

COMMTOUCH SOFTWARE LTD
Form 20-F
March 31, 2008

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

FORM 20-F

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

OR

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
for the fiscal year ended December 31, 2007

OR

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

OR

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

Date of event requiring this shell company report.....

For the transition period from _____ to _____

Commission file number 000-26495

COMMTOUCH SOFTWARE LTD.

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

Israel

(Jurisdiction of incorporation or organization)

**4A Hazoran Street
Poleg Industrial Park,
P.O. Box 8511
Netanya 42504, Israel
011-972-9-863-6888**

(Address of principal executive offices)

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

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

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

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

None

Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the annual report (December 31, 2007).

Ordinary Shares, par value NIS 0.15*	25,346,042*
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Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.
Yes No

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

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Indicate by check mark which financial statement item the registrant has elected to follow. Item 17 Item 18

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

*The Company effected a reverse split at a ratio of one for three Ordinary Shares on January 2, 2008. At December 31, 2007, on a pre-split basis, the outstanding share capital of the Company totaled 76,038,207 Ordinary Shares, par value NIS 0.05 per share. Unless otherwise indicated, all shareholding related information contained in this report reflects post-reverse split data.

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

Not applicable.

Item 2. Offer Statistics and Expected Timetable.

Not Applicable

Item 3. Key Information.

Unless otherwise indicated, all references in this document to “Commtouch,” “the Company,” “we,” “us” or “our” are Commtouch Software Ltd. or its wholly-owned subsidiary, Commtouch Inc., as relating to consolidated financial information contained herein, and former majority-owned subsidiary, Commtouch K.K. (Japan) (during 2002 Commtouch divested itself of its majority holdings and retained an equity interest in this company, which is now known as Imatrix Corporation).

The selected consolidated statements of operations data for the years ended December 31, 2005, 2006 and 2007 and the selected consolidated balance sheet data as of December 31, 2006 and 2007 have been derived from the Consolidated Financial Statements of Commtouch included elsewhere in this report. The selected consolidated statements of operations data for the years ended December 31, 2003 and 2004 and the selected consolidated balance sheet data as of December 31, 2003, 2004 and 2005 have been derived from the Consolidated Financial Statements of Commtouch not included elsewhere in this report. Our historical results are not necessarily indicative of results to be expected for any future period. The data set forth below should be read in conjunction with “Item 5. Operating and Financial Review and Prospects” and the Consolidated Financial Statements and the Notes thereto included elsewhere herein:

	Year Ended December 31,				
	2003	2004	2005	2006	2007
	(USD in thousands, except per share data)				
Selected Data:					
Revenues	\$ 329	\$ 1,523	\$ 3,925	\$ 7,234	\$ 11,250
Net income (loss) attributable to ordinary and equivalently participating shareholders	\$ (6,834)	\$ (7,193)	\$ (2,690)	\$ (190)	\$ 2,109
Basic and diluted net earnings (loss) per share	\$ (0.84)	\$ (0.54)	\$ (0.28)	\$ (0.01)	\$ 0.08
Weighted average number of shares used in computing basic net earnings (loss) per share	8,191	13,323	15,802	22,113	24,847
Weighted average number of shares used in computing diluted net earnings (loss) per share	8,191	13,323	15,802	22,113	27,591
Total Assets	\$ 6,855	\$ 5,479	\$ 7,995	\$ 11,999	\$ 18,210

FORWARD LOOKING STATEMENTS

Except for the historical information contained in this Annual Report, the statements contained in this Annual Report are “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of

1995, as amended, and other federal securities laws with respect to our business, financial condition and results of operations. Such forward-looking statements reflect our current view with respect to future events and financial results.

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

RISK FACTORS

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

Business Risks

If the market does not continue to respond favorably to our current advanced email defense solutions, including our anti-spam and anti-virus solutions, or our future solutions do not gain acceptance, we will fail to generate sufficient revenues.

Our success depends on the continued acceptance and use of our advanced email defense solutions by current and new enterprise, Original Equipment Manufacturer or “OEM”, and Internet Service Provider or “ISP” customers and technology licensees. We have been selling our anti-spam products for over four years, our Zero-Hour™ virus outbreak detection product for approximately three years and our IP reputation service (our latest version being known as GlobalView™ Mail Reputation) for less than two years.

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

Governmental regulation could decrease the distribution of unsolicited bulk (spam) email and malicious software and decrease demand for our solutions or increase our cost of doing business.

On December 16, 2003, President Bush signed into law the Controlling the Assault of Non-Solicited Pornography and Marketing Act of 2003 (CAN-SPAM Act), which establishes a framework of administrative, civil, and criminal tools to combat spam. The law establishes both civil and criminal prohibitions to assist in deterring the most offensive forms of spam, including unmarked sexually-oriented messages and emails containing fraudulent headers. Under the law, senders of email are required to honor a request by a consumer not to receive any further unsolicited messages. While past high profile prosecutions of direct marketers seemingly have not had much of a deterrent effect on marketers of unsolicited email, it is not known whether or not future legislative endeavors will prove effective.

In addition, various state legislatures have enacted laws aimed at regulating the distribution of unsolicited email.

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

We depend upon OEM partners and resellers and we have a limited concentration of products.

We expect to continue to be dependent upon resellers and OEM partners for a significant portion of our revenues, which will be derived from sales of our email defense solutions. Our operating results and financial condition may be materially adversely affected if:

- Our limited product suite fails to remain attractive in the email defense market;
- Anticipated orders or royalty payments from these resellers and OEM partners fail to materialize;

• We are unable to locate and or sign additional OEM partners (given the limited pool of available candidates for our technology); or

• Some of the key resellers or OEM partners cease the promotion of our business or begin to promote additional solutions in a layered approach to email defense management.

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

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

• Our ability to successfully develop and market our email defense solutions to new markets, both domestic and international;

- Our ability to successfully develop and market new, modified or upgraded solutions, as may be needed;
 - The continued market acceptance of our new email defense solutions;
- Our ability to expand our workforce with qualified personnel, as may be needed;
- Unanticipated bugs or other problems affecting the delivery of our email defense solutions to customers;
 - The success of our resellers’ and OEM partners’ sales efforts to potential customers;

• The solvency of our resellers and OEM partners and their ability to allocate sufficient resources towards the marketing of our email defense solutions to their potential customers;

- Our OEM partners’ ability to effectively integrate our solutions into their product offerings;
 - The rate of adoption of email defense solutions by customers;
 - The substantial decrease in information technology spending;
 - The pricing of our solutions;
- Our ability to timely collect fees owed by resellers and OEM partners;

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

•The effectiveness of our customer support, whether provided by our resellers and OEM partners, or directly by Commtouch.

We commenced operations in 1991. Up until 1998, we focused on selling, maintaining and servicing stand-alone email client software products for mainframe and personal computers. From 1998 through 2001, we were a provider of outsourced Web-based email services and, during the first half of 2002, we concentrated on marketing our software messaging solution. In mid-2002, we began focusing on the email defense market, and with the subsequent completion of development of our anti-spam solutions, we began to sell those products during the latter half of 2003. In late 2004, we added to our repertoire of email defense products our Zero-Hour™ anti-virus solution and, in late 2006, we also announced the availability of our IP reputation service, now known as GlobalView Mail Reputation. The above described changes in business models required that we adjust our business processes and workforce, which caused fluctuations in our results from operations. While during the past four years our business has been more stable and we have had success in particular in signing agreements with OEM partners, we remain subject to future fluctuations in our results of operations if any of the enumerated risks occurs. As an example, our current and future expense levels are, to a large extent, fixed, so we may be unable to adjust spending quickly to compensate for any revenue shortfall caused by any of the enumerated risks described herein. Thus, any significant revenue shortfall would have an immediate negative effect on our results of operations and share price.

We have many established competitors who are offering a multitude of solutions to the problems of spam and virus distribution.

The market for email defense products in general and anti-spam solutions in particular is intensely competitive and we expect it to be increasingly competitive. During 2006 and 2007, we began to see more OEM security vendors adopting a “layered approach” to protecting email systems - adding more than one email defense solution to their products in an effort to achieve maximum results. During 2008, it is likely that this approach will remain popular, if not continue to grow. Increased competition and the adoption of a layered approach to fighting spam and viruses could result in pricing pressures, low operating margins and smaller market share, any of which could cause our business to suffer.

In the market for email defense solutions, there are less providers offering somewhat ineffectual “content filtering” solutions (solutions focusing solely on the content of potential spam email) than in the past, and more sophisticated offerings that compete with our solutions. Email defense providers offering forms of software (gateway), multi-functional appliances and managed service solutions and which may be viewed as both competitors and potential customers to Commtouch include Symantec (Brightmail), TrendMicro, McAfee, Secure Computing (CipherTrust) and Cisco (IronPort). Email defense providers offering solutions on an OEM basis similar to Commtouch’s business model, and which may be viewed as direct competitors, include Cloudmark, Mailshell and Mail-Filters. As this market continues to develop, it is likely that companies with greater resources than ours will attempt to either enter or increase their presence in this market by acquiring or forming strategic alliances with our competitors or business partners. Some examples of this are the acquisitions of IronPort by Cisco, CipherTrust by Secure Computing, Brightmail by Symantec Corp. and Microsoft of both Frontbridge Technologies and Sybari Software (which, up until the acquisition, was one of our largest distributors).

Also, there are companies that develop and maintain in-house anti-spam solutions, such as Google and Yahoo. These and other companies could potentially leverage their existing capabilities and relationships to enter the email defense industry.

Competitors could introduce products with superior features, scalability and functionality at lower prices than our products and could also bundle existing or new products with other more established products that discourage users from purchasing our products. As noted above, our market’s level of competition has increased as current competitors have improved the sophistication and effectiveness of their offerings and as new participants have entered the market. In the future, as we expand our offerings, we may encounter increased competition in the development and distribution of these solutions. Some of our current and potential competitors have longer operating histories, larger customer bases, greater brand recognition and greater financial, technical, sales, marketing and other resources than we do and may enter into strategic or commercial relationships on more favorable terms. New technologies and the expansion of existing technologies may increase competitive pressures on us, and we may not be able to compete successfully against current and future competitors.

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

The complexity of the underlying technological base of email defense solutions and the current landscape of the market require highly trained sales and business development personnel to educate prospective resellers, OEM partners and customers regarding the use and benefits of our solutions. It may take time for our current and future employees, OEM partners and resellers to learn how to most effectively market our solutions. As a result, our sales and business development personnel may not be able to compete successfully against larger, more heavily financed and more experienced sales and business development departments of our competitors.

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

Our success depends on the skills, experience and performance of our senior management and other key personnel. The loss of the services of any of our senior management or other key personnel, including Gideon Mantel, our Chief Executive Officer, and Amir Lev, our President and Chief Technical Officer, could materially and adversely affect our business. The loss of our software developers may also adversely affect the continued development and support of our email defense solutions, therefore causing our operating results to suffer and the value of your investment to decline. We do not have employment agreements inclusive of set periods of employment with any of our key personnel. We cannot prevent them from leaving at any time. We do not maintain key-person life insurance policies, listing us as a beneficiary, on any of our employees.

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

As of December 31, 2007, we had sales offices in Israel and the United States. We also are marketing our email defense solutions in international markets by utilizing appropriate distribution channels. However, we may not be able to compete effectively in international markets due to various risks inherent in conducting business internationally, such as:

- Differing technology standards;
- Inability of distribution channels to successfully market our solutions;
 - Export restrictions;
- Difficulties in collecting accounts receivable and longer collection periods;
 - Unexpected changes in regulatory requirements;
 - Political and economic instability;
 - Potentially adverse tax consequences;

• The adoption of new legislation-backed penalties which may discourage the distribution of unsolicited email messages; and

- Limited enforcement mechanisms for protecting intellectual property rights.

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

Technology Risks

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

The email defense industry is characterized by difficult technological challenges, sophisticated "spammers", multiple-variant viruses, unique phishing scams and constantly evolving malevolent software distribution practices and targets that could render our solutions and proprietary technology ineffective. Our success depends, in part, on our ability to continually enhance our existing email defense solutions and to develop new solutions, functions and technology that address the potential needs of prospective customers, OEM partners and their users. The development of proprietary technology and necessary enhancements entails significant technical and business risks and requires substantial expenditures and lead-time. We may not be able to keep pace with the latest technological developments. We may not be able to use new technologies effectively or adapt to customer, OEM or end user requirements or emerging industry standards. Also, we must be able to act more quickly than our competition, and may not be able to do so.

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

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

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Our solutions may be adversely affected if we are not able to receive a sufficient sampling of internet traffic.

Our email defense solutions are dependent, in part, on the ability of our Detection Centers to analyze, in an automated fashion, live feeds of internet traffic received through our services to customers and other contractual arrangements. If we were to suffer an unanticipated, substantial decrease in such traffic, the effectiveness of our technology would drop, and our product offerings would become less attractive.

Investment Risks

If we will be in need of additional capital, we may not be able to secure additional funds on acceptable terms and the Company could fail.

We have invested heavily in technology development. We expect to continue to spend financial and other resources on developing and introducing new offerings and maintaining our corporate organizations and strategic relationships. We also expect to invest resources in research and development projects to develop a URL categorization and blocking service and enhanced anti-spam and anti-virus solutions for enterprises and, possibly, other target markets.

The Company has exhibited incremental improvement in its financial condition over the past few years, eventually leading to the Company becoming profitable in 2007. Nevertheless, we might become dependent upon raising additional funds to finance our business or strategic initiatives. Our cash balance (including marketable securities) was approximately \$14.4 million at December 31, 2007. Based on the cash balance at December 31, 2007, current projections of revenues, related expenses and the ability to further curtail certain discretionary expenses, the Company believes it has sufficient cash to continue operations through at least March 2009.

In the past we have received funds for the development of our business from the State of Israel through the Office of the Chief Scientist, or the OCS. If additional funding becomes necessary and we are unable to raise those funds, the Company could fail. There can be no assurance that we will be able to raise necessary funds or that we will be able to do so on terms acceptable to us. Even if available on acceptable terms, any such additional funding may result in significant dilution to existing shareholders.

If we cannot continue to satisfy NASDAQ's maintenance requirements, it may delist our Ordinary Shares and we may not have an active public market for our Ordinary Shares. The absence of an active trading market would likely make our Ordinary Shares an illiquid investment.

Our Ordinary Shares are quoted on The NASDAQ Capital Market. To continue to be listed, among other requirements, we are required a) to maintain shareholders' equity of at least \$2,500,000, or market value of our outstanding shares (excluding shares held by Company insiders and principal shareholders) of at least \$35,000,000, or we must have realized at least \$500,000 in net income from continuing operations in our last fiscal year or in two of our last three fiscal years and b) we must maintain a minimum bid price per Ordinary Share of \$1.00. Up through 2006, the Company did not meet the applicable listing requirements on several occasions. The Company believes it has solidified its position on The NASDAQ Capital Market and, with the effectuation of a reverse split on January 2, 2008, the Company intended to achieve the requirements necessary to move its listing to The NASDAQ Global Market. A subsequent downturn in the financial markets in general at the beginning of 2008 and in the Company's stock price in particular has delayed the Company's ability to apply for listing on The NASDAQ Global Market. There can be no assurance that the Company will be able to list its Ordinary Shares on The NASDAQ Global Market.

If the Company's business or stock price deteriorates significantly, we may be at risk for a delisting by NASDAQ from the Capital Market.

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

Our directors and affiliates of our directors, our executive officers and our shareholders who currently individually beneficially own over five percent of the voting power in the Company (together known as “affiliated entities”), beneficially own, in the aggregate, approximately 30% of our outstanding Ordinary Shares as of December 31, 2007. Included in the calculation of voting power are warrants and options exercisable by the affiliated entities within 60 days thereof. If they vote together (especially if they were to convert all beneficial holdings into shares entitled to voting rights in the Company), these shareholders will be able to exercise significant influence over all matters requiring shareholder approval, including the election of directors and approval of significant corporate transactions. This concentration of ownership could also delay or prevent a change in control of Commtouch. In addition, conflicts of interest may arise as a consequence of the significant shareholders control relationship with us, including:

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

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

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

Substantial sales of our Ordinary Shares could adversely affect our share price and dilute the interests of our existing shareholders.

The sale, or availability for sale, of large quantities of our Ordinary Shares may have the effect of further depressing its market price. We continue to maintain various registration statements declared effective in prior years by the Securities and Exchange Commission, or SEC, which cover the resale of shares issued and shares to be issued on the exercise of warrants issued under certain private placements closed prior to 2006. In particular, the additional Ordinary Shares to be issued if and when outstanding warrants to purchase 1,035,502 Ordinary Shares (as of January 2, 2008) are exercised will dilute existing shareholders of Ordinary Shares.

If we fail to honor registration rights for past private placements, we will be subject to payment of liquidated damages.

According to registration rights agreements with the selling security holders listed under registration statements on Form F-3 filed by us with the SEC between 2004 and 2006, should we fail to maintain the effectiveness of those registration statements for the periods stated in the respective agreements, we risk having imposed on us liquidated damages as defined in those agreements. For example, one of the agreements provides for liquidated damages of up to one million additional unregistered Series A Preferred Shares (which, given the prior conversion of all outstanding Series A Preferred Shares, and taking into account the reverse split effective January 2, 2008 now equals 666,667 unregistered Ordinary Shares). These liquidated damages would dilute the value of Ordinary Shares held by other shareholders.

Intellectual Property Risks

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

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

During 2004, we purchased a United States patent, U.S. Patent No. 6,330,590. During 2005, we filed in the United States two anti-spam related patent applications, claiming priority for prior periods based on filings of U.S. Provisional Patent Applications, and one virus outbreak detection related patent application. During 2006, we filed in the United States a patent application relating to the prevention of spam in streaming systems or, in other words, unwanted conversational media sessions (i.e. voice and video related). We may seek to patent certain additional software or other technology in the future. Any such patent applications might not result in patents issued within the scope of the claims we seek, or at all.

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

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We cannot be certain that our software does not infringe issued patents that may relate to our anti-spam or anti-virus solutions. In addition, because patent applications in the United States are not publicly disclosed until the patent is issued, applications previously may have been filed which relate to our anti-spam and virus outbreak detection solutions. Therefore, other parties, whether in the United States or elsewhere, may assert infringement claims against us. We may also be subject to legal proceedings and claims from time to time in the ordinary course of our business, including claims of alleged infringement of the patents, trademarks and other intellectual property rights of third parties by ourselves and our licensees. Such claims, even if not meritorious, could result in the expenditure of significant financial and managerial resources. We may not have the proper resources in order to adequately defend against such claims.

Risks Relating to Operations in Israel

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

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

Since the State of Israel was established in 1948, a number of armed conflicts have occurred between Israel and its Arab neighbors. Since October 2000, terrorist violence in Israel has increased significantly. Recently, there was an escalation in violence among Israel, Hamas, the Palestinian Authority and other groups, as well as extensive hostilities along Israel's northern border with Lebanon in the summer of 2006, and extensive hostilities along Israel's border with the Gaza Strip since June 2007 when the Hamas effectively took control of the Gaza Strip. Ongoing and revived hostilities or other Israeli political or economic factors could harm our operations and cause our revenues to decrease.

In addition, Israel and some companies doing business with Israel have been the subject of an economic boycott by Arab countries since Israel's establishment. These restrictive laws and policies may have an adverse impact on our operating results, financial condition or expansion of our business.

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

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

Because a substantial portion of our revenues historically have been generated in U.S. dollars and a portion of our expenses have been incurred in New Israeli Shekels, our results of operations may be adversely affected by currency fluctuations.

We have generated a substantial portion of our revenues in U.S. dollars and incurred a portion of our expenses, principally salaries and related personnel expenses in Israel, in New Israeli Shekels, or NIS. We anticipate that a significant portion of our expenses will continue to be denominated in Israeli shekels. As a result, we are exposed to risk to the extent that the value of the U.S. dollar decreases against the NIS. In that event, the U.S. dollar cost of our operations will increase and our U.S. dollar-measured results of operations will be adversely affected, as occurred in

2006 and 2007, when the NIS appreciated against the U.S. dollar, which resulted in a significant increase in the U.S. dollar cost of our operations. We cannot predict the trend for future years. Our operations also could be adversely affected if we are unable to guard against currency fluctuations in the future. To date, we have not engaged in hedging transactions. In the future, we may enter into currency hedging transactions to decrease the risk of financial exposure from fluctuations in the exchange rate of the dollar against the NIS. These measures, however, may not adequately protect us from material adverse effects due to the impact of inflation in Israel.

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

Prior to 1998, we received grants from the Government of Israel, through the OCS, for the financing of a significant portion of our research and development expenditures in Israel. These grants totaled \$0.6 million. In 2001, we received \$0.6 million and in 2002 we received \$0.2 million. We did not submit an application for funding during the period 2004 - 2007. We have not received OCS funding in recent years, but we may apply for additional grants in the future. The OCS budget has been subject to reductions which may affect the availability of funds for possible future grants. Therefore, we cannot be certain that we will be able to receive future grants in similar amounts, or at all. In addition, the terms of any future OCS grants may be less favorable than our past grants.

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

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

- a requirement to pay the OCS a portion of the consideration we receive upon any sale of such technology to an entity that is not Israeli. The scope of the support received, the royalties that were paid by us, the amount of time that elapsed between the date on which the know-how was transferred and the date on which the grants were received, as well as the sale price, will be taken into account in order to calculate the amount of the payment; and
- the transfer of manufacturing rights could be conditioned upon an increase in the royalty rate and payment of increased aggregate royalties (up to 300% of the amount of the grant plus interest, depending on the percentage of the manufacturing that is foreign).

