

CRA INTERNATIONAL, INC.  
Form 10-Q  
May 09, 2012

Table of Contents

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

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

**For the quarterly period ended March 31, 2012**

or

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

**Commission file number: 000-24049**

**CRA International, Inc.**

(Exact name of registrant as specified in its charter)

**Massachusetts**

(State or other jurisdiction of  
incorporation or organization)

**04-2372210**

(I.R.S. Employer Identification No.)

**200 Clarendon Street, T-33, Boston, MA**

(Address of principal executive offices)

**02116-5092**

(Zip Code)

**(617) 425-3000**

(Registrant's telephone number, including area code)

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

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(Do not check if a smaller reporting company)

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

<b>Class</b>	<b>Outstanding at May 4, 2012</b>
Common Stock, no par value per share	10,384,337 shares

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Table of Contents

**CRA International, Inc.**

**INDEX**

**PART I. FINANCIAL INFORMATION**

<u>ITEM 1.</u>	<u>Financial Statements</u>	<u>3</u>
	<u>Condensed Consolidated Statements of Operations (unaudited) Quarters Ended March 31, 2012 and April 2, 2011</u>	<u>3</u>
	<u>Condensed Consolidated Statements of Comprehensive Income (unaudited) Quarters Ended March 31, 2012 and April 2, 2011</u>	<u>4</u>
	<u>Condensed Consolidated Balance Sheets (unaudited) March 31, 2012 and December 31, 2011</u>	<u>5</u>
	<u>Condensed Consolidated Statements of Cash Flows (unaudited) Quarters Ended March 31, 2012 and April 2, 2011</u>	<u>6</u>
	<u>Condensed Consolidated Statement of Shareholders' Equity (unaudited) - Quarter Ended March 31, 2012</u>	<u>7</u>
	<u>Notes to Condensed Consolidated Financial Statements (unaudited)</u>	<u>8</u>
<u>ITEM 2.</u>	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>15</u>
<u>ITEM 3.</u>	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	<u>21</u>
<u>ITEM 4.</u>	<u>Controls and Procedures</u>	<u>21</u>

**PART II. OTHER INFORMATION**

<u>ITEM 1.</u>	<u>Legal Proceedings</u>	<u>22</u>
<u>ITEM 1A.</u>	<u>Risk Factors</u>	<u>22</u>
<u>ITEM 2.</u>	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>31</u>
<u>ITEM 3.</u>	<u>Defaults Upon Senior Securities</u>	<u>31</u>
<u>ITEM 4.</u>	<u>Mine Safety Disclosures</u>	<u>31</u>
<u>ITEM 5.</u>	<u>Other Information</u>	<u>31</u>
<u>ITEM 6.</u>	<u>Exhibits</u>	<u>32</u>
<u>Signatures</u>		<u>33</u>

Table of Contents**PART I. FINANCIAL INFORMATION****ITEM 1. Financial Statements****CRA International, Inc.****Condensed Consolidated Statements of Operations (unaudited)***(In thousands, except per share data)*

	Quarter Ended	
	March 31, 2012	April 2, 2011
Revenues	\$ 69,132	\$ 78,607
Costs of services	46,487	51,560
Gross profit	22,645	27,047
Selling, general and administrative expenses	17,867	17,828
Depreciation and amortization	1,472	1,299
Income from operations	3,306	7,920
Interest income	66	82
Interest expense	(80)	(392)
Other expense, net	(39)	(146)
Income before provision for income taxes	3,253	7,464
Provision for income taxes	(2,817)	(3,003)
Net income	436	4,461
Net loss (income) attributable to noncontrolling interest, net of tax	83	(26)
Net income attributable to CRA International, Inc.	\$ 519	\$ 4,435
Net income per share attributable to CRA International, Inc.:		
Basic	\$ 0.05	\$ 0.42
Diluted	\$ 0.05	\$ 0.41
Weighted average number of shares outstanding:		
Basic	10,316	10,613
Diluted	10,493	10,798

See accompanying notes to the condensed consolidated financial statements.

Table of Contents**CRA International, Inc.****Condensed Consolidated Statements of Comprehensive Income (unaudited)***(In thousands)*

	Quarter Ended	
	March 31, 2012	April 2, 2011
Net income	\$ 436	\$ 4,461
Other comprehensive income:		
Foreign currency translation adjustments	1,717	2,097
Comprehensive income	2,153	6,558
Less: comprehensive loss (income) attributable to noncontrolling interest	83	(26)
Comprehensive income attributable to CRA International, Inc.	\$ 2,236	\$ 6,532

See accompanying notes to the condensed consolidated financial statements.

Table of Contents**CRA International, Inc.****Condensed Consolidated Balance Sheets (unaudited)***(In thousands, except share data)*

	March 31, 2012	December 31, 2011
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 41,562	\$ 61,587
Short-term investments	9,494	14,495
Accounts receivable, net of allowances of \$8,381 at March 31, 2012 and \$6,548 at December 31, 2011	55,199	68,394
Unbilled services	35,523	16,326
Prepaid expenses and other assets	9,193	8,224
Deferred income taxes	20,776	20,898
<b>Total current assets</b>	<b>171,747</b>	<b>189,924</b>
Property and equipment, net	21,126	21,611
Goodwill	141,904	140,654
Intangible assets, net of accumulated amortization of \$6,587 at March 31, 2012 and \$6,806 at December 31, 2011	2,342	2,472
Deferred income taxes, net of current portion	108	105
Other assets	17,072	17,341
<b>Total assets</b>	<b>\$ 354,299</b>	<b>\$ 372,107</b>
<b>Liabilities and shareholders' equity</b>		
Current liabilities:		
Accounts payable	\$ 10,810	\$ 10,469
Accrued expenses	41,765	60,502
Deferred revenue and other liabilities	7,597	7,707
Current portion of deferred rent	4,216	2,870
Current portion of notes payable	650	650
Current portion of deferred compensation	2,171	75
<b>Total current liabilities</b>	<b>67,209</b>	<b>82,273</b>
Notes payable, net of current portion	1,652	1,631
Deferred rent and other non-current liabilities	8,035	9,423
Deferred compensation	1,714	1,714
Deferred income taxes, net of current portion	8,712	8,659
Commitments and contingencies		
Shareholders' equity:		
Preferred stock, no par value; 1,000,000 shares authorized; none issued and outstanding		
Common stock, no par value; 25,000,000 shares authorized; 10,285,474 shares and 10,329,051 shares issued and outstanding at March 31, 2012 and December 31, 2011, respectively	96,704	98,578
Receivables from shareholders	(236)	(236)
Retained earnings	176,119	175,600
Accumulated other comprehensive loss	(4,621)	(6,338)
<b>Total CRA International, Inc. shareholders' equity</b>	<b>267,966</b>	<b>267,604</b>
Noncontrolling interest	725	803
<b>Total shareholders' equity</b>	<b>268,691</b>	<b>268,407</b>

Total liabilities and shareholders' equity	\$ 354,299	\$ 372,107
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See accompanying notes to the condensed consolidated financial statements.

Table of Contents**CRA International, Inc.****Condensed Consolidated Statements of Cash Flows (unaudited)***(In thousands)*

	<b>Quarter Ended</b>	
	<b>March 31, 2012</b>	<b>April 2, 2011</b>
<b>Operating activities:</b>		
Net income	\$ 436	\$ 4,461
Adjustments to reconcile net income to net cash used in operating activities, net of effect of acquired business:		
Depreciation and amortization	1,477	1,322
Deferred rent	(99)	(1,862)
Deferred income taxes	180	176
Share-based compensation expenses	1,527	1,670
Excess tax benefits from share-based compensation	(37)	
Noncash interest from discount on convertible debentures		129
Changes in operating assets and liabilities, exclusive of acquisitions:		
Accounts receivable	13,811	(787)
Unbilled services	(19,031)	(3,989)
Prepaid expenses and other assets	(556)	(1,102)
Accounts payable, accrued expenses, and other liabilities	(18,793)	(2,885)
Net cash used in operating activities	(21,085)	(2,867)
<b>Investing activities:</b>		
Consideration relating to acquisitions, net		(289)
Purchase of property and equipment	(673)	(2,465)
Purchase of investments	(9,494)	(31,430)
Sale of investments	14,495	
Net cash provided by (used in) investing activities	4,328	(34,184)
<b>Financing activities:</b>		
Issuance of common stock, principally stock option exercises	316	282
Tax withholding payment reimbursed by restricted shares	(719)	(685)
Excess tax benefits from share-based compensation	37	
Repurchase of common stock	(3,050)	
Repurchase of treasury stock by NeuCo, Inc.		(33)
Net cash used in financing activities	(3,416)	(436)
Effect of foreign exchange rates on cash and cash equivalents	148	293
Net decrease in cash and cash equivalents	(20,025)	(37,194)
Cash and cash equivalents at beginning of period	61,587	87,505
Cash and cash equivalents at end of period	\$ 41,562	\$ 50,311
<b>Supplemental cash flow information:</b>		
Cash paid for income taxes	\$ 4,901	\$ 2,420
Cash paid for interest	\$ 56	\$ 34

See accompanying notes to the condensed consolidated financial statements





Table of Contents**CRA International, Inc.****Condensed Consolidated Statement of Shareholders' Equity (unaudited)***(In thousands, except share data)*

	Common Stock		Receivable from Shareholder	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	CRA International, Inc. Shareholders' Equity	Noncontrolling Interest	Total Shareholders' Equity
	Shares Issued	Amount						
<b>BALANCE AT DECEMBER 31, 2011</b>	10,329,051	\$ 98,578	\$ (236)	\$ 175,600	\$ (6,338)	\$ 267,604	\$ 803	\$ 268,407
Net income				519		519	(83)	436
Foreign currency translation adjustment					1,717	1,717		1,717
Other comprehensive income					1,717	1,717		1,717
Exercise of stock options	22,951	316				316		316
Share-based compensation expense for employees		1,499				1,499		1,499
Restricted share vesting	87,437							
Redemption of vested employee restricted shares for tax withholding	(31,165)	(719)				(719)		(719)
Tax benefit on stock options and restricted shares vesting		52				52		52
Shares repurchased	(122,800)	(3,050)				(3,050)		(3,050)
Share-based compensation expense for non-employees		28				28		28
Equity transactions of noncontrolling interest							5	5
<b>BALANCE AT MARCH 31, 2012</b>	10,285,474	\$ 96,704	\$ (236)	\$ 176,119	\$ (4,621)	\$ 267,966	\$ 725	\$ 268,691

See accompanying notes to the condensed consolidated financial statements.

Table of Contents

**CRA International, Inc.**

**Notes to Condensed Consolidated Financial Statements**

**(Unaudited)**

**1. Description of Business**

CRA International, Inc. (the "Company," or "CRA") is a worldwide leading consulting services firm that applies advanced analytic techniques and in-depth industry knowledge to complex engagements for a broad range of clients. CRA offers its services in two broad areas: litigation, regulatory and financial consulting and management consulting. CRA operates in one business segment, which is consulting services. CRA operates its business under its registered trade name, Charles River Associates.

**2. Unaudited Interim Condensed Consolidated Financial Statements and Estimates**

The following financial statements included in this report are unaudited: the condensed consolidated statements of operations for the fiscal quarters ended March 31, 2012 and April 2, 2011, the condensed consolidated statements of comprehensive income for the fiscal quarters ended March 31, 2012 and April 2, 2011, the condensed consolidated balance sheet as of March 31, 2012, the condensed consolidated statements of cash flows for the fiscal quarters ended March 31, 2012 and April 2, 2011, and the condensed consolidated statement of shareholders' equity for the fiscal quarter ended March 31, 2012. In the opinion of management, these statements include all adjustments necessary for a fair presentation of CRA's consolidated financial position, results of operations, and cash flows. The condensed consolidated balance sheet as of December 31, 2011 included in this report was derived from audited consolidated financial statements included in the Company's Annual Report on Form 10-K that was filed on March 2, 2012.

The preparation of financial statements in conformity with generally accepted accounting principles in the U.S. ("U.S. GAAP") requires management to make significant estimates and judgments that affect the reported amounts of assets and liabilities, and disclosure of contingent assets and liabilities, at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Estimates in these consolidated financial statements include, but are not limited to, accounts receivable allowances, revenue recognition on fixed price contracts, depreciation of property and equipment, share-based compensation, valuation of acquired intangible assets, impairment of long lived assets, goodwill, accrued and deferred income taxes, valuation allowances on deferred tax assets, accrued compensation, accrued exit costs, and other accrued expenses. These items are monitored and analyzed by the Company for changes in facts and circumstances, and material changes in these estimates could occur in the future. Changes in estimates are recorded in the period in which they become known. CRA bases its estimates on historical experience and various other assumptions that CRA believes to be reasonable under the circumstances. Actual results may differ from those estimates if CRA's assumptions based on past experience or other assumptions do not turn out to be substantially accurate.

**3. Principles of Consolidation**

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. In addition, the consolidated financial statements include the Company's interest in NeuCo, Inc. ("NeuCo"). All significant intercompany accounts have been eliminated.

CRA's ownership interest in NeuCo constitutes control under U.S. GAAP. Therefore, NeuCo's financial results have been consolidated with CRA and the portion of NeuCo's results allocable to its other owners is shown as "noncontrolling interest."

Table of Contents

**CRA International, Inc.**

**Notes to Condensed Consolidated Financial Statements (Continued)**

**(Unaudited)**

**3. Principles of Consolidation (Continued)**

NeuCo's interim reporting schedule is based on calendar month-ends, but its fiscal year end is the last Saturday of November. CRA's quarterly results could include a few days reporting lag between CRA's quarter end and the most recent financial statements available from NeuCo. CRA does not believe that the reporting lag will have a significant impact on CRA's consolidated statements of operations or financial condition.

