

COMMTouch SOFTWARE LTD  
Form 20-F  
April 25, 2013

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
FORM 20 F**

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

OR

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 for the fiscal year ended December 31, 2012

OR

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

OR

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

Date of event requiring this shell company report \_\_\_\_\_

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 000 26495

**COMMTouch SOFTWARE LTD.**

(Exact name of Registrant as specified in its charter and translation of Registrant's name into English)

**Israel**

(Jurisdiction of incorporation or organization)

**1 Sapir Road  
5<sup>th</sup> Floor, Beit Ampa  
P.O. Box 4014  
Herzliya 46140, Israel  
011 972 9 863 6888**

(Address of principal executive offices)

**Brian Briggs, CFO, 7927 Jones Branch Drive, Suite 2250, Tysons Corner, VA 22102, Fax: 703-760-3321.**  
(Name, Telephone, Email and/or Facsimile number and Address of Company Contact Person)

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

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| Title of each class                           | Name of each exchange on which registered |
|---|---|
| Ordinary Shares, par value NIS 0.15 per share | NASDAQ Capital Market                     |

Securities registered or to be registered pursuant to Section 12(g) of the Act: None

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act: None

Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the annual report (December 31, 2012).

|                                     |            |
|-------------------------------------|------------|
| Ordinary Shares, par value NIS 0.15 | 25,826,234 |
|-------------------------------------|------------|

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

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

Note: Checking the above box will not relieve any registrant required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 from their obligations under those Sections.

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). x Yes o No

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

Large accelerated filer o                      Accelerated filer o                      Non-accelerated filer x

Indicate by check mark which basis of accounting the registrant has used to prepare the financial statements included in this filing.

U.S. GAAP x                      International Financial Reporting Standards as issued by the International Accounting Standards Board o                      Other o

If Other has been checked in response to the previous question, indicate by check mark which financial statement item the registrant has elected to follow. Item 17 o Item 18 o

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No x

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## PART I

**Item 1. Identity of Directors, Senior Management and Advisers.**

Not applicable.

**Item 2. Offer Statistics and Expected Timetable.**

Not applicable

**Item 3. Key Information.**

Unless otherwise indicated, all references in this document to Commtouch, the Company, we, us or our are to Commtouch Software Ltd. wholly-owned subsidiaries (directly or indirectly), Commtouch Inc., Commtouch Iceland hf, and eleven Gesellschaft zur Entwicklung und Vermarktung von Netzwerktechnologien mbH, or eleven, as relating to consolidated financial information contained herein.

The selected consolidated statements of income data for the years ended December 31, 2010, 2011 and 2012 and the selected consolidated balance sheet data as of December 31, 2011 and 2012 have been derived from the Consolidated Financial Statements of Commtouch included elsewhere in this Annual Report on Form 20-F, or this Annual Report. The selected consolidated statements of operations data for the years ended December 31, 2008 and 2009 and the selected consolidated balance sheet data as of December 31, 2008, 2009 and 2010 have been derived from the Consolidated Financial Statements of Commtouch not included elsewhere in this Annual Report. Our historical results are not necessarily indicative of results to be expected for any future period. The data set forth below should be read in conjunction with Item 5. Operating and Financial Review and Prospects and the Consolidated Financial Statements and the Notes thereto included elsewhere herein:

|  | Year Ended December 31, |           |           |           |           |
|--|-------------------------|-----------|-----------|-----------|-----------|
|  | 2008                    | 2009      | 2010      | 2011      | 2012      |
| (USD and share amounts in thousands, except per share data)                        |                         |           |           |           |           |
| Selected Data:   |                         |           |           |           |           |
| Revenues   | \$ 14,092               | \$ 15,189 | \$ 18,161 | \$ 23,016 | \$ 23,910 |
| Operating income   | \$ 1,931                | \$ 2,696  | \$ 3,360  | \$ 3,308  | \$ 780    |
| Net income attributable to ordinary and equivalently participating shareholders    | \$ 2,270                | \$ 5,160  | \$ 4,403  | \$ 4,598  | \$ 1,485  |
| Basic net earnings per share   | \$ 0.09                 | \$ 0.21   | \$ 0.19   | \$ 0.19   | \$ 0.06   |
| Diluted net earnings per share   | \$ 0.08                 | \$ 0.20   | \$ 0.18   | \$ 0.19   | \$ 0.06   |
| Weighted average number of shares used in computing basic net earnings per share   | 25,619                  | 24,532    | 23,575    | 23,620    | 24,610    |
| Weighted average number of shares used in computing diluted net earnings per share | 26,929                  | 25,292    | 24,874    | 24,654    | 25,140    |
| Total Assets   | \$ 20,709               | \$ 25,190 | \$ 31,982 | \$ 39,534 | \$ 59,133 |

**FORWARD LOOKING STATEMENTS**

Except for the historical information contained in this Annual Report, the statements contained in this Annual Report are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, as amended, and other federal securities laws with respect to our business, financial condition and results of operations. Such forward-looking statements reflect our current view with respect to future events and financial results.

We urge you to consider that statements which use the terms anticipate, believe, expect, plan, intend, estimate and expressions are intended to identify forward-looking statements. We remind readers that forward-looking statements are merely predictions and therefore inherently subject to uncertainties and other factors and involve known and unknown risks that could cause the actual results, performance, levels of activity, or our achievements, or industry results, to be materially different from any future results,

performance, levels of activity, or our achievements, or industry results, expressed or implied by such forward-looking statements. Such forward-looking statements appear in Item 4 Information on the Company and Item 5 Operating and Financial Review and Prospects, as well as elsewhere in this Annual Report. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. Except as required by applicable law, including the securities laws of the United States, we undertake no obligation to update or revise any forward-looking statements to reflect new information, future events or circumstances, or otherwise after the date hereof. We have attempted to identify significant uncertainties and other factors affecting forward-looking statements in the Risk Factors section that appears below.

## RISK FACTORS

You should carefully consider the following risk factors before you decide to buy our Ordinary Shares. You should also consider the other information in this Annual Report. If any of the following risks actually occur, our business, financial condition, operating results or cash flows could be materially adversely affected. This could cause the trading price of our Ordinary Shares to decline, and you could lose part or all of your investment. The risks described below are not the only ones facing us. Additional risks not presently known to us, or that we currently deem immaterial, may also impair our business operations.

### Business Risks

*If we are unable to effectively integrate the businesses of eleven and Frisk into our global organization, our operating results will suffer.*

During 2012, we acquired both the antivirus business of the Icelandic company Frisk Software International, or Frisk, and the German Internet security company eleven and, in connection therewith, we literally doubled the size of our organization in terms of personnel (though at the beginning of 2013 we performed an approximately 12% synergistic reduction of headcount to better streamline the organization). For a somewhat small organization such as Commtouch, the acquisition of two companies within less than six months, in two very different parts of the world, is an extremely complex and challenging venture. While we believe that in the future, these acquisitions will be very fruitful for the growth of the Company, in the short term, these acquisitions are stretching our internal resources, both financial and manpower.

Our ability to attain our sales, marketing and development goals will depend in great measure on our ability to create one cohesive organization that is focused on the goals set by a unified management. Should the efforts at integrating these new businesses into Commtouch not continue in a smooth or successful fashion, our business will suffer and shareholder value will decline. Furthermore, any such failure could impact our efforts at acquiring an additional company or technologies during 2013 and beyond.

*If the market does not continue to respond favorably to our traditional Internet security solutions, including our anti-spam, Zero-Hour antivirus, Mail Reputation, Command Antivirus and Uniform Resource Locator or URL filtering solutions, or our new cloud-based solutions or our future solutions do not gain acceptance, we will fail to generate sufficient revenues.*

Our success depends on the continued acceptance and use of our traditional Internet security solutions by current and new businesses, Original Equipment Manufacturers, or OEMs, and service provider customers, plus the interest of such customers in our newest offerings. We have been selling our inbound anti-spam products for over nine years, our Zero-Hour virus outbreak detection product for approximately eight years, our GlobalView Mail Reputation perimeter defense solution for approximately seven years, our URL filtering solutions for over three years, our outbound spam solution for approximately three years and the Command Antivirus solution for over two years. Also, we recently released three new cloud-based Internet security solutions a) email Security as a Service, or email SecaaS, b) Commtouch Mobile Security Services for Android and c) Commtouch Email Security On-Premise for Service Providers.

As the markets for messaging, antivirus and Web security products continue to mature and consolidate, we are seeing increasing competitive pressures and demands for even higher quality products at lower prices. This increasing demand comes at a time when Internet security threats are more varied and intensive, challenging even the top end solutions to keep their performance at an industry acceptable high level of accuracy. If our solutions do not continue to evolve to meet market demand, or newer products on the market prove more effective, our business could fail. Also, if growth in the markets for these solutions begins to slow, our business will suffer dramatically.

***Recurring unfavorable national and global economic conditions could have a material adverse effect on our business, operating results and financial condition.***

The crisis in the financial and credit markets that began in 2008 in the United States, and that led to a global economic slowdown, seems to have become more acute in certain countries of Europe. If the economies of countries in which our customers and potential customers are located continue to be weak or weaken further, our customers may reduce or postpone their spending significantly. This could result in reductions in sales of our services and longer sales cycles, slower adoption of new technologies and increased price competition. In addition, weakness in the end-user market could negatively affect the cash flow of our OEM and service provider partners, distributors and resellers who could, in turn, delay paying their obligations to us. This would increase our credit risk exposure and cause delays in our recognition of revenues on future sales to these customers. Specific economic trends, such as declines in the demand for PCs, servers, and other computing devices, or weakness in corporate information technology spending, could have a more direct impact on our business. Any of these events would likely harm our business, operating results and financial condition.

If economic conditions in key markets do not improve or continue to improve, or revert to a recessionary state, our business, operating results and financial condition may be adversely impacted in a material way.

***Tighter governmental enforcement of regulations could decrease the distribution of unsolicited bulk (spam) email and malicious software and decrease demand for our solutions, or increase our cost of doing business.***

The Controlling the Assault of Non-Solicited Pornography and Marketing Act of 2003 (CAN-SPAM Act) established a framework of U.S. administrative, civil, and criminal tools to combat spam. The law establishes both civil and criminal prohibitions to assist in deterring the most offensive forms of spam, including unmarked sexually-oriented messages and emails containing fraudulent headers. Under the law, senders of email are required to honor a request by a consumer not to receive any further unsolicited messages. While past high profile prosecutions of direct marketers seemingly have not had much of a deterrent effect on marketers of unsolicited email, it is not known whether or not future enforcement actions will prove effective.

In addition, various state legislatures have enacted laws aimed at regulating the distribution of unsolicited email. While we are not clear as to the reasons, two years ago we began to see a gradual decline in the amount of spam traffic on the Internet, and in the past year spam activity remained consistent at this lower level.

These and similar legal measures, both in the United States and worldwide, may have the effect of reducing the amount of unsolicited email and malicious software that is distributed and hence diminish the need for our Internet security solutions. Any such developments would have an adverse impact on our revenues.

***We depend upon OEM partners, service providers and resellers.***

We expect to continue to be dependent upon OEM partners and service providers for a significant portion of our revenues, which will be derived from sales of our messaging, antivirus and Web security solutions. We also expect resellers to become more important in the distribution of our newer cloud-based Internet security solutions. Our operating results and financial condition may be materially adversely affected if:

Anticipated orders or payments from these customers fail to materialize;

Some of the key customers cease the promotion of our business or begin to promote additional solutions in a layered approach to email defense, anti-malware and URL filtering management; or

Some of our key customers' businesses fail as a result of a deepening global economic crisis.

***Our quarterly operating results may fluctuate, which could adversely affect the value of your investment.***

A number of factors, many of which are enumerated in this Risk Factors section, are likely to cause fluctuations in our operating results or cause our share price to decline. These factors include:



Our ability to successfully market both our traditional messaging, antivirus and Web security solutions and our newer cloud-based Internet security solutions in new markets, both domestic and international;

Our ability to successfully develop and market new, modified or upgraded solutions, as may be needed;

The continued acceptance of our solutions by our current customer base;

Our ability to expand our workforce with qualified personnel, as may be needed;

Unanticipated bugs or other problems affecting the delivery of our solutions to customers;

The success of our customers' sales efforts to their customer base;

The solvency of our customers and their ability to allocate sufficient resources towards the marketing of our solutions;

Our customers' ability to effectively integrate our solutions into their product offerings;

The substantial decrease in information technology spending;

The pricing of our solutions;

Our ability to timely collect fees owed by our customers;

A renewed global slowdown;

Sudden, dramatic fluctuations in exchange rates of currencies covering the fees we collect from our foreign customers versus the currencies utilized in our business (namely, the New Israeli Shekel, or NIS, the U.S. Dollar and Euro);

Our ability to add cost-effective space and equipment to our current detection centers, or Detection Centers, in a timely and effective manner to match the rate of growth in our business, plus our ability to build new, cost-effective detection centers as worldwide demand for our products may require; and

The effectiveness of our end user support, whether provided by our customers or directly by Commtouch.

Our products and services have changed many times since we commenced operations in 1991. For example, in September 2010, we acquired the Command Antivirus unit of Authentium, and during 2012 (as noted above) we acquired both the Frisk antivirus business and all of the business of eleven, and we have integrated and continue to integrate these new business into our existing business. These and future changes in our product offerings may require that we adjust our business processes and workforce, which can cause disruption to our business and fluctuations in our results from operations.

***We have many established competitors who are offering a multitude of solutions to the problems of spam/virus distribution and Web-related security threats.***

The market for Internet security products remains intensely competitive and is subject to rapid changes in technology. We expect both product and pricing competitive pressures to increase in the future. Some of our competitors have longer operating histories, greater brand recognition, larger technical staffs and/or greater financial, technical and marketing resources, and other advantages compared to us. This competition could have a negative impact on our business and financial results. Additional details are provided in Item 4. Information on the Company.

***Our ability to continue to increase our revenues will depend on our ability to successfully execute our sales and business development plan.***

The complexity of the underlying technological base of messaging, antivirus and Web security solutions, and the current landscape of the markets, require highly trained sales and business development personnel to educate prospective resellers, OEM and service provider partners and customers regarding the use and benefits of our solutions. During 2012, with the acquisitions of Frisk's antivirus business and eleven, as well as natural turnover in sales personnel, our business development/sales department underwent a higher rate of change than in prior years. It may take time for our current and future employees to convey to potential, as well as current, OEM/service provider partners and resellers how to most effectively market and utilize our solutions. As a result, our sales and business development

personnel may not be able to compete successfully against larger, more heavily financed and experienced sales and business development departments of our competitors.

***The loss of our key employees would adversely affect our ability to manage our business, therefore causing our operating results to suffer and the value of your investment to decline.***

Our success depends on the skills, experience and performance of our senior management and other key personnel. The loss of the services of any of our senior management or other key personnel could materially and adversely affect our business. The loss of our software developers or senior operations personnel may also adversely affect the continued development and support of both our current messaging, antivirus and Web security solutions and future solutions presently included in our roadmap for development, thereby causing our operating results to suffer and the value of your investment to decline.

We do not have employment agreements inclusive of set periods of employment with any of our key personnel. We cannot prevent them from leaving at any time. We do not maintain key-person life insurance policies, listing us as a beneficiary, on any of our employees.

***Our business and operating results could suffer if we do not successfully address potential risks inherent in doing business overseas.***

As of December 31, 2012, we had sales offices in Israel the United States, Germany and Iceland. We also are marketing our messaging, antivirus and Web security solutions in international markets by utilizing appropriate distribution channels. However, we may not be able to compete effectively in international markets due to various risks inherent in conducting business internationally, such as:

Differing technology standards;

Inability of distribution channels to successfully market our solutions;

Export restrictions;

Difficulties in collecting accounts receivable and longer collection periods;

Unexpected changes in regulatory requirements;

Political and economic instability;

Potentially adverse tax consequences; and

Limited enforcement mechanisms for protecting intellectual property rights.

Any of these factors could adversely affect the Company's prospective international sales and, consequently, business and operating results.

***Our Web security and antivirus solutions may be adversely affected if we are not able to receive sufficient components from third party suppliers.***

Our Web security solution relies in part on certain components supplied by third parties pursuant to contractual relationships. If these third parties breach their agreements with us, we may have difficulty in securing alternative sources for these components in a timely manner and thus our Web security solution may not perform at the level we expect. If this were to occur, the effectiveness of this solution would drop, it would become less attractive to customers/potential customers and anticipated revenues could decline.

## **Technology Risks**

***We may not have the resources or skills required to adapt to the changing technological requirements and shifting preferences of our customers and their users.***

The messaging, antivirus and Web security industries are characterized by difficult technological challenges, sophisticated distributors of Internet security threats, multiple-variant viruses, unique phishing scams and constantly evolving malevolent software distribution practices and targets that could render our solutions and proprietary technology ineffective. Our success depends, in part, on our ability to continually enhance our existing messaging, antivirus and Web security solutions and to develop new solutions, functions and technology that address the potential needs of prospective and current customers and their users. The development of proprietary technology and necessary



enhancements entails significant technical and business risks and requires substantial expenditures and lead-time. We may not be able to keep pace with the latest technological developments. We may not be able to use new technologies effectively or adapt to OEM, service provider, customer or end user requirements or emerging industry standards. Also, we must be able to act more quickly than our competition, and may not be able to do so.

***Our solutions may be adversely affected by defects or denial of service attacks, which could cause our OEM and service provider partners, customers or end users to stop using our solutions.***

Our messaging, antivirus and Web security solutions are based in part upon new and complex software and highly advanced computer systems. Complex software and computer systems can contain defects, particularly when first introduced or when new versions are released, and are possible targets for denial of service attacks instigated by hackers. Although we conduct extensive testing and implement Internet security processes, we may not discover defects to or vulnerabilities in our software or systems that affect our new or current solutions or enhancements until after they are delivered. Although we have not experienced any material defects or vulnerabilities to date in our messaging, antivirus and Web security offerings, it is possible that, despite testing by us, defects or vulnerabilities may exist in the solutions we provide. These defects or vulnerabilities could cause or lead to interruptions for customers of our solutions, resulting in damage to our reputation, legal risks, loss of revenue, delays in market acceptance and diversion of our development resources, any of which could cause our business to suffer.

***Our messaging, antivirus and Web security solutions may be adversely affected if we are not able to receive a sufficient sampling of Internet traffic or our Detection Centers were to become unavailable.***

Our messaging, antivirus and Web security solutions are dependent, in part, on the ability of our Detection Centers to analyze, in an automated fashion, live feeds of Internet and Web related traffic received through our services to customers and other contractual arrangements. If we were to suffer an unanticipated, substantial decrease in such traffic or our multiple Detection Centers become unavailable for any significant period, the effectiveness of our technologies would drop, our product offerings would become less attractive to customers/potential customers and revenues could decline.

***Our Antivirus offerings remain relatively new for us, and we still may not fully appreciate the needs of customers and risks inherent in these new markets.***

Our acquisition of the antivirus business from Authentium in September 2010, followed up by our acquisition of Frisk's antivirus business in October 2012, represented our first efforts at expansion into the antivirus market. While we hired the core team of ex-Authentium and ex-Frisk employees and contractors who possess the expertise to manage the antivirus business, nevertheless we cannot be totally certain that we have anticipated all possible issues that might arise with our cloud computing technology infrastructure and our relatively new antivirus offerings. Should unanticipated issues arise, sales of our antivirus solutions likely will slow and our business will suffer.

For example, because of the complexity of the antivirus products, we understand that in the past, errors were found in versions of these products that were not detected before first introduced, or appeared in new versions or enhancements, and we may find such errors in the future. Failures, errors or defects in our antivirus solutions could result in security breaches or compliance violations for our customers, disruption or damage to their networks or other negative consequences and could result in negative publicity, damage to our reputation, declining sales, increased expenses and customer relation issues. Such failures could also result in product liability damage claims against us by our customers, even though our agreements with our customers typically contain provisions designed to limit our exposure to potential product liability claims.

The antivirus products have in the past, and may at times in the future, falsely detect viruses or computer threats that do not actually exist. These false alarms, while typical in the security industry, would likely impair the perceived reliability of our products and may therefore adversely impact market acceptance of our antivirus products.

***Our new cloud-based offerings have not been on the market for very long, so we may not see the customer traction in these offerings that we anticipate.***

In November 2012, we acquired eleven, in part to accelerate our push into the cloud-based Internet security sector. The solutions we are promoting and will promote to this market will enable Internet security vendors and service providers to offer fully cloud-based, Internet security solutions to their customers, without the need for the integration of a software development kit, or SDK, into their product offerings. Among other things, this cloud-based approach is intended to speed up the process of moving our solutions to market, and ease the integration burden for our customers.

While eleven had successfully penetrated the German market with its solutions, it did not have a significant international presence. With Commtouch's international infrastructure both in terms of business development and operations we feel that we should be better positioned to succeed in markets outside of Germany. However, we do not have a record of success with our new offerings, including our a) email SecaaS, b) Commtouch Mobile Security Services for Android and c) Commtouch Email Security On-Premise for Service Providers. We will also be releasing new cloud-based solutions during the course of 2013 that will utilize new technologies that we acquired. Because of the newness of the technologies involved and the resulting learning curve required of all employees in the sale and support of the new offerings, we cannot be certain that we will convince potential customers of the benefits of these new offerings and sell them at the rate we anticipate. If we fall short of our expectations, and especially given the significant resources invested by us in bringing these new offerings to market, our financial results will suffer and the value of shareholder investments will decline.

### Investment Risks

***If we will be in need of additional capital, we may not be able to secure additional funds on acceptable terms, or at all, and the Company's business could suffer.***

We have invested heavily in technology development, and in the past two and a half years we have closed three acquisitions. We expect to continue to spend financial and other resources on developing, acquiring and introducing new offerings and maintaining our corporate organizations and strategic relationships. We also expect to continue to invest resources in research and development projects to further enhance our current solutions.

Given the heavy outlays in capital expended during 2012 in both M&A activities and internal development, the Company's cash balance has dropped significantly and thus the Company is more thinly capitalized in 2013 than it was during the majority of 2012. As a result, at about the time of the filing of this Annual Report, a credit line had been secured from an Israeli bank, and we were in the process of closing on another credit line with a second Israeli bank. Together, both credit lines total a sum of up to \$5,000,000. These credit lines are being put in place in order to ensure sufficient cash is available to fund the strategic growth investments of the Company.

In relation to these credit lines, the Company has agreed to grant security interests generally over all Company assets, and to refrain from encumbering its assets in favor of any other third parties. The Company has already drawn on one of the credit lines in the amount of \$1.5 million.

While we believe that the credit lines will be sufficient to bridge any cash flow issues in the near term, if we will be in need of additional capital and are unable to secure it on acceptable terms or at all and, concurrently, customer collections will be slower than normal, the Company's business will suffer.

***Our business could be materially adversely affected as a result of the risks associated with acquisitions and investments. In particular, we may not succeed in making additional acquisitions or be effective in integrating such acquisitions.***

As part of our growth strategy, we have made a number of acquisitions over the past few years, including a total of three acquisitions during the years 2010 through 2012, and expect to continue to make acquisitions. We frequently evaluate the tactical or strategic opportunity available related to complementary businesses, products or technologies. The process of integrating an acquired company's business into our operations and/or of investing in new technologies, may result in unforeseen operating difficulties and large expenditures and may absorb significant management attention that would otherwise be available for the ongoing development of our business, and which may result in the loss of key customers and/or personnel and expose us to unanticipated liabilities.

Other risks commonly encountered with acquisitions include the effect of the acquisition on our financial and strategic position, the inability to successfully integrate or commercialize acquired technologies and achieve expected synergies or economies of scale on a timely basis and the potential impairment of acquired assets. Further, we may not be able to retain the key employees that may be necessary to operate the business we acquire, and, we may not be able to timely attract new skilled employees and management to replace them. From time to time, we may also need to acquire complementary technologies, whether to execute our strategies or in order to comply with customer needs. There are no assurances that we will be able to acquire or successfully integrate an acquired company, business or technology, or successfully leverage such complementary technology in the market.

Moreover, there can be no assurance that the anticipated benefits of any acquisition or investment will be realized. Future acquisitions or investments could result in potentially dilutive issuances of equity securities, the incurrence of debt and contingent liabilities, amortization expenses related to intangible assets and impairment of goodwill, any of which could have a material adverse effect on our operating results and financial condition. In addition, we may knowingly enter into an acquisition that will have a dilutive impact on our earnings per share.

There can be no assurance that we will be successful in making additional acquisitions or effective in integrating such acquisitions into our existing business. We may also compete with others to acquire companies, and such competition may result in decreased availability of, or increased prices for, suitable acquisition candidates. In addition, for possible commercial and economic considerations, we may not be able to consummate acquisitions that we have identified as crucial to the implementation of our strategy. We may not be able to obtain the necessary regulatory approvals, including those of competition authorities and foreign investment authorities, in countries where we seek to consummate acquisitions. For those and other reasons, we may ultimately fail to consummate an acquisition, even if we announce that we plan to acquire a company.

Due to changes in the industry and market conditions, we could also be required to realign our resources and consider restructuring or other action, which could result in an impairment of goodwill.

***Our directors, executive officers and principal shareholders will be able to exert significant influence over matters requiring shareholder approval and could delay or prevent a change of control.***

Our directors and affiliates of our directors, our executive officers and our shareholders who currently individually beneficially own over five percent of the voting power in the Company (together known as affiliated entities), beneficially own, in the aggregate, approximately 29.3% of our outstanding Ordinary Shares as of March 1, 2013. Included in the calculation of voting power are options exercisable by the affiliated entities within 60 days thereof (with some having an exercise price greater than the market price of our shares as of March 1, 2013). If they vote together (especially if they were to exercise all vested options into shares entitled to voting rights in the Company), these shareholders will be able to exercise significant influence over many matters requiring shareholder approval, including the election of directors and approval of significant corporate transactions. In this regard, we know of no shareholders or voting agreement between major shareholders or between such shareholders and directors or officers.

This concentration of ownership could also delay or prevent a change in control of Commtouch. In addition, conflicts of interest may arise as a consequence of the significant shareholders control relationship with us, including:

Conflicts between significant shareholders, and our other shareholders whose interests may differ with respect to, among other things, our strategic direction or significant corporate transactions;

Conflicts related to corporate opportunities that could be pursued by us, on the one hand, or by these shareholders, on the other hand; or

Conflicts related to existing or new contractual relationships between us, on the one hand, and these shareholders, on the other hand.

***Our Ordinary Shares are traded on more than one market and this may result in price variations.***

Our Ordinary Shares are traded primarily on the NASDAQ Capital Market and also on the Tel Aviv Stock Exchange. Trading in our Ordinary Shares on these markets is made in different currencies (U.S. dollars on the NASDAQ Capital Market, and NIS, on the Tel Aviv Stock Exchange), and at different times (resulting from different time zones, different trading days and different public holidays in the United States and Israel). Consequently, the trading prices of our Ordinary Shares on these two markets often differ. Any decrease in the trading price of our Ordinary Shares on one of these markets could cause a decrease in the trading price of our Ordinary Shares on the other market.

## Intellectual Property Risks

*If we fail to adequately protect our intellectual property rights or face a claim of intellectual property infringement by a third party, we could lose our intellectual property rights or be liable for significant damages.*

We regard our patented and patent pending technology, copyrights, service marks, trademarks, trade secrets and similar intellectual property as critical to our success, and rely on patent, trademark and copyright law, trade secret protection and confidentiality or license agreements with our employees and customers to protect our proprietary rights. See Item 4. Information on the Company, *Intellectual Property* for information pertaining to our patent activities. We may seek to patent certain additional software or other technology in the future. Any such patent applications might not result in patents issued within the scope of the claims we seek, or at all.

Despite our precautions, unauthorized third parties may copy certain portions of our technology, reverse engineer or obtain and use information that we regard as proprietary or otherwise infringe or misappropriate our patent or our patent pending technology, trade secrets, copyrights, trademarks and similar proprietary rights. In addition, the laws of some foreign countries do not protect proprietary rights to the same extent as do the laws of the United States. Thus, our means of protecting our proprietary rights in the United States or abroad, as well as our financial resources, may not be adequate, and competitors may independently develop similar technology.

We cannot be certain that our Internet security solutions do not infringe issued patents in certain parts of the world. Therefore, other parties, whether in the United States or elsewhere, may assert infringement claims against us. We may also be subject to legal proceedings and claims from time to time in the ordinary course of our business, including claims of alleged infringement of copyrights, trademarks and other intellectual property rights of third parties by ourselves and our customers. Our customer agreements typically include indemnity provisions, so we may be obligated to defend against third party intellectual property rights infringement claims on behalf of our customers. Such claims, even if not meritorious, could result in the expenditure of significant financial and managerial resources. We may not have the proper resources in order to adequately defend against such claims. During 2011, one such indemnification demand was made by a customer, and we continue to cooperate with that customer in seeking to defeat the underlying patent infringement claims. While we believe that adequate non-infringement and/or invalidity arguments exist, we are uncertain if the case will proceed to judgment. During early 2013, we learned that our customer is negotiating a settlement of the matter, and we have been asked to contribute a portion towards the settlement. It is too early in the negotiations process to anticipate the outcome of the settlement negotiations and our possible contribution towards any final settlement.

## Risks Relating to Operations in Israel

*We have important facilities and resources located in Israel, which has historically experienced military and political unrest.*

Commtouch Software Ltd. is incorporated under the laws of the State of Israel. Our principal research and development facilities are located in Israel. Although the majority of our past sales were made to customers outside Israel, we are nonetheless directly influenced by the political, economic and military conditions affecting Israel. Any major hostilities involving Israel, or the interruption or curtailment of trade between Israel and its present trading partners, could significantly harm our business, operating results and financial condition.

Since the State of Israel was established in 1948, a number of armed conflicts have occurred between Israel and its Arab neighbors. Recent years have witnessed extensive hostilities from time to time along Israel's northern and southern borders, which resulted in missiles being fired from Lebanon and the Gaza Strip into Israel. Ongoing and revived hostilities or other Israeli political or economic factors could harm our operations and cause our revenues to decrease.

Recent uprisings in various countries in the Middle East and North Africa, known generally as the Arab Spring, are affecting the political stability of those countries. This instability in the region may lead to deterioration of the political and trade relationships that exist between the State of Israel and certain of these and other countries. In addition, this instability may affect the global economy and marketplace, including as a result of increases in oil and gas prices. In addition, Israel and some companies doing business with Israel have been the subject of an economic boycott by Arab countries and their close allies since Israel's establishment.

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The regional instability and restrictive laws and policies described above may have an adverse impact on our operating results, financial condition and expansion of our business.