These restrictions may impair our ability to sell certain of our older technology assets outside of Israel. The restrictions will continue to apply even after we repay the full amount of royalties payable for the grants.

The tax benefits from our approved enterprise programs require us to satisfy specified conditions. If we fail to satisfy these conditions, we may be required to pay additional taxes and would likely be denied these benefits in the future.

The Investment Center of the Israeli Ministry of Industry, Trade and Labor has granted approved enterprise status to several investment programs at our facility. The portion of our income derived from these approved enterprise programs, commencing when we begin to generate net income from these programs, will be exempt from tax for a period of two years and will be subject to a reduced tax rate for an additional five to eight years, depending on the percentage of our share capital held by non-Israelis. The benefits available to an approved enterprise program are dependent upon the fulfillment of conditions stipulated in applicable law and in the certificate of approval. If we fail to comply with these conditions, in whole or in part, we may be required to pay additional taxes during the period in which we would have benefited from the tax exemption or reduced tax rates and would likely be denied these benefits in the future.

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

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

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

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

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

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

Item 4. Information on the Company.

Overview

The legal name of the Company is Commtouch Software Ltd., and its principal executive offices are located at 4A Hazoran Street, Poleg Industrial Park, P.O.Box 8511, Netanya 42504, Israel, where our telephone number is 011-972-9-863-6888. The Company was incorporated under the laws of the State of Israel on February 5, 1991 and its legal form is a company limited by shares. Its Articles of Association are on file in Israel with the office of the Israeli Registrar of Companies and available for public inspection from the Israel Companies Registrar. The Company's wholly owned subsidiary, Commtouch Inc., is located at 292 Gibraltar Drive, Suite 107, Sunnyvale, California 94089, where our telephone number is (650) 864-2000.

We are a provider of email defense products to enterprise customers and OEM distribution partners, including real-time anti-spam, virus outbreak detection and IP reputation solutions. The Company offers its email defense solutions to small, medium and large enterprises through a variety of third party distribution channels. The solutions are also available for integration with security, content filtering, anti-virus and other filtering solutions through alliances and strategic technology partnerships. A combination of proprietary patented and patent-pending technologies makes it possible for Commtouch to detect, alert and block spam and virus attacks as they are distributed over the Internet. At the core of Commtouch email defense offerings is Commtouch's proprietary Recurrent Pattern Detection (RPD)TM technology which, in general terms, analyzes messages associated with mass email outbreaks and directs the blocking of such emails, without the need to analyze individual messages.

Commtouch Offerings

We offer a Software Development Kit or "SDK" comprised of multiple components; each different component enables third-party vendors to integrate one of the Company's licensing offerings. Two components, known as ctasd and ctengine, are two different methods of enabling third-party vendors to integrate the Commtouch anti-spam solution into their existing offerings. Both ctengine and ctasd provide these manufacturers or service providers with full spam identification and spam classification services from the Commtouch Detection Centers (described below). The SDK communicates fully with a remote Detection Center, receiving results to queries about suspicious messages and acting according to set policies on the customer side. These same two components also enable integration of the Company's Zero-Hour™ virus outbreak protection, which is built on our proprietary Recurrent Pattern Detection™ technology. This solution provides customers with the ability to block malevolent software (or as known in the industry "malware"), including email borne viruses, in real time, at the moment the initial attack occurs. During the initial attack phase, traditional anti-virus vendors are typically analyzing messages to determine whether they are indeed infected with a virus. It is this critical lag in response time by traditional anti-virus vendors that the Zero-Hour solution has been developed to remedy.

A third component of the SDK, known as ctipd, enables integration of the Company's Mail Reputation Service. The Reputation Service is typically integrated into a device that sits at the perimeter of the organization, deciding which email traffic to allow to enter the organization, and which to block. It accomplishes this by receiving classification data from a Commtouch Detection Center about the sender of each email message. During 2007, the Company launched an advanced version of this Reputation Service known as "GlobalView".

Products that may benefit from integration of the SDK solution include:

- Anti-virus applications;
- Content filtering solutions;
- Firewall systems;
- Security servers; and
- Other network appliances

We also offer an enterprise anti-spam solution, consisting of both a software element, or the "Enterprise Gateway", and a service component, or a Commtouch "Detection Center". At the Enterprise Gateway, messages are filtered at the customer organization's entry point, before being distributed to recipients, with added user-level controls and a top level of secure spam detection services from the Detection Center, all allowing for real-time reaction to worldwide spam attacks. At the heart of the solution, however, is the Detection Center, which detects new spam attacks as soon as they are launched and distributed over the Internet. The Detection Center provides real-time spam detection services to enterprise customers by maintaining constant communication with Enterprise Gateways that are locally installed at customer premises in different locations worldwide. The Detection Center collects information from multiple sources about new spam attacks, analyzes the input using Commtouch patented technology, identifies and detects spam, classifies the data, matches its stored information against outstanding queries for spam detection from Enterprise Gateways and replies in real-time back to the Enterprise Gateways with a prioritized resolution.

In particular, the Commtouch anti-spam solution operates to help eliminate spam as follows:

- Inbound email enters the Enterprise Gateway, a software add-on to the enterprise SMTP server;

- The Enterprise Gateway matches key characteristics of the message with predefined spam policies created by IT managers or end-users;
- If the solution does not match the message to a known source, either spam or non-spam, it compares characteristics of the incoming message against the Enterprise Gateway cache of recently identified spam;
- If the message remains suspicious, but cannot be confirmed as spam, the Enterprise Gateway queries the Detection Center for remote spam detection and classification services;
 - The outgoing query consists of digital signatures taken from email header information. The signatures may be hashed (one-way encrypted) to ensure enterprise security and confidentiality. The query does not contain the full email body or its attachments and it is therefore very small in size (500 Bytes);
- The Detection Center weighs the values of the outstanding query against its vast database of real-time information about known spam patterns and sources of spam, and replies to the Enterprise Gateway with a unique and up-to-date classification; and

·The Enterprise Gateway applies a locally predefined action to the message and may store the information internally to match against new incoming messages bearing similar characteristics.

Latly, the Company expects to release a URL categorization and blocking service during 2008 that will analyze and categorize for customers of our OEM partners (i.e. enterprises, ISPs and consumers) the source of URLs being accessed by such customers, in order to prevent the possibility of malware attacks being propogated by malicious URLs.

Competitive Landscape

The markets in which Commtouch competes are intensely competitive and rapidly changing. We believe there is no single competitor that offers the complete package of anti-spam, anti-virus and IP reputation protections that Commtouch provides. We are aware of competitors that provide anti-spam, anti-virus and reputation services either alone or as part of a complete messaging system or email security system. However, in the past few years, we began to see more OEM security vendors adopting a “layered approach” to protecting email systems - adding more than one email defense solution to their products in an effort to achieve maximum results. During 2008 it is likely that this approach will remain popular, thereby creating pricing pressure, reduced gross margins and possibly loss of market share for us.

Commtouch’s GlobalView Mail Reputation Service competes in a relatively young and continuously evolving market. While this provides opportunity to attempt to shape the market to suit our strengths, there is also risk that this space will not fully evolve, or that a strong competitor will define the market to suit its needs. While the space is immature, there are some established vendors, including TrendMicro, that are offering reputation-based solutions. In some cases, while the product positioning may be new, the underlying solutions may be mature - for example, Spamhaus repositioning its RBL, or “Real-time Block List”, service as a commercial reputation service. In addition, there are several startups competing in this space, perhaps the most notable being Karmasphere.

In the market for email defense solutions, there are fewer providers offering somewhat ineffectual “content filtering” solutions (solutions focusing solely on the content of potential spam email) than in the past, and more sophisticated offerings that compete with our solutions. Email defense providers offering forms of software (gateway), multi-functional appliances and managed service solutions and which may be viewed as both competitors and potential customers to Commtouch include Symantec (Brightmail), TrendMicro, McAfee, Secure Computing (CipherTrust) and Cisco (IronPort). Email defense providers offering solutions on an OEM basis similar to Commtouch’s business model, and which may be viewed as direct competitors, include Cloudmark, Mailshell and Mail-Filters.

The principal competitive factors in our industry include price, product functionality, product integration, platform coverage and ability to scale, worldwide sales infrastructure and global technical support. Some of our competitors have greater financial, technical, sales, marketing and other resources than we do, as well as greater name recognition and a larger installed customer base. Additionally, some of these competitors have research and development capabilities that may allow them to develop new or improved products that may compete with product lines we market and distribute.

We expect that the market for email defense solutions will continue to become more consolidated, with companies having greater resources than ours increasing their presence in this market by acquiring or forming strategic alliances with our competitors or business partners. Some examples of this are the acquisitions of IronPort by Cisco, CipherTrust by Secure Computing, Brightmail by Symantec Corp. and Microsoft of Sybari Software (which, up until the acquisition, was one of our largest distributors).

Our success will depend on our ability to adapt to these competing forces, to develop more advanced products more rapidly and less expensively than our competitors, and to educate potential customers as to the benefits of licensing our products rather than developing their own products. Competitors could introduce products with superior features, scalability and functionality at lower prices than our products and could also bundle existing or new products with other more established products that discourage users from purchasing our products.

The market for real-time virus protection products is constantly evolving, as those promoting the proliferation of viruses continually seek new distribution techniques. Commtouch's offering differs from traditional anti-virus solutions in that we are offering an additional, complementary solution to signature and heuristic-based anti-virus engines. For this reason, our Zero-Hour virus outbreak protection engine has been licensed by several anti-virus companies, including F-Secure and VirusBuster. If virus distribution methods continue to migrate from email to other formats, there may be less of a demand for our Zero-Hour solution and more of a demand for a web security solution of the type in which we have begun to invest R&D resources.

See also disclosure under “Item 3. Key Information- RISK FACTORS—Business Risks—We have many established competitors who are offering a multitude of solutions to the problems of spam and virus distribution.”

Sales and Marketing

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

Our enterprise anti-spam solution is sold through resellers, who pay us pre-negotiated fees from each sale closed with a reseller’s customer.

All Company sales are managed by the Company’s and its U.S. subsidiary’s business development departments, each of which consists of a department head and a relatively small number of business development professionals. The Company’s marketing efforts are aimed mainly at potential OEM customers. The marketing department is concentrated in the Company’s Israel office, though our personnel travel internationally in furtherance of the Company’s marketing goals.

Intellectual Property

We regard our patented and patent pending anti-spam and anti-virus technology, copyrights, service marks, trademarks, trade secrets and similar intellectual property as critical to our success, and rely on patent, trademark and copyright law, trade secret protection and confidentiality and/or license agreements with our employees, customers, partners and others to protect our proprietary rights. During 2004, we purchased a United States patent, Patent No. 6,330,590, which we believe to be an integral part of our patent strategy aimed at protecting our proprietary anti-spam technology. During 2005, we filed in the United States two anti-spam related patent applications, claiming priority for prior periods based on filings of U.S. Provisional Patent Applications, and one virus outbreak detection related patent application. During 2006, we filed in the United States a patent application relating to the prevention of spam in streaming systems (i.e. voice and video related email). We are only actively maintaining our registered trademark for “COMMTOUCH”, which is registered in the U.S., Canada, India, Israel, European Union, China, Mexico, Norway, Taiwan, Russian Federation, South Korea and Australia. While previous registrations of PRONTO (Canada and South Korea) may still be in force, we are not currently actively maintaining these trademarks and they will lapse. Since at least September 2003, we are also claiming trademark rights in “RPD” and “Recurrent Pattern Detection”, as applicable to our email defense solutions. We have also been claiming trademark rights in Zero-Hour in relation to our virus outbreak detection product and GlobalView in relation to our IP reputation product.

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

Other parties may assert infringement claims against us. We may also be subject to legal proceedings and claims from time to time in the ordinary course of our business, including claims of alleged infringement by us and/or our licensees of the trademarks and other intellectual property rights of third parties. Such claims, even if not meritorious, could result in the expenditure of significant financial and managerial resources.

Government Regulation

Laws aimed at curtailing the spread of spam have been adopted by the United States federal government, i.e. CAN-SPAM Act, and some individual U.S. states, with the CAN-SPAM Act superseding some state laws or certain elements thereof. See also disclosure under “Item 3. Key Information- RISK FACTORS—Business Risks— “Governmental regulation could decrease the distribution of unsolicited bulk (spam) email and malicious software and decrease demand for our solutions or increase our cost of doing business.” Despite this legislation, we have not seen abatement in the amount of spam traffic on the Internet; rather, a continuing increase in large numbers that is being distributed in more sophisticated ways. The continuing growth and development of the spam market may prompt calls for even more stringent Internet user protection laws that would limit the ability of companies and individuals promoting or delivering spam online, and thus potentially negatively affect our business.

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

Employees

As of December 31, 2007, 2006 and 2005, we had 60, 46 and 35 employees, respectively. None of our U.S. employees are covered by a collective bargaining agreement. As of December 31, 2007, our employees were categorized as follows:

LOCATION	General & Administrative	Sales & Marketing	Research & Development	Hosting (Operations)	TOTAL:
ISRAEL OFFICE	9	12	27	-	48
U.S. OFFICE	3	6	-	3	12

We believe that our relations with our employees are good.

Israeli law and certain provisions of the nationwide collective bargaining agreements between the Histadrut (General Federation of Labor in Israel) and the Coordinating Bureau of Economic Organizations (the Israeli federation of employers' organizations) apply to Commtouch's Israeli employees. These provisions principally concern the maximum length of the workday and workweek, minimum wages, contributions to a pension fund, insurance for work-related accidents, procedures for dismissing employees, determination of severance pay and other conditions of employment. Furthermore, pursuant to such provisions, the wages of most of Commtouch's Israeli employees are subject to cost of living adjustments, based on changes in the Israeli Consumer Price Index. The amounts and frequency of such adjustments are modified from time to time. Pursuant to an order issued in December 2007 by the Israeli Minister of Industry, Trade and Labor, new provisions relating to pension arrangements in the collective bargaining agreements will apply to all employees in Israel, including our employees. According to these provisions, all employees employed for at least nine months (or six months commencing in 2009) will be entitled to pension benefits to be funded by preset monthly contributions of the employee and the employer. Israeli law generally requires the payment of severance pay upon the retirement or death of an employee or upon termination of employment by the employer or, in certain circumstances, by the employee. We currently fund our ongoing severance obligations by making monthly payments for insurance policies and by an accrual. A general practice in Israel followed by Commtouch, although not legally required, is the contribution of funds on behalf of certain employees to an individual insurance policy known as "Managers' Insurance." This policy provides a combination of savings plan, insurance and severance pay benefits to the insured employee. It provides for payments to the employee upon retirement or death and secures a substantial portion of the severance pay, if any, to which the employee is legally entitled upon termination of employment. Each participating employee contributes an amount equal to 5% of such employee's base salary, and the employer contributes between 13.3% and 15.8% of the employee's base salary. Full-time employees who are not insured in this way are entitled to a savings account, to which each of the employee and the employer makes a monthly contribution of 5% of the employee's base salary. We also provide certain Israeli employees with an Education Fund, to which each participating employee contributes an amount equal to 2.5% of such employee's base salary, and the employer contributes an amount equal to 7.5% of the employee's base salary, up to a certain maximum base salary set by law.

Description of Property

All of our facilities are leased. Our headquarters, in Netanya, Israel, is approximately 1,007.4 square meters, and it houses senior management, research and development, sales, marketing and administrative personnel. Our subsidiary's Sunnyvale, California office, which is approximately 3,600 square feet in size, houses administrative, sales and hosting (operations) personnel.

Geographic Information

The Company conducts its business on the basis of one reportable segment (see also Note 1 of Notes to the Financial Statements for a brief description of the Company's business). The Company has adopted SFAS No. 131, "Disclosures About Segments of an Enterprise and Related Information".

Revenues for Last Three Financial Years

See Item 5. Operating and Financial Review and Prospects - "Revenue Sources" and the F pages to this Form 20-F below. Below is a breakdown of our revenues by location (in thousands):

	Year December 31,		
	2005	2006	2007
Israel	\$ 365	\$ 344	\$ 742
North America	2,737	4,525	6,424
Europe	687	1,715	2,735
Asia	136	493	1,038
Other	-	157	34
	\$ 3,925	\$ 7,234	\$ 11,250

We have had only negligible capital expenditures and divestitures in the last three financial years.

Item 4A. Unresolved Staff Comments.

[None.]

Item 5. Operating and Financial Review and Prospects.

The following discussion should be read in conjunction with the Consolidated Financial Statements and the Notes thereto included elsewhere in this report. This discussion contains forward-looking statements based upon current expectations that involve risks and uncertainties. Any statements contained herein that are not statements of historical fact may be deemed to be forward-looking statements. For example, the words "expects," "anticipates," "believes," "intends," "plans," "seeks" and "estimates" and similar expressions are intended to identify forward-looking statements. Commtouch's actual results and the timing of certain events may differ significantly from those projected in the forward-looking statements. Factors that might cause future results to differ materially from those projected in the forward-looking statements include, but are not limited to, those set forth under "Item 3. Key Information-Risk Factors" and in the Company's other filings with the SEC.

Overview

From 2003 through 2007, the focus of our business has been the development and selling, through reseller and OEM distribution channels, anti-spam, Zero-Hour virus outbreak detection and IP reputation solutions to enterprise class customers. While no uniform definition of spam exists, the Company generally defines "spam" as the sending of unsolicited bulk email for commercial and non-commercial purposes.

Subsequent to balance sheet date, in January 2008, the Board of Directors and shareholders approved a 3:1 reverse stock split of the Company's share capital. As a result of this action, every three shares (including all authorized, issued and outstanding shares and all outstanding warrants and options to purchase shares) will be combined into one

share of the same respective class of shares bearing a par value of NIS 0.15 each. All of the Company's authorized, issued and outstanding shares (including all outstanding warrants and options to purchase shares) as of December 31, 2007 and 2006, have been restated to reflect the effect of the reverse stock split.

Critical Accounting Policies and Estimates

Operating and Financial Review and Prospects are based upon the Company's consolidated financial statements, which have been prepared in accordance with United States generally accepted accounting principles. The preparation of these financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosure of contingent assets and liabilities. Management believes the critical accounting policies and areas that require the most significant judgments and estimates to be used in the preparation of the consolidated financial statements are accounting for stock-based compensation, revenue recognition, investment in affiliate and commitments and contingencies.

Accounting for Stock-Based Compensation:

On January 1, 2006, we adopted SFAS No. 123 (revised 2004), "Share-Based Payment" ("SFAS No. 123(R)") which requires the measurement and recognition of compensation expense based on estimated fair values for all share-based payment awards made to employees and directors. SFAS No. 123(R) supersedes Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB No. 25"), for periods beginning in fiscal year 2006. In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 107 ("SAB 107") relating to SFAS No. 123(R). We have applied the provisions of SAB 107 in its adoption of SFAS No. 123(R). SFAS No. 123(R) requires companies to estimate the fair value of equity-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as an expense over the requisite service periods in the our consolidated operations statements.

At December 31, 2007, we has three stock-based employee compensation plans, which are described more fully in Note 5 of the financial statements. Prior to January 1, 2006, we accounted for those plans under the recognition and measurement provisions of APB No. 25, "Accounting for Stock Issued to Employees" ("Opinion 25"), and related interpretations, as permitted by FASB Statement No. 123, "Accounting for Stock-Based Compensation". During the years ended December 31, 2005 and 2004, the Company recognized stock-based compensation expenses in the amount of zero and \$ 30 thousands, respectively.

Effective January 1, 2006, we adopted the fair value recognition provisions of SFAS No. 123(R), "Share-Based Payment", using the modified-prospective-transition method. Under that transition method, compensation cost recognized during 2006 includes: (a) compensation cost for all share-based payments granted prior to, but not yet vested as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123, and (b) compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of Statement 123(R). Results for prior periods have not been restated.

As a result of adopting SFAS No. 123(R) on January 1, 2006, our net loss for the year ended December 31, 2006, is \$ 790 thousand higher than if we had continued to account for share- based compensation under Opinion 25. Basic and diluted loss per share for the year ended December 31, 2006, is \$ 0.03 higher than if we had continued to account for share-based compensation under Opinion 25.

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

Revenue recognition

Revenue is recognized when the earnings process is complete, as evidenced by an agreement between the customer and the Company, when delivery has occurred or services have been rendered, when the fee is fixed or determinable and when collection is probable. The service component of the Company's solutions is considered essential to the functionality of the software components. Furthermore, the software components cannot be used on a standalone basis, or with another party's service. The customer has no ability to run the software or the SDK on its own hardware. As the software portion of the product can not stand on its own, the Company considers each sale as a service arrangement. Therefore, revenues deriving from anti-spam services are recognized ratably over the service term, which generally includes a term period of one year to three years. The Company's revenue recognition policy is discussed in Note 2 of Notes to Consolidated Financial Statements.

Commitments and Contingencies

Commtouch periodically records the estimated impacts of various conditions, situations or circumstances involving uncertain outcomes. These events are called "contingencies", and Commtouch's accounting for such events is prescribed by Statement of Financial Accounting Standards No. 5, "Accounting for Contingencies" ("SFAS No. 5"). SFAS No. 5 defines a contingency as "an existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur."

SFAS No. 5 does not permit the accrual of gain contingencies under any circumstances. For loss contingencies, the loss must be accrued if (1) information is available that indicates it is probable that the loss has been incurred, given the likelihood of the uncertain future events; and (2) that the amount of the loss can be reasonably estimated.