**4. Adoption of New Accounting Standards**

*Goodwill*

In September 2011, the FASB issued Accounting Standards Update ("ASU") No. 2011-08, *Intangibles Goodwill and Other (Topic 350): Testing Goodwill for Impairment* ("ASU 2011-08"). The objective of ASU 2011-08 is to simplify how entities test goodwill for impairment. The amendments in ASU 2011-08 permit an entity to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment test described in Topic 350. The more-likely-than-not threshold is defined as having a likelihood of more than 50 percent. ASU 2011-08 is effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. The Company's adoption of ASU 2011-08 in the first quarter of fiscal 2012 had no impact on its financial position, results of operations, cash flows, or disclosures.

*Comprehensive Income*

In June 2011, the FASB issued ASU No. 2011-05, *Comprehensive Income (Topic 220): Presentation of Comprehensive Income* ("ASU 2011-05"). The objective of ASU 2011-05 is to increase the prominence of items reported in other comprehensive income. The main provisions of ASU 2011-05 provide that an entity that reports items of other comprehensive income has the option to present comprehensive income in either one or two consecutive financial statements. The option in current U.S. GAAP that permits the presentation of other comprehensive income in the statement of changes in equity has been eliminated. ASU 2011-05 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011 and should be applied retrospectively. The Company adopted ASU 2011-05 in the first quarter of fiscal 2012 and elected to present other comprehensive income in two consecutive financial statements. The Company's adoption of ASU 2011-05 had no impact on its financial position, results of operations, or cash flows.

*Fair Value Measurements*

In May 2011, the FASB issued ASU No. 2011-04, *Fair Value Measurements (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs* ("ASU 2011-04"). ASU 2011-04 does not require additional fair value measurements and is primarily a convergence of words between U.S. GAAP and IFRS. ASU 2011-04 was effective for the first interim or annual reporting period beginning on or after December 15, 2011. The Company's adoption of ASU 2011-04 in the first quarter of fiscal 2012 had no impact on its financial position, results of operations, cash flows, or disclosures.

Table of Contents

**CRA International, Inc.**

**Notes to Condensed Consolidated Financial Statements (Continued)**

**(Unaudited)**

**5. Cash Equivalents and Investments**

Cash equivalents consist principally of commercial paper, funds holding only U.S. government obligations, and money market funds, with maturities of three months or less when purchased. As of March 31, 2012, a portion of the Company's cash accounts was concentrated at a single financial institution, which potentially exposes the Company to credit risks. The financial institution has generally "stable" credit ratings and its short-term credit rating is A-1 by Standard & Poor's ratings services. The Company has not experienced any losses related to such accounts and does not believe that there is significant risk of non-performance by the financial institution. The Company's cash on deposit at this financial institution is fully liquid, and the Company continually monitors the credit ratings of the institution and limits the amount of cash it maintains at this institution.

Short-term investments generally consist of commercial paper and have maturities of more than three months and less than one year when purchased. These short-term investments are expected to be held-to-maturity and are classified as such in the accompanying condensed consolidated financial statements.

The carrying amounts of the Company's instruments classified as cash equivalents and short-term investments are stated at amortized cost, which approximates fair value because of their short-term maturity. As of March 31, 2012 and December 31, 2011, short-term investments included \$9.5 million and \$14.5 million in commercial paper, respectively, and are considered Level 2 inputs within the fair value hierarchy.

If a decline in fair value below the amortized cost basis of an investment is judged to be other-than-temporary, the cost basis of the investment is written down to fair value. For those investments for which the fair value of the investment is less than its amortized cost, the credit-related portion of other-than-temporary impairment losses is recognized in earnings while the noncredit-related portion is recognized in other comprehensive income, net of related taxes. The Company does not intend to sell such investments, if any, and it is more likely than not that it will not be required to sell such investments prior to the recovery of its amortized cost basis less any current period credit losses. During the first quarter of fiscal 2012 and the first quarter of 2011, the Company did not write-down any investment balances.

**6. Revenue Recognition**

CRA derives substantially all of its revenues from the performance of professional services. The contracts that CRA enters into and operates under specify whether the engagement will be billed on a time-and-materials or a fixed-price basis. Most of CRA's revenue is derived from time-and-materials service contracts. Revenues from time-and-materials service contracts are recognized as services are provided based upon hours worked and contractually agreed-upon hourly rates, as well as indirect fees based upon hours worked. Revenues from a majority of the Company's fixed-price engagements are recognized on a proportional performance method based on the ratio of costs incurred, substantially all of which are labor-related, to the total estimated project costs.

Table of Contents**CRA International, Inc.****Notes to Condensed Consolidated Financial Statements (Continued)****(Unaudited)****6. Revenue Recognition (Continued)**

Revenues also include reimbursements, which include travel and other out-of-pocket expenses, outside consultants, and other reimbursable expenses. Reimbursable expenses are as follows (in thousands):

	<b>Quarter Ended</b>	
	<b>March 31,</b>	<b>April 2,</b>
	<b>2012</b>	<b>2011</b>
Reimbursable expenses	\$ 8,297	\$ 10,376

CRA collects goods and services and value added taxes from customers and records these amounts on a net basis, which is within the scope of Accounting Standards Codification ("ASC") Topic 605-45, "*Principal Agent Considerations*."

**7. Goodwill**

In accordance with ASC Topic 350, "*Intangibles Goodwill and Other*," goodwill is not subject to amortization, but is monitored at least annually for impairment, or more frequently, as necessary, if there are other indicators of impairment. For the Company's goodwill impairment analysis, the Company operates under one reporting unit. The Company completed the annual impairment test required as of fiscal 2011 and determined that there was no impairment. At the time of the annual test, the entity-wide estimated fair value exceeded the net book value by approximately 25%. The Company continues to monitor its market capitalization. If the Company's market capitalization, plus an estimated control premium, is below its carrying value for a period considered to be other-than-temporary, it is possible that the Company may be required to record an impairment of goodwill either as a result of the annual assessment that the Company conducts in the fourth quarter of each fiscal year, or in a future quarter if an indication of potential impairment is evident. A non-cash goodwill impairment charge would have the effect of decreasing the Company's earnings in such period.

The changes in the carrying amount of goodwill during the quarter ended March 31, 2012, are as follows (in thousands):

Balance at December 31, 2011	\$ 140,654
Effect of foreign currency translation	1,250
Balance at March 31, 2012	\$ 141,904

**8. Senior Loan Agreement**

The Company is party to a senior loan agreement with RBS Citizens, N.A for a \$60.0 million revolving line of credit that provides CRA with the additional flexibility to meet any unforeseen financial requirements. The amount available under this revolving line of credit is reduced by certain letters of credit outstanding, which amounted to \$0.7 million as of March 31, 2012. There was no amount outstanding under this revolving line of credit as of March 31, 2012.

Under the senior loan agreement, the Company must comply with various financial and non-financial covenants. As of March 31, 2012, we were in compliance with the senior loan agreement.

Table of Contents**CRA International, Inc.****Notes to Condensed Consolidated Financial Statements (Continued)****(Unaudited)****9. Net Income per Share**

Basic net income per share represents net income divided by the weighted average shares of common stock outstanding during the period. Diluted net income per share represents net income divided by the weighted average shares of common stock and common stock equivalents, if applicable, outstanding during the period. Common stock equivalents arise from stock options and unvested restricted share awards, using the treasury stock method. Under the treasury stock method, the amount the Company would receive on the exercise of stock options and the vesting of the restricted stock awards, the amount of compensation cost for future service that the Company has not yet recognized, and the amount of tax benefits that would be recorded in common stock when these awards become deductible are assumed to be used to repurchase the shares underlying these awards at the average share price for each fiscal period, and these repurchased shares are netted against the underlying stock options and unvested restricted shares. A reconciliation of basic to diluted weighted average shares of common stock outstanding is as follows (in thousands):

	<b>Quarter Ended</b>	
	<b>March 31, 2012</b>	<b>April 2, 2011</b>
Basic weighted average shares outstanding	10,316	10,613
Common stock equivalents:		
Stock options and restricted shares	177	185
Diluted weighted average shares outstanding	10,493	10,798

For the first quarters of fiscal 2012 and fiscal 2011, the anti-dilutive share based awards that were excluded from the calculation of common stock equivalents for purposes of computing diluted weighted average shares outstanding amounted to 1,237,495 and 1,025,198 shares, respectively. These share-based awards were anti-dilutive because their exercise price exceeded the average market price for the respective period.

On August 30, 2011, we announced that our Board of Directors approved a share repurchase program of up to \$7.5 million of our common stock. During the first quarter of fiscal 2012, we repurchased 122,800 shares under this share repurchase program at an average price per share of \$24.87. On February 22, 2012, our Board of Directors authorized the repurchase of up to an additional \$4.45 million of our common stock. As of March 31, 2012, \$4.7 million was available for future repurchases under these share repurchase programs.

On March 5, 2012, the Company's Compensation Committee of its Board of Directors approved for issuance approximately 122,000 share-based awards that were earned (subject in some cases to further time-based vesting) upon the achievement of certain financial performance goals for fiscal 2011. Upon such approval, approximately 25% of such shares vested, with the remaining shares expected to vest equally on November 8, 2012, November 8, 2013, and November 8, 2014.

**10. Income Taxes**

The Company's effective income tax rates were 86.6% and 40.2% for the first quarter of fiscal 2012 and the first quarter of fiscal 2011, respectively. The effective tax rate in the first quarter of fiscal 2012 was higher than the statutory rate primarily due to losses in foreign locations that provided no tax

Table of Contents**CRA International, Inc.****Notes to Condensed Consolidated Financial Statements (Continued)****(Unaudited)****10. Income Taxes (Continued)**

benefit. The effective tax rate in the first quarter of fiscal 2011 was consistent with the Company's combined federal and state statutory tax rate.

**11. Accrued Expenses**

Accrued expenses consist of the following (in thousands):

	March 31, 2012	December 31, 2011
Compensation and related expenses	\$ 36,227	\$ 53,438
Income taxes payable	926	2,602
Other	4,612	4,462
Total	\$ 41,765	\$ 60,502

**12. Restructuring Charges**

During the first quarter of fiscal 2012, the Company incurred pre-tax expenses of \$0.5 million associated principally with vacant leased office space. The Company recorded this expense in the first quarter of fiscal 2012 in selling, general and administrative expenses for a change in the estimate of the future minimum lease payments and related exit costs through the end of the remaining lease term, net of expected future sublease rental income measured at fair value. This estimated expense required management to make assumptions regarding the estimate of the duration of future vacancy periods, the amount and timing of future settlement payments, and the amount and timing of potential sublease income.

The restructuring reserve balance was as follows as of March 31, 2012 (in thousands):

	Office Vacancies
Balance at December 31, 2011	\$ 3,737
Charges incurred in the first quarter of fiscal 2012	545
Amounts paid, net of amounts received, during the first quarter of fiscal 2012	(595)
Adjustments during the first quarter of fiscal 2012	7
Balance at March 31, 2012	\$ 3,694

On the accompanying balance sheet as of March 31, 2012, the reserve balance of \$3.7 million was classified as follows: \$2.5 million in "deferred rent and other non-current liabilities" and \$1.2 million in "current portion of deferred rent".



Table of Contents**CRA International, Inc.****Notes to Condensed Consolidated Financial Statements (Continued)****(Unaudited)****12. Restructuring Charges (Continued)**

The Company did not incur any restructuring charges during the first quarter of fiscal 2011. The restructuring reserve balances were as follows as of April 2, 2011 (in thousands):

	<b>Office Vacancies</b>	<b>Employee Workforce Reduction</b>	<b>Total Restructuring</b>
Balance at January 1, 2011	\$ 4,476	\$ 951	\$ 5,427
Amounts paid, net of amounts received, during the first quarter of fiscal 2011	(841)	(305)	(1,146)
Adjustments and effect of foreign currency translation during the first quarter of fiscal 2011	(37)	(294)	(331)
Balance at April 2, 2011	\$ 3,598	\$ 352	\$ 3,950

**13. Compensation Arrangements**

In connection with a previous acquisition, CRA has agreed to pay an award to certain employees of the acquired business if they achieve specific performance targets through fiscal 2012. Retention of amounts paid to the individual employees is contingent on their continued employment with CRA through 2016. As of March 31, 2012, based upon performance to date and expected performance for the remainder of fiscal 2012, the amount of the award is estimated to be approximately \$9.6 million and is being expensed over the seven and a half year service period ending in December 2016. The amount of the award could fluctuate depending on future performance during fiscal 2012. Any payments under this award would be made in the first quarter of fiscal 2013. Changes in the estimated award are expensed prospectively over the remaining service period. The Company expensed \$0.4 million and \$0.2 million for this award during the first quarters of fiscal 2012 and fiscal 2011, respectively.

**14. Subsequent Events**

On April 2, 2012, the Company entered into an agreement with the landlord of its London, England office to surrender the lease of one of the three floors it currently leases in the office building in London. Under this agreement, the Company will surrender its lease of this floor on June 30, 2012, instead of on the lease's original termination date of October 2, 2016. On the date of surrender, the Company will pay the landlord approximately \$1.2 million in connection with the surrender. The Company estimates that in the second quarter of fiscal 2012, the Company will record pre-tax restructuring charges of approximately \$2 million in connection with the surrender of this lease. Additionally, the Company estimates that its operating lease obligations as disclosed at December 31, 2011 in its annual report on Form 10-K for fiscal 2011 will decrease by approximately \$3.6 million in the aggregate for fiscal 2013 through fiscal 2016. The reduction in contractual lease obligations is a pre-tax amount and any future savings realized by this reduction may be impacted by other costs, including incentive compensation, in fiscal years 2013 through fiscal 2016.

