

MER TELEMAGEMENT SOLUTIONS LTD

Form 20-F

June 25, 2004

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, 2003

OR

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

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

Commission file number: 0-28950

MER TELEMAGEMENT SOLUTIONS LTD.  
(Exact name of Registrant as specified in its charter  
and translation of Registrant's name into English)

Israel  
(Jurisdiction of incorporation or organization)

22 Zarhin Street, Ra'anana 43662, Israel  
(Address of principal executive offices)

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

Securities registered or to be registered pursuant to Section 12(g) of the Act:  
Ordinary Shares, NIS 0.01 Par Value  
(Title of Class)

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:

Ordinary Shares, par value NIS 0.01 per share ..... 4,624,471  
(as of December 31, 2003)

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 \_\_\_\_\_

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

Item 17  Item 18

This Report on Form 20-F is incorporated by reference into our Form F-3 Registration Statement File No. 333-11644 and into our Form S-8 Registration Statement File No. 333-12014.

### INTRODUCTION

Mer Telemanagement Solutions Ltd. designs, develops, markets and supports a comprehensive line of telecommunication management solutions that enable business organizations and other enterprises to improve the efficiency and performance of their IP operations and to significantly reduce associated costs. Our products include call accounting and management products, facility management solutions, fault management systems and Web-based management solutions for converged voice, voice over Internet Protocol, or IP, data and video. These products are designed to provide telecommunication and information technology managers with tools to reduce communication costs, recover charges payable by third parties, detect and report the abuse and misuse of telephone networks, monitor and detect hardware and software faults in telecommunications networks and generate telecommunications usage information for use in the management of an enterprise. We were among the first to offer PC-based call accounting systems when we introduced our TABS product in 1985. To date, over 60,000 TABS call accounting systems have been sold to end-users in more than 60 countries.

Since our public offering in May 1997, our ordinary shares have been listed on the Nasdaq Stock Market (symbol: MTSI). As used in this annual report, the terms "we," "us" and "our" mean Mer Telemanagement Solutions Ltd. and its subsidiaries, unless otherwise indicated.

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 Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, and the Private Securities Litigation Reform Act of 1995, as amended, 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," "do not believe," "expect," "plan," "intend," "estimate," "anticipate" and similar 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 expressed or implied by such forward-looking statements. 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 publicly release any update or revision to 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 in Item 3D. "Key Information - Risk Factors"

TABS by MER (R), TABS.IT(TM), eTABS(TM), VoIPTABS(TM), wTABS(TM),

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FaciliTRAK(TM), TABSbill(TM), TOPS(TM) and PMSi(TM) are our trademarks. All other trademarks and trade names appearing in this annual report are owned by their respective holders.

Our consolidated financial statements appearing in this annual report are prepared in U.S. dollars and in accordance with generally accepted accounting principles in the United States, or U.S.

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GAAP. All references in this annual report to "dollars" or "\$" are to U.S. dollars and all references in this annual report to "NIS" are to New Israeli Shekels.

Statements made in this annual report concerning the contents of any contract, agreement or other document are summaries of such contracts, agreements or documents and are not complete descriptions of all of their terms. If we filed any of these documents as an exhibit to this annual report or to any registration statement or annual report that we previously filed, you may read the document itself for a complete description of its terms.

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PART I

ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS  
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Not applicable.

ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE  
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Not applicable.

ITEM 3. KEY INFORMATION  
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A. SELECTED FINANCIAL DATA

The following selected consolidated financial data for and as of the five years ended December 31, 2003 are derived from our audited consolidated financial statements, which have been prepared in accordance with U.S. GAAP. Our consolidated financial statements were audited by Kost Forer Gabbay & Kasierer, a Member of Ernst & Young Global. Our audited consolidated financial statements with respect to the three years ended December 31, 2003 and as of December 31, 2002 and 2003 appear elsewhere in this Report. The selected consolidated financial data set forth below should be read in conjunction with Item 5. "Operating and Financial Review and Prospects," and our consolidated financial statements and notes thereto included elsewhere in this annual report.

Statement of Operations Data:

	Year Ended December 31,				
	1999	2000	2001	2002	2003
	----	----	----	----	----
	(in thousands, except per share data)				
Revenues.....	\$12,780	\$11,067	\$10,725	\$9,787	\$9,230
Cost of revenues.....	3,137	2,842	2,552	1,896	1,849
	-----	-----	-----	-----	-----
Gross profit.....	9,643	8,225	8,173	7,891	7,381
Selling and marketing, net.....	4,186	4,853	4,911	3,954	3,916
Research and development, net.....	3,491	4,039	3,562	2,127	1,825
General and administrative.....	1,593	1,845	1,943	1,858	1,830
In process research and development write-off .....	--	945	--	--	--
	-----	-----	-----	-----	-----
Operating income (loss).....	373	(3,457)	(2,243)	(48)	(190)
Financial income, net.....	35	374	138	134	124
Other income (expenses).....	5,150	1,591	(654)	(140)	6
	-----	-----	-----	-----	-----
Income (loss) before taxes.....	5,558	(1,492)	(2,759)	(54)	(60)

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Taxes on income (tax benefit).....	1,277	(155)	16	52	198
	-----	-----	-----	-----	-----
Net income (loss) before equity in earnings of affiliates and minority interest.....	4,281	(1,337)	(2,775)	(106)	(258)
Equity in earnings of affiliates...	211	66	221	236	345
Minority interest in a subsidiary....	--	--	--	--	--
	-----	-----	-----	-----	-----
Net income (loss).....	\$4,492	\$(1,271)	\$(2,554)	\$ 130	\$ 87
	=====	=====	=====	=====	=====
Basic net earnings (loss) per share..	\$0.96	\$(0.26)	\$(0.53)	\$0.03	\$0.02
	=====	=====	=====	=====	=====
Diluted net earnings (loss) per share	\$0.94	\$(0.26)	\$(0.53)	\$0.03	\$0.02
	=====	=====	=====	=====	=====

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Balance Sheet Data:

	As of December 31,				
	1999	2000	2001	2002	2003
	----	----	----	----	----
Working capital.....	\$ 13,701	\$ 10,342	\$ 9,060	\$ 9,244	\$ 9,437
Total assets.....	21,615	21,812	18,095	17,707	18,182
Long-term loans.....	8	84	13	8	--
Shareholders' equity.....	17,557	16,497	13,856	14,013	14,464

B. CAPITALIZATION AND INDEBTEDNESS

Not applicable.

C. REASONS FOR THE OFFER AND USE OF PROCEEDS

Not applicable.

D. RISK FACTORS

Investing in our ordinary shares involves a high degree of risk and uncertainty. You should carefully consider the risks and uncertainties described below before investing in our ordinary shares. If any of the following risks actually occurs, our business, prospects, financial condition and results of operations could be harmed. In that case, the value of our ordinary shares could decline, and you could lose all or part of your investment.

Risks Relating to Our Business and Market

We have had a recent history of operating losses and may not achieve or sustain profitability in the future.

We have incurred operating losses in each of the four last fiscal years and we cannot assure you that we will be able to achieve or sustain profitable operations in the future.

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Our operating results fluctuate significantly.

Our quarterly results have fluctuated significantly in the past and are likely to fluctuate significantly in the future. Our future operating results will depend on many factors, including, but not limited to the following:

- o demand for our products;
- o changes in our pricing policies or those of our competitors;
- o the number, timing and significance of product enhancements;
- o new product announcements by us and our competitors;
- o our ability to develop, introduce and market new and enhanced products on a timely basis;
- o changes in the level of our operating expenses;

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- o budgeting cycles of our customers;
- o customer order deferrals in anticipation of enhancements or new products that we or our competitors offer;
- o product life cycles;
- o changes in our strategy;
- o seasonal trends and general domestic and international economic and political conditions, among others; and
- o currency exchange rate fluctuations and economic conditions in the geographic areas where we operate.

Due to the foregoing factors, quarterly revenues and operating results are difficult to forecast, and it is likely that our future operating results will be adversely affected by these or other factors.

Revenues are also difficult to forecast because the market for telecommunication management solutions is rapidly evolving and our sales cycle, from initial evaluation to purchase, is lengthy and varies substantially from customer to customer. We typically ship product orders shortly after receipt of a purchase order and, consequently, order backlog at the beginning of any quarter has in the past represented only a small portion of that quarter's revenues. As a result, license revenues in any quarter depend substantially on orders booked and shipped in that quarter.

Due to all of the foregoing, we cannot predict revenues for any future quarter with any significant degree of accuracy. Accordingly, we believe that period-to-period comparisons of our operating results are not necessarily meaningful and you should not rely upon them as indications of future performance. Although we have experienced revenue growth in the past, we may not be able to sustain this growth rate, and you should not consider such past growth indicative of future revenue growth, or of future operating results.

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Our operating results vary quarterly and seasonally.

We have often recognized a substantial portion of our revenues in the last quarter of the year and in the last month, or even weeks or days, of a quarter. Our expense levels are substantially based on our expectations for future revenues and are therefore relatively fixed in the short term. If revenue levels fall below expectations, our quarterly results are likely to be disproportionately adversely affected because a proportionately smaller amount of our expenses varies with our revenues.

Our operating results reflect seasonal trends and we expect to continue to be affected by such trends in the future. We expect to continue to experience relatively higher sales in the fourth quarter ending December 31, and relatively lower sales in the third quarter ending September 30, as a result of reduced sales activity in Europe during the summer months. Due to the foregoing factors, in some future quarter, our operating results may be below the expectations

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of public market analysts and investors. In such event, it is likely that the price of our ordinary shares would be materially and adversely affected.

We depend on the market for telemanagement products, which market has declined in recent years.

We have derived substantially all of our revenues and expect to continue to derive the vast majority of our revenues in the foreseeable future from sales of our TABS.IT call accounting and billing products. Our future financial performance will depend, in significant part, on the successful development, introduction, marketing and customer acceptance of the new versions of TABS.IT and related telemanagement products. Our revenues have declined each year since 1999 and there can be no assurance that the market for these products will grow in the future. If the market for TABS.IT and related telemanagement products fails to return to previous levels, or grows more slowly than we currently anticipate, our business, operating results and financial condition would be materially and adversely affected.

We depend on business telephone system manufacturers, vendors and distributors for our sales.

One of the primary distribution channels for our call accounting management products are PBX original equipment manufacturers, or OEMs, and vendors who market our products to end-users in conjunction with their own products. Sales by PBX manufacturers and vendors have declined markedly in the recent past, and no assurance can be given that sales through this channel will recover. Our success will be dependent to a substantial degree on the marketing and sales efforts of such third parties in marketing products integrating our products. There can be no assurance that these customers will give priority to the sale of our products as an enhancement to their products. Although most of the major business telephone switching systems manufacturers and vendors currently rely on third-party suppliers to provide call accounting and other telemanagement products, no assurance can be given that these manufacturers and vendors, including our current customers, will not develop their own competing products or purchase competing products from others.

We are highly dependent upon the active marketing and distribution efforts of our PBX OEM's. In 2001, 2002 and 2003, our three major OEMs, Siemens Gmbh, Philips Communications Systems B.V. and Ericsson, generated 44.0%, 46.0%



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and 51.0% of our consolidated revenues respectively. The percentage of sales attributable to each of these OEMs in each of the three years ended December 31, 2003 follows:

	2001	2002	2003
	----	----	----
Siemens.....	32.0%	36.0%	40.0%
Philips.....	8.0%	6.0%	7.0%
Ericsson.....	4.0%	4.0%	4.0%

Because we sell our products through local master distributors in countries where we do not have a marketing subsidiary, we are highly dependent upon the active marketing and distribution efforts of our distributors. We also depend in large part upon our distributors for product maintenance and support. There can be no assurance that our distributors will continue to provide adequate maintenance and support to end-users or will provide maintenance and support for new products, which might cause us to seek new or additional distributors or incur

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additional service and support costs. The distributors to whom we sell our products are generally not contractually required to make future purchases of our products and could, therefore, discontinue carrying our products at any time. None of our distributors or resellers are subject to any minimum purchase requirements under their agreements with us. There can be no assurance that we will continue our relationships with our OEM customers or, if such relationships are not maintained, that we would be able to attract and retain comparable PBX original equipment manufacturers. Although we have distribution agreements with a number of our resellers, we do not have any agreements with the PBX manufacturers who market our products. The loss of any of our major resellers, either to competitive products offered by other companies or products developed by such resellers, would have a material adverse effect on our business, financial condition and results of operations. Our future performance will depend, in part, on our ability to attract additional PBX manufacturers and vendors that will be able to market and support our products effectively, especially in markets in which we have not previously distributed our products.

We may decide to acquire other businesses in the future, which could result in potentially dilutive issuances, the incurrence of debt and the incurrence of other expenses which could negatively impact our operating results and financial condition.

In April 2000 we acquired IntegraTRAK Inc., a privately held developer and marketer of high-end telemanagement software, and in April 2002 we acquired software technology that we are presently marketing under the name FaciliTRAK. FaciliTRAK is a comprehensive software system that greatly simplifies the day-to-day task of maintaining and managing the physical layer details for any network. If we continue to acquire businesses or products in the future, such acquisitions could result in dilutive issuances of equity securities, the incurrence of debt and contingent liabilities and amortization expenses related to goodwill and other intangible assets, any of which could negatively impact our operating results and financial position. Acquisitions may also involve other risks, including entering markets in which we have limited or no direct prior experience and the potential loss of key employees.

We face risks associated with expanding and maintaining our distribution

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network.

We sell our products through distributors, business telephone switching systems manufacturers and vendors, post, telephone and telegraph authorities, or PTTs and our direct sales force. Our ability to achieve revenue growth in the future will depend in large part on our success in establishing and maintaining relationships with business telephone switching systems manufacturers and vendors and PTTs, establishing and maintaining relationships with distributors, and recruiting and training additional direct sales personnel. We plan to invest significant resources to expand our direct sales force and to develop new distribution relationships. Historically, we have at times experienced difficulty in recruiting qualified sales personnel and in establishing effective distribution relationships. There can be no assurance that we will be able to successfully expand our direct sales force or other distribution channels or that any such expansion will result in an increase in revenues. The failure to expand or maintain our direct sales force or other distribution channels could have a material adverse effect on our business, operating results and financial condition.

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We are subject to risks associated with international operations.

We are based in Israel and generate a large percentage of our sales outside the United States. Our sales in the United States accounted for 61.0%, 66.0% and 53.0% of our total revenues for the years ended December 31, 2001, 2002 and 2003, respectively. Although we continue to expand our international operations and commit significant management time and financial resources to developing direct and indirect international sales and support channels, we cannot be certain that we will be able to maintain or increase international market demand for our products. To the extent that we cannot do so in a timely manner, our business, operating results and financial condition will be materially and adversely affected.

International operations are subject to inherent risks, including the following:

- o the impact of possible recessionary environments in multiple foreign markets;
- o costs of localizing products for foreign markets;
- o longer receivables collection periods and greater difficulty in accounts receivable collection;
- o unexpected changes in regulatory requirements;
- o difficulties and costs of staffing and managing foreign operations;
- o reduced protection for intellectual property rights in some countries;
- o potentially adverse tax consequences; and
- o political and economic instability.

We cannot be certain that we, our distributors or resellers will be able to sustain or increase revenues from international operations or that the

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foregoing factors will not have a material adverse effect on our future revenues and, as a result, on our business, operating results and financial condition.

We may be adversely affected by fluctuations in currency exchange rates. While our revenues are generally denominated in U.S. dollars and Euros, a significant portion of our expenses are incurred in NIS. We do not currently engage in any currency hedging transactions intended to reduce the effect of fluctuations in foreign currency exchange rates on our results of operations. If we were to determine that it was in our best interests to enter into any hedging transactions in the future, there can be no assurance that we will be able to do so or that such transactions, if entered into, will materially reduce the effect of fluctuations in foreign currency exchange rates on our results of operations. In addition, if, for any reason, exchange or price controls or other restrictions on the conversion of foreign currencies into NIS were imposed, our business could be adversely affected. Although exposure to currency fluctuations to date has not had a material adverse effect on our business, there can be no assurance such fluctuations in the future will not have a material adverse effect on revenues from international sales and, consequently, on our business, operating results and financial condition.

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We are subject to risks relating to proprietary rights and risks of infringement.

We are dependent upon our proprietary software technology and we rely primarily on a combination of copyright and trademark laws, trade secrets, confidentiality procedures and contractual provisions to protect our proprietary rights. We try to protect our software, documentation and other written materials under trade secret and copyright laws, which afford only limited protection. It is possible that others will develop technologies that are similar or superior to our technology. Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our products or to obtain and use information that we regard as proprietary. It is difficult to police the unauthorized use of our products, and we expect software piracy to be a persistent problem, although we are unable to determine the extent to which piracy of our software products exists. In addition, the laws of some foreign countries do not protect our proprietary rights as fully as do the laws of the United States. We cannot be certain that our means of protecting our proprietary rights in the United States or abroad will be adequate or that our competition will not independently develop similar technology.

We are not aware that we are infringing upon any proprietary rights of third parties. It is possible, however, that third parties will claim infringement by us of their intellectual property rights. We believe that software product developers will increasingly be subject to infringement claims as the number of products and competitors in our industry segment grows and the functionality of products in different industry segments overlaps. It would be time consuming for us to defend any such claims, with or without merit, and any such claims could:

- o result in costly litigation;
- o divert management's attention and resources;
- o cause product shipment delays; or

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- o require us to enter into royalty or licensing agreements. Such royalty or licensing agreements, if required, may not be available on terms acceptable to us, if at all.

If there is a successful claim of product infringement against us and we are not able to license the infringed or similar technology, our business, operating results and financial condition would be materially and adversely affected.

We rely upon certain software that we license from third parties, including software that we integrate with our internally developed software. We cannot be certain that these third-party software licenses will continue to be available to us on commercially reasonable terms. If we lose or are unable to maintain any such software licenses, we could suffer shipment delays or reductions until equivalent software could be developed, identified, licensed and integrated, which would materially and adversely affect our business, operating results and financial condition.

Our results may be adversely affected by competition.

The market for telemanagement products is fragmented and is intensely competitive. Competition in the industry is generally based on product performance, depth of product line, technical support and price. We compete both with international and local competitors

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(including providers of telecommunications services), many of whom have significantly greater financial, technical and marketing resources than us. We anticipate continuing competition in the telemanagement products market and the entrance of new competitors into the market. Our existing and potential customers, including business telephone switching system manufacturers and vendors, may be able to develop telemanagement products and services that are as effective as, or more effective or easier to use than, those offered by us. Such existing and potential competitors may also enjoy substantial advantages over us in terms of research and development expertise, manufacturing efficiency, name recognition, sales and marketing expertise and distribution channels. There can be no assurance that we will be able to compete successfully against current or future competitors or that competition will not have a material adverse effect on our future revenues and, consequently, on our business, operating results and financial condition.

We are subject to risks associated with rapid technological change and risks associated with new versions and new products.

The telecommunications management market in which we compete is characterized by rapid technological change, introductions of new products, changes in customer demands and evolving industry standards. Our future success will depend upon our ability to keep pace with the technological developments and to timely address the increasingly sophisticated needs of our customers by supporting existing and new telecommunication technologies and services and by developing and introducing enhancements to our current and new products. There can be no assurance that we will be successful in developing and marketing enhancements to our products that will respond to technological change, evolving industry standards or customer requirements, that we will not experience difficulties that could delay or prevent the successful development, introduction and sale of such enhancements or that such enhancements will adequately meet the requirements of the marketplace and achieve any significant degrees of market acceptance. If release dates of any new products or

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enhancements are delayed or, if when released, they fail to achieve market acceptance, our business, operating results and financial condition would be materially and adversely affected. In addition, the introduction or announcement of new product offerings or enhancements by us or our competitors may cause customers to defer or forgo purchases of current versions of our product, which could have a material adverse effect on our business, operating results and financial condition.

We may not be able to retain or attract key managerial, technical and research and development personnel we need to succeed.

Our success has largely depended and will depend in the future on our skilled professional and technical employees, substantially all of whom have written employment agreements. The competition for these employees is intense. We may not be able to retain our present employees, or recruit additional qualified employees as we require them.

Three of our shareholders are in a position to control matters requiring a shareholder vote.

Mr. Chaim Mer, our Chairman, and his wife, Dora Mer, currently control the vote of approximately 44.3% of our outstanding ordinary shares, and Isaac Ben-Bassat, one of our directors, is the owner of 14.8% of our outstanding ordinary shares. As a result, such persons control and will continue to control the election of our entire Board of Directors other than our two outside directors and generally have the ability to direct our business and affairs.

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We are subject to risks arising from product defects and potential product liability.

We provide free warranty and support for up to one year for end-users and up to eighteen months for our OEM distributors. Our sales agreements typically contain provisions designed to limit our exposure to potential product liability or related claims. The limitation of liability provisions contained in our agreements may not be effective. Our products are used by businesses to reduce communication costs, recover charges payable by third parties and prevent abuse and misuse of telephone networks and, as a result, the sale of products by us may entail the risk of product liability and related claims. A product liability claim brought against us could have a material adverse effect upon our business, operating results and financial condition. Products such as those offered by us may contain undetected errors or failures when first introduced or when new versions are released. Despite our testing and testing by current and potential customers, there can be no assurance that errors will not be found in new products or releases after commencement of commercial shipments. The occurrence of these errors could result in adverse publicity, loss of or delay in market acceptance or claims by customers against us, any of which could have a material adverse effect upon our business, operating results and financial condition.

### Risk Factors Related to Our Ordinary Shares

Holders of our ordinary shares who are United States residents face income tax risks.

There is a substantial risk that we will be classified as a passive

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foreign investment company, or PFIC. Our treatment as a PFIC could result in a reduction in the after-tax return to the holders of our ordinary shares and would likely cause a reduction in the value of such shares. For U.S. federal income tax purposes, we will be classified as a PFIC for any taxable year in which either (i) 75% or more of our gross income is passive income, or (ii) at least 50% of the average value of all of our assets for the taxable year produce or are held for the production of passive income. For this purpose, passive income includes dividends, interest, royalties, rents, annuities and the excess of gains over losses from the disposition of assets which produce passive income. If we were determined to be a PFIC for U.S. federal income tax purposes, highly complex rules would apply to U.S. holders owning our ordinary shares. Accordingly, you are urged to consult your tax advisors regarding the application of such rules.

As a result of our substantial cash position and the decline in the value of our stock, there is a substantial risk that we will be classified as a PFIC under the asset test described in the preceding paragraph. However, because the determination of whether we are a PFIC is based upon the composition of our income and assets from time to time, this determination can not be made with certainty until the end of the calendar year.

Based on studies performed by an independent consultant, we believe that we were not a PFIC in the years 2001, 2002, or 2003.

U.S. residents should carefully read "Item 10E. Additional Information - Taxation - United States Federal Income Tax Consequences" for a more complete discussion of the U.S. federal income tax risks related to owning and disposing of our ordinary shares.

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Our share price has been volatile in the past and may decline in the future.

Our ordinary shares have experienced significant market price and volume fluctuations in the past and may experience significant market price and volume fluctuations in the future in response to factors such as the following, some of which are beyond our control:

- o quarterly variations in our operating results;
- o operating results that vary from the expectations of securities analysts and investors;
- o changes in expectations as to our future financial performance, including financial estimates by securities analysts and investors;
- o announcements of technological innovations or new products by us or our competitors;
- o announcements by us or our competitors of significant contracts, acquisitions, strategic partnerships, joint ventures or capital commitments;
- o changes in the status of our intellectual property rights;
- o announcements by third parties of significant claims or proceedings against us;

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- o additions or departures of key personnel;
- o future sales of our ordinary shares; and
- o stock market price and volume fluctuations.

Domestic and international stock markets often experience extreme price and volume fluctuations. Market fluctuations, as well as general political and economic conditions, such as a recession or interest rate or currency rate fluctuations or political events or hostilities in or surrounding Israel, could adversely affect the market price of our ordinary shares.

In the past, securities class action litigation has often been brought against a company following periods of volatility in the market price of its securities. We may in the future be the target of similar litigation. Securities litigation could result in substantial costs and divert management's attention and resources.

We do not expect to distribute cash dividends.

We do not anticipate paying cash dividends in the foreseeable future. Our Board of Directors will decide whether to declare any cash dividends in the future based on the conditions then existing, including our earnings and financial condition. According to the Israeli Companies Law, a company may distribute dividends out of its profits, so long as the company reasonably believes that such dividend distribution will not prevent the company from paying all its current and future debts. Profits, for purposes of the Companies Law, means the greater of retained earnings or earnings accumulated during the preceding two years.

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### Risks Relating to Operations in Israel

Conducting business in Israel entails special risks.

We are incorporated under the laws of, and our executive offices and research and development facilities are located in, the State of Israel. Although most of our sales are made to customers outside Israel, we are directly influenced by the political, economic and military conditions affecting Israel. Specifically, we could be adversely affected by any major hostilities involving Israel, a full or partial mobilization of the reserve forces of the Israeli army, the interruption or curtailment of trade between Israel and its present trading partners, or a significant downturn in the economic or financial condition of Israel.

Since the establishment of the State of Israel in 1948, a number of armed conflicts have taken place between Israel and its Arab neighbors, and a state of hostility, varying from time to time in intensity and degree, has led to security and economic problems for Israel. Since September 2000, there has been a marked increase in violence, civil unrest and hostility, including armed clashes, between the State of Israel and the Palestinians, and acts of terror have been committed inside Israel and against Israeli targets in the West Bank and Gaza. There is no indication as to how long the current hostilities will last or whether there will be any further escalation. Any further escalation in these hostilities or any future armed conflict, political instability or

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violence in the region may have a negative effect on our business condition, harm our results of operations and adversely affect our share price. Furthermore, there are a number of countries that restrict business with Israel or Israeli companies. Restrictive laws or policies of those countries directed towards Israel or Israeli businesses may have an adverse impact on our operations, our financial results or the expansion of our business.

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

Many of our directors, officers and employees are obligated to perform up to 36 days, depending on rank and position, of military reserve duty annually and are subject to being called for active duty under emergency circumstances. If a military conflict or war arises, these individuals could be required to serve in the military for extended periods of time. Our operations could be disrupted by the absence for a significant period of one or more of our executive officers or key employees or a significant number of other employees due to military service. Any disruption in our operations could adversely affect our business.

Economic conditions in Israel.

In recent years Israel has been going through a period of recession in economic activity, resulting in low growth rates and growing unemployment. Our operations could be adversely affected if the economic conditions in Israel continue to deteriorate. In addition, due to significant economic measures proposed by the Israeli Government, there have been several general strikes and work stoppages in 2003 and 2004, affecting banks, airports and ports. These strikes have had an adverse effect on the Israeli economy and on business, including our ability to deliver products to our customers. Following the passage by the Israeli Parliament of laws to implement the economic measures, the Israeli trade unions have threatened further strikes or work-stoppages, and these may have a material adverse effect on the Israeli economy and on us.

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Our financial results may be adversely affected by inflation and currency fluctuations.

Since we report our financial results in dollars, fluctuations in rates of exchange between the dollar and non-dollar currencies may affect our results of operations. The majority of our expenses are paid in NIS (primarily salaries) and are influenced by the timing of, and the extent to which, any increase in the rate of inflation in Israel over the rate of inflation in the United States is not offset by the devaluation of the NIS in relation to the dollar. We believe that the rate of inflation in Israel has not had a material adverse effect on our business to date. However, our dollar costs in Israel will increase if inflation in Israel exceeds the devaluation of the NIS against the dollar or if the timing of such devaluation lags behind inflation in Israel. Over time, the NIS has been devalued against the dollar, generally reflecting inflation rate differentials. In 1999 and 2000, while the rate of inflation was low and in 2003 when there was a negative rate of inflation, there was a devaluation of the dollar against the NIS. In the years 2001 and 2002, and in 2003 when there was a negative rate of inflation, the rate of devaluation of the NIS against the dollar exceeded the rate of inflation. We cannot predict any future trends in the rate of inflation in Israel or the rate of devaluation of the NIS against the dollar. If the dollar cost of our operations in Israel



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increases, our dollar measured results of operations will be adversely affected. Likewise, our operations could be adversely affected if we are unable to guard against currency fluctuations in the future.

The government programs and tax benefits we currently participate in or receive require us to meet several conditions and may be terminated or reduced in the future.

We have benefited from certain Israeli Government grants, programs and tax benefits. To remain eligible for these grants, programs and tax benefits, we must comply with certain conditions, including making specified investments in fixed assets from our own equity and paying royalties with respect to grants received. In addition, some of these programs restrict our ability to manufacture particular products and to transfer particular technology outside of Israel. If we do not meet these conditions in the future, the benefits we received could be canceled and we may have to refund payments previously received under these programs or pay increased taxes. The Government of Israel has reduced the benefits available under these programs in recent years and these programs and tax benefits may be discontinued or curtailed in the future. We do not expect to receive any grants during 2004 or 2005.

Service and enforcement of legal process on us and our directors and officers may be difficult to obtain.

Service of process upon our directors and officers and the Israeli experts named herein, most of whom reside outside the United States, may be difficult to obtain within the United States. Furthermore, since substantially all of our assets, most of our directors and officers and the Israeli experts named in this annual report are located outside the United States, any judgment obtained in the United States against us or these individuals or entities may not be collectible within the United States.

There is doubt as to the enforceability of civil liabilities under the Securities Act and the Securities Exchange Act in original actions instituted in Israel. However, subject to certain time limitations and other conditions, Israeli courts may enforce final judgments of United States courts for liquidated amounts in civil matters, including judgments based upon the civil liability provisions of those Acts.

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

Provisions of Israeli corporate and tax law may have the effect of delaying, preventing or making more difficult a merger with, or other acquisition of, us. This could cause our ordinary shares to trade at prices below the price for which third parties might be willing to pay to gain control of us. Third parties who are otherwise willing to pay a premium over prevailing market prices to gain control of us may be unable or unwilling to do so because of these provisions of Israeli law.

Your rights and responsibilities as a shareholder will be governed by Israeli law and differ in some respects from the rights and responsibilities of shareholders under U.S. law.

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We are incorporated under Israeli law. The rights and responsibilities of holders of our ordinary shares are governed by our memorandum of association, our articles of association and by Israeli law. These rights and responsibilities differ in some respects from the rights and responsibilities of shareholders in typical U.S. corporations. In particular, a shareholder of an Israeli company has a duty to act in good faith toward the company and other shareholders and to refrain from abusing his power in the company, including, among other things, in voting at the general meeting of shareholders on certain matters.

### ITEM 4. INFORMATION ON THE COMPANY

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

MER Telemagement Solutions Ltd. was incorporated under the laws of the State of Israel in December 1995. We are a public limited liability company under the Israeli Companies Law 5739-1999 and operate under such law and associated legislation. Our registered offices and principal place of business are located at 22 Zarhin Street, Ra'anana 43662, Israel, and our telephone number is 972-9-762-1777. Our address on the Internet is [www.mtsint.com](http://www.mtsint.com). The information on our website is not incorporated by reference into this annual report.