The accrual of a contingency involves considerable judgment on the part of management. Commtouch uses its internal expertise, and outside experts (such as lawyers, tax specialists and engineers), as necessary, to help estimate the probability that a loss has been incurred and the amount (or range) of the loss. The Company has recorded contingencies in situations where management determined it was probable a loss had been incurred and the amount could be reasonably estimated.

Valuation of investments

Fair values of marketable securities are estimated using quoted market prices where available. Our marketable securities consist of highly-rated federal backed student loan securities. As of December 31, 2007, the marketable securities are stated at market value which is equivalent to par value. We classify our investments as available for sale. Changes in fair value of investments classified as available for sale are not recognized to income during the period, but rather are recognized as a separate component of equity until realized.

Subsequent to balance sheet date, commencing in February 2008, the auction rate securities suffered from failed auctions.

Accounting for income taxes

On January 1, 2007, we adopted FIN 48, "Accounting for Uncertainty in Income Taxes," which contains a two-step approach to recognizing and measuring uncertain tax positions accounted for in accordance with Statement 109, "Accounting for Income Taxes." The first step is to evaluate the tax position taken or expected to be taken in a tax return by determining if the weight of available evidence indicates that it is more likely than not that, on an evaluation of the technical merits, the tax position will be sustained on audit, including resolution of any related appeals or litigation processes. The second step is to measure the tax benefit as the largest amount that is more than 50% likely to be realized upon ultimate settlement. Prior to January 1, 2007, we estimated our uncertain income tax obligations in

accordance with SFAS No. 109, "Accounting for Income Taxes" (SFAS No. 109) and SFAS No. 5 "Accounting for Contingencies" ("SFAS No. 5"). No provision was recommended as a result of the adoption of FIN 48 or for the year ended December 31, 2007.

The Company and its subsidiary have provided a valuation allowance in respect to the deferred tax assets resulting from operating loss carryforwards and other temporary differences. Management currently believes that since the Company and its subsidiary have a history of losses it is more likely than not that the deferred tax regarding the loss carryforwards and other temporary differences will not be realized in the foreseeable future.

Revenue Sources

Service Fees.

We recognize revenues from anti-spam, Zero-Hour virus outbreak detection and GlobalView Mail Reputation Service. Revenues from anti-spam, Zero-Hour virus outbreak detection services and GlobalView Mail Reputation Service are recognized when persuasive evidence of an arrangement exists, services are provided, the fee is fixed or determinable and collectibility is probable. Revenues deriving from anti-spam and Zero-Hour virus outbreak detection services are recognized ratably over the life of the service period.

Patent License Fees.

We also recognize revenues from our patent licensing program. Revenues from patent licenses are recognized when persuasive evidence of an arrangement exists, delivery has occurred and the Company has no further obligations, the fee is fixed or determinable and collectibility is probable.

Results of Operations

The following table sets forth financial data for the years ended December 31, 2005, 2006 and 2007 (in thousands):

	2005	2006	2007
Revenues	\$ 3,925	\$ 7,234	\$ 11,250
Cost of revenues	700	901	1,411
Gross profit	3,225	6,333	9,839
Operating expenses:			
Research and development	1,524	1,763	2,187
Sales and marketing	2,476	2,686	3,453
General and administrative	1,881	2,299	2,589
Total operating expenses	5,881	6,748	8,229
Operating income (loss)	(2,656)	(415)	1,610
Interest and other income (expenses), net	141	274	527
Equity in losses of affiliate	(175)	(49)	-
Net income (loss) before taxes	(2,690)	(190)	2,137
Taxes on income	-	-	28
Amortization of beneficial conversion feature relating to convertible Series A Preferred Shares	(1,751)	—	-
Net income (loss) attributable to ordinary and equivalently participating shareholders	\$ (4,441)	\$ (190)	\$ 2,109

Comparison of Years Ended December 31, 2007 and 2006

Revenues. Revenues increased by \$4.1 million from \$7.2 million in 2006 to \$11.3 million in 2007. The increase is due to an increase in market share, especially in the international market. The number of OEM's increased by 35 in 2007

and amounted to 88 as of December 31, 2007.

Cost of Revenues. Cost of revenues increased by \$0.5 million from \$0.9 million in 2006 to \$1.4 million in 2007. The increase in 2007 is mainly due to higher facility costs and hosting expenses aiming to serve the increasing number of customers. Cost of revenues did not increase in the same proportion as sales in 2007 due to economies of scale. Most costs of revenues are fixed and are not affected by increases or decreases in revenues.

Research and Development. Research and development expenses increased by 24% and amounted to \$2.2 million in 2007 compared to \$1.8 million in 2006. The increase is due to recruitment of more employees as part of the Company's decision to develop new products. Research and development expenses include \$246,000 of expenses in connection with SFAS No. 123(R).

Sales and Marketing. Sales and marketing expenses increased by 29% and amounted to \$3.5 million compared to \$2.7 million in 2006. The increase is mainly due to recruitment of employees and increased selling and marketing activity. In 2007, sales and marketing expenses included \$194,000 expenses in connection with SFAS No. 123(R)

General and Administrative. General and administrative expenses increased by 13% from \$2.3 million in 2006 to \$2.6 million in 2007. The increase is mainly due to the recruitment of two new employees. In 2007, general and administrative expenses included \$544,000 expenses in connection with SFAS No. 123(R).

Interest and Other Income (Expenses), Net. Interest and other income (expenses), net, increased by 92% from net income of \$274,000 in 2006 to net income of \$527,000 in 2007. The increase is primarily due to interest income derived from the proceeds of an equity financing round in 2007

Equity in Earnings (Losses) of Affiliate. In 2006, the Company recorded losses that occurred in Imatrix affiliate up to the carrying amount of its investment as of December 31, 2006. In 2007, since Imatrix did not incur income in excess of its cumulative losses, no equity loss was recorded with respect to such affiliate. Due to our dilution in the equity ownership and lack of significant influence in Imatrix, the investment will be accounted for under the cost method as of December 31, 2007.

Comparison of Years Ended December 31, 2006 and 2005

Revenues. Revenues increased by \$3.3 million from \$3.9 million in 2005 to \$7.2 million in 2006. Revenues increased in 2006 as the Company's new Virus outbreak detection service was available for the full year of 2006 but only a portion of 2005, and also due to increase in market share.

Cost of Revenues. Cost of revenues increased by \$0.2 million from \$0.7 million in 2005 to \$0.9 million in 2006. The increase in cost of revenues is due to an increase in sales. Cost of revenues did not increase in the same proportion as sales in 2006 due to economies of scale. Most costs of revenues are fixed and are not affected by increases or decreases in revenues.

Research and Development. Research and development expenses increase by 16% and amounted to \$1.8 million in 2006 compared to \$1.5 million in 2005. The increase is mainly due to the implementation of SFAS No. 123(R), starting January 1, 2006. The adoption of SFAS No.123(R) increased research and development expenses by \$196,000 (see also note 21 of the consolidated financial statements).

Sales and Marketing. Sales and marketing expenses increased by 8% from \$2.5 million in 2005 to \$2.7 million in 2006. The increase is mainly due to the implementation of SFAS No.123(R) starting January 1, 2006. The adoption of SFAS No.123(R) increased Sales and marketing expenses by \$96,000 (see also note 21 of the consolidated financial statements). The increase is also due to payroll of new recruitments in the sales and marketing department and due to increased marketing activity as part of our decision to meet the increasing demand of our products and to gain more market share.

General and Administrative. General and administrative expenses increased by 22% from \$1.9 million in 2005 to \$2.3 million in 2006. The increase is due to the implementation of SFAS No.123(R) starting January 1, 2006. The adoption of FAS123R increased General and administrative expenses by \$483,000 (see also note 21 of the consolidated financial statements).

Interest and Other Income (Expenses), Net. Interest and other income (expenses), net, increased by 94% from net income of \$141,000 for 2005 to net income of \$274,000 in 2006, primarily due to interest income derived from the proceeds of an equity financing round in 2006.

Equity in Earnings (Losses) of Affiliate. Equity in losses of an affiliate decreased by 72% from \$175,000 for 2005 to \$49,000 in 2006. During 2006 we recorded losses that occurred in the affiliate up to the carrying amount of its investment as of December 31, 2005.

Quarterly Results of Operations (Unaudited)

The following table sets forth certain unaudited quarterly statements of operations data for the eight quarters ended December 31, 2007. This information has been derived from the Company's consolidated unaudited financial statements, which, in management's opinion, have been prepared on the same basis as the audited consolidated financial statements, and include all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of the information for the quarters presented. This information should be read in conjunction with our audited consolidated financial statements and the notes thereto included elsewhere in this report. The operating results for any quarter are not necessarily indicative of the operating results for any future period.

	Mar. 31, 2006	Jun. 30, 2006	Sept. 30, 2006	Three Months Ended				
				Dec. 31, 2006	Mar. 31, 2007	Jun 30, 2007	Sept. 30, 2007	Dec. 31, 2007
	(in thousands) (unaudited)							
Revenues	\$ 1,473	\$ 1,698	\$ 1,866	\$ 2,197	\$ 2,405	\$ 2,617	\$ 2,930	\$ 3,298
Cost of revenues	218*	208*	220*	255	286	346	357	422
Gross profit	1,255	1,490	1,646	1,942	2,119	2,271	2,573	2,876
Operating expenses:								
Research and development	396*	433*	422*	512	456	539	559	633
Sales and marketing	688*	635*	636*	727	826	810	874	943
General and administrative	579*	570*	518*	632	661	627	620	681
Total operating expenses	1,663	1,638	1,576	1,871	1,943	1,976	2,053	2,257
Operating income (loss)	(408)	(148)	70	71	176	295	520	619
Interest and other income (expenses), net	64	49	79	82	91	188	119	129
Equity in losses of affiliate	(34)	(15)	—	—	—	—	—	—
Net income (loss)	(378)	(114)	149	153	267	483	639	748
Taxes on income	—	—	—	—	—	—	—	28
Net income (loss) attributable to ordinary and equivalently participating shareholders	\$ (378)	\$ (114)	\$ 149	\$ 153	\$ 267	\$ 483	\$ 639	\$ 720
Basic								
Net income (loss) per share	\$ (0.03)	\$ (0.00)	\$ 0.00	\$ 0.00	\$ 0.01	\$ 0.02	\$ 0.03	\$ 0.03
Diluted net income (loss) per share	\$ (0.03)	\$ (0.00)	\$ 0.00	\$ 0.00	\$ 0.01	\$ 0.02	\$ 0.02	\$ 0.03

* Certain amounts from prior quarters have been reclassified to conform to the current presentation.

Up through early 2006, we had a history of incurring operating losses, and we cannot be certain that we will continue to achieve profitability on a quarterly or annual basis in the future. A relatively large expense in a quarter could have a negative effect on our financial performance in that quarter. Additionally, as a strategic response to a changing competitive environment, we may elect from time to time to make certain pricing, service, marketing or acquisition decisions that could have a negative effect on our quarterly financial performance. Other factors that may cause our future operating results to fluctuate include, but are not limited to:

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Our ability to successfully develop and market our email defense solutions to new markets, both domestic and international;

- Our ability to successfully develop and market new, modified or upgraded solutions, as may be needed;
 - The continued market acceptance of our new email defense solutions;

- Our ability to expand our workforce with qualified personnel, as may be needed;
 - Unanticipated bugs or other problems affecting the providing of our email defense solutions to customers;
 - The success of our resellers' and OEM partners' sales efforts to potential customers;
- The solvency of our resellers and OEM partners and their ability to allocate sufficient resources towards the marketing of our email defense solutions to their potential customers;
- Our OEM partners' ability to effectively integrate our solutions into their product offerings;
 - The rate of adoption of email defense solutions by customers;
 - The substantial decrease in information technology spending;
 - The pricing of our solutions;
 - Our ability to timely collect fees owed by resellers and OEM partners;
 - Our ability to add space and equipment to our current Detection Centers in a timely and effective manner to match the rate of growth in our business, plus our ability to build new Detection Centers as worldwide demand for our products may require; and
- The effectiveness of our customer support, whether provided by our resellers and OEM partners, or directly by Commtouch.

In addition to the factors set forth above, our operating results will be impacted by the extent to which we incur non-cash charges associated with stock-based arrangements with employees and non-employees.

New Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board ("FASB") issued SFAS No. 157, "Fair Value Measurements" ("SFAS No. 157"). This Standard defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. The provisions of SFAS No. 157 are effective for financial statement issued for fiscal years beginning on January 1, 2008. The FASB issues a FASB Staff Position (FSP) to defer the effective date of SFAS No. 157 for one year for all non-financial assets and non-financial liabilities, except for those items that are recognized or disclosed at fair value in the financial statements on a recurring basis. We are not expecting the adoption will have material impact on our consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities" ("SFAS No. 159"). SFAS No. 159 permits companies to choose to measure certain financial instruments and certain other items at fair value. The standard requires that unrealized gains and losses on items for which the fair value option has been elected be reported in earnings. The provisions of SFAS No. 159 are effective for financial statement issued for fiscal years beginning on January 1, 2008. We are not expecting the adoption will have material impact on our consolidated financial statements

In December 2007, the FASB issued SFAS No. 141 (revised 2007), "Business Combinations" ("SFAS 141R"). SFAS 141R establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, any non-controlling interest in the acquiree and the

goodwill acquired. SFAS 141R also establishes disclosure requirements to enable the evaluation of the nature and financial effects of the business combination. SFAS 141R is effective for fiscal years beginning after December 15, 2008. Earlier adoption is prohibited. We are not expecting the adoption of SFAS 141R will have material impact on our consolidated results of operations and financial condition.

In December 2007, the FASB issued SFAS No. 160, "Non-controlling Interests in Consolidated Financial Statements, an amendment of ARB No. 51". SFAS No. 160 establishes accounting and reporting standards that require that the ownership interests in subsidiaries held by parties other than the parent be clearly identified, labeled, and presented in the consolidated statement of financial position within equity, but separate from the parent's equity; the amount of consolidated net income attributable to the parent and to the non-controlling interest be clearly identified and presented on the face of the consolidated statement of income; and changes in a parent's ownership interest while the parent retains its controlling financial interest in its subsidiary be accounted for consistently. SFAS No. 160 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. We are not expecting that the adoption of SFAS No. 160 will have significant impact on our consolidated financial statement.

On December 21, 2007 the SEC staff issued Staff Accounting Bulletin No. 110 (SAB 110), which, effective January 1, 2008, amends and replaces SAB 107, Share-Based Payment. SAB 110 expresses the views of the SEC staff regarding the use of a “simplified” method in developing an estimate of expected term of “plain vanilla” share options in accordance with FASB Statement No. 123(R), Share-Based Payment. Under the “simplified” method, the expected term is calculated as the midpoint between the vesting date and the end of the contractual term of the option.

The use of the “simplified” method, which was first described in Staff Accounting Bulletin No. 107, was scheduled to expire on December 31, 2007. SAB 110 extends the use of the “simplified” method for “plain vanilla” awards in certain situations. The SEC staff does not expect the “simplified” method to be used when sufficient information regarding exercise behavior, such as historical exercise data or exercise information from external sources, becomes available. We are currently assessing the potential impact that the adoption of SAB 110 could have on our financial statements.

Liquidity and Capital Resources

We have financed our operations from the issuance of equity securities and, to a lesser extent, from private loans and research and development grants from the Israeli government.

On May 8, 2006, the Company entered into a small financing transaction with one private investor, whereby the Company received \$100,000 against the issuance of 31,153 Ordinary Shares and warrants to purchase an additional 23,364 Ordinary Shares.

As of December 31, 2006 and December 31, 2007, we had approximately \$10.0 million and \$14.4 million of cash and cash equivalents and marketable securities, respectively. The increase was due to positive operating cash flow and receipt of proceeds from the exercise of warrants and options in the amount of \$1.7 million.

In 2007, net cash provided by operating activities was approximately \$4.1 million. The increase in operating cash flow was mainly due to our net income in 2007 compared to a loss in 2006. Net cash provided by financing activities in 2007 was approximately \$2.5 million, due to option and warrant exercises. Net cash used by investing activities in 2007 was \$3.0 million and consisted primarily of an increase in short term cash deposits of \$1.6 million, an investment of \$0.8 million in an affiliate and purchase of property and equipment in the amount of \$0.6 million. As of December 31, 2006 and December 31, 2007, we had working capital of \$7.5 million and \$11.8 million, respectively.

Based on the cash balance at December 31, 2007, current projections of revenues and related expenses, the Company believes it has sufficient cash to continue operations at least through March 2009.

Contractual obligations

The following table summarizes our outstanding contractual obligations as of December 31, 2007 (in thousands):

Contractual Obligation	Payments due by period (USD in thousands)				
	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
Operating lease obligation	\$ 438	\$ 285	\$ 153	\$ -	\$ -
Other Long-term liabilities reflected on the Company's Balance Sheet -					
Accrued severance pay	931	-	-	-	931
Other Long-term asset reflected on the Company's Balance Sheet -	(821)	-	-	-	(821)

severance pay fund							
Net - severance pay liability	110	-	-	-	110		
Total	\$ 548	\$ 285	\$ 153	\$ -	\$ 110		

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Effective Corporate Tax Rates

Our tax rate will reflect a mix of the U.S. statutory tax rate on our U.S. income and the Israeli tax rate discussed below. Israeli companies are generally subject to corporate tax on their taxable income. The applicable corporate tax rate was 29% in 2007 and will be progressively reduced to the following tax rates: 2008 - 27%, 2009 - 26%, 2010 and thereafter - 25%.

As of December 31, 2007, the Company's net operating loss carry forwards for tax purposes amounted to approximately \$71,000, which may be carried forward and offset against taxable income in the future, for an indefinite period.

As of December 31, 2007, for federal income tax purposes, our U.S. subsidiary had net operating loss carry-forwards of approximately \$ 91 million. These losses may offset any future U.S. taxable income of the U.S. subsidiary and will expire in the years 2009 through 2025. In light of the subsidiary's recent history of operating losses, the Company has recorded a valuation allowance for all of its deferred tax assets.

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

The Company and its subsidiary have provided valuation allowances in respect to the deferred tax assets resulting from operating loss carry forwards and other temporary differences. Management currently believes that since the Company and its subsidiary, until recently, has had a history of losses, it is more likely than not that the deferred tax assets regarding the loss carry forwards and other temporary differences will not be realized in the foreseeable future.

Impact of Inflation and Currency Fluctuations

Most of our sales are in U.S. dollars. However, a portion of our costs relates to our operations in Israel. A substantial portion of our operating expenses in Israel, primarily our research and development expenses, is denominated in NIS. Costs not denominated in U.S. dollars are re-measured to U.S. dollars, when recorded, at prevailing rates of exchange. This is done for the purposes of our financial statements and reporting. As a result, we are exposed to risk to the extent that the value of the U.S. dollar decreases against the NIS. In that event, the U.S. dollar cost of our operations will increase and our U.S. dollar-measured results of operations will be adversely affected, as occurred in 2006 and 2007, when the NIS appreciated against the U.S. dollar, which resulted in a significant increase in the U.S. dollar cost of our operations. Consequently, we are and will be affected by changes in the prevailing NIS/U.S. dollar exchange rate.

The annual rate of inflation in Israel was 3.4% in 2007, (0.1%) in 2006 and 2.4% in 2005. The NIS appreciated against the U.S. dollar by approximately (8.9%) in 2007 and (8.2%) in 2006 and depreciated against the U.S. dollar by approximately 6.85% in 2005. The representative dollar exchange rate for converting the NIS to U.S. dollars, as reported by the Bank of Israel, was NIS 3.846 for one U.S. dollar on December 31, 2007. The representative dollar exchange rate was NIS 3.474 at March 14, 2008. Because exchange rates between the NIS and the dollar fluctuate continuously, exchange rate fluctuations and especially larger periodic devaluations will have an impact on our operating results and period-to-period comparisons of our results. The effects of foreign currency re-measurements are reported in the consolidated financial statements for relevant periods in the statement of operations.

The Company's affiliate's (Imatrix's) functional currency is the Japanese Yen. Consequently Imatrix's results of operations are translated into U.S. dollars. Because exchange rates between the Yen and the dollar fluctuate continuously, exchange rate fluctuations will have an impact on the Company's shareholders equity.

Item 6. Directors, Senior Management and Employees

The following table presents information with respect to our directors' beneficial ownership of our Ordinary Shares as of December 31, 2007. Beneficial ownership is determined in accordance with the rules of the SEC and includes voting or investment power, with respect to shares. To our knowledge, except under applicable community property laws or as otherwise indicated, the persons named in the table have sole voting and sole investment control and rights to receive economic benefits with respect to all shares beneficially owned. The applicable percentage of ownership for each director is based on 25,346,042 Ordinary Shares outstanding as of December 31, 2007, as adjusted for the reverse split of January 2, 2008. Ordinary Shares issuable upon exercise of options and other rights held and exercisable on or within sixty days of December 31, 2007 are deemed outstanding for the purpose of computing the percentage ownership of the director holding those options and other rights.