Table of Contents

**ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

**Forward-Looking Statements**

Except for historical facts, the statements in this quarterly report are forward-looking statements. Forward-looking statements are merely our current predictions of future events. These statements are inherently uncertain, and actual events could differ materially from our predictions. Important factors that could cause actual events to vary from our predictions include those discussed below under the heading "Risk Factors." We assume no obligation to update our forward-looking statements to reflect new information or developments. We urge readers to review carefully the risk factors described in this quarterly report and in the other documents that we file with the Securities and Exchange Commission, or SEC. You can read these documents at [www.sec.gov](http://www.sec.gov).

Our principal internet address is [www.crai.com](http://www.crai.com). Our website provides a link to a third-party website through which our annual, quarterly, and current reports, and amendments to those reports, are available free of charge. We believe these reports are made available as soon as reasonably practicable after we file them electronically with, or furnish them to, the SEC. We do not maintain or provide any information directly to the third-party website, and we do not check its accuracy.

Our website also includes information about our corporate governance practices. The Investor Relations page of our website provides a link to a web page where you can obtain a copy of our code of ethics applicable to our principal executive officer, principal financial officer, and principal accounting officer.

**Critical Accounting Policies and Significant Estimates**

The discussion and analysis of our financial condition and results of operations are based upon our condensed consolidated financial statements, which have been prepared in accordance with generally accepted accounting principles in the U.S. ("U.S. GAAP"). The preparation of these financial statements requires us to make significant estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses, as well as related disclosure of contingent assets and liabilities, at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Estimates in these condensed consolidated financial statements include, but are not limited to, accounts receivable allowances, revenue recognition on fixed price contracts, depreciation of property and equipment, share-based compensation, valuation of acquired intangible assets, impairment of long lived assets, goodwill, accrued and deferred income taxes, valuation allowances on deferred tax assets, accrued compensation, accrued exit costs, and other accrued expenses. These items are monitored and analyzed by management for changes in facts and circumstances, and material changes in these estimates could occur in the future. Changes in estimates are recorded in the period in which they become known. We base our estimates on historical experience and various other assumptions that we believe to be reasonable under the circumstances. Actual results may differ from our estimates if our assumptions based on past experience or our other assumptions do not turn out to be substantially accurate.

We have described our significant accounting policies in Note 1 to our consolidated financial statements included in our annual report on Form 10-K for fiscal 2011. We have reviewed our accounting policies, identifying those that we believe to be critical to the preparation and understanding of our consolidated financial statements in the list set forth below. See the disclosure under the heading "Critical Accounting Policies" in Item 7 of Part II of our annual report on Form 10-K for fiscal 2011 for a detailed description of these policies and their potential effects on our results of operations and financial condition.

Revenue recognition and accounts receivable allowances

Share-based compensation expense

Table of Contents

Valuation of goodwill and other intangible assets

Accounting for income taxes

We did not adopt any changes in the first quarter of fiscal 2012 that had a material effect on these critical accounting policies nor did we make any changes to our accounting policies in the first quarter of fiscal 2012 that changed these critical accounting policies.

**Recent Accounting Standards**

See Note 4 to our condensed consolidated financial statements included in this quarterly report on Form 10-Q for a discussion of recent accounting standards.

**Results of Operations**

The following table provides operating information as a percentage of revenues for the periods indicated:

	<b>Quarter Ended</b>	
	<b>March 31,</b>	<b>April 2,</b>
	<b>2012</b>	<b>2011</b>
Revenues	100.0%	100.0%
Costs of services	67.2	65.6
Gross profit	32.8	34.4
Selling, general and administrative expenses	25.8	22.7
Depreciation and amortization	2.1	1.7
Income from operations	4.8	10.1
Interest income	0.1	0.1
Interest expense	(0.1)	(0.5)
Other expense, net	(0.1)	(0.2)
Income before provision for income taxes	4.7	9.5
Provision for income taxes	(4.1)	(3.8)
Net income	0.6	5.7
Net loss (income) attributable to noncontrolling interest, net of tax	0.1	
Net income attributable to CRA International, Inc.	0.8%	5.6%

***Quarter Ended March 31, 2012 Compared to the Quarter Ended April 2, 2011***

*Revenues.* Revenues decreased \$9.5 million, or 12.1%, to \$69.1 million for the first quarter of fiscal 2012 from \$78.6 million for the first quarter of fiscal 2011. Our revenue decline was due primarily to lower than expected performance of our management consulting business, which overshadowed a solid performance and continued growth in our litigation, regulatory, and financial consulting areas. A principal cause of the decline in revenue in the management consulting business was the reluctance of some clients to proceed with consulting projects while they were occupied with more fundamental challenges in their own markets. Utilization decreased to 68% for the first quarter of fiscal 2012 from 75% for the first quarter of fiscal 2011 primarily as a result of the revenue shortfall in the management consulting business.

Overall, revenues outside of the U.S. represented approximately 20% of total revenues for the first quarter of fiscal 2012, compared with 28% of total revenues for the first quarter of fiscal 2011. The decrease was due primarily to the softness in our management consulting business for the first quarter

Table of Contents

of fiscal 2012, particularly in Europe where economic uncertainties continued into the first quarter. Revenues derived from fixed-price engagements decreased to 10% of total revenues for the first quarter of fiscal 2012 compared with 25% for the first quarter of fiscal 2011. The decrease in revenues from fixed-price engagements was due primarily to the slowdown in our management consulting business in the first quarter of 2012 as the management consulting business typically has a higher concentration of fixed-price service contracts.

*Costs of Services.* Costs of services decreased \$5.1 million, or 9.8%, to \$46.5 million for the first quarter of fiscal 2012 from \$51.6 million for the first quarter of fiscal 2011. The decrease in costs of services was due primarily to the decrease in revenue in the first quarter of fiscal 2012 as compared with the first quarter of fiscal 2011. As a result, we had a decrease in incentive bonus expense for our employee consultants in the first quarter of fiscal 2012 as compared to the first quarter of fiscal 2011, and client reimbursable expenses decreased by \$2.1 million. Client reimbursable expenses decreased primarily due to a decrease in the usage of outside consultants and travel expenses as a result of the decreased revenue.

As a percentage of revenues, costs of services increased to 67.2% for the first quarter of fiscal 2012 from 65.6% for the first quarter of fiscal 2011. The increase in costs of services as a percentage of revenue was due primarily to the decrease in revenue during the first quarter of fiscal 2012 as compared with the first quarter of fiscal 2011.

*Selling, General and Administrative Expenses.* Selling, general and administrative expenses increased by \$39,000, or 0.2%, to \$17.9 million for the first quarter of fiscal 2012 from \$17.8 million for the first quarter of fiscal 2011. Selling, general and administrative expenses included \$0.5 million of restructuring costs recorded in the first quarter of fiscal 2012 associated with the reduction of vacant leased office space. There were no restructuring charges recorded in the first quarter of fiscal 2011. Partially offsetting this increase is a decrease in compensation expense resulting from decreased headcount in the first quarter of fiscal 2012 as compared with the first quarter of fiscal 2011. As a percentage of revenues, selling, general and administrative expenses increased to 25.8% for the first quarter of fiscal 2012 from 22.7% for the first quarter of fiscal 2011, which was primarily the result of the decrease in revenue during the first quarter of fiscal 2012 as compared with the first quarter of fiscal 2011.

*Depreciation and Amortization.* Depreciation and amortization increased by \$173,000, or 13.3%, to \$1.5 million from \$1.3 million for the first quarter of fiscal 2011 primarily due to the amortization that began at the beginning of fiscal 2012 for software costs related to our implementation of an enterprise-wide financial reporting system at the start of fiscal 2012.

*Interest Expense.* Interest expense decreased by \$312,000 to \$80,000 for the first quarter of fiscal 2012 from \$392,000 for the first quarter of fiscal 2011. The decrease was primarily due to our repurchase, on June 15, 2011, of 100% of the principal amount of the outstanding debentures plus accrued and unpaid interest, which amounted to \$21.9 million and \$0.3 million, respectively. Through this final repurchase date, interest expense primarily consisted of interest incurred on this convertible debt, the amortization of debt issuance costs, and the amortization of the discount on the debt for the equity conversion feature of the debt instrument.

*Other Expense, Net.* Other expense, net decreased by \$107,000 to \$39,000 for the first quarter of fiscal 2012 from \$146,000 for the first quarter of fiscal 2011. Other expense, net consists primarily of foreign currency exchange transaction gains and losses. We continue to manage our foreign currency exchange exposure through frequent settling of intercompany account balances and by self-hedging movements in exchange rates between the value of the dollar and foreign currencies including the Euro and the British Pound.

Table of Contents

*Provision for Income Taxes.* For the first quarter of fiscal 2012, our provision for income taxes was \$2.8 million and the effective tax rate was 86.6% compared to a provision of \$3.0 million and an effective tax rate of 40.2% for the first quarter of fiscal 2011. The effective tax rate in the first quarter of fiscal 2012 was higher than the statutory rate primarily due to losses in foreign locations that provided no tax benefit. The effective tax rate in the first quarter of fiscal 2011 was consistent with our combined federal and state statutory tax rate.

*Net Loss (Income) Attributable to Noncontrolling Interest, Net of Tax.* Our ownership interest in NeuCo constitutes control under U.S. GAAP. As a result, NeuCo's financial results are consolidated with ours, and allocations of the noncontrolling interest's share of NeuCo's net income result in deductions to our net income, while allocations of the noncontrolling interest's share of NeuCo's net loss result in additions to our net income. Our ownership interest in NeuCo is 55.89%. The result of operations of NeuCo allocable to its other owners was a net loss of \$83,000 for the first quarter of fiscal 2012 and net income of \$26,000 for the first quarter of fiscal 2011.

*Net Income Attributable to CRA International, Inc.* Net income attributable to CRA International, Inc. decreased by \$3.9 million to net income of \$0.5 million for the first quarter of fiscal 2012 from net income of \$4.4 million for the first quarter of fiscal 2011. Diluted net income per share was \$0.05 per share for the first quarter of fiscal 2012, compared to \$0.41 per share for the first quarter of fiscal 2011. Diluted weighted average shares outstanding decreased by approximately 305,000 shares to approximately 10,493,000 shares for the first quarter of fiscal 2012 from approximately 10,798,000 shares for the first quarter of fiscal 2011. The decrease in diluted weighted average shares outstanding was primarily due to repurchases of common stock since the first quarter of fiscal 2011, offset in part by an increase as a result of restricted shares that have vested or that have been issued and stock options that have been exercised since the first quarter of fiscal 2011.

**Liquidity and Capital Resources**

We believe that current cash, cash equivalents, and short-term investment balances, cash generated from operations, and amounts available under our bank line of credit will be sufficient to meet our anticipated working capital and capital expenditure requirements for at least the next 12 months.

*General.* In the first quarter of fiscal 2012, cash and cash equivalents decreased by \$20.0 million. We completed the quarter with cash and cash equivalents of \$41.6 million, short term investments of \$9.5 million, and working capital (defined as current assets less current liabilities) of \$104.5 million. Of the total cash and cash equivalents of \$41.6 million at March 31, 2012, \$31.2 million was held within the U.S. The Company has sufficient sources of cash in the U.S. to fund U.S. cash requirements without the need to repatriate any funds.

As of March 31, 2012, a portion of our cash accounts was concentrated at a single financial institution, which potentially exposes us to credit risks. The financial institution has generally "stable" credit ratings and its short-term credit rating is A-1 by Standard & Poor's ratings services. We have not experienced any losses related to such accounts and we do not believe that there is significant risk of non-performance by the financial institution. Our cash on deposit at this financial institution is fully liquid, and we continually monitor the credit ratings of such institution and limit the amount of cash we maintain at this institution. A change in the credit worthiness of this financial institution could materially affect our liquidity and working capital.

*Sources and Uses of Cash.* During the first quarter of fiscal 2012, net cash used in operating activities was \$21.1 million. This use of cash was expected as we paid out a majority of our fiscal 2011 performance bonuses during the first quarter of fiscal 2012, which was the significant factor in the aggregate decrease in accounts payable, accrued expenses, and other liabilities of \$18.8 million. Other uses of cash in operating activities included an increase in unbilled services of \$19.0 million, which was

Table of Contents

expected as our conversion to a new enterprise-wide financial reporting system on January 1, 2012 forestalled our billing process at the outset of the first quarter of fiscal 2012, resulting in an increase in DSOs. The uses of cash in operations were partially offset by the following sources of cash: a decrease in accounts receivable of \$13.8 million as we continued our efforts on more timely collections of outstanding receivables, net income of \$0.4 million, share-based compensation expense of \$1.5 million, and depreciation and amortization expense of \$1.5 million.

During the first quarter of fiscal 2012, net cash provided by investing activities was \$4.3 million, which included \$14.5 million received from the sale of short-term investments, partially offset by \$9.5 million to purchase short-term investments and \$0.7 million for capital expenditures.

We used \$3.4 million of net cash in financing activities during the first quarter of fiscal 2012. Cash used in financing activities was primarily used for the repurchase of shares of our common stock for \$3.1 million and the redemption of \$0.7 million in vested employee restricted shares for tax withholdings, offset partially by \$0.3 million received upon the exercise of stock options.

