long-term investments	5,658	(332)	5,326
Total assets	14,355	(332)	14,023
Accumulated deficit	(36,533)	(332)	(36,865)
Total shareholders' equity	10,873	(332)	10,541
Total liabilities and shareholders' equity	14,355	(332)	14,023

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	DECEMBER 31, 2002		
	AS PREVIOUSLY REPORTED	RESTATEMENT	AS RESTATED
Investment in an affiliated company	2,042	(707)	1,335
Total long-term investments	4,846	(707)	4,139
Total assets	17,192	(707)	16,485
Accumulated deficit	(36,137)	(707)	(36,844)
Total shareholders' equity	8,722	(707)	8,015
Total liabilities and shareholders' equity	17,192	(707)	16,485

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B.O.S. BETTER ONLINE SOLUTIONS LTD.  
AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES

a. Use of estimates:

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

b. Financial statements in U.S. dollars ("dollar"):

A substantial portion of the Company's revenues is generated in U.S. dollar ("dollars"). In addition, most of the Company's costs are incurred in dollars.

Company's management believes that the dollar is the primary currency of the economic environment in which the Company operate. Thus, the functional and reporting currency of the Company is the dollar.

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

c. Principles of consolidation:

The consolidated financial statements include the accounts of the

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Company and its wholly owned subsidiaries. Inter-company transactions and balances including profits from inter-company sales not yet realized outside the group have been eliminated upon consolidation.

d. Cash equivalents:

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

e. Marketable securities:

The Company accounts for investments in debt securities in accordance with Statement of Financial Accounting Standard No.115, "Accounting for Certain Investments in Debt and Equity Securities" ("SFAS No.115"). Management determines the appropriate classification of its investments in debt and equity securities at the time of purchase and reevaluates such determinations at each balance sheet date. Debt securities are classified as held-to-maturity

When the Company has the positive intent and ability to hold the securities to maturity and are stated at amortized cost. The amortized cost of held-to-maturity securities is adjusted for amortization of premiums and accretion of discounts to maturity. Such amortization and decline in value judged to be other than temporary and interest are included in financial income, net.

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B.O.S. BETTER ONLINE SOLUTIONS LTD.  
AND ITS SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

-----  
U.S. DOLLARS IN THOUSANDS

#### NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

f. Restricted cash

Restricted cash is primarily invested in certificates of deposit, which mature within one year and was used as security for the line of credit granted to Pacinfo in 2002 (see Notes 1c and Note 3).

g. Inventories:

Inventory write-offs are provided to cover risks arising from slow-moving items or technological obsolescence. As of December 31, 2003, inventory is presented net of \$ 300 general provision for technological obsolescence and slow moving items (see also note 5).

Inventories are valued at the lower of cost or market value. Cost is determined as follows: Raw and packaging materials- Moving average cost method.

Products in progress and finished products - On the production costs basis with the addition of allocable indirect manufacturing costs.

h. Grants and royalty-bearing grants:

Grants and royalty-bearing grants from the Chief Scientist of the

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Ministry of Industry and Trade in Israel for funding certain approved research projects and for funding marketing activities are recognized at the time the Company is entitled to such grants, on the basis of the related costs incurred, and are presented as a deduction of research and development costs.

i Investment in an affiliated company:

An affiliated company is a company in which the Company is able to exercise significant influence, but that is not a consolidated subsidiary and is accounted for by the equity method, net of write-down for decrease in fair value which is not of a temporary nature.

Investment in affiliated company represents investments in Ordinary shares and Preferred shares. The Company applies EITF 99-10, "Percentage Used to Determine the Amount of Equity Method Losses" (EITF No. 99-10"). Accordingly, losses of the affiliated company are recognized based on the ownership level of the particular investee security held by the investor.

The Company's investment in this company is reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the investment may not be recoverable, in accordance with Accounting Principle Board Opinion No. 18 "The Equity Method of Accounting for Investments in Common Stock" ("APB No. 18"). As of December 31, 2003, based on management's most recent analyses, no impairment losses have been identified.

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B.O.S. BETTER ONLINE SOLUTIONS LTD.  
AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. DOLLARS IN THOUSANDS

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

j. Property and equipment:

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

	%
	-----
Computers and peripheral equipment	20 - 33
Office furniture and equipment	6 - 15
Leasehold improvements	10

The Company's property and equipment are reviewed for impairment in accordance with Statement of Financial Accounting Standard No. 144

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"Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS No. 144") whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to the future undiscounted cash flows expected to be generated by the assets. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Impairment losses have been recorded amounting to \$ 110, \$ 95 and \$ 0 for the years ended December 31, 2003, 2002 and 2001, respectively.

k. Goodwill:

Goodwill represents excess of the costs over the net assets of businesses acquired. Under Statement of Financial Accounting Standard No. 142, "Goodwill and Other Intangible Assets" ("SFAS No. 142") goodwill acquired in a business combination on or after July 1, 2001, is not amortized.

SFAS No. 142 requires goodwill to be tested for impairment on adoption and at least annually thereafter or between annual tests in certain circumstances, and written down when impaired, rather than being amortized as previous accounting standards required. Goodwill attributable to each of the reporting units is tested for impairment by comparing the fair value of each reporting unit with its carrying value. Fair value is determined using discounted cash flows. Significant estimates used in the methodologies include estimates of future cash flows, future short-term and long-term growth rates, weighted average cost of capital and estimates of market multiples for each of the reportable units. As of December 31, 2003, no impairment losses have been identified.

l. Research and development costs:

Statement of Financial Accounting Standards No. 86 "Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed," ("SFAS No. 86") requires capitalization of certain software development costs subsequent to the establishment of technological feasibility. Based on the Company product development process, technological feasibility is established upon completion of a working model. Research and development costs incurred in the process of developing product improvements or new products, are generally charged to expenses as incurred, net of participation of the Office of the Chief Scientist of the Israeli Ministry of Industry and Trade. Costs incurred by the Company between completion of the working model and the point at which the product is ready for general release are insignificant.

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B.O.S. BETTER ONLINE SOLUTIONS LTD.  
AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

-----  
U.S. DOLLARS IN THOUSANDS

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

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m. Severance pay:

The Company's liability for severance pay for Israeli resident employees is calculated pursuant to Israeli severance pay law based on the most recent salary of the employees multiplied by the number of years of employment as of the balance sheet date. Employees are entitled to one month's salary for each year of employment or a portion thereof. The Company's liability for its Israeli resident employees is covered by insurance policies designed solely for distributing severance pay. The value of these policies is recorded as an asset in the Company's balance sheet.

The insurance policies include profits accumulated up to the balance sheet date. The insurance policies may be withdrawn only upon complying with the 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 profits. Severance expenses for 2003, 2002 and 2001, amounted to \$ 178, \$ 114, and \$ 264, respectively.

n. Revenue recognition:

The Company's products are generally a bundled hardware and software solution that are delivered together. The Company sells its products primarily through distributors and resellers.

The Company derives its revenues from the sale of products, license fees for its products, maintenance, support and services.

Revenues from product sales are recognized in accordance with Staff Accounting Bulletin No. 104 "Revenue Recognition in Financial Statements" ("SAB 104") when delivery has occurred, persuasive evidence of an arrangement exists, the vendor's fee is fixed or determinable, no further obligation exists, and collectibility is reasonably assured. When a right of return exists, the Company defers revenues until the right of return expires. Revenues subject to certain price protection and stock rotation are deferred until distributor sells the products, or until the right expires.

Revenue from license fees is recognized in accordance with Statement of Position (SOP 97-2) "Software Revenue Recognition", when persuasive evidence of an agreement exists, delivery of the product has occurred, no significant obligations with regard to implementation remain, the fee is fixed or determinable, and collectibility is probable. The Company generally does not 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.

The provision for product returns is based on prior experience and is net of estimated manufacturing reimbursements.

Revenues from maintenance and support are recognized ratably over the period of the maintenance contract. Revenues from software license that require significant customization, integration and installation are recognized as they are completed, in accordance with SOP 81-1 "Accounting for Performance of Construction-Type and Certain Production-Type Contracts" guidelines.



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AND ITS SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. DOLLARS IN THOUSANDS

### NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

o. Warranty:

The Company provides a warranty between 3 to 36 months at no extra charge, whereby defective hardware covered by the warranty should be sent back to the Company. The Company estimates the costs that may be incurred under its warranty and records a liability in the amount of such costs at the time product revenue is recognized. Factors that affect the Company's warranty liability include the number of installed units, historical and anticipated rates of warranty claims, and cost per claim. The Company periodically assesses the adequacy of its recorded warranty liabilities and adjusts the amounts as necessary.