Name and Position	Age	Ordinary Share Beneficial Ownership >1%	Number of Ordinary Shares Beneficially Owned	Number of Options and Warrants included in Beneficial Ownership
Amir Lev, Director, President and CTO	47	2.5%	637,156	476,005 options (6), at exercise prices ranging from \$0.0375 to \$6.60 per Ordinary Share. Expiration dates range from 3/2/08 to 8/4/15
Aviv Raiz, Director (1)	49	20.9%	5,371,233	29,167 options, at exercise prices ranging from \$3.12 to \$6.60 per Ordinary Share. Expiration dates range from 12/30/11 to 12/14/13. Also, 333,333 warrants, with an exercise price of \$1.95, expiring in early October 2010
Gideon Mantel, Director, Chairman of the Board and CEO	48	4.1%	1,056,022	652,996 options, at exercise prices ranging from \$0.0375 to \$6.60. Expiration dates range from 8/15/11 to 8/4/15
Nahum Sharfman, Director(1)(3)(5)	59	2.4%	608,656	92,188 options, at exercise prices ranging from \$0.0375 to \$6.60. Expiration dates range from 8/15/11 to 12/6/14
Lloyd E. Shefsky, Director(2)(3)(4)	67	1.2%	299,030	68,750 options, at exercise prices ranging from \$1.17 to

\$6.60. Expiration dates range from 12.30.11 to 3.29.15. Also, 56,453 warrants, with exercise prices ranging from \$0.75 to \$1.50, and expiration dates from 2/17/08 to 12/25/08

Dr. Orna Berry, Director (Outside Director) (2)(3)(5)	58	<1%	<1%
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Ofer Segev, Director (Outside Director) (1)(2)(5)	48	<1%	<1%
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(1) Member of the Compensation Committee

(2) Member of the Audit Committee

(3) Member of the Nominating Committee

(4) Mr. Shefsky's ownership information includes his individual holdings and holdings of LENE L.P., in which Mr. Shefsky currently holds a relatively nominal, limited partnership interest.

(5) Orna Berry's and Ofer Segev's respective terms as outside directors expired in late March 2008, and Nahum Sharfman resigned from the Board effective March 31, 2008. See "Election of Directors" below for additional details.

(6) 10,000 of these options expired unexercised on March 2, 2008.

Other Management Employees:

The following table sets forth the names and positions of our management employees at December 31, 2007:

Name	Age	Ownership		Position
			>1%	
Gideon Mantel	48	See table above		CEO and Chairman of the Board
Amir Lev	47	See table above		President and Chief Technical Officer
Ron Ela	37	(1)		Chief Financial Officer
Avner Amram	46	(1)		Executive Vice President, Commtouch Inc.
Gary Davis	46	(1)		Vice President, General Counsel and Corporate Secretary
Udi Trugman(2)	37	(1)		Vice President, Research and Development, Commtouch Software Ltd. Vice President, International Business Development, Commtouch Software Ltd.
Ronni Zehavi(2)	42	(1)		Vice President, Products, Commtouch Software Ltd.
Haggai Carmon	49	(1)		Vice President, Business Development North America
Jay Goldin	39	(1)		Vice President, Network Operations & Customer Services
Yossi Maslaton	41	(1)		
	(1)			less than 1%

(2) Mr. Trugman and Mr. Zehavi left the employment of the Company at the end of January 2008. During early 2008, Ohad Sheory joined the Company as Vice President of Research and Development, Asaf Greiner joined the Company as Vice President of Web Security Products and Ido Hadari joined the Company as Senior Director of International Sales and Business Development. Their biographies may be found on the Company's website at www.commtouch.com, under the "Management" page.

Amir Lev is a co-founder of Commtouch and has served as its Chief Technology Officer and as a Director since its inception in 1991. Mr. Lev was also the General Manager of Commtouch from January 1997 through April 2000, and in May 2000 became President. Mr. Lev received a B.A. in Computer Science and Economics from Hebrew University, Jerusalem.

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

Gideon Mantel is a co-founder of Commtouch and served as its Chief Financial Officer from its inception in February 1991 until October 1995, when he became Commtouch's Chief Operating Officer. In November 1997, he became Commtouch's Chief Executive Officer, and in December 2006, he was confirmed as Chairman of the Board. He has also served as a Director of Commtouch since inception. Mr. Mantel received a B.A. in Political Science and an M.B.A. from Tel Aviv University.

Nahum Sharfman rejoined the Board of Directors in March 2000. Mr. Sharfman is a co-founder of Commtouch and served as its Chief Executive Officer and Chairman of the Board from its inception in February 1991. In November 1997 Mr. Sharfman resigned as Chief Executive Officer to become a founder of Dealttime.com (now known as Shopping.com). Mr. Sharfman remained Chairman of the Board of Commtouch and a Director until January 1999. Prior to founding Commtouch, Mr. Sharfman spent eleven years with National Semiconductor Corporation in various development and management roles. Mr. Sharfman received a Ph.D. in High Energy Nuclear Physics from Carnegie Mellon University and M.S. and B.S. degrees in Physics from the Technion- Israel Institute of Technology, Haifa.

Dr. Orna Berry joined the Board of Directors as an Outside Director under the Israel Companies Law in March 2005. Dr. Berry is a Venture Partner in Gemini Israel Funds Ltd. Dr. Berry co-founded ORNET Data Communication Technologies Ltd., an early Gemini portfolio company, which was sold to Siemens for \$30 million. In addition, she serves as the Chairperson in several Gemini portfolio companies. From 1997 through 2000, Dr. Berry served as the Chief Scientist of the Ministry of Industry, Trade and Labor of the Government of Israel. In this capacity she was responsible for implementing government policy regarding support and encouragement of industrial research and development. Dr. Berry also has served as the Chief Scientist of Fibronics and, prior to that, Dr. Berry served as a senior research engineer in companies such as IBM and UNISYS. Dr. Berry received her Ph.D. in Computer Science from the University of Southern California, and M.A. and B.A. degrees in Statistics and Mathematics from Tel Aviv and Haifa Universities. She is a frequent lecturer on "High-Tech" worldwide.

Ofer Segev has served as an Outside Director under the Israel Companies Law since February 2002. Since April 1, 2007, Mr. Segev is the Executive Vice President and Chief Financial Officer for Ness Technologies, a global provider of end-to-end IT services and solutions. Mr. Segev was the CFO of Attunity Ltd from 2003 through early 2007 and, prior to that position, he served as the CEO for TeleKnowledge, and as CFO for Tundo. Prior to his position at Tundo, Mr. Segev was a partner at Ernst & Young Israel where he led the High Tech Industry practice group. Mr. Segev has a B.A. in economics and accounting from Bar Ilan University in Israel, and has studied at the Kellogg Graduate School of Management at Northwestern University.

Lloyd E. Shefsky has served as a Director of Commtouch since October 2003. He is a Clinical Professor of Entrepreneurship and Co-Director of the Center for Family Enterprises at the Kellogg School of Management and has taught in several countries. In 1970, he founded the Chicago law firm, Shefsky & Froelich Ltd., where he has been Of Counsel since 1996. Since 1981 he has represented the Government of Israel throughout the Midwestern U.S. For nearly forty years he has represented hundreds of entrepreneurs and their companies, and during the past twenty-five years, such representation has included numerous Israeli companies with U.S. operations. Mr. Shefsky authored Entrepreneurs Are Made Not Born, which was translated into five foreign languages. He received his J.D. from the University of Chicago Law School, a B.S.C. from De Paul University (accounting), is a member of the Illinois and Florida Bars, and has a CPA certificate in Illinois.

Avner Amram joined Commtouch in 1996 and currently serves as Executive Vice President. Mr. Amram has over 17 years of experience in the areas of technology, operational management and leadership, and is also a founder of

CVDO. Before 2002, Mr. Amram served as COO of Commtouch and was responsible for worldwide operations. Mr. Amram also held a number of positions at Commtouch prior to being appointed COO. From 1995 to 1996, Mr. Amram served as project manager for Medatech, a leading provider of customer relationship management (CRM) solutions, developing and managing complex installations at large organizations. Prior to Medatech, Mr. Amram acted as General Manager of Fuga Nursery in Israel, where he was responsible for operations, production, marketing and distribution. Mr. Amram holds a Bachelors of Science (BSC), in Computer Engineering and graduated Cum Laude from the Technion, Israel Institute of Technology.

Ron Ela joined Commtouch in July 2006 as its Chief Financial Officer. A Certified Public Accountant, Mr. Ela formerly held management positions at two Israeli-based Nasdaq listed companies, and most recently held the role of Controller at Verint Systems Ltd., a wholly-owned subsidiary of Verint Systems Inc. During the five years prior to that time, Mr. Ela served as Deputy Controller and subsequently Controller for Partner Communication Ltd. Also, Mr. Ela spent 3 years in public accounting with Kesselman & Kesselman, a member of PricewaterhouseCoopers in Israel. Mr. Ela has a B.A. in business administration majoring in accounting from the College of Management Academic Studies.

Gary Davis joined Commtouch in September 1999 and serves as Vice President, General Counsel and Corporate Secretary. Mr. Davis has over 20 years of legal experience in both private law firm and corporate practices. Mr. Davis is certified to practice law in both the State of Israel and California. Prior to September 1999, Mr. Davis was in-house counsel to Israel Military Industries and Elta Electronics Industries. He received a B.A. in Political Economy of Industrial Societies from U.C. Berkeley and a J.D. in law from Golden Gate University.

Udi Trugman joined Commtouch in December 1996 and served as Vice President of Research and Development until January 2008. Prior to 2002, Mr. Trugman was Senior Director of Systems in the R&D group. Mr. Trugman has over 17 years of software development and management experience. Prior to working at Commtouch, Mr. Trugman specialized in development of commercial applications.

Ronni Zehavi joined Commtouch in June 1999 and served as Vice President of International Business Development until January 2008. Prior to joining Commtouch, Mr. Zehavi was Human Resources and Training Manager for “Mondex - ecash”, a subsidiary company of International Mastercard from 1997 to 1999. From 1994 to 1997, Mr. Zehavi was an Organizational Consultant in a counseling firm. Mr. Zehavi received his M.A. degree in Organizational Sociology from Bar-Ilan University and his B.A. degree in History and Educational Psychology from Tel-Aviv University.

Haggai Carmon joined Commtouch in January 2002 and serves as Vice President of Products. From 1998 to 2002, Mr. Carmon was Vice President of Corporate Marketing and of Sales in Asia-Pacific for VCON Telecommunications, a public vendor of corporate videoconferencing solutions, and was also responsible for international pre-sales and technical support. Prior to that, Mr. Carmon was at NetManage Ltd., a public software company of TCP/IP applications for Windows, a founder and CEO of Applico, a Computer-aided Design for Architecture service firm, and managed a college of Fine Arts. Mr. Carmon has over 17 years of experience in technology and international management.

Jay Goldin joined Commtouch in March 2006, as the Vice President Business Development, North America. Prior to joining Commtouch, Mr. Goldin was a consultant to networking and security companies, including Commtouch. Mr. Goldin was a founder of Digital Fountain, a wireless and media networking technology company, where he served as Vice President of Business Development. He also co-founded Alyanza Infosystems, and was a management consultant with Pacific Rim Consulting Group. Mr. Goldin received his M.B.A and A.B. in Economics from Stanford University.

Yossi Maslaton joined Commtouch in 1998 and has served as Vice President of Network Operations and Customer Services since early 2005. Before 2005 he was Director of Service Operations. With over 20 years of experience in the fields of Information Technology and Networking, Mr. Maslaton is responsible for the operations of Commtouch's data centers and customer services, servicing tens of millions of users daily with the highest standards of uptime. From 1991 to 1998 Mr. Maslaton was Manager of Information Systems and labs for RND Networks, a group of hi-tech startups in the network-routing field. Prior to that, Mr. Maslaton managed the technical field-operations of a large project for the Israel Defense Forces in the areas of distributed computing systems and radio communications.

Election of Directors

Directors (other than outside directors, as explained below) are elected by shareholders at the annual general meeting of the shareholders and hold office until the next annual general meeting following the general meeting at which such director is elected and until a successor is elected, or until the director is removed. An annual general meeting must be held at least once in every calendar year, but not more than fifteen months after the preceding annual general meeting. Directors may be removed and other directors may be elected in their place or to fill vacancies in the Board of Directors at any time by the holders of a majority of the voting power at a general meeting of the shareholders. Until a vacancy is filled by the shareholders, the Board of Directors may appoint new directors temporarily to fill vacancies on the Board of Directors. The Amended and Restated Articles of Association of Commtouch authorize the shareholders to determine, from time to time, the number of directors. The maximum number of directors is currently fixed at ten directors, though only seven directors are currently serving on the Board of Directors. An extraordinary general meeting of shareholders is scheduled for March 31, 2008 to elect two new outside directors, Yair Shamir and Yair Bar-Touv, to replace the Company's two outside directors, Orna Berry and Ofer Segev, whose respective terms will expire. Information concerning the nominees for election is set forth in the Company's proxy statement for the extraordinary general meeting of shareholders, a copy of which is attached as an exhibit to the Company's Form 6-K filed with the Securities and Exchange Commission on March 19, 2008. Furthermore, effective March 31, 2008, Nahum Sharfman resigned from the Board, and the Board appointed Hila Karah to fill the resulting Board vacancy. It is anticipated that Ms. Karah will stand for reelection at the next annual general meeting of shareholders. Information concerning Ms. Karah is set forth in the Company's press release of March 19, 2008 which also was filed as an exhibit to the aforementioned Form 6-K.

There are no family relationships among any of the directors, officers or key employees of Commtouch.

Alternate Directors

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

Independent and Outside Directors

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

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

No person may serve as an outside director if the person's position or other business activities create, or may create, a conflict of interest with the person's responsibilities as an outside director or may otherwise interfere with the person's ability to serve as an outside director. If, at the time outside directors are to be appointed, all current members of the Board of Directors are of the same gender, then at least one outside director must be of the other gender. At least one of the outside directors is required to have "financial and accounting expertise," unless another member of the audit committee, who is an independent director under the NASDAQ Marketplace Rules, has "financial and accounting expertise," and the other outside director or directors are required to have "professional expertise," all as defined under the Israel Companies Law.

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

• such majority includes at least one-third of the shares held by non-controlling shareholders who are present and voting at the meeting; or

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

The initial term of an outside director is three years and may be extended for an additional period of three years. Outside directors may be removed only by the same percentage of shareholders as is required for their election, or by a court, and then only if the outside director ceases to meet the statutory qualifications for their appointment or if they

violate their fiduciary duty to the company. Each committee of a company's Board of Directors must include at least one outside director and the audit committee (the existence of which is required under the Israel Companies Law) must include all outside directors. An outside director is entitled to compensation as provided in the regulations adopted under the Israel Companies Law and is otherwise prohibited from receiving any other compensation, directly or indirectly, in connection with service provided as an outside director.

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Dr. Berry and Mr. Segev currently serve as the Company's outside directors. As stated above under "Election of Directors", an extraordinary general meeting of shareholders is scheduled for March 31, 2008 to appoint two new outside directors to replace Dr. Berry and Mr. Segev, whose respective terms will expire. Information concerning the nominees for election is set forth in the Company's proxy statement for the extraordinary general meeting of shareholders, a copy of which is available in the Company's Form 6-K filed with the Securities and Exchange Commission on March 19, 2008.

In addition, the NASDAQ Capital Market currently requires Commtouch to have at least a majority of independent directors, as defined under Marketplace Rule 4200(a)(15), on the Board of Directors and to maintain an audit committee of at least three members, each of whom must:

- (i) be independent as defined under Marketplace Rule 4200(a)(15);
- (ii) meet the criteria for independence set forth in Rule 10A-3(b)(1) under the Securities Exchange Act of 1934, as amended, or "Exchange Act", as set forth below (subject to the exemptions provided in Exchange Act Rule 10A-3(c);
- (iii) not have participated in the preparation of the financial statements of the Company or any current subsidiary of the Company at any time during the past three years; and
- (iv) be able to read and understand fundamental financial statements, including a company's balance sheet, income statement, and cash flow statement.

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

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

NASDAQ rules also require that the Company certify that it has, and will continue to have, at least one member of the audit committee who has past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities. Also, under Item 401(h) of Regulation S-K, the Company is currently obligated to disclose whether or not it has a "financial expert" on its audit committee, as defined under this regulation (See Item 16A. Audit Committee Financial Expert).

The three directors who serve on our audit committee, Dr. Berry, Mr. Segev and Mr. Shefsky, qualify as independent directors under NASDAQ Marketplace Rules (including Exchange Act Rule 10A-3). Furthermore, Dr. Berry and Mr. Segev meet the qualification requirements for outside directors, as required under the Israel Companies Law.

The Company has identified the following Board members as "Independent directors" pursuant to NASDAQ Marketplace Rule 4200(a)(15):

- a. Ofer Segev
- b. Dr. Orna Berry

- c. Aviv Raiz
- d. Nahum Sharfman
- e. Lloyd Shefsky
- f. Yair Shamir, Yair Bar-Touv and Hila Karah (assuming they join the Board at the end of March 2008)

Audit Committee

As noted above in the discussion under “*Independent and Outside Directors*”, the Israel Companies Law requires public companies to appoint an audit committee. The responsibilities of the audit committee include identifying irregularities in the management of the Company’s business, approving management compensation and approving related party transactions as required by law. An audit committee must consist of at least three directors meeting the independence standards under the NASDAQ Marketplace Rules and must include all outside directors under the Israel Companies Law, all as described above. Furthermore, the Israel Companies Law specifically prohibits the chairman of the Board of Directors, any director employed by or otherwise providing services to a company and a controlling shareholder or any relative of a controlling shareholder from being a member of the audit committee. Our Audit Committee is in compliance with the noted requirements.

Compensation Committee

The Compensation Committee is responsible for determining salaries, incentives and other forms of compensation for Commtouch’s directors and its executive officers. The Compensation Committee is also responsible for administering the various stock option plans, including the issuance of grants of options to employees of the Company and its subsidiary.

Nominating Committee

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

Internal Auditor

Under the Companies Law, the Board of Directors must appoint an internal auditor, nominated by the audit committee. The role of the internal auditor is to examine, among other matters, whether a company’s actions comply with relevant law and orderly business procedure. Under the Companies Law, the internal auditor may be an employee of the company but not an interested party or office holder, or a relative of an interested party or office holder, and he or she may not be the company’s independent accountant or its representative. The Company engaged a qualified internal auditor during 2007.

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

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

The duty of loyalty requires an office holder to act in good faith and for the benefit of the company, including to avoid any conflict of interest between the office holder’s position in the company and such person’s personal affairs, avoiding any competition with the company, avoiding exploiting any corporate opportunity of the company in order to receive personal advantage for such person or others, and revealing to the company any information or documents relating to the company’s affairs which the office holder has received due to his or her position as an office holder. A company may approve any of the acts mentioned above provided that all the following conditions apply: the office holder acted in good faith and neither the act nor the approval of the act prejudices the good of the company, and the office holder disclosed the essence of his personal interest in the act, including any substantial fact or document, a reasonable time before the date for discussion of the approval.

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

Under the Israel Companies Law, all arrangements as to compensation of office holders who are not directors require approval of the Board of Directors unless the Articles of Association provide otherwise. Arrangements regarding the compensation of directors also require audit committee and shareholder approval.

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

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

In the case of a transaction that is not an extraordinary transaction, after the office holder complies with the above disclosure requirement, only Board approval is required unless the Articles of Association of the company provide otherwise. Our Amended and Restated Articles of Association do not provide otherwise. Such approval must determine that the transaction is not adverse to the company's interest. If the transaction is an extraordinary transaction, then in addition to any approval required by the Articles of Association, it also must be approved by the audit committee and by the Board and, under specified circumstances, by a meeting of the shareholders. An Israeli company whose shares are publicly traded shall not be entitled to approve such a transaction unless, at the time the approval was granted, two members of the audit committee were outside directors and at least one of them was present at the meeting at which the audit committee decided to grant the approval. An office holder who has a personal interest in a matter that is considered at a meeting of the Board of Directors or the audit committee generally may not be present at this meeting or vote on this matter unless a majority of the board of directors or the audit committee has a personal interest in the matter. If a majority of the board of directors or the audit committee has a personal interest in the transaction, shareholder approval also would be required.

The Israel Companies Law applies the same disclosure requirements to a controlling shareholder of a public company, which includes a shareholder that holds 25% or more of the voting rights if no other shareholder owns more than 50% of the voting rights in the company. Extraordinary transactions, including a private placement, with a controlling shareholder or in which a controlling shareholder has a personal interest, and the terms of compensation of a controlling shareholder who is an office holder, require the approval of the audit committee, the Board of Directors and the shareholders of the company. The shareholder approval must either include at least one-third of the disinterested shareholders who are present, in person or by proxy, at the meeting or, alternatively, the total shareholdings of the disinterested shareholders who vote against the transaction must not represent more than one percent of the voting rights in the company.

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

- any amendment to the Articles of Association;
- an increase of the company's authorized share capital;
- a merger; or
- approval of interested party transactions that require shareholder approval.

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

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

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

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

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

Our Amended and Restated Articles of Association allow us to insure, exculpate and indemnify office holders to the fullest extent permitted by law provided such insurance, exculpation or indemnification is approved in accordance with the Israel Companies Law. We have acquired directors' and officers' liability insurance covering the officers and directors of Commtouch and its subsidiary for certain claims. At the annual meeting of shareholders held on November 18, 2002, the shareholders approved a form of indemnification, exculpation and insurance agreement that is applicable to all our directors. The form of this agreement, as well as related provisions in our Amended and Restated Articles of Association, were amended at the annual meeting of shareholders held on December 30, 2005.

Compensation of Directors and Executive Officers

The directors of Commtouch can be remunerated by Commtouch for their services as directors to the extent such remuneration is approved by Commtouch's audit committee, Board of Directors and shareholders. Directors currently do not receive cash compensation for their services as directors but are reimbursed for their expenses for each Board of Directors meeting attended. However, see Item 10 "Amended and Restated 1999 Non-employee Directors Stock Option Plan" for a discussion of director compensation in the form of option grants. During 2007, options to purchase 384,800 Ordinary Shares (post reverse-split) were granted to directors and executive officers under the Company's stock option plans at a weighted average exercise price of \$2.20 per share.