***Indebtedness***

We are party to a senior loan agreement with RBS Citizens, N.A for a \$60.0 million revolving line of credit with a maturity date of April 30, 2014. The revolving line of credit gives us additional flexibility to meet any unforeseen financial requirements. Subject to the terms of the agreement, we may use borrowings under this revolving line of credit for acquisition financing, working capital, general corporate purposes, letters of credit, and foreign exchanges contracts. The amount available under our bank revolving line of credit is constrained by various financial covenants and is reduced by certain outstanding letters of credit, which amounted to \$0.7 million as of March 31, 2012. As of March 31, 2012, there was no amount outstanding under this revolving line of credit.

Borrowings under our credit facility bear interest at LIBOR plus an applicable margin. Applicable margins range from 1.75% to 2.75%, depending on the ratio of our consolidated total debt to consolidated earnings before interest, taxes, depreciation and amortization, or EBITDA, for the preceding four fiscal quarters, subject to various adjustments stated in the senior loan agreement. These margins are adjusted both quarterly and each time we borrow under the credit facility. Interest is payable monthly. A commitment fee of 0.25% is payable on the unused portion of the credit facility. Borrowings under the credit facility are secured by 100% of the stock of certain of our U.S. subsidiaries and 65% of the stock of certain of our foreign subsidiaries, which represent approximately \$27.7 million in net assets as of March 31, 2012.

Under our senior loan agreement, we must comply with various financial and non-financial covenants. Compliance with these financial covenants is tested on a fiscal quarterly basis. Any indebtedness outstanding under the senior credit facility may become immediately due and payable upon the occurrence of stated events of default, including our failure to pay principal, interest or fees or a violation of any financial covenant. The financial covenants require us to maintain a minimum consolidated working capital of \$25.0 million and to comply with a consolidated senior debt to EBITDA ratio of not more than 2.5 to 1.0. The non-financial covenant restrictions of the senior credit agreement include, but are not limited to, our ability to incur additional indebtedness, engage in acquisitions or dispositions, and enter into business combinations. As of March 31, 2012, we were in compliance with the covenants of our senior loan agreement.

***Compensation Arrangements***

In connection with a previous acquisition, we have agreed to pay an award to certain employees of the acquired business if they achieve specific performance targets through fiscal 2012. Retention of amounts paid to the individual employees is contingent on their continued employment with us through 2016. As of March 31, 2012, based upon performance to date and expected performance for the

Table of Contents

remainder of fiscal 2012, the amount of the award is estimated to be approximately \$9.6 million and is being expensed over the seven and a half year service period ending in December 2016. This amount could fluctuate depending on future performance during fiscal 2012. Changes in the estimated award are expensed prospectively over the remaining service period. Any payments under this award would be made in the first quarter of fiscal 2013 and we expect to fund these payments, if any, from existing cash resources, cash generated from operations, or financing transactions.

*Other Matters*

As part of our business, we regularly evaluate opportunities to acquire other consulting firms, practices or groups or other businesses. In recent years, we have typically paid for acquisitions with cash, or a combination of cash and our common stock, and we may continue to do so in the future. To pay for an acquisition, we may use cash on hand, cash generated from our operations, borrowings under our revolving credit facility, or we may pursue other forms of financing. Our ability to secure short-term and long-term debt or equity financing in the future, including our ability to refinance our current senior loan agreement, will depend on several factors, including our future profitability, the levels of our debt and equity, restrictions under our existing line of credit with our bank, and the overall credit and equity market environments.

On August 30, 2011, we announced that our Board of Directors approved a share repurchase program of up to \$7.5 million of our common stock. During the first quarter of fiscal 2012, we repurchased 122,800 shares under this share repurchase program at an average price per share of \$24.87. On February 22, 2012, our Board of Directors authorized the repurchase of up to an additional \$4.45 million of our common stock. As of March 31, 2012, \$4.7 million was available for future repurchases under these share repurchase programs. We will finance these programs with available cash and cash from future operations. We may repurchase shares in open market purchases or in privately negotiated transactions in accordance with applicable insider trading and other securities laws and regulations. We expect to continue to repurchase shares under these programs.

**Contractual Obligations**

On April 2, 2012, we entered into an agreement with the landlord of our London, England office to surrender the lease of one of the three floors we currently lease in the office building in London. Under this agreement, we will surrender our lease of this floor on June 30, 2012, instead of on the lease's original termination date of October 2, 2016. On the date of surrender, we will pay the landlord approximately \$1.2 million in connection with the surrender. As a result of this transaction, we estimate that our operating lease obligations as disclosed at December 31, 2011 in our annual report on Form 10-K for fiscal 2011 will decrease by approximately \$3.6 million in the aggregate for fiscal 2013 through fiscal 2016. The reduction in contractual lease obligations is a pre-tax amount and any future savings realized by this reduction may be impacted by other costs, including incentive compensation, in fiscal years 2013 through fiscal 2016.

**Factors Affecting Future Performance**

Part II, Item 1A of this quarterly report sets forth risks and uncertainties that could cause actual results to differ materially from the results contemplated by the forward-looking statements contained in this quarterly report. If any of these risks, or any risks not presently known to us or that we currently believe are not significant, develops into an actual event, then our business, financial condition, and results of operations could be adversely affected.

Table of Contents

**ITEM 3. Quantitative and Qualitative Disclosures About Market Risk**

*Foreign Exchange Risk*

The majority of our operations are based in the U.S., and accordingly, the majority of our transactions are denominated in U.S. Dollars. However, we have foreign-based operations where transactions are denominated in foreign currencies and are subject to market risk with respect to fluctuations in the relative value of foreign currencies. Our primary foreign currency exposures relate to our short-term intercompany balances with our foreign subsidiaries and accounts receivable and cash valued in the United Kingdom in U.S. Dollars or Euros. Our primary foreign subsidiaries have functional currencies denominated in the British Pound and the Euro, and foreign denominated assets and liabilities are re-measured each reporting period with any exchange gains and losses recorded in our consolidated statements of operations. We continue to manage our foreign currency exchange exposure through frequent settling of intercompany account balances and by self-hedging movements in exchange rates between the value of the U.S. Dollar and foreign currencies and the Euro and the British Pound. Holding all other variables constant, fluctuations in foreign exchange rates may impact reported revenues and expenses significantly, based on currency exposures at March 31, 2012. A hypothetical 10% movement in foreign exchange rates would have affected our income before provision for income taxes for the first quarter of fiscal 2012 by approximately \$0.8 million. However, actual gains and losses in the future could differ materially from this analysis based on the timing and amount of both foreign currency exchange rate movements and our actual exposure.

From time to time, we may use derivative instruments to manage the risk of exchange rate fluctuations. However, at March 31, 2012, we had no outstanding derivative instruments. We do not use derivative instruments for trading or speculative purposes.

*Interest Rate Risk*

We maintain an investment portfolio consisting mainly of commercial paper with maturities of less than a year. These held-to-maturity securities are subject to interest rate risk. However, a hypothetical change in the interest rate of 10% would not have a material impact to the fair values of these securities at March 31, 2012 primarily due to their short maturity.

**ITEM 4. Controls and Procedures**

*Evaluation of Disclosure Controls and Procedures*

Under the supervision and with the participation of our management, including our President and Chief Executive Officer and our Chief Financial Officer, we evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report. Based upon that evaluation, our President and Chief Executive Officer and our Chief Financial Officer concluded that our disclosure controls and procedures were effective to provide reasonable assurance that we record, process, summarize and report the information we must disclose in reports that we file or submit under the Securities Exchange Act of 1934, as amended, within the time periods specified in the SEC's rules and forms.

*Evaluation of Changes in Internal Control over Financial Reporting*

Under the supervision and with the participation of our management, including our President and Chief Executive Officer and our Chief Financial Officer, we have determined that, during the first quarter of fiscal 2012, there were no changes in our internal control over financial reporting that have affected, or are reasonably likely to affect, materially our internal control over financial reporting.

*Important Considerations*

The effectiveness of our disclosure controls and procedures and our internal control over financial reporting is subject to various inherent limitations, including cost limitations, judgments used in



Table of Contents

decision making, assumptions about the likelihood of future events, the soundness of our systems, the possibility of human error, and the risk of fraud. Moreover, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions and the risk that the degree of compliance with policies or procedures may deteriorate over time. Because of these limitations, there can be no assurance that any system of disclosure controls and procedures or internal control over financial reporting will be successful in preventing all errors or fraud or in making all material information known in a timely manner to the appropriate levels of management.

**PART II. OTHER INFORMATION**

**ITEM 1. Legal Proceedings**

None.

**ITEM 1A. Risk Factors**

Our operations are subject to a number of risks. You should carefully read and consider the following risk factors, together with all other information in this report, in evaluating our business. If any of these risks, or any risks not presently known to us or that we currently believe are not significant, develops into an actual event, then our business, financial condition, and results of operations could be adversely affected. If that happens, the market price of our common stock could decline, and you may lose all or part of your investment.

***We depend upon key employees to generate revenue***

Our business consists primarily of the delivery of professional services, and accordingly, our success depends heavily on the efforts, abilities, business generation capabilities, and project execution capabilities of our employee consultants. In particular, our employee consultants' personal relationships with our clients are a critical element in obtaining and maintaining client engagements. If we lose the services of any employee consultant or group of employee consultants, or if our employee consultants fail to generate business or otherwise fail to perform effectively, that loss or failure could adversely affect our revenues and results of operations. Our employee consultants generated engagements that accounted for approximately 83% and 88% of our revenues for the first quarters of fiscal 2012 and fiscal 2011, respectively. Our top five employee consultants generated approximately 19% and 16% of our revenues for the first quarters of fiscal 2012 and fiscal 2011, respectively.

We do not have non-competition agreements with a majority of our employee consultants, and they can terminate their relationships with us at will and without notice. The non-competition and non-solicitation agreements that we have with some of our employee consultants offer us only limited protection and may not be enforceable in every jurisdiction. In the event that an employee leaves, some clients may decide that they prefer to continue working with the employee rather than with us. In the event an employee departs and acts in a way that we believe violates the employee's non-competition or non-solicitation agreement, we will consider any legal remedies we may have against such person on a case-by-case basis. We may decide that preserving cooperation and a professional relationship with the former employee or clients that worked with the employee, or other concerns, outweigh the benefits of any possible legal recovery.

***Deterioration of global economic conditions, global market and credit conditions, and regulatory and legislative changes affecting our clients, practice areas, or competitors could have an impact on our business***

Overall global economic conditions and global market and credit conditions in the industries we service can negatively impact the market for our services. A number of factors outside of our control include the availability of credit, the costs and terms of borrowing, merger and acquisition activity, and general economic factors and business conditions.

Table of Contents

Similarly, many of our clients are in highly regulated industries. Regulatory and legislative changes in these industries could also impact the market for our service offerings and could render our current service offerings obsolete, reduce the demand for our services, or impact the competition for consulting and expert services. For example, potential changes in the patent laws could have a significant impact on our intellectual property practice. We are not able to predict the positive or negative effects that future events or changes to the U.S. or international business environment could have on our operations.

***Competition from other litigation, regulatory, financial, and management consulting firms could hurt our business***

The market for litigation, regulatory, financial, and management consulting services is intensely competitive, highly fragmented, and subject to rapid change. We may be unable to compete successfully with our existing competitors or with any new competitors. In general, there are few barriers to entry into our markets, and we expect to face additional competition from new entrants into the economic and management consulting industries. In the litigation, regulatory, and financial consulting markets, we compete primarily with other economic and financial consulting firms and individual academics. In the management consulting market, we compete primarily with other business and management consulting firms, specialized or industry-specific consulting firms, the consulting practices of large accounting firms, and the internal professional resources of existing and potential clients. Many of our competitors have national or international reputations as well as significantly greater personnel, financial, managerial, technical, and marketing resources than we do, which could enhance their ability to respond more quickly to technological changes, finance acquisitions, and fund internal growth. Some of our competitors also have a significantly broader geographic presence and resources than we do.

***Our business could suffer if we are unable to hire and retain additional qualified consultants as employees***

Our business continually requires us to hire highly qualified, highly educated consultants as employees. Our failure to recruit and retain a significant number of qualified employee consultants could limit our ability to accept or complete engagements and adversely affect our revenues and results of operations. Relatively few potential employees meet our hiring criteria, and we face significant competition for these employees from our direct competitors, academic institutions, government agencies, research firms, investment banking firms, and other enterprises. Many of these competing employers are able to offer potential employees significantly greater compensation and benefits or more attractive lifestyle choices, career paths, or geographic locations than we can. Competition for these employee consultants has increased our labor costs, and a continuation of this trend could adversely affect our margins and results of operations.

In addition, we utilize loans with some of our employees and non-employee experts, other than our executive officers, as a way to attract and retain them. A portion of these loans are collateralized. Defaults under these loans could have a material adverse effect on our consolidated statements of operations, financial condition and liquidity.

***Our failure to execute our business strategy or manage future growth successfully could adversely affect our revenues and results of operations***

Any failure on our part to execute our business strategy or manage future growth successfully could adversely affect our revenues and results of operations. In the future, we could open offices in new geographic areas, including foreign locations, and expand our employee base as a result of internal growth and acquisitions. Opening and managing new offices often requires extensive management supervision and increases our overall selling, general, and administrative expenses. Expansion creates new and increased management, consulting, and training responsibilities for our employee consultants. Expansion also increases the demands on our internal systems, procedures, and controls, and on our managerial, administrative, financial, marketing, and other resources. We depend heavily upon the

Table of Contents

managerial, operational, and administrative skills of our executive officers to manage our expansion and business strategy. New responsibilities and demands may adversely affect the overall quality of our work.