Changes in the Company's product warranty during the year 2003 period are as follows:

Balance, beginning of the year	\$ 174
Changes in warranties during the year	(42)
	-----
Balance, end of the year	\$ 132

p. Income taxes:

The Company account for income taxes in accordance with Statement of Financial Accounting Standards, SFAS 109, "Accounting for Income Taxes". This Statement prescribes the use of the liability method whereby deferred tax assets and liability account balances are determined based on differences between financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. The Company provide a valuation allowance, if necessary, to reduce deferred tax assets to their estimated realizable value.

q. Concentrations of credit risk:

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

Cash and cash equivalents are invested mainly in U.S. dollars in deposits with major banks in Israel. Such deposits may be in excess of insured limits and are not insured in other jurisdictions. Management believes that the financial institutions that hold the investments of the Company are financially sound and, accordingly, minimal credit risk exists with respect to these investments.

The trade receivables of the Company derived from sales to customers located primarily in the United States, Europe and Israel. The Company

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generally do not require collateral; however, in certain circumstances, the Company may require letters of credit, other collateral, additional guarantees or advanced payments. The Company performs ongoing credit evaluations of its customers and to date (except for customer relating to the discontinuing operations) has not experienced material losses. An allowance for doubtful accounts is determined with respect to specific debts that are doubtful of collection.

Investments in marketable securities are conducted through a bank in Israel, and include investments in corporate and governmental debentures. Management believes that the financial institutions that hold the Company's investments are financially sound, the portfolio is well diversified and accordingly, minimal credit risk exists with respect to these investments.

The Company have no off-balance-sheet concentration of credit risk such as foreign exchange contracts, option contracts or other foreign hedging arrangements.

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B.O.S. BETTER ONLINE SOLUTIONS LTD.  
AND ITS SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. DOLLARS IN THOUSANDS

#### NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

r. Basic and diluted net loss per share:

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

The total weighted average number of shares related to the outstanding options and warrants excluded from the calculations of diluted net loss per share, since they would have an anti-dilutive effect, were 505,178, 288,804 and 243,380 for the years ended December 31, 2003, 2002 and 2001, respectively.

s. 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 Interpretation No. 44, "Accounting for Certain Transactions Involving Stock Compensation" ("FIN 44"), in accounting for its employee stock option plan. Under APB-25, when the exercise price of the Company's employee stock options equals or is above than the market price of the underlying shares on the date of grant, no compensation expense is recognized.

The Company applies SFAS No. 123 "Accounting for stock Based Compensation" ("SFAS No. 123") and EITF 96-18, "Accounting for Equity Instruments that are Issued to Other Than Employees for Acquiring, or

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in Conjunction With, Selling, Goods or Services", with respect to warrants issued to non-employees. SFAS No. 123 requires the use of option valuation models to measure the fair value of the warrants at the date of grant.

Pro-forma disclosure is required by SFAS No. 123 , had the compensation expense for stock options granted under the Company's plans, been determined based on the fair value at the date of grant. The Company's net loss and loss per Ordinary share in 2003, 2002 and 2001 would have changed to the pro forma amounts shown below:

	YEAR ENDED DECEMBER 31,		
	2003 *)	2002 *)	2001 *)
Net loss as reported	\$ (21)	\$ (8,487)	\$ (13,107)
Deduct: stock-based compensation expense determined under fair value method for all awards	124	341	1,187
Pro forma net loss	\$ (145)	\$ (8,828)	\$ (14,294)
Pro forma basic and diluted net loss per share	\$ (0.04)	\$ (2.83)	\$ (4.61)

The fair value of each option granted is estimated on the date of grant, using the Black Scholes option pricing model with expected volatility of approximately 64%, 71% and 79% in 2003, 2002 and 2001, respectively and using the following weighted average assumptions:

- (1) Dividend yield of zero percent for each year.
  - (2) Risk-free interest rate of 1.8%, 1.5% and 2% in 2003, 2002 and 2001, respectively.
  - (3) Expected average lives of the options of three years from the date of grant as of 2003, 2002 and 2001.
- \*) Restated, see Note 1e

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

t. Fair value of financial instruments:

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

The carrying amounts of cash and cash equivalents, restricted cash, trade receivables, other accounts receivable and trade payables approximate their fair value due to the short-term maturities of such instruments.

The fair value for marketable securities is based on quoted market prices.

u. Impact of recently issued accounting standards:

In April 2003, the FASB issued SFAS No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities". SFAS No. 149 amends and clarifies (1) the accounting guidance on derivative instruments (including certain derivative instruments embedded in other contracts) and (2) hedging activities that fall within the scope of SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities". SFAS No. 149 amends SFAS No. 133 to reflect decisions made (1) as part of the Derivatives Implementation Group ("DIG") process that effectively required amendments to SFAS No. 133, (2) in connection with other projects dealing with financial instruments, and (3) regarding implementation issues related to the application of the definition of a derivative. SFAS No. 149 is effective (1) for contracts entered into or modified after June 30, 2003, with certain exceptions, and (2) for hedging relationships designated after June 30, 2003. The guidance is to be applied prospectively.

Generally, SFAS No. 149 improves financial reporting by (1) requiring that contracts with comparable characteristics be accounted for similarly and (2) clarifying when a derivative contains a financing component that warrants special reporting in the statement of cash flows. SFAS No. 149 is not expected to have a material impact on the Company's financial statements.

In November 2002, the FASB issued FASB Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, an interpretation of FASB Statements No. 5, 57, and 107 and Rescission of FASB Interpretation No. 34" ("FIN No. 45"). FIN No. 45 elaborates on the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under certain guarantees that it has issued. It also clarifies that a guarantor is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. FIN No. 45 does not prescribe a specific approach for subsequently measuring the guarantor's recognized liability over the term of the related guarantee. It also incorporates, without change, the guidance in FASB Interpretation No. 34, "Disclosure of Indirect Guarantees of Indebtedness of Others," which is being superseded. The disclosure provisions of FIN No. 45 are effective for financial statements of interim or annual periods that end after December 15, 2002, and the provisions for initial recognition and measurement are effective on a prospective basis for guarantees that are issued or modified after December 31, 2002, irrespective of a guarantor's year-end. The adoption of FIN No. 45 did not have a material impact on the results of operations or financial position.

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B.O.S. BETTER ONLINE SOLUTIONS LTD.  
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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS

### NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

In January 2003, the FASB issued Interpretation No. 46, "Consolidation of Variable Interest Entities" ("FIN 46"). The objective of FIN No. 46 is to improve financial reporting by companies involved with variable interest entities. A variable interest entity is a corporation, partnership, trust, or any other legal structure used for business purposes that either (a) does not have equity investors with voting rights or (b) has equity investors that do not provide sufficient financial resources for the entity to support its activities. FIN No. 46 requires a variable interest entity to be consolidated by a company if that company is subject to a majority of the risk of loss from the variable interest entity's activities or entitled to receive a majority of the entity's residual returns or both. FIN No. 46 also requires disclosures about variable interest entities that the company is not required to consolidate but in which it has a significant variable interest. The consolidation requirements of FIN No. 46 apply immediately to variable interest entities created after January 31, 2003. The consolidation requirements apply to older entities in the first fiscal year or interim period ending after March 15, 2004. Certain of the disclosure requirements apply in all financial statements issued after January 31, 2003, regardless of when the variable interest entity was established. As of December 31, 2003, the Company does not expect the adoption of FIN No. 46 to have a material impact on its consolidated financial statements.

In November 2002, Emerging Issues Task Force ("EITF") reached a consensus on Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables". EITF Issue No. 00-21 provides guidance on how to account for arrangements that involve the delivery or performance of multiple products, services and/or rights to use assets. The provisions of EITF Issue No. 00-21 applied to revenue arrangements entered into in fiscal periods beginning after June 15, 2003. Additionally, companies will be permitted to apply the consensus guidance in this issue to all existing arrangements as the cumulative effect of a change in accounting principle in accordance with APB Opinion No. 20, "Accounting Changes". The adoption of EITF Issue No. 00-21 did not have a material impact upon the Company's financial position, cash flows or results of operations.

#### v. Reclassification:

Certain amounts from prior years have been reclassified to conform to the current year presentation. As a result of the decision of the Board of Directors to cease the operations of Pacinfo (the Computer Networking Segment), the financial statements of the Company classify the assets, liabilities and operations of Pacinfo as a discontinued operations.

### NOTE 3:- RESTRICTED CASH

As of December 31, 2003, a fixed charge that was granted in order to secure the line of credit to Pacinfo has expired.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS

NOTE 4:- OTHER ACCOUNTS RECEIVABLE AND PREPAID EXPENSES

	DECEMBER 31,	
	2003	2002
	----	----
Government authorities	\$ 62	\$104
Prepaid expenses	107	189
Other	148	89
	----	----
	\$317	\$382
	=====	=====

NOTE 5:- INVENTORIES

	DECEMBER 31,	
	2003	2002
	----	----
Raw materials (including packaging materials)	\$299	\$429
Products in progress	277	228
Finished products	385	198
	----	----
	\$961	\$855
	=====	=====

The inventories are presented net of provision for technological obsolescence and slow-moving items of \$ 300 as of December 31, 2003 and 2002.