The aggregate direct remuneration paid by Commtouch to all directors and executive officers (8 persons) in 2007 was approximately \$539 thousand. During the same period Commtouch accrued or set aside approximately \$39 thousand for the same group to provide pension, retirement or similar benefits. As of December 31, 2007, directors and executive officers of Commtouch (8 persons) held an aggregate of 2,576,382 stock options (post-reverse split) to purchase a like number of Ordinary Shares, with 1,496,328 of those options having vested.

Options to Purchase Securities from Registrant or Subsidiaries

As of December 31, 2007, 4,762,259 stock options (post-reverse split) to purchase Ordinary Shares had been granted to then existing employees, consultants, executive officers and non-employee directors under the Company's stock option plans, net of forfeited options, and there were 797,382 shares available for grant under all plans. Of the number of options granted, 3,949,836 had not been exercised and had exercise prices ranging from \$0.0375 to \$6.60 per share and a weighted average per share exercise price of approximately \$2.67, and were held by 51 persons. These options have termination dates ranging from March 2008 to August 2015.

Employee Stock Option Plans

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

Some previous employee option plans have either terminated or were amended and restated, though options remain outstanding and exercisable under those plans. Such plans include the Amended and Restated 1996 CSI Stock Option Plan which expired on January 1, 2006 and the Amended and Restated 1999 3(i) Share Option Plan, which was replaced by the above described Israeli Share Option Plan.

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

Amended and Restated 1999 Non-Employee Directors Stock Option Plan

New directors are currently entitled to an initial grant of 50,000 options. Directors who are reelected at the annual meeting of shareholders are entitled to additional grants of 16,667 options.

Under the Non-Employee Directors Plan, each option becomes exercisable at a rate of 1/16th of the option shares every three months, and has an exercise price equal to the fair market value of the Ordinary Shares on the grant date of such option. Up through 2004, each option has a maximum term of ten years, but will terminate earlier if the optionee ceases to be a member of the Board of Directors. Options granted to directors during 2005 - 2007 have a maximum term of six years. At the annual meeting of shareholders of December 30, 2005, shareholders approved an amendment to the Non-Employee Directors Plan to allow for the acceleration of invested options for any director who has served the company for at least three years, unless the director resigned voluntarily or was removed from the Board of Directors due to a failure to perform any of his/her duties to the Company.

Employees

See Item 4: Employees

Item 7. Major Shareholders and Related Party Transactions.

The following table presents information with respect to beneficial ownership of our Ordinary Shares as of December 31, 2007, including:

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

- all executive officers and directors as a group.

Beneficial ownership is determined in accordance with the rules of the SEC and includes voting or investment power, with respect to shares. To our knowledge, except under applicable community property laws or as otherwise indicated, the persons named in the table have sole voting and sole investment control and rights to receive economic benefits with respect to all shares beneficially owned. The applicable percentage of ownership for each shareholder is based on 25,346,042 Ordinary Shares outstanding as of December 31, 2007 (on a post reverse-split basis). Ordinary Shares issuable upon exercise of options and other rights held and exercisable on or within sixty days of December 31, 2007 are deemed outstanding for the purpose of computing the percentage ownership of the person holding those options and other rights and for all directors and officers as a group, but are not deemed outstanding for computing the percentage ownership of any other person. Major shareholders in the Company have the same voting rights as all other shareholders.

MAJOR SHAREHOLDERS OF ORDINARY SHARES	Amount Owned	Percent of Class
Aviv Raiz*	5,371,233**	20.9%
All directors and officers as a group (8 persons)	8,127,306***	29.9%

* This shareholder of record resides in the host country, Israel.

** Includes 29,167 options and 333,333 warrants, exercisable into a like number of Ordinary Shares.

*** Includes 1,474,315 options exercisable into a like number of Ordinary Shares. Also, this number includes 134,265 shares and warrants held by LENE L.P., in which Mr. Lloyd Shefsky holds a relatively small limited partner interest, without any control over partnership management.

Based on a review of the information provided to us by our transfer agent, as of December 31, 2007, there were 92 holders of record of our Ordinary Shares, including 57 holders of record residing in the United States holding 20,721,615 Ordinary Shares, or 82% of the aggregate 25,346,042 Ordinary Shares outstanding as of such date. These numbers are not representative of the number of beneficial holders of our shares nor is it representative of where such beneficial holders reside since many of these ordinary shares were held of record by brokers or other nominees (including one U.S. nominee company, CEDE & Co., which held approximately 78% of our outstanding Ordinary Shares as of such date).

Significant Changes in Percentage Ownership During the Past Three Years

- Aviv Raiz participated in the private placements of October 31, 2004 (the preferred share issuance) and October 2, 2005, acquiring 500,000 convertible Series A Preferred Shares, 4 million Ordinary Shares and 2 million warrants exercisable into a like number of Ordinary Shares. Subsequent to the preferred share round of October 2004, Mr. Raiz has also purchased in private transactions 1.1 million convertible Series A Preferred Shares from certain investors who participated in that round. The shareholdings referenced in this paragraph are in their original, pre-reverse split format. Together with his holdings from purchases on the open market and director options vesting within 60 days of December 31, 2007, Mr. Raiz beneficially holds 20.9% in the Company. Mr. Raiz is a director of the Company.
- Cranshire Capital LP, Omicron Master Trust, Smithfield Fiduciary LLC and Vertical Ventures, LLC became major shareholders of the Company's Ordinary Shares by virtue of their participation in the private placements of November 26, 2003, May 18, 2004 and October 31, 2004 (though Vertical Ventures did not participate in this transaction), as well as the Redemption, Amendment and Exchange Agreement of October 31, 2004. Due to their sales of Ordinary Shares during 2005, 2006 and, to a lesser extent, 2007, including all Ordinary Shares acquired on the conversion of Series A Preferred Shares and all warrants issued in the November 2003 private placement, plus the increase in the outstanding shares of the Company during the past few years, none of these shareholders remains a major shareholder of the Company. As of December 31, 2007, the total beneficial holdings for all four shareholders amounted to less than 2%, with the overwhelming majority of these holdings being in the form of warrants.
- Israel Seed IV, L.P. was a significant participant in the July 29, 2003, November 26, 2003 and May 18, 2004 private placements, as well as the Redemption, Amendment and Exchange Agreement of October 31, 2004. At December 31, 2004, its beneficial ownership in the Company reached 19.8%. However, due to a number of sales of shares during 2005, 2006 and 2007, the percentage of beneficial ownership of Israel Seed IV, L.P. at December 31, 2007 was zero.

Interest of Management and their Family Members in Certain Transactions

There were no material related party transactions during 2007 or through the date of filing of this Form 20-F.

Item 8. Financial Information.

See Item 18: Financial Statements. If the Company decides to distribute a cash dividend out of income that has been tax exempt due to an “approved enterprise” status under the Law for the Encouragement of Capital Investments, 5719-1959, the amount of cash dividend will be subject to corporate tax at the rate then in effect under Israeli law. The Company has never declared or paid cash dividends on its Ordinary Shares and does not anticipate paying any cash dividends during 2008. The Company intends to retain future earnings to finance the development of its business.

We are not a party to any litigation, and we are not aware of any threatened litigation which, in the aggregate, would be material to the business of the Company.

Except as otherwise disclosed in this Annual Report, there has been no material change in our financial position since December 31, 2007.

Item 9. The Offer and Listing.

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

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

The Company continues to contemplate the filing of an application for admission to the Tel Aviv Stock Exchange, or “TASE”, which would result in the dual listing of its Ordinary Shares on the TASE and NASDAQ Capital Market. It is not certain that the Company will file such an application during 2008 or, if it does proceed with a filing, the TASE will approve the application.

The following table lists the high and low closing sales prices for the Company’s Ordinary Shares, for the periods indicated:

	High	Low
2003:	\$ 4.41	\$ 0.30
2004:	\$ 3.72	\$ 0.81
2005:	\$ 3.90	\$ 1.35
2006:	\$ 4.08	\$ 2.10
2007:	\$ 7.44	\$ 3.69
2006:		
First Quarter	\$ 4.08	\$ 2.79

Second Quarter	\$	3.54	\$	2.10
Third Quarter	\$	2.82	\$	2.22
Fourth Quarter	\$	3.60	\$	2.64

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2007:			
First Quarter	\$	4.80	\$ 3.69
Second Quarter	\$	6.15	\$ 4.41
Third Quarter	\$	7.44	\$ 4.89
Fourth Quarter	\$	7.41	\$ 5.73

Most Recent Six Months:

September 2007	\$	5.97	\$ 5.64
October 2007	\$	7.41	\$ 5.73
November 2007	\$	7.20	\$ 6.15
December 2007	\$	6.75	\$ 6.00
January 2008	\$	6.22	\$ 3.80
February 2008	\$	4.78	\$ 4.20

Item 10. Additional Information.

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

Neither the Amended and Restated Articles of Association of the Company nor the laws of the State of Israel restrict in any way the ownership or voting of Ordinary Shares by non-residents of Israel, except with respect to subjects of countries which are at a state of war with Israel.

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

DESCRIPTION OF SHARES

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

As of December 31, 2007 and as adjusted for the reverse split (one for three) on January 2, 2008, our authorized share capital consisted of 55,353,340 Ordinary Shares, NIS 0.15 par value. As of December 31, 2007, there were 25,346,042 Ordinary Shares issued and outstanding.

DESCRIPTION OF ORDINARY SHARES

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

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

DIVIDEND AND LIQUIDATION RIGHTS

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

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

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MODIFICATION OF CLASS RIGHTS

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

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

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

VOTING, SHAREHOLDER MEETINGS AND RESOLUTIONS

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

An annual general meeting must be held once every calendar year at such time (not more than 15 months after the last preceding annual general meeting) and at such place, either within or outside the State of Israel, as may be determined by the Board of Directors. The quorum required for a general meeting of shareholders consists of at least two shareholders present in person or by proxy and holding at least one-third of the voting rights of the issued share capital. A meeting adjourned for lack of a quorum may be adjourned to the same day in the next week at the same time and place, or to such time and place as the Board of Directors may determine in a notice to shareholders. At such reconvened meeting any two shareholders entitled to vote and present in person or by proxy will constitute a quorum. Generally, shareholder resolutions will be deemed adopted if approved by the holders of a majority of the voting power represented at the meeting, in person or by proxy, and voting thereon. For certain matters as described under the Israel Companies law, there is a requirement that the majority include the affirmative vote of at least one-third of the votes cast by shareholders who are not controlling shareholders of the Company or interested parties in the matter to be voted upon (or their representatives) or, alternatively, the total shareholdings of the votes cast against the proposal (other than by the Company’s controlling shareholders or interested parties in the matter to be voted upon) must not represent more than one percent of the voting rights in the Company.

ANTI-TAKEOVER PROVISIONS UNDER ISRAELI LAW

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

The Companies Law provides that an acquisition of shares in a public company must be made by means of a tender offer if as a result of the acquisition the purchaser would become a 25% shareholder of the company, unless there is already another 25% shareholder of the company. Similarly, the Companies Law provides that an acquisition of shares in a public company must be made by means of tender offer if as a result of the acquisition the purchaser would become a 45% shareholder of the company, unless someone else already holds 45% of the voting power of the company. These rules do not apply if the acquisition is made by way of a merger. Regulations promulgated under the Companies Law provide that these tender offer requirements do not apply to companies whose shares are listed for trading outside of Israel if, according to the law in the country in which the shares are traded, including the rules and

regulations of the stock exchange on which the shares are traded, either:

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- there is a limitation on acquisition of any level of control of the company; or
- the acquisition of any level of control requires the purchaser to do so by means of a tender offer to the public.

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

TRANSFER OF SHARES AND NOTICES

Fully paid Ordinary Shares that are issued and not subject to any legal restrictions on transference may be transferred freely. Each shareholder of record is entitled to receive at least twenty-one days' prior notice (and for certain matters, thirty-five days' prior notice) before the date of a shareholder meeting and at least five days notice before the record date for the meeting. For purposes of determining the shareholders entitled to notice and to vote at such meeting, the Board of Directors may fix a record date not exceeding 40 days prior to the date of any shareholder meeting.

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 by a majority of the votes of shareholders present by person or by proxy and voting at the shareholders meeting.

DESCRIPTION OF INVESTOR AND SERVICE PROVIDER WARRANTS

The following summarizes warrants outstanding as of December 31, 2007:

JANUARY 2003 CONVERTIBLE LOAN WARRANTS

The discussion regarding the January 2003 convertible loan warrants under Item 18, Note 5 to the Notes to Consolidated Financial Statements - Shareholders' Equity is incorporated herein by reference.

JULY 2003 INVESTMENT ROUNDS WARRANTS

The discussion regarding the two July 2003 investment rounds warrants under Item 18, Note 5 to the Notes to Consolidated Financial Statements - Shareholders' Equity is incorporated herein by reference.

MAY 2004 INVESTMENT ROUND WARRANTS

The discussion regarding the May 2004 investment round warrants under Item 18, Note 5 to the Notes to Consolidated Financial Statements - Shareholders' Equity is incorporated herein by reference.

OCTOBER 2005 INVESTMENT ROUND WARRANTS

The discussion regarding the October 2005 investment round warrants under Item 18, Note 6 to the Notes to Consolidated Financial Statements - Shareholders' Equity is incorporated herein by reference.

ADVISOR WARRANT

The discussion under Item 18, Note 6 to the Notes to Consolidated Financial Statements - Shareholders' Equity, regarding a warrant issued in relation to a small investment made by an advisor to the Company during May 2006, is incorporated herein by reference.

REGISTRATION RIGHTS

The Company has not granted registration rights within the two year period prior to the filing of this Form 20-F.

ACCESS TO INFORMATION

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

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

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

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

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

TRANSFER AGENT AND REGISTRAR

The transfer agent and registrar for our Ordinary Shares is Wells Fargo Bank, N.A. Shareowner Services of St. Paul, Minnesota.

MATERIAL CONTRACTS DURING PAST TWO YEARS

Equity Investment. Commtouch made a \$750 thousand investment in Mirapoint, a secure messaging vendor and an OEM licensee, as part of Mirapoint's larger financing round in the fourth quarter of 2007. In connection therewith, Commtouch received a minority ownership interest in Mirapoint of approximately 8%.

Amended and Restated Articles of Association

See the discussion under Item 4 “Information on the Company- Overview” for instructions on how to locate the Company’s Amended and Restated Articles of Association. In addition, the Articles are incorporated by reference to this Form 20-F under Exhibit 1.2 below.

ISRAELI TAXATION AND INVESTMENT PROGRAMS

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

General Corporate Tax Structure

Generally, Israeli companies are subject to “Corporate Tax” on their taxable income. On July 25, 2005, the Knesset (Israeli Parliament) approved the Law of the Amendment of the Income Tax Ordinance (No. 147), 2005, which prescribes, among others, a gradual decrease in the corporate tax rate in Israel to the following tax rates: in 2006 - 31%, in 2007 - 29%, in 2008 - 27%, in 2009 - 26% and in 2010 and thereafter - 25%. 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 Industry (Taxes), 1969

The Law for the Encouragement of Industry (Taxes), 1969, generally referred to as the Industry Encouragement Law, provides several tax benefits for industrial companies. An industrial company is defined as a company resident in Israel, at least 90% of the income of which in a given tax year exclusive of income from specified government loans, capital gains, interest and dividends, is derived from an industrial enterprise owned by it. An industrial enterprise is defined as an enterprise whose major activity in a given tax year is industrial production activity.

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

- deduction of purchase of know-how and patents and/or right to use a patent over an eight-year period ;
- the right to elect, under specified conditions, to file a consolidated tax return with additional related Israeli industrial companies and an industrial holding company;
- accelerated depreciation rates on equipment and buildings.
- Expenses related to a public offering on TA stock exchange and as of 1.1.2003 on recognized stock markets outside of Israel, are deductible in equal amounts over three years.

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

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

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

Special Provisions Relating to Measurement of Taxable Income

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

- Where a company's equity, as calculated under the Inflationary Adjustments Law, exceeds the depreciated cost of its fixed assets (as defined in the Inflationary Adjustments Law), a deduction from taxable income is permitted equal to the excess multiplied by the applicable annual rate of inflation. The maximum deduction permitted in any single tax year is 70% of taxable income, with the unused portion permitted to be carried forward, linked to the Israeli consumer price index. The unused portion that was carried forward may be deductible in full in the following year.
- Where a company's depreciated cost of fixed assets exceeds its equity, then the excess multiplied by the applicable annual rate of inflation is added to taxable income. (hereinafter: "**Inflation supplement**"). Note, the inflation supplement will only be added to the corporate income but not to other incomes such as capital gains.
- Subject to specified limitations, depreciation deductions on fixed assets and losses carried forward are adjusted for inflation based on the change in the consumer price index.

The Minister of Finance may, with the approval of the Knesset Finance Committee, determine by decree, during a certain fiscal year (or until February 28th of the following year) in which the rate of increase of the Israeli consumer price index would not exceed or did not exceed, as applicable, 3.0%, that some or all of the provisions of the Inflationary Adjustments Law shall not apply with respect to such fiscal year, or that the rate of increase of the Israeli consumer price index relating to such fiscal year shall be deemed to be 0%, and to make the adjustments required to be made as a result of such determination

Tax Benefits of Research and Development

Israeli tax law permits, under some conditions, a tax deduction in the year incurred for expenditures, including capital expenditures, in scientific research and development projects, if the expenditures are approved by the relevant government ministry and if the research and development is for the promotion of the enterprise and is carried out by, or on behalf of, a company seeking the deduction.

The OCS has approved some of our research and development programs and we have been able to deduct, for tax purposes, a portion of our research and development expenses net of the grants received. Other research and development expenses that are not approved may be deducted for tax purposes in 3 equal installments during a 3-year period.

Capital Gains Tax on Sales of Our Ordinary Shares

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

As of January 1, 2006, the tax rate applicable to capital gains derived from the sale of shares, whether listed on a stock market or not, is 20% for Israeli individuals, unless such shareholder claims a deduction for financing expenses in connection with such shares, in which case the gain will generally be taxed at a rate of 25%. Additionally, if such shareholder is considered a "material shareholder" at any time during the 12-month period preceding such sale, i.e., such shareholder holds directly or indirectly, including with others, at least 10% of any means of control in the company, the tax rate shall be 25%. Israeli companies are subject to the Corporate Tax rate on capital gains derived from the sale of shares, unless such companies were not subject to the Adjustments Law (or certain regulations) at the time of

publication of the aforementioned amendment to the Tax Ordinance that came into effect on January 1, 2006, in which case the applicable tax rate is 25%. However, the foregoing tax rates do not apply to: (i) dealers in securities; and (ii) shareholders who acquired their shares prior to an initial public offering (that may be subject to a different tax arrangement).

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

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

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

Taxation of Non-Resident Holders of Shares

Non-residents of Israel are subject to income tax on income accrued or derived from sources in Israel. Such sources of income include passive income such as dividends, royalties and interest, as well as non-passive income from services rendered in Israel. On distributions of dividends other than bonus shares, or stock dividends, income tax is withheld at the source at the following rates: for dividends distributed on or after January 1, 2006 - 20%, or 25% for a shareholder that is considered a “material shareholder” at any time during the 12-month period preceding such distribution, unless a different rate is provided in a treaty between Israel and the shareholder’s country of residence. Under the U.S.-Israel Tax Treaty, the maximum tax on dividends paid to a holder of ordinary shares who is a Treaty U.S. Resident is 25%. However, under the Investments Law, dividends generated by an Approved Enterprise (or Benefited Enterprise) are taxed at the rate of 15%. Furthermore, dividends not generated by an Approved Enterprise (or Benefited Enterprise) paid to a U.S. corporation holding at least 10% of our issued voting power during the part of the tax year which precedes the date of payment of the dividend and during the whole of its prior tax year, are generally taxed at a rate of 12.5%.

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

U.S. TAX CONSIDERATIONS REGARDING ORDINARY SHARES ACQUIRED BY U.S. TAXPAYERS

The following discussion summarizes the material U.S. federal income tax consequences arising from the purchase, ownership and sale of the Ordinary Shares. This summary is based on the provisions of the Internal Revenue Code of 1986, as amended (the “Code”), final, temporary and proposed U.S. Treasury Regulations promulgated thereunder, and administrative and judicial interpretations thereof, in effect as of the date of this report, all of which are subject to change, possibly with retroactive effect. Commtouch will not seek a ruling from the Internal Revenue Service with

regard to the United States federal income tax treatment relating to investment in the Ordinary Shares and, therefore, no assurance exists that the Internal Revenue Service will agree with the conclusions set forth below. The summary below does not purport to address all of the U.S. federal income tax consequences that may be relevant to particular investors. This summary does not address the consequences that may be applicable to particular classes of taxpayers, including investors that hold Ordinary Shares as a hedge, part of a hedge, straddle~~or~~, conversion or constructive sale transaction, life insurance companies, banks, regulated investment companies, or other financial institutions or a “financial services entity”, broker- or dealers in securities or foreign currency, tax-exempt organizations, persons that acquire Ordinary Shares in connection with employment or other performance of services, real estate investments, investors that have a functional currency other than the U.S. dollar, and investors who own (directly, indirectly or through attribution) 10% or more of Commtouch’s outstanding voting stock. Further, it does not address the alternative minimum tax consequences of an investment in Ordinary Shares or the indirect consequences to U.S. Holders, as defined below, of equity interests in investors in Ordinary Shares. This summary is addressed only to holders that hold Ordinary Shares as a capital asset within the meaning of Section 1221 of the Code, are U.S. citizens, individuals resident in the United States for purposes of U.S. federal income tax, domestic corporations or partnerships and estates or trusts treated as “United States persons” under Section 7701 of the Code (“U.S. Holders”). This summary also does not address state, local or non-U.S. taxes.