***Our international operations create special risks***

Our international operations carry special financial and business risks, including:

greater difficulties in managing and staffing foreign operations;

difficulties from fluctuations in world-wide utilization levels;

currency fluctuations that adversely affect our financial position and operating results;

unexpected changes in trading policies, regulatory requirements, tariffs, and other barriers;

different practices in collecting accounts receivable;

increased selling, general, and administrative expenses associated with managing a larger and more global organization;

longer sales cycles;

restrictions on the repatriation of earnings;

potentially adverse tax consequences, such as trapped foreign losses;

the impact of differences in the governmental, legal and regulatory environment in foreign jurisdictions, as well as U.S. laws and regulations related to our foreign operations;

less stable political and economic environments; and

civil disturbances or other catastrophic events that reduce business activity.

We conduct a portion of our business in the Middle East. At times, turmoil in the region has interrupted, and could interrupt in the future, our business operations in that region and slow the flow of new opportunities and proposals, which can ultimately affect our revenues and results of operations.

If our international revenues increase relative to our total revenues, these factors could have a more pronounced effect on our operating results.

***We depend on our non-employee experts***

We depend on our relationships with our exclusive non-employee experts. In the first quarters of fiscal 2012 and fiscal 2011, five of our top exclusive non-employee experts generated engagements that accounted for approximately 9% and 7% of our revenues in those periods, respectively. We believe that these experts are highly regarded in their fields and that each offers a combination of knowledge, experience, and

expertise that would be very difficult to replace. We also believe that we have been able to secure some engagements and attract consultants in part because we can offer the services of these experts. Most of these experts can limit their relationships with us at any time for any reason. These reasons could include affiliations with universities with policies that prohibit accepting specified engagements, termination of exclusive relationships, the pursuit of other interests, and retirement.

In many cases we seek to include restrictive covenant agreements in our agreements with our non-employee experts, which could include non-competition agreements, non-solicitation agreements and non-hire agreements. The limitation or termination of any of their relationships with us, or competition from any of them after these agreements expire, could harm our reputation, reduce our business opportunities and adversely affect our revenues and results of operations. These restrictive covenant agreements that we may have with some of our non-employee experts offer us only limited protection and may not be enforceable in every jurisdiction. In the event that non-employee experts leave, clients working with these non-employee experts may decide that they prefer to continue working with them rather than with us. In the event a non-employee expert departs and acts in a way that we

Table of Contents

believe violates the expert's restrictive covenant agreements, we will consider any legal and equitable remedies we may have against such person on a case-by-case basis. We may decide that preserving cooperation and a professional relationship with the former non-employee expert or clients that worked with the non-employee expert, or other concerns, outweigh the benefits of any possible legal action or recovery.

To meet our long-term growth targets, we need to establish ongoing relationships with additional non-employee experts who have reputations as leading experts in their fields. We may be unable to establish relationships with any additional non-employee experts. In addition, any relationship that we do establish may not help us meet our objectives or generate the revenues or earnings that we anticipate.

***Maintaining our professional reputation is crucial to our future success***

Our ability to secure new engagements and hire qualified consultants as employees depends heavily on our overall reputation as well as the individual reputations of our employee consultants and principal non-employee experts. Because we obtain a majority of our new engagements from existing clients, any client that is dissatisfied with our performance on a single matter could seriously impair our ability to secure new engagements. Given the frequently high-profile nature of the matters on which we work, including work before and on behalf of government agencies, any factor that diminishes our reputation or the reputations of any of our employee consultants or non-employee experts could make it substantially more difficult for us to compete successfully for both new engagements and qualified consultants.

***Clients can terminate engagements with us at any time***

Many of our engagements depend upon disputes, proceedings, or transactions that involve our clients. Our clients may decide at any time to seek to resolve the dispute or proceeding, abandon the transaction, or file for bankruptcy. Our engagements can therefore terminate suddenly and without advance notice to us. If an engagement is terminated unexpectedly, our employee consultants working on the engagement could be underutilized until we assign them to other projects. In addition, because much of our work is project-based rather than recurring in nature, our consultants' utilization depends on our ability to secure additional engagements on a continual basis. Accordingly, the termination or significant reduction in the scope of a single large engagement could reduce our utilization and have an immediate adverse impact on our revenues and results of operations.

***We derive our revenues from a limited number of large engagements***

We derive a portion of our revenues from a limited number of large engagements. If we do not obtain a significant number of new large engagements each year, our business, financial condition, and results of operations could suffer. Our 10 largest engagements accounted for approximately 18% of our revenues in each of the first quarters of fiscal 2012 and fiscal 2011. Our 10 largest clients accounted for approximately 23% of our revenues in each of the first quarters of fiscal 2012 and fiscal 2011. In general, the volume of work we perform for any particular client varies from year to year, and due to the specific engagement nature of our practice, a major client in one year may not hire us in the following year.

***We depend on our antitrust and mergers and acquisitions consulting business***

We derive a significant amount of our revenues from engagements related to antitrust and mergers and acquisitions activities. Any substantial reduction in the number or size of our engagements in these areas could adversely affect our revenues and results of operations. Adverse changes in general economic conditions, particularly conditions influencing the merger and acquisition activity of larger companies, could adversely affect engagements in which we assist clients in proceedings before the U.S. Department of Justice, the U.S. Federal Trade Commission, and various foreign antitrust authorities.

Table of Contents

For example, global economic recessions have resulted in, and may in the future result in, reduced merger and acquisition activity levels. Any of these reductions in activity level would adversely affect our revenues and results of operations.

***Acquisitions may disrupt our operations or adversely affect our results***

We regularly evaluate opportunities to acquire other businesses. The expenses we incur evaluating and pursuing acquisitions could adversely affect our results of operations. If we acquire a business, we may be unable to manage it profitably or successfully integrate its operations with our own. Moreover, we may be unable to realize the financial, operational, and other benefits we anticipate from these acquisitions or any other acquisition. Many potential acquisition targets do not meet our criteria, and for those that do, we face significant competition for these acquisitions from our direct competitors, private equity funds, and other enterprises. Competition for future acquisition opportunities in our markets could increase the price we pay for businesses we acquire and could reduce the number of potential acquisition targets. Further, acquisitions may involve a number of special financial and business risks, such as:

diversion of our management's time, attention, and resources;

decreased utilization during the integration process;

loss of key acquired personnel;

increased costs to improve or coordinate managerial, operational, financial, and administrative systems including compliance with the Sarbanes-Oxley Act of 2002;

dilutive issuances of equity securities, including convertible debt securities;

the assumption of legal liabilities;

amortization of acquired intangible assets;

potential write-offs related to the impairment of goodwill, including if our enterprise value declines below certain levels;

difficulties in integrating diverse corporate cultures; and

additional conflicts of interests.

***Fluctuations in our quarterly revenues and results of operations could depress the market price of our common stock***

We may experience significant fluctuations in our revenues and results of operations from one quarter to the next. If our revenues or net income in a quarter fall below the expectations of securities analysts or investors, the market price of our common stock could fall significantly. Our results of operations in any quarter can fluctuate for many reasons, including:

our ability to implement rate increases;

the number, scope, and timing of ongoing client engagements;

the extent to which we can reassign our employee consultants efficiently from one engagement to the next;

the extent to which our employee consultants or clients take holiday, vacation, and sick time, including traditional seasonality related to summer vacation and holiday schedules;

employee hiring;

the extent of revenue realization or cost overruns;

fluctuations in the results and continuity of the operations of our software subsidiary, NeuCo;

Table of Contents

fluctuations in our provision for income taxes due to changes in income arising in various tax jurisdictions, valuation allowances, non-deductible expenses, and changes in estimates of our uncertain tax positions;

fluctuations in interest rates; and

collectability of receivables and unbilled work in process.

Because we generate the majority of our revenues from consulting services that we provide on an hourly fee basis, our revenues in any period are directly related to the number of our employee consultants, their billing rates, and the number of billable hours they work in that period. We have a limited ability to increase any of these factors in the short term. Accordingly, if we underutilize our consultants during one part of a fiscal period, we may be unable to compensate by augmenting revenues during another part of that period. In addition, we are occasionally unable to utilize fully any additional consultants that we hire, particularly in the quarter in which we hire them. Moreover, a significant majority of our operating expenses, primarily office rent and salaries, are fixed in the short term. As a result, if our revenues fail to meet our projections in any quarter, that could have a disproportionate adverse effect on our net income. For these reasons, we believe our historical results of operations are not necessarily indicative of our future performance.

***Our clients may be unable or unwilling to pay us for our services***

Our clients include some companies that may from time to time encounter financial difficulties, particularly during a downward trend in the economy or may dispute the services we provide. If a client's financial difficulties become severe or a dispute arises, the client may be unwilling or unable to pay our invoices in the ordinary course of business, which could adversely affect collections of both our accounts receivable and unbilled services. On occasion, some of our clients have entered bankruptcy, which has prevented us from collecting amounts owed to us. The bankruptcy of a client with a substantial accounts receivable could have a material adverse effect on our financial condition and results of operations. A small number of clients who have paid sizable invoices later declared bankruptcy, and a court determination that we were not properly entitled to that payment may require repayment of some or all of the amount we received, which could adversely affect our financial condition and results of operations.

***Potential conflicts of interests may preclude us from accepting some engagements***

We provide our services primarily in connection with significant or complex transactions, disputes, or other matters that are usually adversarial or that involve sensitive client information. Our engagement by a client may preclude us from accepting engagements with the client's competitors or adversaries because of conflicts between their business interests or positions on disputed issues or other reasons. Accordingly, the nature of our business limits the number of both potential clients and potential engagements. Moreover, in many industries in which we provide consulting services, such as in the telecommunications industry, there has been a continuing trend toward business consolidations and strategic alliances. These consolidations and alliances reduce the number of potential clients for our services and increase the chances that we will be unable to continue some of our ongoing engagements or accept new engagements as a result of conflicts of interests.



Table of Contents

***Fluctuations in the types of service contracts we enter into may adversely impact revenue and results of operations***

We derive a portion of our revenues from fixed-price contracts. We derived approximately 10% and 25% of revenues from fixed-price engagements in the first quarters of fiscal 2012 and fiscal 2011, respectively. These contracts are more common in our management consulting area, and would likely grow in number with any expansion of that area. Fluctuations in the mix between time-and-material contracts, fixed-price contracts and arrangements with fees tied to performance-based criteria, may result in fluctuations of revenue and results of operations. In addition, if we fail to estimate accurately the resources required for a fixed-price project or fail to satisfy our contractual obligations in a manner consistent with the project budget, we might generate a smaller profit or incur a loss on the project. On occasion, we have had to commit unanticipated additional resources to complete projects, and we may have to take similar action in the future, which could adversely affect our revenues and results of operations.

***The market price of our common stock may be volatile***

The market price of our common stock has fluctuated widely and may continue to do so. For example, from April 3, 2011 to March 31, 2012, the trading price of our common stock ranged from a high of \$29.80 per share to a low of \$16.42 per share. Many factors could cause the market price of our common stock to rise and fall. Some of these factors are:

variations in our quarterly results of operations;

the hiring or departure of key personnel or non-employee experts;

changes in our professional reputation;

the introduction of new services by us or our competitors;

acquisitions or strategic alliances involving us or our competitors;

changes in accounting principles or methods;

changes in estimates of our performance or recommendations by securities analysts;

future sales of shares of common stock in the public market; and

market conditions in the industry and the economy as a whole.

In addition, the stock market often experiences significant price and volume fluctuations. These fluctuations are often unrelated to the operating performance of particular companies. These broad market fluctuations may adversely affect the market price of our common stock. When the market price of a company's stock drops significantly, shareholders often institute securities class action litigation against that company. Any litigation against us could cause us to incur substantial costs, divert the time and attention of our management and other resources, or otherwise harm our business.

***We may need to take material write-offs for the impairment of goodwill and other intangible assets, including if our market capitalization declines***

As further described in Note 7 of our Notes to Condensed Consolidated Financial Statements, goodwill and intangible assets with indefinite lives are monitored annually for impairment, or more frequently, if there are indicators of impairment. In performing the first step of the goodwill impairment testing and measurement process, we compare our entity-wide estimated fair value to net book value to identify potential impairment. We estimate the entity-wide fair value utilizing our market capitalization, plus an appropriate control premium. We have utilized a

control premium that considers appropriate industry, market and other pertinent factors, including indications of such premiums from

Table of Contents

data on recent acquisition transactions. If we determine through the impairment evaluation process that goodwill has been impaired, we would record the impairment charge in our consolidated statement of operations.

There were no impairment losses related to goodwill or intangible assets during the first quarters of fiscal 2012 and fiscal 2011, respectively. Uncertainty in the financial markets and weakness in macroeconomic conditions globally could contribute to the volatility of our stock price. The current macroeconomic environment continues to be challenging and we cannot be certain of the duration of these conditions and their potential impact on our stock price performance. If our market capitalization plus an estimated control premium is below our carrying value for a period we consider to be other-than-temporary, we may be required to record an impairment of our goodwill either as a result of our annual assessment that we conduct in the fourth quarter of each fiscal year, or in a future quarter if an indication of potential impairment is evident. A non-cash goodwill impairment charge would have the effect of decreasing our earnings or increasing our losses in such period. If we are required to take a substantial impairment charge, our operating results would be materially adversely affected in such period.

***Our entry into new lines of business could adversely affect our results of operations***

If we attempt to develop new practice areas or lines of business outside our core litigation, regulatory, financial, and management consulting services, those efforts could harm our results of operations. Our efforts in new practice areas or new lines of business involve inherent risks, including risks associated with inexperience and competition from mature participants in the markets we enter. Our inexperience in these new practice areas or lines of business may result in costly decisions that could harm our business.