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

Certain of our officers and employees are currently obligated to perform annual reserve duty in the Israel Defense Forces and are subject to being called for active military duty at any time in the event of a national emergency, such as in connection with the hostilities along Israel's border with the Gaza Strip in December 2008 and January 2009. Although Commtouch has operated effectively under these requirements since its inception, we cannot predict the effect of these obligations on Commtouch in the future. Our operations could be disrupted by the absence for a significant period of one or more of our officers or key employees due to military service. Any disruption in our operations would harm our business.

***Because a substantial portion of our revenues historically have been generated in U.S. dollars and the Euro, and a significant portion of our expenses have been incurred in NIS, our results of operations may be adversely affected by currency fluctuations.***

We have generated a substantial portion of our revenues in U.S. dollars and Euro, and incurred a portion of our expenses, principally salaries and related personnel expenses in Israel, in NIS. We anticipate that a significant portion of our expenses will continue to be denominated in NIS. As a result, we are exposed to risk to the extent that the value of the U.S. dollar decreases against the NIS and the Euro. In that event, the U.S. dollar cost of our operations will increase and our U.S. dollar-measured results of operations will be adversely affected, as occurred during a portion of 2011, when the NIS and the Euro appreciated against the U.S. dollar, which resulted in a significant increase in the U.S. dollar cost of our operational expenses and revenues. We cannot predict the trend for future years. Our operations also could be adversely affected if we are unable to guard against currency fluctuations in the future. To date, we have not engaged in any significant hedging transactions. In the future, we may enter into currency hedging transactions to decrease the risk of financial exposure from fluctuations in the exchange rate of the dollar against the NIS. Foreign currency fluctuations, and our attempts to mitigate the risks caused by such fluctuations, could have a material and adverse effect on our results of operations and financial condition.

***The government programs and benefits which we previously received require us to meet several conditions and may be terminated or reduced in the future.***

Prior to 1998, we received grants from the Government of Israel, through the Office of the Chief Scientist of the Israeli Ministry of Industry, Trade & Labor, or OCS, for the financing of a significant portion of our research and development expenditures in Israel. These grants totaled \$0.6 million. Subsequently, in 2001, we received \$0.6 million and in 2002 we received \$0.2 million. We did not submit an application for funding during the period 2004–2008. In 2009 and 2010, our applications for funding were approved in the amounts of approximately \$0.5 million and \$0.6 million respectively. We again did not submit an application during 2011 and 2012, and we do not expect to receive any grants during 2013.

In order to meet specified conditions in connection with previous grants and programs of the OCS, we have made representations to the Israel government about our Israeli operations. From time to time the conduct of our Israeli operations has deviated from our forecasts. If we fail to meet the conditions of the grants, including the maintenance of a material presence in Israel, or if there is any material deviation from the representations made by us to the Israeli government, we could be required to refund the grants previously received (together with an adjustment based on the Israeli consumer price index and an interest factor) and would likely be ineligible to receive OCS grants in the future.

Under the Law for the Encouragement of Industrial Research and Development, 5744-1984 and the related regulations, the discretionary approval of an OCS committee is required for any transfer of technology developed with OCS funding, including in the context of certain acquisitions of companies that have received OCS funding, or for the transfer of manufacturing rights outside of Israel. OCS approval is not required for the export of any products resulting from the research and development. There is no assurance that we will receive the required approvals for any proposed future transfer. Such approvals, if granted, may be subject to the following additional restrictions:

a requirement to pay the OCS a portion of the consideration we receive upon any sale of such technology to an entity that is not Israeli. The scope of the support received, the royalties that were paid by us, the amount of time that elapsed between the date on which the know-how was transferred and the date on which the grants were received, as well as the sale price, will be taken into account in order to calculate the amount of the payment; and

the transfer of manufacturing rights could be conditioned upon an increase in the royalty rate and payment of increased aggregate royalties (up to 300% of the amount of the grant plus interest, depending on the percentage of the manufacturing that is foreign). These restrictions may impair our ability to sell certain of our older technology assets outside of Israel. The restrictions will continue to apply even after we repay the full amount of royalties payable for the grants.

***You may have difficulties enforcing a U.S. judgment against us and our executive officers and directors or asserting U.S. securities laws claims in Israel.***

Commtouch Software Ltd. is organized under the laws of Israel, and we maintain significant operations in Israel. In addition, most of our assets are located outside the United States. Service of process upon our non-U.S. resident directors and enforcement of judgments obtained in the United States against them and Commtouch Software Ltd. may be difficult to obtain within the United States. It may be difficult to assert U.S. securities law claims in original actions instituted in Israel. Israeli courts may refuse to hear a claim based on a violation of U.S. securities laws because Israel is not the most appropriate forum in which to bring such a claim. In addition, even if an Israeli court agrees to hear a claim, it may determine that Israeli law and not U.S. law is applicable to the claim. If U.S. law is found to be applicable, the substance of the applicable U.S. law must be proved as a fact, which can be a time-consuming and costly process. Certain matters of procedure will also be governed by Israeli law. Furthermore, there is little binding case law in Israel addressing these matters.

Israeli courts might not enforce judgments rendered outside Israel which may make it difficult to collect on judgments rendered against us. Subject to certain time limitations, an Israeli court may declare a foreign civil judgment enforceable only if it finds that (a) the judgment was rendered by a court which was, according to the laws of the state of the court, competent to render the judgment; (b) the judgment may no longer be appealed; (c) the obligation imposed by the judgment is enforceable according to the rules relating to the enforceability of judgments in Israel and the substance of the judgment is not contrary to public policy; and (d) the judgment is executory in the state in which it was given.

Even if these conditions are satisfied, an Israeli court will not enforce a foreign judgment if it was given in a state whose laws do not provide for the enforcement of judgments of Israeli courts (subject to exceptional cases) or if its enforcement is likely to prejudice the sovereignty or security of the State of Israel. An Israeli court also will not declare a foreign judgment enforceable if (i) the judgment was obtained by fraud; (ii) there is a finding of lack of due process; (iii) the judgment was rendered by a court not competent to render it according to the laws of private international law in Israel; (iv) the judgment is at variance with another judgment that was given in the same matter between the same parties and that is still valid; or (v) at the time the action was brought in the foreign court, a suit in the same matter and between the same parties was pending before a court or tribunal in Israel.

***Provisions of Israeli law may delay, prevent or make difficult an acquisition of Commtouch, which could prevent a change of control and therefore depress the price of our shares.***

Israeli corporate law regulates mergers and acquisitions of shares through tender offers, requires special approvals for transactions involving significant shareholders and regulates other matters that may be relevant to these types of transactions. Furthermore, Israeli tax law treats stock-for-stock acquisitions between an Israeli company and a foreign company less favorably than does U.S. tax law. For example, Israeli tax law may subject a shareholder who exchanges his Ordinary Shares for shares in a foreign corporation to immediate taxation or to taxation before his investment in the foreign corporation becomes liquid. These provisions may adversely affect the price of our shares.

***As a foreign private issuer whose shares are listed on the NASDAQ Capital Market, we may follow certain home country corporate governance practices instead of certain NASDAQ requirements.***

As a foreign private issuer whose shares are listed on the NASDAQ Capital Market, we are permitted to follow certain home country corporate governance practices instead of certain requirements of the NASDAQ Listing Rules.

Among other things, we may follow home country practice with regard to composition of our Board of Directors, or Board, and quorum requirements at shareholders' meetings. In addition, we may follow our home country law, instead

of the NASDAQ Listing Rules, which require that we obtain shareholder approval for certain dilutive events, such as for the establishment or amendment of certain equity based compensation plans, an issuance that will result in a change of control of the Company, certain transactions other than a public offering involving issuances of a 20% or more interest in the Company and certain acquisitions of the stock or assets of another company.

A foreign private issuer that elects to follow a home country practice instead of NASDAQ requirements must submit to NASDAQ in advance a written statement from an independent counsel in such issuer's home country certifying that the issuer's practices are not prohibited by the home country's laws. In addition, a foreign private issuer must disclose in its annual reports filed with the Securities and Exchange Commission or on its website each such requirement that it does not follow and describe the home country practice followed by the issuer instead of any such requirement (see Item 16G. Corporate Governance for a list of those home country practices followed by us). Accordingly, our shareholders may not be afforded the same protection as provided under NASDAQ's corporate governance rules.

#### **Item 4. Information on the Company.**

##### *Overview*

The legal name of the Company is Commtouch Software Ltd., and its principal executive offices are located at 1 Sapir Rd., 5th Floor, Beit Ampa, P.O. Box 4014, Herzliya, 46140 Israel, where our telephone number is 972 9 863 6888. The Company was incorporated as a private company under the laws of the State of Israel on February 10, 1991 and its legal form is a company limited by shares. Commtouch became a public company on July 15, 1999. Its Amended and Restated Articles of Association are on file in Israel with the office of the Israeli Registrar of Companies and available for public inspection at that office. The Company wholly owns the following main subsidiary companies, either directly or through holding companies:

- a. Commtouch Inc., a California corporation and a wholly owned subsidiary of the Company, which has its principal office located at 7927 Jones Branch Drive, Suite 2250, Tysons Corner, VA, 22102 where certain members of management and related personnel are located, plus two supporting offices located at 1731 Embarcadero Road, Suite 230, Palo Alto, CA 94303, tel: (650) 864 2000, and 7121 Fairway Dr., Suite 104, Palm Beach Gardens, FL 33418, tel: 561 575-3200. The Company expects to merge the Florida office with its Virginia office later in 2013, terminate its Florida lease and enter into a new lease for expanded space in Virginia.
- b. Commtouch Iceland hf, a limited liability company organized and existing under the laws of Iceland and wholly owned by the Company, with an office at Thverholti 18, IS-105, Reykjavik, Iceland, tel: 354-540-7400.
- c. eleven Gesellschaft zur Entwicklung und Vermarktung von Netzwerktechnologien mbH, a German limited liability company and owned by the Company through a holding company structure, with an office at Hardenbergplatz 2, 10623, Berlin, Germany, tel: 49 (0)30/52 0056 0.

We are a provider of Internet security technology and cloud-based services comprised of messaging, antivirus and Web security solutions. We provide our services to a wide array of customers and OEM and service provider distribution partners, including network and security vendors offering content security gateways, unified threat management, or UTM, solutions, network appliances, antivirus solutions and to service providers such as Software-as-a-Service, or SaaS, vendors, Web hosting providers and Internet service providers. Our multiple services are intended to provide Internet security for various users of the Internet against the harmful effects of spam, malevolent software or malware, unwelcome websites, etc.

Our services include real-time Inbound Anti-Spam, Outbound Spam Protection for service providers, Zero-Hour Virus Outbreak Detection, GlobalView Mail Reputation, Command Antivirus, GlobalView URL Filtering and, more recently, Email Secaas (which is comprised of inbound and outbound anti-spam, plus antivirus) and Email Security On-Premise.

##### *Additional Detail on Our Offerings*

Our anti-spam and antivirus services can be accessed through various means, including i) through the integration of a SDK, which, upon integration, is then able to communicate with our worldwide cloud Detection Centers that provide our customers and users with the most up to date protection against the latest Internet threats ii) through our new full

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cloud-based Email SecaaS service, which is integrated into service providers' existing email infrastructure as an upstream Mail Transfer Agent, or MTA, with incoming email being directed to the Commtouch cloud infrastructure for review, and iii) through Email Security On-Premise, a solution integrated into service providers' existing e-mail server infrastructure either through integration as an SMTP proxy, or a plug-in via numerous interfaces, including SpamAssassin (spamd) and Sendmail Milter. This on-premise solution also offers GlobalView Mail Reputation services.

Our URL filtering services currently are only offered through a SDK integration, though the Company expects to release a cloud-based Web SaaS service during the second half of 2013.

At the core of our messaging security offerings is our proprietary Recurrent Pattern Detection (RPD) technology which, in general terms, analyzes messages associated with mass email outbreaks and directs the blocking of such emails, without the need to analyze individual messages. Outbound Spam Protection is intended to enable service providers to block emails being sent from their system that contain spam, phishing or malware, and identify the source of the problem. Inbound Anti-Spam is intended to enable customers to block their end users' receipt of such unwanted emails. GlobalView Mail Reputation fights unwanted email at a network's perimeter, i.e. fighting them at the entry point, before these messages enter the network, based on identifying characteristics of the source of the email.

At the core of our Web security solutions is our ability to analyze various feeds from worldwide sources, as well as data from our RPD technology, pertaining to URLs, and provide a classification of the URLs based on a set of categories.

At the core of our Command Antivirus solutions is our proprietary detection and remediation technology and unique engine design based on a combination of heuristics, emulation and several types of signatures, as well as an in the cloud infrastructure, which allows for a high degree of flexibility for our OEM customers.

In February 2011, we announced the availability of all three of our principal service offerings—messaging, antivirus and Web security—in one unified SDK. The unified SDK can be integrated into the products of security and networking vendors on an OEM basis, as well as into service providers' infrastructure. Typical solutions that would benefit from the unified engine are software or hardware solutions or services that combine multiple security technologies, such as UTM, secure content filtering gateways and SaaS security solutions. The three principal service offerings—messaging, antivirus and Web security—are still available also in non-unified, individual SDKs for our OEM and service provider customers.

In January 2012, we announced the availability of our Mobile Security SDK, providing antivirus and Web security for Android devices.

We also offer the following services typically through reseller channels:

An enterprise anti-spam and Zero-Hour virus outbreak detection solution, which allows the reseller's customers to download an Enterprise Gateway (a software program) enabling the subject Commtouch services to be provided in real time by our Detection Centers. Through the Enterprise Gateway, messages are filtered at the customer organization's entry point, before being distributed to recipients, with added user-level controls and a top level of secure spam and virus detection services from the Detection Center, all allowing for real-time reaction to worldwide attacks.

Command Anti-Malware service known as CSAM, which offer world-class anti-malware protection for consumers and small businesses, as well as enterprises with hundreds of managed endpoints.

F-PROT Antivirus client for various operation systems directed to consumers and small businesses. The client utilizes signature-based malware detection together with advanced heuristics, and also includes automatic updates to ensure low maintenance.

### *Sales and Marketing*

We utilize third party distribution channels to sell our products. Generally, our SDK is provided to OEM and service provider customers, who in turn integrate the software into their product or service offerings for sale or provision of our services to their customers. We are paid service fees under a variety of fee structures, including fixed fee and fee sharing arrangements.



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We anticipate that our Email SecaaS service will be sold primarily through reseller and OEM/service provider channels.

Our enterprise anti-spam and Zero-Hour virus outbreak detection gateway, CSAM antivirus and F-Prot antivirus services, are sold through resellers, who typically pay us pre-negotiated fees after each sale is closed with a reseller's customer.

All Commtouch sales are managed by our Senior Vice President, Worldwide Sales, who is based in our Virginia office and who works closely with our sales teams in Israel, the United States, Europe and Iceland. The Company's marketing efforts are aimed mainly at potential OEM and service provider customers, as well as resellers and distributors. The marketing department is centralized in our subsidiary's Virginia office, though our personnel travel internationally in furtherance of the Company's marketing goals, and we retain marketing personnel in other offices throughout the organization.

### *Intellectual Property*

We regard our patented and patent pending anti-spam and antivirus technology, copyrights, service marks, trademarks, trade secrets and similar intellectual property as critical to our success, and rely on patent, trademark and copyright law, trade secret protection and confidentiality and/or license agreements with our employees, customers, partners and others to protect our proprietary rights.

During 2004, we purchased a United States patent, U.S. Patent No. 6,330,590. During 2005, we filed in the United States an anti-spam related patent application, claiming priority for a prior period based on the filing of U.S. Provisional Patent Application. This application remains outstanding. During 2006, we filed in the United States a patent application relating to the prevention of spam in streaming systems or, in other words, unwanted conversational media sessions (i.e. voice and video related). This provisional application was converted to a formal patent application and, effective December 7, 2010, the United States Patent and Trademark Office split our application into three pending applications and issued us a new patent under the original application—United States Patent No. 7,849,186. In 2011, a divisional patent was issued in connection with one of those split applications—United States Patent No. 7,991,919, which will have a term concurrent with US Patent No. 7,849,186. On May 29, 2012 and on June 5, 2012, two additional divisional patents were issued in connection with the final two split applications—United States Patent No. 8,190,737 and United States Patent No. 8,195,795, respectively, both of which also will have a term concurrent with U.S. Patent 7,849,186. In 2013, we filed in the United States a new application for a patent regarding a unified platform that leverages the various proprietary Internet security tools we employ to resolve security threats. We may seek to patent certain additional software or other technology in the future.

We are actively maintaining our registered trademark for COMMTOUCH, which is registered in the U.S., Canada, Israel and European Union and China. With the acquisition of certain assets of Authentium during 2010, we also acquired registered trademarks in Command Antivirus, Command Anti-Malware, Command On Demand, Command Interceptor and Galileo, as well as registered service marks in Authentium and Authentium ESP. We are allowing the registration of Command Interceptor to lapse, and may allow others of these trademarks to lapse over time. A previous registration of PRONTO in Canada is still in force, but we are not maintaining this registration and it will lapse in 2014. Since at least September 2003, we have claimed trademark rights in RPD and Recurrent Pattern Detection, as applicable to our messaging security solutions. We have also been claiming trademark rights in Zero-Hour in relation to our virus outbreak detection product (and more recently one of our web security products) and GlobalView in relation to our Internet Protocol, or IP, reputation and Web security products, as well as our cloud computing network infrastructure.

It may be possible for unauthorized third parties to copy or reverse engineer certain portions of our products or obtain and use information that we regard as proprietary. In addition, the laws of some foreign countries do not protect proprietary rights to the same extent as do the laws of the United States. There can be no assurance that our means of protecting our proprietary rights in the United States or abroad will be adequate or that competing companies will not independently develop similar technology.

Other parties may assert infringement claims against us. We may also be subject to legal proceedings and claims from time to time in the ordinary course of our business, including claims of alleged infringement by us and/or our customers of the trademarks and other intellectual property rights of third parties. Our customer agreements typically include indemnity provisions, so we may be obligated to defend against third party intellectual property rights infringement claims on behalf of our customers. Such claims, even if not meritorious, could result in the expenditure of significant

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financial and managerial resources. During 2011, one such indemnification demand was made by a customer, and we continue to cooperate with that customer in seeking to defeat the underlying patent infringement claims. While we believe that adequate non-infringement and/or invalidity arguments exist, we are uncertain if the case will proceed to judgment. During early 2013, we learned that our customer is negotiating a settlement of the matter, and we have been asked to contribute a portion towards the settlement. It is too early in the negotiations process to anticipate the outcome of the settlement negotiations and our possible contribution towards any final settlement.

### *Government Regulation*

Laws aimed at curtailing the spread of spam have been adopted by the United States federal government, i.e. CAN-SPAM Act, and some individual U.S. states, with the CAN-SPAM Act superseding some state laws or certain elements thereof. See also disclosure under Item 3. Key Information Risk Factors Business Risks Tighter governmental enforcement of regulations could decrease the distribution of unsolicited bulk (spam) email and malicious software and decrease demand for our solutions, or increase our cost of doing business. Though not totally clear as to the exact reason, approximately two years ago we began to see a gradual decline in the amount of spam traffic on the Internet. While the decrease leveled off last year, any continuation of this trend can have a negative effect our business, as potential customers may not view the need to acquire a robust anti-spam solution with as much urgency, especially if such solution is to replace a third party legacy anti-spam solution.

The propagation of email viruses, whether through email or Web sites, which are aimed at destroying or stealing third party data, is illegal under standard state and federal law outlawing theft, misappropriation, conversion, etc., without the need for special legislation prohibiting such activities on the Internet. Despite the existence of these laws, sources for Internet viruses continue to spread multi-variant viruses seemingly without much fear of recrimination. New laws providing for more stringent penalties could be adopted in various jurisdictions, but it is unclear what, if any, affect these would have on the anti-virus industry in general and our Command Antivirus, F-Prot antivirus, Zero-Hour Virus Outbreak Detection and GlobalView URL filtering solutions in particular.

### *Employees*

As of December 31, 2012, 2011 and 2010, we had 198, 86, and 93 employees, respectively, with such employees being located in our offices in the United States, Israel, Iceland and Germany. As of December 31, 2012, our employees were categorized as follows:

| <b>LOCATION</b> | <b>General &amp; Administrative</b> | <b>Sales &amp; Marketing</b> | <b>Research &amp; Development</b> | <b>Hosting (Operations)</b> | <b>TOTAL:</b> |
|-----------------|-------------------------------------|------------------------------|-----------------------------------|-----------------------------|---------------|
| ISRAEL OFFICE   | 9                                   | 13                           | 37                                | -                           | 59            |
| U.S. OFFICE:    |                                     |                              |                                   |                             |               |
| California      | 5                                   | 5                            | -                                 | 8                           | 18            |
| Florida         | 2                                   | 2                            | 9                                 | 1                           | 14            |
| Virginia        | 3                                   | 8                            | 1                                 | -                           | 12            |
| Iceland         | 5                                   | 5                            | 21                                | 4 (operations and IT)       | 35            |
| Germany         | 8                                   | 30 (including support)       | 18                                | 4                           | 60            |

While employment related issues occasionally arise in the normal course, we believe that, on the whole, relations with our employees are good.

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None of our U.S. employees are covered by a collective bargaining agreement, rather they sign individual offer letters of employment that, along with relevant Company policies and an employee handbook, formalize employees' relationship with our U.S. subsidiary.

Israeli law and certain provisions of the nationwide collective bargaining agreements between the Histadrut (General Federation of Labor in Israel) and the Coordinating Bureau of Economic Organizations (the Israeli federation of employers' organizations) apply to Commtouch's Israeli employees. These provisions principally concern the maximum length of the workday and workweek, minimum wages, contributions to a pension fund, insurance for work-related accidents, procedures for dismissing employees, determination of severance pay and other conditions of employment. Furthermore, pursuant to such provisions, the wages of most of Commtouch's Israeli employees are subject to cost of living adjustments, based on changes in the Israeli Consumer Price Index. The amounts and frequency of such adjustments are modified from time to time. Also, all Israeli employees employed for at least a year commencing in 2009 are entitled to the funding of pension benefits by preset monthly contributions of the employee and the employer. Israeli law generally requires the payment of severance pay upon the retirement or death of an employee or upon termination of employment by the employer or, in certain circumstances, by the employee. We currently fund our ongoing severance obligations by making monthly payments for insurance policies and by an accrual. A general practice in Israel followed by Commtouch, although not legally required, is the contribution of funds on behalf of certain employees to an individual insurance policy known as Managers' Insurance. This policy provides a combination of savings plan, insurance and severance pay benefits to the insured employee. It provides for payments to the employee upon retirement or death and secures a substantial portion of the severance pay, if any, to which the employee is legally entitled upon termination of employment. Each participating employee contributes an amount equal to 5% of such employee's base salary, and the employer contributes between 13.3% and 15.8% of the employee's base salary. Full-time employees who are not insured in this way are entitled to a savings account, to which both the employee and the employer make a monthly contribution of 5% of the employee's base salary. We also provide certain Israeli employees with an Education Fund, to which each participating employee contributes an amount equal to 2.5% of such employee's base salary, and the employer contributes an amount equal to 7.5% of the employee's base salary, up to a certain maximum base salary set by law.

### *Description of Property*

All of our facilities are leased. We recently relocated our Israel and California offices to Herzliya, Israel and Palo Alto, CA, respectively, and we anticipate moving our McLean, VA offices to a nearby location to accommodate our expansion. Certain employees from our Florida office have relocated to our McLean office, and we anticipate closing our Florida office during the third quarter of 2013.

Our office in Herzliya, Israel, is approximately 1,100 square meters and houses research and development, sales, marketing and administrative personnel. Our U.S. subsidiary Commtouch Inc. is headquartered in McLean, VA, in an office of approximately 3,050 square feet (and will grow to approximately 7,022 square feet) and it houses and will house senior management, marketing, Command Antivirus operations (which is being moved from our Florida office), and administrative personnel; and its office in California (approximately 3,332 square feet), is staffed by hosting (operations), sales and administrative personnel. Our subsidiary Commtouch Iceland hf is located in Reykjavik, Iceland in an office of approximately 1,000 square meters, which houses antivirus operations, sales and some administrative personnel. Our subsidiary eleven is based in Berlin, Germany in an office of approximately 960 square meters, which houses research and development, operations, sales, marketing and administrative personnel.

### *Geographic Information*

The Company conducts its business on the basis of one reportable segment in accordance with Accounting Standards Codification, or ASC, 280, Segment Reporting.

### *Revenues for Last Three Financial Years*

See Item 5. Operating and Financial Review and Prospects - Revenue Sources and the financial statements included elsewhere in this annual report. Below is a breakdown of our revenues by location (in thousands):

|               | Year December 31, |           |           |
|---------------|-------------------|-----------|-----------|
|               | 2010              | 2011      | 2012      |
| Israel        | \$ 2,047          | \$ 2,044  | \$ 2,541  |
| North America | 9,184             | 12,655    | 11,847    |
| Europe        | 4,454             | 4,869     | 5,737     |
| Asia          | 1,976             | 3,036     | 3,484     |
| Other         | 500               | 412       | 301       |
|               | \$ 18,161         | \$ 23,016 | \$ 23,910 |

We made capital expenditures in our cloud infrastructure of approximately \$700 during 2012. We have had only negligible capital divestitures in the last three financial years.

#### *Competitive Landscape*

The markets in which Commtouch competes are intensely competitive and rapidly changing. However, we believe there are very few competitors that offer the complete package of anti-spam, anti-virus (both traditional and complementary real-time offerings), IP reputation and Web security protections that Commtouch provides.

The principal competitive factors in our industry include price, product functionality, product integration, platform coverage and ability to scale, worldwide sales infrastructure and global technical support. Some of our competitors have greater financial, technical, sales, marketing and other resources than we do, as well as greater name recognition and a larger installed customer base. Additionally, some of these competitors have research and development capabilities that may allow them to develop new or improved products that may compete with product lines we market and distribute, possibly at a lower cost. Our success will depend on our ability to adapt to these competing forces, to develop more advanced products more rapidly and less expensively than our competitors and/or to purchase new products by way of strategic acquisitions, and to educate potential customers as to the benefits of using our products rather than developing their own products.

In the market for messaging security solutions, there are sophisticated offerings that compete with our solutions. Email defense security providers offering forms of software as a service (SaaS), packaged software (gateway), multi-functional appliances and managed service solutions and which may be viewed as both competitors and potential customers to Commtouch include Google (Postini), Symantec (Brightmail), TrendMicro, Intel (McAfee) and Cisco (IronPort). Messaging security providers offering solutions on an OEM basis similar to Commtouch's business model, and which may be viewed as direct competitors, include Cloudmark, Mailshell and Vade Retro.

The market for real-time virus protection products is also constantly evolving, as those designing and proliferating viruses and other malware seek new vulnerabilities and distribution techniques, and also continue to leverage email distribution as a cost-effective medium for accurately targeting broad, numerous potential victims. Commtouch's real-time offering differs from traditional anti-virus solutions (such as our Command Antimalware solution) by leveraging our global footprint and patented RPD technology to rapidly detect outbreaks, often hours or days before traditional antimalware solutions; it thereby offers a complementary solution to signature and heuristic-based anti-virus engines. For this reason, our Zero-Hour virus outbreak protection engine has been deployed by several security companies and service providers.

In the market for antimalware solutions, there are vendors offering fairly effective solutions using various technologies based on signatures, emulation and heuristics. Commtouch distinguishes itself in independent tests of detection capability, has an exclusive OEM/service provider focus, plus an increasing focus on heuristics and zero day effectiveness. Most companies in this space provide end-user products and in some cases make software development kits available on an OEM basis. Competitors to Commtouch include McAfee, Sophos, Kaspersky, and open source software such as Clam-AV.

In the market for Web security solutions, there are advanced offerings that compete with our GlobalView URL filtering solution. Web security providers offering forms of software (gateway), multi-functional appliances and managed service solutions and which may be viewed as both competitors and potential customers to Commtouch include Intel (McAfee), WebSense and BlueCoat. Web security providers offering solutions on an OEM basis similar to Commtouch's business model, and which may be viewed as direct competitors, include Webroot (BrightCloud), Symantec (RuleSpace) and IBM (ISS/Cobion).

We expect that the markets for Internet security solutions will continue to become more consolidated, with companies increasing their presence in this market or entering ancillary markets by acquiring or forming strategic alliances with our competitors or business partners. Some examples of this in the messaging security field are the acquisitions of IronPort by Cisco, McAfee by Intel, both Frontbridge and Sybari Software by Microsoft, and Bizanga by Cloudmark. Some examples of this in the Web security field are the acquisitions of Fastdata by Cisco, SurfControl by WebSense, CipherTrust by Secure Computing, Secure Computing by McAfee, McAfee by Intel, RuleSpace by Symantec and BrightCloud by Webroot.

See also disclosure under Item 3. Key Information Risk Factors Business Risks We have many established competitors who are offering a multitude of solutions to the problems of spam/virus distribution and Web-related security threats.

**Item 4A. Unresolved Staff Comments.**

Not applicable.

**Item 5. Operating and Financial Review and Prospects.**

*Overview*

From 2003 through 2008, the sole focus of our business had been the development and selling, through reseller and OEM distribution channels, of anti-spam, Zero-Hour virus outbreak detection and IP reputation solutions to a wide array of customers. During late 2008, we expanded our focus by way of the release of our first URL filtering solutions for the web security market. In 2010, we acquired certain assets comprising the Command Antivirus business unit of Authentium, Inc. On October 1, 2012, the company completed the acquisition of the antivirus business of Frisk. The acquisition enables the company to provide antivirus technology utilizing the combined resources of both organizations. It also helps support the launch of a private label antivirus solution for the OEM and service provider markets while also enhancing the company's SaaS capabilities. On November 16, 2012 the Company completed the acquisition of eleven. The acquisition of eleven enables Commtouch to accelerate delivery of private label cloud based security solutions specifically designed for the OEM and service provider markets.

*Critical Accounting Policies and Estimates*

Operating and Financial Review and Prospects are based upon the Company's consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States (U.S. GAAP). The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates. On an ongoing basis, the Company's management evaluates estimates. Such estimates are based on historical experience and on various other assumptions that are believed to be reasonable, the results of which form the basis for making judgments about the carrying values of assets and liabilities.

*Accounting for Stock Based Compensation:*

ASC 718 - Compensation-stock Compensation ASC 718, requires companies to estimate the fair value of equity-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as an expense over the requisite service periods in the Company's consolidated income statements.