EACH INVESTOR SHOULD CONSULT WITH HIS OR HER OWN TAX ADVISOR AS TO THE PARTICULAR U.S. FEDERAL INCOME TAX CONSEQUENCES OF THE PURCHASE, OWNERSHIP AND SALE OF ORDINARY SHARES, INCLUDING THE EFFECTS OF APPLICABLE STATE, LOCAL, FOREIGN OR OTHER TAX LAWS AND POSSIBLE CHANGES IN THE TAX LAWS.

Tax Basis of Ordinary Shares

A U.S. Holder's tax basis in his or her Ordinary Shares will be the purchase price paid therefore by such U.S. Holder. The holding period of each Ordinary Share owned by a U.S. Holder will commence on the day following the date of the U.S. Holder's purchase of such Ordinary Share and will include the day on which such U.S. Holder sells the Ordinary Share.

Sale or Exchange of Ordinary Shares

A U.S. Holder's sale or exchange of Ordinary Shares will generally result in the recognition of gain or loss by such U.S. Holder in an amount equal to the difference between the amount realized and the U.S. Holder's basis in the Ordinary Shares sold. Subject to the following discussion of the consequences of Commtouch being treated as a Passive Foreign Investment Company or a Foreign Investment Company, such gain or loss will be capital gain or loss if such Ordinary Shares are a capital asset in the hands of the U.S. Holder. Gain or loss realized on the sale of Ordinary Shares will be long-term capital gain or loss if the Ordinary Shares sold had been held for more than one year at the time of their sale. Long-term capital gains recognized by certain taxpayers generally are subject to a reduced rate of U.S. federal tax (currently a maximum of 15%). If the U.S. Holder's holding period on the date of the sale or exchange was one year or less, such gain or loss will be short-term capital gain or loss. Short-term capital gains generally are subject to tax at the same rates as ordinary income. In general, any capital gain recognized by a U.S. Holder upon the sale or exchange of Ordinary Shares will be treated as U.S.-source income for U.S. foreign tax credit purposes.

See discussion under this Item 10 "Israeli Taxation and Investment Programs—Capital Gains and Income Taxes Applicable to Non-Israeli Shareholders" for a discussion of taxation by Israel of capital gains realized on sales of capital assets.

Taxation of Dividends Paid On Ordinary Shares

A U.S. Holder will be required to include in gross income as ordinary income the amount of any distribution paid on Ordinary Shares, including any Israeli taxes withheld from the amount paid, to the extent the distribution is paid out of our current or accumulated earnings and profits as determined for U.S. federal income tax purposes. Distributions in excess of these earnings and profits will be applied against and will reduce the U.S. Holder's basis in the Ordinary Shares and, to the extent in excess of this basis, will be treated as gain from the sale or exchange of Ordinary Shares.

Previously enacted amendments to the Code provide that dividend income may be eligible for a reduced rate of taxation. Dividend income will be taxed at the applicable long-term capital gains rate if the dividend is received from a "qualified foreign corporation," and the shareholder of such foreign corporation holds such stock for more than 61 days during the 120 day period that begins on the date that is 60 days before the ex-dividend date for the stock. The holding period is tolled for any days on which the shareholder has reduced his risk of loss. A "qualified foreign corporation" is one that is eligible for the benefits of a comprehensive income tax treaty with the United States. A foreign corporation will be treated as qualified with respect to any dividend paid, if its stock is readily tradable on an established securities market. However, a foreign corporation will not be treated as a qualified foreign corporation if it is a Passive Foreign Investment Company (as discussed below) for the year in which the dividend was paid or the preceding year.

Distributions of current or accumulated earnings and profits paid in foreign currency to a U.S. Holder will be includible in the income of a U.S. Holder in a U.S. dollar amount calculated by reference to the exchange rate on the day the distribution is received. A U.S. Holder that receives a foreign currency distribution and converts the foreign currency into U.S. dollars subsequent to receipt will have foreign exchange gain or loss based on any appreciation or depreciation in the value of the foreign currency against the U.S. dollar, which will generally be U.S. source ordinary income or loss.

As described above, we will generally be required to withhold Israeli income tax from any dividends paid to holders who are not resident in Israel. See "Israeli Tax Considerations — Taxation of Non-Resident Holders of Shares." If a U.S. Holder receives a dividend from Commtouch that is subject to Israeli withholding, the following would apply:

- You must include the gross amount of the dividend, not reduced by the amount of Israeli tax withheld, in your U.S. taxable income.
- You may be able to claim the Israeli tax withheld as a foreign tax credit against your U.S. federal income tax liability.
- The foreign tax credit is subject to significant and complex limitations. Generally, the credit can offset only the part of your U.S. tax attributable to your net foreign source passive income. Additional special rules apply to taxpayers predominantly engaged in the active conduct of a banking, insurance, financing or similar business. Additionally, if we pay dividends at a time when 50% or more of our stock is owned by U.S. persons, you may be required to treat the part of the dividend attributable to U.S. source earnings and profits as U.S. source income, possibly reducing the allowable credit, unless you elect to calculate your foreign tax credit separately with respect to Commtouch dividends.
- 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 the U.S. Holder has not held the Ordinary Shares for at least 16 days of the 31-day period beginning on the date which is 15 days before the ex-dividend date or to the extent the 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. A U.S. Holder will also be denied a foreign tax credit if the U.S. Holder's reasonably expected economic profit is insubstantial compared to the foreign taxes expected to be paid or accrued.
- If you do not elect to claim foreign taxes as a credit, you will be entitled to deduct the Israeli income tax withheld from your Commtouch dividends in determining your taxable income. The rules relating to the determination of the U.S. foreign tax credit are complex, and U.S. Holders should consult their own tax advisors to determine whether and to what extent they would be entitled to such credit. Individuals who do not claim itemized deductions, but instead utilize the standard deduction, may not claim a deduction for the amount of the Israeli income taxes withheld.
- If you are a U.S. corporation holding our stock, you cannot claim the dividends-received deduction with respect to our dividends.

Special rules, described below, apply if Commtouch is a passive foreign investment company.

Information Reporting and Backup Withholding

U.S. Holders generally are subject to information reporting requirements with respect to dividends paid in the United States on Ordinary Shares. Existing regulations impose back-up withholding on dividends paid in the United States on

Ordinary Shares unless the U.S. Holder provides IRS Form W-9 or otherwise establishes an exemption. U.S. Holders are subject to information reporting and back-up withholding at a rate of 28% on proceeds paid from the disposition of Ordinary Shares unless the U.S. Holder provides IRS Form W-9 or otherwise establishes an exemption.

Backup withholding will not apply with respect to payments made to certain exempt recipients, such as corporations and tax exempt organizations.

Non-U.S. Holders generally are not subject to information reporting or back-up withholding with respect to dividends paid on, or upon the disposition of, Ordinary Shares, provided that the non-U.S. Holder provides taxpayer identification number, certifies to its foreign status, or otherwise establishes an exemption.

Prospective investors should consult their tax advisors concerning the effect, if any, of these Treasury regulations on an investment in Ordinary Shares. The amount of any back-up withholding will be allowed as a credit against a U.S. or Non-U.S. Holder's United States federal income tax liability and may entitle the Holder to a refund, provided that specified required information is furnished to the IRS.

Tax Consequences If We Are a Passive Foreign Investment Company

Generally, a foreign corporation is treated as a passive foreign investment company ("PFIC") for U.S. federal income tax purposes for any tax year if, in such tax year, either (i) 75% or more of its gross income (including its pro rata share of gross income for any company (U.S. or foreign) in which it is considered to own 25% or more of the shares by value), is passive in nature (the "Income Test"), or (ii) the average percentage of its assets during such tax year (including its pro rata share of the assets of any Company (U.S. or foreign) in which it is considered to own 25% or more of the shares by value), that produce, or are held for the production of, passive income (determined by averaging the percentage of the fair market value of its total assets which are passive assets as of the end of each quarter of such year) is 50% or more (the "Asset Test").

Because less than 75% of our gross income in 2007 and in prior years constituted passive income, as defined for purposes of the Income Test, we do not believe that application of the Income Test would have resulted in our classification as a PFIC for any of such years.

For 2003, 2004, 2005, 2006 and 2007, however, it is possible that we could be classified as a PFIC under the Asset Test principally because a significant portion of our assets continued to consist of the cash raised in connection with both a public offering and a private offering of our Ordinary Shares in 2000, coupled with the decline in the public market value of our Ordinary Shares during 2001, 2002 and through the beginning of 2003 and the timing of the required valuations, although there is no definitive method prescribed in the Code, United States Treasury Regulations or administrative or judicial interpretations thereof for determining the value of a foreign corporation's assets for purposes of the Asset Test. While the legislative history of the United States Taxpayer Relief Act of 1997 indicates that "the total value of a publicly-traded foreign corporation's assets generally will be treated as equal to the sum of the aggregate value of its outstanding stock plus its liabilities", there remains substantial uncertainty regarding the valuation of a publicly-traded foreign corporation's assets for purposes of the Asset Test, and it is theoretically arguable that under alternative valuation methodologies, the value of our total assets as of the relevant valuation dates in 2003, 2004, 2005, 2006 and/or 2007 would not result in our classification as a PFIC during any or all of such years.

In view of the uncertainty regarding the valuation of our assets for purposes of the Asset Test and the complexity of the issues regarding our treatment as a PFIC, U.S. Shareholders are urged to consult their own tax advisors for guidance as to our status as a PFIC. For those U.S. Shareholders who determine that we were a PFIC and notify us in writing of their request for the information required in order to effectuate the QEF Election described below, we will promptly make such information available to them.

If we are treated as a PFIC for United States federal income tax purposes for any year during a U.S. Shareholder's holding period of Ordinary Shares and the U.S. Shareholder does not make a QEF Election or a "mark-to-market" election (both as described below), any gain recognized by the U.S. Shareholder upon the sale of Ordinary Shares (or the receipt of certain distributions) would be treated as ordinary income. This income would be allocated over the U.S.

Shareholder's holding period with respect to his Ordinary Shares and an interest charge would be imposed on the amount of deferred tax on the income allocated to prior taxable years.

Although we generally will be treated as a PFIC as to any U.S. Shareholder if we are a PFIC for any year during the U.S. Shareholder's holding period, if we cease to satisfy the requirements for PFIC classification, then under such circumstances, the U.S. Shareholder may avoid the consequences of PFIC classification for subsequent years if he elects to recognize gain based on the unrealized appreciation in the Ordinary Shares through the close of the tax year in which we cease to be a PFIC. Additionally, if we are treated as a PFIC, a U.S. Shareholder who acquires Ordinary Shares from a decedent would be denied the normally available step-up in tax basis for these Ordinary Shares to fair market value at the date of death and instead would have a tax basis equal to the decedent's tax basis in these Ordinary Shares.

For any tax year in which we are treated as a PFIC, a U.S. Shareholder may elect to treat his Ordinary Shares as an interest in a qualified electing fund (a “QEF Election”), in which case, the U.S. Shareholder would be required to include in income currently his proportionate share of our earnings and profits in years in which we are a PFIC regardless of whether distributions of our earnings and profits are actually distributed to the U.S. Shareholder. Any gain subsequently recognized upon the sale by the U.S. Shareholder of his Ordinary Shares, however, generally would be taxed as capital gain.

As an alternative to a QEF Election, a U.S. Shareholder may elect to mark his Ordinary Shares to market annually, recognizing ordinary income or loss (subject to certain limitations) equal to the difference between the fair market value of his Ordinary Shares and the adjusted tax basis of his Ordinary Shares. Losses would be allowed only to the extent of net mark-to-market gain accrued under the election.

We cannot assure you that we have not been or are not a PFIC or will avoid becoming a PFIC. U.S. holders who hold Ordinary Shares during a period when we are a PFIC will be subject to the foregoing rules, even if we cease to be a PFIC. U.S. Holders are urged to consult their tax advisors about the PFIC rules, including QEF elections.

Item 11. Qualitative and Quantitative Disclosure about Market Risk.

We develop our technology in Israel and seek to provide our services worldwide. As a result, our foreign currency exposures give rise to market risk associated with exchange rate movements of the U.S. dollar, our functional and reporting currency, against the shekel. We are exposed to the risk of fluctuation in the U.S. dollar/shekel exchange rate. Our shekel-denominated expenses consist principally of salaries and related personnel expenses, as well as vehicle lease payments. Neither a ten percent increase nor decrease in current exchange rates would have a material effect on our consolidated financial statements in the next six months.

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

Therefore, no quantitative tabular disclosures are provided.

Item 12. Description of Securities Other than Equity Securities.

Not applicable.

PART II

Item 13. Defaults, Dividend Arrearages and Delinquencies.

Not applicable.

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

Other than the reverse stock split described elsewhere in this report, this item is not applicable for the period since January 1, 2007 to date.

Item 15. Controls and Procedures.

(a) As of December 31, 2007, we performed an evaluation under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Exchange Act). Our management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and our management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective as of December 31, 2007, to provide reasonable assurance that the information required to be disclosed in filings and submissions under the Exchange Act, is recorded, processed, summarized, and reported within the time periods specified by the SEC's rules and forms, and that such information related to us and our consolidated subsidiaries is accumulated and communicated to management, including the Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions about required disclosure.

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

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

Our management assessed our internal control over financial reporting as of December 31, 2007. Our management based its assessment on criteria established in Internal Control- Integrated Framework issued by the Committee of Sponsoring Organization of the Treadway Commission. Based on this assessment, our management has concluded that, as of December 31, 2007, our internal control over financial reporting is effective.

(d) Our independent registered public accounting firm, Kost, Forer, Gabbay & Kasierer, a member of Ernst & Young Global, audited management's assessment and independently assessed the effectiveness of the Company's internal control over financial reporting. Kost, Forer, Gabbay & Kasierer, a member of Ernst & Young Global, has issued an attestation report concurring with management's assessment, which is included under Item 18 on page F-3, F-4 of this annual report.

(e) During the period covered by this annual report on Form 20-F, there were no changes to our internal control over financial reporting that occurred during the year ended December 31, 2007 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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

The Board of Directors of the Company has determined that Mr. Ofer Segev, a member of the Audit Committee, is an audit committee financial expert as that term is defined in Item 16A of Form 20-F and is independent as that term is defined in each of NASDAQ Marketplace Rule 4200(a)(15) and SEC Rule 10A-3(b)(1). Mr. Segev's term on the Board and Audit Committee will expire in March 2008. At that time, it is expected that Mr. Yair Shamir will replace Mr. Segev as a Board member and audit committee financial expert.

Item 16B. Code of Ethics.

The Company, by way of Board of Directors resolution, has adopted a Code of Ethics applicable to its senior financial officers, including its principal executive, financial and accounting officers. The Code of Ethics is posted on the Company's website at www.commtouch.com, under the link to "investor relations".

Item 16C. Principal Accountant Fees and Services.

Kost, Forer, Gabbay & Kasierer, a member of Ernst & Young Global, has served as our Independent Registered Public Accounting Firm for each of the fiscal years in the three-year period ended December 31, 2007, for which audited financial statements appear in this annual report on Form 20-F. The following table presents the aggregate fees for professional and other services rendered by Kost, Forer, Gabbay & Kasierer for 2007 and 2006:

	Year ended December 31,	
	2007	2006
	Fees	Fees
Audit fees (1)	\$ 107,000	\$ 92,000
Tax and other (2)	\$ 72,500	\$ 88,500
Total	\$ 179,500	\$ 180,500

(1) Audit fees consist of fees billed for the annual audit services engagement and other audit services, which are those services that only the Independent Registered Public Accounting Firm can reasonably provide, and include the group audit including checking our internal control over Financial reporting; statutory audits; consents; attest services; and assistance in connection with documents filed with the SEC. These fees also include the attestation of our internal control over financial reporting

(2) Tax fees include fees billed for tax compliance services, including the preparation of original and amended tax returns and claims for refund; tax consultations, such as assistance and representation in connection with tax audits and appeals, transfer pricing, and requests for rulings or technical advice from taxing authority; and tax planning services.

Audit Committee Pre-approval Policies and Procedures

Below is a summary of our current Policies and Procedures:

The main role of the Company's audit committee is to assist the Board of Directors in fulfilling its responsibility for oversight of the quality and integrity of the accounting, auditing and reporting practices of the Company. The Audit Committee oversees the appointment, compensation, and oversight of the Company's independent registered public accounting firm engaged to prepare or issue an audit report on the financial statements of the Company. The audit

committee's specific responsibilities in carrying out its oversight role include the approval of all audit and non-audit services to be provided by the external auditor and the quarterly review of the firm's non-audit services and related fees. These services may include audit services, audit-related services, tax services and other services, as described above. It is the policy of the audit committee to approve in advance the particular services or categories of services to be provided to the Company periodically. Additional services may be pre-approved by the audit committee on an individual basis during the year. The audit committee did not avail itself of section (c)(7)(i)(C) of Rule 2-01 of Regulation S-X during 2007, which allows for an exemption from the pre-approval process under certain limited circumstances.

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

Not applicable.

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

Not applicable.

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PART III

Item 17. Financial Statements.

The Company has responded to Item 18

Item 18. Financial Statements.

(a) Financial Statements

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(b) Financial Statement Schedule:

Schedules have been omitted because the information required to be set forth therein is not applicable or is shown in the consolidated financial statements or notes thereto.

COMMTOUCH SOFTWARE LTD. AND ITS SUBSIDIARY

CONSOLIDATED FINANCIAL STATEMENTS

AS OF DECEMBER 31, 2007

U.S. DOLLARS IN THOUSANDS

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of

COMMTOUCH SOFTWARE LTD.

We have audited the accompanying consolidated balance sheets of Commtouch Software Ltd. ("the Company") and its subsidiary as of December 31, 2006 and 2007, 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, 2007. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company and its subsidiary as of December 31, 2006 and 2007, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2007, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 2 to the consolidated financial statements, in 2006 the Company adopted Statement of Financial Accounting Standards Board No. 123 (R), "Share-Based Payment".

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company and its subsidiary's internal control over financial reporting as of December 31, 2007, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 31, 2008 expressed an unqualified opinion thereon.

Tel-Aviv, Israel

March 31, 2008

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

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of

COMMTOUCH SOFTWARE LTD.

We have audited Commtouch Software Ltd.'s and its subsidiary ("Commtouch" or the "Company") internal control over financial reporting as of December 31, 2007, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the "COSO criteria"). Commtouch's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting 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 effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Commtouch maintained in all material respects, effective internal control over financial reporting as of December 31, 2007, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Commtouch and its subsidiary as of December 31, 2006 and 2007, 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, 2007 and our report dated March 31, 2008 expressed an unqualified opinion thereon.