We design, develop, market and support a comprehensive line of telecommunication management solutions that enable business organizations and other enterprises to more effectively manage and optimize the use of their communication resources. Our products include call accounting and management products, fault management systems and Web-based management solutions for converged voice, voice over Internet Protocol, or IP, data and video. These products are designed to provide telecommunication and information technology managers with tools to reduce communication costs, recover charges payable by third parties, detect and report the abuse and misuse of telephone networks, monitor and detect hardware and software faults in telecommunications networks and generate telecommunications usage information for use in the management of an enterprise. We were among the first to offer PC-based call accounting systems when we introduced our TABS product in 1985. To date, over 60,000 TABS call accounting systems have been sold to end-users in more than 60 countries.

Call accounting systems afford businesses easy access to complete information on telephone usage, including the dialed number, calling extension, call duration, time of day, destination, trunk line usage, cost of each call and multi-carrier analysis. We started developing the TABS line of call accounting products for the DOS operating system and have upgraded and

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re-written our call accounting and management systems as the industry and technology advanced providing full compatibility to support the Windows operating systems (3.1, 95, 98, 2000) and most versions of Windows NT. As our sales of TABS were worldwide, we needed to have a flexible and easily updated set of pricing tables to accommodate the different pricing schemes and modes used worldwide and with different carriers. As enterprises expanded and required information from their remote sites, so TABS has expanded to accommodate their needs by providing multi-site solutions and supporting most business telephone switching systems currently available for sale. The solutions are capable of monitoring up to 100,000 extensions. Various modules were developed to service the needs of different vertical markets such as our PMSi module for the hotel industry and a solution for performing tie-line reconciliation for organizations

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and utilities having multiple PBXs. TRAK-View, our fault management system, provides an enterprise with early warning problem detection and prevention for multi-site and multi-vendor networks including PBXs. In 1998, we introduced IP.TRAK, a Web-based call accounting and management system that was built on the original model and principles of TABSweb(TM). IP.TRAK was designed to harness the power of the Internet for the needs of Information Technology managers through its ability to access reports using a standard Internet browser. We then added additional modules that could collect the information from routers, firewalls and gateways. These additional modules provided tools for a comprehensive communications management system. We were able to collect additional data from files, FTP servers, voice over IP (VoIP) and external buffers. We then merged the functionality of PBX systems and IP networks to provide a unified management solution for multiple communication platforms from different vendors supporting voice, VoIP, video and data communications.

On April 24, 2000, we acquired all of the assets and assumed certain liabilities of IntegraTRAK Inc., a privately held Seattle-based company, engaged in the development and sale of packaged computer software for tracking telephone calls and costs.

In line with our strategic planning, we determined in late 2001 not to promote TRAK-View and IP.TRAK as stand-alone products, but to offer them as part of larger solutions.

In 2001, we developed our Web Access module that provides access and control to the communications usage database, under strict control and privacy, from anywhere on the web. During the second quarter of 2002, we added FaciliTRAK, which is a comprehensive software system that greatly simplifies the day-to-day task of maintaining and managing the physical layer details for any network. FaciliTRAK allows the user to record the equipment, cables, and pathways for the cable plant and define the connectivity and circuit routes. A user can utilize FaciliTRAK to plan and manage the moves and changes within his or her organization with the aid of the self-documenting service desk functions. The FaciliTRAK system is an essential tool for any enterprise that is thinking of implementing a disaster recovery program. We operate in five geographical areas. Our operations in Israel include research and development, sales, marketing and support. Our operations in the United States, Brazil, Europe and Asia include sales, marketing and customer service.

Our strategy is to maintain and enhance our position as a leading supplier in the enterprise communication management market of call accounting, facility management solutions and other management solutions while expanding our product line to address the telemanagement needs of the rapidly converging voice, video and data communication markets.

In July 2000, we sold a 31% interest in Silverbyte, a 50% owned privately held affiliate. We received \$150,000 in consideration from the sale payable in 24 equal monthly payments. In December 2000, we reached an agreement to reschedule the remaining balance of the payments due. According to this agreement, the balance of \$110,000 will be repaid in 19 monthly payments starting April 2002. In April 2002, we reached a new agreement rescheduling the remaining \$85,000 balance to be repaid in 48 monthly payments starting April 2002. We recorded a \$73,000 gain from the sale. Although we continue to hold a 19% interest in Silverbyte, we do not have any representation on its board of directors. Accordingly, our investment in Silverbyte is accounted for according

to the cost method.

B. BUSINESS OVERVIEW

Industry Background

Technological advances and worldwide deregulation and privatization in the telecommunications industry have resulted in the growth of alternative telecommunication services providers, such as cellular companies, competitive access providers, cable companies and data transmission companies. This growth, in conjunction with dramatic improvements in computing and communications technology, including the convergence of telephony systems and computers, or computer telephony integration, has fostered the rapid expansion of communication services and an increase in the volume of voice and data traffic by business organizations. The diversification of services and providers using varied pricing algorithms and the proliferation of domestic and international networks using varied equipment and technologies for different services and modes of transmission has placed new demands on telecommunication and information technology managers and has created the need for sophisticated and flexible telecommunication management solutions. This has created a demand for telemanagement solutions that are capable of supporting multiple sites, switching platforms, languages and currencies, as well as the generation of telecommunications usage information vital to an enterprise's operations.

Telemanagement solutions have evolved from the stand-alone PC-based telephone call accounting and billing systems of the mid-1980's to local area network or LAN-based systems operating in Windows 98/2000/XP and Windows NT environments offering call accounting, fraud detection and fault management solutions for users with complex voice and data networks. Today, the trend is moving more and more to Web-based solutions.

Call accounting products, a fundamental management tool, record, retrieve and process data received from a PBX or other telephone switching system, providing a telecommunications manager with information on telephone usage. This information enables managers to optimize an enterprise's telecommunications resources and reduce communication expenses, typically the second or third highest administrative expense of a business, through cost-tracking and management awareness.

As the trend continues toward enterprises utilizing one infrastructure for both voice and data services, more and more emphasis will be placed on finding efficient solutions to cope with the increasing demand on network resources and for reducing congestion. Enterprises have been required to buy additional communications resources to meet this demand immediately rather than optimizing their existing networks due to the time consuming nature of such projects. IT

managers are constantly trying to justify the ever increasing expenses created by managing the enormous amount of data that is being transmitted through the Internet.

The abuse and misuse of telephone and data networks, either by employees making unauthorized telephone calls or by outside "hackers" who tap into an organization's long distance service has become a major problem for organizations resulting in great losses. Likewise, employees surfing the web for private use during working hours overloads the network, preventing critical tasks from getting through as well as reducing the overall productivity of the

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enterprise. These losses have led to the development of intelligent toll fraud detection systems that immediately alert or initiate preventive measures upon detecting a suspicious occurrence in network usage traffic.

Organizations with multiple PBXs and providers of maintenance services require systems that are capable of alerting telecommunications managers of impending or actual problems in a communications network. Financial and operational benefits of a fault management system can be immediate and significant, as down time of the system is reduced due to early problem detection and real information on remote site events. Maintenance costs are significantly lowered through better use of human resources and more efficient inventory management.

In addition, other executives and operational managers are now seeking telemagement solutions which permit them to assess how efficiently employees are using their time, monitor customer service calls, analyze the effectiveness of marketing expenditures, utilize toll-free responses to determine demographics of callers through the use of Caller ID information, know who is using the network and when they are using it, and obtain additional data that aid them in management of the business.

IP telephony and video conferencing are reaching technological maturity and are being adopted by an increasing number of organizations. Enterprises have begun to use the IP platform as a single common telecommunication infrastructure for all services. The convergence of voice, data and video has become commonplace, and there is a trend of data equipment manufacturers and PBX system manufacturers offering platforms that support all services. These developments as well as customer demands will require future management systems to be upgraded to support the convergence of voice, data and video and provide a unified management system that will provide information technology managers with knowledge about the usage of their resources, the ability to ensure the optimal use of these resources and centralized control over their networks.

With today's greater mobility, the need to keep track of moves and changes in an organization requires the use of tools to control, manage and document these changes more effectively. The useful life of a standard cabling structure should be fifteen years. This means that existing cables should be able to support an average of three upgrades of communication equipment during its lifetime, plus an average of five changes to all outlets. It is virtually impossible to achieve this performance level without maintaining accurate records reflecting all details of cabling installations.

The continuing increase in use of cellular phones for business, during and outside working hours, has created the need to develop products that will enable an enterprise to generate a true and full record of all the calls made by its employees, including cellular calls and calls made by calling cards and other charge plans.

### Products and Services

We offer a range of call accounting and converged voice/data management solutions, based on our standard platform which can be adjusted to specific customers' needs and requests, as well as fault management systems for networks and PBXs, and facilities management for cabling and equipment. Additionally, some of our products are geared for communications resellers and as such enable

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them to issue regular bills for the communications services rendered. Today these products and services, starting with the original TABS line, constitute the basic building blocks for adding modules to cater to the new advanced communications infrastructures and services.

### Background History

We were the first to offer a PC-based non-dedicated call accounting system when we introduced the first version of TABS in 1985. To date, over 60,000 TABS accounting systems have been sold to end-users located in over 60 countries. TABS supports worldwide charging methods (pulse and duration), call pricing tables and currencies and is available in different languages. Our PBX interface database includes default formats for the major PBX manufacturers and business phone systems, including those manufactured by Ericsson, Philips, Siemens, Lucent, Nortel, Alcatel, ECI/Tadiran, Harris, NEC, Avaya, Mitel, Damovo, LG and Panasonic, making TABS compatible with substantially all currently available PBX and business phone systems. Our flexible format allows some of the newer equipment such as VoIP PBXs and routers/gateways to be inputted to and reported on TABS. This includes the RADVision and Cisco gateways and gatekeepers.

### Call Accounting and Management Solutions for Enterprises

#### TABS.IT

TABS.IT is a solution for small offices, medium sized businesses, and Fortune 500 enterprises that want to take full control over their communications network. Specific applications enable hotels, shared tenant environments, hospitals, universities and service bureaus to resell communications services to users employing simple, yet efficient mark-up formulas.

TABS.IT tracks the details of all voice communications usage (dialed numbers, call duration, destination, cost of each call, trunk line usage, etc.) and produces accurately priced individual customer bills. In addition, TABS.IT tracks the details of all data communications (IP address, name, number of bytes, bandwidth usage, nodes, etc.) and can produce a relative cost figure. TABS.IT products are able to:

- o Register and track incoming and outgoing, trunk-to-trunk and internal calls, including response time, ring time and Caller ID.
- o Add billing details and cost of calls according to applicable pricing tables, including mark-up calculations by extension and other user-defined categories and rate updates.
- o Perform multi-carrier analysis, providing carrier comparison "what if" reports.

- o Support authorization and account codes.
- o Identify inactive and defective trunks and extensions.
- o Operate in a LAN environment, permitting multi-user and multi-tasking functionality.

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- o Generate and electronically distribute billing documents, management and verification reports and 3-D color graphs for easy data analysis.

With additional modules, the following optional features are available:

- o Reporting on e-mails (eTABS).
- o Reporting on VoIP (VoIPTABS).
- o Reporting on web browsing (wTABS).
- o Accessing the information over the Internet (Web Access).

These additional modules were developed especially for Internet usage and provide enterprises with the scalability necessary to permit growing enterprise organizations to further extend their ability to monitor and optimize their local networks. With the introduction of Web Access, multiple users now have the ability to access the TABS database and easily generate reports and graphs from any PC that has access to the Internet. With this new module, each authorized user anywhere in the world can browse and review reports containing restricted data, according to his authorization. These reports are created from the TABS database by using a web browser at a remote station. In addition, powerful graphs give the manager an immediate overview of the situation. Both the graphs and reports can be exported to other applications, such as PowerPoint for the graphs or Excel for the reports.

The powerful TABS.IT report generator provides a wide variety of usage reports that are easy to read and understand, yet provide all the information necessary to identify how communications network resources are being utilized. These reports can be generated either as a summary of the call data or complete with all the details necessary to make informed management decisions. Their structural flexibility allows the user to quickly zero in on the specific data of greatest interest. Historical reports may be maintained for an unlimited period of time and can become useful tools for assessing budget needs for the coming months or years. Specific report categories include ring time reports, call breakdown reports, hit parade reports, directory reports, exception reports and trunk reports. In addition, a robust custom reporting feature offers the user an effective means of generating reports that can go far beyond the standard categories. With this feature, the user is able to create reports that can be tailored to meet even the most specific of reporting requirements, and they can be scheduled to run automatically at a prescribed time.

Version 7 of TABS.IT is fully web-based allowing users to see their own call usage on-line from anywhere, and incorporates most of the features that were offered as separate modules in previous versions. This version is easily adapted to companies that have multiple sites, and would want to view the activity from a central site. The administrative functions can also be

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performed remotely using Internet Explorer. Full security and privacy is assured by use of various levels of password protection.

The WinTRAK family of products is MTS IntegraTrak's telemanagement solution that has been sold in the U.S. market since 1985. After incorporating all the functionality of WinTRAK, we migrated TABS.IT for use in the United States in 2002. Although we are no longer marketing WinTRAK, we continue to support this product.

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### Facilities Management System

With today's greater mobility, the need to keep track of moves and changes in an organization requires the use of tools to control, manage and document these changes more effectively. In March 2002, we acquired a software product from Total Wire Software Company, Inc., a privately held Florida-based company. The purchase of this software, now marketed as FaciliTRAK, enables us to offer a product that provides tracking of inventory such as telephones, computers and ancillary equipment associated with a user and develop a complete composite report of an enterprise's resources. Additionally, it gives us the ability to provide a full "total information" system to enterprises for controlling and managing the entire physical layer of an organization's voice and data system. The "top of the line" FaciliTRAK product is a full featured, graphic-oriented cable and asset management system, that comes complete with Visio Technical, a CAD interface, and is available in both a single workstation and a multi-user network version. Its unique flexibility allows users to "mirror" complex networks commonly found in large companies, while its enhanced ability allows it to document and design cable plant projects of all sizes.

FaciliTRAK documents and controls the management of the physical layer, device configuration and circuit connectivity for a wide range of network topologies including ethernet, token ring, voice, fiber distributed data interface, etc. that range in size, from just a few hundred nodes to many thousand, and with its universal functionality can be extended to interface with logical network management systems, cable testing and labeling systems, help desk, call accounting, and other facility management tools. Using a flexible and multipurpose database, FaciliTRAK documents the physical characteristics for any network, recording the network, asset, user, device configuration, and exact connections between equipment and cabling. The results are then presented in either a database view, dynamic schematic, or Visio Technical drawing. The schematics generated by those modules are used to show the physical connectivity and logical path of the equipment and cabling connections in the database.

As a multi site system, FaciliTRAK can store information for multiple buildings or campuses and show views by floor, closet and zones. Specific information such as port or pair assignment, network addresses, and circuit connections are easily entered to match the level of detail required.

The FaciliTRAK help desk feature provides both an administrative process and audit trail for recording, scheduling and maintenance changes that need to be made to items and connections in a site. There are three options within service desk: (i) service requests, (ii) trouble tickets, and (iii) work orders. Each provides its own choices and reference numbering for easy tracking and assignment. Both service requests and trouble tickets provide the option of being used globally for the entire organization, regardless of whether the item in service has been

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recorded in the site database, or used for items within the current site. We intend to migrate to a new facilities management product in late summer 2004.

### Billing Solutions

In 2002 we introduced the TABSBill module for vertical enterprises, such as hospitals, universities, medical clinics and tenant sharing facilities, enabling the enterprises to rapidly generate bills based on usage. TABSBill, which is geared to resellers of billing services, provides for the scheduled reporting and automatic distribution of customer communications bills based on



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tracking phone calls, e-mail, network usage as well as for one time or recurring charges. The bills can be generated directly from the data collected by TABS, from CDs from the service provider, or from downloaded files of call data. All kinds of communications usage data may be billed. The user can view his bills on-line as TABSBill is web based. The bills can be displayed, printed out or sent by e-mail. There is even provision for the secure payment of the bill on-line.

### Other Modules

An add-on module, Tie Line Reconciliation, or TLR, provides for the accurate costing of calls in a private PBX network by calculating the actual cost of calls routed over private tie lines and assigning charges to the originating extension. The call is resolved into an accurate origination-destination configuration even though the call may pass many "nodes" along the way, with each potentially discharging an independent call record.

Another add-on module, Property Management System interface, or PMSi, provides an interface protocol and format for telecommunication management systems with hotel billing solutions (Front Office or PMS systems). Through the use of this interface, which can also connect to PBXs, the hotel system is able to control the opening and closing of guest extensions on check in or out.

### New Trends

We have implemented a new strategy for our company that has led to the introduction of an application suite. The suite is built on the Microsoft.Net platform and establishes a framework for us to provide customized solutions that include customer care and billing, in addition to the traditional telemanagement solutions. We are currently investing heavily in research and development to support these new operations.

### Customer Service and Installation

We provide customer support to end-user customers in the United States, Israel, Hong Kong, the Netherlands and Brazil on both a service contract and a per-incident basis. Our technical support engineers answer support calls directly and generally seek to provide same-day responses. We provide updated telephone rate tables to customers on a periodic basis under annual service contracts. The rate tables are obtained from third-party vendors who provide this data for all major long-distance service providers. Our distributors provide a full range of service and technical support functions for our products, including rate tables, to their respective end-user customers.

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Our support staff installs products at end-user locations from offices in Israel, the United States, Hong Kong, the Netherlands and Brazil. Customers who maintain their own technical staffs are often able to install our products themselves with minimal telephone support from us. We charge our customers a fee for each installation performed by our employees. Our distributors are responsible for the installation and support of our products with respect to their end-user customers.

### Sales and Marketing

We market our products in over 60 countries worldwide through OEM

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distribution channels and our own direct sales force in the United States, Europe, Israel, Hong Kong and Brazil, and through a network of local distributors in these and various other countries in Europe, Asia and Latin America. We employed 15 persons in our sales and marketing force and 31 persons in support as of December 31, 2003. With the acquisition of IntegraTRAK in April 2000, our marketing efforts in North America were significantly increased. This also enabled us to acquire additional Fortune 500 companies as our customers. We also sell our products to business telephone switching systems manufacturers and vendors, distributors and PTTs. Since 1985, over 60,000 TABS call accounting products have been sold, many of which have been sold to large organizations. In addition, as customers move to consolidate the management of their multi-site telecommunications activities, we intend to capitalize on our initial successes with our customers and expand the use of our products by offering these organizations the added capabilities of expanding and monitoring on the Web. By acquiring the FaciliTRAK software in March 2002, we gained access to a whole new realm of opportunities and we now are able to offer a complete solution to the high-end market sector.

Managed Services

Our managed services solution is an outsourcing solution geared to multi-national companies that centrally manage their telecommunications usage and is being offered as an added value service. This solution has been offered in the U.S. where our Seattle office acts as a service bureau.

Switching Systems Manufacturers and Vendors. We believe that the most efficient means of selling our telemanagement products is to enter into relationships with major business telephone system manufacturers and vendors who market our products on either an original equipment manufacturer, or OEM, basis, or supplemental sales basis at the time they sell their switching systems. We also utilize our distributors to market our products to local business telephone switching systems manufacturers and distributors. We intend to establish additional strategic relationships with business telephone switching systems manufacturers and vendors and PTTs. These manufacturers have begun to consider telemanagement capability as a competitive tool when selling their products and have begun to offer end-users a complete, integrated solution. Among the companies that have been selling our products are Siemens, Philips, Ericsson, Nortel, Alcatel, ECI/Tadiran, NEC, Cisco, Damovo and Panasonic. The percentages of sales attributable to our three largest OEM customers, Siemens, Philips and Ericsson, in each of the three years ended December 31, 2003 are as follows:

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	2001	2002	2003
	----	----	----
Siemens.....	32.0%	36.0%	40.0%
Philips.....	8.0%	6.0%	7.0%
Ericsson.....	4.0%	4.0%	4.0%

Distributors. In general, in those countries where we do not have a marketing subsidiary, we distribute our products through a local distributor. Marketing, sales, training, product and client support are provided by our local distributors. A local distributor is typically a telecommunication products marketing organization with the capability to add value with installation, training, and support. Distributors are generally responsible for the localization of our products into their native language. The distributor also translates our standardized product marketing literature and technical

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documentation. Prior to becoming an authorized distributor, the distributor's employees must undergo sales and technical training. We are available for second-tier support for the distributor and for end-users. In coordination with the distributors, we also provide technical support for large and multinational accounts. We have distributors worldwide and intend to expand our network of distributors and resellers and to expand our direct sales force and field organization in selected markets.

PTTs. We also market our products to PTTs who integrate our solutions with the telephone systems they sell or lease to their customers. Among the PTTs who sell our products are Telecom Italy, Cable and Wireless, Trinidad PTT and Hong Kong Telecom.

Strategic Relationships. As part of our marketing strategy, we attempt to develop and establish new strategic relationships with manufacturers of voice and data communication systems and IP based equipment as means of entering new markets and channels. We are also continuing our relationship with RADVision, a recognized IP technology leader. Together with RADVision, we offer solutions consisting of RADVision's Gatekeeper and our advanced Web-based call management solution. We also signed an agreement with Cisco, pursuant to which Cisco may use our VoIP solution in their CallManager call processing software, a key component of Cisco's AVVID (Architecture for Voice, Video and Integrated Data). Our software provides validated reports on call records, start time, duration, and origin and final destination. Additional features include the ability to allocate usage-sensitive call costing and, using an integrated fraud module, detect unauthorized or inappropriate system access.

We recently entered into an OEM agreement with TeleKnowledge Group Ltd., a leading provider of carrier-class billing & rating solutions, pursuant to which we will market TeleKnowledge's Total-e billing, rating and customer care solutions on an OEM basis as a comprehensive end-to-end solution.

Other Marketing Activities. We are conducting a wide range of marketing activities aimed at generating awareness and leads, including public relations, attendance at trade shows and exhibitions, user conferences, direct mail, response mail and seminars. We have joined alliances with strategic partners such as Alcatel and Cisco. We regularly advertise our products in prominent trade publications, and we also participate in major regional and international technology and communications trade shows, forums, and fairs worldwide. These activities are intended both to generate leads and maintain the general public awareness of our products. We maintain our web site on-line, allowing for correspondence and queries from new potential customers as well as promoting support for our existing customer base.

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### Competition

The market for telemanagement products is fragmented and is intensely competitive. Competition in the industry is generally based on product performance, depth of product line, technical support and price. We compete both with international and local competitors (including providers of telecommunications services), many of whom have significantly greater financial, technical and marketing resources than we do. Our existing and potential customers, including business telephone switching system manufacturers and vendors, may be able to develop telemanagement products and services that are as effective as, or more effective or easier to use than, those offered by us. Such existing and potential competitors may also enjoy substantial advantages over us in terms of research and development expertise, manufacturing efficiency, name

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recognition, sales and marketing expertise and distribution channels. Although we believe that the quality of our products is equal to or better than the product quality of our competitors with regard to performance and reliability, we have no quantitative data other than the evaluations of our present customers from which to assess our current ability to compete. There can be no assurance that we will be able to compete successfully against current or future competitors or that competition will not have a material adverse effect on our future revenues and, consequently, on our business, operating results and financial condition.

### Intellectual Property Rights

We do not hold any patents and rely upon a combination of security devices, copyrights, trademarks, trade secret laws, confidentiality procedures and contractual restrictions to protect our rights in our products. Our policy has been to pursue copyright protection for our software and related documentation and trademark registration of our product names. Some of our products have the added protection afforded by a hardware component which has embedded software that it is difficult to misappropriate. In addition, our key employees and independent contractors are required to sign non-disclosure and secrecy agreements. All of the intellectual property rights with respect to our products are held by Mer Telemangement Solutions Ltd.

Our trademark rights include rights associated with the use of our trademarks, and rights obtained by registration of our trademarks. We have obtained trademark registrations in Israel and the United States. The use and registration rights of our trademarks does not ensure that we have superior rights over other third parties that may have registered or used identical related marks on related goods or services.

We believe that, because of the rapid pace of technological change in the communication industry, the legal protections for our products are less significant factors in our success than the knowledge, ability and experience of our employees, the frequency of product enhancements and the timeliness and quality of support services provided by us.

### C. ORGANIZATIONAL STRUCTURE

Our wholly owned subsidiaries in the United States, Hong Kong, the Netherlands and Brazil, MTS IntegraTRAK Inc., MTS Asia Ltd., JARAGA B.V. and TABS Brazil Ltd., respectively, act as marketing and customer service organizations in those countries. Our 50% owned affiliate in Spain, Jusan S.A., is engaged in the development and distribution of telemangement products.

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### D. PROPERTY, PLANTS AND EQUIPMENT

Our executive offices and research and development facilities are located at 22 Zarhin Street, Ra'anana, Israel, where we occupy approximately 7,310 feet. The lease, which expires on December 31, 2005, has an annual rental charge of approximately \$107,335.

Our U.S. operations are headquartered in an 8,408 square foot space in Bellevue, Washington at annual rental of approximately \$208,000. The lease will expire in September 2004. We have subleased 2,040 square feet of this space until September 2004 and are receiving annual rental income of approximately

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\$46,305. The lease for space we previously utilized in Secaucus, New Jersey expired in April 2003. The annual rental for the Secaucus space was \$103,780. The annual rental cost for our Hong Kong and Sao Paulo offices is approximately \$34,000.

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

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The following discussion of our results of operations should be read together with our consolidated financial statements and the related notes, which appear elsewhere in this annual report. The following discussion contains forward-looking statements that reflect our current plans, estimates and beliefs and involve risks and uncertainties. Our actual results may differ materially from those discussed in the forward-looking statements. Factors that could cause or contribute to such differences include those discussed below and elsewhere in this annual report.

#### General

#### Overview

We design, develop, market and support a comprehensive line of telecommunication management solutions that enable business organizations and other enterprises to improve the efficiency and performance of all IP operations, and to significantly reduce associated costs. Our products include call accounting and management products, fault management systems and Web-based management solutions for converged voice, voice over Internet Protocol, or IP, data and video. These products are designed to provide telecommunication and information technology managers with tools to reduce communication costs, recover charges payable by third parties, detect and report the abuse and misuse of telephone networks, monitor and detect hardware and software faults in telecommunications networks and generate telecommunications usage information for use in the management of an enterprise. We were among the first to offer PC-based call accounting systems when we introduced our TABS product in 1985. To date, over 60,000 TABS call accounting systems have been sold to end-users in more than 60 countries.

#### General

Our consolidated financial statements are stated in dollars and prepared in accordance with generally accepted accounting principles in the United States. Transactions and balances originally denominated in dollars are presented at their original amounts. Transactions and balances in other currencies are remeasured into dollars in accordance with the principles set forth in Financial Accounting Standards Board Statement No. 52. The majority of our sales are made outside Israel in dollars. In addition, substantial portions of our costs are incurred in dollars. Since the dollar is the primary currency of the economic environment in which we and

certain of our subsidiaries operate, the dollar is our functional and reporting currency and, accordingly, monetary accounts maintained in currencies other than the dollar are remeasured using the foreign exchange rate at the balance sheet date. Operational accounts and non-monetary balance sheet accounts are measured and recorded at the exchange rate in effect at the date of the transaction. The financial statements of certain subsidiaries and an affiliate whose functional

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currency is not the dollar, have been translated into dollars. All balance sheet accounts have been translated using the exchange rates in effect at the balance sheet date. Statement of operations amounts have been translated using the average exchange rate for the period. The resulting translation adjustments are reported as a component of shareholders' equity in accumulated other comprehensive income (loss).

### Discussion of Critical Accounting Policies

The preparation of financial statements in conformity with generally accepted accounting principles requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates and the use of different assumptions would likely result in materially different results of operations.

Critical accounting policies are those that are both most important to the portrayal of a company's financial position and results of operations, and require management's most difficult, subjective or complex judgments. Although not all of our significant accounting policies require management to make difficult, subjective or complex judgments or estimates, the following policies and estimates are those that we deem most critical.

#### Impairment of long-lived assets

Our long-lived assets are reviewed for impairment in accordance with Statement of Financial Accounting Standard No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," or SFAS No. 144, whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to the future undiscounted cash flows expected to be generated by the assets. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. As of December 31, 2003, no impairment was required. The use of different assumptions with respect to the expected cash flows from our assets and other economic variables, primarily the discount rate, may lead to different conclusions regarding the recoverability of our assets' carrying values and to the potential need to record an impairment loss for our long-lived assets.

#### Goodwill

Goodwill represents excess of the costs over the net assets of business acquired. Goodwill from acquisitions made prior to July 1, 2001 was amortized until December 31, 2001 by the straight-line method over 10 years. Under SFAS No. 142, goodwill acquired in a business contraction on or after July 1, 2001 will not be amortized.

Effective January 1, 2002, we adopted SFAS No. 142. SFAS No. 142 requires goodwill to be tested for impairment on adoption and at least annually thereafter, and written down when impaired, rather than being amortized as previous accounting standards required. Goodwill attributable to each of our reporting units is tested for impairment by comparing the fair value of each reporting unit with its carrying value. Fair value is determined using

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discounted cash flows. Significant estimates used in the methodologies include estimates of future cash flows, future short-term and long-term growth rates, and weighted average cost of capital for each of the reportable units. We have selected December 31, as the date we will perform our annual goodwill impairment tests. The annual goodwill impairment test for 2003 was prepared for us by an independent consulting firm. As of December 31, 2003, no impairment was required. Any changes in our key assumptions could result in an impairment charge and such a change could have a material adverse affect on our financial position and results of operations.

### Investments in affiliates and other companies

Investments in privately held companies, in which we hold 20% to 50% ownership of voting rights and can exercise significant influence over operating and financial policy of the affiliate, are presented using the equity method of accounting. In accordance with SFAS No. 142, goodwill related to investments in affiliates is no longer amortized. The goodwill is reviewed annually (or more frequently if circumstances indicate impairment has occurred) for impairment in accordance with Accounting Principles Board Opinion No. 18. "The Equity Method of Accounting for Investments in Common Stock," or "APB No. 18." Before the adoption of SFAS No. 142 on January 1, 2002, goodwill was amortized on a straight-line basis over 10 years, in accordance with APB Opinion No. 17, "Intangible Assets."

Investments in privately held companies in which the we hold less than 20% and do not have the ability to exercise significant influence over their operating and financial policy, are presented at cost. We periodically review the carrying value, in accordance with APB No. 18. If this review indicates that the carrying value is not recoverable, the carrying value is reduced to its estimated fair value. As of December 31, 2003, no impairment losses have been identified. Any changes in our key assumptions concerning their carrying value could have a material adverse affect on our financial position and results of operations.

### Research and development costs

Research and development costs, net of grants received, are charged to expenses as incurred. Statement of Financial Accounting Standard No. 86, "Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed," requires capitalization of certain software development costs subsequent to the establishment of technological feasibility. Based on our product development process, technological feasibility is established upon completion of a working model. Costs incurred by us between completion of the working model and the point at which the product is ready for general release should be capitalized. During 2003 such costs were immaterial.