The Company recognizes compensation expense for the value of its awards on a straight line basis over the requisite service period of each of the awards, net of estimated forfeitures. Estimated forfeitures are based on actual historical pre-vesting forfeitures. ASC 718 requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

The Company estimates the fair value of stock options granted using the Black-Scholes option-pricing model. The option-pricing model requires a number of assumptions, of which the most significant are the expected stock price volatility and the expected option term. Expected volatility was calculated based upon actual historical stock price movements. The expected term of options granted represents the period of time that options granted are expected to be

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outstanding. The risk-free interest rate is based on the yield from U.S. treasury bonds with an equivalent term. The Company has historically not paid dividends and has no foreseeable plans to pay dividends.

The Company applies ASC 718, and ASC 505-50, Equity Based Payments to Non Employees, or ASC 505-50, with respect to options issued to non-employees.

The fair value for options granted in 2010, 2011 and 2012 is estimated at the date of grant using a Black-Scholes options pricing model with the following weighted average assumptions:

| Employee stock options     | 2010      | Year ended<br>December 31,<br>2011 | 2012      |
|----------------------------|-----------|------------------------------------|-----------|
| Volatility                 | 71%-73%   | 68%-70%                            | 38%-51%   |
| Risk-free interest rate    | 1.1%-1.6% | 0.6%-2.1%                          | 0.5%-0.9% |
| Dividend yield             | 0%        | 0%                                 | 0%        |
| Expected life (years)      | 3.7-4.6   | 3.6-4.8                            | 3.8-4.9   |
| <i>Revenue recognition</i> |           |                                    |           |

We derive revenues from the sale of real-time Inbound Anti-Spam, Outbound Spam Protection for service providers, Zero-Hour virus outbreak protection, GlobalView Mail Reputation, Command Antivirus, GlobalView URL Filtering and, more recently, Email SecaaS (which is comprised of inbound and outbound anti-spam, plus antivirus) and Email Security On-Premise.

Revenue is recognized when there is a persuasive evidence of an arrangement, the service has been rendered, the collection of the fee is probable and the amount of fees to be paid by the customer is fixed or determinable.

Revenues from such services are recognized ratably over the contractual service term, which generally includes a term period of one to three years.

Deferred revenues include unearned amounts received from customers, but not yet recognized as revenues.

### *Accounting for Income Tax*

We account for income taxes in accordance with FASB ASC 740, *Income Taxes*. ASC 740 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. We record a valuation allowance, if necessary, to reduce deferred tax assets to the amount that we believe is more likely than not to be realized.

Deferred tax assets are classified as current or non-current based on the classification of the related asset or liability for financial reporting, or according to the expected reversal dates of the specific temporary differences if not related to an asset or liability for financial reporting.

ASC 740 contains a two-step approach to recognizing and measuring a liability for uncertain tax positions. The first step is to evaluate the tax position taken or expected to be taken in a tax return by determining if the weight of available evidence indicates that it is more likely than not that, on an evaluation of the technical merits, the tax position will be sustained on audit, including resolution of any related appeals or litigation processes. The second step is to measure the tax benefit as the largest amount that is more than 50% likely to be realized upon ultimate settlement. No liability for unrecognized tax benefits was recorded as a result of the implementation of ASC 740.

*Goodwill and Intangible Assets*

Goodwill and certain other purchased intangible assets have been recorded as a result of acquisitions made in 2010 and 2012. Goodwill represents the excess of the purchase price in a business combination over the fair value of net tangible and intangible assets acquired. Goodwill is not amortized, but rather is subject to an impairment test. The Company performs an annual impairment test at December 31 of each fiscal year, or more frequently if impairment indicators are present. We operate in one operating segment, and this segment comprises the only reporting unit.

ASC 350 prescribes a two-phase process for impairment testing of goodwill. The first phase screens for impairment, while the second phase (if necessary) measures impairment. Goodwill impairment is deemed to exist if the net book value of a reporting unit exceeds its estimated fair value determined using market capitalization. In such case, the second phase is then performed, and the Company measures impairment by comparing the carrying amount of the reporting unit's goodwill to the implied fair value of that goodwill. An impairment loss is recognized in an amount equal to the excess. For each of the two years in the period ended December 31, 2012, no impairment losses have been identified.

Intangible assets that are not considered to have an indefinite useful life are amortized over their estimated useful lives, which range from 8 to 15 years. Acquired customer contracts and relationships are amortized over their estimated useful lives in proportion to the economic benefits realized. This accounting policy results in accelerated amortization of such customer contracts and relationships arrangements as compared to the straight-line method. Other intangible assets consist primarily of technology, and are amortized over their estimated useful lives on a straight-line basis.

The carrying amount of these assets to be held and used is reviewed whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable. Recoverability of these assets is measured by comparison of the carrying amount of each asset (or asset group) to the future undiscounted cash flows the asset (or asset group) is expected to generate. If the asset is considered to be impaired, the amount of any impairment is measured as the difference between the carrying value and the fair value of the impaired asset.

In conjunction with Authentium's sale of its remaining business to a third party and the discontinuation of Authentium, in 2011, the Company wrote off the remaining asset related to covenants not-to-compete in the amount of \$502, which was recorded in sales and marketing expenses.

*Results of Operations*

The following table sets forth financial data for the years ended December 31, 2010, 2011 and 2012 (in thousands):

|   | 2010      | 2011      | 2012      |
|---|-----------|-----------|-----------|
| Revenues  | \$ 18,161 | \$ 23,016 | \$ 23,910 |
| Cost of revenues  | 2,918     | 4,091     | 4,350     |
| Gross profit  | 15,243    | 18,925    | 19,560    |
| Operating expenses:   |           |           |           |
| Research and development, net   | 3,397     | 5,410     | 6,281     |
| Sales and marketing   | 4,575     | 5,486     | 5,860     |
| General and administrative  | 3,911     | 4,721     | 6,639     |
| Total operating expenses  | 11,883    | 15,617    | 18,780    |
| Operating income  | 3,360     | 3,308     | 780       |
| Financial income (expenses), net  | (55)      | (27)      | 80        |
| Net income before tax benefit   | 3,305     | 3,281     | 860       |
| Tax benefit   | (1,098)   | (1,317)   | (625)     |
| Net income attributable to ordinary and equivalently participating shareholders | \$ 4,403  | \$ 4,598  | \$ 1,485  |

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### *Comparison of Years Ended December 31, 2012 and 2011*

*Revenues.* Revenues increased by \$0.9 million from \$23 million in 2011 to \$23.9 million in 2012, which represents a 4% increase. The increase is mainly due to the acquisition and the first consolidation of eleven and Frisk into Commtouch in the fourth quarter of 2012.

*Cost of Revenues.* Cost of revenues increased by \$0.3 million from \$4.1 million in 2011 to \$4.4 million in 2012, which represents a 6% increase. The increase in 2012 is mainly due to the first consolidation of eleven and Frisk into Commtouch as well as higher facility costs and hosting expenses aimed to serve the increasing number of customers.

*Research and Development, net.* Research and development expenses increased by \$0.9 million and amounted to \$6.3 million in 2012 compared to \$5.4 million in 2011. \$0.7 million out of the total increase is due to the first consolidation of eleven and Frisk in the fourth quarter of 2012 and \$0.2 million out of the total increase is due to increase in outside services utilized in 2012.

Research and development expenses in 2012 include \$0.2 million of expenses in connection with equity based compensation, compared to \$0.3 million of expenses in 2011.

*Sales and Marketing.* Sales and marketing expenses increased by \$0.4 million and amounted to \$5.9 million in 2012, compared to \$5.5 million in 2011. The increase is mainly due to the first consolidation of Frisk and eleven in the fourth quarter of 2012. Excluding eleven and Frisk, Sales and Marketing payroll increased by \$0.3 million in order to expand our existing sales and product marketing resources and rent increased by \$0.2 million due to the opening of the new headquarters in Virginia. This increase is offset by a decrease of \$0.5 million due to the write off in 2011 of a covenant not to compete asset (acquired in our Authentium acquisition). Sales and marketing expenses in 2012 included \$0.2 million expenses in connection with equity based compensation, compared to \$0.4 million of expenses in 2011.

*General and Administrative.* General and administrative expenses increased by \$1.9 million, from \$4.7 million in 2011 to \$6.6 million in 2012. \$0.8 million of the total increase is due to acquisition related costs of eleven and Frisk. Salary expenses increased by \$0.7 million from \$2.8 million in 2011 to \$3.5 million in 2012 mainly due to recruitment of additional employees in the Virginia headquarters. Additionally, \$0.3 million is due to the first consolidation of Frisk and eleven in the fourth quarter of 2012.

In 2012, general and administrative expenses included \$0.8 million expenses in connection with equity based compensation, compared to \$0.7 million of expenses in 2011.

*Financial Income (Expenses), Net.* Financial income (expenses), net, resulted in income of \$0.08 million in 2012 compared to expenses of \$0.03 million in 2011.

*Tax benefit.* Tax benefit decreased by \$0.7 million from \$1.3 million in 2011 to \$0.6 million in 2012. In 2012, the deferred tax asset increased by \$0.7 million due to an increase in forecasted taxable income that is more likely than not to be realized in the foreseeable future, based on our established pattern of profitability in the last few years resulting, among others, from the new acquisitions that took place in 2012.

### *Comparison of Years Ended December 31, 2011 and 2010*

*Revenues.* Revenues increased by \$4.8 million from \$18.2 million in 2010 to \$23.0 million in 2011 which represent 27% increase. The increase is mainly due to a growth in market share, an increase in sales derived from our Web security product launched in the fourth quarter of 2008 and sales of the Antivirus product following the purchase of Command Antivirus in September 2010.

*Cost of Revenues.* Cost of revenues increased by \$1.2 million from \$2.9 million in 2010 to \$4.1 million in 2011 which represents a 40% increase. The increase in 2011 is mainly due to higher facility costs and hosting expenses aimed to serve the increasing number of customers and the Command Antivirus expenses fully consolidated into Commtouch.

*Research and Development, net.* Research and development expenses increased by \$2 million and amounted to \$5.4 million in 2011 compared to \$3.4 million in 2010. The increase is mainly due to the related Command Antivirus expenses being fully consolidated into Commtouch from September 2010. The increase in our research and development expenses is also due to an OCS grant in 2010, which reduced our payroll cost by \$0.8 million, compared to \$0 in 2011. Research and development expenses include \$0.3 million of expenses in connection with equity based compensation in 2011, compared to \$0.3 million of expenses in 2010.



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*Sales and Marketing.* Sales and marketing expenses increased by \$0.9 million and amounted to \$5.5 million compared to \$4.6 million in 2010. The increase is mainly due to the impairment of a covenant not to compete asset (acquired in our Authentium acquisition) in the amount of \$0.5 million, increased sales and marketing activity and the related Command Antivirus expenses fully being consolidated into Commtouch beginning in September 2010. Sales and marketing expenses included \$0.4 million expenses in connection with ASC 718.

*General and Administrative.* General and administrative expenses increased by \$0.8 million, from \$3.9 million in 2010 to \$4.7 million in 2011. The increase is mainly due to the update of the earnout liability in the amount of \$0.4 million in connection with the acquisition of the assets of the Antivirus business of Authentium Inc. (now known as SafeCentral Inc.) The contingent consideration is subject to adjustments upward or downward based on the revenue derived from the purchased customer contracts and the related Command Antivirus expenses fully being consolidated into Commtouch from September 2010. In 2011, general and administrative expenses included \$0.7 million expenses in connection with ASC 718, compared to \$0.7 million of expenses in connection with equity based compensation in 2010.

*Financial Income (Expenses), Net.* Financial income (expenses), net, resulted in expenses of \$0.03 million in 2011 compared to expenses of \$0.1 million in 2010.

*Tax benefit.* Tax benefit increased by \$0.3 million from \$1 million in 2010 to \$1.3 million in 2011. In 2011, the deferred tax asset increased by \$1.4 million due to an increase in forecasted taxable income that is more likely than not to be realized in the foreseeable future, based on our established pattern of profitability in the last few years.

### *Quarterly Results of Operations (Unaudited)*

The following table sets forth certain unaudited quarterly statements of operations data for the eight quarters ended December 31, 2012. This information has been derived from the Company's consolidated unaudited financial statements, which, in management's opinion, have been prepared on the same basis as the audited consolidated financial statements, and include all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of the information for the quarters presented. This information should be read in conjunction with our audited consolidated financial statements and the notes thereto included elsewhere in this Annual Report. The operating results for any quarter are not necessarily indicative of the operating results for any future period.

#### **Three Months Ended**

|   | <b>Mar 31<br/>2011</b> | <b>June 30<br/>2011</b> | <b>Sep. 30<br/>2011</b> | <b>Dec. 31<br/>2011</b> | <b>Mar 31<br/>2012</b> | <b>June 30<br/>2012</b> | <b>Sep. 30<br/>2012</b> | <b>Dec. 31<br/>2012</b> |
|---|------------------------|-------------------------|-------------------------|-------------------------|------------------------|-------------------------|-------------------------|-------------------------|
| (in thousands)  |                        |                         |                         |                         |                        |                         |                         |                         |
| (unaudited)   |                        |                         |                         |                         |                        |                         |                         |                         |
| Revenues  | \$ 5,515               | \$ 5,696                | \$ 5,855                | \$ 5,950                | \$ 5,896               | \$ 5,671                | \$ 5,558                | \$ 6,785                |
| Cost of revenues  | 1,010                  | 938                     | 1,019                   | 1,124                   | 1,052                  | 1,014                   | 917                     | 1,367                   |
| Gross profit  | 4,505                  | 4,758                   | 4,836                   | 4,826                   | 4,844                  | 4,657                   | 4,641                   | 5,418                   |
| Operating expenses:   |                        |                         |                         |                         |                        |                         |                         |                         |
| Research and development, net   | 1,247                  | 1,377                   | 1,342                   | 1,444                   | 1,270                  | 1,364                   | 1,462                   | 2,185                   |
| Sales and marketing   | 1,391                  | 1,318                   | 1,138                   | 1,639                   | 1,142                  | 1,288                   | 1,564                   | 1,866                   |
| General and administrative  | 893                    | 1,004                   | 1,209                   | 1,615                   | 1,331                  | 1,384                   | 1,550                   | 2,374                   |
| Total operating expenses  | 3,531                  | 3,699                   | 3,689                   | 4,698                   | 3,743                  | 4,036                   | 4,576                   | 6,425                   |
| Operating income  | 974                    | 1,059                   | 1,147                   | 128                     | 1,101                  | 621                     | 65                      | (1,007)                 |
| Financial income(expenses), net   | (14)                   | (45)                    | 15                      | (23)                    | 23                     | 64                      | 63                      | (70)                    |
| Net income  | 960                    | 1,014                   | 1,162                   | 105                     | 1,124                  | 685                     | 128                     | (1,077)                 |
| Taxes on income (tax benefit)   | (61)                   | (401)                   | 275                     | (1,170)                 | (85)                   | (119)                   | 109                     | (530)                   |
| Net income attributable to ordinary and equivalently participating shareholders | \$ 1,021               | \$ 1,415                | \$ 887                  | \$ 1,275                | \$ 1,209               | \$ 804                  | \$ 19                   | \$ (547)                |
| Basic   |                        |                         |                         |                         |                        |                         |                         |                         |
| Net income per share  | \$ 0.04                | \$ 0.06                 | \$ 0.04                 | \$ 0.05                 | \$ 0.05                | \$ 0.03                 | \$ 0.00                 | \$ (0.02)               |

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Diluted net income per share           \$ 0.04 \$ 0.06 \$ 0.04 \$ 0.05 \$ 0.05 \$ 0.03 \$ 0.00 \$ (0.02)  
22

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*New Accounting Pronouncements*

In February 2013, the FASB (Financial Accounting Standards Board) issued ASU No. 2013-02, Reporting of Amounts Reclassified out of Accumulated Other Comprehensive Income. Under ASU No. 2013-02, an entity is required to provide information about the amounts reclassified out of Accumulated Other Comprehensive Income, or AOCI by component. In addition, an entity is required to present, either on the face of the financial statements or in the notes, significant amounts reclassified out of AOCI by the respective line items of net income, but only if the amount reclassified is required to be reclassified in its entirety in the same reporting period. For amounts that are not required to be reclassified in their entirety to net income, an entity is required to cross-reference to other disclosures that provide additional details about those amounts. ASU No. 2013-02 does not change the current requirements for reporting net income or other comprehensive income in the financial statements. ASU No. 2013-02 is effective for the Company as of January 1, 2013. Since this standard only impacts presentation and disclosure requirements, its adoption will not have a material impact on the Company's consolidated results of operations or financial condition.

*Liquidity and Capital Resources*

As of December 31, 2011 and December 31, 2012, we had approximately \$20.9 million and \$5 million of cash and cash equivalents, respectively. The decrease is mainly due to net cash used in investing activities in 2012 of \$11.2 million, which consisted primarily of the payments for the acquisitions of eleven and Frisk and to a lesser degree due to net cash used in operating activities which amounted to approximately \$0.4 million and net cash used in financing activities which was approximately \$4.2 million. As of December 31, 2011 and December 31, 2012, we had working capital of \$17.3 million and \$1.5 million, respectively.

Based on the cash balance at December 31, 2012, current projections of revenues and related expenses, the Company believes it has sufficient cash to continue operations at least through May 2014.

The Company financed its acquisitions of Frisk and eleven from its cash reserves, share capital and future contingent payments (earnouts) based on related product performance, which may be adjusted upward or downward. In connection with the contingent earn-out consideration which is related to the Frisk acquisition, the Company recorded an estimated amount of \$1,037,000 as of the acquisition date. As of December 31, 2012, the fair value of the contingent consideration of \$73,000 is presented in short term liabilities, and the fair value of the contingent consideration of \$985,000 is presented in long term liabilities.

In connection with the contingent earn-out consideration, derived from the eleven acquisition, the Company recorded an estimated amount of \$9,399,000 as of the acquisition date. As of December 31, 2012, the fair value of the contingent consideration of \$4,048,000 is presented in short term liabilities, and the fair value of the contingent consideration of \$6,409,000 is presented in long term liabilities.

*Trends*

Several key factors and trends affect the information security market and impact how Commtouch conducts business.

**Information Security Threats Continue to Evolve.** These threats, against consumers and organizations of all sizes, drive demand for security offerings from service providers and hardware and software vendors. Examples include high profile hacker groups such as Anonymous targeting businesses and governmental organizations with attacks designed to disrupt access and operations and a wide range of malicious software designed to steal information from or gain control of computing systems.

**Mobility.** Mobile computing, using devices such as smartphones and tablets along with hundreds of thousands of Internet-connected mobile applications, is rapidly overtaking traditional personal computing paradigms. The "bring your own device" trend in which organizations allow or encourage employees to access organizational resources and process and store organizational data using their personally-owned devices has become prominent across many geographies and market segments. Meanwhile, Commtouch and other security vendors witnessed a dramatic rise in malware on the Android mobile platform in 2012.

**Cloud-Based Computing.** Cloud-based computing, in which consumers or organizations remotely access and leverage computing infrastructure or complete information services via the Internet continues to grow rapidly in today's environment thanks to increased connectivity, mobility and the efficiencies offered by cloud based services. Cloud-based "Security as a Service" includes many of the most rapidly growing sub-segments in the information security market. For instance, industry analysts estimate that the market for cloud-based Secure Web Gateway market has a five year CAGR between 22% and 27%.

*Contractual Obligations*

The following table summarizes our outstanding contractual obligations as of December 31, 2012 (in thousands):

| Contractual Obligation   | Payments due by period |                    |                 |               |                   |
|--|------------------------|--------------------|-----------------|---------------|-------------------|
|  | Total                  | (USD in thousands) |                 |               |                   |
|  |                        | Less than 1 year   | 1-3 years       | 3-5 years     | More than 5 years |
| Operating lease obligation   | \$ 3,722               | \$ 1,032           | \$ 1,788        | \$ 791        | \$ 110            |
| Other Long-term liabilities reflected on the Company's Balance Sheet - Accrued severance pay | 915                    | -                  | -               | -             | 915               |
| Other Long-term asset reflected on the Company's Balance Sheet - severance pay fund          | (756)                  | -                  | -               | -             | (756)             |
| Net - severance pay liability  | 159                    | -                  | -               | -             | 159               |
| Earnout obligation   | 10,457                 | 4,048              | 6,409           | -             | -                 |
| <b>Total</b>   | <b>\$ 14,338</b>       | <b>\$ 5,080</b>    | <b>\$ 8,197</b> | <b>\$ 791</b> | <b>\$ 269</b>     |

#### *Effective Corporate Tax Rates*

The Israeli corporate tax rate was 25% in 2010, 24% in 2011 and 25% in 2012 and onwards.

The Company may currently qualify as an industrial company within the definition of the Law for the Encouragement of Industry (Taxation). As such, it may be eligible for certain tax benefits, including, inter alia, special depreciation rates for machinery, equipment and buildings, amortization of patents, certain other intangible property rights and deduction of share issuance expenses.

As of December 31, 2012, the Company's net operating loss carryforwards for tax purposes amounted to approximately \$ 70,008,000 (including capital loss carryforward of \$15,659,000) which may be carried forward and offset against taxable income in the future, for an indefinite period.

As of December 31, 2012, for federal income tax purposes, the U.S. subsidiary had net operating loss carryforwards of approximately \$91,755,000 (including capital loss carryforwards of \$1,700,000). These losses may offset any future U.S. taxable income of the U.S. subsidiary and will expire in the years 2012 through 2025.

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

Management currently believes that since the Company has a history of losses, and uncertainty with respect to future taxable income, it is more likely than not that some of the deferred tax assets regarding the loss carryforwards will not

be utilized in the foreseeable future. Thus, a valuation allowance was provided to reduce deferred tax assets to their realizable value.

*Impact of Inflation and Currency Fluctuations*

The currency of the primary economic environment in which the operations of Commtouch and certain subsidiaries are conducted is the U.S. dollar ( "dollar" ); thus, the dollar is the functional currency of Commtouch and certain subsidiaries.

Commtouch and certain subsidiaries' transactions and balances denominated in dollars are presented at their original amounts. Non-dollar transactions and balances have been remeasured to dollars in accordance with ASC 830, "Foreign Currency Matters". All transaction gains and losses from remeasurement of monetary balance sheet items denominated in non-dollar currencies are reflected in the statements of income as financial income or expenses, as appropriate.

For those subsidiaries whose functional currency has been determined to be their local currency, assets and liabilities are translated at year-end exchange rates and statement of income items are translated at average exchange rates prevailing during the year. Such translation adjustments are recorded as a separate component of accumulated other comprehensive income (loss) in shareholders' equity.

Most of our sales are in U.S. dollars, and the rest are mainly in Euros. However, a portion of our costs relate to our operations in Israel. A substantial portion of our operating expenses in Israel, primarily our research and development expenses are denominated in NIS. Costs and revenues not denominated in U.S. dollars are re-measured to U.S. dollars, when recorded, at prevailing rates of exchange. This is done for the purposes of our financial statements and reporting. As a result, we are exposed to risk to the extent that the value of the U.S. dollar decreases against the NIS. In that event, the U.S. dollar cost of our operations will increase and our U.S. dollar-measured results of operations will be adversely affected. dollar cost of our operations. Also, in the event that the U.S. dollar appreciates against the Euro, our revenues will decrease. Consequently, we are and will be affected by changes in the prevailing NIS/U.S. dollar and Euro/ U.S. dollar exchange rates.

The annual rate of deflation in Israel was 1.7% in 2012, 4% in 2011 and 2.7% in 2010. The NIS appreciated against the U.S. dollar by approximately 2% in 2012, 8% in 2011 and 6% in 2010. The representative dollar exchange rate for converting the NIS to U.S. dollars, as reported by the Bank of Israel, was NIS 3.733 for one U.S. dollar on December 31, 2012. The representative dollar exchange rate was NIS 3.629 on April 22, 2013. Because exchange rates between the NIS and the dollar fluctuate continuously, exchange rate fluctuations and especially larger periodic devaluations will have an impact on our operating results and period to period comparisons of our results. The effects of foreign currency re-measurements are reported in the consolidated financial statements for relevant periods in the statement of operations.

**Item 6. Directors, Senior Management and Employees.**

The following table presents information with respect to our directors' beneficial ownership of our Ordinary Shares as of March 1, 2013. Beneficial ownership is determined in accordance with the rules of the SEC and includes voting or investment power, with respect to shares. To our knowledge, except under applicable community property laws or as otherwise indicated, the persons named in the table have sole voting and sole investment control and rights to receive economic benefits with respect to all shares beneficially owned. The applicable percentage of ownership for each director is based on 26,061,383 Ordinary Shares outstanding as of March 1, 2013. Ordinary Shares issuable upon the exercise of options and other rights, which are exercisable on or within sixty days of March 1, 2013, are deemed outstanding for the purpose of computing the percentage ownership of the director holding those options and other rights.

| Name and Position  | Age | Percentage of Ordinary Shares Beneficially Owned | Number of Ordinary Shares Beneficially Owned | Number of Options and Warrants included in Beneficial Ownership  |
|--|-----|--|--|--|
| Lior Samuelson, Director and Chairman of the Board       | 63  | 1.2%   | 180,000                                      | 141,551 options, at exercise prices ranging from \$3.18 to \$3.47 per Ordinary Share. Expiration dates range from 8/2/16 to 12/13/18.  |
| Aviv Raiz, Director (3)                                  | 54  | 21.3%  | 5,561,068                                    | 75,199 options, at exercise prices ranging from \$1.58 to \$6.60 per Ordinary Share. Expiration dates range from 12/14/13 to 12/13/18. |
| Hila Karah, Director (1)(3)                              | 44  | <1%  |  |  |
| Shlomi Yanai, CEO and Director                           | 42  | <1%  |  |  |
| Yair Shamir, Director (Outside Director) (1)(2)(3)(4)(5) | 68  | 5.5%   | 1,437,995                                    | 108,532 options, at exercise prices ranging from \$1.58 to \$4.10. Expiration dates range from 3/31/14 to 12/13/18.                    |
| Yair Bar-Touv, Director (Outside Director) (1)(2)(3)     | 52  | <1%  |  |  |
| Todd Thomson (2)   | 52  | <1%  |  |  |
| James Hamilton (1)(2)(6)                                 | 49  | <1%  |  |  |

- (1) Member of the Compensation Committee
- (2) Member of the Audit Committee
- (3) Member of the Nominating Committee
- (4) Mr. Shamir's ownership interest includes 1,264,023 of the Company's Ordinary Shares purchased by Catalyst Private Equity Partners II, for which Mr. Shamir has acted as chairman and managing partner. Mr. Shamir's options, as noted in the table above, are also held on behalf of Catalyst.
- (5) Due to Mr. Shamir's acceptance of a position in the new government of the State of Israel, he resigned his position as outside director of the Company effective April 17, 2013. The Company intends to seek the appointment of a new outside director as soon as possible and prior to the lapse of the 90 day period from Mr. Shamir's resignation.
- (6) With the departure of Mr. Shamir from the Board, Mr. Hamilton has been appointed to the Audit and Compensation Committees, and Mr. Bar-Touv has joined the Nominating Committee.

*Other Senior Management Employees:*

The following table sets forth the names and positions of our senior management employees, with ownership data being as of March 1, 2013:

| Name             | Age | Ownership | Position  |
|------------------|-----|-----------|---|
| Brian Briggs (2) | 46  | (1)       | Chief Financial Officer                                 |
| Gary Davis       | 51  | (1)       | Vice President, General Counsel and Corporate Secretary |
| Haniel Ilouz     | 42  | (1)       | Vice President, Global Engineering                      |
| Uri Gal          | 61  | (1)       | Global Vice President, Human Resources                  |
| Brett Wilson     | 44  | (1)       | Vice President, Products and Marketing                  |
| Pete Shah        | 44  | (1)       | Senior Vice President, Worldwide Sales                  |

(1) less than 1%

(2) Executive Officer, along with Shlomi Yanai, for purposes of the aggregation of compensation and share ownership of major shareholders, directors and executive officers, as appearing elsewhere in this Annual Report

Lior Samuelson has been a member of the Board since August 2010 and has held the position of Chairman of the Board since December 2010. Mr. Samuelson is the founder and managing partner of Mercator Capital, a merchant bank specializing in advising and investing in the technology and telecom sectors. During his extensive career, Mr. Samuelson served as chairman, CEO and board member of several companies focused on technology, telecom, financial services and management consulting. In 2008, he was the chairman of Deltathree (DDDC); from 1997 to 1999, he was the president and CEO of PricewaterhouseCoopers Securities. Prior to that, he was the president and CEO of The Barents Group, a merchant bank specializing in advising and investing in companies in emerging markets. He previously was a managing partner with KPMG and held a senior management position at Booz, Allen & Hamilton. Mr. Samuelson earned B.S. and M.S. degrees in Economics from Virginia Tech.

Aviv Raiz has served as a Director since December 2005. He is the founder and president of Eurotrust Ltd., a company specializing in enterprise level foreign exchange transactions. Mr. Raiz has been active in the foreign exchange markets for over twenty years, and has been a private equity investor in several high-tech, bio-tech and Internet companies. He holds an M.B.A. from Tel Aviv University.

Hila Karah joined the Board of Directors in March 2008. Ms. Karah has been the CIO of Eurotrust Ltd. since 2006, and has been a private and public equity investor in several high-tech, bio-tech and Internet companies since 2000. Prior to joining Eurotrust, Ms. Karah served as a partner financial analyst at Perceptive Life Sciences Ltd., a New York-based hedge fund. Prior to her position at Perceptive, Ms. Karah was a research analyst at Oracle Partners Ltd., a health care-focused hedge fund based in Connecticut. Ms. Karah holds a B.A. in Molecular and Cell Biology from the University of California, Berkeley, and has studied at the [UCB-UCSF JMP].

Yair Shamir joined the Board of Directors as an Outside Director under the Israel Companies Law in March 2008. Mr. Shamir has recently accepted a position in the new Israeli government, and has resigned from the Board effective April 17, 2013. Mr. Shamir has been the Chairman and Managing Partner of Catalyst Investments, and the Chairman of IAI, Israeli Aerospace Industries. From 2004 to 2005, Mr. Shamir was Chairman of El Al, Israeli Airlines and lead the privatization process of the firm. From 1997 to 2005, Mr. Shamir served as Chairman and CEO of VCON Telecommunications Ltd. From 1995 to 1997, Mr. Shamir served as executive vice president of the Challenge Fund-Etgar L.P. From 1994 to 1995, he served as Chief Executive Officer of Elite Food Industries, Ltd. From 1988 to 1993, Mr. Shamir served as Executive Vice President and General Manager of Scitex Corporation, Ltd. Mr. Shamir served in the Israeli Air Force as a pilot and commander from 1963 to 1988. During his term in the Israeli Air Force, Mr. Shamir attained the rank of colonel and served as head of the electronics department, the highest professional electronics position within the Israeli Air Force. He currently serves as a director of DSP Group Corporation, and also serves as director of other private hi-tech companies. Mr. Shamir holds a B.Sc. Electronics Engineering from the Technion, Israel Institute of Technology.