NOTE 6:- MARKETABLE SECURITIES

The following is a summary of held-to-maturity securities:

DECEMBER 31,						
2003			2002			
-----			-----			
AMORTIZED	GROSS UNREALIZED	GROSS UNREALIZED	ESTIMATED FAIR MARKET	AMORTIZED	GROSS UNREALIZED	GROSS UNREALIZED

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	COST	GAINS	LOSSES	VALUE	COST	GAINS	LO
	-----	-----	-----	-----	-----	-----	-----
HELD-TO-MATURITY:							
Government debts	\$ 612	\$ 9	\$ -	\$ 621	\$ 1,036	\$ 17	\$
Corporate debentures	2,264	50	-	2,314	2,009	8	
	-----	-----	-----	-----	-----	-----	-----
	\$ 2,876	\$ 59	\$ -	\$ 2,935	\$ 3,045	\$ 25	\$
	=====	=====	=====	=====	=====	=====	=====

Aggregate maturities of held-to-maturity securities for years subsequent to December 31, 2003 are:

	AMORTIZED COST	ESTIMATED FAIR MARKET VALUE
	-----	-----
HELD-TO-MATURITY:		
2004 (short-term marketable securities)	\$1,014	\$1,027
2005	1,568	1,604
2006	294	304
	-----	-----
	\$2,876	\$2,935
	=====	=====

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS

NOTE 7:- INVESTMENT IN A COMPANY

a. Investment in Surf

In November 2001, the Company invested \$ 1,000 as part of a private placement in Surf. At the same time, the Company converted its convertible loan in the amount of \$ 1,042 (principal and accrued interest) into Preferred shares in Surf at an exercise price equal to Surf's fair value as determined in the investment agreement. As a result of this private placement, the Company's holding in Surf was diluted to 17%, Accordingly the investment was accounted based on the cost accounting method.

In March 2003, the Company engaged with Catalyst Investors L.P. ("Catalyst"), in order to purchase additional 191,548 series C Preferred shares of Surf. In consideration, the Company issued to Catalyst Ordinary Shares, representing 19.90% of the issued and outstanding share capital of the Company immediately prior to the

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transaction and prior to the issuance of the shares, at a purchase price of \$2.776, aggregating to \$ 1,755. Catalyst also granted the Company, at no additional consideration, an option to purchase on or prior to January 31, 2006, any shares of Surf then held by Catalyst at an exercise price of \$9.1632 plus interest of 4.75%. In the event that Catalyst will sell its remaining shares in Surf prior to January 1, 2006, the Company will be entitled to the gain that will be realized in such sale.

As a result of this investment, the Company has the ability to exercise significant influence over Surf and therefore applied the equity method. According to APB 18 when an investment qualifies for use of the equity method, the investor should adopt the equity method of accounting by adjusting retroactively the investment, results of operations (current and prior periods presented), and retained earnings, in a manner consistent with the accounting for a step-by-step acquisition of a subsidiary.

### NOTE 8:- PROPERTY AND EQUIPMENT

	DECEMBER 31,	
	2003	2002
	-----	-----
Cost:		
Computers and software	\$1,798	\$1,816
Office furniture and equipment	532	682
Leasehold improvements	778	774
Vehicles	6	6
	-----	-----
	3,114	3,278
	-----	-----
Accumulated depreciation:		
Computers and software	1,561	1,398
Office furniture and equipment	351	385
Leasehold improvements	598	526
Vehicles	6	4
	-----	-----
	2,516	2,313
	-----	-----
Depreciated cost	\$ 598	\$ 965
	=====	=====

Depreciation expenses amounted to \$ 307, \$ 390 and \$ 386 for the years ended December 31, 2003, 2002 and 2001, respectively.



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U.S. DOLLARS IN THOUSANDS

NOTE 9:- GOODWILL

a. Purchase of additional holdings in BOScom:

In February 2002, the Company purchased additional 3% of the share capital of BOScom in consideration of \$ 30. The consideration was paid by the issuance of 3,750 Ordinary shares of the Company. Consequently, BOScom became a wholly owned subsidiary. As a result of the purchase, the Company recorded an additional amount \$ 30 as goodwill.

As of December 31, 2002 and 2003 the amortized goodwill amounted to \$ 741.

b. The pro forma results of operations presented below for the years ended December 31, 2001, 2002 and 2003, reflect the impact on results of operations had the Company adopted the non-amortization provisions of SFAS No. 142 effective January 1, 2001:

	YEAR ENDED DECEMBER 31,		
	2003 *)	2002 *)	2001 *
Reported net loss	\$ (21)	\$ (8,487)	\$ (13,1
Goodwill amortization	-	-	1
Adjusted net loss	\$ (21)	\$ (8,487)	\$ (12,9
Basic net loss per share:			
Reported net loss	\$ (0.01)	\$ (2.72)	\$ (4.
Goodwill amortization	-	-	0.
Adjusted basic and diluted net loss per share	\$ (0.01)	\$ (2.72)	\$ (4.

\*) Restated, see Note 1e

NOTE 10:- ACCRUED EXPENSES AND OTHER LIABILITIES

	DECEMBER 31,	
	2003	2002
Government of Israel	\$ 635	\$ 882
Provision for warranty	132	174
Other	144	237
	\$ 911	\$1,293

NOTE 11:- COMMITMENTS AND CONTINGENT LIABILITIES

a. Commitments:

1. Royalty commitments:

- i) Under the Company's research and development agreements with the Office of the Chief Scientist ("OCS") and pursuant to applicable laws, the Company is required to pay royalties at the rate of 3.5% of sales of products developed with funds provided by the OCS, up to an amount equal to 100% of the research and development grants (dollar-linked) received from the OCS. The obligation to pay these royalties is contingent upon actual sales of the products. Royalties payable with respect to grants received under programs approved by the OCS after January 1, 1999, are subject to interest on the U.S. dollar-linked value of the total grants received at the annual rate of LIBOR applicable to U.S. dollar deposits at the time the grants are received.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. DOLLARS IN THOUSANDS

As of December 31, 2003, the Company has an outstanding contingent obligation to pay royalties in the amount of approximately \$ 5,621, in respect of these grants.

- ii) The Israeli Government, through the Overseas Marketing Fund, awarded the Company grants for participation in expenses for overseas marketing. The Company is committed to pay royalties to the Fund for Encouragement of Marketing Activities at the rate of 3% of the increase in export sales, up to the amount of the grants received by the Company linked to the dollar and bearing interest of LIBOR (for a period of six months).

As of December 31, 2003, the Company had outstanding contingent obligations to pay royalties of \$ 144 with respect to these grants.

2. Other commitments:

The premises occupied by the Company and the Company's motor vehicles are rented under various operating lease agreements. The lease agreements for the premises and the motor vehicles expire on various dates ending in 2005.

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B.O.S. BETTER ONLINE SOLUTIONS LTD.  
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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA

### NOTE 11:- COMMITMENTS AND CONTINGENT LIABILITIES (CONT.)

Minimum future rental payments due under the above leases, at rates in effect at December 31, 2003, are as follows:

YEAR ENDED DECEMBER 31,

2004	\$286
2005	185
	----
	\$471
	====

Rental payments in 2003, 2002 and 2001 amounted to \$ 426, \$ 383 and \$ 283, respectively.

- b. In July 2002, the Company received a claim letter from Operate Lease Ltd., under which it claims that the Company's termination notice of the leasing agreement in March 2002 constitutes a breach of the agreement and Operate Lease is demanding compensation in which the nominal claim amount of \$ 292. No legal proceeding has yet been filed. At this stage, according to the Company's counsel assessment, the prospects of Operate Lease to prevail and recover a significant amount, seem remote. The financial statements do not include any provision in that regard.
- c. In 1998, as part of Pacinfo Share Purchase Agreement between the Company and Mr. Jacob Lee (the seller of Pacinfo who became a shareholder of the Company), certain actions involving PacInfoSystems, if occurring before the end of 2003, may trigger a tax event for Mr. Jacob Lee. The Company may be obligated, under the purchase agreement, to grant Mr. Lee a loan on a full recourse basis for certain tax payments Mr. Lee may be liable for, currently estimated at approximately \$1,500. The Company will receive a security interest in shares of the Company that Mr. Lee holds at the time of the loan with a fair market value as of the date of the loan of at least 125% of the amount of the loan as security for the repayment of the loan. In addition, in the event the Company is required to loan such sum to Mr. Lee, the Company may also be required to reimburse Mr. Lee for certain interest on taxes that he may owe. It is possible that the windup of PacInfoSystems during 2002 and 2003 may have triggered such a tax event for Mr. Lee, which would result in an obligation by the Company to loan Mr. Lee such amount and to reimburse him for interest expenses incidental to the tax event.

### NOTE 12:- SHAREHOLDERS' EQUITY

- a. In February 2003, the Board of Directors resolved to effect a one-to-four reverse split. The reverse split was approved by the

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shareholders in May 2003 and became effective on May 29, 2003. Upon effecting the reverse split; 4 Ordinary shares of NIS 1 par value each, have been converted and reclassified as one Ordinary share of NIS 4 par value.