Tel-Aviv, Israel

March 31, 2008

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

COMMTOUCH SOFTWARE LTD. AND ITS SUBSIDIARY

CONSOLIDATED BALANCE SHEETS

U.S. dollars in thousands

	December 31	
	2006	2007
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 8,004	\$ 10,807
Short-term cash deposit	-	1,600
Marketable securities	2,000	2,000
Trade receivables	570	1,110
Prepaid expenses	134	193
Other accounts receivable	62	110
Total current assets	10,770	15,820
LONG-TERM ASSETS:		
Long-term lease deposits	13	33
Investment in affiliate	-	750
Severance pay fund	607	821
Property and equipment, net	609	786
Total long-term assets	1,229	2,390
Total assets	\$ 11,999	\$ 18,210

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

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COMMTOUCH SOFTWARE LTD. AND ITS SUBSIDIARY

CONSOLIDATED BALANCE SHEETS

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

	December 31	
	2006	2007
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accounts payable	\$ 344	\$ 335
Employees and payroll accruals	503	746
Accrued expenses and other liabilities	187	351
Government authorities	192	64
Deferred revenues	2,032	2,534
Total current liabilities	3,258	4,030
LONG-TERM LIABILITIES:		
Long-term deferred revenues	542	901
Accrued severance pay	706	931
Total long-term liabilities	1,248	1,832
COMMITMENTS AND CONTINGENCIES		
SHAREHOLDERS' EQUITY:		
Ordinary shares nominal value NIS 0.15 par value- Authorized: 55,353,340 shares as of December 31, 2006 and 2007, respectively; Issued and outstanding: 24,011,155 and 25,346,042 shares as of December 31, 2006 and 2007, respectively	845	893
Additional paid-in capital	177,095	179,793
Accumulated other comprehensive income	23	23
Accumulated deficit	(170,470)	(168,361)
Total shareholders' equity	7,493	12,348
Total liabilities and shareholders' equity	\$ 11,999	\$ 18,210

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

COMMTouch SOFTWARE LTD. AND ITS SUBSIDIARY

CONSOLIDATED STATEMENTS OF OPERATIONS

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

	Year ended December 31,		
	2005	2006	2007
Revenues	\$ 3,925	\$ 7,234	\$ 11,250
Cost of revenues	700	901	1,411
Gross profit	3,225	6,333	9,839
Operating expenses:			
Research and development	1,524	1,763	2,187
Sales and marketing	2,476	2,686	3,453
General and administrative	1,881	2,299	2,589
Total operating expenses	5,881	6,748	8,229
Operating income (loss)	(2,656)	(415)	1,610
Financial income (expenses), net	141	274	527
Equity in losses of affiliate	(175)	(49)	-
Net income (loss) before taxes on income	(2,690)	(190)	2,137
Taxes on income	-	-	28
Amortization of beneficial conversion feature relating to convertible Series A Preferred shares	(1,751)	-	-
Net income (loss) attributable to Ordinary and equivalently participating shareholders	\$ (4,441)	\$ (190)	\$ 2,109
Basic and diluted net earnings (loss) per share	\$ (0.28)	\$ (0.01)	\$ 0.08
Weighted average number of shares used in computing basic net earnings (loss) per share	15,801,945	22,112,944	24,846,690
Weighted average numbers of shares used in computing diluted net earnings (loss) per share	15,801,945	22,112,994	27,591,498

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

**COMMTOUCH SOFTWARE LTD. AND ITS SUBSIDIARY
STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY**

U.S. dollars in thousands, except share data

	Series A Preferred		Series A Ordinary		Accumulated			Total	
	shares	amount	shares	amount	paid-in capital	comprehensive income	accumulated deficit	comprehensive loss	Total
Balance as of January 1, 2005	2,426,667	\$ 83	14,262,608	\$ 520	\$ 167,784	\$ 45	\$ (165,839)		\$ 2,593
Issuance of shares and warrants, net	-	-	2,000,000	65	2,857	-	-		2,922
Issuance of shares upon exercise of options and warrants	-	-	1,232,723	43	1,263	-	-		1,306
Conversion of Series A Preferred shares to Ordinary shares	(650,000)	(22)	1,133,333	36	(14)	-	-		-
Amortization of beneficial conversion feature relating to Convertible Series A Preferred Shares	-	-	-	-	1,751	-	(1,751)		-
Stock-based compensation related to options granted to non-employees									92
Foreign currency translation adjustment	-	-	-	-	-	(24)	-	\$ (24)	(24)
Net loss	-	-	-	-	-	-	(2,690)	(2,690)	(2,690)
Total comprehensive loss								\$ (2,714)	
Balance as of December 31, 2005	1,776,667	\$ 61	18,628,664	\$ 664	\$ 173,733	\$ 21	\$ (170,280)		\$ 4,199

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

COMMTOUCH SOFTWARE LTD. AND ITS SUBSIDIARY
STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

U.S. dollars in thousands, except share data

	Series A Preferred shares	Series A Preferred shares amount	Ordinary shares	Ordinary shares amount	Additional paid-in capital	Accumulated other comprehensive income	Accumulated deficit	Total comprehensive loss
Balance as of January 1, 2006	1,776,667	\$61	18,628,664	\$664	\$173,733	\$21	\$(170,280)	
Issuance of shares	-	-	31,153	1	99	-	-	
Issuance of shares upon exercise of options and warrants	-	-	1,798,005	58	2,379	-	-	
Conversion of Series A Preferred shares to Ordinary Shares	(1,776,667)	(61)	3,553,333	122	(61)	-	-	
Stock-based compensation related to employees	-	-	-	-	790	-	-	
Stock-based compensation related to options granted to non-employees	-	-	-	-	155	-	-	
Foreign currency translation adjustment	-	-	-	-	-	2	-	\$ 2
Net loss	-	-	-	-	-	-	(190)	(190)
Total comprehensive loss								\$(188)
Balance as of December 31, 2006	-	\$ -	24,011,155	\$ 845	\$ 177,095	\$ 23	\$(170,470)	

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

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COMMTouch SOFTWARE LTD. AND ITS SUBSIDIARY

STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

U.S. dollars in thousands, except share data

	Ordinary shares	Ordinary shares amount	Additional paid-in capital	Accumulated other comprehensive income *)	Accumulated deficit	Total comprehensive income	Total
Balance as of January 1, 2007	24,011,155	\$ 845	\$ 177,095	\$ 23	\$(170,470)	\$ -	\$ 7,493
Issuance of shares upon exercise of options and warrants	1,334,887	48	1,615	-	-	-	1,663
Stock-based compensation related to employees	-	-	1,015	-	-	-	1,015
Stock-based compensation related to options granted to non-employees	-	-	68	-	-	-	68
Net income					2,109	\$ 2,109	2,109
Total comprehensive income						\$ 2,109	
Balance as of December 31, 2007	25,346,042	\$ 893	\$ 179,793	\$ 23	\$(168,361)		\$ 12,348

*) Relates to foreign currency translation adjustments

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

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COMMTouch SOFTWARE LTD. AND ITS SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

	Year ended December 31,		
	2005	2006	2007
Cash flows from operating activities:			
Net income (loss)	\$ (4,441)	\$ (190)	\$ 2,109
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Depreciation and amortization	147	209	397
Amortization of convertible loan discount and beneficial conversion feature	1,751	-	-
Compensation related to options granted to employees and non-employees	92	945	1,083
Equity in losses of affiliate	175	49	-
Changes in assets and liabilities:			
Increase in trade receivables	(258)	(215)	(540)
Increase in prepaid expenses and other accounts receivable	(21)	(28)	(107)
Increase (decrease) in accounts payable	76	(40)	24
Increase (decrease) in employees and payroll accruals, accrued expenses and other liabilities and Government authorities	41	(37)	279
Increase in deferred revenues	719	655	861
Increase in accrued severance pay, net	11	8	11
Other	(7)	-	(2)
Net cash provided by (used in) operating activities	(1,715)	1,356	4,115
Cash flows from investing activities:			
Change in short-term cash deposit	-	-	(1,600)
Decrease (increase) in long-term lease deposits	-	5	(20)
Purchase of marketable securities	(2,500)	-	-
Sale of marketable securities	-	500	-
Investment in affiliate	-	-	(750)
Purchase of property and equipment	(176)	(380)	(605)
Net cash provided by (used in) investing activities	(2,676)	125	(2,975)
Cash flows from financing activities:			
Proceeds from issuance of shares and warrants, net	2,922	100	-
Proceeds from options and warrants exercised	1,306	2,437	1,663
Net cash provided by financing activities	4,228	2,537	1,663
Increase (decrease) in cash and cash equivalents	(163)	4,018	2,803

Cash and cash equivalents at the beginning of the year	4,149	3,986	8,004
Cash and cash equivalents at the end of the year	\$ 3,986	\$ 8,004	\$ 10,807

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

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COMMTOUCH SOFTWARE LTD. AND ITS SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

	Year ended December 31,		
	2005	2006	2007
(a) Non-cash transactions:			
Amortization of beneficial conversion feature relating to convertible Series A Preferred Shares	\$ (1,751)	\$ -	\$ -
Conversion of Series A Preferred shares to Ordinary shares	\$ 36	\$ 122	\$ -
Purchase of property and equipment - trade payables	\$ -	\$ (33)	\$ 65

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COMMTOUCH SOFTWARE LTD. AND ITS SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 1: GENERAL

- a. Commtouch Software Ltd. ("Commtouch" or the Company") was incorporated under the laws of Israel in 1991. The Company and its subsidiary (Commtouch Inc.) develop and provide email defense solutions to OEM licensees and enterprises. During 2005, 2006 and 2007, the Company's business was to develop and sell, through a variety of third party distribution channels, email defense solutions to various customers. The Company's email defense solutions are comprised of anti-spam, Zero-Hour anti-virus and GlobalView Mail Reputation solutions.
- b. During the second half of 2003, the Company launched its first anti-spam solution, and began generating revenues therefrom. During 2004, the Company launched its Zero Hour solution, and began recognizing revenues from this product. During 2005, the Company also began to recognize revenues from its patent licensing program. These revenues were not significant during 2006 and 2007. In late 2006, the Company launched its GlobalView Reputation Services.
- c. The Company expects that it will continue to be dependent upon third party distribution channels for a significant portion of its revenues, which are expected to be derived from sales of the Company's anti-spam, anti-virus solutions and reputation services. See Note 7c for Company's major customer.
- d. Subsequent to balance sheet date, the Company consummated a 3:1 revenue stock split of the Company's share capital, see Note 5a.

NOTE 2: SIGNIFICANT ACCOUNTING POLICIES

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

a. Use of estimates:

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

b. Financial statements in U. S. dollars:

A majority of the revenues of the Company and its subsidiary is generated in United States dollars ("dollars"). In addition, a substantial portion of their costs is incurred or determined in dollars. The Company's management believes that the dollar is the currency of the primary economic environment in which the Company and its subsidiary operate. Thus, 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 ("SFAS") No. 52, "Foreign Currency Translation" ("SFAS No. 52"). All transaction gains and losses of the remeasured monetary balance sheet items are reflected in the statements of operations as financial income or expenses, as appropriate.

COMMTOUCH SOFTWARE LTD. AND ITS SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 2: SIGNIFICANT ACCOUNTING POLICIES (Cont.)

The financial statements of the Company's affiliate, Imatrix Inc. ("Imatrix"), are reported using the equity method of accounting for the year ended December 31, 2007. Imatrix's functional currency is not the dollar. The results have been translated into dollars in accordance with SFAS No. 52. The resulting aggregate translation adjustments are reported as foreign currency translation adjustment under accumulated other comprehensive income (loss) in shareholders' equity.

c. Principles of consolidation:

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

d. Cash and cash equivalents:

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

e. Marketable securities:

In accordance with SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities" ("SFAS No. 115"), the Company has classified its marketable securities as available-for-sale. The marketable securities that are held for the short-term and available for immediate sale are stated at quoted market prices at balance sheet date. The Company's marketable securities consist of highly-rated auction rate (AAA) securities ("ARS") which are federal backed student loan securities. These ARS may be liquidated at par value on the rate reset date, which is generally 30 days. Available-for-sale securities are carried at fair value, with the unrealized gains and losses, reported in "accumulated other comprehensive income (loss)" in shareholders' equity. The effective maturity may differ from the contractual maturities, due to the periodical auction mechanism. Subsequent to balance sheet date, commencing February 2008, the ARS (comprised of five securities) suffered from failed auctions. Since the failed auctions only commenced in February 2008, there is no effect on such securities as of December 31, 2007.

f. Investment in affiliate:

For the purposes of these financial statements, an affiliated company is a company held to the extent of 20% or more, or a company less than 20% held, in which the Company can exercise significant influence over operating and financial policy of the affiliate. For the year ended December 31, 2007, 2006 and 2005, the investment in an affiliated company (Imatrix) is accounted for under the equity method in accordance with APB 18, "The Equity Method of Accounting for Investments in Common Stock". Profits on inter-company sales not realized outside the group were eliminated.

As of December 31, 2007, the Company lacks the ability to exercise significant influence over operating and financial policies of Imatrix and, accordingly, the investment is accounted for on a cost basis.

COMMTouch SOFTWARE LTD. AND ITS SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 2: SIGNIFICANT ACCOUNTING POLICIES (Cont.)

The carrying amount of the investment in Imatrix as of December 31, 2006 and 2007 is zero. During the year 2006, the Company recognized losses in respect of Imatrix up to the carrying amount of its investment as of December 31, 2006.

In November 2007, the Company made a \$ 750 cash investment in Mirapoint Inc. ("Mirapoint"), a secure messaging vendor and an OEM licensee. The investment (8%) in an affiliated company is accounted for under the cost method since the Company cannot exercise significant influence over the operating and financial policies of Mirapoint.

The Company's investments are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an investment may not be recoverable. As of December 31, 2007, no impairment losses have been identified.

g. Property and equipment:

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

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

h. Impairment of long-lived assets:

The Company and its subsidiary's long-lived assets are reviewed for impairment in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets", 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. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell. No impairment losses were recorded in 2005 through 2007.

i. Revenue recognition:

The company derives revenues from Anti-Spam, Zero-Hour™ Virus Outbreak Protection and GlobalView Mail Reputation Services. The service component of the Company's solutions is considered essential to the functionality of

the software components. Furthermore, the software components can not be effectively used on a standalone basis, or with a third party's service. The customer has no ability to effectively run the software or the Software Development Kit ("SDK") on its own hardware. As the software portion of the product can not effectively stand on its own, the Company considers each sale as a service arrangement.

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COMMTOUCH SOFTWARE LTD. AND ITS SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 2: SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Therefore, revenues from such services are recognized over the service term, which generally includes a term period of one year to three years.

Revenue is recognized in accordance with Staff Accounting Bulletin ("SAB") No. 104, "Revenue Recognition", when the earnings process is complete, as evidenced by an agreement between the customer and the Company, when delivery has occurred or services have been rendered, when the fee is fixed or determinable and when collectibility is probable.

j. Research and development costs:

Statement of Financial Accounting Standards ("SFAS") No. 86, "Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed", requires capitalization of certain software development costs subsequent to the establishment of technological feasibility.

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

k. Concentrations of credit risk:

SFAS No. 105, "Disclosure of Information About Financial Instruments with off-Balance-Sheet Risk and Financial Instruments with Concentration of Credit Risk" requires disclosure of any significant off balance sheet and credit risk concentrations. The Company and its subsidiary have no significant off-balance-sheet concentration of credit risk such as foreign exchange contracts, option contracts or other foreign hedging arrangements.

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

Marketable securities of the Company represent short-term municipal auction rate securities which are purchased at Par (100) and are valued at Par (100) as at December 31, 2007. They are all invested in triple A rating securities. Such investments in the United States may be in excess of insured limits and are not insured in other jurisdictions. Management believes that the financial institutions that hold the Company's investments are financially sound and, accordingly, minimal credit risk exists with respect to these investments.

The trade receivables of the Company are derived from transactions with companies located primarily in North America, Europe, Israel and Asia. An allowance for doubtful accounts is determined with respect to those amounts that the Company and its subsidiary have determined to be doubtful of collection. The allowance for doubtful accounts was zero as at December 31, 2006 and 2007. Bad debt expense (recovery) for the years ended December 31,

2005, 2006 and 2007 was \$ (6), \$ 0 and \$ 0, respectively.

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COMMTouch SOFTWARE LTD. AND ITS SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 2: SIGNIFICANT ACCOUNTING POLICIES (Cont.)

The fair value for options granted in 2005, 2006 and 2007 is estimated at the date of grant using a Black-Scholes options pricing model with the following weighted average assumptions:

Employee stock options	Year ended December 31,		
	2005	2006	2007
Volatility	91%	70%	70%
Risk-free interest rate	4.18%	4.35%-4.85%	3.76%-4.94%
Dividend yield	0%	0%	0%
Expected life (years)	4	4.08	4.08

The following table illustrates the effect on 2005 net loss and loss per share if the Company had applied the fair value recognition provisions of Statement 123 to options granted under the Company's stock option plans in all periods. For purposes of this pro forma disclosure, the value of the options is estimated using a Black-Scholes option-pricing formula and amortized to expense over the options' vesting periods.

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

	December 31, 2005
Net loss as reported	\$ (4,441)
Add - stock-based employee compensation - intrinsic value	-
Deduct - stock-based employee compensation - fair value	(414)
Pro forma net loss	\$ (4,855)
Basic and diluted net loss per Ordinary share and equivalently participating shareholders - as reported	\$ (0.28)
Basic and diluted net loss per Ordinary share and equivalently participating shareholders - pro forma	\$ (0.30)

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

Basic and diluted net earnings (loss) per share is presented in accordance with SFAS No. 128, "Earnings per Share", for all periods presented.

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

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COMMTouch SOFTWARE LTD. AND ITS SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 2: SIGNIFICANT ACCOUNTING POLICIES (Cont.)

In compliance with Emerging Issues Task Force ("EITF") 03-6, "Participating Securities and the Two-Class Method under FASB No. 128", the series of Preferred shares that was outstanding in 2005 did not participate in losses, and therefore was not included in the computation of net earning (loss) per share for that year.

In 2005 and 2006 all outstanding stock options and warrants have been excluded from the calculation of the diluted earnings (loss) per share because all such securities are anti-dilutive for all periods presented. In 2007, 363,133 weighted average number of shares related to options and warrants outstanding have been excluded from calculation of the diluted earnings per share since they would have an anti-dilutive effect.

n. Severance pay:

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

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

Severance expense for the years ended December 31, 2005, 2006 and 2007 was approximately \$ 11, \$ 8 and \$ 11, respectively.

o. Fair value of financial instruments:

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

p. Income taxes:

The Company accounts for income taxes in accordance with SFAS No. 109, "Accounting for Income Taxes" ("SFAS No. 109"). SFAS No. 109 prescribes the use of the liability method whereby deferred tax asset and liability account balances are determined based on differences between financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. The Company provides a valuation allowance, if necessary, to reduce deferred tax assets to amounts more likely than not to be realized.

COMMTOUCH SOFTWARE LTD. AND ITS SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 2: SIGNIFICANT ACCOUNTING POLICIES (Cont.)

On January 1, 2007, the Company adopted FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No. 109" (FIN 48). FIN 48 contains a two-step approach to recognizing and measuring uncertain tax positions accounted for in accordance with SFAS No. 109. The first step is to evaluate the tax position taken or expected to be taken in a tax return by determining if the weight of available evidence indicates that it is more likely than not that, on an evaluation of the technical merits, the tax position will be sustained on audit, including resolution of any related appeals or litigation processes. The second step is to measure the tax benefit as the largest amount that is more than 50% likely to be realized upon ultimate settlement.

q. Recently issued accounting pronouncements:

In September 2006, the Financial Accounting Standards Board ("FASB") issued SFAS No. 157, "Fair Value Measurements" ("SFAS No. 157"). This Standard defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. The provisions of SFAS No. 157 are effective for the Company beginning January 1, 2008. The FASB issues a FASB Staff Position (FSP) to defer the effective date of SFAS No. 157 for one year for all nonfinancial assets and nonfinancial liabilities, except for those items that are recognized or disclosed at fair value in the financial statements on a recurring basis. The Company does not expect the adoption will have material impact on its consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities" ("SFAS No. 159"). SFAS No. 159 permits companies to choose to measure certain financial instruments and certain other items at fair value. The standard requires that unrealized gains and losses on items for which the fair value option has been elected be reported in earnings. The provisions of SFAS No. 159 are effective for the Company beginning January 1, 2008. The Company does not expect the adoption of SFAS No. 159 will have an impact on its consolidated financial statements.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), "Business Combinations" ("SFAS 141R"). SFAS 141R establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, any non controlling interest in the acquiree and the goodwill acquired. SFAS 141R also establishes disclosure requirements to enable the evaluation of the nature and financial effects of the business combination. SFAS 141R is effective for fiscal years beginning after December 15, 2008. Earlier adoption is prohibited. The Company does not expect the adoption of SFAS 141R will have an impact on its financial statements.

COMMTOUCH SOFTWARE LTD. AND ITS SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 2: SIGNIFICANT ACCOUNTING POLICIES (Cont.)

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements, an Amendment of ARB No. 51" ("SFAS No. 160"). SFAS No. 160 establishes accounting and reporting standards that require that the ownership interests in subsidiaries held by parties other than the parent be clearly identified, labeled, and presented in the consolidated statement of financial position within equity, but separate from the parent's equity; the amount of consolidated net income attributable to the parent and to the noncontrolling interest be clearly identified and presented on the face of the consolidated statement of income; and changes in a parent's ownership interest while the parent retains its controlling financial interest in its subsidiary be accounted for consistently. SFAS No. 160 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. The Company does not expect the adoption of SFAS No. 160 will have significant impact on its consolidated financial statements.

On December 21, 2007 the SEC staff issued Staff Accounting Bulletin No. 110 (SAB 110), which, effective January 1, 2008, amends and replaces SAB 107, "Share-Based Payment". SAB 110 expresses the views of the SEC staff regarding the use of a "simplified" method in developing an estimate of expected term of "plain vanilla" share options in accordance with FASB Statement No. 123(R), "Share-Based Payment". Under the "simplified" method, the expected term is calculated as the midpoint between the vesting date and the end of the contractual term of the option.

The use of the "simplified" method, which was first described in Staff Accounting Bulletin No. 107, was scheduled to expire on December 31, 2007. SAB 110 extends the use of the "simplified" method for "plain vanilla" awards in certain situations. The SEC staff does not expect the "simplified" method to be used when sufficient information regarding exercise behavior, such as historical exercise data or exercise information from external sources, becomes available. We are currently assessing the potential impact that the adoption of SAB 110 could have on our financial statements.

NOTE 3: PROPERTY AND EQUIPMENT, NET

	December 31	
	2006	2007
Cost:		
Computers and peripheral equipment	\$ 1,877	\$ 2,242
Office furniture and equipment	589	770
Motor vehicles	88	88
Leasehold improvements	1,137	1,150
	3,691	4,250
Less accumulated depreciation	(3,080)	(3,464)
Depreciated cost	\$ 609	\$ 786

Depreciation expense amounted to approximately \$ 147, \$ 209 and \$ 397 in 2005, 2006 and 2007, respectively.

COMMTOUCH SOFTWARE LTD. AND ITS SUBSIDIARY**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

U.S. dollars in thousands, **except share and per share data****NOTE 4: COMMITMENTS AND CONTINGENCIES**

Operating leases:

The Company leases its facility in Israel under an operating lease agreement expiring on November 30, 2008. In 2007, lease payments under this non-cancelable lease were \$ 96.

The subsidiary leases its facility in the U.S. under an operating lease agreement expiring on February 28, 2009. In 2007, lease payments under this non-cancelable lease were \$ 67.

Rent expense for 2005, 2006 and 2007 was approximately \$ 199, \$ 131 and \$164, respectively.

Annual minimum future lease payments due under the above agreements (and motor vehicle leases), at the exchange rate in effect on December 31, 2007, are approximately as follows:

2008	\$	285
2009		114
2010		39
	\$	438

NOTE 5: SHAREHOLDERS' EQUITY

a. General:

The Ordinary shares of the Company have been traded on the Nasdaq National Market and Nasdaq Capital Market (formerly The Nasdaq SmallCap Market), since July 1999 and 2002, respectively.