Capitalized software costs are amortized by the greater of: (i) ratio of current gross revenues from sales of the software to the total of current and anticipated future gross revenues from sales of that software or (ii) the straight-line method over the remaining estimated useful life of the product (not greater than three years). We assess the recoverability of this intangible asset on a regular basis by determining whether the amortization of the asset over our remaining

life can be recovered through undiscounted future operating cash flows from the

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specific software product sold. Based on the most recent analyses, our management believes that no impairment of capitalized software development costs exists as at December 31, 2003. Under different assumptions with respect to the recoverability of this intangible asset, our determination may be different, which may negatively affect our financial position and results of operations.

### Concentrations of credit risk

Financial instruments that potentially subject us and our subsidiaries to concentrations of credit risk consist principally of cash and cash equivalents, short and long-term bank deposits, trade receivables and long-term trade receivables. Our cash and cash equivalents and short-term and long-term bank deposits are invested in major Israeli and U.S. banks. Such deposits in U.S. banks may be in excess of insured limits and are not insured in other jurisdictions. We believe that the financial institutions that hold our investments are financially sound and, accordingly, minimal credit risk exists with respect to these investments.

We perform ongoing credit evaluations of our customers and have not experienced any material losses in recent years. An allowance for a doubtful account is determined with respect to those amounts that we have determined to be doubtful of collection. Any changes in our assumptions relating to the collectability of our accounts receivable may affect our financial position and results of operations.

### Recently Issued Accounting Standards

In January 2003, the FASB issued FASB Interpretation No. 46, or FIN 46, "Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51," which addresses consolidation by business enterprises of variable interest entities, or VIEs, either: (1) that do not have sufficient equity investment at risk to permit the entity to finance its activities without additional subordinated financial support, or (2) in which the equity investors lack an essential characteristic of a controlling financial interest. In December 2003, the FASB completed deliberations of proposed modifications to FIN 46, or the Revised Interpretation, resulting in multiple effective dates based on the nature as well as the creation date of the VIE. VIEs created after January 31, 2003, but prior to January 1, 2004, may be accounted for either based on the original interpretation or the Revised Interpretation. However, the Revised Interpretation must be applied no later than our first quarter of fiscal 2004. VIEs created after January 1, 2004 must be accounted for under the Revised Interpretation. Special Purpose Entities, or SPEs, created prior to February 1, 2003 may be accounted for under the original or Revised Interpretation's provision no later than our fourth quarter of fiscal 2003. Non-SPEs created prior to February 1, 2003, should be accounted for under the Revised Interpretation's provisions no later than our first quarter of fiscal 2004.

We have not entered into any material arrangements with VIEs created prior to or after January 31, 2003.

### Operating Results

The following table presents certain financial data expressed as a percentage of total revenues for the periods indicated:



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	Year Ended December 31,		
	2001	2002	2003
Revenues			
Product sales.....	73.1%	75.6%	75.2%
Services.....	26.9	24.4	24.8
Total revenues.....	100.0%	100.0%	100.0%
Cost of revenues			
Product sales.....	17.8	16.9	16.5
Services.....	6.0	2.5	3.5
Total cost of revenues.....	23.8	19.4	20.0
Gross profit.....	76.2	80.6	80.0
Selling and marketing.....	45.8	40.4	42.5
Research and development.....	33.2	21.7	19.8
General and administrative.....	18.1	19.0	19.8
Operating loss.....	(20.9)	(0.5)	(2.1)
Financial income, net.....	1.3	1.4	1.3
Other income (expenses).....	(6.1)	(1.5)	0.1
Loss before taxes.....	(25.7)	(0.6)	(0.7)
Taxes on income.....	0.2	0.5	2.1
Net loss before equity in earnings of affiliate.....	(25.9)	(1.1)	(2.8)
Equity in earnings of affiliate.....	2.1	2.4	3.7
Net income (loss).....	(23.8)%	1.3%	0.9%

Years Ended December 31, 2003 and 2002

Revenues. Revenues consist primarily of products sales and revenues from services, including service center income, custom made projects, maintenance and support. Revenues decreased 5.8% to \$9.23 million in 2003 from \$9.8 million in 2002 as a result of the continued global decline in the demand for telecommunication products, such as PBX systems, which effected our revenue stream. In 2003, the revenues from our wholly owned U.S. subsidiary, MTS IntegraTRAK, declined 23% from 2002 and accounted for 53.0% of our total revenues. In 2004, we took measures to reverse the sales decline in the United States, but no assurance can be given that we will be successful in our efforts.

Cost of Revenues. Cost of revenues consists primarily of (i) production costs (including hardware, media, packaging, freight and documentation); (ii) certain royalties and licenses payable to third parties (including the Office of the Chief Scientist of the Ministry of Industry and Trade of the State of Israel, or OCS) and (iii) warranty and support costs for up to one year for end-users. Cost of revenues decreased 2.6% to \$1.85 million in 2003 from \$1.9 million in 2002, principally as a result of the overall decrease in revenues.

Gross margin. Gross profit as a percentage of revenues was 80% in 2003 compared to 80.6% in 2002. We expect that our gross margin will fluctuate on a quarterly basis due to the changing nature of our sales and the timing of product introductions.

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**Selling and Marketing, Net.** Selling and marketing expenses consist primarily of costs relating to promotion, advertising, trade shows and exhibitions, sales compensation, presales support, and travel expenses. Selling and marketing expenses were \$3.92 million in 2003, a decrease of 1% from \$3.95 million in 2002. In 2003, we succeeded in increasing our sales to existing OEM customers, which increased by 45% to \$2.3 million compared to \$1.59 million in 2002. During 2004, we began to increase our selling efforts, particularly in the U.S. and Europe, and we expect to increase our selling and marketing investment during the year.

**Research and Development, Net.** Research and development expenses consist primarily of salaries of employees engaged in on-going research and development activities, outsourcing subcontractor development and other related costs. Net research and development costs decreased 14% to \$1.83 million in 2003 from \$2.13 million in 2002. The total research and development expenses decreased due to the downsizing process that we continued to implement until the end of the third quarter of 2003. Beginning in the fourth quarter of 2003, we began to increase our research and development expenses. We did not receive any royalty-bearing grants from the OCS in 2002 or 2003 and we do not expect to receive any grants during 2004. We did not capitalize any software development costs in either year.

**General and Administrative.** General and administrative expenses consist primarily of compensation costs for administration, finance and general management personnel, professional fees and office maintenance and administrative costs. General and administrative expenses decreased 1.6% to \$1.83 million in 2003 from \$1.86 million in 2002 as we attempted to contain such expenses in light of our decreased sales.

**Financial Income, Net.** Financial income consists primarily of interest income on bank deposits and foreign currency translation adjustments. As a result of interest income earned on the remaining proceeds from our initial public offering, the sale of our wholly owned subsidiary, STS Software Systems Ltd., to NICE Systems Ltd. and the sale of our office condominium space on Fifth Avenue in New York, we recorded financial income of \$124,000 in 2003 as compared to financial income of \$134,000 in 2002. During the last three years our interest income was negatively affected by the prevailing low interest rates in both the United States and in Israel.

**Other Income.** During 2003 we recorded income of \$6,000 from the exercise of marketable securities compared to a loss of \$140,000 in 2002. During 2002 the loss was the result of the decline in the value of our marketable securities whose value had decreased as a result of the global recession.

**Taxes on Income.** In 2003 our taxes on income were \$198,000 as compared to \$52,000 in 2002. Most of the taxes in 2003 were the result of our realization of the deferred tax assets according to our conservative accounting policy. During 2003 we realized a tax benefit of \$80,000 from a tax return received from the Spanish tax authorities.

**Equity Interest in Results of Affiliates.** We recognize income and loss from the operations of our 50%-owned affiliate, Jusan S.A. In 2003 and in 2002, we recognized income of \$345,000 and \$236,000, respectively.

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Years Ended December 31, 2002 and 2001

**Revenues.** Revenues decreased 8.4% to \$9.8 million in 2002 from \$10.7 million in 2001 as a result of the depressed global economic environment and the decline in worldwide sales of telecommunication products. In 2002, revenues from software products increased while revenues from products with hardware components decreased. In 2002, our wholly owned U.S. subsidiary, MTS IntegraTRAK, accounted for 66.0% of our total revenues.

**Cost of Revenues.** Cost of revenues decreased 25.5% to \$1.9 million in 2002 from \$2.55 million in 2001, principally as a result of the significant efforts that we initiated beginning in the fourth quarter of 2001 to reduce costs and the decrease in our revenues.

**Gross Margin.** Gross profit as a percentage of revenues, increased to 80.6% in 2002 from 76.2% in 2001, principally as a result of our cost cutting measures.

**Selling and Marketing, Net.** Selling and marketing expenses decreased significantly by 19.4% to \$3.95 million in 2002 from \$4.9 million in 2001. Although we reduced our selling and marketing expenses in 2002 by participating in fewer trade shows and focusing on development of new channels and direct sales, we enhanced our marketing efforts, particularly in the United States, and were able to maintain our sales to existing OEM customers.

**Research and Development, Net.** Net research and development costs decreased 40.2% to \$2.13 million in 2002 from \$3.56 million in 2001, as a result of a downsizing process that we implemented during 2002. We did not receive any royalty-bearing grants from the OCS in 2002 as compared to \$990,000 received in 2001 and we do not expect to receive any grants during 2003. We did not capitalize any software development costs in either 2002 or 2001.

**General and Administrative.** General and administrative expenses decreased 4.1% to \$1.86 million in 2002 from \$1.94 million in 2001, principally as a result of downsizing that we implemented during year 2002.

**Financial Income, Net.** As a result of interest income earned on the remaining proceeds from our initial public offering, the sale of our wholly owned subsidiary, STS Software Systems Ltd. to NICE Systems Ltd. and the sale of our office condominium space on Fifth Avenue in New York, we recorded financial income of \$134,000 in 2002 as compared to financial income of \$138,000 in 2001. During both 2002 and 2001 our interest income was negatively affected by the prevailing low interest rates in both the U.S. and in Israel.

**Other Income (Expenses).** During 2001 we recorded a one-time capital loss of \$741,000 (\$606,000 after tax) from a permanent value depreciation of the NICE Systems Ltd. securities we acquired as part of the consideration received from the sale of STS Software Ltd. to NICE Systems Ltd. During 2002 we recorded a loss of \$140,000 from an exercise of marketable securities, whose value had decreased as a result of the global recession.

**Taxes on Income.** In 2002 our taxes on income was \$52,000 as compared to \$16,000 in 2001.

**Equity Interest in Results of Affiliate.** In 2002 and in 2001, we recognized income of \$236,000 and \$221,000 respectively from the operations of our 50%-owned affiliate, Jusan S.A.

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Quarterly Results of Operations

The following tables set forth certain unaudited quarterly financial information for the two years ended December 31, 2003. The data has been prepared on a basis consistent with our audited consolidated financial statements included elsewhere in this annual report and include all necessary adjustments, consisting only of normal recurring adjustments, that we consider necessary for a fair presentation. The operating results for any quarter are not necessarily indicative of results for any future periods.

	Three months ended						
	2002				2003		
	Mar. 31,	Jun. 30,	Sept.30,	Dec. 31,	Mar. 31,	Jun. 30,	
Revenues.....	\$2,581	\$2,494	\$2,196	\$2,516	\$2,240	\$2,193	\$2,
Cost of revenues.....	569	407	475	445	540	411	
Gross profit.....	2,012	2,087	1,721	2,071	1,700	1,782	1,
Selling and marketing, net.....	1,014	1,071	970	899	918	1,061	
Research and development, net...	605	539	497	486	441	386	
General and administrative.....	460	473	459	466	483	422	
Operating expenses.....	2,079	2,083	1,926	1,851	1,842	1,869	1,
Operating income (loss).....	(67)	4	(205)	220	(142)	(87)	
Financial income (expense), net.	3	101	42	(12)	16	22	
Other income (loss).....	17	(5)	(71)	(81)	--	6	
Income (loss) before taxes.....	(47)	100	(234)	127	(126)	(59)	
Taxes on income (tax benefit)...	--	65	(51)	38	--	(2)	
Net income (loss) before equity in earnings (loss) of affiliate..	(47)	35	(183)	89	(126)	(57)	(
Equity interest in results of affiliate.....	38	84	84	30	139	48	
Net income (loss).....	\$ (9)	\$ 119	\$ (99)	\$ 119	\$ 13	\$ (9)	
Revenues.....	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	10
Cost of revenues.....	22.0	16.3	21.6	17.7	24.1	18.7	2
Gross profit.....	78.0	83.7	78.4	82.3	75.9	81.3	8
Selling and marketing, net.....	39.3	42.9	44.2	35.7	41.0	48.4	4
Research and development, net .....	23.4	21.6	22.6	19.3	19.7	17.6	1

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General and administrative.....	17.8	19.0	20.9	18.5	21.6	19.2	2
Operating expenses.....	80.5	83.5	87.7	73.5	82.3	85.2	8
Operating income (loss).....	(2.5)	0.2	(9.3)	8.8	(6.4)	(3.9)	(
Financial income (expense), net.	0.1	4.1	1.9	(0.5)	0.7	1.0	(
Other income (loss).....	0.7	(0.2)	(3.2)	(3.2)	--	0.3	-
Income (loss) before taxes.....	(1.7)	4.1	(10.6)	5.1	(5.7)	(2.6)	(
Taxes on income (tax benefit)...	--	(2.6)	2.3	(1.5)	--	(0.1)	(
Net income (loss) before equity in results of affiliate.....	(1.7)	1.5	(8.3)	3.6	(5.7)	(2.5)	(
Equity interest in results of affiliate.....	1.5	3.4	3.8	1.2	6.2	2.2	(
Net income (loss).....	(0.2%)	4.9%	(4.5%)	4.8%	0.5%	(0.3)%	(

Seasonality

Our operating results are generally not characterized by a seasonal pattern except that our volume of sales in Europe are generally lower in the summer months.

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Impact of Inflation and Devaluation on Results of Operations, Liabilities and Assets

The dollar cost of our operations in Israel is influenced by the extent to which any increase in the rate of inflation in Israel is not offset, or is offset on a lagging basis, by a devaluation of the NIS in relation to the dollar. When the rate of inflation in Israel exceeds the rate of devaluation of the NIS against the dollar, companies experience increases in the dollar cost of their operations in Israel. Unless offset by a devaluation of the NIS, inflation in Israel will have a negative effect on our profitability, as we receive payments in dollars or dollar-linked NIS for most of our sales, while we incur a portion of our expenses in NIS.

In addition, since part of our sales are quoted in NIS, and a portion of our expenses are incurred in NIS, our results may be adversely affected by a change in the rate of inflation in Israel if the amount of our revenues in NIS decreases and is less than the amount of our expenses in NIS (or if such decrease is offset on a lagging basis) or if such change in the rate of inflation is not offset, or is offset on a lagging basis, by a corresponding devaluation of the NIS against the dollar and other foreign currencies.

The following table presents information about the rate of inflation in Israel, the rate of devaluation of the NIS against the dollar, and the rate of inflation in Israel adjusted for the devaluation:

Year ended December 31,	Israeli inflation rate %	NIS devaluation rate %	Israeli inflation adjusted for devaluation %
-----	-----	-----	-----

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1999	1.3	(0.2)	1.5
2000	0	(2.7)	--
2001	1.4	9.3	(7.2)
2002	6.5	7.3	(0.7)
2003	(1.9)	(7.6)	6.2

A devaluation of the NIS in relation to the dollar has the effect of reducing the dollar amount of any of our expenses or liabilities which are payable in NIS, unless those expenses or payables are linked to the dollar. This devaluation also has the effect of decreasing the dollar value of any asset which consists of NIS or receivables payable in NIS, unless the receivables are linked to the dollar. Conversely, any increase in the value of the NIS in relation to the dollar has the effect of increasing the dollar value of any unlinked NIS assets and the dollar amounts of any unlinked NIS liabilities and expenses.

Because exchange rates between the NIS and the dollar fluctuate continuously, with a historically declining trend in the value of the NIS, exchange rate fluctuations, particularly larger periodic devaluations, may have an impact on our profitability and period-to-period comparisons of our results. We cannot assure you that in the future our results of operations may not be materially adversely affected by currency fluctuations.

### Conditions in Israel

Our principal executive offices and manufacturing and research and development facilities are located in the State of Israel. Accordingly, our operations in Israel are directly

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affected by political, economic and military conditions in Israel. Specifically, we could be adversely affected by any major hostilities involving Israel, a full or partial mobilization of the reserve forces of the Israeli army, the interruption or curtailment of trade between Israel and its present trading partners, and a significant downturn in the economic or financial condition of Israel.

### Political Conditions

Since the establishment of the State of Israel in 1948, a number of armed conflicts have taken place between Israel and its Arab neighbors, and a state of hostility, varying from time to time in intensity, has led to security and economic problems for Israel. Since September 2000, there has been a marked increase in violence, civil unrest and hostility, including armed clashes, between the State of Israel and the Palestinians, and acts of terror have been committed inside Israel and against Israeli targets in the West Bank and Gaza. There is no indication as to how long the current hostilities will last or whether there will be any further escalation. Any further escalation in these hostilities or any future armed conflict, political instability or violence in the region may have a negative effect on our business condition, harm our results of operations and adversely affect our share price. Furthermore, there are a number of countries that restrict business with Israel and with Israeli companies. Restrictive laws or policies of those countries directed towards Israel or Israeli businesses may have an adverse impact on our operations, our financial results or the expansion of our business.

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In addition, some of our executive officers and employees in Israel are obligated to perform up to 36 days, depending on rank and position, of military reserve duty annually and are subject to being called for active duty under emergency circumstances. If a military conflict or war arises, these individuals could be required to serve in the military for extended periods of time. Our operations could be disrupted by the absence for a significant period of one or more of our executive officers or key employees or a significant number of other employees due to military service. Any disruption in our operations could adversely affect our business.

To date, no executive officer or key employee has been recruited for military service for any significant time period. Any further deterioration of the hostilities between Israel and the Palestinian Authority into a full-scale conflict might require more significant military reserve service by some of our employees, which may have a material adverse effect on our business.

### Economic Conditions

Israel's economy has been subject to numerous destabilizing factors, including a period of rampant inflation in the early to mid-1980s, low foreign exchange reserves, fluctuations in world commodity prices, military conflicts and civil unrest. Due to the continuing budget deficit of the Israeli Government and the slow down of the Israeli economy in recent years, the Israeli Parliament approved, during 2003, several economic measures which entail, among other things, budget cuts in various sources of government spending, the increase of various tax liabilities and cuts in various social benefits. It is not known at this stage what impact the implementation of the approved economic plan will have on the Israeli economy.

As a result of political instability, the increased level of hostilities with the Palestinian Authority and the world-wide economic crisis in the hi-tech and communication industries, the Israeli rate of economic growth deteriorated in 2001 and 2002, the NIS was devalued and the rate

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of inflation increased. The Israeli Government has proposed certain budgetary cuts and other changes, which were recently adopted by the Israeli Parliament. Although with the assistance of the U.S. Government economic stability was reached in 2003 and the rate of inflation was negative for the first since the establishment of the State, we cannot assure you that the Israeli Government will be successful in its attempts to stabilize the Israeli economy or to maintain Israel's current credit rating. Should Israel's credit rating decline, the ability of the Israeli Government to generate foreign financial and economic assistance may be adversely affected. Economic decline as well as price and exchange rate instability may have a material adverse effect on us.

### Trade Relations

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

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duty-free or at reduced tariffs.

Israel and the European Union Community concluded a Free Trade Agreement in July 1975, which confers certain advantages with respect to Israeli exports to most European countries and obligates Israel to lower its tariffs with respect to imports from these countries over a number of years. In 1985, Israel and the United States entered into an agreement to establish a Free Trade Area. The Free Trade Area has eliminated all tariff and specified non-tariff barriers on most trade between the two countries. On January 1, 1993, an agreement between Israel and the European Free Trade Association, known as EFTA, established a free-trade zone between Israel and the EFTA nations. In November 1995, Israel entered into a new agreement with the European Union, which includes redefinition of rules of origin and other improvements, including providing for Israel to become a member of the research and technology programs of the European Union. In recent years, Israel has established commercial and trade relations with a number of other nations, including China, India, Russia, Turkey and other nations in Eastern Europe and Asia.

### Effective Corporate Tax Rate

Israeli companies are generally subject to tax at the rate of 36% of taxable income. However, certain of our manufacturing facilities have been granted "Approved Enterprise" status under the Law for the Encouragement of Capital Investments, 1959, as amended, commonly referred to as the Investment Law, and, consequently, are eligible, subject to compliance with specified requirements, for tax benefits beginning when such facilities first generate taxable income. The tax benefits under the Investment Law are not available with respect to income derived from products manufactured outside of Israel. Subject to certain restrictions, we are entitled to a tax exemption in respect of income derived from our approved facilities for a period of two to four years, commencing in the first year in which such income is earned, and will be entitled to a reduced tax rate of 15% for an additional eight years if we qualify as a foreign investors' company. If we do not qualify as a foreign investors' company, we will instead be entitled to a reduced rate of 25% for an additional five, rather than eight, years.

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Our effective tax rates in Israel were 25% during the years 2001, 2002 and 2003. Our effective corporate tax rate may substantially exceed the Israeli tax rate.

Our taxes outside Israel are dependent on our operations in each jurisdiction as well as relevant laws and treaties. Under Israeli tax law, the results of our foreign consolidated subsidiaries, which have generally been unprofitable, cannot be consolidated for tax purposes with the results of operations of the parent company, which historically have been profitable.

### B. LIQUIDITY AND CAPITAL RESOURCES

On December 31, 2003, we had \$8.7 million in cash and cash equivalents, \$1.6 million in marketable securities and working capital of \$9.4 million as compared to \$9.1 million in cash and cash equivalents, \$1.2 million in marketable securities and \$9.2 million in working capital on December 31, 2002. The increase in working capital in 2003 is mainly due to an increase in both accounts receivables and other accounts receivable and prepaid expenses. During 2003 we continued our stock buy back program, purchasing 130,510 ordinary shares



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through December 31, 2003 at a cost of \$147,000, an average of \$1.13 per share. During 2003 we retired 384,610 ordinary shares, which we purchased pursuant to our stock buy-back program. Depending upon market conditions, we may decide to continue this program during 2004. We may use the repurchased shares for issuance upon exercise of employee stock options or other corporate purposes.

One of the principal factors affecting our working capital is the payment cycle on our sales. Payment for goods shipped is generally received from 60 to 70 days after shipment. Any material change in the aging of our accounts receivable could have an adverse effect on our working capital.

The decrease in inventory for the year ended December 31, 2003 was primarily due to our efforts to reduce inventories in light of the difficult economic conditions prevailing worldwide. Our net accounts receivable at year-end 2003 were \$1.39 million compared to \$1.26 million as of December 31, 2002. The change is attributed to outstanding accounts receivable belong to recent projects that were performed at the end of 2003. The allowance for doubtful accounts was \$356,000 and \$350,000 as of December 31, 2002 and 2003, respectively.

Our operations provided \$163,000 for the year ended December 31, 2003, compared to \$489,000 for the year ended December 31, 2002. The decrease in cash provided from operations was primarily due the reduced equity in the earnings of our affiliates and an increase in trade payables, accounts receivable and prepaid expenses.

As of December 31, 2003, our principal commitments consisted of obligations outstanding under operating leases. We currently do not have significant capital spending or purchase commitments, but we expect to continue to engage in capital spending consistent with the level of our operations. We anticipate that our cash on hand and cash flow from operations will be sufficient to meet our working capital and capital expenditure requirements for at least 12 to 18 months. Thereafter, if we do not generate sufficient cash from operations, we may be required to obtain additional financing. There can be no assurance that such financing will be available in the future, or, if available, will be on terms satisfactory to us.

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### C. RESEARCH AND DEVELOPMENT

Our product development plans are market-driven and address the major, fast-moving trends that are influencing the telecommunications industry. We intend to expand upon our existing family of telemanagement solutions by adding new features and functions to address evolving market needs. We work closely with our customers and prospective customers to determine their requirements and design enhancements and new releases to meet their needs. Research and development activities take place in our facilities in Israel. We are ISO 9001:1994 certified and we are currently in the process of upgrading the quality system according to ISO 9001:2000.

We are evaluating approaches to solutions which will permit an information technology manager to effectively measure the quality of the services received from their service providers and to ensure that the users within the organization received such services according to their needs and the overall policy and priorities of the organization.

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On December 31, 2003, we employed 23 persons in research and development. As part of our product development team, we employ technical writers who prepare user documentation for our products.

We have committed substantial financial resources to research and development for our telemanagement business. We enjoyed the aid of the Israeli Ministry of Industry and Trade's Office of the Chief Scientist for selected research and development projects. During 2001, 2002 and 2003, our research and development expenditures were \$4.6 million, \$2.1 million and \$1.8 million, respectively, for which the Office of the Chief Scientist reimbursed us approximately \$0.99 million in 2001. We did not receive any grants in 2002 or 2003.

Under research and development agreements with the Office of the Chief Scientist, we are required to pay royalties on the revenues derived from products incorporating know-how developed with grants received from the Office of the Chief Scientist (including ancillary services in connection therewith), up to a dollar-linked amount equal to 100% to 150% of such grants and bearing LIBOR interest. Commencing in June 1997, we have paid the Office of the Chief Scientist royalties on all call accounting product sales at the applicable rates at the time of payment. Under these agreements and existing laws and regulations, we are required to pay royalties at a rate of 3%-5% of our software sales. See Item 10E. "Additional Information - Taxation - Grants under the Law for the Encouragement of Industrial Research and Development, 1984."

We have expensed royalties relating to the repayment of such grants in the amounts of \$176,000, \$132,000 and \$146,000 for the years ended December 31, 2001, 2002 and 2003, respectively.

As of December 31, 2003, we had a contingent obligation to pay royalties in the amount of approximately \$7.52 million. The \$3.45 million of grants received after January 1999 are subject to interest at a rate equal to the 12 month LIBOR rate. We do not expect to receive additional grants from the Government of Israel during 2004.

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### D. TREND INFORMATION

As a result of a less predictable business environment and the decline in worldwide sales of PBX systems, we are unable to provide any guidance as to current sales and profitability trends. We expect that our results will continue to be impacted by a shift to a new line of products and increased marketing and research and development expenditures.

### E. OFF-BALANCE SHEET ARRANGEMENTS

We are not a party to any material off-balance sheet arrangements. In addition, we have no unconsolidated special purpose financing or partnership entities that are likely to create material contingent obligations.

### F. TABULAR DISCLOSURE OF CONTRACTUAL OBLIGATIONS

The following table summarizes our minimum contractual obligations and commercial commitments, including obligations of discontinued operations, as of December 31, 2003 and the effect we expect them to have on our liquidity and cash flow in future periods.

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Contractual Obligations	Payments due by Period				
	Total	less than 1 year	1-3 Years	3-5 Years	more than 5 years
Long-term debt obligations.....	--	--	--	--	--
Capital (finance) lease obligations	--	--	--	--	--
Operating lease obligations.....	\$540,000	\$276,000	\$264,000	--	--
Purchase obligations.....	--	--	--	--	--
Other long-term liabilities reflected on our balance sheet under U.S. GAAP .....	--	--	--	--	--
Total.....	\$540,000	\$276,000	\$264,000	--	--
	=====	=====	=====	==	==

ITEM 6. DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES

A. DIRECTORS AND SENIOR MANAGEMENT

Set forth below are the name, age, principal position and a biographical description of each of our directors and executive officers:

Name	Age	Position with the Company
Chaim Mer.....	56	Chairman of the Board
Eytan Bar.....	38	President and Chief Executive Officer
Yossi Brikman.....	46	Corporate Chief Operating Officer and Chief Financial Officer-Israel
Richard Bruyere.....	40	Chief Operating Officer-MTS IntegraTRAK Inc.
Alon Aginsky.....	41	Director
Isaac Ben-Bassat.....	50	Director

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Name	Age	Position with the Company
Dr. Yehoshua Gleitman...	54	Director
Steven J. Glusband.....	57	Director
Yaacov Goldman.....	49	Director
Prof. Nava Pliskin.....	56	Director

Messrs. Mer, Aginsky, Ben-Bassat, Glusband and Goldman will serve as directors until our 2004 Annual General Meeting of Shareholders. Dr. Gleitman and Prof. Pliskin serve as outside directors pursuant to the provisions of the Israeli Companies Law for a three-year term from the date of their appointment until our 2004 annual general meeting of shareholders. At that time, they may be re-elected for only one additional three-year term.

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Chaim Mer has served as Chairman of our Board of Directors and a director since our inception in December 1995. Mr. Mer has been the President, Chief Executive Officer and Chairman of the Board of C. Mer Industries Ltd. since 1988. Mr. Mer holds a B.Sc. degree in Computer Sciences and Mathematics from the Technion Israel Institute for Technology.

Eytan Bar has served as our President and Chief Executive Officer since December 2003. Prior to joining us, and between 2001 and 2003, Mr. Bar served as General Manager of the CEM product division of NICE Systems Ltd. From 2000 through 2001 Mr. Bar served as a Vice President of Professional Services at NICE Systems Inc. From 1993 through 1999, Mr. Bar served as a General Manager of STS Software Systems Ltd., a company that developed a unique VoIP technology for recording solutions.

Yossi Brikman has been our Vice President and Chief Financial Officer since January 1998. Since March 2000, Mr. Brikman has also served as our Secretary. He was appointed as General Manager of our operations in Israel in August 2000. Before joining us, he served as co-founder and co-manager of STS Software Systems Ltd. from its inception in 1988 until January 1998. Mr. Brikman holds a B.Sc. degree from Fairleigh Dickenson University and an M.B.A. degree from Haifa University.

Richard Bruyere has been the Chief Operating Officer of our subsidiary, MTS IntegraTRAK Inc., since January 2002. After having served as Director of Telecommunications for Memorial Hospital from 1987 to 1995, Mr. Bruyere joined IntegraTRAK Inc. in January 1995. In October 1998, he was elected Vice President of Operations of IntegraTRAK Inc. Mr. Bruyere joined MTS as part of our acquisition of IntegraTRAK Inc. in April 2000.

Alon Aginsky has been a director since June 1996. Since July 2000 Mr. Aginsky has served as President and Chief Executive Officer of cVidya Inc., which is engaged in the development of a service assurance platform for next generation broadband service providers. Mr. Aginsky served as our Vice President Marketing and Sales from October 1996 until April 1999, when he was appointed Manager of C. Mer Industries Ltd. He served as President of MTS Inc., our U.S. based marketing subsidiary from 1990 until September 1996. Mr. Aginsky holds a B.A. degree in Business Administration from the New York Technology Institute.

Isaac Ben-Bassat has been a director since our inception in December 1995. He has been Executive Vice President and a director of C. Mer Industries Ltd. since 1988.