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Yair Bar-Touv joined the Board of Directors as an Outside Director under the Israel Companies Law in March 2008. Mr. Bar-Touv previously served as the CIO of a leading government enterprise specializing in analytic software solutions for knowledge discovery (text and data mining) of large volumes of data, with a focus on changing the ways enterprise organizations make decisions with regards to primary business processes. Mr. Bar-Touv is also the former CEO of Elron Telesoft and co-CEO of NCC, a leading Systems Integrator operating in Israel and the USA, which was acquired in 1997 by Elron Electronics. Mr. Bar-Touv holds an M.Sc. in Computer Engineering from the Technion Institute of Technology and a B.Sc. in Electronic Engineering from Ben-Gurion University.

Todd Thomson joined the Board of Directors in November 2011. Mr. Thomson is currently the chairman of Dynasty Financial Partners, a firm dedicated to providing investment and technology platforms to independent advisors. Mr. Thomson is also the founder & CEO of Headwaters Capital, a proprietary investment business and strategic consulting firm. From 1998 through 2007, Mr. Thomson served in top management positions at Citigroup, including as CFO of Citigroup and as CEO of the Global Wealth Management division of Citigroup. Prior to joining Citigroup, Mr. Thomson held senior positions at GE Capital, Barents Group and Bain & Co. Mr. Thomson is also a member of the board of directors of Cordia Bancorp, Bank of Virginia and the World Resources Institute. Mr. Thomson is also a chairman of the Wharton Leadership Advisory Board and was formerly a member of the Board of Trustees of Davidson College. Mr. Thomson received his M.B.A., with distinction, from the Wharton School of Business and his B.A. in Economics from Davidson College.

James Hamilton joined the Board of Directors in February 2012. Mr. Hamilton has been in the technology industry for 26 years and is currently CEO of CPSG Partners, a professional services and consulting company based in Houston. During the past eleven years, he has provided services to security-focused companies, including TippingPoint, Inc., an industry-leading provider of network-based Intrusion Prevention Systems, where he served as President and CEO. [TippingPoint was acquired by 3Com in January of 2005.] Mr. Hamilton also spent two years at SafeNet as EVP of Corporate Development, leading M&A and Strategic Alliances. Additionally, he served as President and CEO of Efficient Networks (acquired by Siemens, Inc. in 2001), after running both global sales and product teams as COO, and also held executive positions with Picazo Communications (acquired by Intel in 1998), Compaq, Network (acquired by Compaq in 1995), 3Com and Grid Systems. Mr. Hamilton holds a B.Sc. from Lawrence Technical University.

Shlomi Yanai became the CEO of Commtouch in October 2011 and joined the Board of Directors in December 2012. He brings over two decades of experience in the information security industry to the Company. He was previously the vice president of corporate development strategy at SafeNet, a global leader in information security, where he led SafeNet's strategic decisions regarding product and solution partnerships, as well as mergers and acquisitions. Mr. Yanai also served as the vice president for the rapidly-growing authentication business unit and award-winning two-factor authentication solutions at SafeNet, Inc. and Aladdin Knowledge Systems, which merged with SafeNet. Prior to Aladdin, Mr. Yanai managed the product team of BMC Software's security division, specializing in identity and password management systems. Mr. Yanai holds a B.Sc. in mathematics and computer science and an M.B.A. from Ben Gurion University in Israel.

Brian Briggs joined Commtouch in January 2013 as its Chief Financial Officer, bringing more than 22 years of finance and operations experience in building and growing profitable companies. Prior to Commtouch, Mr. Briggs served as executive vice president and CFO at SecureNet Payment Systems, a payment processing technology provider. Prior to his post at SecureNet, Mr. Briggs served in various management roles at Custom Direct, Ashton-Potter, Ithaca Bancorp (now M&T Bank), and Ernst & Young. He has earned a degree in finance and economics from Cornell University and completed executive education programs at Harvard Business School, The Wharton School, University of Pennsylvania, Stanford Graduate School of Business and Johnson School of Business at Cornell.

Gary Davis joined Commtouch in September 1999 and he currently serves as Vice President, General Counsel and Corporate Secretary. Mr. Davis has over 25 years of legal experience in both private law firm and corporate practices. Mr. Davis is certified to practice law in both the State of Israel and California. Prior to September 1999, Mr. Davis was in-house counsel to Israel Military Industries and Elta Electronics Industries. He received a B.A. in Political Economy of Industrial Societies from U.C. Berkeley and a J.D. from Golden Gate University.

Pete Shah joined Commtouch in June 2012 as Senior Vice President, Worldwide Sales. He is responsible for leading Commtouch's global field organization in exceeding customer expectations and driving business in both new and existing markets. In addition, Mr. Shah serves as an advisor to Acceleprise, an enterprise technology accelerator



focused on helping early stage technology companies. Before joining Commtouch, Mr. Shah held senior executive leadership positions with InfoVista, as senior vice president of worldwide field operations and at Telarix, as vice president of worldwide sales. In years prior, he held various sales management positions with Portal Software/Oracle, Lawson Software/Infor and Automatic Data Processing (ADP). Mr. Shah holds a B.Sc degree in International Marketing from Penn State University.

Haniel Ilouz joined Commtouch in April 2012 as Vice President, Global Engineering, overseeing Commtouch's research and development department globally. Mr. Ilouz has over 14 years of software development experience, including extensive experience in the management of large global engineering teams. Prior to joining Commtouch, Mr. Ilouz was the research and development director at HP Software, with overall responsibility for planning, design, implementation and maintenance of the Business Service Management Platform and Service Intelligence products. At HP, Mr. Ilouz drove the release of several new products while overseeing a team of over 140 engineers spread across several countries. Before HP, Mr. Ilouz was the research and development manager of SiteScope at Mercury Interactive, which was acquired by HP. He holds a B.A. in Computer Science and Mathematics from the Hebrew University of Jerusalem.

Brett Wilson joined Commtouch in April 2012 as Vice President, Products, and recently has also assumed the role as acting VP, Marketing. Mr. Wilson has more than 20 years of technology and communications experience, including more than 10 years of experience in the information security industry. Before joining Commtouch, Mr. Wilson led portfolio management across product lines and drove multiple technology and service initiatives as vice president of product strategy for Trustwave. He subsequently restructured Trustwave's strategic and tactical partnering approaches as vice president of global channels and business development. Mr. Wilson also led product management, global business development and EMEA sales and marketing for Breach Security. He has also held business development, product management, strategy, and operations roles at Symantec. Prior to joining the information security industry, Brett was a technology policy lobbyist for Rockwell International and a market strategy consultant serving Bell Operating Companies. Mr. Wilson has a B.A. from Cornell University and an M.B.A. from the University of Maryland.

Uri Gal joined Commtouch in February 2013 as Global Vice President, Human Resources. Mr. Gal has more than 20 years of human resources and administration experience and has had success in building and supporting the ever-changing needs of growing and profitable technology companies. Prior to joining Commtouch, Mr. Gal served as global vice president of human resources and administration for Nilit, an industrial company with over 1,500 employees worldwide. Before Nilit, he served as Global VP of human resources in various management roles at Oridion, a globally active medical device company, Converse, a software and systems company for business enablement, and DHL International. Mr. Gal earned a degree in Behavioral Sciences from Haifa University in Israel, and completed high level human resources executive courses in the United States and at the Israeli Institute.

To the best of our knowledge, there no arrangements or understandings with major shareholders, customers, suppliers or others pursuant to which any person referred to above was selected as a director or member of senior management.

#### *Election of Directors*

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

*Alternate Directors*

The Amended and Restated Articles of Association of Commtouch provide that any director may appoint another person to serve as an alternate director and may remove such alternate. Any alternate director possesses all the rights and obligations of the director who appointed him, except that the alternate has no standing at any meeting while the appointing director is present, the alternate may not in turn appoint an alternate for himself (unless the instrument appointing him otherwise expressly provides) and the alternate is not entitled to remuneration. A person who is not qualified to be appointed as a director may not be appointed as an alternate director, and a person who is not qualified to be appointed as an outside or independent director may not be appointed as an alternate director for an outside or independent director, respectively. Unless the appointing director limits the time or scope of the appointment, the appointment is effective for all purposes until the appointing director ceases to be a director or terminates the appointment. The appointment of an alternate director does not in itself diminish the responsibility of the appointing director as a director. No director has appointed, and, to our knowledge, no director currently intends to appoint, any other person as an alternate director.

*Chairman of the Board*

Under the Companies Law, the general manager of a company (or a relative of the general manager) may not serve as the chairman of the board of directors, and the chairman of the board of directors (or a relative of the chairman of the board of directors) may not serve as the general manager, unless approved by the shareholders by a special majority vote prescribed by the Companies Law. In any event, the shareholder vote cannot authorize the appointment for a period longer than three years, which period may be extended from time to time by the shareholders with a similar special majority vote. The chairman of the board of directors shall not hold any other position with the company (except as general manager if approved in accordance with the above procedure) or in any entity controlled by the company, other than as chairman of the board of directors of a controlled entity, and the company shall not delegate to the chairman duties that, directly or indirectly, make him or her subordinate to the general manager.

*Independent and Outside Directors*

A. Under the Israel Companies Law:

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

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

No person may serve as an outside director if the person's position or other business activities create, or may create, a conflict of interest with the person's responsibilities as an outside director or may otherwise interfere with the person's ability to serve as an outside director. If, at the time outside directors are to be appointed, all current members of the Board of Directors are of the same gender, then at least one outside director must be of the other gender. At least one of the outside directors is required to have financial and accounting expertise, unless another member of the audit committee, who is an independent director under the NASDAQ Listing Rules, has financial and accounting expertise, and the other outside director or directors are required to have professional expertise, all as defined under the Israel Companies Law. However, if at least one of our other directors (i) meets the independence requirements under the Exchange Act, (ii) meets the standards of the NASDAQ Listing Rules for membership on the audit committee, and (iii) has accounting and financial expertise as defined under Israeli law, then neither of our outside directors is required to possess accounting and financial expertise as long as both possess other requisite professional qualifications.

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

such majority includes a majority of the shares held by non-controlling shareholders and shareholders who have no personal interest in the election of the outside directors (excluding a personal interest that is not related to a relationship with the controlling shareholders) who are present and voting at the meeting; or

the total number of shares held by non-controlling shareholders and disinterested shareholders voting against the election of the director at the meeting does not exceed two percent of the aggregate voting rights in the company.

The initial term of an outside director is three years and may be extended for up to two additional periods of three years each. An outside director may be reelected by our shareholders for such additional periods of up to three years each only if (1) the audit committee and the Board of Directors, in nominating the outside director, confirms that, in light of the outside director's expertise and special contribution to the work of the board of directors and its committees, the reelection for such additional period(s) is beneficial to us, and the election was approved by the majority of shareholders required to appoint external directors for their initial term; or (2) a shareholder holding 1% or more of the voting rights proposed the reelection of the nominee, and the reelection is approved by a majority of the votes cast by the shareholders of the company, excluding the votes of controlling shareholders and those who have a personal interest in the matter as a result of their relations with the controlling shareholders, provided that the aggregate votes cast in favor of the reelection by such non-excluded shareholders constitute more than 2% of the voting rights in the company.

Outside directors may be removed only by the same percentage of shareholders as is required for their election, or by a court, and then only if the outside director ceases to meet the statutory qualifications for their appointment or if they violate their fiduciary duty to the company. Each committee of a company's Board of Directors must include at least one outside director and both the audit committee and compensation committee, the existence of which is required under the Israel Companies Law, must include all outside directors.

An outside director is entitled to compensation as provided in the regulations adopted under the Israel Companies Law and is otherwise prohibited from receiving any other compensation, directly or indirectly, in connection with service provided as an outside director.

As noted previously, due to Mr. Shamir's recent resignation, Mr. Bar-Touv is our only outside director. The Company intends to seek shareholder approval for the appointment of a new outside director as soon as possible and prior to the lapse of 90 days period from Mr. Shamir's resignation.

#### B. Under Nasdaq and SEC Rules and Regulations:

In addition, the NASDAQ Listing Rules currently require Commtouch to have at least a majority of independent directors, as defined under Listing Rule 5605(a)(2), on the Board and to maintain an audit committee of at least three members, each of whom must:

- (i) be independent as defined under Listing Rule 5605(a)(2);
- (ii) meet the criteria for independence set forth in Rule 10A-3(b)(1) under the Securities Exchange Act of 1934, as amended, or Exchange Act, as set forth below (subject to the exemptions provided in Exchange Act Rule 10A-3(c));
- (iii) not have participated in the preparation of the financial statements of the Company or any current subsidiary of the Company at any time during the past three years; and
- (iv) be able to read and understand fundamental financial statements, including a company's balance sheet, income statement and cash flow statement.

Under limited circumstances, the Company may have one audit committee member not independent in accordance with the above, but such a member would only be able to serve for a maximum of two years.

Exchange Act Rule 10A-3(b)(1) requires that members of the audit committee meet that rule's definition of independence, which requires that an audit committee member may not, except in his or her capacity as a director or committee member, (i) accept directly or indirectly any consulting, advisory, or other compensatory fee from the Company or any of its subsidiaries (except for fixed amounts of compensation under a retirement plan for prior service with the Company, provided that such compensation is not contingent in any way on continued service), and (ii) be an affiliated person of the Company or any of its subsidiaries.

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NASDAQ rules also require that the Company certify that it has, and will continue to have, at least one member of the audit committee who has past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities. Also, the Company is required to disclose whether or not it has an audit committee financial expert on its audit committee, as defined under Item 16A to Form 20-F.

The three directors who serve on our audit committee, Mr. Bar-Touv, Mr. Thompson and Mr. Hamilton, qualify as independent directors under NASDAQ Listing Rules (including Exchange Act Rule 10A-3) and further qualify to act as members of our audit committee under the Israel Companies Law.

The Company has identified the following Board members as Independent directors pursuant to NASDAQ Listing Rule 5605(a)(2):

- a. Yair Bar-Touv
- b. Aviv Raiz
- c. Hila Karah
- d. Todd Thomson
- e. James Hamilton

Pursuant to the Israeli Companies Law, an Israeli company, whose shares are publicly traded, may elect to adopt a provision in its articles of association pursuant to which a majority of its board of directors (or a third of its Board of Directors in case the company has a controlling shareholder) will constitute individuals complying with certain independence criteria prescribed by the Israel Companies Law, as well as certain other recommended corporate governance provisions. We have not included such a provision in our articles of association since our board of directors complies with the independence requirements of the NASDAQ and Securities and Exchange Commission regulations described above.

### *Audit Committee*

As noted above in the discussion under *Independent and Outside Directors*, the Israel Companies Law requires public companies to appoint an audit committee. The audit committee's duties include providing assistance to the board of directors in fulfilling its legal and fiduciary obligations in matters involving our accounting, auditing, financial reporting, internal control and legal compliance functions. In this respect the audit committee approves the services performed by our independent registered public accounting firm and reviews their reports regarding our accounting practices and systems of internal accounting controls. The audit committee also oversees the audits conducted by our independent registered public accounting firm and takes those actions as it deems necessary to confirm that the accountants are independent of management. Under the Israeli Companies Law, the audit committee also is required to monitor whether there are any deficiencies in the administration of our company, including by consulting with the internal auditor and independent registered public accounting firm, to review, classify and approve related party transactions and extraordinary transactions, to review the internal auditor's audit plan and to establish and monitor whistleblower procedures.

An audit committee must consist of at least three directors meeting the independence standards under NASDAQ Listing Rules.

Under the Israel Companies Law, all outside directors must serve on the audit committee, and in any case it must include a majority of independent directors. One of the outside directors must serve as the chair of the audit committee. Furthermore, under the Israel Companies Law, the audit committee may not include the chairman of the board, or any director employed by the Company, by a controlling shareholder or by any entity controlled by a controlling shareholder, or any director providing services to us, to a controlling shareholder or to any entity controlled by a controlling shareholder on a regular basis, or any director whose income is primarily dependent on a controlling shareholder, and may not include a controlling shareholder or any relatives of a controlling shareholder. Under the Companies Law, a meeting of the audit committee is properly convened if a majority of the committee members attend the meeting, and such majority includes at least one outside director. Individuals who are not permitted to be audit committee members may not participate in the committee's meetings other than to make a presentation regarding a particular issue. However, an employee who is not a controlling shareholder or relative may participate in the

committee's discussions but not in any vote, and the company's legal counsel and corporate secretary may participate in the committee's discussions and votes if requested by the committee.

#### *Compensation Committee*

On December 12, 2012, Amendment 20 to the Israel Companies Law, or Amendment 20, came into force, and its provisions are summarized below:

All public companies and bond companies are required to establish a compensation committee, with one member of serving as chairman of the committee. The committee is to be made up of at least three directors, with a majority of outside directors. The remaining directors shall be directors who do not receive direct or indirect compensation for their role as directors (other than compensation paid or given in accordance with Israeli Companies Law regulations applicable to the compensation of external directors, or amounts paid pursuant to indemnification and/or exculpation contracts or commitments and insurance coverage). The compensation committee may not include the chairman of the board, any director employed by or otherwise providing services on a regular basis to the Company, to a controlling shareholder or to any entity controlled by a controlling shareholder, any director whose main livelihood is dependent on a controlling shareholder, or a controlling shareholder or a relative thereof. The committee is responsible for (i) proposing an office holder compensation policy to the Board of Directors, (ii) proposing necessary revisions to the compensation policy and examining its implementation, (iii) determining whether to approve transactions with respect to compensation of office holders, and (iv) determining, in accordance with our office holder compensation policy, whether to exempt the compensation terms with an unaffiliated nominee for the position of chief executive officer from requiring shareholders' approval, provided such terms meet with the company's compensation policy.

**Say before pay rules:** The compensation policy recommended by the compensation committee is to be approved by the Board and then, before it takes effect, by shareholders in a non-binding vote by the affirmative vote of a majority of the shares voting on the matter, provided that (i) such majority includes at least a majority of the shares of shareholders who are non-controlling shareholders and do not have a personal interest in the said resolution; or (ii) the total number of shares of shareholders specified in clause (i) who voted against this resolution does not exceed 2% of the voting rights in the Company. If the shareholders do not approve the policy, the policy will be returned for further deliberation by the Board, taking into account the rejection of the policy by the minority shareholders. The Board may ultimately approve the policy despite the minority's disapproval, if it finds that the policy is in the company's best interest. The compensation policy must be approved at least every three years. The Board is required to reevaluate the policy from time to time and if a material change occurs.

Prior to the effectiveness of Amendment 20, a compensation committee already existed and was responsible for formulating the Company's executive compensation policies. This committee will continue to function under the guidelines of the new law. As of the date of the filing of this Annual Report, the Company had not yet adopted a compensation policy. The deadline under Israeli law for completing the compensation policy adoption process is September 12, 2013. In the interim period until the adoption of the compensation policy, the approval of office holder compensation, other than the CEO and directors, requires compensation committee and Board approval, which must take into account certain consideration enumerated in the new law. If the compensation committee determines that a compensation arrangement constitutes an immaterial amendment to an existing compensation arrangement of an officer who is not a director, the approval of the compensation committee without Board approval is sufficient. Any changes in CEO or director compensation during this interim period require shareholder approval by a special majority.

The Compensation Committee is also responsible for administering the Company's various stock option plans, including the issuance of option grants to employees of the Company and its subsidiaries.

#### *Nominating Committee*

The committee's responsibilities include identifying individuals qualified to become board members and recommending director nominees to the board.

#### *Internal Auditor*

Under the Israel Companies Law, the Board of Directors must appoint an internal auditor, nominated by the audit committee. The role of the internal auditor is to examine, among other matters, whether a company's actions comply with relevant law and orderly business procedure. Under the Israel Companies Law, the internal auditor may be an employee of the company but not an interested party or office holder, or a relative of an interested party or office

holder, and he or she may not be the company's independent accountant or its representative. The Company routinely engages an Internal Auditor who is an independent third party.

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

The Israel Companies Law codifies the fiduciary duties that office holders, including directors and executive officers, owe to a company. An office holder's fiduciary duties consist of a duty of care and a duty of loyalty. Each person listed in the first table that appears above at the beginning of this Item 6 is an office holder.

The duty of loyalty requires an office holder to act in good faith and for the benefit of the company, including to avoid any conflict of interest between the office holder's position in the company and such person's personal affairs, avoiding any competition with the company, avoiding exploiting any corporate opportunity of the company in order to receive personal advantage for such person or others, and revealing to the company any information or documents relating to the company's affairs which the office holder has received due to his or her position as an office holder. A company may approve any of the acts mentioned above provided that all the following conditions apply: the office holder acted in good faith and neither the act nor the approval of the act prejudices the good of the company, and the office holder disclosed the essence of his personal interest in the act, including any substantial fact or document, a reasonable time before the date for discussion of the approval. A director is required to exercise independent discretion in fulfilling his or her duties and may not be party to a voting agreement with respect to his or her vote as a director. A violation of these requirements is deemed a breach of the director's duty of loyalty.

The duty of care requires an office holder to act with a level of care that a reasonable office holder in the same position would employ under the same circumstances. This includes the duty to use reasonable means to obtain information regarding the advisability of a given action submitted for his or her approval or performed by virtue of his or her position and all other relevant information material to these actions.

Since the effectiveness of Amendment 20, all arrangements as to compensation of office holders should follow the process described above under *Compensation Committee*.

The Israel Companies Law requires that an office holder promptly disclose any personal interest that he or she may have and all related material information known to him or her, in connection with any existing or proposed transaction by the company. Personal interest, as defined by the Companies Law, includes a personal interest of any person in an act or transaction of the company, including a personal interest of his relative or of a corporation in which that person or a relative of that person is a 5% or greater shareholder, a holder of 5% or more of the voting rights, a director or general manager, or in which he or she has the right to appoint at least one director or the general manager, and includes shares for which the person has the right to vote pursuant to a power-of-attorney. Personal interest does not apply to a personal interest stemming merely from holding shares in the company.

The office holder must make the disclosure of his personal interest no later than the first meeting of the company's board of directors that discusses the particular transaction. This duty does not apply to the personal interest of a relative of the office holder in a transaction unless it is an extraordinary transaction. An extraordinary transaction is defined as a transaction not in the ordinary course of business, a transaction that is not on market terms, or a transaction that is likely to have a material impact on the company's profitability, assets or liabilities, and a relative as a spouse, sibling, parent, grandparent or descendant, and the sibling, parent or descendant of a spouse, as well as the spouse of any of the foregoing.

In the case of a transaction that is not an extraordinary transaction and that does not relate to compensation or terms of employment, after the office holder complies with the above disclosure requirement, only Board approval is required unless the Articles of Association of the company provide otherwise. Our Amended and Restated Articles of Association do not provide otherwise. Such approval must determine that the transaction is not adverse to the company's interest. If the transaction is an extraordinary transaction, then in addition to any approval required by the Articles of Association, it also must be approved by the audit committee and by the Board and, under specified circumstances, by a meeting of the shareholders. An office holder who has a personal interest in a matter that is considered at a meeting of the Board of Directors or the audit committee generally may not be present at this meeting or vote on this matter unless a majority of the board of directors or the audit committee has a personal interest in the matter, or if such person is invited by the Chairman of the Board of Directors or audit committee, as applicable, to present the matter being considered. If a majority of the board of directors or the audit committee has a personal interest in the transaction, shareholder approval also would be required.

The Israel Companies Law applies the same disclosure requirements set forth above to a controlling shareholder of a public company, which includes a shareholder that holds 25% or more of the voting rights if no other shareholder owns more than 50% of the voting rights in the company. Extraordinary transactions, including a private placement with a controlling shareholder or in which a controlling shareholder has a personal interest (including for the provision of services to the company through a company controlled by a controlling shareholder, but not including transactions covering the terms of compensation of a controlling shareholder who is an office holder), require the approval of the audit committee, the Board of Directors and the shareholders of the company. Extraordinary transactions covering the terms of compensation of a controlling shareholder who is an office holder, require the approval of the compensation committee, the Board of Directors and the shareholders of the company. The shareholder approval must either include a majority of the non-controlling and disinterested shareholders who are present, in person or by proxy, at the meeting or, alternatively, the total shareholdings of the non-controlling and disinterested shareholders who vote against the transaction must not represent more than two percent of the voting rights in the company. Generally, the approval of such a transaction may not extend for more than three years, except that in the case of an extraordinary transaction with a controlling shareholder or in which a controlling shareholder has a personal interest that does not concern terms of compensation for service as an office holder, or as a service provider to the company, the transaction may be approved for a longer period if the audit committee determines that the approval of the transaction for a period longer than three years is reasonable under the circumstances.

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

any amendment to the Articles of Association;

an increase of the company's authorized share capital;

a merger; or

approval of interested party transactions that require shareholder approval.

In addition, any controlling shareholder, any shareholder who can determine the outcome of a shareholder vote and any shareholder who, under the company's Articles of Association, can appoint or prevent the appointment of an office holder, are under a duty to act with fairness towards the company. The Israel Companies Law provides that a breach of the duty of fairness will be governed by the laws governing breach of contract. The Israel Companies Law does not describe the substance of this duty.

*Insurance, Indemnification and Exculpation of Directors and Officers; Limitations on Liability*

The Israel Companies Law permits a company to insure an office holder in respect of liabilities incurred by him or her as a result of the breach of his or her duty of care to the company or to another person, or as a result of the breach of his or her duty of loyalty to the company, to the extent that he or she acted in good faith and had reasonable cause to believe that the act would not prejudice the company. A company can also insure an office holder for monetary liabilities as a result of an act or omission that he or she committed in connection with his or her serving as an office holder. Moreover, a company can indemnify an office holder for (a) any monetary liability imposed upon such an office holder for the benefit of a third party pursuant to a court judgment, including a settlement or an arbitrator's decision, confirmed by a court, (b) reasonable legal costs, including attorney's fees, expended by an office holder as a result of an investigation or proceeding instituted against the office holder by a competent authority, provided that such investigation or proceeding concludes without the filing of an indictment against the office holder and either i) no financial liability was imposed on the office holder in lieu of criminal proceedings or ii) financial liability was imposed on the office holder in lieu of criminal proceedings but the alleged criminal offense does not require proof of criminal intent, (c) legal expenses (including attorneys' fees) incurred by an office holder in an administrative enforcement proceeding and any compensation payable to injured parties for damages suffered by them as determined in the proceeding (up to a maximum of 20% of the fine imposed on the violating party) and (d) reasonable litigation expenses, including legal fees, actually incurred by such an office holder or imposed upon the office holder by a court order, in a proceeding brought against the office holder by or on behalf of the company or by others, or in a criminal action in which he was acquitted, or in a criminal action which does not require proof of criminal intent in which he was convicted. The Companies Law further provides that the indemnification provision in a company's articles of association (i) may be an obligation to indemnify in advance, provided that, other than litigation expenses, it is limited to events the board of directors can foresee in light of the company's actual activities when providing the obligation

and that it is limited to a sum or standards the board of directors determines is reasonable in the circumstances, and (ii) may permit the company to indemnify an officer or a director after the fact.

Furthermore, a company can, with one limited exception, exculpate an office holder in advance, in whole or in part, from liability for damages sustained by a breach of duty of care to the company.

All of these provisions are specifically limited in their scope by the Companies Law, which provides that a company may not indemnify or exculpate an officer or director nor enter into an insurance contract that would provide coverage for any monetary liability incurred as a result of (i) a breach by the officer or director of the duty of loyalty, unless the officer or director acted in good faith and had a reasonable basis to believe that the act would not prejudice the company, in which case the company is permitted to indemnify and provide insurance to but not to exculpate; (ii) an intentional or reckless breach by the officer or director of the duty of care, other than if solely done in negligence; (iii) any act or omission done with the intent to derive an illegal personal benefit; or (iv) any fine levied or forfeit against the director or officer.

Our Amended and Restated Articles of Association allow us to insure, exculpate and indemnify office holders to the fullest extent permitted by law provided such insurance, exculpation or indemnification is approved in accordance with the Israel Companies Law. We have acquired directors and officers liability insurance covering the officers and directors of Commtouch and its subsidiary for certain claims. At the annual meeting of shareholders held on November 18, 2002, the shareholders approved a form of indemnification, exculpation and insurance agreement that is applicable to all our directors. The form of this agreement, as well as related provisions in our Amended and Restated Articles of Association, were last amended at the annual meeting of shareholders held on December 15, 2011.

#### *Compensation of Directors and Executive Officers*

Under Amendment 20, the directors of Commtouch can be remunerated by Commtouch for their services as directors to the extent such remuneration is in accordance with the compensation policy to be adopted by the Company after approval by Commtouch's compensation committee, Board of Directors and shareholders.

The cash compensation paid to directors in 2012 (other than the CEO and Chairman) is as follows:

- a. NIS 31,700 base annually per director, as linked to the applicable Israeli consumer price index, payable in four equal installments at the beginning of each calendar quarter; and
- b. NIS 1,590 per director per in-person Board or committee meeting, or NIS954 (60% of NIS 1590) in case of telephonic participation at such meeting, payable at the beginning of each calendar quarter following the quarter during which a Board member participated in a meeting. No separate per meeting compensation was paid for committee meetings that were held on the same day immediately prior or subsequent to a Board meeting. In that event, a Board and committee meeting would be considered one meeting for purposes of compensation.
- c. For non-Israeli based directors, the amounts set forth will be paid in United States dollars, according to the representative rate of exchange published by the Bank of Israel on the date of payment.

Directors also are reimbursed for their expenses for each Board of Directors meeting attended. See in this item 6, Amended and Restated 1999 Non-employee Directors Stock Option Plan for a discussion of director compensation in the form of option grants.

During 2012, options to purchase 166,669 Ordinary Shares were granted to directors and executive officers under the Company's stock option plans at a weighted average exercise price of \$3.17 per share. The aggregate direct remuneration paid by Commtouch to all directors and executive officers (11 persons) in 2012 was approximately \$971,000. During the same period Commtouch accrued or set aside approximately \$53,000 for the same group to provide pension, retirement or similar benefits. As of March 1, 2013, directors and executive officers of Commtouch (9 persons) held an aggregate of 2,058,550 stock options to purchase a like number of Ordinary Shares, with 1,007,530 of those options being vested and exercisable within sixty days of said date. Generally, unless exercised previously, options terminate within six years of their issuance.