All shares, options and earnings per share amounts have been retroactively adjusted for all periods presented to reflect the stock splits.

- b. In December 2003, the Company completed a private placement for the Company's Ordinary Shares with two European private investors. The Company issued to the investors 357,143 shares at a purchase price of \$ 2.80, for consideration of \$ 928 (net of \$ 72 issuance expenses).

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### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA

#### NOTE 12:- SHAREHOLDERS' EQUITY (CONT.)

- c. Stock options plan:

During 1994, 1995, 1999, 2000, 2001 the Board of Directors of the Company adopted stock option plans ("the Plans") pursuant to which 656,250 options for the purchase of the Company's Ordinary shares may be granted to officers, directors, consultants and employees of the Company. The Board of Directors has resolved that no further grants shall be made from the existing plans which, as of December 31, 2003, had in the aggregate 337,902 options left for issuance from the existing option pools previously approved by the shareholders. In May 2003 the Company's shareholders approved the adoption of the 2003 Stock Option Plan, pursuant to which 625,000 Ordinary Shares are reserved for purchase by employees, directors, consultants and service providers of the Company. As of December 31, 2003, an aggregate to 414,424 of these options are still available for future grant.

Each option granted under the plans expires between 5-10 years from the date of the grant. The options vest gradually over a period ranging between two to three years. Any options, which are cancelled or forfeited before expiration, become available for future grants.

The following is a summary of the Company's stock options granted to officers, directors, and employees among the various plans:

YEAR ENDED DECEMBER 31,					
2003		2002		2001	
NUMBER OF OPTIONS	WEIGHTED AVERAGE EXERCISE PRICE	NUMBER OF OPTIONS	WEIGHTED AVERAGE EXERCISE PRICE	NUMBER OF OPTIONS	WEIGHTED AVERAGE EXERCISE PRICE

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Options outstanding at beginning of year	211,929	16.00	243,380	16.48	224,740	21.16
Changes during the year:						
Granted	278,076	8.97	55,000	6.76	98,048	8.20
Forfeited or cancelled	(63,753)	12.53	(86,451)	11.40	(79,408)	19.48
	-----		-----		-----	
Options outstanding at end of year	426,252	11.93	211,929	16.00	243,380	16.48
	=====	=====	=====	=====	=====	=====
Options exercisable at the end of the year	194,926	20.36	169,054	16.24	127,293	18.32
	=====	=====	=====	=====	=====	=====

The options outstanding as of December 31, 2003, have been separated into ranges of exercise price as follows:

RANGE OF EXERCISE PRICE	OPTIONS OUTSTANDING AS OF DECEMBER 31, 2003	WEIGHTED AVERAGE EXERCISE PRICE	WEIGHTED AVERAGE REMAINING CONTRACTUAL LIFE (YEARS)	OPTIONS EXERCISABLE AS OF DECEMBER 31, 2003	WEIGHTED AVERAGE EXERCISE PRICE OF OPTIONS EXERCISABLE
-----	-----	-----	----	-----	-----
1.84-2.00	203,076	1.95	8.07	-	-
6.80	39,168	6.80	7.78	35,918	6.8
10.60	3,695	10.60	3.76	3,695	10.60
14.00	14,000	14.00	3.27	14,000	14.00
17.00-18.00	45,988	17.83	5.27	45,988	17.83
28.00	120,325	28.00	3.84	95,325	28.00
	-----			-----	
	426,252	11.93	6.13	194,926	20.36
	=====		=====	=====	=====

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA

NOTE 12:- SHAREHOLDERS' EQUITY (CONT.)

Options granted to employees in 2003, 2002 and 2001, have an exercise price equal to the fair market value of Ordinary share at the grant date. The weighted average fair values of the options granted during 2003, 2002 and 2001 were \$ 3.91, \$ 3.2 and \$ 4.27, respectively.

d. Options issued to service providers:

The Company accounts for these options in accordance with the provisions of SFAS 123 and EITF 96-18. The fair value for these

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options was estimated at the date of grant using an option pricing model with the following assumptions: risk-free interest rate of 1.5%, dividend yields of 0% volatility of 0.7, and an expected life of 2.5 year.

The compensation expense that has been recorded in the consolidated financial statements regarding these warrants for the years 2003, 2002 and 2001 were \$ 23, \$ 7 and \$ 4, respectively.

The Company's outstanding warrants to service providers as of December 31, 2003 are as follows:

ISSUANCE DATE	WARRANTS FOR ORDINARY SHARES	EXERCISE PRICE PER SHARE	WARRANTS EXERCISABLE	EXERCISABLE THROUGH
October 2002	75,000	\$ 4.00	31,250	June 2011
December 2002	938	\$ 8.00	938	December 2005
December 2002	937	\$ 4.00	937	December 2005
March 2003	1,025	\$ 8.00	1,025	December 2005
March 2003	1,026	\$ 4.00	1,026	December 2005
	-----		-----	
	78,926		35,176	
	=====		=====	

### NOTE 13:- TAXES ON INCOME

- a. Tax benefits under the Law for the Encouragement of Capital Investments, 1959:

The Company's production facilities have been granted an "Approved Enterprise" status under the above Law under four separate investment programs. According to the Capital Investments Law, the Company has elected to receive for the first program state-guaranteed loans and grants, for the second and third programs, the Company has elected to receive only state-guaranteed loans. As for the fourth program, the Company has elected the "alternative benefits" and has waived Government grants in return for a tax exemption.

The Company is also a "Foreign Investors' Company", as defined by the abovementioned law, and as such, is entitled to a 10-year period of benefits and to an additional reduction in tax rates, up to 10% or 25% (based on the percentage of foreign ownership in each taxable year).

Income from the second, third, fourth programs, which commenced operations in 1992, 1994, 1997, respectively, are exempt from income tax for a period of ten years commencing with the first year in which they generate taxable income. During 2002, as part of the transfer of operations from the Company to BOScom, all tax benefits that were related to the Approved Enterprise of the Company, were transferred to BOScom. In addition, since 2002, the Company's investment are not subject to Approved Enterprise program. Accordingly, taxable income generated in that period will be split by the assets ratio into a taxable income that is entitled to the benefits of the approved enterprise and into an income that will be taxed at the 36% corporate tax rate.

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U.S. DOLLARS IN THOUSANDS

NOTE 13:- TAXES ON INCOME (CONT.)

BOScom has also a production facility, which was granted an "Approved Enterprise" status and had a separate investment program. BOScom elected to receive the "alternative benefits". Income derived from BOScom investment program, which commenced operations in 1997 and 2002, are exempt from income tax for a period of ten years commencing with the first year in which taxable income is generated.

The period of tax benefits detailed above is subject to limits of the earlier of 12 years from commencement of production, or 14 years from receiving the approval. Accordingly, the period of benefits relating to all investment programs expire in the years 2001 through 2014.

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

The tax-exempt income attributable to the "Approved Enterprise" can be distributed to shareholders without imposing tax liability on the Company only upon the complete liquidation of the Company. In the event of a distribution of such tax-exempt income as a cash dividend in a manner other than in the complete liquidation of the Company and BOScom, the Company and BOScom will be required to pay tax at the rate of 10% to 25% on the amount distributed. In addition, these dividends will be subject to 15% withholding tax.

The Company's Board of Directors has determined that such tax-exempt income will not be distributed as dividends. Accordingly, no deferred taxes have been provided on income attributable to the Company "Approved Enterprise".

If the Company and BOScom derive income from sources other than an "Approved Enterprise", such income will be taxable at the regular corporate tax rate of 36%.

b. Loss carryforwards:

Domestic:

The Company and its Israeli subsidiary have accumulated losses for Israel income tax purposes as of December 31, 2003, in the amount of approximately \$ 14,000. These losses may be carryforward (linked to the Israeli Consumer Price Index ("CPI")) and offset against taxable income in the future for an indefinite period.

Foreign:

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As of December 31, 2003, the U.S. subsidiaries which were classified as discontinuing operations had U.S. Federal and State net operating loss carryforward of approximately \$ 11,300, that can be carried forward and offset against taxable income and expire through 2021. Utilization of U.S. net operating losses may be subject to substantial annual limitations due to the "change in ownership" provisions of the Internal Revenue Code of 1986 and similar state law provisions. The annual limitations may result in the expiration of net operating losses before utilization.

As of December 31, 2003, B.O.S. U.K. had net operating loss carryforward of approximately \$ 3,900, which can be carried forward indefinitely and offset against taxable income.

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B.O.S. BETTER ONLINE SOLUTIONS LTD.  
AND ITS SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS

#### NOTE 13:- TAXES ON INCOME (CONT.)

- c. Taxable income under the Inflationary Income Tax (Inflationary Adjustments) Law 1985:

Results of the Company and its Israeli subsidiary for tax purposes are measured and reflected in real terms in accordance with the changes in the Israeli CPI. As explained in Note 2b, the financial statements are presented in U.S. dollars. The difference between the change in the Israeli CPI and in the NIS/U.S. dollar exchange rate causes a difference between taxable income or loss and the income or loss before taxes reflected in the financial statements. In accordance with FASB 109, the Company has not provided deferred income taxes on this difference between the reporting currency and the tax bases of assets and liabilities.