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Mr. Ben-Bassat holds a B.Sc. degree in Civil Engineering from the Technion Israel Institute for Technology.

Dr. Yehoshua Gleitman has served as an outside director since July 2001. Since March 2000, Dr. Gleitman has been Chief Executive Officer of SFKT, a company whose activities include: venture capital management, finance and investments in high-tech and telecommunications. Mr. Gleitman was Chief Executive Officer of Ampal-American Israel Corporation, or Ampal, from May 1997 and Managing Director of Ampal's Israeli wholly owned subsidiaries and head of Ampal's Israeli operations from April 1, 1997 until his resignation in July 1999. From August 1996 until February 1997, he was Director General of the Israeli Ministry of Industry and Trade and was Chief Scientist at the Ministry

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of Industry and Trade from January 1993 through February 1997. From 1991 through 1992, he was the general manager of AIMS Ltd., and between 1990-1991, was an advisor in charge of marketing and business for Ashtrom Ltd. Dr. Gleitman holds a Ph.D. and an M.Sc. in Physical Chemistry and a B.Sc. from the Hebrew University of Jerusalem.

Steven J. Glusband has served as a director since August 1, 1996. Mr. Glusband has been a partner with Carter Ledyard & Milburn LLP, our U.S. counsel, since March 1987. Mr. Glusband holds a B.B.A. degree from the City College of the City University of New York, a J.D. degree from Fordham University School of Law and an L.L.M. degree from the New York University School of Law.

Yaacov Goldman was elected as a director by our Board of Directors in May 2004 and will be a nominee for election at our 2004 Annual General Meeting of Shareholders. Mr. Goldman provides consulting services to companies in strategic-financial areas, through his wholly owned company, Maanit-Goldman Management & Investments (2002) Ltd. Mr. Goldman serves as a director of Bank Leumi Le-Israel Ltd. and Elron Electronic Industries Ltd. From March 2002 until October 2002, he served as consultant for Poalim Capital Markets and Investments Ltd. From September 2000 until November 2001, he served as Managing Director of Argoquest Holdings, LLC, a U.S. based investment company focused on early stage high-tech companies. From November 1981 until August 2000, he was associated with Kessleman & Kessleman, the Israeli member firm of PricewaterhouseCoopers, and was a Partner and Senior Partner at such firm from January 1991 through August 2000. Mr. Goldman is a Certified Public Accountant (Israel) since 1981 and holds a B.A. degree in Economics and Accounting from Tel Aviv University.

Prof. Nava Pliskin has served as an outside director since July 2001. Prof. Pliskin has been a Full Professor since 2002 in the areas of Information Systems (IS) and Information Technology (IT) at the Department of Industrial Engineering and Management of Ben-Gurion University in Israel. She has been a faculty member at Ben-Gurion University since 1985, receiving tenure in 1992. Prof. Pliskin was a Thomas Henry Carroll Ford Foundation Visiting Associate Professor at the Harvard Business School in 1996-1997. Prof. Pliskin holds Ph.D. and S.M. degrees in Engineering and Applied Physics from Harvard University and a B.Sc. in Mathematics and Statistics from Tel Aviv University.

### B. COMPENSATION

The following table sets forth all compensation we paid with respect to all of our directors and executive officers as a group for the year ended December 31, 2003.

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	Salaries, fees, commissions and bonuses -----	Pension, retirement and similar benefits -----
All directors and executive officers as a group, consisting of twelve (12) persons	\$625,694	\$179,327

All our executive officers work full time for us, except for Mr. Mer, who is employed on a part-time basis. We provide automobiles to our executive officers at our expense. During the year ended December 31, 2003, we paid each of our independent directors an annual fee of approximately \$8,400 and a per

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meeting attendance fee of \$300.

As of December 31, 2003, our directors and executive officers as a group, consisting of 12 persons, held options to purchase an aggregate 262,990 ordinary shares.

### C. BOARD PRACTICES

Our Articles of Association provide for a Board of Directors consisting of up to 10 members or such other number as may be determined from time to time at a general meeting of shareholders. Our Board of Directors is currently composed of seven directors. All directors (except the outside directors) hold office until the next annual general meeting of shareholders and until their successors have been elected.

#### Election of Directors

Pursuant to our articles of association, all of our directors are elected at our annual general meeting of shareholders by a vote of the holders of a majority of the voting power represented and voting at such meeting. All the members of our Board of Directors (except the outside directors) may be reelected upon completion of their term of office. All of our current directors (except our outside directors) were elected by our shareholders at our annual general meeting of shareholders of July 2003.

#### Independent and Outside Directors

The Israeli 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:

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

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No person may serve as an outside director if the person's position or other 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 an outside director is to be appointed, all current members of the board of directors are of the same gender, then the outside director must be of the other gender.

Outside directors are elected by shareholders. The shareholders voting in favor of their election must include at least one-third of the shares of the non-controlling shareholders of the company who are present at the meeting and voting on the matter. This minority approval requirement need not be met if the

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total shareholdings of those non-controlling shareholders who vote against their election represent 1% or less of all of the voting rights in the company. Outside directors serve for a three-year term, which may be renewed for only one additional three-year term. Outside directors can be removed from office only by the same special percentage of shareholders as can elect them, or by a court, and then only if the outside directors cease to meet the statutory qualifications with respect to their appointment or if they violate their duty of loyalty to the company.

Any committee of the board of directors must include at least one outside director and the audit committee must include all of the outside directors. An outside director is entitled to compensation as provided in regulations adopted under the Israeli Companies Law and is otherwise prohibited from receiving any other compensation, directly or indirectly, in connection with such service.

In addition, the Nasdaq Stock Market requires us to have at least two independent directors on our Board of Directors and to establish an audit committee. Under Nasdaq rules promulgated pursuant to the Sarbanes-Oxley Act of 2002, we will be required in the future to have three independent directors on our audit committee. Dr. Yehoshua Gleitman and Prof. Nava Pliskin qualify both as independent directors under the Nasdaq Stock Market requirements and as outside directors under the Israeli Companies Law requirements. Messrs. Alon Aginsky and Yaacov Goldman qualify as independent directors under the Nasdaq Stock Market requirements.

### Approval of Related Party Transactions Under Israeli Law

The Israeli 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. The duty of care requires an office holder to act at a level of care that a reasonable office holder in the same position would employ under the same circumstances. The duty of loyalty includes avoiding any conflict of interest between the office holder's position in the company and his personal affairs, avoiding any competition with the company, avoiding exploiting any business opportunity of the company in order to receive personal gain for the office holder or others, and disclosing to the company any information or documents relating to the company's affairs which the office holder has received due to his position as an office holder. Each person listed as a director or executive officer in the table under Item 6A. "Directors, Senior Management and Employees -- Directors and Senior Management" is an office holder. Under the Israeli Companies Law, all arrangements as to compensation of office holders who are not directors require approval of our board of directors, and the compensation of office holders who are directors must be approved by our audit committee, board of directors and shareholders.

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The Israeli 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 us. In addition, if the transaction is an extraordinary transaction, that is, a transaction other than in the ordinary course of business, other than on market terms, or likely to have a material impact on the company's profitability, assets or liabilities, the office holder must also disclose any personal interest held by the office holder's spouse, siblings,

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parents, grandparents, descendants, spouse's descendants and the spouses of any of the foregoing, or by any corporation in which the office holder or a relative is a 5% or greater shareholder, director or general manager or in which he or she has the right to appoint at least one director or the general manager. Some transactions, actions and arrangements involving an office holder (or a third party in which an office holder has an interest) must be approved by the board of directors or as otherwise provided for in a company's articles of association, as not being adverse to the company's interest. In some cases, such a transaction must be approved by the audit committee and by the board of directors itself (with further shareholder approval required in the case of extraordinary transactions). An office holder who has a personal interest in a matter, which is considered at a meeting of the board of directors or the audit committee, may not be present during the board of directors or audit committee discussions and may not vote on this matter, unless the majority of the members of the board or the audit committee have a personal interest, as the case may be.

The Israeli Companies Law also provides that some transactions between a public company and a controlling shareholder, or transactions in which a controlling shareholder of the company has a personal interest but which are between a public company and another entity, require the approval of the board of directors and of the shareholders. Moreover, an extraordinary transaction with a controlling shareholder or the terms of compensation of a controlling shareholder must be approved by the audit committee, the board of directors and shareholders. The shareholder approval for an extraordinary transaction must include at least one-third of the shareholders who have no personal interest in the transaction and are present at the meeting. The transaction can be approved by shareholders without this one-third approval, if the total shareholdings of those shareholders who have no personal interest and voted against the transaction do not represent more than one percent of the voting rights in the company.

However, under the Companies Regulations (Relief from Related Party Transactions), 5760-2000, promulgated under the Israeli Companies Law and amended in January 2002, certain transactions between a company and its controlling shareholder(s) do not require shareholder approval.

In addition, pursuant to the recent amendment to these regulations, directors' compensation and employment arrangements do not require the approval of the shareholders if both the audit committee and the board of directors agree that such arrangements are for the benefit of the company. If the director or the office holder is a controlling shareholder of the company, then the employment and compensation arrangements of such director or office holder do not require the approval of the shareholders provided that certain criteria are met.

The above exemptions will not apply if one or more shareholders, holding at least 1% of the issued and outstanding share capital of the company or of the company's voting rights, objects to the grant of such relief, provided that such objection is submitted to the company in writing not later than seven (7) days from the date of the filing of a report regarding the adoption

of such resolution by the company pursuant to the requirements of the Israeli Securities Law. If such objection is duly and timely submitted, then the compensation arrangement of the directors will require shareholders' approval as detailed above.



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The Israeli 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 become a 25% shareholder of the company. This rule does not apply if 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 a tender offer if as a result of the acquisition the purchaser would become a 45% shareholder of the company, unless there is a 50% shareholder of the company. Regulations under the Companies Law provide that the Companies Law's tender offer rules do not apply to a company whose shares are publicly traded outside of Israel, if pursuant to the applicable foreign securities laws and stock exchange rules there is a restriction on the acquisition of any level of control of the company, or if the acquisition of any level of control of the company requires the purchaser to make a tender offer to the public shareholders.

### Exculpation, Indemnification and Insurance of Directors and Officers

The Israeli Companies Law provides that an Israeli company cannot exculpate an office holder from liability with respect to a breach of his duty of loyalty, but may, if permitted by its articles of association, exculpate in advance an office holder from his liability to the company, in whole or in part, with respect to a breach of his duty of care. Our Articles of Association permit us to exempt an officer for his liability, in whole or in part, for damage caused due to the breach of the duty of care, subject to the provisions of the Israeli Companies Law.

Our Articles of Association provide that, subject to the provisions of the Israeli Companies Law, we may enter into an insurance contract for the liability of an officer with respect to an act performed by him in his capacity as an officer, for:

- o a breach of his duty of care to us or to another person;
- o breach of his duty of loyalty to us, provided that the office holder acted in good faith and had reasonable cause to assume that his act would not prejudice our interests; or
- o a financial liability imposed upon him in favor of another person.

In addition, our Articles of Association provide that we may, with respect to an act performed by an officer in such capacity, (i) undertake in advance to indemnify an officer, provided that the undertaking shall be restricted to types of events that the board of directors shall deem to have been foreseeable at the time the undertaking to indemnify is made, and to a sum which shall not exceed an amount in NIS equal to \$3 million; and (ii) indemnify an officer retroactively; against:

- o a financial liability imposed on him in favor of another person by any judgment, including a settlement or an arbitration award approved by a court; and

- o reasonable litigation expenses, including attorneys' fees, expended by such office holder or charged to him by a court, in a proceeding we instituted against him or instituted on our behalf or by another person, or in a criminal charge from which he was acquitted or in

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which he was convicted of an offense that does not require proof of criminal intent.

These provisions are specifically limited in their scope by the Israeli Companies Law, which provides that a company may not indemnify an office holder, nor exculpate an office holder, nor enter into an insurance contract which would provide coverage for any monetary liability, incurred as a result of certain improper actions.

Pursuant to the Companies Law, exculpation of, procurement of insurance coverage for, and an undertaking to indemnify or indemnification of, our office holders must be approved by our audit committee and our board of directors and, if such office holder is a director, also by our shareholders.

Our audit committee, board of directors and shareholders resolved to indemnify our office holders, pursuant to a standard indemnification agreement that provides for indemnification of an office holder in an amount up to \$3 million. We currently maintain a directors' and officers' liability insurance policy with a per claim and aggregate coverage limit of \$2.5 million including legal costs incurred in Israel. We intend to increase our coverage to \$5 million, subject to shareholder ratification at our Annual General Meeting that is scheduled to take place in July 2004.

### Directors' Service Contracts

We do not have any service contracts with our directors. Our directors are not entitled to any benefits upon termination of their service as our directors.

### Audit Committee

Our audit committee, which was established in accordance with Section 114 of the Israeli Companies Law and Section 3(a)(58)(A) of the Securities Exchange Act of 1934, assists our board of directors in overseeing the accounting and financial reporting processes of our company and audits of our financial statements, including the integrity of our financial statements, compliance with legal and regulatory requirements, our independent public accountants' qualifications and independence, the performance of our internal audit function and independent public accountants, finding any defects in the business management of our company for which purpose the audit committee may consult with our independent auditors and internal auditor, proposing to the board of directors ways to correct such defects, approving related-party transactions as required by Israeli law, and such other duties as may be directed by our board of directors.

Our audit committee consists of four board members who satisfy the respective "independence" requirements of the Securities and Exchange Commission, Nasdaq and Israeli Law for audit committee members. Our audit committee is currently composed of Dr. Yehoshua Gleitman, Prof. Nava Pliskin and Messrs. Alon Aginsky and Yaacov Goldman. Our Board of Directors has determined that Mr. Goldman qualifies as a financial expert. The audit committee meets at least once each quarter.

The responsibilities of the audit committee also include approving related-party transactions as required by law. Under Israeli law an audit

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committee may not approve an action or a transaction with a controlling shareholder, or with an office holder, unless at the time of approval two outside directors are serving as members of the audit committee and at least one of the outside directors was present at the meeting in which an approval was granted.

### Internal Audit

The Israeli Companies Law also requires the board of directors of a public company to appoint an internal auditor nominated by the audit committee. A person who does not satisfy the Israeli Companies Law's independence requirements may not be appointed as an internal auditor. The role of the internal auditor is to examine, among other things, the compliance of the company's conduct with applicable law and orderly business practice. Mr. Shaul Sofer serves as our internal auditor.

### D. EMPLOYEES

On December 31, 2003, we and our consolidated subsidiaries employed 86 persons, of which 23 persons were employed in research and development, 31 in training and technical support, 15 in marketing and sales and 17 in operations and administration. As of December 31, 2003, 40 of our employees were located in Israel, 31 of our employees were located in the United States, 8 of our employees were located in Hong Kong, 2 of our employees were located in Holland and 5 of our employees were located in Brazil.

On December 31, 2002, we and our consolidated subsidiaries employed 90 persons, of which 27 persons were employed in research and development, 31 in training and technical support, 15 in marketing and sales and 17 in operations and administration.

On December 31, 2001, we and our consolidated subsidiaries employed 106 persons, of which 33 persons were employed in research and development, 37 in training and technical support, 20 in marketing and sales and 16 in operations and administration.

Certain provisions of the collective bargaining agreements between the Histadrut (General Federation of Labor in Israel) and the Coordination Bureau of Economic Organizations (including the Industrialists Association) are applicable to our employees by order of the Israeli Ministry of Labor. These provisions concern mainly the length of the workday, minimum daily wages for professional workers, contributions to a pension fund, insurance for work-related accidents, procedures for dismissing employees, determination of severance pay and other conditions of employment. We generally provide our employees with benefits and working conditions beyond the required minimums.

Cost of living adjustments of employees' wages are determined on a nationwide basis and are legally binding. Under the current inflation rates, these adjustments compensate employees for approximately 40% of the change in the cost of living, with certain lag factors in implementation. Israeli employers and employees are required to pay predetermined amounts to the National Insurance Institute, which is similar to the United States Social Security Administration. In 2003, payments to the National Insurance Institute amounted to approximately 14.5% of wages, of which approximately two-thirds was contributed by employees with the balance contributed by the employer.

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Pursuant to Israeli law, we are legally required to pay severance benefits upon certain circumstances, including the retirement or death of an employee or the termination of employment of an employee without due cause. We satisfy approximately 8.3% of this obligation by contributing funds to a fund known as "Managers' Insurance." This fund provides a combination of savings plans, insurance and severance pay benefits to the employee, giving the employee a lump sum payment upon retirement and a severance payment, if legally entitled, upon termination of employment. The remaining part of this obligation is presented in our balance sheet as "provision of severance pay."

### E. SHARE OWNERSHIP

The following table sets forth certain information as of June 1, 2004 regarding the beneficial ownership of our ordinary shares by each of our directors and executive officers.

Name	Number of Ordinary Shares Beneficially Owned(1)	Percentage of Outstanding Ordinary Shares(2)
----	-----	-----
Chaim Mer.....	2,099,778 (3) (4)	44.3%
Eytan Bar .....	31,250	*
Yossi Brikman.....	150,000 (5)	3.2
Richard Bruyere.....	20,000 (5)	*
Alon Aginsky.....	-- (5)	--
Isaac Ben-Bassat.....	689,214 (6)	14.8
Dr. Yehoshua Gleitman.....	--	--
Steven J. Glusband.....	5,722 (5) (7)	*
Yaacov Goldman.....	--	--
Prof. Nava Pliskin.....	--	--
-----		

\* Less than 1%.

- (1) Beneficial ownership is determined in accordance with the rules of the Securities and Exchange Commission and generally includes voting or investment power with respect to securities. Ordinary shares relating to options currently exercisable or exercisable within 60 days of the date of this table are deemed outstanding for computing the percentage of the person holding such securities but are not deemed outstanding for computing the percentage of any other person. Except as indicated by footnote, and subject to community property laws where applicable, the persons named in the table above have sole voting and investment power with respect to all shares shown as beneficially owned by them.
- (2) The percentages shown are based on 4,641,804 ordinary shares (excluding 7,000 shares held in treasury) issued and outstanding as of June 1, 2004.
- (3) Mr. Chaim Mer and his wife, Mrs. Dora Mer, are the holders of 244,821 ordinary shares, and are the beneficial owners of 1,744,453 ordinary shares through their

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their controlling interest in Mer Services Ltd., 95 ordinary shares through their controlling interest in Mer & Co. (1982) Ltd. and 46 ordinary shares through their controlling interest in C. Mer Industries Ltd.

- (4) Includes 98,824 ordinary shares issuable upon exercise of stock options.
- (5) Subject to currently exercisable stock options.
- (6) Includes 630,045 ordinary shares held by Ron Dan Investments Ltd., a corporation controlled by Mr. Ben-Bassat.
- (7) Includes 4,722 ordinary shares subject to currently exercisable stock options.

### Stock Option Plans

#### 1996 Stock Option Plan

Under our 1996 Stock Option Plan, as amended, or the 1996 Plan, options to purchase up to 400,000 ordinary shares may be granted to our employees, management, officers and directors or those of our subsidiaries. Any options which are canceled or forfeited within the option period will become available for future grants. The 1996 Plan will terminate in 2006, unless earlier terminated by the Board of Directors.

The 1996 Plan is administered by the Board of Directors or an Option Committee which may be appointed by the Board of Directors, which has the authority, subject to applicable law, to determine the persons to whom options will be granted, the number of ordinary shares to be covered by each option the time or times at which options will be granted or exercised, and the terms and conditions of the options. The exercise price of options granted under the 1996 Plan may not be less than 100% of the fair market value of our ordinary shares on the date of the grant of incentive stock options and 75% in the case of options not designated as incentive stock options. Fair market value is the mean between the highest and lowest quoted selling prices on the date of grant of our shares traded on Nasdaq or a stock exchange on which such shares are principally traded. According to the 1996 Plan, we may provide loans to employees to assist them in purchasing the shares upon exercise of an option on terms and conditions approved by the Board of Directors and subject to applicable law. Such loans have never been granted.

Options granted under the 1996 Plan will generally be exercisable under such circumstances as the Board or Option Committee determines. Such options will not be transferable by an optionee other than by will or by laws of descent and distribution, and during an option holder's lifetime will be exercisable only by such option holder or by his or her legal representative. Options granted under the 1996 Plan will terminate at such time and under such circumstances as the Board or Option Committee determines.

During 2003, options to purchase 35,000 ordinary shares were granted under our 1996 Plan, with an average exercise price of \$2.94 and no options were exercised into ordinary shares. At December 31, 2003, options to purchase 103,350 ordinary shares were outstanding under the 1996 Plan, exercisable at an average exercise price of \$2.85 per share.

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### Section 102 Stock Option Plan

In 1996 we adopted a Section 102 Stock Option Plan, as amended, or the 1996 102 Plan, providing for the grant of options to our Israeli employees, management, officers and directors or those of our subsidiaries. The 1996 102 Plan was adopted pursuant to Section 102 of the Israeli Income Tax Ordinance [New Version] - 1961, or Section 102, and provided recipients with tax advantages under the Israeli Income Tax Ordinance. As of January 1, 2003, Section 102 was amended, pursuant to which certain new tax advantages are afforded with respect to option grants to employees and directors. In order to enable employees and directors to benefit from such tax advantages with respect to future grants of options and issuance of shares upon exercise thereof, such grants have to be performed under a share option plan that is adjusted to the amended Section 102, and therefore we adopted our 2003 Israeli Share Option Plan. We do not intend to grant any more options under the 1996 102 Plan and the ordinary shares that remained available for grant under the 1996 102 Plan were rolled-over into our new 2003 Israeli Share Option Plan for issuance thereunder.

Options granted under our 1996 102 Plan are exercisable under such circumstances as the Board of Directors or Option Committee determined. According to the 1996 102 Plan, we may provide loans to employees to assist them in purchasing the shares upon exercise of an option on terms and conditions approved by the Board of Directors and subject to applicable law. Such loans have never been granted. Options granted under the this plan are not transferable by an optionee other than by will or by laws of descent and distribution, and during an option holder's lifetime will be exercisable only by such option holder or by his or her legal representative.

During 2003, options to purchase 67,000 ordinary shares were granted under the 1996 102 Plan at an exercise price below the fair market value of the stock on the date of grant and options to purchase 133,333 ordinary shares were exercised into ordinary shares. At December 31, 2003, options to purchase 362,791 ordinary shares were outstanding, exercisable at an average exercise price of \$2.85 per share.

### 2003 Israeli Share Option Plan

Under our 2003 Israeli Share Option Plan, or the 2003 Plan, options to purchase up to 893,915 ordinary shares may be granted to directors, employees, consultants, advisors, service providers, controlling shareholders and other persons not employed by us or by our affiliates. Any options which are canceled or forfeited within the option period will become available for future grants. The 2003 Plan will terminate in 2013, unless earlier terminated by the Board of Directors.

Options to Israeli employees, directors and officers, other than controlling shareholders (as such term is defined in the Israeli Income Tax Ordinance), under the 2003 Plan may only be granted under Section 102. Under amended Section 102, options granted pursuant to Section 102 may be designated as "Approved 102 Options" or "Unapproved 102 Options." An Approved 102 Option may either be classified as a capital gains option or an ordinary income option. We elected to initially grant our options pursuant to Section 102 as capitals gain options. Such election is effective as of the first date of grant of such capital gains options under the 2003 Plan and shall remain in effect at least until the lapse of one year following the end of the tax year during which we first granted capital gains options. All Approved 102 Options (or the ordinary shares issued upon exercise thereof) must be held in trust by a trustee for the requisite

holding period under Section 102 in order to benefit from the certain tax advantages. We may also grant Unapproved 102 Options, which do not have any tax benefit and are not held by a trustee. Options granted under Section 102 are taxed on the date of sale of the exercised ordinary shares and/or the date of the release of the options or such exercised ordinary shares from the trust.

The 2003 Plan is administered by the Board of Directors or a committee of the Board of Directors, if appointed, which has the authority, subject to applicable law, to determine, the persons to whom options will be granted, the terms and conditions of the respective options, including the time and the extent to which the options may be exercised, may designate the type of options, make an election as to the type of Approved 102 Option. However, such committee, if appointed, is not entitled to grant options. The exercise price of options granted under the 2003 Plan will be based on the fair market value of our ordinary shares and are determined by the Board of Directors or the committee at the time of the grant.

Options granted under the 2003 Plan are not assignable or transferable by an optionee, other than by will or by laws of descent and distribution, and during the lifetime of an optionee may be exercised only by the optionee or by the optionee's legal representative. Such options may be exercised as long as the optionee is employed by, or providing services to us or any of our affiliates, to the extent the options have vested.

During 2003, options to purchase an aggregate of 332,500 ordinary shares were granted under the 2003 Plan at an average exercise price of \$2.11 per share, including 250,000 options having exercise prices below the fair market value of our ordinary shares on the date of grant. No options were exercised into ordinary shares in 2003. At December 31, 2003, there were 332,500 options outstanding under the 2003 Plan having an exercise price of \$2.11 per share.

Warrants

On February 7, 2001, we issued five-year warrants to purchase 25,000 of our ordinary shares to Investec Bank (Mauritius) Ltd. in connection with certain financial services performed on our behalf. The warrants had an exercise price of \$4.95 per ordinary share until February 2004, and from thereafter until February 2006, the exercise price is \$5.625 per ordinary share.

ITEM 7. MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS

A. MAJOR SHAREHOLDERS

The following table sets forth certain information as of June 1, 2004 regarding the beneficial ownership by all shareholders known to us to own beneficially 5.0% or more of our ordinary shares:

Number of Ordinary Shares	Percentage of Outstanding
------------------------------	------------------------------

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Name ----	Beneficially Owned(1) -----	Ordinary Shares(2) -----
Chaim Mer and Dora Mer.....	2,099,778 (3) (4)	44.3%
Isaac Ben-Bassat.....	689,214	14.8%
	-----	----
Total.....	2,788,992 =====	59.1% =====
	-----	-----

- (1) Beneficial ownership is determined in accordance with the rules of the Securities and Exchange Commission and generally includes voting or investment power with respect to securities. Ordinary shares relating to options currently exercisable or exercisable within 60 days of the date of this table are deemed outstanding for computing the percentage of the person holding such securities but are not deemed outstanding for computing the percentage of any other person. Except as indicated by footnote, and subject to community property laws where applicable, the persons named in the table above have sole voting and investment power with respect to all shares shown as beneficially owned by them.
- (2) The percentages shown are based on 4,641,803 ordinary shares (excluding 384,610 shares held in treasury) issued and outstanding as of June 1, 2004.
- (3) Mr. Chaim Mer and his wife, Mrs. Dora Mer, are the holders of 234,821 ordinary shares, and are the beneficial owners of 1,744,453 ordinary shares through their controlling interest in Mer Ofekim Ltd., 11,539 ordinary shares through their controlling interest in Mer Services Ltd., 95 ordinary shares through their controlling interest in Mer & Co. (1982) Ltd. and 46 ordinary shares through their controlling interest in C. Mer Industries Ltd.
- (4) Includes 98,824 ordinary shares issuable upon exercise of stock options.

As of June 1, 2004 there were 26 holders of record of our ordinary shares, of which 8 record holders holding approximately 32% of our ordinary shares had registered addresses in the United States. We believe that there were over 52 beneficial holders of our ordinary shares on June 1, 2004.

### B. RELATED PARTY TRANSACTIONS

Ms. Dora Mer, the wife of Chaim Mer, provides legal services to us and receives a monthly retainer of \$5,000. The conditions of retaining the services of Ms. Mer were approved by the Board of Directors and by the Audit Committee.

Our subsidiaries, MTS Asia Ltd. and MTS IntegraTRAK, entered into an agreement with C. Mer Industries Ltd., or C. Mer, pursuant to which they distribute and support certain of C. Mer's products and provide certain services on behalf of C. Mer. Generally, C. Mer compensates MTS Asia Ltd. for these activities at cost plus 10% and compensates MTS IntegraTRAK at cost plus 5%. C. Mer is a publicly traded company controlled by Mr. Chaim Mer, and Mr. Mer has been its President, Chief Executive Officer and Chairman of its Board of Directors since 1988.



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Presently, the only service provided to us by C. Mer is our participation in its umbrella liability insurance coverage. We believe that the terms under which C. Mer provides such participation to us is on a basis no less favorable than could be obtained from an unaffiliated third party.

### C. INTERESTS OF EXPERTS AND COUNSEL

Not applicable.

## ITEM 8. FINANCIAL INFORMATION

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### A. CONSOLIDATED STATEMENTS AND OTHER FINANCIAL INFORMATION

See the consolidated financial statements, including the notes thereto, and the exhibits listed in Item 19 hereof and incorporated herein by this reference.

#### Export Sales

See Note 17(b) of our Consolidated Financial Statements.

#### Legal Proceedings

In March 2004, our U.S.-based subsidiary was named as a defendant in a complaint filed in the United States District Court for the Northern District of Georgia, Atlanta Division, captioned Telemate.net Software, Inc. v. James A. Myers, Total Wire Software Company, Inc. and MTS Integratrak, Inc., Civ. No. 1:04-CV 0570. The plaintiff alleges among other things federal copyright infringement, federal unfair competition, common law unfair competition and misappropriation of trade secrets in connection with our license of software from James A. Myers. In a related action in the State Court of Fulton County, State of Georgia, captioned James A. Myers v. Telemate.net Software, Inc. v. MTS Integratrak, Inc. and Total Wire Software Company, Inc., Case No. OIVS021284-Y, Telemate filed a third-party complaint against MTS Integratrak based on the same license, claiming misappropriation of trade secrets. The plaintiff is seeking an injunction against our future sales of the product, damages, an accounting of any sales of such product, and attorneys' fees. We have moved to dismiss the federal complaint and have not responded to the state complaint as yet, but believe that we have good and valid defenses that we will assert.

#### Tax assessment

In April 2000, the tax authorities in Israel issued to us a demand for a tax payment in the amount of approximately NIS 6,000,000 (approximately \$1,350,000) for the period of 1997 to 1999.

We have appealed to the Israeli district court in respect of the abovementioned tax demand. Based on the opinion of our tax counsel, we believe that certain defenses can be raised against the demand of the tax authorities. We believe that the outcome of this matter will not have a material adverse effect on our financial position or results of operations. We made a provision for such assessment based on the current evidence and the opinion of our tax consultants, which we believe is adequate.

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### Dividend Distribution Policy

We have never paid cash dividends to our shareholders. We intend to retain future earnings for use in our business and do not anticipate paying cash dividends on our ordinary shares in the foreseeable future. Any future dividend policy will be determined by the Board of Directors and will be based upon conditions then existing, including our results of operations, financial condition, current and anticipated cash needs, contractual restrictions and other conditions as the Board of Directors may deem relevant.

According to the Israeli Companies Law, a company may distribute dividends out of its profits, so long as the company reasonably believes that such dividend distribution will not prevent the company from paying all its current and future debts. Profits, for purposes of the Israeli Companies Law, means the greater of retained earnings or earnings accumulated during the preceding two years. In the event cash dividends are declared, such dividends will be paid in NIS.