***Our engagements may result in professional liability and we may be subject to other litigation, claims or assessments***

Our services typically involve difficult analytical assignments and carry risks of professional and other liability. Many of our engagements involve matters that could have a severe impact on a client's business, cause the client to lose significant amounts of money, or prevent the client from pursuing desirable business opportunities. Accordingly, if a client is dissatisfied with our performance, the client could threaten or bring litigation in order to recover damages or to contest its obligation to pay our fees. Litigation alleging that we performed negligently, disclosed client confidential information, or otherwise breached our obligations to the client could expose us to significant liabilities to our clients and other third parties and tarnish our reputation.

Despite our efforts to prevent litigation, from time to time we are party to various lawsuits, claims, or assessments in the ordinary course of business. Disputes may arise, for example, from business acquisitions, employment issues, regulatory actions, and other business transactions. The costs and outcome of any lawsuits or claims could have a material adverse effect on us.

***Our debt obligations may adversely impact our financial performance***

We have a revolving line of credit with our bank for \$60.0 million. The amounts available under this line of credit are constrained by various financial covenants and reduced by certain letters of credit outstanding. Our loan agreement with the bank will mature on April 30, 2014. The degree to which we are leveraged could adversely affect our ability to obtain further financing for working capital, acquisitions or other purposes and could make us more vulnerable to industry downturns and competitive pressures. Our ability to secure short-term and long-term debt or equity financing in the future will depend on several factors, including our future profitability, the levels of our debt and

Table of Contents

equity, restrictions under our existing revolving line of credit, and the overall credit and equity market environments.

***We could incur substantial costs protecting our proprietary rights from infringement or defending against a claim of infringement***

As a professional services organization, we rely on non-competition and non-solicitation agreements with many of our employees and non-employee experts to protect our proprietary rights. These agreements, however, may offer us only limited protection and may not be enforceable in every jurisdiction. In addition, we may incur substantial costs trying to enforce these agreements.

Our services may involve the development of custom business processes or solutions for specific clients. In some cases, the clients retain ownership or impose restrictions on our ability to use the business processes or solutions developed from these projects. Issues relating to the ownership of business processes or solutions can be complicated, and disputes could arise that affect our ability to resell or reuse business processes or solutions we develop for clients.

In recent years, there has been significant litigation in the U.S. involving patents and other intellectual property rights. We could incur substantial costs in prosecuting or defending any intellectual property litigation, which could adversely affect our operating results and financial condition.

Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to obtain and use information that we regard as proprietary. Litigation may be necessary in the future to enforce our proprietary rights, to protect our trade secrets, to determine the validity and scope of the proprietary rights of others or to defend against claims of infringement or invalidity. Any such resulting litigation could result in substantial costs and diversion of resources and could adversely affect our business, operating results and financial condition. Any failure by us to protect our proprietary rights, or any court determination that we have either infringed or lost ownership of proprietary rights could adversely affect our business, operating results and financial condition.

***Insurance and claims expenses could significantly reduce our profitability***

We are exposed to claims related to group health insurance. We self-insure a portion of the risk associated with these claims. If the number or severity of claims increases, or we are required to accrue or pay additional amounts because the claims prove to be more severe than our original assessment, our operating results would be adversely affected. Our future insurance and claims expense might exceed historical levels, which could reduce our earnings. We expect to periodically assess our self-insurance strategy. We are required to periodically evaluate and adjust our claims reserves to reflect our experience. However, ultimate results may differ from our estimates, which could result in losses over our reserved amounts. We maintain individual and aggregate medical plan stop loss insurance with licensed insurance carriers to limit our ultimate risk exposure for any one case and for our total liability.

Many businesses are experiencing the impact of increased medical costs as well as greater variability in ongoing costs. As a result, our insurance and claims expense could increase, or we could raise our self-insured retention when our policies are renewed. If these expenses increase or we experience a claim for which coverage is not provided, results of our operations and financial condition could be materially and adversely affected.

***Our charter and by-laws, and Massachusetts law may deter takeovers***

Our amended and restated articles of organization and amended and restated by-laws and Massachusetts law contain provisions that could have anti-takeover effects and that could discourage, delay, or prevent a change in control or an acquisition that our shareholders may find attractive. These

Table of Contents

provisions may also discourage proxy contests and make it more difficult for our shareholders to take some corporate actions, including the election of directors. These provisions could limit the price that investors might be willing to pay for shares of our common stock.

**ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds**

(a) Not applicable.

(b) Not applicable.

(c) The following table provides information about our repurchases of shares of our common stock during the fiscal quarter ended March 31, 2012. During that period, we did not act in concert with any affiliate or any other person to acquire any of our common stock and, accordingly, we do not believe that purchases by any such affiliate or other person (if any) are reportable in the following table. For purposes of this table, we have divided the fiscal quarter into three periods of four weeks, four weeks, and five weeks, respectively, to coincide with our reporting periods during the first quarter of fiscal 2012.

**Issuer Purchases of Equity Securities**

<b>Period</b>	<b>(a) Total Number of Shares Purchased</b>	<b>(b) Average Price Paid per Share</b>	<b>(c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs(3)</b>	<b>(d) Maximum Number (or Approximate Dollar Value) of Shares that May Yet Be Purchased Under the Plans or Programs(3)</b>
January 1, 2012 to January 28, 2012	180 shares(1)	\$22.00 per share(1)		\$ 3,266,340
January 29, 2012 to February 25, 2012	46,526 shares(2)(3)	\$24.31 per share(2)(3)	26,800	\$ 7,046,487
February 26, 2012 to March 31, 2012	107,259 shares(3)(4)	\$24.59 per share(3)(4)	96,000	\$ 4,662,307

- (1) During the four weeks ended January 28, 2012, we accepted 180 shares of our common stock as a tax withholding from certain of our employees, in connection with the vesting of restricted shares that occurred during the indicated period, pursuant to the terms of our 2006 equity incentive plan, at an average share price of \$22.00.
- (2) During the four weeks ended February 25, 2012, we accepted 19,726 shares of our common stock as a tax withholding from certain of our employees, in connection with the vesting of restricted shares that occurred during the indicated period, pursuant to the terms of our 2006 equity incentive plan, at an average share price of \$23.39.
- (3) On August 30, 2011, we announced that our Board of Directors approved a share repurchase program of up to \$7.5 million of our common stock. During the four weeks ended February 25, 2012, we purchased 26,800 shares under this program at an average price per share of \$24.99. During the five weeks ended March 31, 2012, we repurchased 96,000 shares authorized under this program at an average price per share of \$24.84. On February 22, 2012, our Board of Directors authorized the repurchase of up to an additional \$4.45 million of our common stock.
- (4) During the five weeks ended March 31, 2012, we accepted 11,259 shares of our common stock as a tax withholding from certain of our employees, in connection with the vesting of restricted shares that occurred during the indicated period, pursuant to the terms of our 2006 equity incentive plan, at an average share price of \$22.53.

**ITEM 3. Defaults Upon Senior Securities**

None.

**ITEM 4. Mine Safety Disclosures**

None.

**ITEM 5. Other Information**

None.

Table of Contents

**ITEM 6. Exhibits**

<b>Item No.</b>	<b>Description</b>
10.1*	CRA International, Inc. Cash Incentive Plan, as amended (incorporated by reference to Exhibit 10.1 to our current report on Form 8-K filed on March 2, 2012).
31.1	Rule 13a-14(a)/15d-14(a) certification of principal executive officer
31.2	Rule 13a-14(a)/15d-14(a) certification of principal financial officer
32.1	Section 1350 certification
101**	The following financial statements from CRA International, Inc.'s Quarterly Report on Form 10-Q for the fiscal quarter ended March 31, 2012, formatted in XBRL (eXtensible Business Reporting Language), as follows: (i) Condensed Consolidated Statement of Operations (unaudited) for the fiscal quarters ended March 31, 2012 and April 2, 2011, (ii) Condensed Consolidated Statement of Comprehensive Income (unaudited) for the fiscal quarters ended March 31, 2012 and April 2, 2011, (iii) Condensed Consolidated Balance Sheets (unaudited) as at March 31, 2012 and December 31, 2011, (iv) Condensed Consolidated Statements of Cash Flows (unaudited) for the fiscal quarters ended March 31, 2012 and April 2, 2011, (v) Condensed Consolidated Statement of Shareholders' Equity (unaudited) for the fiscal quarter ended March 31, 2012, and (vi) Notes to Condensed Consolidated Financial Statements (Unaudited).

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\*  
Management contract or compensatory plan.

\*\*  
Pursuant to Rule 406T of Regulation S-T, the Interactive Data Files in Exhibit 101 hereto shall not be deemed filed for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, or Section 18 of the Securities Exchange Act of 1934, as amended, or otherwise subject to liability under those sections.





Table of Contents

**EXHIBIT INDEX**

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visions of SFAS 123R are effective for us for reporting periods beginning after December 15, 2005.

We are required to adopt SFAS 123R in the first quarter of fiscal 2006. The pro forma disclosures previously permitted under SFAS 123 no longer will be an alternative to financial statement recognition. See Note 2 in our Notes to the Consolidated Financial Statements for the pro forma net loss and net loss per share amounts, as if we had used a fair-value-based method similar to the methods required under SFAS 123R to measure compensation expense for employee stock incentive awards. Although we have not yet determined the method of adoption and whether the adoption of SFAS 123R will result in amounts that are similar to the current pro forma disclosures under SFAS 123, we are evaluating the requirements under SFAS 123R and the impact their adoption will have on our consolidated statements of operations and net income (loss) per share.

## **Liquidity and Capital Resources**

### *General*

From our inception through December 31, 2004, our operations have been funded almost entirely through the proceeds we received from issuance of four series of convertible preferred stock, convertible promissory notes in the first quarter of 2004, and our IPO in last quarter of 2004. The amounts raised were used primarily to fund research and development, sales and marketing, business development and general and administrative costs.

As of December 31, 2004, we had \$8,907,183 of assets consisting of \$1,565,415 in cash and cash equivalents, \$5,850,000 in investment securities, \$277,819 in other current assets and the remaining balance in property and equipment, long-term deposits, domain name, capitalized software development costs and deferred tax asset. Total liabilities as of December 31, 2004, reflect current liabilities of \$1,004,513, consisting primary of accounts payable and accrued expenses and compensation. Long-term liabilities of \$1,078,548, is comprised primarily by liabilities in respect of employee severance obligations and deferred revenues, long-term.

Cash flows in 2004 and 2003 were as follows:

	<b>2004</b>	<b>2003</b>
Net cash used in operating activities	\$ (4,269,514)	\$ (1,361,028)
Net cash used in investing activities	\$ (6,181,856)	\$ (35,913)
Net cash provided by financing activities	\$ 11,904,779	\$ 45,884

The increase in net cash used in operating activities during 2004 compared to 2003, of \$2,908,486, is the result of a number of factors, the most significant of which, are as follows: Firstly, our operating loss in 2004 was \$3,544,812, approximately, \$782,000 more than 2003. We also incurred approximately \$450,000 of cash interest, in 2004, while interest expense was insignificant in 2003. Finally, changes in our operating assets and liabilities impacted favorably on cash, in 2003, by approximately \$1,137,000, while in 2004, changes in our operating assets and liabilities caused cash to decrease approximately \$337,000. The aforesaid decrease to cash resulting from changes in operating assets and liabilities in 2004 was driven by many factors, the largest of which is an increase in our prepaid content at December 31, 2004, of approximately \$238,000 over the balance of that account at December 31, 2003. The increase to cash resulting from changes in operating assets and liabilities in 2003 was driven by many factors the largest of which were the increase in long-term deferred revenue due to the sale of lifetime subscriptions, and decreases to accounts receivable that resulted from the collection of accounts relating to 2002 enterprise sales, in early 2003.

Cash used in investing activities of \$6,181,856 in 2004 is attributable primarily to purchases of investment securities of \$5,850,000, capital expenditures of \$209,875, the purchase of a domain name for \$80,200, and capitalized software development costs of \$39,736. Cash used in investing activities of \$35,913 in 2003, is attributable to capital expenditures of \$48,454 offset by a decrease in long-term deposits.

Cash and cash equivalents and investment securities at December 31, 2003 were insufficient to provide the capital we needed to operate. In January and February 2004, we issued \$5,000,000 aggregate principal amount of bridge notes, which brought us \$4,125,000, net of issuance costs and not including the \$200,000 we received from the sale of promissory notes to four investors in 2003. The proceeds of the convertible promissory notes enabled us to continue operating during the first nine months of 2004.

On October 13, 2004, we completed our IPO of 2,350,000 shares of our common stock at \$5 per share pursuant to a Registration Statement on Form SB-2. Additionally, the underwriters involved in our IPO exercised their over-allotment option and purchased an additional 352,500 shares of our common stock, at \$5 per share, on November 18, 2004. Total proceeds of the IPO, including the exercise of the over-allotment option, were approximately \$10,786,000, net of underwriting fees and offering expenses of approximately \$2,726,000. In conjunction with the offering, \$1,840,000 of the \$5,000,000 of promissory notes we owed to bridge noteholders, converted into 490,678 shares of common stock and the remaining \$3,160,000 was repaid from the net proceeds of the offering.

Cash flow from financing activities during 2003 was comprised primarily of \$200,000 we received from the sale of promissory notes to four investors, less approximately \$155,000 we expended on costs relating to the \$5,000,000 of bridge notes issued in 2004.