- d. Deferred income taxes:

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

	DECEMBER 31,	
	2003	2002
Net operating loss carryforward	\$ 5,975	\$ 4,013
Reserves and allowances	105	598
Net deferred tax asset before valuation allowance	6,080	4,611
Valuation allowance	(6,080)	(4,611)



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Net deferred tax asset \$ - \$ -  
===== =====

The Company has provided valuation allowances in respect of deferred tax assets resulting from tax loss carryforwards and other reserves and allowances due to its history of operating losses and current uncertainty concerning its ability to realize these deferred tax assets in the future.

e. Tax assessments:

The Company and BOScom received final assessments through the 1997 tax year.

NOTE 14:- SUPPLEMENTARY INFORMATION TO STATEMENTS OF OPERATIONS

a. Non recurring royalty reversal:

Certain research and development activities of the Company are supported by the OCS. In return for the OCS's participation, the Company was committed to pay royalties as described in Note 11a.1. During the third quarter of 2003, the OCS completed its examination of the Company's technology and use of grant funding for the years 1991 through 1999, which reduced the royalties' expenses provision. Accordingly, the Company reversed \$339 of accrued royalties as a reduction in cost of sales during the third quarter of 2003.

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B.O.S. BETTER ONLINE SOLUTIONS LTD.  
AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

-----  
U.S. DOLLARS IN THOUSANDS

NOTE 14:- SUPPLEMENTARY INFORMATION TO STATEMENTS OF OPERATIONS (CONT.)

b. Financial income:

	YE 2003*)
Interest on bank deposits and marketable securities	\$ 158
Other (mainly translation gains)	48
	206
Financial expenses:	
In respect of long-term loans	-
Other (mainly translation losses)	(97)
	-----

	(97)
	-----
	\$ 109
	=====
c. Other income (expenses):	
Capital loss from sale of property and equipment	\$ (6)
Impairment of property and equipment	-
Prior year's royalties to the Israeli Chief Scientist	-
Legal settlement	-
Other	51
	-----
	\$ 45
	=====
d. Loss per share:	
1. Numerator:	
Numerator for basic and diluted net earnings (loss) per share -	
Net loss from continuing operations	\$ (2,057)
	=====
Net income (loss) from discontinued operation	\$ 2,036
	=====
Net loss available to Ordinary shareholders	\$ (21)
	=====
2. Denominator (in thousands): Denominator for basic and diluted net earnings (loss) per share -	
Weighted average number of shares	3,683
	=====

\*) Restated, see Note 1e

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B.O.S. BETTER ONLINE SOLUTIONS LTD.  
AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

-----  
U.S. DOLLARS IN THOUSANDS

NOTE 15:- RELATED PARTIES

The Company has entered an engagement with an Investment House, to provide non-exclusive investment-banking services and business development services to the Company, effective April 15, 2003. The Investment House is a company indirectly controlled by the Chairman of our Board of Directors, and is a co-manager of the Catalyst Fund, the Company's largest shareholder. For its services, The Investment House is paid a monthly sum of \$10, in addition to a success fee of 4-6% for a consummated private placement. According to its terms the Company may terminate the agreement at any time, by giving one month prior

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written notice.

### NOTE 16:- SEGMENTS AND GEOGRAPHICAL INFORMATION

- a. Subsequent to the liquidation of Pacinfo operation, the Computer Networking Segment, the Company manages its business on a basis of one reportable segment, which consists of three product lines. See Note 1 for a description of the Company's business. Total revenues are attributed to geographic areas based on the location of customers in accordance with Statement of Financial Accounting No. 131, "Disclosures about Segments of an Enterprise and Related Information": ("SFAS 131").

The following presents total revenues and long-lived assets for the years ended December 31, 2003, 2002 and 2001:

	YEAR ENDED DECEMBER 31,					
	2003		2002		2001	
	TOTAL REVENUES	* LONG-LIVED ASSETS	TOTAL REVENUES	*LONG-LIVED ASSETS	TOTAL REVENUES	*LONG-LI ASSET
United States	\$2,974	\$ 5	\$4,989	\$ 10	\$3,184	\$ 13
Europe	1,198	-	2,148	154	1,491	18
Israel	1,556	1,334	2,294	1,542	1,255	1,68
Other	-----	-----	-----	-----	-----	-----
	\$5,728	\$1,339	\$9,441	\$1,706	\$6,042	\$2,00
	=====	=====	=====	=====	=====	=====

\*) Long-lived assets comprise goodwill and property and equipment.

- b. Product lines:

Total revenues from external customers divided on the basis of the Company's product lines are as follows:

	YEAR ENDED DECEMBER	
	2003	2002
Connectivity	\$4,670	\$7,156
Software Utilities	492	1,387
Voice over IP	566	898
	-----	-----
	\$5,728	\$9,441
	=====	=====

- c. Major customers data as a percentage of total revenues:

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Customer A	52%	-
	=====	=====
Customer B	2%	13%
	=====	=====

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B.O.S. BETTER ONLINE SOLUTIONS LTD.  
AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

-----  
U.S. DOLLARS IN THOUSANDS, EXCEPT SHARE AND PER SHARE

NOTE 17:- SUBSEQUENT EVENT (UNAUDITED)

On June 10, 2004 the Company has entered into a Securities Purchase Agreement (the "Purchase Agreement"), with Laurus Master Fund Ltd. (the "Investor"), under which the Company issued to the Investor in a private placement (i) a Secured Convertible Term Note of a \$2,000 principal amount, due June 10, 2007 (the "Note"). The Note is convertible into Ordinary Shares at a price of \$3.08 per share (subject to adjustment). The principal amount of the Note is repayable in monthly installments, commencing as of October 1, 2004, in the initial amount of \$20 eventually increasing to \$74, and may be paid in cash or, subject to certain conditions, in Ordinary Shares. Interest on the Note is payable monthly and may be paid in cash or, subject to certain conditions, in Ordinary Shares. The Note is secured by a security interest in certain assets of the Company, and (ii) a warrant to purchase 130,000 Ordinary Shares at an exercise price of \$4.04 per share (the "Warrant"). The Warrant is exercisable, in whole or in part, until June 10, 2011. The Note bears interest at a fluctuating interest rate equal at all times to the prime rate plus 3%, subject to reduction if the average closing price of the Company's Ordinary Shares exceeds certain benchmarks.

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SURF-COMMUNICATION SOLUTIONS LTD. AND SUBSIDIARIES

CONSOLIDATED FINANCIAL STATEMENTS

AS OF DECEMBER 31, 2003

IN U.S. DOLLARS

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REPORT OF INDEPENDENT AUDITORS

CONSOLIDATED BALANCE SHEETS

CONSOLIDATED STATEMENTS OF OPERATIONS

STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

CONSOLIDATED STATEMENTS OF CASH FLOWS

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

ERNST & YOUNG

o KOST FORER GABBAY & KASIERER  
3 Aminadav St.  
Tel-Aviv 67067, Israel

o Phone: 972-3-6232525  
Fax: 972-3-5622555

REPORT OF INDEPENDENT AUDITORS

TO THE SHAREHOLDERS OF

SURF-COMMUNICATION SOLUTIONS LTD.

We have audited the accompanying consolidated balance sheets of Surf-Communication Solutions Ltd. (the "Company") and its subsidiaries as of December 31, 2002 and 2003, and the related consolidated statements of operations, changes in shareholders' equity (deficiency) and cash flows for each of the two years in the period ended December 31, 2003. 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 did not audit the financial statements of two wholly-owned subsidiaries, which statements reflect total assets constituting 7% and 12% as of December 31, 2002 and 2003, respectively, and total revenues constituting 27% and 36% of the related consolidated totals for the years ended December 31, 2002 and 2003, respectively. Those statements were audited by other auditors whose reports have been furnished to us, and our opinion, insofar as it relates to data included for those subsidiaries is based solely on the reports of the other auditors.

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. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in

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the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits and the reports of the other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audit and the reports of the other auditors, the consolidated financial statements referred to above, present fairly, in all material respects, the consolidated financial position of the Company and its subsidiaries as of December 31, 2002 and 2003, and the consolidated results of their operations and cash flows for each of the two years in the period ended December 31, 2003, in conformity with accounting principles generally accepted in the United States.