The Ordinary shares confer upon their holders the right to receive notice to participate and vote in general shareholder meetings of the Company and to receive dividends, if declared. Subsequent to balance sheet date, in January 2008, the Board of Directors and shareholders approved a 3:1 reverse stock split of the Company's share capital. As a result of this action, every three shares (including all authorized, issued and outstanding shares and all outstanding warrants and options to purchase shares) will be combined into one share of the same respective class of shares bearing a par value of NIS 0.15 each. All of the Company's authorized, issued and outstanding shares (including all outstanding warrants and options to purchase shares) as of December 31, 2007 and 2006, have been restated to reflect the effect of the reverse stock split.

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COMMTouch SOFTWARE LTD. AND ITS SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 5: SHAREHOLDERS' EQUITY (Cont.)

b. Warrants to investors:

As of December 31, 2007, the Company's outstanding warrants issued to various parties were as follows:

Issuance date	Warrants granted for Ordinary shares	Exercise price per share	Remaining warrants exercisable	Exercisable through
January 2003	1,884,072	\$0.75 - \$1.50	214,391	January 2008
July 2003	480,000	\$0.50	30,000	August 2008
May 2004	969,971	\$2.211	309,416	June 2009
October 2005 (i)	500,000	\$1.95	458,333	October 2010
May 2006 (ii)	23,364	\$ 3.21	23,364	May 2011
Total	3,857,407		1,035,504	

(i) Under the Securities Purchase Agreement dated October 2, 2005, the Company issued 2,000,000 Ordinary shares at \$ 1.50 per share for gross proceeds of \$ 3,000. The investors also received two sets of warrants, each representing an option to purchase up to 500,000 Ordinary shares, with one set exercisable within nine months at \$ 1.50 per share and the other set exercisable within five years at \$ 1.95 per share. The warrants exercisable at \$ 1.50 per share were exercised by the end of 2006 and 500,000 warrants exercisable at \$ 1.95 per share are exercisable through October 2010.

(ii) In May 2006, the Company issued warrants to purchase 23,364 of the Company's Ordinary shares at a price of \$ 3.21 per share to one investor as part of a private placement, in which the Company issued 31,153 Ordinary shares for a total consideration of \$ 100. The warrants will expire in May 2011.

c. Preferred share issuance:

On October 31, 2004, the Company entered into a Securities Purchase Agreement ("SPA") for the sale of Series A Preferred shares to investors of the Company identified in the schedule of buyers to the SPA. The transaction closed on December 9, 2004. Under the transaction:

1. The Company issued 2,126,667 Series A Preferred shares to new and existing investors, including three of its directors at that time, for an aggregate purchase price of \$ 3,190. The purchase price per share paid in the transaction was \$ 1.50.

2.

The Series A Preferred shares were convertible into the Company's Ordinary shares, and enjoyed certain preferences and other rights relating to liquidation and business combinations, as described in the Company's Amended and Restated Articles of Association.

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COMMTOUCH SOFTWARE LTD. AND ITS SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 5: SHAREHOLDERS' EQUITY (Cont.)

In accordance with the terms of the SPA, the Redemption, Amendment and Exchange Agreement ("RAE") and the requirements of EITF 98-05 and EITF 00-27, a beneficial conversion feature for the Series A Preferred shares granted under the October 2004 agreements was valued at approximately \$ 1,900, and was amortized over a nine month period as deemed dividends.

A non-cash amortization of beneficial conversion feature, relating to the Series A Preferred share was recorded in the amounts of \$ 141 and \$ 1,751 in 2004 and 2005, respectively.

During 2005, 650,000 Series A Preferred shares were converted into 1,133,333 Ordinary shares.

During the quarter ended March 31, 2006, 500,000 Series A Preferred shares were converted into 1,000,000 Ordinary shares. By early May 2006, 100,000 Series A Preferred Shares were converted into 200,000 Ordinary shares triggering a provision in the Company's Amended and Restated Articles of Association causing the conversion of the remaining outstanding 1,176,667 Series A Preferred shares into 2,353,333 Ordinary shares. This provision required the automatic conversion of all outstanding Preferred shares following conversions exceeding 50% of the originally issued Preferred shares. As a result, the Company no longer has a Preferred class of securities outstanding.

d. Employee stock options:

In 1996, the Company adopted the 1996 CI Stock Option Plan for granting options to its U.S. employees and consultants to purchase Ordinary shares of the Company. Until 1999, the Company issued options to purchase Ordinary shares to its Israeli employees pursuant to individual agreements. In 1999, the Company approved the 1999 Section 3(i) share option plan for its Israeli employees and consultants, (which was amended in 2001 and 2003 and renamed the Amended Israeli share option plan). As of December 31, 2007, an aggregate of 789,049 Ordinary shares of the Company are still available for future grant to employees and directors.

Options granted under such plans and agreements up to September 2005, expire generally after 10 years from the date of grant, with grants from September 2005 having six-year terms from the date of grant. Options cease vesting upon termination of the optionee's employment or other relationship with the Company. The options generally vest over a period of four years. The exercise price of the options granted under the individual agreements may not be less than the nominal value of the shares into which such options are exercisable. Any options that are canceled or not exercised within the option term become available for future grant.

COMMTOUCH SOFTWARE LTD. AND ITS SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 5: SHAREHOLDERS' EQUITY (Cont.)

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

	Number of shares			Weighted average exercise price		
	2005	2006	2007	2005	2006	2007
Outstanding at the beginning of the year	2,134,645	2,626,956	3,063,413	\$ 0.90	\$ 1.29	\$ 1.80
Granted	759,167	810,833	626,135	\$ 2.43	\$ 3.15	\$ 5.97
Exercised	(73,397)	(260,117)	(345,713)	\$ 1.14	\$ 0.67	\$ 0.97
Forfeited	(193,459)	(114,259)	(60,668)	\$ 1.71	\$ 1.96	\$ 3.38
Outstanding at the end of the year	2,626,956	3,063,413	3,283,167	\$ 1.29	\$ 1.80	\$ 2.65
Exercisable options at the end of the year	1,285,636	1,515,131	1,736,229	\$ 0.69	\$ 0.96	\$ 1.42
Options vested and expected to vest at the end of the year		2,939,411	3,163,369		\$ 1.77	\$ 2.61
Weighted average fair value of options granted during the year				\$ 1.59	\$ 1.44	\$ 3.17

The aggregate intrinsic value of the Company's options is the difference between the fair value of the Company's Ordinary shares and the exercise price, times the number of options. The total intrinsic value of options outstanding at December 31, 2006 and 2007 was \$ 5,538 and \$11,345, respectively. The total intrinsic value of exercisable options at the end of 2006 and 2007 was approximately \$ 4,018 and \$8,048, respectively. The total intrinsic value of options vested and expected to vest at December 31, 2006 and 2007 was approximately \$ 5,389 and \$ 11,071, respectively. The total intrinsic value of options exercised during the year ended December 31, 2006 and 2007 was approximately \$ 699 and \$ 2,223, respectively.

As of December 31, 2007 the total unrecognized estimated compensation cost related to non-vested stock options granted prior to that date was \$3,520 which is expected to be recognized over a period of up to four years.

COMMTouch SOFTWARE LTD. AND ITS SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 5: SHAREHOLDERS' EQUITY (Cont.)

The options outstanding as of December 31, 2007, have been separated into ranges of exercise price, as follows:

Exercise price per share	Options outstanding as of December 31, 2007	Weighted average remaining contractual life (years)	Weighted average exercise price per share	Options exercisable as of December 31, 2007	Weighted average exercise price per share of exercisable options
\$0.03-\$0.27	132,620	3.67	\$ 0.05	132,620	\$ 0.05
\$0.33-\$0.60	500,000	4.66	\$ 0.35	500,000	\$ 0.35
\$0.81-\$0.84	38,667	3.85	\$ 0.82	38,667	\$ 0.82
\$0.93-\$1.89	721,458	5.94	\$ 1.24	514,542	\$ 1.19
\$2.31-\$2.91	268,167	4.65	\$ 2.61	190,326	\$ 2.53
\$3.12-\$4.35	1,073,455	4.61	\$ 3.24	360,074	\$ 3.25
\$4.35-\$6.60	548,800	5.84	\$ 6.24	-	-
\$					
0.03-\$6.60	3,283,167	4.99	\$ 2.65	1,736,229	\$ 1.42

f. Non-employee directors stock option plan:

In 1999, the Company adopted the 1999 Non-Employee Directors Stock Option Plan, which has since been amended. The original allotment of shares to this plan was 60,000 Ordinary shares and was increased in several tranches to 1,263,333. On December 15, 2006, the Company combined the remaining pool of options in the employee stock option plans' reserve with the amount of options remaining in the Non-Employee Directors Stock Option Plan reserve.

Since the annual meeting of shareholders in 2003, new directors joining the Board are entitled to an option grant of 50,000 Ordinary shares.

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

During 2006 and 2007, the Company granted 83,333 and 83,333 options, respectively, to non-employee directors at a weighted average exercise price of \$ 3.12 and \$6.60 per share respectively. As of December 31, 2006 and 2007, 448,090 and 369,895 options were vested and unexercised and 706,944 and 610,000 were outstanding under the Non-Employee Directors Stock Option Plan, respectively.

COMMTouch SOFTWARE LTD. AND ITS SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 5: SHAREHOLDERS' EQUITY (Cont.)

Issuance date	f.		Options to non-employees:		
	Options granted for Ordinary Shares	Exercise price per share	Remaining options exercisable	Exercisable through	
June 2004 (i)	196,667	\$ 1.77	-		March 2007
May 2006 (ii)	66,667	\$ 3.21-\$5.73	20,833		May 2012
Total	263,334		20,833		

(i) In June 2004, 493,333 options were granted to the then Executive Chairman of the Board, with a four year vesting schedule. In August 2005, the Executive Chairman of the Board and the Company agreed to modify the number of options granted from 493,333 options to 246,667 options. The Company has accounted for this grant under the fair value method of SFAS No. 123 and EITF 96-18, "Accounting for Equity Instruments that are Issued to Other than Employees for Acquiring, or in Conjunction with Selling, Goods or Services" ("EITF 96-18"). The fair value for these options was estimated using a Black-Scholes option-pricing model. Following the modification, the compensation expense for 2005, 2006 and 2007 amounted to \$ 92, \$ 131 and \$ 0, respectively. On December 15, 2006, the term of the Executive Chairman of the Board expired. In 2007, all 149,028 remaining options as of December 31, 2006 were exercised.

(ii) As consideration for consulting services, on May 7, 2006 the Company issued 50,000 options to a service provider to purchase the Company's Ordinary shares at a price of \$ 3.21 per option. On May 5, 2007, the Company issued additional 16,667 options to the service provider to purchase the Company's Ordinary shares at a price of \$ 5.73 per option. The options shall vest and become exercisable at a rate of 1/16 of the options every three months. The Company has accounted for this grant under the fair value method of EITF 96-18. The fair value for these options was estimated using a Black-Scholes option-pricing model. Compensation expense for 2006 and 2007 amounted to \$ 24 and \$ 70, respectively.

h. Total stock-based compensation expenses recognized in 2006 and 2007:

The total stock-based compensation expense related to all of the Company's equity-based awards, recognized for the year ended December 31, 2006 and 2007, was comprised as follows:

	Year ended December 31,	
	2006	2007
Cost of revenues	\$ 15	\$ 31
Research and development	196	246
Selling and marketing	96	194

General and administrative	638	612
	\$ 945	\$ 1,083

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COMMTouch SOFTWARE LTD. AND ITS SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 6: INCOME TAXES

a. Corporate tax structure:

Taxable income of Israeli companies is subject to tax at the rate of 31% in 2006, 29% in 2007, 27% in 2008, 26% in 2009 and 25% in 2010 and thereafter.

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

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

Subsequent to balance sheet date, in February 2008, the inflation adjustment law was cancelled.

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

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

d. Net operating loss carryforwards:

As of December 31, 2007, the Company's net operating loss carryforwards for tax purposes amounted to approximately \$ 71,000 which may be carried forward and offset against taxable income in the future, for an indefinite period.

As of December 31, 2007, for federal income tax purposes, the U.S. subsidiary had net operating loss carry-forwards of approximately \$ 91,000. These losses may offset any future U.S. taxable income of the U.S. subsidiary and will expire in the years 2009 through 2025. In light of the subsidiary's history of operating losses, the Company has recorded a valuation allowance for all its deferred tax assets.

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

The Company and its subsidiary have provided valuation allowances in respect to the deferred tax assets resulting from operating loss carryforwards and other temporary differences. Management currently believes that since the Company and its subsidiary have a history of losses it is more likely than not that the deferred tax regarding the loss carryforwards and other temporary differences will not be realized in the foreseeable future.

COMMTOUCH SOFTWARE LTD. AND ITS SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 6:- INCOME TAXES (Cont.)

e. Deferred income taxes:

Deferred income taxes reflect the net tax effects of net operating loss carryforwards between the carrying amounts of assets and liabilities for financial reporting purposes and amounts used for income tax purposes. The Company's deferred tax assets resulting from tax loss carryforwards are as follows:

	2005	December 31, 2006	2007
Deferred tax assets are as follows:			
Operating loss carry-forwards	\$ 47,002	\$ 50,098	\$ 51,520
Non-deductible expenses and other temporary differences	952	890	1,016
Deferred tax asset before valuation allowance	47,954	50,988	52,536
Valuation allowance	(47,954)	(50,988)	(52,536)
Net deferred tax asset	\$ -	\$ -	\$ -

f. The Company adopted the provisions of FIN 48 on January 1, 2007. The adoption of FIN 48 did not result in a change to the Company's accumulated deficit.

Income (loss) before taxes on income consists of the following:

	2005	Year December 31, 2006	2007
Israel	\$ (2,668)	\$ (393)	\$ 1,080
U.S.	(22)	203	1,057
	\$ (2,690)	\$ (190)	\$ 2,137

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

COMMTOUCH SOFTWARE LTD. AND ITS SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 6:- INCOME TAXES (Cont.)

g. Taxes on income are comprised of the following:

	Year December 31,		
	2005	2006	2007
Domestic	-	-	-
Foreign	-	-	\$ 28*)
	-	-	28

*) Current

h. The main reconciling items between the statutory tax rate of the Company and the effective tax rate are the non-recognition of the benefits from accumulated net operating loss carry forward due to the uncertainty of the realization of such tax benefits.

i. Tax assessments:

The Company has closed tax assessments in Israel until 2002. As a result of the closure of these tax assessments, the Company amended the tax return in Israel for tax year 2003, and reduced its net operating losses carryforwards for the respective years as reflected in f above.

NOTE 7: GEOGRAPHIC INFORMATION

The Company conducts its business on the basis of one reportable segment. The Company has adopted SFAS No. 131, "Disclosures About Segments of an Enterprise and Related Information".

a. Revenues from external customers:

	Year ended December 31,		
	2005	2006	2007
Israel	\$ 365	\$ 344	\$ 742
North America	2,737	4,525	6,424
Europe	687	1,715	2,735
Asia	136	493	1,038
Other	-	157	311
	\$ 3,925	\$ 7,234	\$ 11,250

COMMTOUCH SOFTWARE LTD. AND ITS SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, **except share and per share data****NOTE 7: GEOGRAPHIC INFORMATION (Cont.)**

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

	December 31	
	2006	2007
Israel	\$ 200	\$ 179
U.S.A.	409	607
	\$ 609	\$ 786

c. Revenues from principal customer:

	Year ended December 31,		
	2005	2006	2007
		%	
Customer A	9	14	9

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Item 19. Exhibits.

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

SIGNATURES

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

COMMTOUCH SOFTWARE LTD.

By: /s/ Ron Ela
Ron Ela
Chief Financial Officer
March 31, 2008

Item 19. Exhibits

Exhibit Number	Description of Document
1.1	Memorandum of Association of the Company.(1)
1.2	Amended and Restated Articles of Association of the Company, as amended on December 14, 2007.
2.1	Amended and Restated Registration Rights Agreement dated as of April 19, 1999.(1)
2.1.1	Amendment No. 1 to Amended and Restated Registration Rights Agreement dated as of December 29, 1999.(3)
2.1.2	Amendment No. 2 to Amended and Restated Registration Rights Agreement dated as of March 10, 2000.(4)
2.2	Ordinary Shares and Warrants Purchase Agreement dated as of February 27, 2002 by and between Commtouch Software Ltd., and the Investors Listed on Exhibit A Thereto. (13)
2.3	Ordinary Shares and Warrants Purchase Agreement dated July 10, 2003, inclusive of Exhibits “A” and “B” thereto, between Commtouch Software Ltd. and certain investors thereunder.(9)
2.4	Ordinary Shares and Warrants Purchase Agreement dated July 29, 2003, inclusive of Exhibits “A” and “B” thereto, between Commtouch Software Ltd. and certain investors thereunder.(10)
2.5	Ordinary Shares and Warrants Purchase Agreement dated July 29, 2003, inclusive of Exhibits “A” and “B” thereto, between Commtouch Software Ltd. and certain investors thereunder.(11)
2.6	Exhibit “D” to Securities Purchase Agreement dated May 18, 2004 between Commtouch Software Ltd. and certain investors thereunder - Form of Registration Rights Agreement.(14)
2.7	Exhibit “A” to Securities Purchase Agreement dated May 18, 2004 between Commtouch Software Ltd. and certain investors thereunder - Form of Initial Warrants.(15)
2.8	Exhibit “A” to Securities Purchase Agreement dated October 31, 2004 between Commtouch Software Ltd. and certain investors thereunder - Form of Registration Rights Agreement.(16)
2.9	Redemption, Amendment and Exchange Agreement dated October 31, 2004 between Commtouch Software Ltd. and certain investors thereunder.(17)
2.10	Exhibit “B” to Securities Purchase Agreement dated October 2, 2005 between Commtouch Software Ltd. and certain investors thereunder - Form of Series 2 Warrant.(18)
2.11	Exhibit “C” to Securities Purchase Agreement dated October 2, 2005 between Commtouch Software Ltd. and certain investors thereunder - Form of Registration Rights Agreement.(19)
2.12	Addendum 1 to Registration Rights Agreement, dated October 6, 2005 between Commtouch Software Ltd. and certain investors thereunder.(20)

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- 4.1 Commtouch Software Ltd. Amended and Restated 1996 CSI Stock Option Plan.(5)
 - 4.2 Commtouch Software Ltd. 2006 U.S. Stock Option Plan.(6)
 - 4.3 Amended and Restated 1999 Section 3(i) Share Option Plan.(12)
 - 4.4 Amended and Restated Commtouch Software Ltd. 1999 Non-Employee Directors Stock Option Plan.(7)
 - 4.5 Commtouch Software Ltd. Amended and Restated Israeli Share Option Plan [fka 1999 Section 3(i) Share Option Plan].(8)
 - 4.6 Summary of Director Compensation.
 - 8 List of Subsidiaries of the Company.
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- 12.1 Certification of Company's Principal Executive Officer Pursuant to Exchange Act Rule 13a-14(a) or 15d-14(a).
- 12.2 Certification of Company's Principal Financial Officer Pursuant to Exchange Act Rule 13a-14(a) or 15d-14(a).
- 13 Certification of Company's Principal Executive Officer and Principal Financial Officer Pursuant to 18 U.S.C. 1350.
- 15 Consent of Kost, Forer, Gabbay & Kasierer, independent auditors.

(1) Incorporated by reference to exhibits in Amendment No. 1 to Registration Statement on Form F-1 of Commtouch Software Ltd., File No. 333-78531.

(2) Reserved.

(3) Incorporated by reference to exhibit in Amendment No. 1 to Registration Statement on Form F-1 of Commtouch Software Ltd., File No. 333-89773.

(4) Incorporated by reference to exhibits in Amendment No. 2 to Registration Statement on Form F-1 of Commtouch Software Ltd., File No. 333-89773, filed March 28, 2000.

(5) Incorporated by reference to Exhibit 99.2 to Registration Statement on Form S-8 No. 333-141177.

(6) Incorporated by reference to Exhibit 99.4 to Registration Statement on Form S-8 No. 333-141177.

(7) Incorporated by reference to Exhibit 99.1 to Registration Statement on Form S-8 No. 333-141177.

(8) Incorporated by reference to Exhibit 99.3 to Registration Statement on Form S-8 No. 333-141177.

(9) Incorporated by reference to Exhibit 2 to Report on Form 6-K for the month of July 2003, filed July 28, 2003.

(10) Incorporated by reference to Exhibit 2 to Report on Form 6-K for the month of August 2003, filed August 15, 2003.

(11) Incorporated by reference to Exhibit 3 to Report on Form 6-K for the month of August 2003, filed August 15, 2003.

(12) Incorporated by reference to Exhibit 5 to Schedule TO, filed July 20, 2001.

(13) Incorporated by reference to Exhibit 2.8 to Annual Report on Form 20-F for the year ended December 31, 2001.

(14) Incorporated by reference to Exhibit 99.2 to Report on Form 6-K for the month of May 2004, filed May 19, 2004.

(15) Incorporated by reference to Exhibit 99.3 to Report on Form 6-K for the month of May 2004, filed May 19, 2004.

(16) Incorporated by reference to Exhibit 99.4 to Report on Form 6-K for the month of November 2004, filed November 5, 2004.

- (17) Incorporated by reference to Exhibit 99.5 to Report on Form 6-K for the month of November 2004, filed November 5, 2004.
- (18) Incorporated by reference to Exhibit 99.6 to Report on Form 6-K for the month of October 2005, filed October 11, 2005.
- (19) Incorporated by reference to Exhibit 99.3 to Report on Form 6-K for the month of October 2005, filed October 11, 2005.
- (20) Incorporated by reference to Exhibit 99.4 to Report on Form 6-K for the month of October 2005, filed October 11, 2005.
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