### ***Current and Future Financing Needs***

We have incurred negative cash flow from operations since we started our business. We have spent, and expect to continue to spend, substantial amounts in connection with implementing our business strategy. As noted above, we raised approximately \$10,786,000, net of underwriting fees and offering expenses, through our IPO and the over-allotment option. After repaying the portion of the bridge notes that did not convert to common shares, of \$3,160,000, approximately \$7,600,000 remained. Further, in February 2005 the Company entered into an agreement

(the "Warrant Reload Agreement"), with certain holders of warrants that were issued by the Company in 2004 in connection with the bridge financing, pursuant to which such holders exercised an aggregate of 1,871,783 Bridge Warrants. As a result, the Company raised approximately \$12,220,000, net of fees and expenses relating to the exercise. Further, in 2005, to date, we raised additional amounts, in excess of \$1,000,000, from other exercises of options and warrants. Based on our current plans, we believe that the net proceeds of the aforementioned IPO and the over-allotment option, and Warrant Reload Agreement will be sufficient to enable us to meet our planned operating needs for the foreseeable future and to fund possible future acquisitions. Notwithstanding, we may decide to raise funds in the future, via public or private sales of our shares or debt and/or other sources, to finance acquisitions and growth.

**Off-Balance Sheet Arrangements**

We have not entered into any transactions with unconsolidated entities in which we have financial guarantees, subordinated retained interests, derivative instruments or other contingent arrangements that expose us to material continuing risks, contingent liabilities or any other obligations under a variable interest in an unconsolidated entity that provides us with financing, liquidity, market risk or credit risk support.

**Obligations and Commitments**

As of December 31, 2004, we had the following known contractual obligations, commitments and contingencies:

Year Ending December 31	Purchase Contracts	Operating Leases	Total
2005	\$ 269,516	\$ 183,421	\$ 364,937
2006	2,500	55,644	58,144
2007	--	20,210	20,210
Total	\$ 272,016	\$ 259,275	\$ 443,291

## BUSINESS

### General

Through our flagship Website, [www.Answers.com](http://www.Answers.com), and our proprietary 1-Click Answers™ software, we provide integrated online reference answers and offer technology that enables rapid delivery of concise information over the Internet. Since our inception in 1998, we have developed and acquired technology that intelligently and automatically integrates and retrieves information from disparate sources and delivers the result in a single consolidated browser view.

Answers.com delivers snapshot, multi-faceted definitions and explanations from attributable reference sources covering the topics in our database. We seek to differentiate ourselves by providing our users with relevant, reference information that enhances results achieved through traditional search engines. Most search engines respond to an Internet user's query by displaying a long list of links to other Websites that may be related in some way to the query term. By contrast, Answers.com automatically displays relevant, content-based responses to a user's query without requiring the user to review a list of hyperlinks offered in response to a query. Answers.com also includes other related information in various formats such as charts, graphs and maps, and provides pointers to relevant sites, blogs and other external search resources.

We seek to monetize visitor traffic to our Website in the form of sponsored links and paid advertisements. We intend to generate this traffic by offering, licensing and co-branding our technology and establishing partnerships with third-party Websites, and through the marketing of our Website.

1-Click Answers™, the software component of our business, is available for users of both Microsoft Windows® and Apple's Macintosh OS X. Utilizing 1-Click Answers™, users need only "alt-click" (on the Macintosh, select the text and Cmd-Shift-G) on a word or phrase within a text and 1-Click Answers™ will access our online library to display information about that word or phrase in a browser window. 1-Click Answers™ can be used when working in almost any application such as e-mail, spreadsheet, word processing, database or other program or application. Our 1-Click Answers™ for Windows® analyzes surrounding words in context for a more accurate response. For example, when clicking on the word "Ford" appearing in the context of Ford Motor Company, Harrison Ford or Francis Ford Coppola, the system will process and recognize the context and deliver information on vehicles, movie stars and film directors, respectively. In Windows, 1-Click Answers™ also includes a downloaded toolbar for query lookup while using Microsoft Internet Explorer for Windows® as well as a docked AnswerBar utility. While Web users can access our integrated reference information, some functionality is only available after downloading 1-Click Answers™.

We cull our reference information from over 100 reference sources, such as:

- Houghton Mifflin's American Heritage Dictionary (Fourth Edition);
- Roget's II New Thesaurus, (Third Edition);
- Columbia University Electronic Encyclopedia (Sixth Edition); and
- Wikipedia.

By attributing the source of each piece of our information on each web page, we enable our users to make their own independent evaluation as to the reliability of our information.

### Previous Business and Transition to New Business Model

During 2003, we sold lifetime subscriptions to our answer engine product, "GuruNet", generally for \$40.00. In December 2003, we decided to alter our pricing model and moved to an annual subscription model, generally, \$30.00 per year. In conjunction with selling subscriptions, we also offered free access to dictionary, thesaurus, encyclopedia

and other basic reference information through our products. Under our business model during those years, our ability to generate revenues was dependent upon our ability to increase the number of subscribers and increase the number of users who used our basic free product. Usage of our basic free product was our means of encouraging users to upgrade to our subscription product and increase our subscription revenue. Although we earned some advertising revenue during those years from pay-per-click keyword advertising in our subscription and free products, such amounts were not significant. Our business model at the time strongly encouraged subscriptions, and thus we limited the amount of content available in our free product. This approach did not facilitate the amount of traffic we needed to earn significant amounts of revenue from advertising. Further, the aforesaid business model required us to maintain an infrastructure for billing and subscriptions, and we met resistance from customers to pay for "information freely accessible on the Internet". A desire to gain more expansive, ubiquitous growth led to our current implementation, in January 2005, of a free-to-customer product, Answers.com and "1-Click Answers" software, containing practically all the content that we used to sell via subscriptions.

On January 3, 2005 the Company announced the release of Answers.com, a website that had been launched in August 2004 in beta version. The Company also released "1-Click Answers" software, allowing users to click anywhere on the screen for instant facts about a word or phrase. 1-Click Answers allows users working in any application such as e-mail, spreadsheet, word processing, database or other program or application to "alt-click" on a word or phrase within a document and access our online library and display information about that word or phrase in a pop-up window. While Web users enjoy our integrated reference information, our Web-based product does not provide the "alt-click" command and context analysis that we include in our software. Our revenue model for these products is currently based solely on advertising revenue. When a user searches sponsored keywords, a link to an advertiser's Website is displayed in a premium position and identified as a sponsored result to the search. In contrast to the GuruNet product, we do not plan to generate revenues from selling subscriptions to Answers.com.

In conjunction with the release of Answers.com, GuruNet.com began functioning primarily as a corporate site. We are no longer offering new subscriptions to GuruNet or offering downloads of GuruNet software to users who do not have existing subscriptions. Notwithstanding, users who purchased GuruNet subscriptions prior to January 3, 2005, will continue to be fully supported through their subscription periods, and can access GuruNet services through GuruNet software or at GuruNet.com.

### **Industry Background**

The emergence and wide acceptance of the Internet has fundamentally changed how millions of people and businesses find information, shop and purchase goods and services. Web search engines are one of the most popular and useful services on the Internet for people seeking to find information about businesses, goods and services. According to Nielson/NetRatings, approximately 76% of the active online U.S. population used a search engine during January 2004. Also according to Nielson/NetRatings, the 114.5 million unique users each spent nearly forty minutes using search engines during the month, making search sites second only to email providers as the most popular category of Website.

Search engines provide two critical functions. First, they gather, index and store information about Websites in a database. Second, they present search results in the form of links directly to Websites. Businesses seeking to increase the number of visitors to their Websites have increasingly recognized the value of being included in search results in response to relevant words or phrases. According to Search Engine News Journal, U.S. online advertising revenues were approximately \$7.3 billion in 2003, a 21% increase from \$6.0 billion in 2002. According to Gartner, Inc., by 2005, U.S. online advertising expenditures are expected to exceed \$8.6 billion.

Historically, companies in the Internet industry have earned money through payment from advertisers for Web space, as well as by charging subscribers for access to Web content. Today, only companies offering superior content have managed to profit through these methods. However, search engine companies are earning revenues through paid search results. According to the eMarketer Search Engine Marketing report, U.S. paid search advertising spending increased by 123% from \$923 million in 2002 to over \$2 billion in 2004. Estimated to grow by \$0.5 billion in 2004 and 2005, paid search will remain a substantial part of online advertising revenues according to eMarketer.

Internet advertisers can select from a variety of performance-based advertising alternatives, including pay-per-click banner display advertisements, e-mail, pop-up campaigns and keyword-targeted search-based advertisements. We may use these and/or other methods, depending on their effectiveness. However, one advantage of keyword-targeted advertisements is that they get an advertiser's message in front of prospects at the time that a prospect has shown he or she is interested in what the advertiser has to offer, either because the prospect has searched for the keyword, clicked on a directory link, or has visited a site that relates to that keyword. Keyword search advertising showed the strongest growth in advertising revenue in 2003, accounting for 35% of all online advertising revenue in 2003, up from 15% in 2002, according to a report by the Interactive Advertising Bureau and PricewaterhouseCoopers LLP.



Many Internet users and advertisers have come to rely on browser applications, customized downloadable applications and Websites that provide Web directories, search engines or contextually relevant listings as ways for potential buyers to find the companies that provide the products and services they seek to purchase. These applications and Websites enable consumers and businesses to find a listing of advertiser Websites matching a descriptive word or phrase, while offering advertisers exposure to a highly relevant Internet audience that has already indicated an interest in their products or services. However, in order to attract and retain users, many of these applications and Websites have created additional tools and a vast array of content and services that are costly to build and maintain.

## Our Strategy

Our goal is to establish GuruNet as a leading service provider for reference information on the Internet. Going forward, we plan to generate revenues by:

- attracting advertising revenues by providing advertisers with focused and targeted audiences for their products;
- partnering with other Websites that would place a topic lookup bar or other links on their own Web pages, thus increasing traffic to our Website, which in turn will enhance our revenues from advertising; and
- bundling our products with various computer equipment manufacturers, software vendors, Internet portal properties and service providers, thereby increasing the number of users and, potentially, advertising revenues.

The key elements of our strategy are to:

*Continue strengthening the Answers.com brand.* To enhance public awareness of our product, we are pursuing a brand development strategy through public relations, product features that encourage word-of-mouth sharing and active direct marketing to strategic target sectors. Our branding strategy centers on positioning us as an alternative and complement to traditional search for users seeking quick, concise and accurate information rather than a long list of links to sift through. To date, we have received favorable reviews from numerous publications including The Wall Street Journal, Forbes and the Washington Post. We believe that building our brand will increase traffic to Answers.com and, as a result, increase revenues by attracting customers and advertisers.

*Continue developing our reference information.* To maintain our competitive advantage, we must continue to develop a rich base of reference information. To supplement our ongoing efforts in increasing the depth and breadth of our reference information, we intend to continue entering into arrangements with content providers to display their reference information in response to our users' queries. We will also continue to analyze site activity to determine where specific improvements will be most effective.

*Expand our capacity to solicit paid advertising by further developing our ability to target our audience.* We believe that we can serve advertisers on the Internet by effectively targeting interested audiences and consumers. We are able to provide focused sponsored links and advertisements related to a given user's specific search and we will add content that will serve as an effective "trigger" to prompt these ads. We intend to continue our development and monitoring of our user base so that our advertisers may effectively reach their target audiences and we may enjoy increased revenues from paid search results.

*Develop co-branding partnerships and revenue-sharing arrangements with third-party Websites and service providers seeking to enhance their users' experience.* We believe that opportunities exist for partnering with other Websites and service providers to enhance their users' experience and our brand and revenues. For example, we have entered into agreements with Comet Systems Inc., a leader in connected, intelligent desktop software and A9.com, a new search engine introduced by A9.com, Inc., a subsidiary of Amazon.com, Inc. to place our topic lookup bar inside their Web pages. We believe that this will result in an increase in traffic to our Website, which in turn will enhance our revenues from click-through advertising. Revenue-sharing arrangements may involve, among others, a lump sum payment made from the partner in consideration for the service, collection of a stream of royalties from the partner or a simple split of ad revenue.

*Offering Answers.com as a co-branded, free service.* We are positioning Answers.com as a free service that users may possibly be offered directly from a third party's Website, with no financial obligation by any party. In this context, our business relationship with such third parties may be based on contractual, non-monetary, mutually beneficial relationships, whereby our financial benefit would be derived from related advertisement driven revenues.

## Future Products and Enhancements

We intend to enhance and develop new versions of our products to increase usability and accessibility in finding information.

26

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## Sales, Marketing and Distribution

**Direct to consumer.** We attract users to our Website primarily through press coverage, blogs, links from other Websites who partner with us, and advertising. The primary ways in which we intend to reach our target audience are:

- *Public Relations.* We have contracted with public relations services and have experienced success in building our brand. We have received multiple favorable reviews from numerous publications including *USA Today*, *The Washington Post*, *The Wall Street Journal*, *Forbes* and *PC Magazine* and plan on expanding our public relations efforts.
- *Electronic Advertising.* We have primarily advertised with sites that attract users interested in reference tools and software such as Download.com, Word-of-the-Day, LockerGnome and InfoPackets. We plan on continuing to focus our advertising efforts to most effectively reach consumers who are interested in our products and software applications.
- *Word of mouth.* We have seen ongoing success in distribution when fans of our products speak of their experiences using our product with friends, colleagues, family, and others. While this trend seems to transpire on its own, we will work to encourage the practice by adding features that make it a simple act to link to us or send an e-mail with information about the site. We also work with computer User Groups and others who share new technologies with constituents. Additionally, we are running a number of radio advertising campaigns in a number of markets to test the “word of mouth” approach using well-known talk radio hosts. Ongoing marketing in the area will depend on the success of these initial tests.
- *Search Engines.* We work to optimize our pages to increase the likelihood that search engines will display links to our Website when users search for information located in our database. Hence, if a user performs a standard search for terms on a standard search engine, it is our goal to appear high in the list of results returned.

**Education Channels.** We see the educational sector as a key market that could benefit from our products, which provide:

- credible, attributed information; and
- filtered results, avoiding offensive or inappropriate materials for students.