### B. SIGNIFICANT CHANGES

#### ITEM 9. THE OFFER AND LISTING

##### A. OFFER AND LISTING DETAILS

###### Annual Stock Information

The following table sets forth, for each of the years indicated, the range of high ask and low bid prices of our ordinary shares on the Nasdaq SmallCap Market.

Year	High	Low
----	----	---
2003.....	\$3. 56	\$0. 87
2002.....	1. 65	0. 75
2001.....	4. 63	0. 90
2000.....	17. 75	2. 50
1999.....	7. 13	1. 25

###### Quarterly Stock Information

The following table sets forth, for each of the full financial quarters in the years indicated, the range of high ask and low bid prices of our ordinary shares on the Nasdaq SmallCap Market.

	High	Low
	----	---
2002		
----		
First Quarter.....	\$1. 65	\$0. 98
Second Quarter.....	1. 05	0. 91
Third Quarter.....	1. 00	0. 80
Fourth Quarter.....	1. 23	0. 75
2003		
----		
First Quarter.....	\$1. 05	\$0. 87
Second Quarter.....	1. 90	0. 97
Third Quarter.....	2. 65	1. 65
Fourth Quarter.....	3. 56	2. 01

Monthly Stock Information

The following table sets forth, for each of the most recent six months, the range of high ask and low bid prices of our ordinary shares on the Nasdaq SmallCap Market.

Month -----	High -----	Low ---
December 2003.....	\$3. 56	\$2. 82
January 2004.....	4. 00	3. 20
February 2004.....	3. 90	3. 15
March 2004.....	3. 90	3. 18
April 2004.....	3. 62	3. 29
May 2004.....	3. 45	3. 00

B. PLAN OF DISTRIBUTION

Not applicable.

C. MARKETS

Our ordinary shares were listed on the Nasdaq National Market in connection with our initial public offering on May 21, 1997. On December 23, 1998, the listing of our ordinary shares was transferred to the Nasdaq SmallCap Market (symbol: MTSI).

D. SELLING SHAREHOLDERS

Not applicable.

E. DILUTION

Not applicable.

F. EXPENSE OF THE ISSUE

Not applicable.

ITEM 10. ADDITIONAL INFORMATION

A. SHARE CAPITAL

Not applicable.

B. MEMORANDUM AND ARTICLES OF ASSOCIATION

Purposes and Objects of the Company

We are a public company registered under the Israel Companies Law, 1999-5759, or the Israeli Companies Law, as MER Telemanagement Solutions Ltd., registration number 520042904. Our objects and purposes, as provided by our Articles of Association, are to carry on any lawful activity.

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On February 1, 2000, the Israeli Companies Law came into effect and superseded most of the provisions of the Israeli Companies Ordinance (New Version), 5743-1983, except for certain provisions which relate to bankruptcy, dissolution and liquidation of companies. Under the Israeli Companies Law, various provisions, some of which are detailed below, overrule the current provisions of our Articles of Association.

### The Powers of the Directors

Under the provisions of the Israeli Companies Law and our Articles of Association, a director cannot participate in a meeting nor vote on a proposal, arrangement or contract in which he or she is materially interested. In addition, our directors cannot vote compensation to themselves or any members of their body without the approval of our audit committee and our shareholders at a general meeting. See Item 6C. "Directors, Senior Management and Employees - Board Practices - Approval of Related Party Transactions Under Israeli Law."

The authority of our directors to enter into borrowing arrangements on our behalf is not limited, except in the same manner as any other transaction by us.

Under our articles of association, retirement of directors from office is not subject to any age limitation and our directors are not required to own shares in our company in order to qualify to serve as directors.

### Rights Attached to Shares

Our authorized share capital consists of 12,000,000 ordinary shares of a nominal value of NIS 0.01 each. All outstanding ordinary shares are validly issued, fully paid and non-assessable.

The rights attached to the ordinary shares are as follows:

Dividend rights. Holders of our ordinary shares are entitled to the full amount of any cash or share dividend subsequently declared. The board of directors may declare interim dividends and propose the final dividend with respect to any fiscal year only out of the retained earnings, in accordance with the provisions of the Israeli Companies Law. Our Articles of Association provide that the declaration of a dividend requires approval by an ordinary resolution of the shareholders, which may decrease but not increase the amount proposed by the board of directors. See Item 8A. "Financial Information - Consolidated and Other Financial Information - Dividend Distribution." If after one year a dividend has been declared and it is still unclaimed, the board of directors is entitled to invest or utilize the unclaimed amount of dividend in any manner to our benefit until it is claimed. We are not obligated to pay interest or linkage differentials on an unclaimed dividend.

Voting rights. Holders of ordinary shares have one vote for each ordinary share held on all matters submitted to a vote of shareholders. Such voting rights may be affected by the grant of any special voting rights to the holders of a class of shares with preferential rights that may be authorized in the future.

The quorum required for an ordinary meeting of shareholders consists of at least two shareholders present in person or represented by proxy who hold or represent, in the aggregate, at least one third of the voting rights of the issued share capital. A meeting adjourned for lack of a

quorum generally is adjourned to the same day in the following week at the same time and place or any time and place as the directors designate in a notice to the shareholders. At the reconvened meeting, the required quorum consists of any two members present in person or by proxy.

An ordinary resolution, such as a resolution for the declaration of dividends, requires approval by the holders of a majority of the voting rights represented at the meeting, in person, by proxy or by written ballot, and voting thereon. Under our Articles of Association, a special resolution, such as amending our memorandum of association or articles of association, approving any change in capitalization, winding-up, authorization of a class of shares with special rights, or other changes as specified in our Articles of Association, requires approval of a special majority, representing the holders of no less than 65% of the voting rights represented at the meeting in person, by proxy or by written ballot, and voting thereon.

Pursuant to our articles of association, our directors are elected at our annual general meeting of shareholders by a vote of the holders of a majority of the voting power represented and voting at such meeting. See Item 6C. "Directors, Senior Management and Employees - Board Practices - Election of Directors."

Rights to share in our company's profits. Our shareholders have the right to share in our profits distributed as a dividend and any other permitted distribution. See this Item 10B. "Additional Information - Memorandum and Articles of Association - Rights Attached to Shares - Dividend Rights."

Rights to share in surplus in the event of liquidation. In the event of our liquidation, after satisfaction of liabilities to creditors, our assets will be distributed to the holders of ordinary shares in proportion to the nominal value of their holdings. This right may be affected by the grant of preferential dividend or distribution rights to the holders of a class of shares with preferential rights that may be authorized in the future.

Liability to capital calls by our company. Under our memorandum of association and the Israeli Companies Law, the liability of our shareholders is limited to the par value of the shares held by them.

Limitations on any existing or prospective major shareholder. See Item 6C. "Directors and Senior Management -Board Practices - Approval of Related Party Transactions Under Israeli Law."

#### Changing Rights Attached to Shares

According to our Articles of Association, in order to change the rights attached to any class of shares, unless otherwise provided by the terms of the class, such change must be adopted by a general meeting of the shareholders and by a separate general meeting of the holders of the affected class with a majority of 75% of the voting power participating in such meeting.

#### Annual and Extraordinary Meetings

The Board of Directors must convene an annual meeting of shareholders at least once every calendar year, within fifteen months of the last annual meeting. Notice of at least twenty-

one days prior to the date of the meeting is required. An extraordinary meeting may be convened by the board of directors, as it decides or upon a demand of any two directors or 25% of the directors, whichever is less, or of one or more shareholders holding in the aggregate at least 5% of our issued capital. An extraordinary meeting must be held not more than thirty-five days from the publication date of the announcement of the meeting. See Item 10B. "Additional Information -- Memorandum and Articles of Association -- Rights Attached to Shares--Voting Rights."

#### Limitations on the Rights to Own Securities in Our Company

Neither our memorandum of association or our articles of association nor the laws of the State of Israel restrict in any way the ownership or voting of shares by non-residents, except with respect to subjects of countries, which are in a state of war with Israel.

#### Provisions Restricting Change in Control of Our Company

The Israeli Companies Law requires that mergers between Israeli companies be approved by the board of directors and general meeting of shareholders of both parties to the transaction. The approval of the board of directors of both companies is subject to such boards' confirmations that there is no reasonable doubt that after the merger the surviving company will be able to fulfill its obligations towards its creditors. Each company must notify its creditors about the contemplated merger. Under the Israeli Companies Law, our Articles of Association are deemed to include a requirement that such merger be approved by an extraordinary resolution of the shareholders, as explained above. The approval of the merger by the general meetings of shareholders of the companies is also subject to additional approval requirements as specified in the Israeli Companies Law and regulations promulgated thereunder. See also Item 6C. "Directors, Senior Management and Employees - Board Practices - Approval of Related Party Transactions Under Israeli Law."

#### Disclosure of Shareholders Ownership

The Israeli Securities Law and regulations promulgated thereunder do not require a company whose shares are publicly traded solely on a stock exchange outside of Israel, as in the case of our company, to disclose its share ownership.

#### Changes in Our Capital

Changes in our capital are subject to the approval of the shareholders at a general meeting by a special majority of 65% of the votes of shareholders participating and voting in the general meeting.

#### C. MATERIAL CONTRACTS

None.

#### D. EXCHANGE CONTROLS

Israeli law and regulations do not impose any material foreign exchange restrictions on non-Israeli holders of our ordinary shares. In May 1998, a new

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"general permit" was issued under the Israeli Currency Control Law, 1978, which removed most of the restrictions that

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previously existed under such law, and enabled Israeli citizens to freely invest outside of Israel and freely convert Israeli currency into non-Israeli currencies.

Non-residents of Israel who purchase our ordinary shares will be able to convert dividends, if any, thereon, and any amounts payable upon our dissolution, liquidation or winding up, as well as the proceeds of any sale in Israel of our ordinary shares to an Israeli resident, into freely repatriable dollars, at the exchange rate prevailing at the time of conversion, provided that the Israeli income tax has been withheld (or paid) with respect to such amounts or an exemption has been obtained.

### E. TAXATION

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

The following is a discussion of Israeli and United States tax consequences material to our shareholders. To the extent that the discussion is based on new tax legislation which has not been subject to judicial or administrative interpretation, the views expressed in the discussion might not be accepted by the tax authorities in question. The discussion is not intended, and should not be construed, as legal or professional tax advice and does not exhaust all possible tax considerations.

Holders of our ordinary shares should consult their own tax advisors as to the United States, Israeli or other tax consequences of the purchase, ownership and disposition of ordinary shares, including, in particular, the effect of any foreign, state or local taxes.

#### General Corporate Tax Structure

Israeli companies are subject to "Company Tax" at the rate of 36% of taxable income. However, the effective tax rate payable by a company, which derives income from an approved enterprise (as further discussed below), may be considerably less.

#### Tax Benefits Under the Law for the Encouragement of Capital Investments, 1959

The Law for the Encouragement of Capital Investments, 1959, as amended, commonly referred to as the Investment Law, provides that a proposed capital investment in eligible facilities may, upon application to the Investment Center of the Ministry of Industry and Trade of the State of Israel, be designated as an approved enterprise. Each certificate of approval for an approved enterprise relates to a specific investment program delineated both by its financial scope, including its capital sources, and by its physical characteristics, e.g., the

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equipment to be purchased and utilized pursuant to the program. An approved enterprise is entitled to benefits including Israeli Government cash grants and tax benefits in specified development areas. The tax benefits derived from any such certificate of approval relate only to taxable income attributable to the specific approved enterprise. If a company has more than one approval or only

a portion of its capital investments is approved, its effective tax rate is the result of a weighted average of the applicable rates.

Taxable income of a company derived from an approved enterprise is subject to company tax at the maximum rate of 25% (rather than 36%) for the benefit period. This period is ordinarily seven years (or ten years if the company qualifies as a foreign investors' company as described below) commencing with the year in which the approved enterprise first generates taxable income, and is limited to twelve years from commencement of production or 14 years from the date of approval, whichever is earlier. The Investment Law also provides that a company that has an approved enterprise within Israel will be eligible for a reduced tax rate and is entitled to claim accelerated depreciation on buildings, machinery and equipment used by the approved enterprise during the first five years of use.

A company owning an approved enterprise may elect to forego entitlement to the grants otherwise available under the Investment Law and in lieu thereof participate in an alternative track of benefits. Under the alternative track of benefits, a company's undistributed income derived from an approved enterprise will be exempt from company tax for a period of between two and ten years from the first year of taxable income, depending on the geographic and social economical location of the approved enterprise within Israel, and such company will be eligible for a reduced tax rate for the remainder, if any, of the otherwise applicable benefits period.

A company that has an approved enterprise program is eligible for further tax benefits if it qualifies as a foreign investors' company. A foreign investors' company is a company more than 25% of whose share capital and combined share and loan capital is owned by non-Israeli residents. A company, which qualifies as a foreign investors' company and has an approved enterprise program is eligible for tax benefits for a ten-year benefit period. The company tax rate applicable to income from the approved enterprise earned in the benefit period (distributed or not) is as follows:

For a company with foreign investment of	The company tax rate is
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Less than 49%	25%
49% or more but less than 74%...	20%
74% or more but less than 90%...	15%
90% or more.....	10%

In addition, the dividend recipient is taxed at the reduced rate applicable to dividends from approved enterprises income (15%), if the dividend, deriving from the approved enterprises, is distributed during the tax benefit period or within 12 years thereafter, yet, no time limit is applicable to dividends from a foreign investment company. The company must withhold this tax at source, regardless of whether the dividend is converted into foreign currency.



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Subject to applicable provisions concerning income under the alternative track, all dividends are considered to be attributable to the entire enterprise and their effective tax rate is the result of a weighted average of the various applicable tax rates. We currently intend to reinvest any income derived from our approved enterprise programs and not to distribute such income as a dividend.

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The Investment Center bases its decision as to whether or not to approve an application on the criteria set forth in the Investment Law and regulations, the prevailing policy of the Investment Center and the specific objectives and financial criteria of the applicant. Accordingly, we cannot assure you that any of our applications, if made, will be approved in the future.

C. Mer Industries Ltd. was granted approved enterprise status with respect to five investment projects and chose the alternative track with respect to each of these projects. Subsequent to our incorporation, C. Mer Industries Ltd. transferred four continuing approved programs to us were also granted approval. A fifth and sixth program were also granted approval. See Item 5A. Operating and Financial Review and Prospects - Operating Results - Effective Corporate Tax Rate."

The benefits available to an approved enterprise are conditional upon the fulfillment of conditions stipulated in the Investment Law and its regulations and the criteria set forth in the specific certificate of approval, as described above. In the event that a company does not meet these conditions, it would be required to refund the amount of tax benefits, with the addition of the Israeli consumer price index linkage adjustment and interest. In our opinion, we have been in full compliance with the conditions of the above programs through December 31, 2003.

Grants under the Law for the Encouragement of Industrial Research and Development, 1984

Under the Law for the Encouragement of Industrial Research and Development, 1984, or the Research Law, research and development programs which meet specified criteria and are approved by a research committee of the Office of the Chief Scientist of the Israeli Ministry of Industry and Trade are eligible for grants of up to 50% of certain of the project's expenditure, as determined by the research committee, in exchange for the payment of royalties from revenues derived from products (and ancillary services) incorporating technology developed within the framework of the approved research and development program. Regulations promulgated under the Research Law generally provide for the payment of royalties to the Office of the Chief Scientist of 3%-5% of such revenues, until 100% to 150% of the U.S. dollar-linked grant is repaid. Effective for grants received from the Office of the Chief Scientist under programs approved after January 1, 1999, the outstanding balance of such grants will be subject to interest equal to the 12 month LIBOR rate applicable to U.S. dollar deposits that is published on the first business day of each calendar year. Following the full repayment of the grant, there is no further liability for repayment.

The terms of the Israeli Government participation generally requires that the manufacture of products developed with such grants be performed in Israel. However, under regulations promulgated under the Research Law, upon the

approval of the Chief Scientist, some of the manufacturing volume may be performed outside Israel, provided that the grant recipient pays royalties at an increased rate and the aggregate repayment amount is increased, depending on the portion of the total manufacturing volume that is performed outside Israel (120% of the grant if the manufacturing volume performed outside of Israel is less than 50%; 150% of the grant if the manufacturing volume performed outside of Israel is between 50% and 90%, and 300% of the grant if the manufacturing volume performed outside of Israel is more than 90%). As of April 1, 2003, the Research Law also allows for the approval of grants in cases in which the applicant declares that part of the manufacturing will be performed outside of Israel or by non-Israeli residents and the research committee is convinced that the same is essential for the execution of

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the program. This declaration will be a significant factor in the determination of the Office of Chief Scientist whether to approve a research and development program and the amount and other terms of benefits to be granted. In such cases, the increased royalty and repayment amount will be required.

The technology developed pursuant to the Chief Scientist grants may not be transferred to third parties in Israel without the prior approval of the research committee. Approval of the transfer of technology may be granted in specific circumstances, only if the recipient agrees to abide by the provisions of the Research Law and regulations promulgated thereunder, including the restrictions on the transfer of technology and the obligation to pay royalties in an amount that may be increased. We cannot assure you that such consent, if requested, will be granted. The Research Law provides that the technology developed under an approved research and development program may not be transferred to any third parties outside Israel. No approval is required for the export of any products developed under the funded plan.

The funds generally available for grants from the Office of the Chief Scientist were reduced in 1998, and the Israeli authorities have indicated in the past that the government may further reduce or abolish grants from the Office of the Chief Scientist in the future. We did not receive any grants from the Office of the Chief Scientist during 2003, and we do not expect to receive any grants during 2004. In the event that development of a specific product in which the Chief Scientist participates is successful, we will become obligated to repay the grants received relating to the specific product through royalty payments at the rate of 3% to 5%, based on our sales revenues, up to an amount equal to 100% to 150% of the grant received, linked to the exchange rate of the U.S. dollar. As of December 31, 2003, we had a contingent obligation to pay royalties in the amount of approximately \$7,520,000. The outstanding balance of grants received after January 1999 is subject to interest equal to the 12-month LIBOR rate.

#### Tax Benefits and Grants for Research and Development

Israeli tax law allows, under specific conditions, a tax deduction in the year incurred for expenditures, including capital expenditures, relating to scientific research and development projects, if the expenditures are approved by the relevant Israeli Government ministry, determined by the field of research, and the research and development is for the promotion of the company and is carried out by or on behalf of the company seeking such deduction. Expenditures not so approved are deductible over a three-year period.

Tax Benefits Under the Law for the Encouragement of Industry (Taxes), 1969

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According to the Law for the Encouragement of Industry (Taxes), 1969, or the Industry Encouragement Law, an Industrial Company is a company resident in Israel, at least 90% of the income of which, in a given tax year, determined in Israeli currency (exclusive of income from some 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 the following preferred corporate tax benefits:

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- o amortization of purchases of know-how and patents over an eight-year period for tax purposes;
- o right to elect, under specified conditions, to file a consolidated tax return with additional related Israeli Industrial Companies.

Eligibility for benefits under the Industry Encouragement Law is not subject to receipt of prior approval from any governmental authority. We cannot assure you that we will continue to qualify as an Industrial Company or that the benefits described above will be available to us in the future.

### Special Provisions Relating to Taxation under Inflationary

The Income Tax Law (Inflationary Adjustments), 1985, generally referred to as the Inflationary Adjustments Law, represents an attempt to overcome the problems presented to a traditional tax system by an economy undergoing rapid inflation. The Inflationary Adjustments Law is highly complex. Its features, which are material to us, can be summarized as follows:

There is a special tax adjustment for the preservation of equity whereby some corporate assets are classified broadly into fixed assets and non-fixed assets. Where a company's equity, as defined in such law, exceeds the depreciated cost of fixed assets, a deduction from taxable income that takes into account the effect of the applicable annual rate of inflation on such excess is allowed up to a ceiling of 70% of taxable income in any single tax year, with the unused portion permitted to be carried forward on a linked basis. If the depreciated cost of fixed assets exceeds a company's equity, then such excess multiplied by the applicable annual rate of inflation is added to taxable income.

- o Subject to specific limitations, depreciation deductions on fixed assets and losses carried forward are adjusted for inflation based on the increase in the consumer price index.
- o Capital gains on specific marketable securities are exempt from tax for individuals until December 31, 2002 and from January 1, 2003, individuals are subject to a 15% tax rate on the real capital gains, companies are subject to a 36% tax rate on the real capital gains and dealers in securities are subject to the regular tax rules applicable to business income in Israel.

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

Israeli law imposes a capital gains tax on the sale of capital assets.

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The law distinguishes between real gain and inflationary surplus. The inflationary surplus is a portion of the total capital gain that is equivalent to the increase of the relevant asset's purchase price which is attributable to the increase in the Israeli consumer price index 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. The inflationary surplus accumulated from and after December 31, 1993 is exempt from any capital gains tax in Israel while the real gain is added to ordinary income, which is taxed at ordinary rates of 30% to 50% for individuals and 36% for corporations. For purchases subject to capital gains treatment made since January 1, 2003, the tax has been reduced to 25%. Purchases made prior to January 1, 2003 will be subject to taxes ranging up to 36%.

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Under current law, sales of our ordinary shares until December 31, 2002, are exempt from Israeli capital gains for individuals so long as they are quoted on Nasdaq or listed on a stock exchange in another country and we qualify as an Industrial Company. We cannot assure you that we qualify or will maintain such qualification or our status as an Industrial Company. Notwithstanding the foregoing, dealers in securities in Israel are taxed at regular tax rates applicable to business income. From January 1, 2003, individuals are subject to a 15% tax rate on the real capital gain.

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 "Treaty"), the sale, exchange or disposition of ordinary shares by a person who qualifies as a resident of the United States within the meaning of the Treaty and who is entitled to claim the benefits afforded to such person by the Treaty generally will not be subject to the Israeli capital gains tax unless 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 particular conditions. A sale, exchange or disposition of ordinary shares by a Treaty U.S. Resident who holds, directly or indirectly, shares representing 10% or more of our voting power at any time during such preceding 12-month period would be subject to such Israeli tax, to the extent applicable; however, under the 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 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 at the rate of 25% (12.5% for dividends not generated by an approved enterprise if the non-resident is a U.S. corporation that holds 10% of our voting power, and 15% for dividends generated by an approved enterprise) is withheld at source, unless a different rate is provided by a treaty between Israel and the shareholder's country of residence. Under the Treaty, the maximum tax on dividends paid to a holder of ordinary shares who is a Treaty U.S. Resident will be 25%. However, under the Investment Law, dividends generated by an approved enterprise are taxed at the rate of 15%.

Under an amendment to the Inflationary Adjustments Law, non-Israeli

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entities might be subject to Israeli taxes on the sale of traded securities in an Israeli company, subject to the provisions of any applicable double taxation treaty.

### Foreign Exchange Regulations

Dividends (if any) paid to the holders of our ordinary shares, and any amounts payable with respect to our ordinary shares upon dissolution, liquidation or winding up, as well as the proceeds of any sale in Israel of the ordinary shares to an Israeli resident, may be paid in non-Israeli currency or, if paid in Israeli currency, may be converted into freely reparable U.S. dollars at the rate of exchange prevailing at the time of conversion.

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### Recent Tax Reform Legislation

On July 24, 2002, Amendment 132 to the Israeli Tax Ordinance was approved by the Israeli parliament and came into effect on January 1, 2003. The principal objectives of the amendment were to broaden the categories of taxable income and to reduce the tax rates imposed on employees' income.

The material consequences of the amendment applicable to our company include, among other things, imposing a tax upon all income of Israeli residents, individuals and corporations, regardless of the territorial source of the income and certain modifications in the qualified taxation tracks of employee stock options.

### United States Federal Income Tax Consequences

The following is a summary of certain material U.S. federal income tax consequences that apply to U.S. Holders who hold ordinary shares as capital assets. This summary is based on the United States Internal Revenue Code of 1986, as amended, or the Code, Treasury regulations promulgated thereunder, judicial and administrative interpretations thereof, and the Treaty, all as in effect on the date hereof and all of which are subject to change either prospectively or retroactively. This summary does not address all tax considerations that may be relevant with respect to an investment in ordinary shares. This summary does not account for the specific circumstances of any particular investor, such as:

- o broker-dealers,
- o financial institutions,
- o certain insurance companies,
- o investors liable for alternative minimum tax,
- o tax-exempt organizations,
- o regulated investment companies,
- o non-resident aliens of the U.S. or taxpayers whose functional currency is not the U.S. dollar,
- o persons who acquired their ordinary shares through the exercise or

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cancellation of employee stock options or otherwise as compensation for services,

- o persons who hold the ordinary shares through partnerships or other pass-through entities,
- o investors that own, or have owned, actually or constructively own 10% or more of our voting shares, and
- o investors holding ordinary shares as part of a straddle or appreciated financial position or a hedging or conversion transaction.

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This summary does not address the effect of any U.S. federal taxation other than U.S. federal income taxation. In addition, this summary does not include any discussion of state, local or foreign taxation.

You are urged to consult your tax advisors regarding the foreign and United States federal, state and local tax considerations of an investment in ordinary shares.

For purposes of this summary, a U.S. Holder is any beneficial owner of ordinary shares that is:

- o an individual who is a citizen or, for U.S. federal income tax purposes, a resident of the United States;
- o a partnership, corporation or other entity created or organized in or under the laws of the United States or any political subdivision thereof;
- o an estate whose income is subject to U.S. federal income tax regardless of its source; or
- o a trust that (a) is subject to the primary supervision of a court within the United States and the control of one or more U.S. persons or (b) has a valid election in effect under applicable U.S. Treasury regulations to be treated as a U.S. person.

### Taxation of Dividends

The gross amount of any distributions received with respect to ordinary shares, including the amount of any Israeli taxes withheld therefrom, will constitute dividends for U.S. federal income tax purposes, to the extent of our current and accumulated earnings and profits as determined for U.S. federal income tax principles. You will be required to include this amount of dividends in gross income as ordinary income (see "-New Tax Law Applicable to Dividends and Long-Term Capital Gain," below). Distributions in excess of our earnings and profits will be treated as a non-taxable return of capital to the extent of your tax basis in the ordinary shares and any amount in excess of your tax basis, will be treated as gain from the sale of ordinary shares. See "-Disposition of Ordinary Shares" below for the discussion on the taxation of capital gains. Dividends will not qualify for the dividends-received deduction generally available to corporations under Section 243 of the Code.

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Dividends that we pay in NIS, including the amount of any Israeli taxes withheld therefrom, will be included in your income in a U.S. dollar amount calculated by reference to the exchange rate in effect on the day such dividends are received. A U.S. Holder who receives payment in NIS and converts NIS into U.S. dollars at an exchange rate other than the rate in effect on such day may have a foreign currency exchange gain or loss that would be treated as ordinary income or loss. U.S. Holders should consult their own tax advisors concerning the U.S. tax consequences of acquiring, holding and disposing of NIS.

Any Israeli withholding tax imposed on such dividends will be a foreign income tax eligible for credit against a U.S. Holder's U.S. federal income tax liability, subject to certain limitations set out in the Code (or, alternatively, for deduction against income in determining such tax liability). The limitations set out in the Code include computational rules under which foreign tax credits allowable with respect to specific classes of income cannot exceed the U.S.

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federal income taxes otherwise payable with respect to each such class of income (see "-New Tax Law Applicable to Dividends and Long-Term Capital Gain," below). Dividends generally will be treated as foreign-source passive income or financial services income for United States foreign tax credit purposes. Foreign income taxes exceeding the credit limitation for the year of payment or accrual may be carried back for two taxable years and forward for five taxable years in order to reduce U.S. federal income taxes, subject to the credit limitation applicable in each of such years. Other restrictions on the foreign tax credit include a prohibition on the use of the credit to reduce liability for the U.S. individual and corporation alternative minimum taxes by more than 90%. A U.S. Holder will be denied a foreign tax credit with respect to Israeli income tax withheld from dividends received on the ordinary shares to the extent such U.S. Holder has not held the ordinary shares for at least 16 days of the 30-day period beginning on the date which is 15 days before the ex-dividend date or to the extent such U.S. Holder is under an obligation to make related payments with respect to substantially similar or related property. Any days during which a U.S. Holder has substantially diminished its risk of loss on the ordinary shares are not counted toward meeting the 16-day holding period required by the statute. The rules relating to the determination of the foreign tax credit are complex, and you should consult with your personal tax advisors to determine whether and to what extent you would be entitled to this credit.

### Disposition of Ordinary Shares

If you sell or otherwise dispose of ordinary shares, you will recognize gain or loss for U.S. federal income tax purposes in an amount equal to the difference between the U.S. dollar value of the amount realized, as discussed below, on the sale or other disposition and the adjusted tax basis in ordinary shares. Subject to the discussion below under the heading "Passive Foreign Investment Companies," such gain or loss generally will be capital gain or loss and will be long-term capital gain or loss if you have held the ordinary shares for more than one year at the time of the sale or other disposition. In general, any gain that you recognize on the sale or other disposition of ordinary shares will be U.S.-source for purposes of the foreign tax credit limitation; losses, will generally be allocated against U.S. source income. Deduction of capital losses is subject to certain limitations under the Code.

In the case of a cash basis U.S. Holder who receives NIS in connection with the sale or disposition of ordinary shares, the amount realized will be

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based on the U.S. dollar value of the NIS received with respect to the ordinary shares as determined on the settlement date of such exchange. A U.S. Holder who receives payment in NIS and converts NIS into United States dollars at a conversion rate other than the rate in effect on the settlement date may have a foreign currency exchange gain or loss that would be treated as ordinary income or loss.

An accrual basis U.S. Holder may elect the same treatment required of cash basis taxpayers with respect to a sale or disposition of ordinary shares, provided that the election is applied consistently from year to year. Such election may not be changed without the consent of the Internal Revenue Service, or the IRS. In the event that an accrual basis U.S. Holder does not elect to be treated as a cash basis taxpayer (pursuant to the Treasury regulations applicable to foreign currency transactions), such U.S. Holder may have a foreign currency gain or loss for U.S. federal income tax purposes because of differences between the U.S. dollar value of the currency received prevailing on the trade date and the settlement date. Any such currency gain or

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loss would be treated as ordinary income or loss and would be in addition to gain or loss, if any, recognized by such U.S. Holder on the sale or disposition of such ordinary shares.

### New Tax Law Applicable to Dividends and Long-Term Capital Gain

Under recently enacted amendments to the Code, dividends received by individual U.S. Holders from certain foreign corporations, and long-term capital gain realized by individual U.S. Holders, generally are subject to a reduced maximum tax rate of 15 percent through December 31, 2008. Dividends received with respect to ordinary shares should qualify for the 15 percent rate. The rate reduction does not apply to dividends received from "foreign investment companies," "foreign personal holding company" or "passive foreign investment companies" (see below), or in respect of certain short-term or hedged positions in the common stock or in certain other situations. The legislation contains special rules for computing the foreign tax credit limitation of a taxpayer who receives dividends subject to the rate reduction. U.S. Holders should consult their own tax advisors regarding the implications of these rules in light of their particular circumstances.