At the meeting of shareholders in December 2010, shareholders approved the payment to Hila Karah of up to \$10,000 annually for the performance of any additional services as a committee member, as agreed upon by Ms. Karah and the



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Company on a case by case basis. During 2011, Ms. Karah received a total of \$2,500 for her additional services as a director. No compensation was paid for such additional services during 2012.

### *Options to Purchase Securities from Registrant or Subsidiaries*

As of March 1, 2013, options to purchase 5,718,990 Ordinary Shares were outstanding and held by 198 persons made up of then existing employees, consultants, executive officers, non employee directors and ex-options holders within their post-termination period for exercise under the Company's stock option plans, and there were 776,282 shares available for grant under all plans. Of the number of options outstanding, 2,032,004 were vested and exercisable. Additionally, these outstanding options had exercise prices ranging from \$0.93 to \$6.60 per share, a weighted average per share exercise price of approximately \$3.16 and termination dates ranging from March 14, 2013 to February 13, 2019.

### *Employee Stock Option Plans*

Employees, including executive officers and other management employees, participate in the Company's employee option plans. The Commtouch Software Ltd. 2006 U.S. Stock Option Plan, primarily covering option grants to employees and consultants based in the United States, was adopted on December 15, 2006 and has a term of ten years. The Commtouch Software Ltd. Amended and Restated Israeli Share Options Plan, primarily covering option grants to employees, consultants and directors based in Israel, was adopted on June 22, 2003 and has a term of ten years. While Israeli based directors receive their grants under the Israeli plan, the principal terms of their grants are identical to those of non-Israeli based directors receiving their grants under the non-employee director plan (discussed below).

All employee stock option plans are administered by the Compensation Committee. Subject to the provisions of the employee stock plans and applicable law, the Compensation Committee has the authority to determine, among other things, to whom options may be granted; the number of Ordinary Shares to which an option may relate; the exercise price for each share; the vesting period of the option and the terms, conditions and restrictions thereof, including accelerated vesting on change of control provisions; to amend provisions relating to such plans; and to make all other determinations deemed necessary or advisable for the administration of such plans.

### *Amended and Restated 1999 Non Employee Directors Stock Option Plan*

New non-employee directors are currently entitled to an initial grant of 50,000 options pursuant to the Amended and Restated 1999 Non-Employee Directors Stock Option Plan, or the Non-Employee Directors Plan. Non-employee directors who are re-elected at the annual meeting of shareholders are entitled to additional grants of 16,667 options, though at the annual meeting held October 26, 2009 shareholders approved a one-time increase in the grants to re-elected directors to 30,000 options.

The Non Employee Directors Plan was extended by an additional ten years at the annual meeting of shareholders held on December 15, 2008. Under this plan, each option becomes exercisable at a rate of 1/16th of the option shares every three months, and has an exercise price equal to the fair market value of our Ordinary Shares on the grant date of such option. Options granted through 2004 had a maximum term of ten years, but would terminate earlier if the option holder ceased to be a member of the Board of Directors. Options granted to directors during 2005 - 2012 generally have a maximum term of six years. At the annual meeting of shareholders of December 30, 2005, shareholders approved an amendment to the Non-Employee Directors Plan to allow for the acceleration of unvested options for any director who has served the Company for at least three years, unless the director resigned voluntarily or was removed from the Board of Directors due to a failure to perform any of his/her duties to the Company.

### *Employees*

See Item 4. Information on the Company Employees .

**Item 7. Major Shareholders and Related Party Transactions.**

The following table presents information with respect to beneficial ownership of our Ordinary Shares as of March 1, 2013, including:

each person or entity known to Commtouch to own beneficially five percent or more of Commtouch's Ordinary Shares, and

all executive officers and directors as a group.

Beneficial ownership is determined in accordance with the rules of the SEC and includes voting or investment power, with respect to shares. To our knowledge, except under applicable community property laws or as otherwise indicated, the persons named in the table have sole voting and sole investment control and rights to receive economic benefits with respect to all shares beneficially owned. The applicable percentage of ownership for each shareholder is based on 26,061,383 Ordinary Shares outstanding as of March 1, 2013. Ordinary Shares issuable upon exercise of options, which are exercisable on or within sixty days of March 1, 2013, are deemed outstanding for the purpose of computing the percentage ownership of the person holding those options for all directors and executive officers as a group, but are not deemed outstanding for computing the percentage ownership of any other person. Major shareholders in the Company have the same voting rights as all other shareholders.

| <b>MAJOR SHAREHOLDERS OF ORDINARY SHARES</b>                               | <b>Amount<br/>Owned</b> | <b>Percent of<br/>Class</b> |
|--|-------------------------|-----------------------------|
| Aviv Raiz*(1)  | 5,561,068               | 21.3%                       |
| Catalyst Private Equity Partners II LP*(2)                                 | 1,372,555               | 5.2%                        |
| All directors and executive officers as a group [at 3/1/13] (9 persons)(3) | 7,851,195               | 29.3%                       |

\*This shareholder of record resides in Israel. With respect to Catalyst Private Equity Partners II LP, the former Chairman and Managing Partner of this limited partnership, Mr. Yair Shamir, a former director of the Company, resides in Israel.

(1)Includes 75,199 options, exercisable into a like number of Ordinary Shares.

(2)Includes 108,532 options exercisable into a like number of Ordinary Shares.

(3)Includes 769,198 options exercisable into a like number of Ordinary Shares.

Based on a review of the information provided to us by third parties, including our transfer agent, as of March 1, 2013, there were 53 holders of record of our Ordinary Shares. One of such holders is the nominee company known as CEDE & Co., which held 21,592,221 Ordinary Shares on behalf of approximately 81 brokers and banks, or approximately 83% of the aggregate 26,061,383 Ordinary Shares outstanding as of such date. Out of the 21,592,221 Ordinary Shares held through CEDE, approximately 15.4 million are managed by Broadridge Financial Solutions, Inc. on behalf of certain banks and brokers, and Broadridge recently provided to us reports on the geographical location of shareholders holding through such banks and brokers. According to these reports, plus our transfer agent reports, we were able to identify at least 13.7 million Ordinary Shares held by Israeli shareholders, approximately 5.3 million shares held US based shareholders and 3.4 million held by non-Israeli and non-U.S. shareholders.

*Significant Changes in Percentage Ownership of Major Shareholders During the Past Three Years*

None.

*Interest of Management and their Family Members in Certain Transactions*

There were no related party transactions, as such term is defined in Item 7.B to Form 20-F, during 2012 or through the date of filing of this Annual Report.

**Item 8. Financial Information.**

See Item 18: Financial Statements. If the Company decides to distribute a cash dividend out of income that has been tax exempt due to an approved enterprise status under the Law for the Encouragement of Capital Investments, 5719-1959, the amount of cash dividend will be subject to corporate tax at the rate then in effect under Israeli law. The Company has never declared or paid cash dividends on its Ordinary Shares. However, the Company has not adopted a policy not to pay cash dividends and therefore may declare a dividend in the future. The Company's current plans are to retain future earnings primarily to finance the development of its business and for other corporate purposes.

*Legal Proceedings*

In December 2012, our U.S. subsidiary filed a lawsuit in the Superior Court of the State of California against one of its largest customers, Watchguard Technologies, Inc. The lawsuit includes a claim for breach of contract. In mid-April 2013, Watchguard filed its formal answer and a cross-complaint to Commtouch's complaint. Commtouch's lawsuit alleges damages in excess of \$7 million, while WatchGuard's cross-complaint does not set forth a fixed amount that it is seeking. It is expected that the discovery phase of the litigation will commence in the near future.

Our new subsidiary company, eleven, is currently involved in three lawsuits: i) the first relates to a claim by a former employee regarding payment of a commission alleged to be in the amount of approximately EURO 139,000; ii) the second relates to a claim by a hardware vendor in the amount of approximately EURO 90,000; and iii) the final claim was brought by eleven against Boxsentry, a customer, for failure to pay fees in the amount of approximately EURO 840,000.

Other than the above, we are not a direct party to any litigation, and we are not aware of any threatened litigation which, in the aggregate, would be material to the business of the Company. As noted under Item 3. Key Information Risk Factors, one customer has made an indemnification demand on us during the past year as a result of patent infringement actions brought against that customer and other defendants.

Except as otherwise disclosed in this Annual Report, there has been no material change in our financial position since December 31, 2012.

**Item 9. The Offer and Listing.**

The Company's Ordinary Shares have been traded publicly on NASDAQ as follows:

- a. From July 13, 1999 through June 29, 2004, under the symbol CTCH (up to June 7, 2002 on the National Market, and subsequently on the Small Cap Market, which during 2005 was renamed the Capital Market );
- b. From June 30, 2004 through June 26, 2005, under the symbol CTCHC ;
- c. From June 27, 2005 through January 1, 2008, under the symbol CTCH ;
- d. From January 2, 2008 through January 29, 2008, under the symbol CTCHD ; and
- e. From January 30, 2008, under the symbol CTCH.

Since December 16, 2009, the Company's Ordinary Shares have also been traded on the Tel Aviv Stock Exchange, or TASE , under the symbol CTCH.

The following table lists the high and low closing sales prices for the Company's Ordinary Shares on the NASDAQ Capital Market for the periods indicated:

|                         | <b>High</b> | <b>Low</b> |
|-------------------------|-------------|------------|
| 2008:                   | \$ 6.22     | \$ 1.50    |
| 2009:                   | \$ 4.30     | \$ 1.57    |
| 2010:                   | \$ 3.90     | \$ 1.35    |
| 2011:                   | \$ 3.98     | \$ 2.93    |
| 2012:                   | \$ 3.40     | \$ 2.42    |
| 2011:                   |             |            |
| First Quarter           | \$ 3.98     | \$ 3.23    |
| Second Quarter          | \$ 3.59     | \$ 3.20    |
| Third Quarter           | \$ 3.66     | \$ 2.95    |
| Fourth Quarter          | \$ 3.60     | \$ 2.93    |
| 2012:                   |             |            |
| First Quarter           | \$ 3.40     | \$ 2.90    |
| Second Quarter          | \$ 3.21     | \$ 2.42    |
| Third Quarter           | \$ 3.00     | \$ 2.48    |
| Fourth Quarter          | \$ 3.20     | \$ 2.42    |
| First Quarter 2013      | \$ 3.87     | \$ 2.91    |
| Most Recent Six Months: |             |            |
| October 2012            | \$ 2.70     | \$ 2.42    |
| November 2012           | \$ 3.19     | \$ 2.44    |
| December 2012           | \$ 3.20     | \$ 3.00    |
| January 2013            | \$ 3.19     | \$ 2.92    |
| February 2013           | \$ 3.87     | \$ 3.04    |
| March 2013              | \$ 3.50     | \$ 2.91    |

The following table lists the high and low closing sales prices for the Company's Ordinary Shares on the TASE for the periods indicated. Share prices on the TASE are quoted in NIS:

|                         | <b>High</b> | <b>Low</b> |
|-------------------------|-------------|------------|
| 2011:                   |             |            |
| First Quarter           | NIS 14.47   | NIS 11.87  |
| Second Quarter          | NIS 12.50   | NIS 10.97  |
| Third Quarter           | NIS 12.81   | NIS 10.75  |
| Fourth Quarter          | NIS 13.82   | NIS 11.48  |
| 2012:                   |             |            |
| First Quarter           | NIS 13.37   | NIS 10.83  |
| Second Quarter          | NIS 12.76   | NIS 9.22   |
| Third Quarter           | NIS 11.64   | NIS 10.06  |
| Fourth Quarter          | NIS 12.34   | NIS 9.49   |
| First Quarter 2013      | NIS 14.29   | NIS 10.62  |
| Most Recent Six Months: |             |            |
| October 2012            | NIS 10.55   | NIS 9.49   |
| November 2012           | NIS 12.34   | NIS 9.88   |
| December 2012           | NIS 12.07   | NIS 11.57  |
| January 2013            | NIS 12.03   | NIS 11.58  |
| February 2013           | NIS 14.29   | NIS 11.27  |
| March 2013              | NIS 13.21   | NIS 10.62  |

**Item 10. Additional Information.**

We are registered under the Israel Companies Law as a public company with registration number 52-004418-1. The objective stated in our memorandum of association is to engage in any lawful activity.

**DESCRIPTION OF SHARES**

Set forth below is a summary of the material provisions governing our share capital. This summary is not complete and should be read together with our Memorandum of Association and Amended and Restated Articles of Association, copies of which are filed with this Annual Report or have been filed as exhibits to certain of our prior filings with the SEC.

As of December 31, 2012, our authorized share capital consisted of 55,353,340 Ordinary Shares, NIS 0.15 par value. As of March 1, 2013, there were 26,061,383 Ordinary Shares issued and outstanding.

**DESCRIPTION OF ORDINARY SHARES**

All issued and outstanding Ordinary Shares of Commtouch are duly authorized and validly issued, fully paid and non-assessable.

The Ordinary Shares do not have preemptive rights. Our Memorandum of Association, Amended and Restated Articles of Association and the laws of the State of Israel do not restrict in any way the ownership or voting of Ordinary Shares by non residents of Israel, except with respect to subjects of countries which are in a state of war with Israel.

**DIVIDEND AND LIQUIDATION RIGHTS**

The Ordinary Shares are entitled to their full proportion of any cash or share dividend declared.

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

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

**MODIFICATION OF CLASS RIGHTS**

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

Pursuant to Israel's securities laws, a company registering its shares for trade on the Tel Aviv Stock Exchange may not have more than one class of shares for a period of one year following registration, after which it is permitted to issue preferred shares, if the preference of those shares is limited to a preference in the distribution of dividends and these preferred shares have no voting rights.

**SPECIAL PROVISIONS IN AMENDED AND RESTATED ARTICLES OF ASSOCIATION RELATING TO DIRECTORS**

The discussion regarding approval of director compensation and transactions with the Company under Item 6. Directors, Senior Management and Employees - Approval of Certain Transactions; Obligations of Directors, Officers and Shareholders is incorporated herein by reference.

**VOTING, SHAREHOLDER MEETINGS AND RESOLUTIONS**

Holders of Ordinary Shares have one vote for each share held on all matters submitted to a vote of shareholders.

An annual general meeting must be held once every calendar year at such time (not more than 15 months after the last preceding annual general meeting) and at such place, either within or outside the State of Israel, as may be determined by the Board of Directors. The quorum required for a general meeting of shareholders consists of at least two shareholders present in person or by proxy and holding at least one-third of the voting rights of the issued share capital. A meeting adjourned for lack of a quorum may be adjourned to the same day in the next week at the same time and place, or to such time and place as the Board of Directors may determine in a notice to shareholders. At such reconvened meeting any two shareholders entitled to vote and present in person or by proxy will constitute a quorum. Rule 5620(c) to Nasdaq Listing Rules requires that an issuer listed on Nasdaq should have a quorum requirement that in no case be less than 33 1/3% of the outstanding shares of the company's common voting stock. However, as mentioned above, our articles of association, consistent with the Companies Law, provides for a lower quorum requirement at an adjourned meeting.

Generally, shareholder resolutions will be deemed adopted if approved by the holders of a majority of the voting power represented at the meeting, in person or by proxy, and voting thereon. For certain matters as described under the Israel Companies law, there is a requirement that the majority include the affirmative vote of at least a majority of the votes cast by shareholders who are not controlling shareholders of the Company or interested parties in the matter to be voted upon (or their representatives) or, alternatively, the total shareholdings of the votes cast against the proposal (other than by the Company's controlling shareholders or interested parties in the matter to be voted upon) must not represent more than two percent of the voting rights in the Company.

**ANTI TAKEOVER PROVISIONS UNDER ISRAELI LAW**

Under the Companies Law, a merger is generally required to be approved by the shareholders and board of directors of each of the merging companies. If the share capital of the company that will not be the surviving company is divided into different classes of shares, the approval of each class is also required. In addition, a merger can be completed only after 30 days have passed from the shareholders' approval of each of the merging companies, all approvals have been submitted to the Israeli Registrar of Companies and at least fifty days have passed from the time that a proposal for approval of the merger was filed with the Registrar.

The Companies Law provides that an acquisition of shares in a public company must be made by means of a tender offer if as a result of the acquisition the purchaser would hold 25% or more of the voting rights in the company, unless there is already another 25% shareholder of the company. Similarly, the Companies Law provides that an acquisition of shares in a public company must be made by means of tender offer if as a result of the acquisition the purchaser would hold more than 45% of the voting rights in the company, unless someone else already holds 45% of the voting power of the company.

Finally, Israeli tax law treats specified acquisitions, including a stock for stock swap between an Israeli company and a foreign company, less favorably than does U.S. tax law. For example, Israeli tax law may subject a shareholder who exchanges his Ordinary Shares for shares in a foreign corporation to taxation before it would become taxable in the United States, even though the investment has not become liquid, although in the case of shares of a foreign corporation that are traded on a stock exchange, the tax may be postponed subject to certain conditions.

**TRANSFER OF SHARES AND NOTICES**

Fully paid Ordinary Shares that are issued and not subject to any legal restrictions on transference may be transferred freely. Each shareholder of record is entitled to receive at least twenty-one days' prior notice (and for certain matters,

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thirty-five days prior notice) before the date of a shareholder meeting and at least five days notice before the record date for the meeting. For purposes of determining the shareholders entitled to notice of and to vote at such meeting, the Board of Directors may fix a record date not exceeding 40 days prior to the date of any shareholder meeting.

### CHANGES IN OUR CAPITAL

Changes in our capital are subject to the approval of the shareholders by a majority of the votes of shareholders present by person or by proxy and voting at the shareholders meeting.

### ACCESS TO INFORMATION

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

We are subject to certain of the information reporting requirements of the Exchange Act. As a foreign private issuer, we are exempt from the rules and regulations under the Exchange Act prescribing the furnishing and content of proxy statements, and our officers, directors and principal shareholders are exempt from the reporting and short-swing profit recovery provisions contained in Section 16 of the Exchange Act, with respect to their purchase and sale of our Ordinary Shares. In addition, we are not required to file reports and financial statements with the SEC as frequently or as promptly as U.S. companies whose securities are registered under the Exchange Act. However, we file with the SEC an Annual Report on Form 20-F containing financial statements audited by an independent registered public accounting firm. We also furnish quarterly reports on Form 6-K containing unaudited financial information after the end of each quarter and other reports on Form 6-K from time to time. We post our Annual Report on Form 20-F on our Website ([www.commtouch.com](http://www.commtouch.com)) promptly following the filing of our Annual Report with the Securities and Exchange Commission. The information on our website is not incorporated by reference into this Annual Report.

This Annual Report and other information filed or to be filed by us can be inspected and copied at the public reference facilities maintained by the SEC at:

100 F Street, NE  
Public Reference Room  
Washington, D.C. 20549

The SEC maintains a Web site at [www.sec.gov](http://www.sec.gov) that contains reports, proxy and information statements, and other information regarding registrants that make electronic filings with the SEC using its EDGAR system.

In addition, since we are also listed on the Tel Aviv Stock Exchange we submit copies of all our filings with the Securities and Exchange Commission to the Israeli Securities Authority and the Tel Aviv Stock Exchange. Such copies can be retrieved electronically through the Tel Aviv Stock Exchange's internet messaging system ([www.maya.tase.co.il](http://www.maya.tase.co.il)) and through the MAGNA distribution site of the Israeli Securities Authority ([www.magna.isa.gov.il](http://www.magna.isa.gov.il)).

### MATERIAL CONTRACTS DURING PAST TWO YEARS

*Company Acquisition of Frisk Software International's Antivirus Business (hereinafter the division )*

In July 2012, Commtouch and Frisk, entered into a definitive agreement under which Commtouch agreed to acquire the division, including:

- i. Antivirus products, including its F-PROT line of products, which are aimed at protecting customers against spyware, Trojan downloaders and other such Internet related threats;

- ii. certain contracts with OEM licensees pursuant to which such licensees are authorized to integrate the FRISK antivirus engine API/SDK into their solutions and to sell and support such integrated solutions;
- iii. certain contracts with distributors and resellers pursuant to which such entities are authorized to sell the F-PROT products;
- iv. all such products intellectual property, including all interests in relevant brand names and all associated trademarks, trade names and related property;
- v. all accounts receivable relating to this division; and
- vi. certain furniture, fixtures, equipment, office equipment, supplies, computers and other tangible personal property connected with the division.

In consideration for the sale of this division, Commtouch agreed to pay i) in cash, the sum of \$2.2 million, \$1 million of which was placed in escrow for payment in one installment on the one year anniversary of closing, provided those funds are not needed to satisfy certain obligations of the division relating to the pre-closing period, and ii) in equity, 750,000 restricted Ordinary Shares in Commtouch, vesting in annual installments over four years commencing on the first anniversary of the closing date. Additionally, from the closing and through March 31, 2015, Commtouch is required to make periodic earnout payments to the sellers equal to 5% of the combined revenue generated by all Commtouch antivirus solutions.

The closing of the transaction occurred on October 1, 2012, and Commtouch, through a new Icelandic company known as Commtouch Iceland hf, added approximately 37 new employees at that time.

#### *Company Acquisition of eleven GmbH*

On November 16, 2012, Commtouch and eleven simultaneously signed and closed a share purchase agreement under which we acquired eleven, including:

- i. all outstanding shares of eleven from its current shareholders;
- ii. eleven's products and services, including its eXpurgate line of products, which are aimed at protecting customers against email-borne spam, viruses and other such Internet related threats;
- iii. all contracts with OEM licensees pursuant to which such licensees are authorized to integrate the eleven API/SDK into their solutions and to sell and support such integrated solutions;
- iv. all contracts with distributors and resellers pursuant to which such entities are authorized to sell the eleven products and services;
- v. all direct contracts with enterprises, businesses, and ISPs pursuant to which eleven provides direct service through a hosted managed service offering or on-premise managed platform;
- vi. all eleven products intellectual property, including all interests in relevant brand names and all associated trademarks, trade names and related property; and
- vii. all assets and liabilities of eleven, including all fixed assets, such as data center servers, computer equipment, furniture, fixtures, office equipment, supplies, and other tangible personal property connected with eleven.

In consideration for the sale of eleven, at the closing Commtouch paid:

- i. in cash, the sum of Euro 9.05 million (approximately \$11.53 million based on the exchange rate on the date of acquisition), including 1.84 million (\$2.34 million) cash which will stay in the business for a net purchase price of 7.21 million (\$9.19 million); 0.82 million (\$1.05 million) of the cash price will be placed in escrow, for release to the sellers in one installment on the one year anniversary of the closing of the transaction, provided those funds are not needed to satisfy certain obligations of eleven relating to the pre-closing period;
- ii. in equity, 806,750 restricted Ordinary Shares in Commtouch, with a value of approximately \$2.10 million based on an averaging of Commtouch's Ordinary Share price on the day of closing, vesting in equal annual installments over a 2 year



vesting period commencing on the first anniversary of the closing date; and

- iii. additionally, from the closing and through December, 2015, Commtouch shall make periodic earnout payments to the sellers calculated at between 3% - 12% of certain revenues generated by eleven's platform, products, and services.

- c. At the closing, 60 new employees joined the Commtouch organization by virtue of the acquisition of eleven.

#### *Company Credit Lines*

During 2012, we made significant investments (from our cash reserves) in the above described acquisitions of eleven and Frisk. Due in part to these investments, at about the time of the filing of this Annual Report, a credit line had been secured from an Israeli bank, and we were in the process of closing on another credit line with a second Israeli bank. Together, both credit lines total a sum of up to \$5,000,000. These credit lines are being put in place in order to ensure sufficient cash is available to fund the strategic growth investments of the Company.

In relation to these credit lines, the Company has agreed to grant security interests generally over all Company assets, and to refrain from encumbering its assets in favor of any other third parties. The Company has already drawn on one of the credit lines in the amount of \$1.5 million.

### **EXCHANGE CONTROLS**

Non-residents of Israel who own our Ordinary Shares may freely convert all amounts received in Israeli currency in respect of such Ordinary Shares, whether as a dividend, liquidation distribution or as proceeds from the sale of our Ordinary Shares, into non-Israeli currencies at the rate of exchange prevailing at the time of conversion (provided in each case that the applicable Israeli income tax, if any, is paid or withheld).

Until May 1998, Israel imposed extensive restrictions on transactions in foreign currency. These restrictions were largely lifted in May 1998. Since January 1, 2003, all exchange control restrictions have been eliminated although there are still reporting requirements for certain foreign currency transactions. Legislation remains in effect, however, pursuant to which currency controls can be imposed by administrative action at any time.

The State of Israel does not restrict in any way the ownership or voting of our Ordinary Shares by non-residents of Israel, except with respect to subjects of countries that are in a state of war with Israel.

### **ISRAELI TAXATION**

The following is a summary of the principal tax laws applicable to companies in Israel, including special reference to their effect on us, and Israeli government programs benefiting us. This section also contains a discussion of the material Israeli tax consequences to you if you acquire Ordinary Shares of our company. This summary does not discuss all the acts of Israeli tax law that may be relevant to you in light of your personal investment circumstances or if you are subject to special treatment under Israeli law. To the extent that the discussion is based on new tax legislation which has not been subject to judicial or administrative interpretation, we cannot assure you that the views expressed in this discussion will be accepted by the tax authorities. The discussion should not be understood as legal or professional tax advice and is not exhaustive of all possible tax considerations.

#### *General Corporate Tax Structure*

Israeli companies were generally subject to corporate tax at the rate of 24% of their taxable income in 2011. Corporate tax rates applicable for 2008, 2009 and 2010 were 27%, 26% and 25%, respectively.

On December 5, 2011, the Israeli Parliament (the Knesset) passed the Law for Tax Burden Reform (Legislative Amendments), 2011 which, among others, effective from 2012 cancels the scheduled progressive reduction in the corporate tax rate, and increases the corporate tax rate to 25% in 2012 and subsequent years.

#### *Tax Benefits under the Law for the Encouragement of Industry (Taxes), 1969*

The Law for the Encouragement of Industry (Taxes), 1969, generally referred to as the Industry Encouragement Law, provides several tax benefits for industrial companies. An industrial company is defined as a company resident in

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Israel, at least 90% of the income of which in a given tax year exclusive of income from specified government loans, capital gains, interest and dividends, is derived from an industrial enterprise owned by it. An industrial enterprise is defined as an enterprise whose major activity in a given tax year is industrial production activity.

Under the Industry Encouragement Law, industrial companies are entitled to a number of corporate tax benefits, including:

- deduction of purchase of know-how and patents and/or right to use a patent over an eight-year period;
- the right to elect, under specified conditions, to file a consolidated tax return with additional related Israeli industrial companies and an industrial holding company;
- accelerated depreciation rates on equipment and buildings.

Expenses related to a public offering on TA stock exchange and as of 1.1.2003 on recognized stock markets outside of Israel, are deductible in equal amounts over three years.

Under some tax laws and regulations, an industrial enterprise may be eligible for special depreciation rates for machinery, equipment and buildings. These rates differ based on various factors, including the date the operations begin and the number of work shifts. An industrial company owning an approved enterprise may choose between these special depreciation rates and the depreciation rates available to the approved enterprise.

Eligibility for benefits under the Industry Encouragement Law is not subject to receipt of prior approval from any governmental authority.

We believe that we currently qualify as an industrial company within the definition of the Industry Encouragement Law. We cannot assure you that the Israeli tax authorities will agree that we qualify, or, if we qualify, that we will continue to qualify as an industrial company or that the benefits described above will be available to us in the future.

### *Capital Gains Tax on Sales of Our Ordinary Shares*

Israeli law generally imposes a capital gains tax on the sale of any capital assets by residents of Israel, as defined for Israeli tax purposes, and on the sale of assets located in Israel, including shares in Israeli companies, by both residents and non-residents of Israel, unless a specific exemption is available or unless a tax treaty between Israel and the shareholder's country of residence provides otherwise. The law distinguishes between real gain and inflationary surplus. The inflationary surplus is a portion of the total capital gain which is equivalent to the increase of the relevant asset's purchase price which is attributable to the increase in the Israeli consumer price index or, in certain circumstances, a foreign currency exchange rate, between the date of purchase and the date of sale. The real gain is the excess of the total capital gain over the inflationary surplus.

As of January 1, 2006, the tax rate applicable to capital gains derived from the sale of shares, whether listed on a stock market or not, is 20% for Israeli individuals, unless such shareholder claims a deduction for financing expenses in connection with such shares, in which case the gain will generally be taxed at a rate of 25%. Additionally, if such shareholder is considered a material shareholder at any time during the 12-month period preceding such sale, i.e., such shareholder holds directly or indirectly, including with others, at least 10% of any means of control in the company, the tax rate shall be 25%. Israeli companies are subject to the Corporate Tax rate on capital gains derived from the sale of shares, unless such companies were not subject to the Adjustments Law (or certain regulations) at the time of publication of the aforementioned amendment to the Tax Ordinance that came into effect on January 1, 2006, in which case the applicable tax rate is 25%. However, the foregoing tax rates do not apply to: (i) dealers in securities; and (ii) shareholders who acquired their shares prior to an initial public offering (that may be subject to a different tax arrangement).

Non-Israeli residents are exempt from Israeli capital gains tax on any gains derived from the sale of shares of Israeli companies publicly traded on a recognized stock exchange or regulated market outside of Israel, provided however that such capital gains are not derived from a permanent establishment in Israel, such shareholders are not subject to the Adjustments Law, and such shareholders did not acquire their shares prior to an initial public offering. However, non-Israeli corporations will not be entitled to such exemption if an Israeli resident (i) has a controlling interest of 25% or more in such non-Israeli corporation, or (ii) is the beneficiary or is entitled to 25% or more of the revenues or profits of such non-Israeli corporation, whether directly or indirectly.

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In some instances where our shareholders may be liable to Israeli tax on the sale of their Ordinary Shares, the payment of the consideration may be subject to the withholding of Israeli tax at the source.

Pursuant to the Convention Between the government of the United States of America and the government of Israel with Respect to Taxes on Income, as amended (the U.S.-Israel Tax Treaty), the sale, exchange or disposition of Ordinary Shares by a person who (i) holds our Ordinary Shares as a capital asset, (ii) qualifies as a resident of the United States within the meaning of the U.S.-Israel Tax Treaty and (iii) is entitled to claim the benefits afforded to such person by the U.S.-Israel Tax Treaty, generally, will not be subject to the Israeli capital gains tax. Such exemption will not apply if (i) such Treaty U.S. Resident holds, directly or indirectly, shares representing 10% or more of our voting power during any part of the 12-month period preceding such sale, exchange or disposition, subject to certain conditions, or (ii) the capital gains from such sale, exchange or disposition can be allocated to a permanent establishment in Israel. In such case, the sale, exchange or disposition of Ordinary Shares would be subject to Israeli tax, to the extent applicable; however, under the U.S.-Israel Tax Treaty, such Treaty U.S. Resident would be permitted to claim a credit for such taxes against the U.S. federal income tax imposed with respect to such sale, exchange or disposition, subject to the limitations in U.S. laws applicable to foreign tax credits. The U.S.-Israel Tax Treaty does not relate to U.S. state or local taxes.