Tel-Aviv, Israel  
April 4, 2004

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

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SURF-COMMUNICATION SOLUTIONS LTD. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

U.S. DOLLARS IN THOUSANDS

	DECEMBER 31,	
	2002	2003
	-----	-----
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$7,048	\$3,552
Short-term deposits	121	1,124
Trade receivables (Note 3)	475	434
Other accounts receivable (Note 4)	208	229
	-----	-----
Total current assets	7,852	5,339
	-----	-----
LONG-TERM INVESTMENTS:		
Long-term deposits	73	34
Severance pay fund	391	388
	-----	-----
Total long-term investments	464	422
	-----	-----

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PROPERTY AND EQUIPMENT, NET (Note 5)	818	471
	-----	-----
	\$9,134	\$6,232
	=====	=====

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

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SURF-COMMUNICATION SOLUTIONS LTD. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

-----  
U.S. DOLLARS IN THOUSANDS (EXCEPT FOR SHARE DATA)

	DECEMBER
	2002
	-----
LIABILITIES AND SHAREHOLDERS' EQUITY	
CURRENT LIABILITIES:	
Trade payables	\$ 177
Accrued expenses and other liabilities (Note 6)	609
	-----
Total current liabilities	786
	-----
LONG-TERM LIABILITIES:	
Accrued severance pay	470
	-----
COMMITMENTS AND CONTINGENT LIABILITIES (Note 7)	
SHAREHOLDERS' EQUITY (Note 8):	
Ordinary shares of NIS 0.01 par value:	
Authorized: 15,631,286 shares as of December 31, 2002 and 2003; Issued and outstanding: 965,000 and 1,055,471 shares as of December 31, 2002 and 2003, respectively	3
Preferred shares of NIS 0.01 par value:	
Authorized: 4,368,714 shares as of December 31, 2002 and 2003; Issued and outstanding: 3,300,034 shares as of December 31, 2002 and 2003;	
Aggregate liquidation preference of \$ 43,062 as of December 2002 and 2003	7
Additional paid-in capital	30,773
Deferred stock compensation	(207)
Accumulated deficit	(22,698)
	-----
Total shareholders' equity	7,878

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

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SURF-COMMUNICATION SOLUTIONS LTD. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

-----  
U.S. DOLLARS IN THOUSANDS

	YEAR ENDED DECEMBER 31,	
	2002	2003
	-----	-----
Revenues:		
Software licenses	\$ 798	\$ 1,242
Royalties	310	161
	-----	-----
Total revenues	1,108	1,403
	-----	-----
Cost of revenues:		
Software license	687	522
Royalties	71	41
	-----	-----
Total cost of revenues	758	563
	-----	-----
Gross profit	350	840
	-----	-----
Operating expenses:		
Research and development, net	3,797	2,035
Selling and marketing (Note 10a)	2,518	1,486
General and administrative	640	577
Non-recurring costs	224	234
	-----	-----
Total operating expenses	7,179	4,332
	-----	-----
Operating loss	6,829	3,492
Financial income, net (Note 10b)	(70)	(72)
Other expenses	10	-
	-----	-----



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Loss before income taxes	6,769	3,420
Income taxes	4	7
	-----	-----
Net loss	\$ 6,773	\$ 3,427
	=====	=====

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

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SURF-COMMUNICATION SOLUTIONS LTD. AND SUBSIDIARIES

STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

U.S. DOLLARS IN THOUSANDS (EXCEPT FOR SHARE AMOUNTS)

	ORDINARY SHARES		PREFERRED SHARES		ADDITIONAL PAID-IN CAPITAL	DE COM
	SHARES	AMOUNT	SHARES	AMOUNT		
Balance as of January 1, 2002	965,000	\$ 3	2,308,475	\$ 5	\$ 22,624	\$
Issuance of Preferred C shares, net	-	-	991,559	2	8,016	
Deferred compensation related to options issued to employees	-	-	-	-	133	
Amortization of deferred stock compensation	-	-	-	-	-	
Net loss	-	-	-	-	-	
	-----	-----	-----	-----	-----	-----
Balance as of December 31, 2002	965,000	3	3,300,034	7	30,773	
Deferred compensation related to options issued to employees	-	-	-	-	108	
Amortization of deferred stock compensation	-	-	-	-	-	
Exercise of stock options	90,471	*)	-	-	-	
Net loss	-	-	-	-	-	
	-----	-----	-----	-----	-----	-----
Balance as of December 31, 2003	1,055,471	\$ 3	3,300,034	\$ 7	\$ 30,881	\$
	=====	=====	=====	=====	=====	=====

\*) Represents an amount lower than \$ 1.

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

## SURF-COMMUNICATION SOLUTIONS LTD. AND SUBSIDIARIES

-----  
 CONSOLIDATED STATEMENTS OF CASH FLOWS  
 U.S. DOLLARS IN THOUSANDS

	YEAR ENDED D
	----- 2002 -----
CASH FLOWS FROM OPERATING ACTIVITIES:	
Net loss	\$(6,773)
Adjustments to reconcile net loss to net cash used in operating activities:	
Depreciation	490
Increase (decrease) in accrued severance pay, net	(100)
Loss on sale and write-off of property and equipment	10
Amortization of deferred stock compensation	143
Interest rate income on short-term deposits	-
Decrease in trade receivables	1,239
Increase in other accounts receivable	(133)
Decrease in trade payables	(206)
Increase (decrease) in accrued expenses and other liabilities	(1,679)
	-----
Net cash used in operating activities	(7,009)
	-----
CASH FLOWS FROM INVESTING ACTIVITIES:	
Purchase of property and equipment	(46)
Long-term deposits	60
Short-term bank deposit	-
	-----
Net cash provided by (used in) investing activities	14
	-----
CASH FLOWS FROM FINANCING ACTIVITIES:	
Repayment of third party's loan	(3,214)
Proceeds from issuance of Preferred shares, net	8,018
	-----
Net cash provided by financing activities	4,804
	-----
Decrease in cash and cash equivalents	(2,191)
Cash and cash equivalents at the beginning of the year	9,239
	-----
Cash and cash equivalents at the end of the year	\$ 7,048
	=====
NON-CASH ACTIVITY:	
Write-off of property against other liabilities	\$ 12
	=====

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

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### SURF-COMMUNICATION SOLUTIONS LTD. AND SUBSIDIARIES

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

---

U.S. DOLLARS IN THOUSANDS

##### NOTE 1:- GENERAL

Surf-Communication Solutions Ltd. ("the Company") was incorporated and commenced its activities under the laws of Israel in 1996. The Company is a developer and global supplier of universal access and network convergence software solutions to the wireline and wireless telecommunications and data communications industries.

The Company owns and controls 100% of its subsidiaries "Surf Communication Solutions Inc.", registered in the USA and "Surf Communication Solutions B.V." registered in Holland.

##### NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States.

###### a. Use of estimates:

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

###### b. Financial statements in U.S. dollars:

The functional currency of the Company and its subsidiaries is the U.S. dollar, as the U.S. dollar is the primary currency of the economic environment in which the Company and its subsidiaries have operated and expect to continue to operate in the foreseeable future. The majority of the Company's operations is currently conducted in Israel and most of the Israeli expenses are currently paid in new Israeli shekels ("NIS"). A majority of the revenues of the Company and its subsidiaries is generated in U.S. dollars ("dollar"). Financing activities including loans, equity transactions and cash investments, are made in U.S. dollars.

The Company's transactions and balances denominated in U.S. dollars are presented at their original amounts. Non-dollar transactions and balances have been remeasured to U.S. dollars in accordance with Statement No. 52 of the Financial Accounting Standards Board ("SFAS"). All transaction gains and losses from remeasurement of monetary balance sheet items denominated in non-dollar currencies are reflected in the statements of operations as financial income or expenses, as appropriate. For the years ended December 31, 2002 and 2003, these

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expenses were immaterial (see Note 10b)

c. Principles of consolidation:

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

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### SURF-COMMUNICATION SOLUTIONS LTD. AND SUBSIDIARIES

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS

#### NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

d. Cash equivalents:

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

e. Short-term deposits:

Bank deposits with maturities of more than three months but less than one year are included in short-term deposits. The short-term deposits are presented at their cost, including accrued interest.

f. Property and equipment:

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

	%
	-----
Computers and peripheral equipment	33
Office furniture and equipment	6 - 15
Motor vehicles	15
Leasehold improvements	over the term of the lease

The Company and its subsidiaries periodically assess the recoverability of the carrying amount of property and equipment and provide for any possible impairment loss based upon the difference between the carrying amount and fair value of such assets. As of December 31, 2003, no impairment losses have been identified.

g. Research and development costs:

FASB No. 86, "Accounting for the Costs of Computer Software to be Leased or Otherwise Marketed", requires capitalization of certain software development costs subsequent to the establishment of technological feasibility.

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Based on the Company's product development process, technological feasibility is established upon completion of a working model. The Company does not incur material costs between the completion of the working model and the point at which the products are ready for general release. Therefore, research and development costs are charged to the statement of operations as incurred.