### Passive Foreign Investment Companies

For U.S. federal income tax purposes, we will be considered a passive foreign investment company, or PFIC, for any taxable year in which either (i) 75% or more of our gross income is passive income, or (ii) at least 50% of the average value of all of our assets for the taxable year produce or are held for the production of passive income. For this purpose, passive income includes dividends, interest, royalties, rents, annuities and the excess of gains over losses from the disposition of assets which produce passive income. If we were determined to be a PFIC for U.S. federal income tax purposes, highly complex rules would apply to U.S. Holders owning ordinary shares. Accordingly, you are urged to consult your tax advisors regarding the application of such rules.

As a result of our substantial cash position and the declining value of our stock, there is a substantial risk that we will be classified as a PFIC under the asset test described in the preceding paragraph. However, because the determination of whether we are a PFIC is based upon the composition of our income and assets from time to time, this determination can not be made with certainty until the end of each calendar year. Based on studies performed by an



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independent consultant, we believe that we were not a PFIC in 2001, 2002 or 2003.

If we are treated as a PFIC for any taxable year, then, unless you elect either to treat your investment in ordinary shares as an investment in a "qualified electing fund," or a QEF election, or to "mark-to-market" your ordinary shares, as described below, dividends would not qualify for the reduced maximum tax rate, discussed above, and

- o you would be required to allocate income recognized upon receiving certain dividends or gain recognized upon the disposition of ordinary shares ratably over the holding period for such ordinary shares,
- o the amount allocated to each year during which we are considered a PFIC other than the year of the dividend payment or disposition would be subject to tax at the highest individual or corporate tax rate, as the case may be, and an interest

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charge would be imposed with respect to the resulting tax liability allocated to each such year,

- o the amount allocated to the current taxable year and any taxable year before we became a PFIC, would be taxable as ordinary income in the current year, and
- o you would be required to make an annual return on IRS Form 8621 regarding distributions received with respect to ordinary shares and any gain realized on your ordinary shares.

If you make either a timely QEF election or a timely mark-to-market election in respect of your ordinary shares, you would not be subject to the rules described above. If you make a timely QEF election, you would be required to include in your income for each taxable year your pro rata share of our ordinary earnings as ordinary income and your pro rata share of our net capital gain as long-term capital gain, whether or not such amounts are actually distributed to you. You would not be eligible to make a QEF election unless we comply with certain applicable information reporting requirements. We will provide U.S. Holders with the information needed to report income and gain under a QEF election if we are classified as a PFIC.

Alternatively, if you elect to "mark-to-market" your ordinary shares, you will generally include in income any excess of the fair market value of the ordinary shares at the close of each tax year over your adjusted basis in the ordinary shares. If the fair market value of the ordinary shares had depreciated below your adjusted basis at the close of the tax year, you may generally deduct the excess of the adjusted basis of the ordinary shares over its fair market value at that time. However, such deductions generally would be limited to the net mark-to-market gains, if any, that you included in income with respect to such ordinary shares in prior years. Income recognized and deductions allowed under the mark-to-market provisions, as well as any gain or loss on the disposition of ordinary shares with respect to which the mark-to-market election is made, is treated as ordinary income or loss.

Backup Withholding and Information Reporting

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Payments in respect of ordinary shares may be subject to information reporting to the U.S. Internal Revenue Service and to U.S. backup withholding tax at a rate equal to the fourth lowest income tax rate applicable to individuals which, under current law, is 28%. Backup withholding will not apply, however, if you (i) are a corporation or come within certain exempt categories, and demonstrate the fact when so required, or (ii) furnish a correct taxpayer identification number and make any other required certification.

Backup withholding is not an additional tax. Amounts withheld under the backup withholding rules may be credited against a U.S. Holder's U.S. tax liability, and a U.S. Holder may obtain a refund of any excess amounts withheld under the backup withholding rules by filing the appropriate claim for refund with the IRS.

Any U.S. holder who holds 10% or more in vote or value of our ordinary shares will be subject to certain additional United States information reporting requirements.

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### U.S. Gift and Estate Tax

An individual U.S. Holder of ordinary shares will be subject to U.S. gift and estate taxes with respect to ordinary shares in the same manner and to the same extent as with respect to other types of personal property.

#### F. DIVIDEND AND PAYING AGENTS

Not applicable.

#### G. STATEMENT BY EXPERTS

Not applicable.

#### H. DOCUMENTS ON DISPLAY

We are subject to the reporting requirements of the United States Securities Exchange Act of 1934, as amended, as applicable to "foreign private issuers" as defined in Rule 3b-4 under the Exchange Act, and in accordance therewith, we file annual and interim reports and other information with the Securities and Exchange Commission.

As a foreign private issuer, we are exempt from certain provisions of the Exchange Act. Accordingly, our proxy solicitations are not subject to the disclosure and procedural requirements of Regulation 14A under the Exchange Act, transactions in our equity securities by our officers and directors are exempt from reporting and the "short-swing" profit recovery provisions contained in Section 16 of the Exchange Act. In addition, we are not required under the Exchange Act to file periodic reports and financial statements as frequently or as promptly as U.S. companies whose securities are registered under the Exchange Act. However, we distribute annually to our shareholders an annual report containing financial statements that have been examined and reported on, with an opinion expressed by, an independent public accounting firm, and we file reports with the Securities and Exchange Commission on Form 6-K containing unaudited financial information for the first three quarters of each fiscal year.

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This annual report and the exhibits thereto and any other document we file pursuant to the Exchange Act may be inspected without charge and copied at prescribed rates at the following Securities and Exchange Commission public reference rooms: 450 Fifth Street, N.W., Judiciary Plaza, Room 1024, Washington, D.C. 20549; and on the Securities and Exchange Commission Internet site (<http://www.sec.gov>) and on our website [www.mtsint.com](http://www.mtsint.com). You may obtain information on the operation of the Securities and Exchange Commission's public reference room in Washington, D.C. by calling the Securities and Exchange Commission at 1-800-SEC-0330. The Exchange Act file number for our Securities and Exchange Commission filings is 0-28950.

The documents concerning our company, which, referred to in this annual report, may also be inspected at our offices located at 22 Zarhin Street, Ra'anana 43662, Israel.

### I. SUBSIDIARY INFORMATION

Not applicable.

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## ITEM 11. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISKS

-----

### Exposure To Market Risks

We are exposed to a variety of risks, including changes in interest rates affecting primarily the interest received on short-term deposits, and foreign currency fluctuations. We do not use derivative financial instruments to hedge against such exposure.

#### Interest Rate Risk

Our exposure to market risk for changes in interest rates relates primarily to our short term deposits. Our short term deposits are held in dollars and bear annual interest of 1.0% to 1.5%, which is based upon the London Inter Bank Offered Rate (LIBOR). We place our short term deposits with major financial center U.S. banks. For purposes of specific risk analysis, we use sensitivity analysis to determine the impact that market risk exposure may have on the financial income derived from our short term deposits. The potential loss to us over one year that would result from a hypothetical change of 10% in the LIBOR rate would be approximately \$20,000.

#### Foreign Currency Exchange Risk

We have operations in several countries in connection with the sale of our products. A substantial portion of our sales and expenditures are denominated in dollars. We have mitigated, and expect to continue to mitigate, a portion of our foreign currency exposure through salaries, marketing and support operations in which all costs are local currency based. As a result, our results of operations and cash flows can be affected by fluctuations in foreign currency exchange rates (primarily the Euro). A hypothetical 10% movement in foreign currency rates (primarily the Euro) against the dollar, with all other variables held constant on the expected sales, would result in a decrease or increase in expected 2004 sales of \$500,000. In 2003 we entered into a commitment to purchase dollars and sell euros having a value of euro 700,000, of which euro

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300,000 was purchased in January 2001.

ITEM 12. DESCRIPTION OF SECURITIES OTHER THAN EQUITY SECURITIES  
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Not applicable.

PART II

ITEM 13. DEFAULTS, DIVIDEND ARREARAGES AND DELINQUENCIES  
-----

None.

ITEM 14. MATERIAL MODIFICATIONS TO THE RIGHTS OF SECURITY HOLDERS AND USE OF  
PROCEEDS  
-----

Not applicable.

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ITEM 15. CONTROLS AND PROCEDURES  
-----

During 2003, we carried out an evaluation, under the supervision and with the participation of our senior management, including our chief executive officer and chief financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Rule 13(a)-14 of the Securities Exchange Act of 1934. Based upon that evaluation, our management, including our chief executive officer and chief financial officer, concluded that our company's disclosure controls and procedures are effective in timely alerting them to material information relating to us required to be included in the our periodic SEC filings.

There have been no significant changes in our internal controls or other factors which could significantly affect internal controls subsequent to the date of the evaluation.

It should be noted that any system of controls, however well designed and operated, can provide only reasonable, and not absolute, assurance that the objectives of the system are met. In addition, the design of any control system is based in part upon certain assumptions about the likelihood of future events. Because of these and other inherent limitations of control systems, there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions.

ITEM 16. [RESERVED]  
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ITEM 16A. AUDIT COMMITTEE FINANCIAL EXPERT  
-----

Our board of directors has determined that Mr. Yaacov Goldman meets the definition of an audit committee financial expert, as defined in Item 401 of Regulation S-K.

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ITEM 16B. CODE OF ETHICS  
-----

We have adopted a code of ethics that applies to our chief executive officer and all senior financial officers of our company, including the chief financial officer, chief accounting officer or controller, or persons performing similar functions. Our code of ethics has been filed as an exhibit to this annual report. Written copies are available upon request. If we make any substantive amendment to the code of ethics or grant any waivers, including any implicit waiver, from a provision of the codes of ethics, we will disclose the nature of such amendment or waiver on our website.

ITEM 16C. PRINCIPAL ACCOUNTING FEES AND SERVICES  
-----

Fees Paid to Independent Public Accountants

The following table sets forth, for each of the years indicated, the fees paid to our independent public accountants and the percentage of each of the fees out of the total amount paid to the accountants.

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Services Rendered	Year Ended December 31,			
	2002		2003	
	Fees	Percentages	Fees	Percentages
Audit (1).....	\$53,269	51.0%	\$45,500	61.0%
Audit-related (2)....	2,047	2.0%	484	1.0%
Tax (3).....	48,485	47.0%	28,700	38.0%
Other (4).....	--	--	--	--
Total .....	\$103,801	100.0%	\$74,684	100.0%

- 
- (1) Audit fees consist of services that would normally be provided in connection with statutory and regulatory filings or engagements, including services that generally only the independent accountant can reasonably provide.
  - (2) Audit-related fees relate to attestation services that are required by statute or regulation.
  - (3) Tax fees relate to services performed by the tax division for tax compliance, planning, and advice.
  - (4) Other fees relate to products and services provided by the independent accountant, other than the services reported under the categories above.

Pre-Approval Policies and Procedures

Our audit committee has adopted a policy and procedures for the

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pre-approval of audit and non-audit services rendered by our independent public accountants, Kost Forer Gabbay & Kasierer, a member firm of Ernst & Young Global. Pre-approval of an audit or non-audit service may be given as a general pre-approval, as part of the audit committee's approval of the scope of the engagement of our independent auditor, or on an individual basis. Any proposed services exceeding general pre-approved levels also require specific pre-approval by our audit committee. The policy prohibits retention of the independent public accountants to perform the prohibited non-audit functions defined in Section 201 of the Sarbanes-Oxley Act or the rules of the SEC, and also requires the audit committee to consider whether proposed services are compatible with the independence of the public accountants all the services provided by our independent accountants in 2003 were approved in advance by our Audit committees.

ITEM 16D. EXEMPTIONS FROM THE LISTING REQUIREMENTS AND STANDARDS FOR AUDIT COMMITTEE

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Not applicable.

ITEM 16E. PURCHASE OF EQUITY SECURITIES BY THE ISSUER AND AFFILIATES AND PURCHASERS

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Issuer Purchase of Equity Securities

The following table sets forth, for each of the months indicated, the total number of shares purchased by us or on our behalf or any affiliated purchaser, the average price paid per share, the number of shares purchased as part of a publicly announced repurchase plan or

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program, the maximum number of shares or approximate dollar value that may yet be purchase under the plans or programs.

Period in 2003	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number (or Approximate Dollar Value) of Shares that May Yet Be Purchased Under the Plans or Programs
-----	-----	-----	-----	-----
January.....	4,450	\$0.963	265,550	34,450
February.....	7,360	\$0.99	272,910	27,090
March.....	2,900	\$1.035	275,810	24,190
April.....	108,800	\$1.0489	384,610	215,390
May.....	---	---	384,610	215,390
June.....	---	---	384,610	215,390
July.....	---	---	384,610	215,390
August.....	2,000	\$2.095	386,610	213,390
September.....	1,100	\$2.06	387,710	212,290
October.....	---	---	387,710	212,290
November.....	---	---	387,710	212,290

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December.....	3,900	\$3.077	391,610	208,390
---------------	-------	---------	---------	---------

1. Under our stock repurchase program, which was publicly announced in December 2000, our officers were authorized to repurchase up to 300,000 of our ordinary shares. In May 2003 our board of directors increased the number of shares to be repurchased under our stock repurchase program to 600,000 ordinary shares. Through June 1, 2004 we have repurchased 391,610 ordinary shares, at a total cost of \$477,000.

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PART III

ITEM 17. FINANCIAL STATEMENTS

We have elected to furnish financial statements and related information specified in Item 18.

ITEM 18. FINANCIAL STATEMENTS

Consolidated Financial Statements.

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ITEM 19. EXHIBITS

Index to Exhibits

Exhibit	Description
-----	-----
*3.1	Memorandum of Association of the Registrant
*3.2	Articles of Association of the Registrant
*4.1	Specimen of Ordinary Share Certificate
8.1	List of Subsidiaries of the Registrant

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- \*10.1 1996 Employee Stock Option Plan
- \*10.2 Section 102 Stock Option Plan
- 10.3 2003 Israeli Share Option Plan
- \*\*10.4 Form of Consultant's Warrant
- 14.1 Code of Ethics

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- 23.1 Consent of Kost Forer Gabbay & Kasierer, a Member of Ernst & Young Global
- 31.1 Certification of Chief Executive Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended.
- 31.2 Certification of Chief Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended.
- 32.1 Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

- 
- \* Filed as an exhibit to our registration statement on Form F-1, registration number 333-05814, filed with the Securities and Exchange Commission, and incorporated herein by reference.
  - \*\* Filed as exhibit 10.5 to our Annual Report on Form 20-F for the year ended December 31, 2002, and incorporated herein by reference.

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MER TELEMAGEMENT SOLUTIONS LTD. AND ITS SUBSIDIARIES

CONSOLIDATED FINANCIAL STATEMENTS

AS OF DECEMBER 31, 2003

U.S. DOLLARS IN THOUSANDS



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ERNST & YOUNG

o Kost Forer Gabbay & Kasierer  
3 Aminadav St. o Phone: 972-3-6232525  
Tel-Aviv 67067, Israel Fax: 972-3-5622555

REPORT OF INDEPENDENT AUDITORS

To the Shareholders of

MER TELEMAGEMENT SOLUTIONS LTD.

We have audited the accompanying consolidated balance sheets of MER Telemagement Solutions Ltd. ("the Company") and its subsidiaries as of December 31, 2002 and 2003, and the related consolidated statements of operations, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2003. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

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

As discussed in Note 10a to the financial statements, the Company adopted Statement of Financial Accounting Standards No. 142 in 2002.

Tel-Aviv, Israel  
February 2, 2004

/s/ Kost Forer Gabbay and Kasierer  
KOST FORER GABBAY & KASIERER  
A Member of Ernst & Young Global

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### MER TELEMANAGEMENT SOLUTIONS LTD. AND ITS SUBSIDIARIES

#### CONSOLIDATED BALANCE SHEETS

U.S. dollars in thousands

	December 31,	
	2002	2003
<b>ASSETS</b>		
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents	\$ 9,062	\$ 8,684
Marketable securities (Note 3)	1,153	1,644
Trade receivables (net of allowance for doubtful accounts of \$ 356 and \$ 350 as of December 31, 2002 and 2003, respectively)	1,259	1,391
Other accounts receivable and prepaid expenses (Note 4)	511	566
Inventories (Note 5)	240	193

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Total current assets	12,225	12,478
-----	-----	-----
LONG-TERM INVESTMENTS:		
Investments in an affiliate (Note 6)	1,335	1,859
Long-term loans, net of current maturities (Note 7)	86	95
Severance pay fund	545	564
Other investments (Note 8)	368	368
-----	-----	-----
Total long-term investments	2,334	2,886
-----	-----	-----
PROPERTY AND EQUIPMENT, NET (Note 9)	602	482
-----	-----	-----
OTHER ASSETS:		
Goodwill (Note 10a)	2,025	2,025
Other intangible assets, net (Note 10b)	360	206
Deferred income taxes (Note 14)	161	105
-----	-----	-----
Total other assets	2,546	2,336
-----	-----	-----
Total assets	\$17,707	\$18,182
-----	=====	=====

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

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MER TELEMANAGEMENT SOLUTIONS LTD.  
AND ITS SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

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

	December 31,	
	2002	2003
	-----	-----
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Current maturities of long-term loans (Note 12)	\$ 8	\$ 8
Trade payables	350	393
Accrued expenses and other liabilities (Note 11)	1,439	1,421
Deferred revenues	1,184	1,219
-----	-----	-----

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Total current liabilities	2,981	3,041
-----	-----	-----
LONG-TERM LIABILITIES:		
Long-term loans, net of current maturities (Note 12)	8	-
Accrued severance pay	705	677
	-----	-----
Total long-term liabilities	713	677
-----	-----	-----
COMMITMENTS AND CONTINGENT LIABILITIES (Note 13)		
SHAREHOLDERS' EQUITY (Note 16):		
Share capital -		
Ordinary shares of NIS 0.01 par value - Authorized: 12,000,000 shares as of December 31, 2002 and 2003; Issued: 4,882,748 and 4,631,471 shares as of December 31, 2002 and 2003, respectively; Outstanding: 4,621,648 and 4,624,471 shares as of December 31, 2002 and 2003, respectively	15	14
Additional paid-in capital	12,846	12,603
Treasury shares (261,100 and 7,000 shares as of December 31, 2002 and 2003, respectively)	(330)	(20)
Accumulated other comprehensive income (loss)	(211)	87
Retained earnings	1,693	1,780
	-----	-----
Total shareholders' equity	14,013	14,464
-----	-----	-----
Total liabilities and shareholders' equity	\$ 17,707	\$ 18,182
-----	=====	=====

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

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MER TELEMANAGEMENT SOLUTIONS LTD.  
AND ITS SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

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

	Year ended December 31,		
	2001	2002	2003
	-----	-----	-----
Revenues (Note 17):			
Products sales	\$ 7,843	\$ 7,397	\$ 6,944
Services	2,882	2,390	2,286
	-----	-----	-----
Total revenues	10,725	9,787	9,230
	-----	-----	-----

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Cost of revenues:			
Products sales	1,909	1,655	1,523
Services	643	241	326
	-----	-----	-----
Total cost of revenues	2,552	1,896	1,849
	-----	-----	-----
Gross profit	8,173	7,891	7,381
	-----	-----	-----
Operating expenses:			
Research and development, net (Note 17c)	3,562	2,127	1,825
Selling and marketing	4,911	3,954	3,916
General and administrative	1,943	1,858	1,830
	-----	-----	-----
Total operating expenses	10,416	7,939	7,571
	-----	-----	-----
Operating loss	(2,243)	(48)	(190)
Financial income, net (Note 17d)	138	134	124
Other income (expenses), net (Note 17e)	(654)	(140)	6
	-----	-----	-----
Loss before taxes on income	(2,759)	(54)	(60)
Taxes on income (Note 14)	16	52	198
	-----	-----	-----
	(2,775)	(106)	(258)
Equity in earnings of affiliate	221	236	345
	-----	-----	-----
Net income (loss)	\$ (2,554)	\$ 130	\$ 87
	=====	=====	=====
Net earnings (loss) per share:			
Basic net earnings (loss) per ordinary share	\$ (0.53)	\$ 0.03	\$ 0.02
	=====	=====	=====
Diluted net earnings (loss) per ordinary share	\$ (0.53)	\$ 0.03	\$ 0.02
	=====	=====	=====
Weighted average number of ordinary shares used in computing basic net earning (loss) per share	4,826,126	4,709,796	4,617,099
	=====	=====	=====
Weighted average number of ordinary shares used in computing diluted net earning (loss) per share	4,826,126	4,709,796	4,628,249
	=====	=====	=====

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

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MER TELEMAGEMENT SOLUTIONS LTD.  
AND ITS SUBSIDIARIES

STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

-----  
U.S. dollars in thousands

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	Share capital	Additional paid-in capital	Treasury shares	Accumulated other comprehensive Income (loss)	Retain earn
	-----	-----	-----	-----	-----
Balance as of January 1, 2001	\$ 15	\$ 12,836	\$ (40)	\$ (431)	\$ 4,
Exercise of options	*) -	10	-	-	
Purchases of treasury shares	-	-	(118)	-	
Other comprehensive income (loss):					
Unrealized gains on available for sale marketable securities	-	-	-	72	
Foreign currency translation adjustments	-	-	-	(51)	
Total other comprehensive income					
Net loss	-	-	-	-	(2,
	-----	-----	-----	-----	-----
Total comprehensive loss					
Balance as of December 31, 2001	15	12,846	(158)	(410)	1,
Purchase of treasury shares	-	-	(172)	-	
Other comprehensive income:					
Unrealized losses on available for sale marketable securities	-	-	-	(3)	
Foreign currency translation adjustments	-	-	-	202	
Total other comprehensive income					
Net income	-	-	-	-	
	-----	-----	-----	-----	-----
Total comprehensive income					
Balance as of December 31, 2002	15	12,846	(330)	(211)	1,
Exercise of options	*) -	-	-	-	
Employee stock based compensation	-	213	-	-	
Retirement of treasury shares	(1)	(456)	457	-	
Purchase of treasury shares	-	-	(147)	-	
Other comprehensive income:					
Unrealized gains on available for sale marketable securities, net	-	-	-	109	
Foreign currency translation adjustments	-	-	-	196	
Loss from cash flows hedges transaction	-	-	-	(7)	
Total other comprehensive income					
Net income	-	-	-	-	
	-----	-----	-----	-----	-----
Total comprehensive income					
Balance as of December 31, 2003	\$ 14	\$ 12,603	\$ (20)	\$ 87	\$ 1,
	=====	=====	=====	=====	=====
Accumulated unrealized gains from available-for-sale marketable securities				3	
Accumulated foreign currency translation adjustments				91	
Accumulated losses from cash flow hedges				(7)	
				-----	
				\$ 87	
				=====	

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

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

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MER TELEMAGEMENT SOLUTIONS LTD.  
AND ITS SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

	Year ended December 31,		
	2001	2002	2003
<b>Cash flows from operating activities:</b>			
Net income (loss)	\$ (2,554)	\$ 130	\$ 87
Adjustments required to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Loss (gain) on sale of available-for-sale and trading marketable securities, net	279	140	(6)
Loss on sale of property and equipment	51	6	39
Loss from impairment of investment in warrants	375	-	-
Equity in earnings of affiliates	(221)	(236)	(345)
Proceeds from trading securities, net	-	81	-
Depreciation and amortization	1,110	501	401
Deferred income taxes, net	(20)	29	23
Employee stock-based compensation	-	-	213
Accrued severance pay, net	57	(2)	(47)
Decrease (increase) in trade receivables	269	(87)	(132)
Decrease (increase) in other accounts receivable and prepaid expenses	673	215	(89)
Decrease in inventories	220	82	47
Increase (decrease) in trade payables	(169)	(149)	43
Decrease in accrued expenses and other liabilities	(623)	(419)	(99)
Increase (decrease) in deferred revenues	(173)	187	35
Others	-	11	(7)
Net cash provided by (used in) operating activities	(726)	489	163
<b>Cash flows from investing activities:</b>			
Changes in related parties account, net	50	108	-
Proceeds from sale of property and equipment	45	26	5
Purchase of property and equipment	(226)	(166)	(171)
Investment in short-term bank deposit	(7,528)	-	-
Proceeds from realization of short-term bank deposits	7,448	1,942	-

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Investment in available for sale marketable securities	(401)	(1,512)	(969)
Investment in held-to-maturity marketable securities	-	(476)	-
Proceeds from sale of available-for-sale marketable securities	1,631	2,508	318
Proceeds from redemption of held-to-maturity marketable securities	-	201	275
Dividend from an affiliate	56	190	100
Others	-	(12)	16
	-----	-----	-----
Net cash provided by (used in) investing activities	1,075	2,809	(426)
	-----	-----	-----

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

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MER TELEMANAGEMENT SOLUTIONS LTD.  
AND ITS SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

	Year ended December 31,		
	2001	2002	2003
	----	----	----
Cash flows from financing activities:			
-----			
Changes in related parties, net	-	4	51
Repayment of long-term loans	(91)	(55)	(8)
Proceeds from exercise of options and warrants, net	10	-	*) -
Purchase of treasury shares	(118)	(172)	(147)
	-----	-----	-----
Net cash used in financing activities	(199)	(223)	(104)
	-----	-----	-----
Effect of exchange rate changes on cash and cash equivalents	-	-	(11)
	-----	-----	-----
Increase (decrease) in cash and cash equivalents	150	3,075	(378)
Cash and cash equivalents at the beginning of the year	5,837	5,987	9,062
	-----	-----	-----
Cash and cash equivalents at the end of the year	\$ 5,987	\$ 9,062	\$ 8,684
	=====	=====	=====
Supplemental disclosure of cash flows activities:			
-----			
Cash paid during the year for:			
Interest	\$ 45	\$ 10	\$ 1
	=====	=====	=====
Income taxes	\$ 8	\$ 58	\$ 49
	=====	=====	=====



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

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

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MER TELEMAGEMENT SOLUTIONS LTD.  
AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 1:- GENERAL

MER Telemanagement Solutions Ltd. ("MTS") was incorporated on December 27, 1995. MTS and its subsidiaries ("the Company") designs, develops, markets and supports a comprehensive line of telecommunication management solutions that enable business organizations and other enterprises to improve the efficiency and performance of all IP operations, and reduce associated costs. The Company's products include call accounting and management products, fault management systems and web based management solutions for converged voice, voice over Internet Protocol or IP data and video. As for MTS's subsidiaries, see Note 18.

These products are designed to provide telecommunication and information technology managers with tools to reduce communication costs, recover charges payable by third parties, and to detect and prevent abuse and misuse of telephone networks including fault telecommunication usage.

The Company markets its products worldwide through distributors, business telephone switching systems manufacturers and vendors and its direct sales force. Several international PBX manufacturers market the Company's products as part of their PBX selling efforts or on an Original Equipment Manufacturer ("OEM") basis. The Company is highly dependent upon the active marketing and distribution of its OEM's. In 2001, 2002 and 2003, two major customers generated 40%, 42% and 47% of the Company's revenues, respectively (see Note 17a).

Certain components and subassemblies included in the Company's products are obtained from a single source or a limited group of suppliers and subcontractors. If such supplier fails to deliver the necessary components or subassemblies, the Company may be required to seek alternative source of supply. A change in supplier could result in manufacturing delays, which could cause a possible loss of sales and, consequently, could adversely affect the Company's results of operations and cash position.

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MTS's shares are listed for trade on the Nasdaq SmallCap Market.

### NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES

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

a. Use of estimates:

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

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MER TELEMANAGEMENT SOLUTIONS LTD.  
AND ITS SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

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

b. Financial statements in U.S. dollars:

The majority of the Company's sales is made outside Israel in U.S. dollars ("dollars"). In addition, a substantial portion of MTS and certain portion of its subsidiaries costs is incurred in dollars. Since the Company's management believes that the dollar is the primary currency of the economic environment in which MTS and certain of its subsidiaries operate, the dollar is their functional and reporting currency.

Accordingly, monetary accounts maintained in currencies other than the dollar are remeasured into U.S. dollars in accordance with Statement of Financial Accounting Standard No. 52, "Foreign Currency Translation" ("SFAS No. 52"). All effects of foreign currency remeasurement of monetary balance sheet items are reflected in the statements of operations as financial income or expenses, as appropriate.

The subsidiaries and affiliate whose functional currency has been determined to be other than U.S. dollars, assets and liabilities are translated at year-end exchange rates and statement of operations 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 MTS and its subsidiaries. Intercompany balances and transactions have been eliminated upon consolidation.

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d. Cash equivalents:

The Company considers all highly liquid investments originally purchased with maturities of three months or less to be cash equivalents.

e. Marketable securities:

The Company accounts for investments in debt and equity securities (other than those accounted for under the equity method of accounting) in accordance with Statement of Financial Accounting Standard No. 115, "Accounting for Certain Investments in Debt and Equity Securities" ("SFAS No. 115").

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MER TELEMANAGEMENT SOLUTIONS LTD.  
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Management determines the appropriate classification of its investments in marketable debt and equity securities at the time of purchase and reevaluates such determinations at each balance sheet date. Debt securities are classified as held to maturity when the Company has a positive intent and ability to hold the securities to maturity, and are stated at amortized cost. The amortized cost of debt securities is adjusted for amortization of premiums and accretion of discounts to maturity. Such amortization and interest are included in the statement of operations as other expenses or income. Debt securities for which the Company does not have the intent or ability to hold to maturity are classified as available-for-sale, along with any investments in equity securities that have not been classified as "trading securities". Securities available for sale are carried at fair value, with the unrealized gains and losses, net of income taxes, reported as a separate component of shareholders' equity, under accumulated other comprehensive income (loss). Realized gains and losses on sales of investments, as determined on a specific identification basis, are included in the consolidated statements of operations in other income (expenses).

The Company's trading securities are carried at their fair value based upon the quoted market price of those investments at each balance sheet date. Net realized and unrealized gains and losses on these securities are included in the statements of operations in other income (expenses).

At December 31, 2003, all marketable securities covered by SFAS No. 115 were designated as available-for-sale. Accordingly, these securities are stated at fair value, with unrealized gains and losses reported in accumulated other comprehensive income (loss), a separate component of shareholders' equity, net of taxes. Realized gains and losses on sales of investments, as determined on a specific identification basis, are included in the consolidated Statement of Operations.

f. Inventories:

Inventories are stated at the lower of cost or market value. Cost is determined as follows: Raw materials, parts and supplies -using the "first in, first out" method with the addition of allocable indirect manufacturing costs. Finished products are recorded on the basis of direct manufacturing costs with the addition of allocable indirect manufacturing costs. Inventories write-offs are provided to cover risks arising from slow moving items or technological obsolescence.

g. Investments in affiliate and other companies:

Investment in privately held company in which the Company holds 20% to 50% ownership of voting rights and can exercise significant influence over operating and financial policy of the affiliate is presented using the equity method of accounting. Profits on intercompany sales, not realized outside the Company, were eliminated. The excess of the purchase price over the fair value of net tangible assets acquired has been attributed to goodwill. In accordance with Statement of Financial Accounting Standard No. 142, "Goodwill and Other Intangible Assets" ("SFAS No. 142") goodwill related to investments in affiliates is no longer amortized. The goodwill is reviewed for impairment in accordance with Accounting Principles Board Opinion No. 18, "The Equity Method of Accounting for Investments in Common Stock" ("APB No. 18"). Before the adoption of SFAS No. 142 on January 1, 2002, goodwill was amortized on a straight-line basis over 10 years, in accordance with APB Opinion No. 17, "Intangible Assets".