### *Taxation of Non-Resident Holders of Shares*

Non-residents of Israel are subject to income tax on income accrued or derived from sources in Israel. Such sources of income include passive income such as dividends, royalties and interest, as well as non-passive income from services rendered in Israel. On distributions of dividends other than bonus shares, or stock dividends, income tax is withheld at the source at the following rates: for dividends distributed on or after January 1, 2006 - 20%, or 25% for a shareholder that is considered a material shareholder at any time during the 12-month period preceding such distribution, unless a different rate is provided in a treaty between Israel and the shareholder's country of residence. Under the U.S.-Israel Tax Treaty, the maximum tax on dividends paid to a holder of our Ordinary Shares who is a Treaty U.S. Resident is 25%. Furthermore, dividends not generated by an Approved Enterprise (or Benefited Enterprise) paid to a U.S. corporation holding at least 10% of our issued voting power during the part of the tax year which precedes the date of payment of the dividend and during the whole of its prior tax year, are generally taxed at a rate of 12.5%.

For information with respect to the applicability of Israeli capital gains taxes on the sale of Ordinary Shares by United States residents, see above Capital Gains Tax on Sales of Our Ordinary Shares.

## UNITED STATES FEDERAL INCOME TAX CONSEQUENCES

THE FOLLOWING SUMMARY IS INCLUDED HEREIN FOR GENERAL INFORMATION AND IS NOT INTENDED TO BE, AND SHOULD NOT BE CONSIDERED TO BE, LEGAL OR TAX ADVICE. EACH U.S. HOLDER SHOULD CONSULT WITH HIS OR HER OWN TAX ADVISOR AS TO THE PARTICULAR U.S. FEDERAL INCOME TAX CONSEQUENCES OF THE PURCHASE, OWNERSHIP AND SALE OF OUR ORDINARY SHARES, INCLUDING THE EFFECTS OF APPLICABLE STATE, LOCAL, FOREIGN OR OTHER TAX LAWS AND POSSIBLE CHANGES IN THE TAX LAWS.

### *U.S. Federal Income Taxation*

Subject to the limitations described in the next paragraph, the following discussion summarizes the material U.S. federal income tax consequences to a U.S. Holder arising from the purchase, ownership and sale of our Ordinary Shares. For this purpose, a U.S. Holder is a holder of Ordinary Shares that is: (1) an individual citizen or resident of the United States, including an alien individual who is a lawful permanent resident of the United States or meets the substantial presence residency test under U.S. federal income tax laws; (2) a corporation (or other entity treated as a corporation for U.S. federal income tax purposes) or a partnership (other than a partnership that is not treated as a U.S. person under any applicable U.S. Treasury Regulations) created or organized in or under the laws of the United States or the District of Columbia or any political subdivision thereof; (3) an estate, the income of which is subject to U.S. federal income tax regardless of source; (4) a trust if a court within the United States is able to exercise primary supervision over the administration of the trust and one or more U.S. persons have authority to control all substantial decisions of the trust; (5) a trust that has a valid election in effect to be treated as a U.S. person to the extent provided in

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U.S. Treasury Regulations; or (6) any person otherwise subject to U.S. federal income tax on a net income basis in respect of our Ordinary Shares, if such status as a U.S. Holder is not overridden pursuant to the provisions of an applicable tax treaty.

This summary is for general information purposes only and does not purport to be a comprehensive description of all of the U.S. federal income tax considerations that may be relevant to a decision to purchase or hold our Ordinary Shares. This summary generally considers only U.S. Holders that will own our Ordinary Shares as capital assets. Except to the limited extent discussed below, this summary does not consider the U.S. federal tax consequences to a person that is not a U.S. Holder, nor does it describe the rules applicable to determine a taxpayer's status as a U.S. Holder. This summary is based on the provisions of the Internal Revenue Code of 1986, as amended, or the Code, final, temporary and proposed U.S. Treasury Regulations promulgated thereunder, administrative and judicial interpretations thereof, and the U.S./Israel Income Tax Treaty, all as in effect as of the date hereof and all of which are subject to change, possibly on a retroactive basis, and all of which are open to differing interpretations. Commtouch will not seek a ruling from the U.S. Internal Revenue Service, or the IRS, with regard to the U.S. federal income tax treatment of an investment in our Ordinary Shares by U.S. Holders and, therefore, can provide no assurances that the IRS will agree with the conclusions set forth below.

This discussion does not address all of the aspects of U.S. federal income taxation that may be relevant to a particular shareholder based on such shareholder's particular circumstances and in particular does not discuss any estate, gift, generation-skipping, transfer, state, local or foreign tax considerations. In addition, this discussion does not address the U.S. federal income tax treatment of a U.S. Holder who is: (1) a bank, life insurance company, regulated investment company, or other financial institution or financial services entity; (2) a broker or dealer in securities or foreign currency; (3) a person who acquired our Ordinary Shares in connection with employment or other performance of services; (4) a U.S. Holder that is subject to the U.S. alternative minimum tax; (5) a U.S. Holder that holds our Ordinary Shares as a hedge or as part of a hedging, straddle, conversion or constructive sale transaction or other risk-reduction transaction for U.S. federal income tax purposes; (6) a tax-exempt entity; (7) real estate investment trusts; (8) a U.S. Holder that expatriates out of the United States or a former long-term resident of the United States; or (9) a person having a functional currency other than the U.S. dollar. This discussion does not address the U.S. federal income tax treatment of a U.S. Holder that owns, directly or constructively, at any time, Ordinary Shares representing 10% or more of our voting power. Additionally, the U.S. federal income tax treatment of persons who hold Ordinary Shares through a partnership or other pass-through entity are not considered.

You are encouraged to consult your own tax advisor with respect to the specific U.S. federal and state income tax consequences to you of purchasing, holding or disposing of our Ordinary Shares, including the effects of applicable state, local, foreign or other tax laws and possible changes in the tax laws.

### *Distributions on Ordinary Shares*

Subject to the discussion under the heading "Passive Foreign Investment Companies" below, a U.S. Holder will be required to include in gross income as ordinary income the amount of any distribution paid on Ordinary Shares (including the amount of any Israeli tax withheld on the date of the distribution), to the extent that such distribution does not exceed our current and accumulated earnings and profits, as determined for U.S. federal income tax purposes. The amount of a distribution which exceeds our earnings and profits will be treated first as a non-taxable return of capital, reducing the U.S. Holder's tax basis in its Ordinary Shares to the extent thereof, and then capital gain. Corporate holders generally will not be allowed a deduction for dividends received. For non-corporate U.S. Holders, to the extent that their total adjusted income does not exceed applicable thresholds, the maximum federal income tax rate for "qualified dividend income" and long-term capital gains is generally 15%. For those non-corporate U.S. Holders whose total adjusted income exceeds such income thresholds, the maximum federal income tax rate on "qualified dividend income" and long-term capital gains is generally 20%. For this purpose, "qualified dividend income" means, *inter alia*, dividends received from a "qualified foreign corporation." A "qualified foreign corporation" is a corporation that is entitled to the benefits of a comprehensive tax treaty with the United States which includes an exchange of information program. The IRS has stated that the Israel/U.S. Tax Treaty satisfies this requirement and we believe we are eligible for the benefits of that treaty.

In addition, our dividends will be qualified dividend income if our Ordinary Shares are readily tradable on NASDAQ or another established securities market in the United States. Dividends will not qualify for the preferential rate if we

are treated, in the year the dividend is paid or in the prior year, as a passive foreign investment company, or PFIC. A U.S. Holder will not be entitled to the preferential rate: (i) if the U.S. Holder has not held our Ordinary Shares or ADRs for at least 61 days of the 121 day period beginning on the date which is 60 days before the ex-dividend date, or (ii) to the extent the U.S. Holder is under an obligation to make related payments on substantially similar property. Any days during which the U.S. Holder has diminished its risk of loss on our Ordinary Shares are not counted towards meeting the 61-day holding period. Finally, U.S. Holders who elect to treat the dividend income as investment income pursuant to Code section 163(d)(4) will not be eligible for the preferential rate of taxation.

The amount of a distribution with respect to our Ordinary Shares will be measured by the amount of the fair market value of any property distributed, and for U.S. federal income tax purposes, the amount of any Israeli taxes withheld therefrom. (See discussion above under Taxation of Non-Resident Holders of Shares. ) Cash distributions paid by us in NIS will be included in the income of U.S. Holders at a U.S. dollar amount based upon the spot rate of exchange in effect on the date the dividend is includible in the income of the U.S. Holder, and U.S. Holders will have a tax basis in such NIS for U.S. federal income tax purposes equal to such U.S. dollar value. If the U.S. Holder subsequently converts the NIS, any subsequent gain or loss in respect of such NIS arising from exchange rate fluctuations will be U.S. source ordinary exchange gain or loss.

Distributions paid by us will generally be foreign source income for U.S. foreign tax credit purposes. Subject to the limitations set forth in the Code, U.S. Holders may elect to claim a foreign tax credit against their U.S. income tax liability for Israeli income tax withheld from distributions received in respect of our Ordinary Shares. In general, these rules limit the amount allowable as a foreign tax credit in any year to the amount of regular U.S. tax for the year attributable to foreign source taxable income. This limitation on the use of foreign tax credits generally will not apply to an electing individual U.S. Holder whose creditable foreign taxes during the year do not exceed \$300, or \$600 for joint filers, if such individual's gross income for the taxable year from non-U.S. sources consists solely of certain passive income. A U.S. Holder will be denied a foreign tax credit with respect to Israeli income tax withheld from dividends received with respect to our Ordinary Shares if such U.S. Holder has not held our Ordinary Shares for at least 16 days out of the 31-day period beginning on the date that is 15 days before the ex-dividend date or to the extent that such U.S. Holder is under an obligation to make certain related payments with respect to substantially similar or related property. Any day during which a U.S. Holder has substantially diminished his or her risk of loss with respect to our Ordinary Shares will not count toward meeting the 16-day holding period. A U.S. Holder will also be denied a foreign tax credit if the U.S. Holder holds our Ordinary Shares in an arrangement in which the U.S. Holder's reasonably expected economic profit is insubstantial compared to the foreign taxes expected to be paid or accrued. The rules relating to the determination of the U.S. foreign tax credit are complex, and U.S. Holders should consult with their own tax advisors to determine whether, and to what extent, they are entitled to such credit. U.S. Holders that do not elect to claim a foreign tax credit may instead claim a deduction for Israeli income taxes withheld, provided such U.S. Holders itemize their deductions.

#### *Disposition of Shares*

Except as provided under the PFIC rules described below, upon the sale, exchange or other disposition of our Ordinary Shares, a U.S. Holder will recognize capital gain or loss in an amount equal to the difference between such U.S. Holder's tax basis in the sold Ordinary Shares and the amount realized on the disposition of such Ordinary Shares (or its U.S. dollar equivalent determined by reference to the spot rate of exchange on the date of disposition, if the amount realized is denominated in a foreign currency). The gain or loss realized on the sale or exchange or other disposition of Ordinary Shares will be long-term capital gain or loss if the U.S. Holder has a holding period of more than one year at the time of the disposition.

In general, gain realized by a U.S. Holder on a sale, exchange or other disposition of Ordinary Shares will generally be treated as U.S. source income for U.S. foreign tax credit purposes. A loss realized by a U.S. Holder on the sale, exchange or other disposition of Ordinary Shares is generally allocated to U.S. source income. However, U.S. Treasury Regulations require such loss to be allocated to foreign source income to the extent specified dividends were received by the taxpayer within the 24-month period preceding the date on which the taxpayer recognized the loss. The deductibility of a loss realized on the sale, exchange or other disposition of Ordinary Shares is subject to limitations.

#### *Tax on Net Investment Income*

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U.S. Holders who are individuals, estates or trusts will generally be required to pay a new 3.8% tax on their net investment income (including dividends on and gains from the sale or other disposition of our Ordinary Shares), or in the case of estates and trusts, on their net investment income that is not distributed. In each case, this tax applies only to the extent that the U.S. Holder's total adjusted income exceeds applicable thresholds.

### *Passive Foreign Investment Companies*

Special U.S. federal income tax laws apply to a U.S. Holder who owns shares of a corporation that was (at any time during the U.S. Holder's holding period) a PFIC. We would be treated as a PFIC for U.S. federal income tax purposes for any tax year if, in such tax year, either:

75% or more of our gross income (including our *pro rata* share of gross income for any company, U.S. or foreign, in which we are considered to own 25% or more of the shares by value), in a taxable year is passive (the *Income Test*); or

At least 50% of our assets, averaged over the year and generally determined based upon value (including our *pro rata* share of the assets of any company in which we are considered to own 25% or more of the shares by value), in a taxable year are held for the production of, or produce, passive income (the *Asset Test*).

For this purpose, passive income generally consists of dividends, interest, rents, royalties, annuities and income from certain commodities transactions and from notional principal contracts. Cash is treated as generating passive income.

If we are or become a PFIC, each U.S. Holder who has not elected to treat us as a qualified electing fund by making a QEF election, or who has not elected to mark the shares to market (as discussed below), would, upon receipt of certain distributions by us and upon disposition of our Ordinary Shares at a gain, be liable to pay U.S. federal income tax at the then prevailing highest tax rates on ordinary income plus interest on such tax, as if the distribution or gain had been recognized ratably over the taxpayer's holding period for our Ordinary Shares. In addition, when shares of a PFIC are acquired by reason of death from a decedent that was a U.S. Holder, the tax basis of such shares would not receive a step-up to fair market value as of the date of the decedent's death, but instead would be equal to the decedent's basis if lower, unless all gain were recognized by the decedent. Indirect investments in a PFIC may also be subject to special U.S. federal income tax rules.

The PFIC rules described above would not apply to a U.S. Holder who makes a QEF election for all taxable years that such U.S. Holder has held our Ordinary Shares while we are a PFIC, provided that we comply with specified reporting requirements. Instead, each U.S. Holder who has made such a QEF election is required for each taxable year that we are a PFIC to include in income such U.S. Holder's *pro rata* share of our ordinary earnings as ordinary income and such U.S. Holder's *pro rata* share of our net capital gains as long-term capital gain, regardless of whether we make any distributions of such earnings or gain. In general, a QEF election is effective only if we make available certain required information. The QEF election is made on a shareholder-by-shareholder basis and generally may be revoked only with the consent of the IRS. Although we have no obligation to do so, we intend to comply with the applicable information reporting requirements for U.S. Holders to make a QEF election.

A U.S. Holder of PFIC shares which are traded on qualifying public markets, including the NASDAQ, can elect to mark the shares to market annually, recognizing as ordinary income or loss each year an amount equal to the difference as of the close of the taxable year between the fair market value of the PFIC shares and the U.S. Holder's adjusted tax basis in the PFIC shares. Losses are allowed only to the extent of net mark-to-market gain previously included income by the U.S. Holder under the election for prior taxable years.

In light of the complexity of PFIC rules, we cannot assure you that we have not been or are not a PFIC or will avoid becoming a PFIC in the future. U.S. Holders who hold Ordinary Shares during a period when we are a PFIC will be subject to the foregoing rules, even if we cease to be a PFIC, subject to specified exceptions for U.S. Holders who made a QEF or mark-to-market election. U.S. Holders are strongly urged to consult their tax advisors about the PFIC rules, including tax return filing requirements and the eligibility, manner, and consequences to them of making a QEF or mark-to-market election with respect to our Ordinary Shares in the event that we qualify as a PFIC. For those U.S. Holders who determine that we were a PFIC in any of our taxable years and notify us in writing of their request for the

information required in order to effectuate the QEF election described above, we will promptly make such information available to them.

*Information Reporting and Withholding*

A U.S. Holder may be subject to backup withholding at a rate of 28% with respect to cash dividends and proceeds from a disposition of Ordinary Shares. In general, back-up withholding will apply only if a U.S. Holder fails to comply with specified identification procedures. Backup withholding will not apply with respect to payments made to designated exempt recipients, such as corporations and tax-exempt organizations. Backup withholding is not an additional tax and may be claimed as a credit against the U.S. federal income tax liability of a U.S. Holder, provided that the required information is timely furnished to the IRS.

Under the Hiring Incentives to Restore Employment Act of 2010 (the HIRE Act), some payments made to foreign financial institutions in respect of accounts of U.S. stockholders at such financial institutions may be subject to withholding at a rate of 30%. U.S. Treasury Regulations provide that such withholding will only apply to distributions paid on or after January 1, 2014, and to other withholdable payments (including payments of gross proceeds from a sale or other disposition of our Ordinary Shares) made on or after January 1, 2017. U.S. Holders should consult their tax advisors regarding the effect, if any, of the HIRE Act on their ownership and disposition of our Ordinary Shares. See Non-U.S. Holders of Ordinary Shares.

*Non-U.S. Holders of Ordinary Shares*

Except as provided below, an individual, corporation, estate or trust that is not a U.S. Holder generally will not be subject to U.S. federal income or withholding tax on the payment of dividends on, and the proceeds from the disposition of, our Ordinary Shares.

A non-U.S. Holder may be subject to U.S. federal income or withholding tax on a dividend paid on our Ordinary Shares or the proceeds from the disposition of our Ordinary Shares if: (1) such item is effectively connected with the conduct by the non-U.S. Holder of a trade or business in the United States or, in the case of a non-U.S. Holder that is a resident of a country which has an income tax treaty with the United States, such item is attributable to a permanent establishment or, in the case of gain realized by an individual non-U.S. Holder, a fixed place of business in the United States; (2) in the case of a disposition of our Ordinary Shares, the individual non-U.S. Holder is present in the United States for 183 days or more in the taxable year of the sale and other specified conditions are met; (3) the non-U.S. Holder is subject to U.S. federal income tax pursuant to the provisions of the U.S. tax law applicable to U.S. expatriates.

In general, non-U.S. Holders will not be subject to backup withholding with respect to the payment of dividends on our Ordinary Shares if payment is made through a paying agent or office of a foreign broker outside the United States. However, if payment is made in the United States or by a U.S. related person, non-U.S. Holders may be subject to backup withholding, unless the non-U.S. Holder provides on an applicable Form W-8 (or a substantially similar form) a taxpayer identification number, certifies to its foreign status, or otherwise establishes an exemption. A U.S. related person for these purposes is a person with one or more current relationships with the United States.

The amount of any backup withholding from a payment to a non-U.S. Holder will be allowed as a credit against such holder's U.S. federal income tax liability and may entitle such holder to a refund, provided that the required information is timely furnished to the IRS.

The HIRE Act may impose withholding taxes on some types of payments made to foreign financial institutions and some other non-U.S. entities. Under the HIRE Act, the failure to comply with additional certification, information reporting and other specified requirements could result in withholding tax being imposed on payments of dividends and sales proceeds to U.S. Holders that own Ordinary Shares through foreign accounts or foreign intermediaries and specified non-U.S. Holders. The HIRE Act imposes a 30% withholding tax on dividends on, and gross proceeds from the sale or other disposition of, Ordinary Shares paid from the United States to a foreign financial institution or to a foreign nonfinancial entity, unless (i) the foreign financial institution undertakes specified diligence and reporting obligations or (ii) the foreign nonfinancial entity either certifies it does not have any substantial U.S. owners or furnishes identifying information regarding each substantial U.S. owner. In addition, if the payee is a foreign financial



institution, it generally must enter into an agreement with the U.S. Treasury that requires, among other things, that it undertake to identify accounts held by specified U.S. persons or U.S.-owned foreign entities, annually report certain information about such accounts, and withhold 30% on payments to other specified account holders. U.S. Treasury Regulations provide that such withholding will only apply to distributions paid on or after January 1, 2014, and to other withholdable payments (including payments of gross proceeds from a sale or other disposition of our Ordinary Shares) made on or after January 1, 2017. You should consult your tax advisor regarding the HIRE Act.

**Item 11. Quantitative and Qualitative Disclosures about Market Risk.**

We develop our technology in Israel and in Germany and seek to provide our services worldwide. As a result, our foreign currency exposures give rise to market risk associated with exchange rate movements of the U.S. dollar, our functional and reporting currency, against the NIS and Euro. We are exposed to the risk of fluctuation in the U.S. dollar/NIS and the U.S. dollar/Euro exchange rate. Our NIS and Euro-denominated expenses consist principally of salaries and related personnel expenses. Although the majority of our revenues are in US dollars, a substantial portion of our sales are derived from the Euro currency. Neither a ten percent increase nor decrease in current exchange rates would have a material effect on our consolidated financial statements in the next six months.

Due to the fact that we do not have any material debt, we have concluded that there is currently no material interest market risk exposure.

Therefore, no quantitative tabular disclosures are provided.

**Item 12. Description of Securities Other than Equity Securities.**

The Company does not have any outstanding American Depositary Shares or American Depositary Receipts.

**PART II**

**Item 13. Defaults, Dividend Arrearages and Delinquencies.**

None.

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

None.

**Item 15. Controls and Procedures.**

(a) As of December 31, 2012, we performed an evaluation under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Exchange Act). Our management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and our management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective as of December 31, 2012, to provide reasonable assurance that the information required to be disclosed in filings and submissions under the Exchange Act, is recorded, processed, summarized, and reported within the time periods specified by the SEC's rules and forms, and that such information related to us and our consolidated subsidiary is accumulated and communicated to management, including the Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions about required disclosure.

(b) Our management is responsible for establishing and maintaining adequate internal control over our financial reporting, as such term is defined in Rule 13a-15(f) under the Security Exchange Act. Our internal control over financial reporting system was designed to provide reasonable assurance regarding the reliability of financial reporting

and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements and even when determined to be effective can only provide reasonable assurance with respect to financial statements. Also projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Our management assessed our internal control over financial reporting as of December 31, 2012. Our management based its assessment on criteria established in Internal Control- Integrated Framework issued by the Committee of Sponsoring Organization of the Treadway Commission. Based on this assessment, our management has concluded that, as of December 31, 2012, our internal control over financial reporting is effective.

This Annual Report does not include an attestation report of our independent registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by our independent registered public accounting firm pursuant to a provision under the Dodd-Frank Wall Street Reform and Consumer Protection Act which grants a permanent exemption for non-accelerated filers from complying with Section 404(b) of the Sarbanes-Oxley Act of 2002.

(c) During the period covered by this Annual Report, there were no changes to our internal control over financial reporting that occurred during the year ended December 31, 2012 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**Item 16A. Audit Committee Financial Expert.**

The Board of Directors of the Company has determined that Mr. Todd Thomson, a member of the Audit Committee, is an audit committee financial expert as that term is defined in Item 16A of Form 20-F, and is independent as that term is defined in NASDAQ Listing Rule 5605(a)(2).

**Item 16B. Code of Ethics.**

The Company, by way of Board of Directors resolution, has adopted a Code of Ethics applicable to its senior financial officers, including its principal executive, financial and accounting officers. The Code of Ethics is posted on the Company's website at [www.commtouch.com](http://www.commtouch.com), under the tab for Corporate Governance located on the link to the Investor Relations page.

**Item 16C. Principal Accountant Fees and Services.**

Kost, Forer, Gabbay & Kasierer, a member of Ernst & Young Global, has served as our Independent Registered Public Accounting Firm for each of the fiscal years in the three-year period ended December 31, 2012, for which audited financial statements appear in this Annual Report. The following table presents the aggregate fees for professional and other services rendered by Kost, Forer, Gabbay & Kasierer for 2012 and 2011:

|                   | <b>Year ended December 31,</b> |                   |
|-------------------|--------------------------------|-------------------|
|                   | <b>2012</b>                    | <b>2011</b>       |
|                   | <b>Fees</b>                    | <b>Fees</b>       |
| Audit fees (1)    | \$ 127,000                     | \$ 132,000        |
| Audit Related (2) | \$ 74,000                      | -                 |
| Tax Fees (3)      | \$ 28,000                      | \$ 28,000         |
| Other             | \$ 40,000                      | -                 |
| <b>Total</b>      | <b>\$ 269,000</b>              | <b>\$ 160,000</b> |

(1) Audit fees consist of fees billed for the annual audit services engagement and other audit services, which are those services that only the independent registered public accounting firm can reasonably provide, and include the group audit including statutory audits; consents; attest services; and assistance in connection with documents filed with the SEC.

(2) Audit-related fees relate to assurance and associated services that traditionally are performed by the independent auditor, including: accounting consultation and consultation concerning financial accounting, reporting standards and government approvals and due diligence investigations.

(3) Tax fees are for professional services rendered by our auditors for tax compliance, tax advice on actual or contemplated transactions, tax consulting associated with international transfer prices and global mobility of employees.

#### *Audit Committee Pre-approval Policies and Procedures*

Below is a summary of our current Policies and Procedures:

The main role of the Company's audit committee is to assist the Board of Directors in fulfilling its responsibility for oversight of the quality and integrity of the accounting, auditing and reporting practices of the Company. The Audit Committee oversees the appointment, compensation, and oversight of the Company's independent registered public accounting firm engaged to prepare or issue an audit report on the financial statements of the Company. The audit committee's specific responsibilities in carrying out its oversight role include the approval of all audit and non-audit services to be provided by the external auditor and the quarterly review of the firm's non-audit services and related fees. These services may include audit services, audit-related services, tax services and other services, as described above. It is the policy of the audit committee to approve in advance the particular services or categories of services to be provided to the Company periodically. Additional services may be pre-approved by the audit committee on an individual basis during the year. The audit committee did not avail itself of section (c)(7)(i)(C) of Rule 2-01 of Regulation S-X during 2012, which allows for an exemption from the pre-approval process under certain limited circumstances.

#### **Item 16D. Exemptions from the Listing Standards for Audit Committees.**

Not applicable.

#### **Item 16E. Purchases of Equity Securities by the Issuer and Affiliated Purchasers.**

Following completion of its Ordinary Share buyback plans during 2009 and 2010 (see Item 16E of the annual reports on Form 20-F filed for 2009 and 2010), in May 2012, the Company announced the commencement of its third Ordinary Share buyback plan, under which the Company purchased almost \$2 million worth of its Ordinary Shares through the end of 2012 (out of a total amount allocated of \$2.5 million). The Company completed this buyback plan in November 2012 and, in total, it expended \$1.7 million to repurchase 600,337 Ordinary Shares at an average price of \$2.79 per share. Repurchases during 2012 are summarized in the following table:

## ISSUER PURCHASES OF SECURITIES DURING 2012

| Period                      | Total Number<br>Of Shares<br>Purchased | Average Price<br>Paid Per Share<br>(\$) | Total Number<br>Of Shares<br>Purchased As<br>Part of Publicly<br>Announced<br>Plan | Maximum U.S. Dollar<br>Value That May Yet<br>Be Purchased Under<br>The Plan |
|-----------------------------|--|---|--|---|
| May 1<br>May 31             | 62,494                                 | 2.7                                     | 62,494   | 2,331,418   |
| June 1<br>June 30           | 135,596                                | 2.94                                    | 135,596  | 1,932,796   |
| July 1<br>July 31           | 130,209                                | 2.69                                    | 130,209  | 1,582,571   |
| August 1-<br>August 31      | 113,451                                | 2.91                                    | 113,451  | 1,251,942   |
| September 1<br>September 30 | 53,274                                 | 2.83                                    | 53,274   | 1,101,369   |
| October 1<br>October 31     | 76,254                                 | 2.59                                    | 76,254   | 904,089   |
| November 1<br>November 30   | 29,059                                 | 2.63                                    | 29,059   | 827,596   |
| Total                       | 600,337                                | 2.79                                    | 600,337  | N/A   |

**Item 16F. Change in Registrant's Certifying Accountant.**

Not applicable.

**Item 16G. Corporate Governance.**

Under NASDAQ Listing Rule 5615(a)(3), foreign private issuers, such as our Company, are permitted to follow certain home country corporate governance practices instead of certain provisions of certain NASDAQ Listing Rules. We do not comply with the following requirements of the NASDAQ Listing Rules, and instead follow Israeli law and practice with respect to such corporate governance practices:

NASDAQ Listing Rule 5250(d) requires that an annual report be delivered to shareholders in accordance with three alternative delivery methods set forth in the rule. One of those delivery methods allows for the posting of the annual report on the Company's website. However, that method also requires that i) a prominent undertaking be posted on the website indicating that, upon request, shareholders may receive a hard copy of the annual report free of charge, and ii) simultaneous with this posting, the Company issue a press release stating that its annual report has been filed with the SEC (or other appropriate regulatory authority). This press release must also state that the annual report is available on the Company's website and include the website address and that shareholders may receive a hard copy free of charge upon request.

While the Company's most current annual report on Form 20-F, inclusive of consolidated financial statements, is available on its website at [www.commtouch.com](http://www.commtouch.com), and the Company has indicated publicly that it will provide copies of that report free of charge, upon shareholder request, nevertheless the Company is not in strict compliance with the NASDAQ rule. The Company does not include a statement on its website in the form noted above and does not issue a press release upon the posting of the annual report to its website; rather, the Company is following its home country practice (in Israel, which, in addition to the Company's activities noted above, also enables shareholders to inspect the Company's annual consolidated financial statements in person at its principal offices).

Rule 5620(c) to NASDAQ Listing Rules requires that an issuer listed on NASDAQ have a quorum requirement that in no case be less than 33 1/3% of the outstanding shares of a company's common voting stock. However, the Company's articles of association, consistent with the Companies Law, provide for a lower quorum in the event of a meeting adjourned for lack of a quorum, in which case any two shareholders entitled to vote and present in person or by proxy at such adjourned meeting shall constitute a quorum. Our quorum requirements for an adjourned meeting do not comply with the NASDAQ requirements and we instead follow our home country practice.

Rule 5635(c) of the NASDAQ Listing Rules requires that, except in certain defined instances, an issuer receive shareholder approval prior to the issuance of securities when a stock option or purchase plan is to be established or materially amended or other equity compensation arrangement made or materially amended, pursuant to which stock may be acquired by officers, directors, employees, or consultants. During 2012, the Company notified NASDAQ that it is opting to follow home country practice in this regard. Under Israeli law, shareholder approval is not required for some of the matters listed under Rule 5635(c), and thus Board of Director approval, together with that of the Compensation Committee, will be sufficient to approve those matters. As noted above under Item 6, *Compensation Committee*, the Company is planning to adopt a compensation policy focused on director, CEO and corporate officer compensation (hereinafter "executive compensation"). Pursuant to Israeli law, such policy must be presented to shareholders for approval prior to September 2, 2013. Included within that policy will be provisions relating to the equity component of executive compensation, so in relation to those provisions, the Company will continue to follow NASDAQ Listing Rules in seeking shareholder approval. As noted under Item 6, even if our shareholders fail to approve the compensation policy, the Board nevertheless is entitled to adopt such policy if it determines that it is in the best interests of the Company.