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### SURF-COMMUNICATION SOLUTIONS LTD. AND SUBSIDIARIES

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

-----  
U.S. DOLLARS IN THOUSANDS

#### NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

h. Income taxes:

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

i. Revenue recognition:

The Company has adopted Statement of Position ("SOP") 97-2, "Software Revenue Recognition," as amended. SOP 97-2, generally requires revenue earned on software arrangements involving multiple elements to be allocated to each element based on the relative fair value of the elements. The Company has also adopted SOP 98-9, "Modification of SOP 97-2, Software Revenue Recognition with Respect to Certain Transactions," for all transactions entered into after January 1, 2000. SOP 98-9 requires that revenue be recognized under the "residual method" when vendor specific objective evidence (VSOE) of fair value exists for all undelivered elements and no VSOE exists for the delivered elements.

To date, the Company has derived its revenue from licensing fees and royalties on its products, maintenance and support, and rendering of consulting services, including implementation, training and installation. The Company sells its products primarily through its direct sales force.

Revenue from license fees is recognized when persuasive evidence of an agreement exists, delivery of the product has occurred, no significant obligations with regard to implementation remain, the fee is fixed or determinable, and collectibility is probable. The Company generally does not 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. The Company considers all arrangements with payment terms extending beyond 180 days not to be fixed or determinable. 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.

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Maintenance and support revenue included in multiple element arrangements is deferred and recognized on a straight-line basis over the term of the maintenance and support agreement. The VSOE of fair value of the undelivered elements (maintenance, support and services) is determined based on the price charged for the undelivered element when sold separately.

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### SURF-COMMUNICATION SOLUTIONS LTD. AND SUBSIDIARIES

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

---

U.S. DOLLARS IN THOUSANDS

#### NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

The Company is entitled to royalties from revenue sharing upon the sublicensing of the Company's products to end-users. Royalties out of revenue sharing arrangements are recognized when such royalties are reported to the Company.

Arrangements that include consulting services are evaluated to determine whether those services are essential to the functionality of other elements of the arrangement. When services are considered essential, revenue under the arrangement is recognized using contract accounting. When services are not considered essential, the revenue allocable to the software services is recognized as the services are performed. To date, the Company had determined that the services are not considered essential to the functionality of other elements of the arrangement.

Revenues from software license that require significant customization, integration and installation are recognized using contract accounting on a percentage of completion method based on the relationship of actual costs incurred to total costs estimated to be incurred over the duration of the contract.

j. Concentrations of credit risk:

Financial instruments that potentially subject the Company and its subsidiaries to concentrations of credit risk consist principally of cash, cash equivalents, short-term deposits and trade receivables.

Cash and cash equivalents and short-term deposits are invested in major banks in Israel and the United States. Such deposits in the United States may be in excess of insured limits and are not insured in other jurisdictions. Management believes that the financial institutions that hold the Company's investments are financially sound and, accordingly, minimal credit risk exists with respect to these investments.

The trade receivables of the Company and its subsidiaries are mainly derived from sales to customers located primarily in the U.S., Europe and Asia. The Company performs ongoing credit evaluations of its customers and to date has not experienced any material losses. An allowance for doubtful accounts is determined with respect to those amounts that the Company has determined to be doubtful of collection.

The Company has no significant off-balance-sheet concentration of credit risk such as foreign exchange contracts, option contracts or

other foreign hedging arrangements.

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SURF-COMMUNICATION SOLUTIONS LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

k. Accounting for stock-based compensation:

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

The Company applies FASB 123 and EITF 96-18, "Accounting for Equity Instruments that are Issued to Other than Employees for Acquiring, or in Conjunction with Selling Goods or Services" with respect to options issued to non-employees. FASB 123 requires use of an option valuation model to measure the fair value of the options at the grant date.

l. Government grant:

Royalty-bearing grants from the Government of Israel for funding approved research and development projects are recognized at the time the Company is entitled to such grants, on the basis of the costs incurred and included as a deduction of research and development costs. Research and development grants amounted to \$ 257 in 2003. Total royalties, accrued or paid, amounted to \$ 19 in 2003, and were recorded as part of the cost of goods sold.

m. Severance pay, net:

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. Employees are entitled to one month's salary for each year of employment or a portion thereof. The Company's liability for all of its employees, is fully provided by monthly deposits with insurance policies and by an accrual. The value of these policies is recorded as an asset in the Company's balance sheet.

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

Severance pay expenses for the years ended December 31, 2002 and 2003, amounted to approximately, \$ 183 and \$ 92, respectively.

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SURF-COMMUNICATION SOLUTIONS LTD. AND SUBSIDIARIES

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS

### NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

n. Fair value of financial instruments:

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

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

The carrying amount of the Company's long-term borrowing approximates its fair value. The fair value was estimated using discounted cash flow analyses, based on the Company's incremental borrowing rates for similar type of borrowing arrangements.

### NOTE 3:- TRADE RECEIVABLES

	DECEMBER 31,	
	2002	2003
Accounts receivable	\$ 605	\$ 486
Less: allowance for doubtful accounts	130	52
	\$ 475	\$ 434
	=====	=====

### NOTE 4:- OTHER ACCOUNTS RECEIVABLE

Government authorities	\$ 163	\$ 186
Prepaid expenses and others	45	43
	\$ 208	\$ 229
	=====	=====

### NOTE 5:- PROPERTY AND EQUIPMENT

Cost:		
Computers and peripheral equipment	\$1,735	\$1,780
Office furniture and equipment	271	256
Leasehold improvements	180	188
Motor vehicles	22	22
	2,208	2,246
	=====	=====
Accumulated depreciation:		
Computers and peripheral equipment	1,243	1,577
Office furniture and equipment	64	93
Leasehold improvements	72	91



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Motor vehicles	11	14
	-----	-----
	1,390	1,775
	-----	-----
Depreciated cost	\$ 818	\$ 471
	=====	=====

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SURF-COMMUNICATION SOLUTIONS LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. DOLLARS IN THOUSANDS

NOTE 6:- ACCRUED EXPENSES AND OTHER LIABILITIES

	DECEMBER 31	
	2002	2003
	-----	-----
Accrued expenses and other liabilities	\$ 71	\$ 336
Employees and payroll accruals	423	421
Deferred revenue	37	207
Provision for warranty costs	78	78
	-----	-----
	\$ 609	\$1,042
	=====	=====

NOTE 7:- COMMITMENTS AND CONTINGENT LIABILITIES

a. Lease commitments:

The facilities of the Company and its subsidiaries are rented under operating leases, for periods ending in 2005. Future minimum lease commitments under non-cancelable leases for the years ended December 31, are as follows:

2004	209
2005	136
	-----
	\$ 345
	=====

Rent expenses for the years ended December 31, 2002 and 2003, amounted to \$ 267 and \$ 234, respectively.

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b. Guarantees:

The Company purchased bank guarantees in the amount of \$ 100 as security for the rental of its facilities.

c. Royalties:

The Company participated in a program sponsored by the Israeli Government for the support of research and development activities. Through December 31, 2003, the Company had obtained a grant from the Office of the Chief Scientist of the Israeli ministry of Industry and Trade ("the OCS") aggregating to \$ 257 for certain of the Company's research and development projects. The Company is obligated to pay royalties to the OCS, amounting to 3-5% of the sales of the products and other related revenues generated from such projects, up to 100%-150% of the grants received, linked to the U.S. dollars and bearing interest at the rate of LIBOR. The obligation to pay these royalties is contingent on actual sales of the products and in the absence of such sales no payment is required.

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SURF-COMMUNICATION SOLUTIONS LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS (EXCEPT FOR SHARE DATA)

NOTE 8:- SHAREHOLDERS' EQUITY

a. Share capital:

	DECEMBER 31,			
	2002		2003	
	AUTHORIZED	ISSUED AND OUTSTANDING	AUTHORIZED	ISSUED AND OUTSTANDING
	NUMBER OF SHARES			
Shares of NIS 0.01par value:				
Ordinary shares (1)	15,631,286	965,000	15,631,286	1,055,471
Preferred "A" shares (2)	340,000	336,704	340,000	336,704
Preferred "A1" shares (2)	130,000	128,300	130,000	128,300
Preferred "B" shares (2)	169,500	169,500	169,500	169,500
Preferred "B1" shares (2)	18,834	18,834	18,834	18,834
Preferred "C" shares (2)	3,710,380	2,646,696	3,710,380	2,646,696
	20,000,000	4,265,034	20,000,000	4,355,505

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In October 2001, the Company issued 2,428,432 Preferred "C" shares of NIS 0.01 par value each. 1,655,137 of those shares were fully paid for net proceeds in the amount of \$ 14,488, of which \$ 2,580 were received by conversion of bridge loans. The net proceeds for the remaining shares in the amount of \$ 6,201, including an accumulated interest rate of \$ 142, were accepted in November 2002.

In March 2002, the Company issued additional 218,264 Preferred "C" shares to new investors for net proceeds of \$ 1,817.

The Company granted to the Preferred C investors and previous bridge loan lender a total of 866,297 warrants to purchase Preferred C shares at exercise prices between \$ 7.33 and \$ 9.16 per share, exercisable until four years from the grant date.