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MER TELEMAGEMENT SOLUTIONS LTD.  
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Investments in privately held companies in which the Company holds less than 20% and does not have the ability to exercise significant influence over operating and financial policy of the Company, are presented at cost. The carrying value is periodically reviewed by management, in accordance with APB 18. If this review indicates that the carrying value is not recoverable, the carrying value is reduced to its estimated fair value. As of December 31, 2003, no impairment losses have been identified.

h. 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 depreciation rates:

-----  
%

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Computers and peripheral equipment	33
Office furniture and equipment	6 - 20
Motor vehicles	15
Leasehold improvements	Over the term of the lease agreement

i. Impairment of long-lived assets:

Long-lived assets of the Company are reviewed for impairment in accordance with Statement of Financial Accounting Standard No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS No. 144"), whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. 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. As of December 31, 2003 no impairment was required.

j. Goodwill:

Goodwill represents excess of the costs over the net assets of business acquired. Goodwill from acquisitions prior to July 1, 2001 was amortized until December 31, 2001, by the straight-line method, over 10 years. Under SFAS No. 142, goodwill acquired in a business combination on or after July 1, 2001, will not be amortized.

SFAS No. 142 requires goodwill to be tested for impairment on adoption and at least annually thereafter or between annual tests in certain circumstances, and written down when impaired, rather than being amortized as previous accounting standards required. Goodwill is tested for impairment by comparing the fair value of the reporting unit with its carrying value. Fair value is determined using discounted cash flows. Significant estimates used in the methodologies include estimates of future cash flows, future short-term and long-term growth rates, and weighted average cost of capital. The Company has selected December 31 as the date it will perform its annual goodwill impairment tests. As of December 31, 2003 no impairment was required. As for application of SFAS No. 142, see Note 10a.

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MER TELEMAGEMENT SOLUTIONS LTD.  
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

k. Other intangible assets:

Intangible assets acquired in a business combination are being amortized on a straight-line basis, over their useful life. Acquired developed technology is amortized using the straight-line method over 5 years.

Distributor relationship and Assembled workforce were amortized over 10 and 4 years, respectively, until December 31, 2001. According to SFAS No. 142, the net carrying amount of Distributor relationship and Assembled workforce was subsumed into goodwill at January 1, 2002 (see Note 10a).

l. Research and development costs:

Research and development costs, net of grants received, are charged to the Statement of Operations as incurred. Statement of Financial Accounting Standard No. 86 "Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed" ("SFAS No. 86"), requires capitalization of certain software development costs subsequent to the establishment of technological feasibility.

Based on the Company's product development process, technological feasibility is established upon completion of a 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.

m. Royalty-bearing 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.

n. Income taxes:

The Company accounts for income taxes, in accordance with Statement of Financial Accounting Standard No. 109, "Accounting for Income Taxes" ("SFAS No. 109"). This statement prescribes the use of the liability method whereby deferred tax assets and liability account balances are determined based on 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. Valuation allowances are provided to reduce deferred tax assets to their estimated realizable value.

o. Revenue recognition:

The Company generates revenues from licensing the rights to use their software products directly to end-users and indirectly through resellers and OEM's (who are considered end users). The Company also generates revenues from rendering maintenance, service bureau and support.

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MER TELEMAGEMENT SOLUTIONS LTD.  
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

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

Revenues from software license agreements are recognized when all criteria outlined in Statement of Position No. 97-2 "Software Revenue Recognition" ("SOP No. 97-2") as amended are met. Revenue from license fees is recognized when persuasive evidence of an agreement exists, delivery of the product has occurred, the fee is fixed or determinable and collectibility is probable. The Company generally does not grant a right of return to its customers. When a right of return exists, the Company defers revenue until the right of return expires, at which time revenue is recognized provided that all other revenue recognition criteria are met.

Where software arrangements involve multiple elements, revenue is allocated to each undelivered element based on vendor specific objective evidence ("VSOE") of the relative fair values of each undelivered element in the arrangement, in accordance with the "residual method" prescribed by SOP No. 98-9, "Modification of SOP No. 97-2, Software Revenue Recognition With Respect to Certain Transactions". The VSOE used by the Company to allocate the sales price to support services and maintenance is based on the renewal rate charged when these elements are sold separately. License revenues are recorded based on the residual method. Under the residual method, revenue is recognized for the delivered elements when (1) there is VSOE of the fair values of all the undelivered elements, and (2) all revenue recognition criteria of SOP No. 97-2, as amended, are satisfied. Under the residual method any discount in the arrangement is allocated to the delivered element. Arrangements that include services are evaluated to determine whether those services are essential to the functionality of other elements of the arrangement.

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

Revenues from maintenance and support services are recognized over the life of the maintenance agreement or at the time that support services are rendered.

Deferred revenues include unearned amounts received under maintenance and support contracts, not yet recognized as revenues.

p. Warranty costs:

The Company provides free warranty for up to one year for end-users and up to 15 months for the "OEM"/ distributors. A provision is recorded for probable costs in connection with these services based on the Company's experience.

The Company estimates the costs that may be incurred under its basic limited warranty and records a liability in the amount of such costs at the time product revenue is recognized. Factors that affect the Company's warranty liability include the number of installed units, historical and anticipated rates of warranty claims, and cost per claim. The Company periodically assesses the

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adequacy of its recorded warranty liabilities and adjusts the amounts as necessary. The provision for the year ending December 31, 2003 amounted to of \$ 22.

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MER TELEMANAGEMENT SOLUTIONS LTD.  
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

q. Accounting for stock-based compensation:

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

The following table illustrates the effect on net income (loss) and earnings (loss) per share as if the fair value method had been applied to all outstanding and unvested awards in each period:

	Year ended December 31,		
	2001	2002	2003
Net income (loss), as reported	\$ (2,554)	\$ 130	\$ 87
Add: Stock-based employee compensation - intrinsic value	-	-	213
Deduct: Total stock-based compensation expense determined under fair value method for all awards, net of related tax effect	(769)	(177)	(286)
Pro forma net income (loss)	\$ (3,323)	\$ (47)	\$ 14
Basic and diluted net earnings (loss) per share, as reported	\$ (0.53)	\$ 0.03	\$ 0.02
Basic and diluted net loss per share, pro forma	\$ (0.68)	\$ (0.01)	\$ -

The fair value for each option granted was estimated at the date of grant using a Black-Scholes option-pricing model, assuming no expected dividends and the following weighted average assumptions:



	Year ended December 31,		
	2001	2002	2003
Dividend	0%	0%	0%
Average risk-free interest rates	3.5%	2%	2%
Average expected life (in years)	4	4	2.5
Volatility	87.2%	66.8%	71.8%

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

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MER TELEMANAGEMENT SOLUTIONS LTD.  
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

r. Severance pay:

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

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

Severance expenses for the years ended December 31, 2001, 2002 and 2003 amounted to approximately \$ 189, \$ 104 and \$ 13, respectively.

s. Fair value of financial instruments:

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

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

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

Long-term loans - The carrying amounts of the Company's borrowings under its long-term agreements, both as a lender and as a borrower, approximate their fair value. The fair value was estimated using discounted cash flow analyses, based on the Company's incremental borrowing rates for similar type of borrowing arrangements.

t. Concentrations of credit risk:

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

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

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MER TELEMAGEMENT SOLUTIONS LTD.  
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

The trade receivables of the Company are mainly derived from sales to customers in the U.S. and Europe (see Note 17b). The Company performs ongoing credit evaluations of its customers. The allowance for doubtful accounts is determined with respect to specific debts that are doubtful of collection according to management estimates. In certain circumstances, the Company may require letters of credit, other collateral or additional guarantees.

The Company's marketable securities include mainly investments in corporate debts and mutual funds. Management believes that the portfolio is well diversified, and accordingly, minimal credit risk exists with respect to these marketable securities.

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

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

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

The total number of shares related to the outstanding options excluded from the calculation of diluted net earnings (loss) per share was 1,227,141, 757,580 and 766,141 for the years ended December 31, 2001, 2002 and 2003, respectively.

v. Derivatives and hedging:

The Company in 2003 hedged the exposure of revenues denominated in foreign currencies with forward. To protect against the risk of overall changes in cash flows resulting from export sales over the year.

The Company accounts for derivatives and hedging based on Statement of Financial Accounting Standard No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("SFAS No. 133"). SFAS No. 133 requires the Company to recognize all derivatives on the balance sheet at fair value. If the derivative meets the definition of a hedge and is so designated, depending on the nature of the hedge, changes in the fair value of derivatives will either be offset against the change in fair value of the hedged assets, liabilities, or firm commitments through earnings or recognized in other comprehensive income until the hedged item is recognized in earnings. The derivative's change in fair value is recognized in earnings. During 2003 there were no significant gains or losses recognized in earnings for hedge ineffectiveness.

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MER TELEMANAGEMENT SOLUTIONS LTD.  
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

w. Impact of recently issued accounting standards:

In April 2003, the FASB issued SFAS No. 149 ("SFAS 149"), "Amendment of Statement 133 on Derivative Instruments and Hedging Activities." SFAS 149 amends and clarifies (1) the accounting guidance on derivative instruments (including certain derivative instruments embedded in other contracts) and (2) hedging activities that fall within the scope of FASB Statement No. 133 ("SFAS 133"), "Accounting for Derivative Instruments and Hedging Activities." SFAS 149 amends SFAS 133 to reflect decisions made (1) as part of the Derivatives Implementation Group ("DIG") process that effectively required amendments to SFAS 133, (2) in connection with other projects dealing with financial

instruments, and (3) regarding implementation issues related to the application of the definition of a derivative. SFAS 149 is effective (1) for contracts entered into or modified after June 30, 2003, with certain exceptions, and (2) for hedging relationships designated after June 30, 2003. The guidance is to be applied prospectively. Generally, SFAS 149 improves financial reporting by (1) requiring that contracts with comparable characteristics be accounted for similarly and (2) clarifying when a derivative contains a financing component that warrants special reporting in the statement of cash flows. SFAS 149 is not expected to have a material impact on the Company's financial statements.

In January 2003, the Financial Accounting Standards Board issued Interpretation No. 46, Consolidation of Variable Interest Entities, an interpretation of Accounting Research Bulletin No. 51 ("the interpretation"). In general, a variable interest entity (VIE) is an entity that has (1) insufficient amount of equity for the entity to carry on its principal operations, without additional subordinated financial support from other parties, (2) equity investors that as a group do not have the ability through voting or similar rights to make decisions about the entity's activities, or (3) investors that as a group do not have the obligation to absorb the entity's losses or have the right to receive the benefits of the entity. The interpretation requires the consolidation of a VIE by the primary beneficiary. The primary beneficiary is the entity that absorbs a majority of the entity's expected losses, receives a majority of the entity's expected residual returns, or both, as a result of ownership, contractual or other financial interests in the entity. Presently, entities are generally consolidated by an enterprise that has a controlling financial interest through ownership of a majority voting interest in the entity.

The Interpretation requires a public entity with a variable interest in a VIE that is a special-purpose entity created before February 1, 2003 to apply the provisions of the revised Interpretation, or the Interpretation as originally issued, to that entity no later than the end of the first reporting period ending after December 15, 2003, and the provisions of the revised Interpretation to all variable interests no later than the end of the first reporting period ending after March 15, 2004.

The Company is currently evaluating the effects of this interpretation in respect of its investments. It is possible that some of its unconsolidated investees may be considered a VIE in accordance with the interpretation, but it is the management opinion that the Company would not be considered the primary beneficiary of the above VIE.

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MER TELEMAGEMENT SOLUTIONS LTD.  
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

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### NOTE 3:- MARKETABLE SECURITIES

The following is a summary of the Company's investment in marketable securities:

	December 31, 2002			
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Estima fair ma valu
Held-to-maturity corporate debt	\$ 275	\$ 26	\$ -	\$
Available-for-sale:				
Mutual funds	566	-	(49)	
Equity securities	418	-	(57)	
	\$ 1,259	\$ 26	\$ (106)	\$ 1

	December 31, 2003			
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Estima fair ma valu
Available-for-sale:				
Mutual funds	\$ 623	\$ 5	\$ -	\$
Equity securities	51	12	-	
Corporate bonds	702	-	(8)	
Israeli governmental debts	265	-	(6)	
	\$ 1,641	\$ 17	\$ (14)	\$ 1

The gross realized gains (losses) on sales of available-for-sale securities totaled \$ 31, \$ (128) and \$ 6 in 2001, 2002 and 2003, respectively. The net increase (decrease) to unrealized holding losses on available-for-sale securities included as a separate component of shareholders' equity, under other comprehensive income (loss), totaled \$ (3) and \$ 109 in 2002 and 2003, respectively.

During 2001, the Company recorded a loss in the gross amount of \$ 282 due to other than temporary decline in the value of available for sale marketable securities.

The amortized cost and estimated fair value of debt and marketable equity securities as of December 31, 2003, by contractual maturity, are shown below.

	December 31, 2003	
	Amortized cost	Market value
Matures in one year	\$ 295	\$ 291

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Matures after one year through nine years	672	662
Equity securities and mutual funds	674	691
	-----	-----
Total	\$ 1,641	\$ 1,644
	=====	=====

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MER TELEMANAGEMENT SOLUTIONS LTD.  
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 4:- OTHER ACCOUNTS RECEIVABLE AND PREPAID EXPENSES

	December 31,	
	2002	2003
	-----	-----
Government authorities	\$ 288	\$ 232
Prepaid expenses	91	103
Deferred income taxes	33	66
Others	99	165
	-----	-----
	\$ 511	\$ 566
	=====	=====

NOTE 5:- INVENTORIES

Raw materials	\$ 118	\$ 73
Finished products	122	120
	-----	-----
	\$ 240	\$ 193
	=====	=====

The Company periodically assesses its inventory valuation in accordance with its revenues forecasts, technological obsolescence, and the market conditions. Marked down inventory that is expected to be sold at a price lower than the carrying value is not material.

NOTE 6:- INVESTMENTS IN AFFILIATE

a. Composed as follows:

	December 31,	
	2002	2003
	-----	-----
Investment in Jusan S.A.: (50% owned)		
Equity, net (1)	\$ 1,300	\$ 1,824
Goodwill	35	35
	-----	-----
	\$ 1,335	\$ 1,859
	=====	=====
(1) Investment as of purchase date	\$ 1,171	\$ 1,171
Foreign currency translation adjustments	(136)	143

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Accumulated net earnings	265	510
	-----	-----
	\$ 1,300	\$ 1,824
	=====	=====
Dividend received from Jusan S.A. during the year:	\$ 190	\$ 100
	=====	=====

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MER TELEMAGEMENT SOLUTIONS LTD.  
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U.S. dollars in thousands (except share data)

NOTE 6:- INVESTMENTS IN AFFILIATE (Cont.)

b. Summarized financial information of Jusan S.A. (50% owned):

	December 31,	
	2002	2003
	-----	-----
Current assets	\$ 4,397	\$ 5,266
Non-current assets	\$ 149	\$ 99
Current liabilities	\$ (1,454)	\$ (1,861)

  

	Year ended December 31,		
	2001	2002	2003
	-----	-----	-----
Revenues	\$ 5,906	\$ 6,848	\$ 6,049
Gross profit	\$ 2,944	\$ 3,260	\$ 3,079
Net income	\$ 704	\$ 708	\$ 594

NOTE 7:- LONG-TERM LOANS

a. Composed as follows:

	December 31,	
	2002	2003
	-----	-----
Loans to others in NIS (New Israeli Shekels) - unlinked (1)	\$ 140	\$ 131
Less - current maturities (2)	54	36
	-----	-----
	\$ 86	\$ 95
	=====	=====

(1) The weighted average interest rate for the year ended December 31, 2003 and 2002 is 6.375%.

(2) Included in other accounts receivable.

b. As of December 31, 2003, the aggregate annual maturities of long-term loans are as follows:

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	December 31, 2003
First year (current maturities)	\$ 36
Second year	39
Third year	36
Fourth year	20
	-----
	\$ 131
	=====

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

NOTE 8:- OTHER INVESTMENTS

	December 31,	
	2002	2003
Long-term deposits (1)	\$ 21	\$ 21
Investment in other companies (2)	347	347
	-----	-----
	\$ 368	\$ 368
	=====	=====

(1) Linked to the Israeli CPI.

(2) These investments are stated at cost and represent investments in which the Company holds less than 20% of the voting rights and does not have the right to have representation on the board of directors. Based on assessment performed by the Company no impairment is required.

NOTE 9:- PROPERTY AND EQUIPMENT, NET

	December 31,	
	2002	2003
Cost:		
Computers and peripheral equipment	\$2,387	\$2,528
Office furniture and equipment	492	536
Motor vehicles	107	96
Leasehold improvements	191	100
	-----	-----
	3,177	3,260
	-----	-----
Accumulated depreciation:		
Computers and peripheral equipment	2,116	2,300
Office furniture and equipment	310	358



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Motor vehicles	66	64
Leasehold improvements	83	56
	-----	-----
	2,575	2,778
	-----	-----
Depreciated cost	\$ 602	\$ 482
	=====	=====

Depreciation expenses for the years ended December 31, 2001, 2002 and 2003 were \$ 488, \$ 348 and \$ 247, respectively.

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MER TELEMANAGEMENT SOLUTIONS LTD.  
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NOTE 10:- GOODWILL AND OTHER ASSETS

a. Goodwill:

Effective January 1, 2002, the Company adopted SFAS No. 142.

The Company evaluated its goodwill and intangibles acquired prior to June 30, 2001 using the criteria of SFAS No. 142, which resulted in the net carrying amount of \$ 1,872 related to other intangibles to be subsumed into goodwill. Such intangibles comprise assembled workforce, with an original cost of \$ 848 (amortized cost of \$ 495), and distributors' relationship with an original cost of \$ 1,653 (amortized cost of \$ 1,377) being subsumed into goodwill at January 1, 2002. As of December 31, 2003, \$ 2,025 of the goodwill balance is attributed to the Company's operation since the Company has one reporting unit.

The results of operations presented below for the year ended December 31, 2001, reflect the operations had the Company adopted the non-amortization provisions of SFAS No. 142 effective January 1, 2001:

	Year ended December 31, 2001
	-----
Reported net loss	\$ (2,554)
Goodwill amortization	431
	-----
Adjusted net loss	\$ (2,123)
	=====
Basic and diluted net loss per share:	
Reported net loss per share	\$ (0.53)
Goodwill amortization	0.09
	-----
Adjusted basic and diluted net loss per share	\$ (0.44)
	=====

b. Other intangibles consist of the following:

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	December 31, 2002			December 31, 2003		
	Gross carrying amount	Accumulated amortization	Other intangibles, net	Gross carrying amount	Accumulated amortization	Other intangibles, net
Developed technology	\$ 750	\$ (390)	\$ 360	\$ 750	\$ (544)	\$

Developed technology amortization expenses for the years ended December 31, 2001, 2002 and 2003, were \$ 142, \$ 154 and \$ 154, respectively. The expected amortization expenses for 2004 and 2005 are \$ 154 and \$ 52, respectively.

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MER TELEMANAGEMENT SOLUTIONS LTD.  
AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 11:- ACCRUED EXPENSES AND OTHER LIABILITIES

	December 31,	
	2002	2003
Employees and payroll accruals	\$ 550	\$ 473
Income tax payable	26	242
Accrued expenses	422	456
Customer advances	437	203
Related parties	4	47
	\$ 1,439	\$ 1,421

NOTE 12:- LONG-TERM LOANS

	December 31,	
	2002	2003
Loan from others (1)	\$ 16	\$ 8
Less - current maturities	8	8
	\$ 8	\$ -

(1) In U.S. dollars, bearing an average interest rate of 18.14%.

NOTE 13:- COMMITMENTS AND CONTINGENT LIABILITIES

a. Lease commitments:

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1. The facilities of the Company are rented under operating leases for periods ending in 2005.

Future minimum lease commitments under non-cancelable operating leases as of December 31, are as follows:

2004	\$	276
2005		264
		-----
	\$	540
		=====

Rent expenses for the years ended December 31, 2001, 2002 and 2003, were approximately \$ 576, \$ 446 and \$ 372, respectively.

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### MER TELEMAGEMENT SOLUTIONS LTD. AND ITS SUBSIDIARIES

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

#### NOTE 13:- COMMITMENTS AND CONTINGENT LIABILITIES (Cont.)

##### b. Royalty commitments:

1. The Company is committed to pay royalties to the Office of the Chief Scientist of the Ministry of Trade ("OCS") of the Government of Israel on proceeds from sales of products resulting from the research and development projects in which the Government participated up to the amount received by the Company. In the event that development of a specific product in which the OCS participated is successful, the Company will be obligated to repay the grants through royalty payments at the rate of 3% to 5% based on the sales of the Company, up to 100%-150% of the grants received linked to the dollar. As of December 31, 2003, the Company has a contingent obligation to pay royalties in the amount of \$ 7,520. The obligation to pay these royalties is contingent upon actual sales of the products and, in the absence of such sales, no payment is required.

The outstanding balance of obligations in respect of grants received after January 1999 amounts to \$ 3,447 and also bears LIBOR interest.

The Company has paid or accrued royalties relating to the repayment of such grants in the amount of \$ 176, \$ 132 and \$ 146 for the years ended December 31, 2001, 2002 and 2003, respectively.

2. The Israeli Government, through the Fund for Encouragement of Marketing Activities, awarded the Company grants for participation in marketing expenses overseas. The Company is committed to pay royalties at the rate of 3% of the increase in export sales, up to the amount of the grants received linked to the U.S. dollar. As of December 31, 2003, the

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Company has a contingent obligation to pay royalties in the amount of \$ 259. The Company did not pay or accrue any royalties during the three years ending on December 31, 2003.

c. Claim and demand:

In April 2000, the tax authorities in Israel issued to MTS a demand for a tax payment, for the period of 1997 - 1999, in the amount of approximately NIS 6,000 thousand (approximately \$ 1,350).

MTS has appealed to the Israeli district court in respect of the abovementioned tax demand. Based on the opinion of its tax counsel, MTS believes that certain defenses can be raised against the demand of the tax authorities. MTS believes that the outcome of this matter will not have a material adverse effect on its financial position or results of operations and, MTS provided a provision, based on the current evidence and on the basis of the said opinion of its tax consultants, which in the opinion of MTS is an adequate provision.

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MER TELEMAGEMENT SOLUTIONS LTD.  
AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 14:- TAXES ON INCOME

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

MTS was granted the status of an "Approved Enterprise" under the Law in respect of expansion projects. According to the provisions of the Law, MTS elected to enjoy "alternative benefits" - waiver of grants in return for tax exemption and, accordingly, income derived from the "Approved Enterprise" is tax-exempt for a period of two to four years, commencing with the year it first earns taxable income, and subject to corporate tax at the rate of 25%, for additional periods of three to five years.

The expansion programs which are assigned to MTS are as follows:

1. One program entitled MTS to tax-exemption for a two-year period ended December 31, 1999, and is subject to a reduced tax rate of 25% for a five-year period ending December 31, 2004.
2. The current program entitles MTS to tax exemption for a two year period and were subject to tax rate of 25% for five year period. The benefits in respect of this program have not yet commenced.

The period of tax benefits detailed above is subject to limit of the earlier of 12 years from the commencement of production or 14 years from receiving the approval.

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

The tax-exempt income attributable to the "Approved Enterprise" amounting to \$ 2,250 as of December 31, 2003 can be distributed to shareholders without subjecting MTS to taxes only upon the complete liquidation of MTS. MTS has determined that such tax-exempt income will not be distributed as dividends and permanently re-invested these profits. Accordingly, no deferred taxes have been nor will be provided on income attributable to MTS's "Approved Enterprise".

Should the retained tax-exempt income be distributed in a manner other than in the complete liquidation of MTS, it would be taxed at the corporate tax rate applicable to such profits as if MTS had not elected the alternative tax benefits (currently - 25% for an "Approved Enterprise").

Should MTS and its Israeli subsidiary derive income from sources other than an "Approved Enterprise", they will be subject to tax at regular rates of 36%.

Since MTS is operating under more than one "Approved Enterprise" and since part of its taxable income is not entitled to tax benefits under the abovementioned law and is taxed at the regular tax rate of 36%, its effective tax rate is the result of a weighted combination of the various applicable rate and tax exemptions, and the computation is made for income derived from each program on the basis of formulas specified in the law and in the approvals.

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MER TELEMAGEMENT SOLUTIONS LTD.  
AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 14:- TAXES ON INCOME (Cont.)

- b. Measurement of results for tax purposes under the Income Tax Law (Inflationary Adjustments), 1985:

Results for tax purposes are measured in terms of earnings in NIS after certain adjustments for increases in the Israeli Consumer Price Index ("CPI"). As explained in Note 2b, the financial statements are presented in dollars. The difference between the annual change in the CPI and in the NIS/dollar exchange rate causes a further difference between taxable income and the income before taxes presented in the financial statements. In accordance

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with paragraph 9(f) of SFAS 109, MTS and its Israeli subsidiary have not provided for deferred income taxes on the difference between the functional currency and the tax bases of assets and liabilities.

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

MTS is an "industrial company" as defined by this law and, as such, is entitled to certain tax benefits, mainly accelerated depreciation of machinery and equipment, as prescribed by regulations published under the Inflationary Adjustments Law, the right to claim public issuance expenses and amortization of intangible property rights as a deduction for tax purposes.

- d. Tax loss carryforward:

The Company's subsidiaries in Asia, U.S., Holland and Israel have estimated a total amount of available carryforward tax losses of \$ 177, \$486, \$ 212 and \$ 71, respectively to offset against future taxable profits.

Tax loss carryforward in Israel may be used indefinitely to offset against operating income. The operating loss carryforwards of MTS and its Israeli subsidiary, which can be used indefinitely, amounted to approximately \$ 2,662.

- e. Tax assessment:

Regarding the claim from the tax authorities in Israel, see Note 13c.

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MER TELEMAGEMENT SOLUTIONS LTD.  
AND ITS SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

#### NOTE 14:- TAXES ON INCOME (Cont.)

- f. 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. Significant components of the Company's deferred tax liabilities and assets are as follows:

	December 31,	
	2002	2003
Tax loss carryforwards of the Company	\$ 364	\$ 845
Allowances for doubtful accounts and provisions for employee benefits	92	121
In respect of marketable securities	29	84
Capitalized software and other intangible assets	93	134

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Other	(140)	5
	-----	-----
Net deferred tax asset before valuation allowance	438	1,189
Valuation allowance	(244)	(1,018)
	-----	-----
Net deferred income taxes	\$ 194	\$ 171
	=====	=====
Presented as follows:		
Current assets - foreign	\$ 21	\$ 66
	=====	=====
Other assets - foreign	\$ -	\$ 73
	=====	=====
Current assets - domestic	\$ 12	\$ -
	=====	=====
Other assets - domestic	\$ 161	\$ 32
	=====	=====

MTS and certain of its subsidiaries have provided valuation allowances in respect of deferred tax assets resulting from tax loss carryforward and other temporary differences, since they have a history of losses over the past years. Management currently believes that it is more likely than not that part of the deferred tax regarding the loss carryforward in the Company and other temporary differences will not be realized in the foreseeable future.

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MER TELEMANAGEMENT SOLUTIONS LTD.  
AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 14:- TAXES ON INCOME (Cont.)

- g. A reconciliation between the theoretical tax expense, assuming all income is taxed at the statutory tax rate applicable to income of the Company and the actual tax expense as reported in the statements of operations, is as follows:

	Year ended December 31,		
	2001	2002	2003
	-----	-----	-----
Loss before taxes as reported in the statements of operations	\$ (2,759)	\$ (54)	\$ (
	=====	=====	=====
Tax rates	36%	36%	
	=====	=====	=====
Theoretical tax benefit	\$ (993)	\$ (19)	\$ (
Increase in taxes resulting from:			
Effect of different tax rates and "Approved Enterprise" benefit	396	200	
Tax adjustment in respect of inflation in Israel and others	193	(61)	(

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Utilization of carryforward tax losses for which valuation allowance was provided	-	(246)	(
Non-deductible expenses and tax exempt income	(43)	(24)	
Taxes and deferred taxes in respect of previous years	-	-	1
Deferred taxes for which valuation allowance was provided	463	202	1
	-----	-----	-----
Taxes on income as reported in the statements of operations	\$ 16	\$ 52	\$ 1
	=====	=====	=====

h. Loss before income taxes is comprised as follows:

Domestic	\$ (1,772)	\$ (841)	\$ (3
Foreign	(987)	787	2
	-----	-----	-----
	\$ (2,759)	\$ (54)	\$ (
	=====	=====	=====

i. Taxes on income are comprised as follows:

Current taxes	\$ 36	\$ 23	\$
Deferred taxes	(20)	29	
Taxes and deferred taxes in respect of previous years	-	-	1
	-----	-----	-----
	\$ 16	\$ 52	\$ 1
	=====	=====	=====
Domestic	\$ (42)	\$ 29	\$ 3
Foreign	58	23	(1
	-----	-----	-----
	\$ 16	\$ 52	\$ 1
	=====	=====	=====

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MER TELEMANAGEMENT SOLUTIONS LTD.  
AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 14:- TAXES ON INCOME (Cont.)

j. On January 1, 2003, a comprehensive tax reform took effect in Israel. Pursuant to the reform, resident companies are subject to Israeli tax on income accrued or derived in Israel or abroad. In addition, the concept of "controlled foreign corporation" was introduced according to which an Israeli company may become subject to Israeli taxes on certain income of a non-Israeli subsidiary if the subsidiary's primary source of income is passive income (such as interest, dividends, royalties, rental income or capital gains). The tax reform also substantially changed the system of taxation of capital gains. The Company does not expect the tax reform to have a material impact on its results of operations or financial position.



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### NOTE 15:- RELATED PARTIES TRANSACTIONS

- a. On November 8, 1999, the board of directors and the audit committee approved, subject to shareholders' approval, an increase in the monthly salary of the Chairman of the Board of Directors from \$ 5 to \$ 7 per month and the grant of options to purchase 98,824 ordinary shares. The options were granted to him at his request in lieu of salary for the twelve month period ending December 31, 2000. The exercise price of the options is \$ 6 per share, expected dividend yield is 0%, and the risk free interest rate is 6%. The options will vest ratably over an eight-month period beginning January 1, 2000 and will terminate five years from the date of grant.