As a foreign private issuer listed on the NASDAQ Capital Market, we may also follow home country practice with regard to, among other things, composition of the board of directors, director nomination process and regularly scheduled meetings at which only independent directors are present. In addition, we may follow our home country practice, instead of the NASDAQ Listing Rules, which require that we obtain shareholder approval for certain dilutive events, such as an issuance that will result in a change of control of the company, certain transactions other than a public offering involving issuances of a 20% or more interest in the company and certain acquisitions of the stock or assets of another company. A foreign private issuer that elects to follow a home country practice instead of NASDAQ requirements, must submit to NASDAQ in advance a written statement from an independent counsel in such issuer's home country certifying that the issuer's practices are not prohibited by the home country's laws. In addition, a foreign private issuer must disclose in its annual reports filed with the Securities and Exchange Commission or on its website each such requirement that it does not follow and describe the home country practice followed by the issuer instead of any such requirement. Accordingly, our shareholders may not be afforded the same protection as provided under NASDAQ's corporate governance rules.

**Item 16H. Mine Safety Disclosure.**

Not applicable.

**PART III**

**Item 17. Financial Statements.**

The Company has responded to Item 18

**Item 18. Financial Statements.**

See pages F-1 to F-31.

COMMTOUCH SOFTWARE LTD. AND ITS SUBSIDIARIES

CONSOLIDATED FINANCIAL STATEMENTS

AS OF DECEMBER 31, 2012

U.S. DOLLARS IN THOUSANDS

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

**To the Board of Directors and Shareholders of**

**COMMTouch SOFTWARE LTD.**

We have audited the accompanying consolidated balance sheets of Commtouch Software Ltd. ( the Company ) and its subsidiaries as of December 31, 2011 and 2012, and the related consolidated statements of income, comprehensive income, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2012. 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. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company and its subsidiaries as of December 31, 2011 and 2012, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2012, in conformity with U.S. generally accepted accounting principles.

Tel-Aviv, Israel  
April 25, 2013

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



**COMMTouch SOFTWARE LTD.  
AND ITS SUBSIDIARIES**

**CONSOLIDATED BALANCE SHEETS**

U.S. dollars in thousands

|  | <b>December 31</b> |                  |
|--|--------------------|------------------|
|  | <b>2011</b>        | <b>2012</b>      |
| <b>ASSETS</b>                                  |                    |                  |
| <b>CURRENT ASSETS:</b>                         |                    |                  |
| Cash and cash equivalents                      | \$ 20,868          | \$ 5,137         |
| Trade receivables, net                         | 2,838              | 5,996            |
| Deferred income taxes                          | 1,996              | 2,239            |
| Prepaid expenses and other accounts receivable | 463                | 1,503            |
| <b>Total current assets</b>                    | <b>26,165</b>      | <b>14,875</b>    |
| <b>LONG-TERM ASSETS:</b>                       |                    |                  |
| Investment in affiliates                       | 1,227              | 1,403            |
| Deferred income taxes                          | 2,889              | 3,348            |
| Intangible assets, net                         | 3,505              | 14,568           |
| Goodwill                                       | 3,792              | 22,518           |
| Severance pay fund                             | 1,031              | 756              |
| Lease deposits                                 | 40                 | 57               |
| Property and equipment, net                    | 885                | 1,608            |
| <b>Total long-term assets</b>                  | <b>13,369</b>      | <b>44,258</b>    |
| <b>Total assets</b>                            | <b>\$ 39,534</b>   | <b>\$ 59,133</b> |

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

**COMMTouch SOFTWARE LTD.  
AND ITS SUBSIDIARIES**

**CONSOLIDATED BALANCE SHEETS**

U.S. dollars in thousands, except share and per share data

|   | December 31      |                  |
|---|------------------|------------------|
|   | 2011             | 2012             |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>  |                  |                  |
| <b>CURRENT LIABILITIES:</b>   |                  |                  |
| Accounts payable  | \$ 551           | \$ 958           |
| Employees and payroll accruals  | 1,215            | 2,280            |
| Accrued expenses and other liabilities  | 628              | 1,587            |
| Earn-out consideration  | 3,372            | 4,048            |
| Deferred revenues   | 3,058            | 4,535            |
| <b>Total current liabilities</b>  | <b>8,824</b>     | <b>13,408</b>    |
| <b>LONG-TERM LIABILITIES:</b>   |                  |                  |
| Long-term deferred revenues   | 694              | 492              |
| Earn-out consideration  | -                | 6,409            |
| Deferred tax liability  | -                | 3,187            |
| Accrued severance pay   | 1,192            | 915              |
| <b>Total long-term liabilities</b>  | <b>1,886</b>     | <b>11,003</b>    |
| <b>COMMITMENTS AND CONTINGENCIES</b>  |                  |                  |
| <b>SHAREHOLDERS EQUITY:</b>   |                  |                  |
| Ordinary shares nominal value NIS 0.15 par value-   |                  |                  |
| Authorized: 55,353,340 shares as of December 31, 2011 and 2012; Issued: 27,287,909 and 27,915,392 shares as of December 31, 2011 and 2012, respectively; Outstanding: 24,093,617 and 25,826,234 shares as of December 31, 2011 and 2012, respectively | 960              | 986              |
| Additional paid-in capital  | 188,463          | 190,436          |
| Treasury shares 3,194,292 Ordinary shares as of December 31, 2011 and 2,089,158 ordinary shares as of December 31, 2012   | (8,692)          | (6,653)          |
| Accumulated other comprehensive income  | 23               | 469              |
| Accumulated deficit   | (151,930)        | (150,516)        |
| <b>Total shareholders equity</b>  | <b>28,824</b>    | <b>34,722</b>    |
| <b>Total liabilities and shareholders equity</b>  | <b>\$ 39,534</b> | <b>\$ 59,133</b> |

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

**COMMTouch SOFTWARE LTD.  
AND ITS SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF INCOME**  
U.S. dollars in thousands, except share and per share data

|   | <b>Year ended<br/>December 31,</b> |             |             |
|---|------------------------------------|-------------|-------------|
|   | <b>2010</b>                        | <b>2011</b> | <b>2012</b> |
| Revenues  | \$ 18,161                          | \$ 23,016   | \$ 23,910   |
| Cost of revenues  | 2,918                              | 4,091       | 4,350       |
| Gross profit  | 15,243                             | 18,925      | 19,560      |
| Operating expenses:   |                                    |             |             |
| Research and development, net   | 3,397                              | 5,410       | 6,281       |
| Sales and marketing   | 4,575                              | 5,486       | 5,860       |
| General and administrative  | 3,911                              | 4,721       | 6,639       |
| Total operating expenses  | 11,883                             | 15,617      | 18,780      |
| Operating income  | 3,360                              | 3,308       | 780         |
| Financial income (expenses), net  | (55)                               | (27)        | 80          |
| Income before taxes   | 3,305                              | 3,281       | 860         |
| Tax benefit   | 1,098                              | 1,317       | 625         |
| Net income  | \$ 4,403                           | \$ 4,598    | \$ 1,485    |
| Basic net earnings per share  | \$ 0.19                            | \$ 0.19     | \$ 0.06     |
| Diluted net earnings per share  | \$ 0.18                            | \$ 0.19     | \$ 0.06     |
| Weighted average number of shares used in computing basic net earnings per share    | 23,575,354                         | 23,620,171  | 24,610,267  |
| Weighted average numbers of shares used in computing diluted net earnings per share | 24,873,778                         | 24,654,458  | 25,140,439  |

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

**COMMTOUCH SOFTWARE LTD.  
AND ITS SUBSIDIARIES****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

U.S. dollars in thousands, except share and per share data

|  | 2010     | Year ended<br>December 31,<br>2011 | 2012     |
|--|----------|------------------------------------|----------|
| Net Income                               | \$ 4,403 | \$ 4,598                           | \$ 1,485 |
| Other comprehensive income:              |          |                                    |          |
| Foreign currency translation adjustments | -        | -                                  | 446      |
| Other comprehensive income               | \$ -     | \$ -                               | \$ 446   |
| Total comprehensive income               | \$ 4,403 | \$ 4,598                           | \$ 1,931 |

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## COMMTouch SOFTWARE LTD. AND ITS SUBSIDIARIES

STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY  
U.S. dollars in thousands, except share data

|  | Number of<br>Ordinary<br>shares | Ordinary<br>shares<br>amount | Additional<br>paid-in<br>capital | Treasury<br>stock | Accumulated<br>other<br>comprehensive<br>income *) | Accumulated<br>deficit | Total     |
|--|---------------------------------|------------------------------|----------------------------------|-------------------|--|------------------------|-----------|
| Balance as of January 1, 2010  | 23,958,761                      | \$ 926                       | \$ 183,731                       | \$ (4,872)        | \$ 23  | \$ (160,931)           | \$ 18,877 |
| Purchase of treasury shares  | (1,030,466)                     | -                            | -                                | (3,820)           | -  | -                      | (3,820)   |
| Issuance of shares upon exercise of options and warrants             | 577,418                         | 12                           | 785                              | -                 | -  | -                      | 797       |
| Stock-based compensation related to employees                        | -                               | -                            | 1,465                            | -                 | -  | -                      | 1,465     |
| Stock-based compensation related to options granted to non-employees | -                               | -                            | 31                               | -                 | -  | -                      | 31        |
| Net income   | -                               | -                            | -                                | -                 | -  | 4,403                  | 4,403     |
| Balance as of December 31, 2010                                      | 23,505,713                      | 938                          | 186,012                          | (8,692)           | 23   | (156,528)              | 21,753    |
| Issuance of shares upon exercise of options and warrants             | 587,904                         | 22                           | 1,238                            | -                 | -  | -                      | 1,260     |
| Stock-based compensation related to employees                        | -                               | -                            | 1,213                            | -                 | -  | -                      | 1,213     |
| Net income   | -                               | -                            | -                                | -                 | -  | 4,598                  | 4,598     |
| Balance as of December 31, 2011                                      | 24,093,617                      | 960                          | 188,463                          | (8,692)           | 23   | (151,930)              | 28,824    |
| Purchase of treasury shares  | (600,337)                       | -                            | -                                | (1,720)           | -  | -                      | (1,720)   |
| Issuance of shares upon exercise of options                          | 627,483                         | 26                           | 686                              | -                 | -  | -                      | 712       |
| Issuance of treasury shares upon acquisitions                        | 1,556,750                       | -                            | 104                              | 3,406             | -  | -                      | 3,510     |
| Issuance of treasury shares upon exercise of options                 | 148,721                         | -                            | (104)                            | 353               | -  | (71)                   | 178       |
| Stock based compensation related to options granted to non-employees | -                               | -                            | 11                               | -                 | -  | -                      | 11        |
| Other comprehensive income   | -                               | -                            | -                                | -                 | 446  | -                      | 446       |
| Stock-based compensation related to employees                        | -                               | -                            | 1,276                            | -                 | -  | -                      | 1,276     |
| Net income   | -                               | -                            | -                                | -                 | -  | 1,485                  | 1,485     |
| Balance as of December 31, 2012                                      | 25,826,234                      | \$ 986                       | \$ 190,436                       | \$ (6,653)        | \$ 469   | \$ (150,516)           | \$ 34,722 |

\*) Relates to foreign currency translation adjustments

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

## COMMTOUCH SOFTWARE LTD. AND ITS SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

|   | 2010           | Year ended<br>December 31,<br>2011 | 2012            |
|---|----------------|------------------------------------|-----------------|
| <b>Cash flows from operating activities:</b>  |                |                                    |                 |
| Net income  | \$ 4,403       | \$ 4,598                           | \$ 1,485        |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: |                |                                    |                 |
| Depreciation  | 520            | 545                                | 560             |
| Compensation related to options granted to employees and non-employees                      | 1,496          | 1,213                              | 1,287           |
| Amortization and impairment of intangible assets  | 158            | 1,005                              | 589             |
| Increase in deferred income taxes   | (1,096)        | (1,385)                            | (806)           |
| Capital gain from sale of equipment   | (9)            | -                                  | -               |
| <b>Changes in assets and liabilities:</b>   |                |                                    |                 |
| Decrease (increase) in trade receivables  | (1,036)        | 130                                | (2,194)         |
| Decrease (increase) in prepaid expenses and other accounts receivable                       | 287            | (79)                               | (541)           |
| Increase in accounts payable  | 138            | 17                                 | 300             |
| Increase in employees and payroll accruals, accrued expenses and other liabilities          | 163            | 981                                | (861)           |
| Decrease in deferred revenues   | (697)          | (390)                              | (164)           |
| Increase (decrease) in accrued severance pay, net   | (10)           | 66                                 | (2)             |
| <b>Net cash provided by (used in) operating activities</b>                                  | <b>4,317</b>   | <b>6,701</b>                       | <b>(347)</b>    |
| <b>Cash flows from investing activities:</b>  |                |                                    |                 |
| Decrease (Increase) in long-term lease deposits   | 22             | 1                                  | (17)            |
| Payment for business acquisitions, net of cash acquired                                     | (4,600)        | -                                  | (10,243)        |
| Investment in affiliate   | -              | -                                  | (176)           |
| Proceeds from sale of equipment   | 9              | -                                  | -               |
| Purchase of property and equipment  | (568)          | (526)                              | (805)           |
| <b>Net cash used in investing activities</b>  | <b>(5,137)</b> | <b>(525)</b>                       | <b>(11,241)</b> |

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

## COMMTouch SOFTWARE LTD. AND ITS SUBSIDIARIES

**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**U.S. dollars in thousands**

|   | 2010      | Year ended<br>December 31,<br>2011 | 2012     |
|---|-----------|------------------------------------|----------|
| <b>Cash flows from financing activities:</b>                    |           |                                    |          |
| Purchase of treasury shares at cost                             | (3,820)   | -                                  | (1,720)  |
| Contingent payment of acquisition                               | -         | -                                  | (3,400)  |
| Proceeds from options and warrants exercised                    | 797       | 1,260                              | 890      |
| Net cash provided by (used in) financing activities             | (3,023)   | 1,260                              | (4,230)  |
| Increase (decrease) in cash and cash equivalents                | (3,843)   | 7,436                              | (15,818) |
| Effect of exchange rate changes on cash                         | -         | -                                  | 87       |
| Cash and cash equivalents at the beginning of the year          | 17,275    | 13,432                             | 20,868   |
| Cash and cash equivalents at the end of the year                | \$ 13,432 | \$ 20,868                          | \$ 5,137 |
| <b><u>Supplemental disclosure of cash flows activities:</u></b> |           |                                    |          |
| <b><u>Cash paid during the year for:</u></b>                    |           |                                    |          |
| Taxes paid  | \$ -      | \$ 67                              | \$ 148   |
| <b><u>Non-cash transactions:</u></b>                            |           |                                    |          |
| Purchase of property and equipment - trade payables             | \$ (55)   | \$ (16)                            | (48)     |

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

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 1: GENERAL**

- a. Commtouch Software Ltd. ( Commtouch or the Company ) was incorporated under the laws of Israel in 1991. The Company and its subsidiaries develop and provide internet security solutions to OEM partners and enterprises. The Company's business is to develop and sell, through a variety of third party distribution channels, these solutions to various customers. The Company's messaging solutions are comprised of anti-spam, Zero-Hour Virus Outbreak Detection and GlobalView Mail Reputation solutions, its Web security solution is known as GlobalView URL filtering, and its antivirus solution is known as Command Antivirus. The Company operates in one reportable segment.
- b. The Company expects that it will continue to be dependent upon third-party distribution channels for a significant portion of its revenues, which are expected to be derived from sales of the Company's anti-spam, Zero-Hour, anti-virus, IP reputation, URL filtering solutions and Command Antivirus.
- c. On October 1, 2012, the Company completed the acquisition of the antivirus business of Frisk Software, an Incorporated Icelandic private limited company, or Frisk . The acquisition accelerated Commtouch's antivirus roadmap and enabled the Company to more quickly provide the most advanced antivirus technology utilizing the combined resources of both organizations. It also helps support the launch of private label antivirus solution for the OEM and service provider markets while also enhancing the company's Saas Capabilities.

The purchase price amounted to \$4,915 out of which \$2,200 was paid in cash at the closing date, \$1,678 was paid by issuance of 750,000 ordinary shares. An additional contingent consideration in an estimated fair value of \$1,037 will be paid based on future revenues. The earn out payment will be based on revenues for each of the years ended December 31, 2012 December 31, 2013 and December 31, 2014 and in respect of the First quarter of 2015.

The total purchase price was allocated to the net tangible and identifiable intangible assets on their estimated fair values at the acquisition date as set forth below. The excess of the purchase price over the net tangible and identifiable intangible assets was to goodwill. The value of goodwill is attributed to operational synergies between Commtouch and Frisk and to the strengthening of the Company's position in the market.

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

## NOTE 1: GENERAL (Cont.)

The following table summarizes the estimated fair values of the assets acquired and liabilities assumed:

|  |                 |
|--|-----------------|
| Cash                                   | \$ 202          |
| Trade receivables                      | 36              |
| Other receivables and prepaid expenses | 287             |
| Property and equipment                 | 64              |
| Other intangible assets                | 2,250           |
| Goodwill                               | 3,501           |
| <b>Total assets acquired</b>           | <b>6,340</b>    |
| Trade payables                         | (571)           |
| Deferred revenues                      | (565)           |
| Long-term deferred tax liabilities     | (289)           |
| <b>Total liabilities assumed</b>       | <b>(1,425)</b>  |
| <b>Net assets acquired</b>             | <b>\$ 4,915</b> |

Intangible assets that are subject to amortization are amortized over their estimated useful lives using the straight-line method at an annual weighted average rate of 8%. The following table sets forth the components of intangible assets associated with the acquisition and their annual rates of amortization:

|                                | Fair value      | %   |
|--------------------------------|-----------------|-----|
| Trademark                      | \$ 984          | 10  |
| Intellectual Property          | 1,266           | 6.7 |
| <b>Total intangible assets</b> | <b>\$ 2,250</b> |     |

## d. Acquisition of Eleven GMBH:

On November 16, 2012, the Company completed the acquisition of Eleven GMBH, Germany based company, or Eleven .

Eleven is well known throughout Germany as the leading provider of mail - based security as a service (SecaaS) solutions.

The acquisition of eleven enables Commtouch to accelerate delivery of private label cloud - based security solutions specifically designed for OEM and service provider markets. In addition, Commtouch's global reach should accelerate sales and adoption of this leading security technology developed by eleven.

The purchase price amounted to \$22,293 out of which, \$11,543 was paid in cash at the closing date.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

U.S. dollars in thousands, except share and per share data

**NOTE 1: GENERAL (Cont.)**

\$1,832 was paid by issuance of 806,750 ordinary shares. An additional contingent consideration in an estimated fair value of \$8,918 will be paid based on the business revenues from 2012 to 2015.

The total purchase price was allocated to the company's business net tangible and identifiable assets based on their estimated fair values at the acquisition date as set forth below. The excess of the purchase price over the net tangible and identifiable intangible assets was assigned to goodwill. The value of goodwill is attributed to synergies between Commtouch and Eleven's services and the strength of the Company's position in the market.

The following table summarizes the estimated fair values of the assets acquired and liabilities assumed:

|  |           |                |
|--|-----------|----------------|
| Cash                                   | \$        | 3,297          |
| Trade receivables                      |           | 846            |
| Other receivables and prepaid expenses |           | 252            |
| Property and equipment                 |           | 449            |
| Other intangible assets                |           | 9,100          |
| Goodwill                               |           | 14,732         |
| <b>Total assets acquired</b>           |           | <b>28,676</b>  |
| Trade payables                         |           | (128)          |
| Employees and payroll accruals         |           | (194)          |
| Accrued expenses and other liabilities |           | (2,313)        |
| Deferred revenues                      |           | (844)          |
| Long-term deferred tax liabilities     |           | (2,904)        |
| <b>Total liabilities assumed</b>       |           | <b>(6,383)</b> |
| <b>Net assets acquired</b>             | <b>\$</b> | <b>22,293</b>  |

The Intangible assets that are subject to amortization are amortized over their estimated useful lives using the straight-line method at an annual weighted average rate of 10%, except for customer relations which is amortized on an accelerated basis.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

**NOTE 1: GENERAL (Cont.)**

The following table sets forth the components of intangible assets associated with the acquisition and their annual rates of amortization:

|                                | Fair value      | %                  |
|--------------------------------|-----------------|--------------------|
| Trademark                      | 671             | 10                 |
| Customer relations             | 3,037           | Accelerated method |
| Technology                     | 4,611           | 10                 |
| In Process R&D *               | 781             | (*)                |
| <b>Total intangible assets</b> | <b>\$ 9,100</b> |                    |

(\*) The In Process R&D will be amortized when the development will be completed.

Unaudited pro forma condensed results of income:

The following represents the unaudited pro forma condensed results of income for the years ended December 31, 2012 and 2011, assuming that the acquisition occurred on January 1, 2011. The pro forma information is not necessarily indicative of the results of operations that would have actually occurred had the acquisition been consummated on those dates, nor does it purport to represent the results of income for future periods.

|                                | Year ended<br>December 31, |                   |
|--------------------------------|----------------------------|-------------------|
|                                | 2011<br>Unaudited          | 2012<br>Unaudited |
| Revenues                       | \$ 31,748                  | \$ 31,203         |
| Net income                     | \$ 4,102                   | \$ 1,048          |
| Basic net earnings per share   | \$ 0.17                    | \$ 0.04           |
| Diluted net earnings per share | \$ 0.16                    | \$ 0.04           |

f. Acquisitions in previous years:

In 2010, the Company completed the acquisition of the assets of the Antivirus business of Authentium Inc. (subsequently known as SafeCentral Inc.). Total fair value of purchase consideration for the acquisitions was \$ 7,431, which includes cash paid and estimated fair value of earn-out payment. In connection with this acquisition, the Company recorded intangibles and goodwill in the amounts of \$ 4,663 and \$ 3,792, respectively. In 2012, the Company paid an additional amount of \$ 3,400 based on the Antivirus business's 2011 revenues.

**COMMTOUCH SOFTWARE LTD.  
AND ITS SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 2: SIGNIFICANT ACCOUNTING POLICIES**

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

a. Use of estimates:

The preparation of consolidated financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates. On an ongoing basis, the Company s management evaluates estimates. Such estimates are based on historical experience and on various other assumptions that are believed to be reasonable, the results of which form the basis for making judgments about the carrying values of assets and liabilities.

b. Financial statements in U. S. dollars:

The currency of the primary economic environment in which the operations of Commtouch and certain subsidiaries are conducted is the U.S. dollar ( dollar ); thus, the dollar is the functional currency of Commtouch and certain subsidiaries.

Commtouch and certain subsidiaries transactions and balances denominated in dollars are presented at their original amounts. Non-dollar transactions and balances have been re-measured to dollars in accordance with ASC 830, Foreign Currency Matters . All transaction gains and losses from re-measurement of monetary balance sheet items denominated in non-dollar currencies are reflected in the statements of income as financial income or expenses, as appropriate.

For those subsidiaries whose functional currency has been determined to be their local currency, assets and liabilities are translated at year-end exchange rates and statement of income items are translated at average exchange rates prevailing during the year. Such translation adjustments are recorded as a separate component of accumulated other comprehensive income (loss) in shareholders equity.

c. Principles of consolidation:

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

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 when purchased.

**COMMTouch SOFTWARE LTD.  
AND ITS SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

U.S. dollars in thousands, except share and per share data

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

## e. Restricted cash:

The Company maintains certain cash amounts restricted as to withdrawal or use. On December 31, 2012, the Company maintained a balance of \$122 that represents security deposits with respect to leases, restricted due to the lease agreement and security deposits for credit lines from banks. Restricted cash is presented within the prepaid expenses and other accounts receivable balance.

## f. Investment in affiliates:

The Company's investments in affiliated companies comprises of investments in which the Company owns less than 20% and in which the Company cannot exercise significant influence over the affiliates' operating and financial policies are stated at cost.

The Company's investments are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an investment may not be recoverable. As of December 31, 2012 and 2011, the Company's investments are accounted for on a cost basis and no impairment losses have been identified.

## g. Property and equipment:

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

|                                    | %   |
|------------------------------------|---|
| Computers and peripheral equipment | 33.33   |
| Office furniture and equipment     | 7 - 20  |
| Motor vehicles                     | 15  |
| Leasehold improvements             | Over the shorter of the term of the lease or the life of the assets |

## Impairment of long-lived assets:

The Company and its subsidiaries long-lived assets and certain identifiable intangibles are reviewed for impairment in accordance with ASC 360 Property, Plant and Equipment, 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. No impairment losses were recorded in 2010 through 2012.

COMMTouch SOFTWARE LTD.  
AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

h. Goodwill:

Goodwill and certain other purchased intangible assets have been recorded as a result of acquisitions made in 2010 and in 2012. Goodwill represents the excess of the purchase price in a business combination over the fair value of net tangible and intangible assets acquired. Goodwill is not amortized, but rather is subject to an impairment test. The Company performs an annual impairment test at December 31, of each fiscal year, or more frequently if impairment indicators are present. The Company operates in one operating segment, and this segment comprises its only reporting unit.

ASC 350 prescribes a two-phase process for impairment testing of goodwill. The first phase screens for impairment, while the second phase (if necessary) measures impairment. Goodwill impairment is deemed to exist if the net book value of a reporting unit exceeds its estimated fair value determined using market capitalization. In such case, the second phase is then performed, and the Company measures impairment by comparing the carrying amount of the reporting unit's goodwill to the implied fair value of that goodwill. An impairment loss is recognized in an amount equal to the excess. For each of the three years in the period ended December 31, 2012, no impairment losses have been identified.

i. Intangible assets:

Intangible assets that are not considered to have an indefinite useful life are amortized over their estimated useful lives, which range from 8 to 15 years. Acquired customer contracts and relationships are amortized over their estimated useful lives in proportion to the economic benefits realized. This accounting policy results in accelerated amortization of such customer contracts and relationships arrangements as compared to the straight-line method. Technology & IP and Trademark are amortized over their estimated useful lives on a straight-line basis.

The IP R&D will be amortized to cost of goods sold when the acquired technology development will be completed.

The carrying amount of these assets to be held and used is reviewed whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable. Recoverability of these assets is measured by comparison of the carrying amount of each asset (or asset group) to the future undiscounted cash flows the asset (or asset group) is expected to generate. If the asset is considered to be impaired, the amount of any impairment is measured as the difference between the carrying value and the fair value of the impaired asset.

During 2012 and 2010, no impairment losses have been identified. In 2011, impairment losses of \$502 were recorded in respect of covenants not to compete.

COMMTouch SOFTWARE LTD.  
AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

j. Fair value measurements:

Concurrently with the adoption of ASC 820, the Company adopted ASC Topic 825, Financial Instruments, (ASC 825) which permits entities to elect, at specified election dates, to measure eligible financial instruments at fair value. As of December 31, 2011 and 2012, the Company did not elect the fair value option under ASC 825 for any financial assets and liabilities that were not previously measured at fair value.

The carrying amounts of cash and cash equivalents, trade receivables, prepaid expenses, other accounts receivable and accounts payable, approximate their fair values due to the short-term maturities of financial instruments.

k. Revenue recognition:

The Company derives its revenues from the delivery of services of real-time Inbound Anti-Spam, Outbound Spam Protection for service providers, Zero-Hour Virus Outbreak Detection, GlobalView Mail Reputation, Command Antivirus, GlobalView URL Filtering and recently from Email Security SaaS (which is comprised of inbound and outbound anti-spam, plus antivirus) and Email Security On-Premise.

Revenue is recognized when there is a persuasive evidence of an arrangement, the service has been rendered, the collection of the fee is probable and the amount of fees to be paid by the customer is fixed or determinable.

Revenues from such services are recognized ratably over the contractual service term, which generally includes a term period of one to three years.

Deferred revenues include unearned amounts received from customers, but not yet recognized as revenues.

l. Research and development costs:

Research and development costs are charged to statements of income as incurred.

ASC 985-20, Costs of Software to be Sold, Leased or Marketed, requires capitalization of certain software development costs subsequent to the establishment of technological feasibility.

Based on the Company's product development process, technological feasibility is established upon completion of a working model. Costs incurred by the Company between completion of the working models and the point at which the products are ready for general release, have been insignificant. Therefore, all research and development costs have been expensed.

**COMMTouch SOFTWARE LTD.  
AND ITS SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

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

m. Government grants:

Royalty-bearing grants from the Government of Israel for funding certain approved research and development projects are recognized at the time the Company is entitled to such grants, on the basis of the related costs incurred and recorded as a deduction of research and development costs. Research and development grants from the Government of Israel amounted to \$257, \$131 and \$774 in 2012, 2011 and 2010, respectively. See Note 5a.

n. Concentrations of credit risk:

The Company and its subsidiaries have no significant off-balance-sheet concentration of credit risk.

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

The trade receivables of the Company are derived from transactions with companies located primarily in North America, Europe, Israel and Asia. An allowance for doubtful accounts is determined with respect to those amounts that the Company and its subsidiaries have determined to be doubtful of collection. The provision for doubtful accounts amounted to \$32 and \$462 at December 31, 2011 and 2012 respectively. Bad debt expense for each of the years ended December 31, 2010, 2011 and 2012 was \$77, \$7 and \$456, respectively.

o. Accounting for stock-based compensation:

ASC 718 - Compensation-stock Compensation - ( ASC 718 ) requires companies to estimate the fair value of equity-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as an expense over the requisite service periods in the Company's consolidated statements of income.

The Company recognizes compensation expense for the value of its awards on a straight line basis over the requisite service period of each of the awards, net of estimated forfeitures. Estimated forfeitures are based on actual historical pre-vesting forfeitures. ASC 718 requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.



**COMMTouch SOFTWARE LTD.  
AND ITS SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

U.S. dollars in thousands, except share and per share data

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

The Company estimates the fair value of stock options granted using the Black-Scholes option-pricing model. The option-pricing model requires a number of assumptions, of which the most significant are the expected stock price volatility and the expected option term. Expected volatility was calculated based upon actual historical stock price movements. The expected term of options granted represents the period of time that options granted are expected to be outstanding, based upon historical experience. The risk-free interest rate is based on the yield from U.S. treasury bonds with an equivalent term. The Company has historically not paid dividends and has no foreseeable plans to pay dividends.

The Company applies ASC 718, and ASC 505-50, Equity Based Payments to Non Employees ( ASC 505-50 ), with respect to options issued to non-employees.