- (1) The Ordinary shares confer upon the holders the right to receive notice to participate and vote in shareholders meetings of the Company and to receive dividend, if declared.
- (2) The Preferred shares ("A", "A1", "B", "B1" and "C") have the same rights as the Ordinary shares (except for the Preferred "A1" and "B1" shares, which do not confer voting rights). In addition, the shares are convertible into Ordinary shares, have an aggregate preference in liquidation of \$ 43,062 as of December 31, 2003 and 2002 and have veto rights in certain matters. The Preferred shares are convertible, at the holders' option, upon an IPO of the Company, into Ordinary shares.

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SURF-COMMUNICATION SOLUTIONS LTD. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS (EXCEPT FOR SHARE DATA)

#### NOTE 8:- SHAREHOLDERS' EQUITY (CONT.)

##### b. Stock Option Plans:

Under the Company's 1999 and 2003 Stock Option Plans, options may be granted to officers, directors, employees and consultants of the Company or its subsidiaries.

The 2003 Employee Stock Option Plan is designed to benefit from, and is made pursuant to the provisions of Section 102 of the Israeli Income Tax Ordinance.

As of December 31, 2003, an aggregate of 1,992,737 Ordinary shares of the Company are still available for future grant.

Each option granted under the Plans is exercisable until ten years from the grant date. The exercise price of the options granted under the Plans may not be less than the nominal value of the shares, into which such options are exercised. Each option granted can be exercised to one Ordinary share of the Company. The options vest over one to four years. Any options, which are forfeited or not exercised before expiration, become available for future grants.

In February 2002, 211,521 previously granted options with exercise prices ranging from \$ 6 to \$ 14 were repriced to par value of NIS

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0.01, which resulted in a total compensation expense of \$ 133, of which an amount of \$ 87 was recognized in 2002 for the portion already vested, and the remaining amount of \$ 46 was deferred to be recognized over the remaining vesting period ending in 2006.

In July 2003, 175,155 previously granted options with an exercise price of \$ 6 were repriced to par value of NIS 0.01 resulting in a total compensation expense of \$ 108, of which 30 was recognized in 2003 for the portion already vested and \$ 78 was deferred to be recognized over the remaining vesting period ending in 2006.

A summary of the Company's stock option activity and related information is as follows:

	YEAR ENDED DECEMBER 31,			
	2002		2003	
	NUMBER OF OPTIONS	WEIGHTED AVERAGE EXERCISE PRICE	NUMBER OF OPTIONS	WEIGHTED AVERAGE EXERCISE PRICE
Outstanding at the beginning of the year	667,139	\$ 4.69	837,369	\$ 1.93
Granted	237,015	\$ 6	779,046	\$ -
Exercised	-	\$ -	(90,471)	\$ -
Forfeited	(66,785)	\$ 14	(145,887)	\$ 2.23
Outstanding at the end of the year	837,369	\$ 1.93	1,380,057	\$ 0.15
Exercisable options	305,502	\$ 0.57	502,838	\$ 0.41

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SURF-COMMUNICATION SOLUTIONS LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS (EXCEPT FOR SHARE DATA)

NOTE 8:- SHAREHOLDERS' EQUITY (CONT.)

The options outstanding as of December 31, 2003, have been separated into ranges of exercise price as follows:

EXERCISE	OPTIONS OUTSTANDING AS OF DECEMBER 31,	WEIGHTED AVERAGE REMAINING CONTRACTUAL	WEIGHTED AVERAGE EXERCISE	OPTIONS EXERCISABLE AS OF DECEMBER 31,	EXE PRI OP
----------	---	---	---------------------------------	---	------------------

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PRICE	2003	LIFE	PRICE	2003	EXE
-----	-----	-----	-----	-----	-----
\$ 0.01-1.36	1,360,457	8	\$ 0.03	483,238	\$
\$ 6-9.75	14,100	6	\$ 7.33	14,100	\$
\$ 10-14	5,500	5	\$ 13.64	5,500	\$
	-----			-----	
	1,380,057			502,838	
	=====			=====	

c. Options issued to consultants:

1. The Company's outstanding options to consultants as of December 31, 2002, are as follows:

ISSUANCE DATE	OPTIONS FOR ORDINARY SHARES	EXERCISE PRICE PER SHARE	OPTIONS EXERCISABLE
-----	-----	-----	-----
April 1998	22,012	\$ 1.36	22,012
	=====	=====	=====

2. The fair value for these options was estimated using a Black-Scholes option-pricing model with the following weighted-average assumptions for 2002 and 2003: risk-free interest rates of 0%, dividend yields of 0%, volatility factors of the expected market price of the Company's Ordinary shares of 0 for each year, and a weighted-average expected life of the options of approximately 4 years.

d. Dividends:

In the event that cash dividends are declared in the future, such dividends will be paid in NIS. The Company does not intend to pay cash dividends in the foreseeable future.

NOTE 9:- TAXES ON INCOME

- a. Measurement of taxable income under the Income Tax (Inflationary Adjustments) Law, 1985:

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

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### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. DOLLARS IN THOUSANDS (EXCEPT FOR SHARE DATA)

#### NOTE 9:- TAXES ON INCOME (CONT.)

- b. Tax benefits under the Law for the Encouragement of Capital Investments, 1959 ("the Law"):

The Company's production facilities were granted the status of "Approved Enterprise", under the law. According to the provisions of said law, the Company elected the "alternative benefits" and waived Government grants, in return for a tax exemption. Income derived from the "Approved Enterprise" will be tax exempt for a period of ten years, commencing with the year in which the Company first earns taxable income. The period of benefits has not yet commenced.

Two expansion projects have been granted "Approved Enterprises" status under the Law.

The two expansion programs are as follows:

1. In December 1997, the Company received approval for the first program, which entitles the Company to a ten-year tax exemption period. The period of benefits for this expansion has not yet commenced.
2. In July 2001, the Company received approval for the second program of its "Approved Enterprises". This program entitles the Company to a ten-year tax exemption period. The period of benefits for this expansion has not yet commenced.

The entitlement to the above benefits is conditional upon the Company fulfilling the conditions stipulated by the above law, regulations published thereunder and the instruments of approval for the specific investments in "Approved Enterprises". In the event of failure to comply with these conditions, the benefits may be canceled and the Company may be required to refund the amount of the benefits, in whole or in part, including interest. As of December 31, 2003, management believes that the Company is meeting all of the aforementioned conditions.

In the event of a distribution of such tax-exempt income as cash dividend in a manner other than in the complete liquidation of the Company, the Company will be taxed at the rate of 10% to 25% on the amount distributed (based on the percentage of foreign ownership in each taxable year).

The period of tax benefits described above is limited to 12 years from the commencement of production, or 14 years from date of approval, whichever is earlier.

Income from sources other than the "Approved Enterprise" will be taxable at the regular tax rate of 36%.

The Law also allows the Company to claim accelerated depreciation on machinery and equipment used by the "Approved Enterprise", during five tax years.

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SURF-COMMUNICATION SOLUTIONS LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. DOLLARS IN THOUSANDS (EXCEPT FOR SHARE DATA)

NOTE 9:- TAXES ON INCOME (CONT.)

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

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

- d. Net operating losses carryforward:

As of December 31, 2003, the Company's operating loss carryforward amounted to approximately \$ 16,235, which can be carried forward and offset against taxable income in the future for an indefinite period.

As of December 31, 2003, the U.S. subsidiary's operating loss carryforward amounted to approximately \$ 3,789, which can be carried forward and offset against taxable income for 20 years no later than 2022.

NOTE 10:- SELECTED STATEMENTS OF OPERATIONS DATA

- a. Selling and marketing expenses, net:

	YEAR ENDED DECEMBER 31,	
	2002	2003
Salaries	\$ 1,128	\$ 856
Advertising	74	47
Other	1,316	583
	\$ 2,518	\$ 1,486
	=====	=====

- b. Financial income, net:

Financial expenses:		
Interest	\$ 8	\$ 12
Foreign currency remeasurement differences	29	107
	37	119
Financial income:		
Interest	84	74
Foreign currency remeasurement differences	23	117
	107	191

-----  
 \$ (70) \$ (72)  
 =====

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SURF-COMMUNICATION SOLUTIONS LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

-----  
 U.S. DOLLARS IN THOUSANDS (EXCEPT FOR SHARE DATA)

NOTE 11:- RELATED PARTIES TRANSACTIONS AND BALANCES

The balances with and the revenues derived from related parties were as follows:

a. Balances with related parties:

	YEAR ENDED DECEMBER 31,	
	2002	2003
	----	----
Texas Instruments *)	\$ 38	\$ -
	=====	=====

b. Revenues from related parties:

	YEAR ENDED DECEMBER 31,	
	2002	2003
	----	----
Texas Instruments	\$ 91	\$ -
Motorola Inc.	-	51
	-----	-----
	\$ 91	\$ 51
	=====	=====

c. Expenses to related parties:

Motorola Inc.	\$ 11	\$ -
	=====	=====

\*) The balance is unlinked and bears no interest.

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