The wife of the Chairman of the Board of Directors provides ongoing legal services to the Company and receives a monthly retainer of \$ 5. The conditions of retaining the services of her were approved by the Company's board of directors and audit committee.

MTS's subsidiaries, MTS Asia Ltd. and MTS IntegraTRAK, entered into an agreement with C. Mer, pursuant to which they distribute and support certain of C. Mer's (company under common control) products and provide certain services on behalf of C. Mer. Generally, C. Mer compensates MTS Asia Ltd. for these activities at cost plus 10% and compensates MTS IntegraTRAK at cost plus 5%.

- b. In 2002 and 2003, the balance with C. Mer reflects short-term debt and other receivable. Due to the short-term nature no interest was charged by or paid to C. Mer through December 31, 2002 and 2003.

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MER TELEMAGEMENT SOLUTIONS LTD.  
AND ITS SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

### NOTE 15:- RELATED PARTIES TRANSACTIONS (Cont.)

- c. Transactions with related parties were as follows:

	Year ended December 31,		
	2001	2002	2003
Sales through related parties	\$ 58	\$ 65	\$
Amounts charged by related parties:			
Cost of revenues	62	\$ 239	\$
Research and development	58	8	
Selling and marketing	-	2	
General and administrative	-	4	

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	\$ 120	\$ 253	\$
	=====	=====	=====
Amounts charged by MTS Integra TRAK and MTS Asia to related parties:			
Selling and marketing	\$ 44	\$ 2	\$
	=====	=====	=====
Repayments to the related parties, net	\$ (10)	\$ (172)	\$
	=====	=====	=====

d. Amounts due from an affiliate:

	December 31,	
	-----	-----
	2002	2003
	-----	-----
Jusan S.A	\$ 10	\$ (2)
	=====	=====

NOTE 16:- SHAREHOLDERS' EQUITY

a. Share capital:

The ordinary shares entitle their holders the right to receive notice to participate and vote in general meetings of MTS and the right to receive cash dividends, if declared.

b. Share Option Plan:

MTS has authorized, through its 1996 Incentive Share Option plan, the grant of options to officers, management, employees and directors of MTS or any subsidiary of up to 1,900,000 of MTS's Ordinary shares. 1,500,000 options were granted pursuant to section 102 of the Israel Income Tax Ordinance. Any option, which is canceled or forfeited before expiration, will become available for future grants.

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MER TELEMANAGEMENT SOLUTIONS LTD.  
AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 16:- SHAREHOLDERS' EQUITY (Cont.)

Each option granted under the Plan is exercisable until the earlier of four years from the date of the grant of the option or the expiration dates of the option plan. The exercise price of the options granted under the plans may not be less than the nominal value of the shares into which such options were exercised. The options vest primarily gradually over three or four years of employment.

In 2002, Section 102 of the Israeli Income Tax Ordinance was amended effective as of January 1, 2003. Therefore MTS has rolled-over the remaining options available for grant into a new plan that conforms with the newly amended provisions of Section

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102 of the Israel Income Tax Ordinance. The Incentive Share Option Plan will terminate in 2013, unless cancelled earlier by MTS's board of directors.

As of December 31, 2003, 826,776 options are available for future grant.

Summary of MTS's stock options activity and related information for the three years ended December 31, is as follows:

	Options available for grant	Number of options outstanding	Options exercisable	Weighted average exercise price
Options exercisable at January 1, 2001			778,325	\$
Balance on January 1, 2001	447,598	1,315,152		\$
Options granted	(436,405)	436,405		\$
Options forfeited	520,416	(520,416)		\$
Options exercised	-	(4,000)		\$
Options exercisable at December 31, 2001			800,887	\$
Balance on December 31, 2001	531,609	1,227,141		\$
Options granted	(35,000)	35,000		\$
Options forfeited	504,561	(504,561)		\$
Options exercisable at December 31, 2002			502,644	\$
Balance on December 31, 2002	1,001,170	757,580		\$
Options granted	(434,500)	434,500		\$
Options exercised	-	(133,333)		\$
Options forfeited	260,106	(260,106)		\$
Options exercisable at December 31, 2003			355,413	\$
Balance on December 31, 2003	826,776	798,641		\$

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MER TELEMAGEMENT SOLUTIONS LTD.  
AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 16:- SHAREHOLDERS' EQUITY (Cont.)

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

Options outstanding	Weighted average	Weighted	Weighted average
------------------------	---------------------	----------	---------------------

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Exercise price	as of December 31, 2003	remaining contractual life (in years)	average exercise price	Options exercisable	exerci of exe opti
\$ 0.93 - \$ 1.3	32,500	2.08	\$1.19	10,830	\$1.
\$ 1.844	250,000	4.92	\$1.844	-	\$
\$ 1.9 - \$ 2.05	239,967	1.38	\$1.96	192,213	\$1.
\$ 2.9 - \$ 2.95	117,500	4.93	\$2.91	-	\$
\$ 4.5	2,000	1.08	\$4.5	1,333	\$4.
\$ 5.5	19,000	0.58	\$5.5	19,000	\$5.
\$ 5.9375 - \$ 6	116,724	1.00	\$5.99	115,749	\$5.
\$ 7.0625	20,950	0.33	\$7.0625	16,288	\$7.
	798,641		\$2.85	355,413	\$3.

- c. The weighted average fair value of options granted during 2001 and 2002, whose exercise price equals the fair value of the stock on the date of grant, was \$ 2.05 and \$ 1.20 per option, respectively.

During 2003, the Company granted 434,500 options, of such options, 117,500 options were granted at a weighted average exercise price of \$ 2.91 per share (the fair market value of the shares on the date of grant) and 317,000 options with a weighted average exercise price of \$ 1.45 were granted at exercise prices below the fair value of the shares on the date of grant.

The Company has recorded deferred stock compensation expense for options issued with an exercise price below the fair market value of the shares; the deferred stock compensation expense has been amortized and recorded as compensation expense ratably over the vesting period of the options. Compensation expense of approximately \$ 60 was recognized during 2003.

During 2003, the Company reduced the exercise price of 83,000 options to zero resulting in a compensation expense of approximately \$ 153.

- d. In January 2000, MTS granted 98,824 options to Mr. Chaim Mer, chairman of the Company, having an exercise price of \$ 6.00 per share. These options were granted in lieu of Mr. Mer's salary (\$ 7 per month) in 2000. The options are exercisable for five years commencing January 1, 2000 (see Note 15).
- e. On February 7, 2001, MTS issued five-year warrants to purchase 25,000 ordinary shares of MTS to Investec Bank (Mauritius) Ltd. in connection with certain financial services performed on MTS's behalf. The warrants have an exercise price of \$ 4.95 per share for warrants exercised until February 2004 and \$ 5.625 per share for warrants exercised until February 2006. The fair value of the warrants, at the date of the grant, using a Black-Scholes option pricing model was immaterial and therefore no compensation expenses were recorded.

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MER TELEMANAGEMENT SOLUTIONS LTD.  
AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 16:- SHAREHOLDERS' EQUITY (Cont.)

f. Treasury shares:

During the years 2001, 2002 and 2003, the Company purchased 54,665, 195,183 and 130,510 treasury shares in consideration of \$ 118, \$ 172 and \$ 147 respectively, according to the stock repurchase program, which authorized the Company's officers to repurchase up to 600,000 ordinary shares of MTS and was approved by the Company's board of directors.

During the year, MTS cancelled \$458 of its treasury shares, which represent 384,610 Ordinary shares.

g. Dividends:

Dividends, if any, will be paid in NIS. Dividends paid to shareholders outside Israel will be converted into dollars, on the basis of the exchange rate prevailing at the date of payment.

NOTE 17:- SELECTED STATEMENTS OF OPERATIONS DATA

The Company adopted Statement of Financial Accounting Standard No. 131, "Disclosures About Segments of an Enterprise and Related Information", ("SFAS No. 131"). The Company operates in one reportable segment (see Note 1 for a brief description of the Company's business). The total revenues are attributed to geographic areas based on the location of the customer.

a. Major customers as a percentage of total revenues:

	Year ended December 31,		
	2001	2002	2003
	%		
Philips	8	6	7
Siemens	32	36	40

b. The following is a summary of revenues within geographic areas based on end customer location and long-lived assets:

	Year ended December 31,		
	2001	2002	2003
Revenues from sales:			
Israel	\$ 358	\$ 217	\$ 186
United States	6,496	6,449	4,917
Germany	1,355	1,130	1,826

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Holland	1,009	756	924
Europe (excluding Austria, Germany and Holland)	448	296	516
Asia	500	469	364
South America	419	328	368
Austria	24	-	-
Others	116	142	129
	-----	-----	-----
	\$ 10,725	\$ 9,787	\$ 9,230
	=====	=====	=====

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MER TELEMANAGEMENT SOLUTIONS LTD.  
AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

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

	Year ended December 31,		
	2001	2002	2003
	-----	-----	-----
Long-lived assets:			
-----			
Israel	\$ 809	\$ 624	\$ 394
United States	2,437	2,302	2,268
Holland	10	10	8
Asia	35	29	16
South America	23	22	27
	-----	-----	-----
	\$ 3,314	\$ 2,987	\$ 2,713
	=====	=====	=====
 c. Research and development, net:			
Total costs	\$ 4,552	\$ 2,128	\$ 1,825
Less - grants and participations	(990)	(1)	-
	-----	-----	-----
	\$ 3,562	\$ 2,127	\$ 1,825
	=====	=====	=====
 d. Financial income, net			
Financial expenses:			
Interest expenses	\$ (232)	\$ (205)	\$ (64)
Other expenses	(9)	(7)	-
Foreign currency translation differences	(81)	-	(11)
	-----	-----	-----
	(322)	(212)	(75)
	-----	-----	-----
Financial income:			
Interest income	403	310	186
Other income	57	1	13

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Foreign currency translation differences	-	35	-
	-----	-----	-----
	460	346	199
	-----	-----	-----
Financial income, net	\$ 138	\$ 134	\$ 124
	=====	=====	=====

e. Other income (expenses):

Loss from impairment of investments in warrants	\$ (375)	\$ -	\$ -
Gain (loss) on marketable securities, net	(279)	(140)	6
	-----	-----	-----
	\$ (654)	\$ (140)	\$ 6
	=====	=====	=====

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MER TELEMANAGEMENT SOLUTIONS LTD.  
AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 18:- SUBSIDIARIES AND AFFILIATES

Subsidiaries:	Percentage of ownership	Jurisdiction of incorporation
-----	-----	-----
MTS IntegraTRAK Inc.	100%	Delaware
MER Fifth Avenue Realty Inc. (a subsidiary of MTS IntegraTRAK Inc.)	100%	New York
MTS Asia Ltd.	100%	Hong Kong
Telegent Ltd.	100%	Israel
Jaraga B.V.	100%	The Netherlands
Verdura B.V. (a subsidiary of Jaraga B.V.)	100%	The Netherlands
Voltera Technologies V.O.F. (a partnership held 99% by Jaraga B.V. and 1% by Verdura B.V.)	100%	The Netherlands
Bohera B.V. (a subsidiary of Jaraga B.V.)	100%	The Netherlands
Tabs Brazil Ltd. (a subsidiary of Bohera B.V.)	100%	Brazil
 Affiliate: -----		
Jusan S.A. (a subsidiary of Jaraga B.V.)	50%	Spain

NOTE 19:- SUBSEQUENT EVENTS (UNAUDITED)

In March 2004, MTS IntegraTRAK was named as a defendant in a complaint filed in the United States District Court for the Northern District of

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Georgia, Atlanta Division, captioned Telemate.net Software, Inc. v. James A. Myers, Total Wire Software Company, Inc. and MTS IntegraTRAK, Inc. The plaintiff alleges among other things federal copyright infringement, federal unfair competition, common law unfair competition and misappropriation of trade secrets in connection with MTS IntegraTRAK license of software from James A. Myers. In a related action in the State Court of Fulton County, State of Georgia, captioned James A. Myers v. Telemate.net Software, Inc. v. MTS IntegraTRAK, Inc. and Total Wire Software Company, Inc., Telemate filed a third-party complaint against MTS IntegraTRAK based on the same license, claiming misappropriation of trade secrets. The plaintiff is seeking an injunction against MTS IntegraTRAK future sales of the product, damages, an accounting of any sales of such product, and attorneys' fees. MTS IntegraTRAK has not responded to the complaints as yet, but believes that it has good and valid defenses that it will assert.

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JUSAN, S.A.

FINANCIAL STATEMENTS

AS OF DECEMBER 31, 2003

EUROS IN THOUSANDS

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ERNST & YOUNG

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REPORT OF INDEPENDENT AUDITORS

To the Shareholders of

JUSAN, S.A.

We have audited the accompanying balance sheets of JUSAN, S.A. ("the Company") as of December 31, 2003 and 2002, and the related statements of income, changes in shareholders' equity and cash flows for each of the two years in the period ended December 31, 2003. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

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

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Tel-Aviv, Israel  
January 14, 2004

/s/ Kost Forer Gabbay and Kasierer  
KOST FORER GABBAY & KASIERER  
A Member of Ernst & Young Global

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JUSAN, S.A.

BALANCE SHEETS

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Euros in thousands

	December 31,	
	2002	2003
	-----	-----
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	(euro) 338	(euro) 953
Short-term bank deposits	402	450
Trade receivables (net of allowance for doubtful accounts of 6 euros as of December 31, 2002 and 2003 and provision for returns of 7 euros as of December 31, 2003)	1,578	1,732
Other accounts receivable and prepaid expenses (Note 3)	262	240
Inventories (Note 4)	900	793
	-----	-----
Total current assets	3,480	4,168
	-----	-----
PROPERTY AND EQUIPMENT, NET (Note 5)	118	78
	-----	-----
Total assets	(euro) 3,598	(euro) 4,246
	=====	=====
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Short-term bank debt (Note 6)	(euro) 16	(euro) 38
Trade payables	623	795
Accrued expenses and other liabilities (Note 7)	386	408
Deferred revenues	126	232
	-----	-----
Total current liabilities	1,151	1,473
	-----	-----
COMMITMENTS (NOTE 8)		
SHAREHOLDERS' EQUITY (Note 11):		
Share capital - 15,052 Ordinary shares of (euro) 0.0042		

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par value (Authorized,  
issued and outstanding) as of  
December 31, 2002 and 2003  
Retained earnings

	63	63
	2,384	2,710
	-----	-----
Total shareholders' equity	2,447	2,773
-----	-----	-----
Total liabilities and shareholders' equity	(euro) 3,598	(euro) 4,246
-----	=====	=====

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

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JUSAN, S.A.

### STATEMENTS OF INCOME

Euros in thousands (except share and per share data)

	Year ended December 31,		
	2001	2002	2003
	----- Unaudited -----	-----	-----
Revenues (Note 12):			
Product sales	(euro) 5,227	(euro) 6,060	(euro) 5,227
Services	986	819	1,000
	-----	-----	-----
Total revenues	6,213	6,879	6,227
	-----	-----	-----
Cost of revenues:			
Product sales	2,871	3,336	2,871
Services	737	658	737
	-----	-----	-----
Total cost of revenues	3,608	3,994	3,608
	-----	-----	-----
Gross profit	2,605	2,885	2,619
	-----	-----	-----
Operating expenses:			
Research and development	325	470	325
Selling and marketing	628	718	628
General and administrative	852	892	852
	-----	-----	-----
Total operating expenses	1,805	2,080	1,805
	-----	-----	-----
Operating income	800	805	800
Financial income, net (Note 13)	6	7	6
	-----	-----	-----
Income before taxes on income	806	812	806
Income taxes (Note 9)	183	185	183

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Net income	(euro) 623	(euro) 627	(euro)
Basic and diluted net earnings per share	(euro) 41.4	(euro) 41.7	(euro) 34
Weighted average number of shares used in computing basic and diluted net earnings per share	15,052	15,052	15,

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

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JUSAN, S.A.

STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY  
Euros in thousands

	Share Capital	Retained earnings	Total shareholders equity
Balance as of January 1, 2001 (unaudited)	(euro) 63	(euro) 1,934	(euro) 1,997
Dividends	-	(120)	(120)
Net income	-	623	623
Balance as of December 31, 2001 (unaudited)	63	2,437	2,500
Dividends	-	(680)	(680)
Net income	-	627	627
Balance as of December 31, 2002	63	2,384	2,447
Dividend paid	-	(100)	(100)
Accrued dividend	-	(100)	(100)
Net income	-	526	526
Balance as of December 31, 2003	(euro) 63	(euro) 2,710	(euro) 2,773

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

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JUSAN, S.A.

STATEMENTS OF CASH FLOWS

Euros in thousands

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	Year ended December 31,		
	2001	2002	2003
	Unaudited		
Cash flows from operating activities:			
Net income	(euro) 623	(euro) 627	(euro)
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Depreciation	48	63	
Decrease (increase) in trade receivables	71	(236)	
Decrease (increase) in other accounts receivable and prepaid expenses	31	(51)	
Decrease (increase) in inventories	270	(252)	
Increase (decrease) in trade payables	422	(264)	
Increase (decrease) in accrued expenses and other liabilities	176	(218)	
Increase in deferred revenues	-	126	
Net cash provided by (used in) operating activities	1,641	(205)	
Cash flows from investing activities:			
Investment in short-term bank deposits	(1,103)	702	
Purchase of property and equipment	(62)	(94)	
Net cash provided by (used in) investing activities	(1,165)	608	
Cash flows from financing activities:			
Dividend paid	(120)	(680)	
Short-term bank debt	(129)	(61)	
Net cash used in financing activities	(249)	(741)	
Increase (decrease) in cash and cash equivalents	227	(338)	
Cash and cash equivalents at the beginning of the year	449	676	
Cash and cash equivalents at the end of the year	(euro) 676	(euro) 338	(euro)
Non-cash financing information:			
Accrued dividend	-	-	(euro)
Supplemental disclosure of cash flows activities:			
Cash paid during the year for:			
Interest	(euro) 7	(euro) 9	(euro)
Income taxes	(euro) 82	(euro) 183	(euro)

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

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JUSAN, S.A.

### NOTES TO FINANCIAL STATEMENTS

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Euros in thousands

#### NOTE 1:- ORGANIZATION AND OPERATIONS

- a. JUSAN, S.A. ("the Company") was incorporated in Spain on June 19, 1959. The Company is engaged in development, manufacturing and assembly, sales and distribution, and maintenance of vocal server and call billing applications, as well as is in the television rental business.
- b. The Company has two major customers (see also Note 12a).

#### NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES

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

a. Use of estimates:

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

b. Financial statements in euros

Monetary accounts maintained in currencies other than the Euro are remeasured into Euros in accordance with Statement of Financial Accounting Standard No. 52, "Foreign Currency Translation" ("SFAS No. 52"). All effects of foreign currency remeasurement of monetary balance sheet items are reflected in the statements of operations as financial income or expenses, as appropriate.

c. Cash equivalents:

The Company considers all highly liquid investments originally purchased with maturities of three months or less to be cash equivalents.

d. Short-term bank deposits:

Short-term bank deposits are deposits with maturities of more than three months but less than one year. The deposits are in Euro and bear interest at an average rate of 2%. The short-term deposits are presented at their cost, including accrued interest.

e. Inventories:

Inventories are stated at the lower of cost or market value. Cost is determined as follows: Raw materials, parts and supplies -using the weighted average cost method. Work in progress and finished products are recorded on the basis of direct manufacturing costs. Inventories write-offs are provided to cover risks arising from slow moving items or technological obsolescence.

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JUSAN, S.A.

NOTES TO FINANCIAL STATEMENTS

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 Euros in thousands

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

f. 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 depreciation rates:

	----- %
Computers and peripheral equipment	33
Office furniture and equipment	20
Motor vehicles	20

The Company's long-lived assets are reviewed for impairment in accordance with Statement of Financial Accounting Standard No. 144 "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS No. 144") whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. 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.

g. Research and development costs:

Research and development costs, are charged to the Statement of Operations as incurred. Statement of Financial Accounting Standard No. 86 "Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed" ("SFAS No. 86"), requires capitalization of certain software development costs subsequent to the establishment of technological feasibility.

Based on the Company's product development process, technological feasibility is established upon completion of a 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.

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### h. Income taxes:

The Company accounts for income taxes in accordance with Statement of Financial Accounting Standard No. 109, "Accounting for Income Taxes" ("SFAS No. 109"). This statement prescribes the use of the liability method whereby deferred tax assets and liability account balances are determined based on 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. Valuation allowances are provided to reduce deferred tax assets to their estimated realizable value.

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JUSAN, S.A.

### NOTES TO FINANCIAL STATEMENTS

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Euros in thousands

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

##### i. Revenue recognition:

The Company generates revenues from selling software-based products through resellers and distributors who are considered end-users. The Company also generates revenues from rendering maintenance and support services.

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

Where the arrangements involve multiple elements, revenue is allocated to each element based on vendor specific objective evidence ("VSOE") of the relative fair values of each element in the arrangement, in accordance with the "residual method" prescribed by SOP No. 98-9, "Modification of SOP No. 97-2, Software Revenue Recognition With Respect to Certain Transactions". The VSOE used by the Company to allocate the sales price to support services and maintenance is based on the renewal rate charged when these elements are sold separately. Revenues from products are recorded based on the residual method. Under the residual method, revenue is recognized for the delivered elements when (1) there is VSOE of the fair values of all the undelivered elements, and (2) all revenue recognition criteria of SOP No. 97-2, as amended, are satisfied. Under the residual method any discount in the arrangement is allocated to the delivered element.

Provision for returns as of December 31, 2003 in the amount of (euro) 7 is determined principally on the basis of past experience.

Revenues from maintenance and support services are recognized over the life of the maintenance agreement or at the time support services are rendered.

Deferred revenues include unearned amounts received under maintenance



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and support contracts, not yet recognized as revenues.

j. Warranty costs:

The Company provides free warranty for up to one year. A provision as of December 31, 2003 in the amount of (euro) 18 is recorded for probable costs in connection with these services based on the Company's experience.

The Company estimates the costs that may be incurred under its basic limited warranty and records a liability in the amount of such costs at the time product revenue is recognized. Factors that affect the Company's warranty liability include the number of installed units, historical and anticipated rates of warranty claims, and cost per claim. The Company periodically assesses the adequacy of its recorded warranty liabilities and adjusts the amounts as necessary.

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JUSAN, S.A.

### NOTES TO FINANCIAL STATEMENTS

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Euros in thousands

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

k. Fair value of financial instruments:

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

l. Concentrations of credit risk:

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

Cash and cash equivalents and short-term bank deposits are deposited with major banks in Spain. Management believes that the financial institutions that hold the Company's investments are financially sound, and accordingly, minimal credit risk exists with respect to these investments.

The trade receivables of the Company are mainly derived from sales to customers in Spain and Europe (see Note 12a). The Company performs ongoing credit evaluations of its customers. The allowance for doubtful accounts is determined with respect to specific debts that are doubtful of collection according to management estimates. In certain circumstances, the Company may require letters of credit, other collateral or additional guarantees.

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

m. Basic and diluted net earnings per share:

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

n. Reclassification:

Certain amounts from prior years have been reclassified to conform the current year's presentation. The reclassification had no effect on previously reported net loss, shareholders' equity or cash flows.

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JUSAN, S.A.

NOTES TO FINANCIAL STATEMENTS

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Euros in thousands

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

o. Impact of recently issued accounting standards:

In January 2003, the Financial Accounting Standards Board issued Interpretation No. 46, Consolidation of Variable Interest Entities, an interpretation of Accounting Research Bulletin No. 51 ("the interpretation"). In general, a variable interest entity (VIE) is an entity that has (1) insufficient amount of equity for the entity to carry on its principal operations, without additional subordinated financial support from other parties, (2) equity investors that as a group do not have the ability through voting or similar rights to make decisions about the entity's activities, or (3) investors that as a group do not have the obligation to absorb the entity's losses or have the right to receive the benefits of the entity. The interpretation requires the consolidation of a VIE by the primary beneficiary. The primary beneficiary is the entity that absorbs a majority of the entity's expected losses, receives a majority of the entity's expected residual returns, or both, as a result of ownership, contractual or other financial interests in the entity. Presently, entities are generally consolidated by an enterprise that has a controlling financial interest through ownership of a majority voting interest in the entity.

The Company's management believes that this standard will have no effect on the Company.

NOTE 3:- OTHER ACCOUNTS RECEIVABLE AND PREPAID EXPENSES

	December 31,	
	2002	2003
	-----	-----
Government authorities	(euro)201	(euro)191
Employee advances	34	33

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Deposits	16	16
Other	11	-
	-----	-----
	(euro) 262	(euro) 240
	=====	=====

NOTE 4:- INVENTORIES

Raw materials	(euro) 551	(euro) 489
Work in progress	38	23
Finished products	311	281
	-----	-----
	(euro) 900	(euro) 793
	=====	=====

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JUSAN, S.A.

NOTES TO FINANCIAL STATEMENTS

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Euros in thousands

NOTE 5:- PROPERTY AND EQUIPMENT, NET

	December 31,	
	2002	2003
	-----	-----
Cost:		
Computers and peripheral equipment	(euro) 140	(euro) 152
Office furniture and equipment	285	294
Motor vehicles	100	103
Leasehold improvements	140	140
	-----	-----
	665	689
	-----	-----
Accumulated depreciation:		
Computers and peripheral equipment	97	127
Office furniture and equipment	243	265
Motor vehicles	67	79
Leasehold improvements	140	140
	-----	-----
	547	611
	-----	-----
Depreciated cost	(euro) 118	(euro) 78
	=====	=====

Depreciation expenses for the years ended December 31, 2001, 2002 and 2003 were (euro) 48, (euro) 63 and (euro) 64, respectively.

NOTE 6:- SHORT-TERM BANK DEBT

The Company has a short-term bank debt in the amount of (euro)38, bearing interest of 3.5%.

NOTE 7:- ACCRUED EXPENSES AND OTHER LIABILITIES

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	December 31,	
	2002	2003
Employees and payroll accruals	(euro) 53	(euro) 55
Income tax payable	184	131
Government authorities	131	104
Accrued dividends	-	100
Warranty costs	18	18
	(euro) 386	(euro) 408

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JUSAN, S.A.

NOTES TO FINANCIAL STATEMENTS

Euros in thousands

NOTE 8:- CONTINGENT LIABILITIES AND COMMITMENTS

The facilities of the Company are rented under operating leases for periods ending in 2006.

Future minimum lease commitments under non-cancelable operating leases as of December 31, are as follows:

2004	(euro) 140
2005	92
2006	35
	(euro) 267

Rent expenses for years ended December 31, 2001, 2002, and 2003, were approximately (euro) 141, (euro) 142 and (euro) 152, respectively.

NOTE 9:- TAXES ON INCOME

Reconciliation between the theoretical tax expense, assuming all income is taxed at the statutory tax rate applicable to income of the Company and the actual tax expense as reported in the statements of operations, is as follows:

	Year ended December 31,		
	2001	2002	2003
	Unaudited		
Income before taxes as reported in the statements of operations	(euro) 806	(euro) 812	(euro)
Tax rates	35%	35%	

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Theoretical tax benefit	(euro)282	(euro)284	(euro)
Decrease in taxes resulting from:			
Tax deduction for development	(99)	(99)	
	-----	-----	-----
Taxes on income (tax benefit) as reported in the statements of operations	(euro)183	(euro)185	(euro)
	=====	=====	=====

Under the current tax legislation, 35% of development expense can be deducted from the income tax with the limits of 45% of the theoretical tax benefits. In 2001 and 2002 this limit was 35%.

All the income before income taxes is domestic. Income taxes include only current tax expenses.

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JUSAN, S.A.

NOTES TO FINANCIAL STATEMENTS

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Euros in thousands (except per share data)

NOTE 10:- RELATED PARTIES TRANSACTIONS

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

a. Payments to related parties:

	Year ended December 31,		
	-----	-----	-----
	2001	2002	2003
	-----	-----	-----
	Unaudited		
	-----		
Wages	(euro)295	(euro)274	(euro)308
	=====	=====	=====

In 2002 and 2003, the balance with personnel reflects short-term debt.

b. Transactions with related parties were as follows:

	Year ended December 31,		
	-----	-----	-----
	2001	2002	2003
	-----	-----	-----
	Unaudited		
	-----		
Sales through related parties	(euro) -	(euro) -	(euro) 15
	=====	=====	=====
Amounts charged by related parties:			
Cost of revenues	(euro)117	(euro)80	(euro)205

=====

c. Amounts receivable from and payables to related parties:

	December 31,	
	2002	2003
	-----	-----
Receivables:		
Mer Telemagement Solutions	(euro)1	(euro) 9
	=====	=====
Payables:		
Beheer	(euro)-	(euro)128
	=====	=====

NOTE 11:- SHAREHOLDERS' EQUITY

a. Share capital:

The ordinary shares entitle their holders the right to receive notice to participate and vote in general meetings of the Company and the right to receive dividends, if declared.

b. Dividends:

On October 31, 2003 the General Meeting of Shareholders approved to pay dividend of (euro) 200 ((euro) 13.29 per share) of which (euro) 100 has been paid during the year. The remaining amount of (euro) 100 is included in accrued expenses and other liabilities include accrued dividend to one of the shareholders as of December 31, 2003.

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JUSAN, S.A.

NOTES TO FINANCIAL STATEMENTS

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Euros in thousands

NOTE 11:- SHAREHOLDERS' EQUITY (Cont.)

c. Legal reserve

As established by the Spanish Companies' Act, 10% of profits must be allocated to the legal reserve, until such reserve is equal to 20% of share capital. The legal reserve can only be used to compensate for losses or to increase capital.

NOTE 12:- SEGMENTS, CUSTOMERS AND GEOGRAPHIC INFORMATION

a. Major customers as a percentage of total revenues:

	Year ended December 31,		
	2001	2002	2003
	-----	-----	-----
Unaudited			
	-----	-----	-----

%

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Adictis	-	3%	13%
Telefonica de Espana	7%	3%	10%

- b. The following is a summary of revenues within geographic areas based on end customer location:

	Year ended December 31,		
	2001	2002	2003
	Unaudited		
Spain	(euro) 4,016	(euro) 4,335	(euro) 3,360
European Community	1,902	2,067	2,179
Other	295	477	521
	(euro) 6,213	(euro) 6,879	(euro) 6,060

NOTE 13:- SELECTED STATEMENTS OF OPERATIONS DATA

Financial income, net

	Year ended December 31,		
	2001	2002	2003
	Unaudited		
Financial expenses:			
Interest expenses	(euro) 7	(euro) 9	(euro) 5
Other expenses	12	13	8
	19	22	13
Financial income:			
Interest income	25	29	22
Financial income, net	(euro) 6	(euro) 7	(euro) 9

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S I G N A T U R E S

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

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undersigned to sign this annual report on its behalf.

MER TELEMANAGEMENT SOLUTIONS LTD.

By: /s/Eytan Bar

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Eytan Bar  
Chief Executive Officer

By: /s/Yossi Brikman

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Yossi Brikman  
Chief Financial Officer

Dated: June 24, 2004