The fair value for options granted in 2010, 2011 and 2012 is estimated at the date of grant using a Black-Scholes options pricing model with the following assumptions:

| <b>Employee stock options</b> | <b>2010</b> | <b>Year ended<br/>December 31,<br/>2011</b> | <b>2012</b> |
|-------------------------------|-------------|---|-------------|
| Volatility                    | 71%-73%     | 68%-70%                                     | 38%-51%     |
| Risk-free interest rate       | 1.1%-1.6%   | 0.6%-2.1%                                   | 0.5%-0.9%   |
| Dividend yield                | 0%          | 0%  | 0%          |
| Expected term (years)         | 3.7-4.6     | 3.6-4.8                                     | 3.8-4.9     |

p. Basic and diluted net earnings per share:

Basic and diluted net earnings per share are presented in accordance with ASC 260, Earnings per Share , for all periods presented.

Basic net earnings per share have been computed using the weighted-average number of Ordinary shares outstanding during the year. Diluted net earnings per share is computed based on the weighted average number of Ordinary shares outstanding during each year, plus the weighted average number of dilutive potential Ordinary shares considered outstanding during the year.

In 2010, 2011 and 2012, the difference between the denominator of basic and diluted net earnings per share is due to the effect of dilutive securities for stock options and warrants. In 2010, 2011 and 2012 1,211,247, 1,034,288 and 530,172, respectively, weighted average number of shares related to options and warrants outstanding were excluded from calculation of the diluted earnings per share since they would have an anti-dilutive effect.

COMMTouch SOFTWARE LTD.  
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

q. Severance pay:

The Company's liability for severance pay in Israel is calculated pursuant to Israel's 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 obligation for all of its Israeli employees is fully provided by monthly deposits with severance pay funds and insurance policies, and by an accrual. The value of those funds and policies is recorded as an asset in the Company's balance sheet.

The deposited funds include profits and losses accumulated up to the balance sheet date. The deposited funds may be withdrawn only upon the fulfillment of the obligation pursuant to Israel's Severance Pay Law or labor agreements. The value of the deposited funds is based on the cash surrendered value of these policies.

Severance expense (income) for the years ended December 31, 2010, 2011 and 2012 was approximately \$ (10), \$ 66 and \$ (2), respectively.

r. Treasury shares:

The Company repurchases its Ordinary shares from time to time on the open market and holds such shares as Treasury shares. The Company presents the cost to repurchase Treasury shares as a reduction in shareholders' equity.

The Company reissues treasury shares under the stock purchase plan, upon exercise of option and upon issuance of shares upon acquisitions. Reissuance of treasury shares is accounted for in accordance with ASC 505-30 whereby gains are credited to additional paid-in capital and losses are charged to additional paid-in capital to the extent that previous net gains are included therein; otherwise to retained earnings.

s. Income taxes:

The Company accounts for income taxes in accordance with ASC 740, Income Taxes (ASC 740). ASC 740 prescribes the use of the liability method whereby deferred tax asset and liability account balances are determined based on differences between financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. The Company provides a valuation allowance, if necessary, to reduce deferred tax assets to amounts more likely than not to be realized.

Deferred tax assets are classified as current or non-current based on the classification of the related asset or liability for financial reporting, or according to the expected reversal dates of the specific temporary differences if not related to an asset or liability for financial reporting.

**COMMTouch SOFTWARE LTD.  
AND ITS SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**U.S. dollars in thousands, except share and per share data**

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

ASC 740 contains a two-step approach to recognizing and measuring a liability for uncertain tax positions. The first step is to evaluate the tax position taken or expected to be taken in a tax return by determining if the weight of available evidence indicates that it is more likely than not that, on an evaluation of the technical merits, the tax position will be sustained on audit, including resolution of any related appeals or litigation processes. The second step is to measure the tax benefit as the largest amount that is more than 50% likely to be realized upon ultimate settlement. No liability for unrecognized tax benefits was recorded as a result of the implementation of ASC 740.

t. Comprehensive income:

The Company accounts for comprehensive income in accordance with ASC No. 220, Comprehensive Income. Comprehensive income generally represents all changes in shareholders' equity during the period except those resulting from investments by, or distributions to, shareholders. The Company determined that its items of other comprehensive income relate to gains and losses from functional currency translation adjustments on behalf of subsidiaries whose functional currency has been determined to be their local currency.

u. Recently issued accounting pronouncements:

In February 2013, the FASB issued ASU No. 2013-02, Reporting of Amounts Reclassified out of Accumulated Other Comprehensive Income. Under ASU 2013-02, an entity is required to provide information about the amounts reclassified out of Accumulated Other Comprehensive Income (AOCI) by component. In addition, an entity is required to present, either on the face of the financial statements or in the notes, significant amounts reclassified out of AOCI by the respective line items of net income, but only if the amount reclassified is required to be reclassified in its entirety in the same reporting period. For amounts that are not required to be reclassified in their entirety to net income, an entity is required to cross-reference to other disclosures that provide additional details about those amounts. ASU 2013-02 does not change the current requirements for reporting net income or other comprehensive income in the financial statements. ASU 2013-02 is effective for the Company as of January 1, 2013. Since this standard only impacts presentation and disclosure requirements, its adoption will not have a material impact on the Company's consolidated results of operations or financial condition.

**COMMTouch SOFTWARE LTD.  
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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

U.S. dollars in thousands, except share and per share data

**NOTE 3: PROPERTY AND EQUIPMENT, NET**

|                                    | <b>December 31</b> |             |
|------------------------------------|--------------------|-------------|
|                                    | <b>2011</b>        | <b>2012</b> |
| <b>Cost:</b>                       |                    |             |
| Computers and peripheral equipment | \$ 4,717           | \$ 5,848    |
| Office furniture and equipment     | 640                | 848         |
| Motor vehicles                     | 45                 | 10          |
| Leasehold improvements             | 1,195              | 1,225       |
|                                    | 6,597              | 7,931       |
| Less accumulated depreciation      | (5,712)            | (6,323)     |
| Property and Equipment, net        | \$ 885             | \$ 1,608    |

Depreciation expense amounted to approximately \$520, \$545 and \$560 in 2010, 2011 and 2012, respectively.

**NOTE 4:- INTANGIBLE ASSETS, NET**

- a. Definite-lived other intangible assets:

|                                      | <b>December 31,</b> |             |
|--------------------------------------|---------------------|-------------|
|                                      | <b>2011</b>         | <b>2012</b> |
| <b>Original amounts:</b>             |                     |             |
| Customer contracts and relationships | \$ 2,476            | \$ 5,614    |
| Technology                           | 1,546               | 7,576       |
| Covenants not-to-compete             | 646                 | -           |
| Trademarks                           | -                   | 1,677       |
| In Process R&D                       | -                   | 807         |
|                                      | 4,668               | 15,674      |
| <b>Accumulated amortization:</b>     |                     |             |
| Customer contracts and relationships | 260                 | 542         |
| Technology                           | 257                 | 531         |
| Covenants not-to-compete             | (*)646              | -           |
| Trademarks                           | -                   | 33          |
| In Process R&D                       | -                   | -           |
|                                      | 1,163               | 1,106       |
| Other intangible assets, net         | \$ 3,505            | \$ 14,568   |

(\*) Includes write-off of covenants not-to-compete of \$502 for the year ended December 31, 2011.

**COMMTOUCH SOFTWARE LTD.  
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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

U.S. dollars in thousands, except share and per share data

**NOTE 4:- INTANGIBLE ASSETS, NET (Cont.)**

- b. Amortization expense amounted to \$ 158, \$ 503 and \$ 589 for 2010, 2011 and 2012, respectively.

**NOTE 5:- GOODWILL**

The changes in the carrying amount of goodwill for the year ended December 31, 2011 and 2012 are as follows:

|   | <b>Year ended<br/>December 31,</b> |             |
|---|------------------------------------|-------------|
|   | <b>2011</b>                        | <b>2012</b> |
| Balance at the beginning of the year        | \$ 3,792                           | \$ 3,792    |
| Acquisitions                                | -                                  | 18,232      |
| Functional currency translation adjustments | -                                  | 494         |
| Balance at the year end                     | \$ 3,792                           | \$ 22,518   |

**NOTE 6: COMMITMENTS AND CONTINGENCIES**

- a. Commtouch Software Ltd., which was incorporated in Israel, partially financed its research and development expenditures under programs sponsored by the Office of Chief Scientist ( OCS ) for the support of certain research and development activities conducted in Israel.

In connection with its research and development, the Company received \$ 1,354 of participation payments from the OCS. In return for the OCS's participation, the Company is committed to pay royalties at a rate of 3% of sales of the developed product, up to 100% of the amount of grants received (100% plus interest at LIBOR). The Company's total commitment for royalties payable with respect to future sales, based on OCS participations received or accrued, net of royalties paid or accrued, totaled approximately \$ 1,210 as of December 31, 2012. For the years ended December 31, 2012, 2011 and 2010, the amounts of \$ 58, \$ 61 and \$ 17, respectively, were recorded as cost of revenues with respect to royalties due to the OCS.

- b. Operating leases:

The Company leases its facility in Israel under an operating lease agreement expiring on April 30, 2018. The subsidiaries in Iceland and Germany lease their facilities in Iceland and in Germany under operating lease agreements expiring on September 30, 2016 and December 31, 2015, respectively.

**COMMTOUCH SOFTWARE LTD.  
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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 6: COMMITMENTS AND CONTINGENCIES (Cont.)**

The US subsidiary leases its facilities in California, Florida and Washington D.C under operating lease agreements expiring on April 16, 2016, August 31, 2013 and February 28, 2015, respectively

Facilities rent expense for 2010, 2011 and 2012 was approximately \$352, \$410 and \$531, respectively.

Annual minimum future lease payments due under the above agreements (and motor vehicle leases, which expire in 2013), at the exchange rate in effect on December 31, 2012, are approximately as follows:

|      |          |
|------|----------|
| 2013 | \$ 1,033 |
| 2014 | 952      |
| 2015 | 835      |
| 2016 | 461      |
| 2017 | 330      |
| 2018 | 110      |
|      | \$ 3,721 |

- c. (1) During late 2010, one of the Company's customers, among others, was named as a defendant in a patent infringement claim in a United States District Court involving four distinct patents. In September 2011, the Company received an indemnification notification from the customer indicating that one or two of those patents may relate to Commtouch technology, and the customer was reserving its rights. During early 2013, the Company learned that its customer is negotiating a settlement of the matter, and the Company has been asked to contribute a portion towards the settlement. It is too early in the negotiations process to anticipate the outcome of the settlement negotiations and the Company possible contribution towards any final settlement.
- (2) In December 2012, the U.S. subsidiary of the Company filed a lawsuit in the Superior Court of the State of California against one of its customers. The lawsuit includes a claim for breach of contract. In mid-April 2013, the customer filed its formal answer and a cross-complaint to the Company's complaint. The Company's lawsuit alleges damages in excess of \$7,000, while the customer's cross-complaint does not set forth a fixed amount that it is seeking. It is expected that the discovery phase of the litigation will commence in the near future.

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**COMMTouch SOFTWARE LTD.  
AND ITS SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 7: SHAREHOLDERS EQUITY**

a. General:

Ordinary shares confer upon their holders the right to receive notice to participate and vote in general shareholder meetings of the Company and to receive dividends, if declared.

b. Employee stock options:

In 1996, the Company adopted the 1996 CSI Stock Option Plan for granting options to its U.S. employees and consultants to purchase Ordinary shares of the Company, which was replaced in 2006 by the 2006 U.S. Stock Option Plan. Until 1999, the Company issued options to purchase Ordinary shares to its Israeli employees pursuant to individual agreements. In 1999, the Company approved the 1999 Section 3(i) share option plan for its Israeli employees and consultants, (which was amended in 2003 and renamed the Amended and Restated Israeli Share Option Plan ). As of December 31, 2011, an aggregate of 1,544,033 Ordinary shares of the Company are still available for future grant to employees and directors.

Options granted under such plans and agreements through September 2005, generally expire after ten years from the date of grant and options granted after September 2005 generally expire six-years from the date of grant. Options cease vesting upon termination of the optionee's employment or other relationship with the Company. The options generally vest over a period of four years. The exercise price of the options granted under the individual agreements may not be less than the nominal value of the shares into which such options are exercisable. Any options that are canceled or not exercised within the option term become available for future grant.

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**COMMTouch SOFTWARE LTD.  
AND ITS SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

U.S. dollars in thousands, except share and per share data

**NOTE 7: SHAREHOLDERS EQUITY (Cont.)**

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

|  | Number of<br>options<br>2012 | Weighted<br>average<br>exercise price<br>2012 | Aggregate<br>intrinsic<br>value<br>2012 |
|--|------------------------------|---|---|
| Outstanding at the beginning of the year                       | 4,032,681                    | \$ 3.06                                       | \$ 2,554                                |
| Granted  | 1,716,552                    | 2.65  |   |
| Exercised  | (738,995)                    | 1.05  |   |
| Expired and forfeited  | (1,018,770)                  | 3.92  |   |
| Outstanding at the end of the year                             | 3,991,468                    | \$ 3.03                                       | \$ 1,525                                |
| Options vested and expected to vest at the end of the year     | 3,800,579                    | \$ 3.03                                       | \$ 1,462                                |
| Exercisable options at the end of the year                     | 1,401,584                    | \$ 3.28                                       | \$ 727                                  |
| Weighted average fair value of options granted during the year | -                            | \$ 2.88                                       | -                                       |

The aggregate intrinsic value of the Company's options is the difference between (i) the Company's closing share price on the last trading day of the fiscal year 2012 and (ii) the exercise price, times the number of options.

As of December 31, 2012, the Company had approximately \$3,174 of unrecognized compensation expense related to non-vested stock options, expected to be recognized over a period of 4.25 years.



COMMTouch SOFTWARE LTD.  
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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

## NOTE 7: SHAREHOLDERS EQUITY (Cont.)

The options outstanding as of December 31, 2012, have been separated into ranges of exercise prices, as follows:

| Exercise price per share | Options outstanding | Weighted average remaining contractual life in years | Weighted average price per share | Options exercisable | Weighted average exercise price per share of exercisable options |
|--------------------------|---------------------|--|----------------------------------|---------------------|--|
| \$0.93-\$1.89            | 283,784             | 1.93   | \$ 1.33                          | 283,784             | \$ 1.33  |
| \$1.93-\$2.44            | 778,219             | 5.22   | 2.35                             | 148,125             | 1.98   |
| \$2.46-\$2.92            | 956,500             | 4.74   | 2.64                             | 162,500             | 2.74   |
| \$3.12-\$3.14            | 36,948              | 4.38   | 3.17                             | 29,325              | 3.17   |
| \$3.16-\$3.18            | 248,000             | 5.13   | 3.16                             | -                   | -  |
| \$3.21-\$3.28            | 555,000             | 4.81   | 3.21                             | 161,858             | 3.21   |
| \$3.41-\$3.69            | 583,000             | 4.72   | 3.44                             | 173,517             | 3.46   |
| \$3.75-\$4.35            | 319,337             | 3.2  | 3.9                              | 211,795             | 3.91   |
| \$4.69-\$6.6             | 230,680             | 0.87   | 6.25                             | 230,680             | 6.25   |
|                          | 3,991,468           | 4.31   | \$ 3.03                          | 1,401,584           | \$ 3.28  |

## d. Directors stock option plan:

In 1999, the Company adopted the 1999 Directors Stock Option Plan, and in 2008 shareholders approved an extension of the term of this plan through July 13, 2019. The original allotment of ordinary shares to this plan was 1,263,333. On December 15, 2006, the Company combined the remaining pool of options in the employee stock option plans reserve with the amount of options remaining in the Directors Stock Option Plan reserve.

Since the annual meeting of shareholders in 2003, new directors joining the Board are entitled to a grant of 50,000 options. Directors who are re-elected at the annual meeting of shareholders are entitled to additional grants of 16,667 options, though at the annual meeting held October 26, 2009 shareholders approved a one-time increase in the grants to re-elected directors to 30,000 options.

Each option granted under the Directors Stock Option Plan becomes exercisable at a rate of 1/16th of the shares every three months. Each option has an exercise price equal to the fair market value of the Ordinary shares on the grant date of such option. Until September 2005, each option granted had a maximum term of ten years, but since September 2005, the term of granted options is six years. Options will terminate earlier if the optionee ceases to be a member of the Board of Directors.

**COMMTouch SOFTWARE LTD.  
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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

U.S. dollars in thousands, except share and per share data

**NOTE 7: SHAREHOLDERS EQUITY (Cont.)**

On January 1, 2012, 1,047,827 options were outstanding under the Directors Stock Option Plan. During 2012, the Company granted 166,669 options to Directors at a weighted average exercise price at \$3.17 per share. The weighted average fair value of options granted during the year is \$1.39. During the year, 37,209 options were exercised at a weighted average exercise price at \$3.16 per share. As of December 31, 2012, 696,848 options were vested and unexercised and 1,131,885 were outstanding under the Directors Stock Option Plan.

- e. Options to non-employees:

| Issuance date     | Options<br>granted for<br>Ordinary<br>Shares | Exercise<br>price per<br>share | Options<br>exercisable | Exercisable<br>through |
|-------------------|--|--------------------------------|------------------------|------------------------|
| May 2006-2008     | 33,334                                       | \$ 3.21-\$5.73                 | 33,334                 | May 2013               |
| February 16, 2012 | 53,000                                       | \$ 3.16                        | 11,594                 | February 2016          |
|                   | 86,334                                       |                                | 44,928                 |                        |

The options vest and become exercisable at a rate of 1/16 of the options every three months. The Company has accounted for this grant under the fair value method of ASC 505-50. The fair value for these options was estimated using a Black-Scholes option-pricing model. Compensation expense for 2010, 2011 and 2012 amounted to \$31, \$0 and \$11, respectively.

As of December 31, 2012, the Company had approximately \$40 of unrecognized compensation expense related to non-vested stock options, expected to be recognized over a period of up to four years.

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**COMMTouch SOFTWARE LTD.  
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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

U.S. dollars in thousands, except share and per share data

**NOTE 7: SHAREHOLDERS EQUITY (Cont.)**

- g. Total stock-based compensation expenses recognized in 2010, 2011 and 2012:

The total stock-based compensation expense related to all of the Company's equity-based awards, recognized for the years ended December 31, 2010, 2011 and 2012, was comprised as follows:

|                            | 2010     | Year ended<br>December 31,<br>2011 | 2012     |
|----------------------------|----------|------------------------------------|----------|
| Cost of revenues           | \$ 38    | \$ 24                              | \$ 51    |
| Research and development   | 316      | 294                                | 229      |
| Selling and marketing      | 373      | 355                                | 195      |
| General and administrative | 769      | 540                                | 812      |
|                            | \$ 1,496 | \$ 1,213                           | \$ 1,287 |

**NOTE 8: INCOME TAXES**

- a. Corporate tax structure:

The Israeli corporate tax rate was 25% in 2010, 24% in 2011 and 25% in 2012 and onwards.

- b. Tax benefits under Israel's Law for the Encouragement of Industry (Taxation), 1969:

The Company may currently qualify as an industrial company within the definition of the Law for the Encouragement of Industry (Taxation), as such, it may be eligible for certain tax benefits, including, inter alia, special depreciation rates for machinery, equipment and buildings, amortization of patents, certain other intangible property rights and deduction of share issuance expenses.

- c. Net operating loss carryforwards:

As of December 31, 2012, the Company's net operating loss carryforwards for tax purposes amounted to approximately \$70,008 (including capital loss carryforward of \$15,659) which may be carried forward and offset against taxable income in the future, for an indefinite period.

As of December 31, 2012, for federal income tax purposes, the U.S. subsidiary had net operating loss carry-forwards of approximately \$91,755 (including capital loss carryforwards of \$1,700). These losses may offset any future U.S. taxable income of the U.S. subsidiary and will expire in the years 2012 through 2025.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

U.S. dollars in thousands, except share and per share data

**NOTE 8: INCOME TAXES (Cont.)**

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

Management currently believes that since the Company has a history of losses, and uncertainty with respect to future taxable income, it is more likely than not that some of the deferred tax assets regarding the loss carry forwards will not be utilized in the foreseeable future. Thus, a valuation allowance was provided to reduce deferred tax assets to their realizable value.

## d. Deferred income taxes:

Deferred 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. As of December 31, 2011 and 2012, the Company's deferred taxes were in respect of the following:

|  | <b>December 31,</b> |             |
|--|---------------------|-------------|
|  | <b>2011</b>         | <b>2012</b> |
| <b>Deferred tax assets:</b>                    |                     |             |
| Net operating loss carry-forwards              | \$ 50,234           | \$ 48,709   |
| Capital loss carry-forwards                    | 4,487               | 4,578       |
| Reserves and allowances                        | 192                 | 183         |
| Deferred revenues                              | 244                 | 188         |
| Intangibles, Property and Equipment            | 116                 | 76          |
| Research and development costs                 | 672                 | 878         |
| Deferred tax assets before valuation allowance | 55,945              | 54,612      |
| Valuation allowance                            | (51,060)            | (49,025)    |
| Deferred tax asset                             | \$ 4,885            | \$ 5,587    |
| <b>Domestic:</b>                               |                     |             |
| Current deferred tax asset, net                | \$ 1,572            | \$ 1,569    |
| Non-current deferred tax asset, net            | 2,485               | 2,352       |
|  | 4,057               | 3,921       |
| <b>Foreign:</b>                                |                     |             |
| Current deferred tax asset, net                | 424                 | 670         |
| Non-current deferred tax asset, net            | 404                 | 996         |
|  | 828                 | 1,666       |
|  | \$ 4,885            | \$ 5,587    |
| <b>Deferred tax liabilities:</b>               |                     |             |
| Acquired intangibles                           | -                   | (3,187)     |
| Deferred tax liabilities                       | \$ -                | \$ (3,187)  |



**COMMTOUCH SOFTWARE LTD.  
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U.S. dollars in thousands, except share and per share data

**NOTE 8: INCOME TAXES (Cont.)**

- e. For the year ended December 31, 2010, the main reconciling items between the statutory tax rate of the Company and the effective tax rate are the non-recognition of the benefits from accumulated net operating loss carry forward due to the uncertainty of the realization of such tax benefits, as well as utilization of deferred tax asset of approximately \$500 during 2010, offset by a recognition of a deferred tax asset of approximately \$1,600 in respect of net operating loss carry-forwards and temporary differences that are more likely than not to be realized in the foreseeable future.

For the year ended December 31, 2011, the main reconciling items between the Company's statutory tax rate and the effective tax rate relates to changes in valuation allowance due to utilization of net operating loss carry forwards, recognition of net operating loss carry forward due to certainty of future realization of taxable income, and an increase in the Israeli tax rate (which resulted in an increase in the deferred tax asset), offset by increase in the exchange rate of the US dollars compared to the New Israeli Shekel.

For the year ended December 31, 2012, the main reconciling items between the Company's statutory tax rate and the effective tax rate relates to changes in valuation allowance due to utilization of net operating loss carry forwards, in the amount of \$215 and a decrease in valuation allowance related to net operating losses expected to be realized in the foreseeable future, in the amount of \$840.

- f. Income before tax benefit consists of the following:

|          | <b>Year ended<br/>December 31,</b> |                 |               |
|----------|------------------------------------|-----------------|---------------|
|          | <b>2010</b>                        | <b>2011</b>     | <b>2012</b>   |
| Domestic | \$ 3,124                           | \$ 3,114        | \$ 1,430      |
| Foreign  | 181                                | 167             | (570)         |
|          | <b>\$ 3,305</b>                    | <b>\$ 3,281</b> | <b>\$ 860</b> |

The Company is required to calculate and account for income taxes in each jurisdiction in which the Company or its subsidiary operate. Significant judgment is required in determining its worldwide provision for income taxes and recording the related assets and liabilities.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

U.S. dollars in thousands, except share and per share data

**NOTE 8: INCOME TAXES (Cont.)**

Tax expense (benefit) is comprised of the following:

|                        | <b>Year ended<br/>December 31,</b> |             |             |
|------------------------|------------------------------------|-------------|-------------|
|                        | <b>2010</b>                        | <b>2011</b> | <b>2012</b> |
| <b>Current taxes:</b>  |                                    |             |             |
| Foreign                | \$ (2)                             | \$ (2)      | \$ 124      |
| Domestic               | -                                  | 70          | 57          |
|                        | \$ (2)                             | \$ 68       | \$ 181      |
| <b>Deferred taxes:</b> |                                    |             |             |
| Foreign                | \$ (270)                           | \$ (357)    | \$ (942)    |
| Domestic               | (826)                              | (1,028)     | 136         |
|                        | \$ (1,096)                         | \$ (1,385)  | \$ (806)    |
|                        | \$ (1,098)                         | \$ (1,317)  | \$ (625)    |

## h. Tax assessments:

The Company has final tax assessments in Israel through 2006.

**NOTE 9: GEOGRAPHIC INFORMATION**

The Company conducts its business on the basis of one reportable segment. The Company has adopted ASC 280, Segment Reporting .

## a. Revenues from external customers:

|               | <b>Year ended December 31,</b> |             |             |
|---------------|--------------------------------|-------------|-------------|
|               | <b>2010</b>                    | <b>2011</b> | <b>2012</b> |
| Israel        | \$ 2,047                       | \$ 2,044    | \$ 2,541    |
| North America | 9,184                          | 12,655      | 11,847      |
| Europe        | 4,454                          | 4,869       | 5,737       |
| Asia          | 1,976                          | 3,036       | 3,484       |
| Other         | 500                            | 412         | 301         |
|               | \$ 18,161                      | \$ 23,016   | \$ 23,910   |

For the years ended December 31, 2010, 2011 and 2012, there are no major customers.

**COMMTouch SOFTWARE LTD.  
AND ITS SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

U.S. dollars in thousands, except share and per share data

**NOTE 9: GEOGRAPHIC INFORMATION (Cont.)**

b. The Company's net amount of long-lived assets is as follows:

|               | <b>December 31</b> |                  |
|---------------|--------------------|------------------|
|               | <b>2011</b>        | <b>2012</b>      |
| Israel        | \$ 246             | \$ 11,807        |
| United States | 4,144              | 3,807            |
| Germany       | -                  | 462              |
| Iceland       | -                  | 100              |
|               | <b>\$ 4,390</b>    | <b>\$ 16,176</b> |

**NOTE 10: FINANCIAL INCOME (EXPENSES), NET**

|  | <b>Year ended December 31,</b> |                |              |
|--|--------------------------------|----------------|--------------|
|  | <b>2010</b>                    | <b>2011</b>    | <b>2012</b>  |
| <b>Income:</b>   |                                |                |              |
| Interest on cash and cash equivalents and short term deposit | \$ 20                          | \$ 177         | \$ 144       |
| <b>Expenses:</b>   |                                |                |              |
| Foreign currency exchange differences and other              | (75)                           | (204)          | (64)         |
|  | <b>\$ (55)</b>                 | <b>\$ (27)</b> | <b>\$ 80</b> |

**NOTE 11: SUBSEQUENT EVENTS**

At about the time of the filing of this Annual Report, we were in the process of securing two credit lines from two Israeli banks in the total sum of up to \$5,000. During 2012, we made significant investments (from our cash reserves) in the above described acquisitions of eleven and Frisk. In relation to these credit lines, the Company has agreed to grant security interests generally over all Company assets, and to refrain from encumbering its assets in favor of any other third parties. The Company anticipates that it will draw on these credit lines in the near future.



**Item 19. Exhibits.**

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

**SIGNATURES**

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

COMMTOUCH SOFTWARE LTD.

By: /s/ Brian Briggs  
Brian Briggs  
Chief Financial Officer  
April 25, 2013

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**Item 19. Exhibits**

**Exhibit Index**

| <u>Exhibit Number</u> | <u>Description of Document</u>  |
|-----------------------|---|
| 1.1                   | Memorandum of Association of the Company.(1)  |
| 1.2                   | Amended and Restated Articles of Association of the Company, as amended on December 15, 2011.(2)  |
| 4.1                   | Commtouch Software Ltd. 2006 U.S. Stock Option Plan.(3)   |
| 4.2                   | Amended and Restated Commtouch Software Ltd. 1999 Non Employee Directors Stock Option Plan.(4)  |
| 4.3                   | Extension of Amended and Restated Commtouch Software Ltd. 1999 Non-Employee Directors Stock Option Plan.(5)   |
| 4.4                   | Commtouch Software Ltd. Amended and Restated Israeli Share Option Plan.(6)  |
| 4.5                   | Summary of Director Compensation.   |
| 4.6                   | Share Purchase Agreement of July 24, 2012 between Commtouch and former shareholders of Frisk.   |
| 4.7                   | Purchase and Assignment Agreement of November 15, 2012 between Commtouch and eleven.  |
| 4.8                   | Summary of two credit lines of April 2013.  |
| 8                     | List of Subsidiaries of the Company.  |
| 12.1                  | Certification of Company s Principal Executive Officer Pursuant to Exchange Act Rule 13a-14(a) or 15d-14(a).  |
| 12.2                  | Certification of Company s Principal Financial Officer Pursuant to Exchange Act Rule 13a-14(a) or 15d-14(a).  |
| 13                    | Certification of Company s Principal Executive Officer and Principal Financial Officer Pursuant to 18 U.S.C. 1350.  |
| 15                    | Consent of Kost, Forer, Gabbay & Kasierer, independent registered public accounting firm.   |
| 101                   | The following materials from our Annual Report on Form 20-F for the year ended December 31, 2012 formatted in XBRL (eXtensible Business Reporting Language) are furnished herewith: (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Operations, (iii) the Statements of Changes in Shareholders Equity, (iv) the Consolidated Statements of Cash Flows and (v) the Notes to Consolidated Financial Statements, tagged as blocks of text and in detail. |

- (1) Incorporated by reference to exhibits in Amendment No. 1 to Registration Statement on Form F 1 of Commtouch Software Ltd., File No. 333 78531. [filed June 3, 1999]
- (2) Incorporated by reference to Exhibit 1.2 to Annual Report on form 20-F for the year ended December 31, 2012
- (3) Incorporated by reference to Exhibit 99.4 to Registration Statement on Form S 8 No. 333 141177. [filed March 9, 2007]
- (4) Incorporated by reference to Exhibit 99.1 to Registration Statement on Form S 8 No. 333 141177. [filed March 9, 2007]

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- (5) Incorporated by reference to Exhibit 4.6 to Annual Report on form 20-F for the year ended December 31, 2008.
  - (6) Incorporated by reference to Exhibit 99.3 to Registration Statement on Form S 8 No. 333 141177. [filed March 9, 2007]
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