We help students of all ages focus on finding facts, not surfing web links. Our products offer students and teachers quick, accurate, focused information that comes to the point of need and reduces potential distractions associated with searching for information on the Internet. Our specific target market is parents and teachers concerned with filtering and improving the quality of information that their children and students access on the Internet.

## Advertising Revenue

We have the capacity to monetize two kinds of advertisements and sponsored search. The first is to display advertisements and sponsored links in our “Results” page. The second is showing sponsored search results in our own “Search Web” page. We have executed agreements with a number of providers of Sponsored Ads and other advertisements and will be assessing the effectiveness of working with each. The result may be working on an ongoing basis with a number of providers, or using a single partner offering optimal results.

## Content Providers and Hosting Services

**Scope and quality of information.** Our library contains over 100 sources of reference information, culled and integrated from both premium reference sources such as Houghton Mifflin and the Columbia University Press, and publicly available Web sources, such as The Official Website of The Baseball Hall of Fame. In the case of Web Sources, integration is often in the form of displaying a thumbnail of the Website with a link to that page.

Our answer engine offers customers access to various topics, including:

- General reference: dictionary, thesaurus, encyclopedia and history;
- Language: idioms, translations, new words, acronyms, abbreviations, lexicon, idioms, grammar, sign language, quotes about and quotes by;
  - Business: company snapshot descriptions, economics, finance, investment terms and currency conversions;
  - Arts and culture: fine arts, literature, poets, music, instruments and study guide;
    - Legal: legal dictionary and famous US Supreme Court cases;
  - Medical: medical dictionary, medical analysis, health topics and phobias;

- Science and technology: conversions, computer encyclopedia, science, genetics, chemistry, mathematics and e-mail shorthand;
- People: famous personalities and celebrities, historical figures, musical artists, authors, columnists, royalty and sports biographies;
  - Food and nutrition: nutritional values, recipes, diets and wine glossary;
- Government: US presidents, US cabinet, US congress, political parties (international), national anthems and world leaders;
  - Leisure: holidays, gardening, movies, TV shows, song lyrics, Harry Potter terms, word glossary and yoga;
  - Religion: Bible, Christianity, Judaism, Islam, Hinduism and Buddhism;
- Places: countries, states, weather, maps, dialing codes, local times, currencies by country, state parks and universities;
  - Military: military terms, weapons and bio-terrorism; and
  - Sports: baseball hall of fame, golf, tennis, MLB, NFL, NHL and NBA.

We may change any of the topics covered from time to time. The information displayed for our users is automatically consolidated from various source references into an easy to read, user-friendly format.

***Content License Agreements.*** We license content provided in our products pursuant to written agreements with recognized collators of useful information, including, but not limited to, Houghton Mifflin (Dictionaries), Columbia University Press (Encyclopedia) and Wizcom (Word-for-word translations). These agreements are generally for one year periods or more, renewable by consent of the parties, and give us the right to provide the licensed information to our end users through our product in return for a lump sum amount payable over the life of the agreement. Our product also includes content we license at no cost, content publicly available from the Web and content we develop and author independently. If we are unable to renew our current license agreements on terms acceptable to us, we will need to develop relationships with alternative providers of content of comparable value to our users.

***Web Hosting.*** We currently outsource our Web hosting to Data Return LLC. Although we purchased the servers ourselves, they are operated and managed by Data Return LLC in multiple data centers to operate our proprietary software and host the tools and databases required to maintain our consolidated information sources. The servers receive a user's query, analyze the query for the best possible match and return a properly formatted result. We anticipate that we have the ability to add server capacity and Internet bandwidth as required by our growth in traffic. Our agreement with Data Return, effective November 9, 2004, will continue through the latest date that any Statement of Work issued pursuant to the agreement is in effect. Web hosting services are generally available from multiple sources and we believe that we can replace Data Return if they can no longer supply Web hosting services to us on acceptable terms.

## **Research and Development**

We devote a substantial portion of our resources to inventing and developing new products, maintaining and enhancing existing products, expanding and improving our fundamental technology and strengthening our technological expertise. In fiscal years 2003 and 2004, we spent approximately \$910,000 and \$1,033,521, respectively, on research and development of our products. Our engineering and production teams are located in our Jerusalem, Israel development facility. We have developed internally, acquired or licensed the products and services we offer.

## **Competition**

As providers of a unique service, we hope to be seen as a differentiator in the search space. However, we face formidable competition in every aspect of our business, particularly from search engines and other companies that seek to connect users with information on the Web and provide them with relevant advertising. We operate in the

market for Internet products and services, which is highly competitive and characterized by rapid change, converging technologies and increased competition from companies offering information integrated into other products and media properties. Our ability to compete depends on numerous factors, many of which are outside our control. Some of our primary competitors, such as Google, Microsoft, Ask Jeeves and Yahoo! have longer operating histories, greater name recognition, larger customer bases and significantly greater financial, technical and marketing resources than we do. Therefore, they may be able to devote greater resources to the development and promotion of their services than we can to ours. Our competitors may develop products and services that are equal or superior to those of ours or that achieve greater market acceptance. Many of our competitors offer a wider range of products than we do, which could attract our customers to competitive search sites, and consequently, result in less traffic to our Websites and reduced advertising-generated revenues.

Our competition can be divided into three primary areas:

- destination portals and search engines including Google, Yahoo!, The Microsoft Network (MSN), Ask Jeeves, Dogpile, MetaCrawler, Time Warner, Inc. and Looksmart;
- online reference sites including Britannica.com, WorldBook.com, Groliers.com, Encarta.msn.com and Dictionary.com; and
  - one-click information access software providers including Babylon and CleverKeys.

We seek to differentiate ourselves by providing our users with information more quickly and simply than traditional search engines. While most search engines respond to an Internet user's query by displaying a long list of links to other Websites that in some way may be related to the query term, our answer engine product automatically displays relevant, narrative responses to a user's query. We compete with online reference sites and one-click information access software providers by aggregating significantly greater amounts of content sources to be made available to our users.

We seek to generate advertising revenues through pay-per-click or pay-per-impression text or graphical advertising or other advertising. The primary method is to attract users with a service on the Web that is perceived to be useful and differentiated enough to generate their query traffic. Once users are using our product and looking up topics in it, we have the opportunity to furnish relevant sponsored links and advertising. Our ability to compete for advertising revenue will be dependent on our ability to increase the number of users who use our products and search for keywords that are in demand by the advertisers who advertise through Internet advertising aggregators that we may choose to work with in the future.

### **Regulation of the Internet**

There are still relatively few laws or regulations specifically addressed to the Internet. As a result, the manner in which existing laws and regulations should be applied to the Internet in general, and how they relate to our business in particular, is unclear in many cases. Such uncertainty arises under existing laws regulating matters, including user privacy, defamation, pricing, advertising, taxation, gambling, sweepstakes, promotions, content regulation, quality of products and services and intellectual property ownership and infringement. At the present time there are no requirements that we obtain prior governmental approval in any jurisdiction for our principal products or services.

However, to resolve some of the current legal uncertainty, we expect new laws and regulations to be adopted that will be directly applicable to our activities. Any existing or new legislation applicable to GuruNet could expose us to substantial liability, including significant expenses necessary to comply with such laws and regulations, and could dampen the growth in use of the Internet in general. Several new federal laws have already been adopted that could have an impact on our business. The CAN-SPAM Act of 2003 is intended to regulate spam and create criminal penalties for unmarked sexually-oriented material and emails containing fraudulent headers. The USA Patriot Act is intended to give the government greater ability to conduct surveillance on the Internet by allowing it to intercept communications regarding terrorism and computer fraud and abuse. The Digital Millennium Copyright Act is intended to reduce the liability of online service providers for listing or linking to third-party Websites that include materials that infringe copyrights or other rights of others. The Children's Online Protection Act, the Children's Online Privacy Protection Act and the Prosecutorial Remedies and Other Tools to End Exploitation of Children Today Act of 2003, are intended to restrict the distribution of certain materials deemed harmful to children and impose additional restrictions on the ability of online services to collect user information from minors. In addition, the Protection of Children From Sexual Predators Act of 1998 requires online service providers to report evidence of violations of federal child pornography laws under certain circumstances. Under the U.K. Data Protection Act and the European Union Data Protection Directive, a failure to ensure that personal information is accurate and secure or a transfer of personal information to a country without adequate privacy protections could result in criminal or civil penalties. Such legislation may impose significant additional costs on our business or subject us to additional liabilities. We post our



privacy policy and practices concerning the use and disclosure of user data. Any failure by us to comply with our posted privacy policy, Federal Trade Commission requirements or other domestic or international privacy-related laws and regulations could result in proceedings by governmental or regulatory bodies that could potentially harm our business, results of operations and financial condition. In this regard, there are a large number of legislative proposals before the European Union, as well as before the United States Congress and various state legislative bodies regarding privacy issues related to our business. It is not possible to predict whether or when such legislation may be adopted, and certain proposals, if adopted, could harm our business through a decrease in user registrations and revenues. These decreases could be caused by, among other possible provisions, the required use of disclaimers or other requirements before users can utilize our services.

Due to the global nature of the Web, it is possible that the governments of other states and foreign countries might attempt to regulate its transmissions or prosecute us for violations of their laws. We might unintentionally violate such laws, such laws may be modified and new laws may be enacted in the future. Any such developments could harm our business, operating results and financial condition. We may be subject to legal liability for our online services. We direct users to a wide variety of services that enable individuals to exchange information, generate content, conduct business and engage in various online activities on an international basis, including public message posting, sweepstakes and services relating to online auctions and homesteading. The law relating to the liability of providers of these online services for activities of their users is currently unsettled both within the United States and abroad. Claims may be threatened against us for aiding and abetting defamation, negligence, copyright or trademark infringement, or other theories based on the nature and content of information that we provide links to or that may be posted online.

### Intellectual Property

We have been granted three United States patents by the United States Patent and Trademark Office. In addition, we have been granted one Israeli patent by the Israel Patent Office and have one patent pending in the United States for various aspects of our word-based referencing search and Web-wide based information retrieval technologies which power our proprietary Website. The following chart sets forth details concerning our three U.S. issued patents:

Patent	Expiration Date	Description
Method for providing computerized word-based referencing (U.S. Patent 6,393,443)	August 2, 2018	This patent claims a method by which our product points at text on a screen, eliminates ambiguities based on contextual analysis and displays the appropriate definitions, information entries and/or translations, as requested by the user.
Web-based information retrieval responsive to displayed word identified by a text-grabbing algorithm (U.S. Patent 6,341,306)	August 12, 2019	This patent claims a method by which our application displays promotional data in response to a look-up query of a word displayed in the body of a text.
Web-based information retrieval (U.S. Patent 6,519,631)	August 12, 2019	The patent claims a method by which a user can use the keyboard and mouse in combination to mark a word on a computer screen, disambiguate such word based on context indicators in the document and retrieve information from a remote server relating to the meaning of the word marked.

The status of any patent involves complex legal and factual questions, and the breadth of claims allowed is uncertain. Accordingly, we cannot assure you that any patent application filed by us will result in a patent being issued, or that our patents, and any patents that may be issued in the future, will afford adequate protection against competitors with similar technology. We similarly face the risk that any patents issued to us might be infringed or designed around by others.

While we rely on patent and other intellectual property laws to protect our technology, we also believe that factors such as the technological and creative skills of our personnel, new product developments, frequent product enhancements and reliable product maintenance are essential to establishing and maintaining our market position. We enter into confidentiality agreements, as appropriate, with our employees, consultants and customers, and otherwise seek to control access to, and distribution of, our proprietary information. These measures, however, afford only limited protection. There is no guarantee that these safeguards will protect our technology and other valuable competitive information from being used by competitors.

From time to time in the ordinary course of business we have been, and we expect to continue to be, subject to claims of alleged infringement of the trademarks and other intellectual property rights of third parties. These claims and any resultant litigation, should it occur, could subject us to significant liability for damages. In addition, even if we prevail, litigation could be time-consuming and expensive to defend, and could result in the diversion of our time and attention. Any claims from third parties may also result in limitations on our ability to use the intellectual property subject to these claims unless we are able to enter into agreements with the third parties making these claims.

## **Property**

Our corporate headquarters and research and development facility is located in Building 98, Jerusalem Technology Park, P.O. Box 48253, Jerusalem 91481, Israel, in approximately 7,000 square feet of space occupied under a lease with a monthly rental rate of approximately \$11,000 that expires in December 2005, with an option to extend the term for an additional 47 months thereafter at the same monthly rate (as adjusted for local inflation). We believe that our facilities are in good condition, though we anticipate the need to lease additional space in the short term to accommodate our planned increase in staff. We also maintain an address for receipt of correspondence at 441 Route 306, Wesley Hills, New York 10952 at no cost. At the present, we are seeking limited office space in New York City to accommodate our needs driven by U.S. operations to be headed by our Chief Revenue Officer.

## **Employees**

As of April 6, 2005, we have 26 full-time employees and 7 part-time employees, all except two of whom are based at our offices in Jerusalem, Israel. Our Chief Revenue Officer and our Director of Systems Operations are both located in New York. None of our employees are subject to a collective bargaining agreement, and we consider our employee relations to be positive.

## **Operations in Israel**

The Law for the Encouragement of Capital Investments, 1959, provides that upon the meeting of certain criteria, including the criteria defining an Industrial Enterprise, a proposed capital investment in eligible capital expenditures may be designated as an Approved Enterprise. Each certificate of approval for an Approved Enterprise relates to a specific investment program delineated both by its financial scope, including its capital sources, and by its physical characteristics, such as the equipment to be purchased and utilized under the program. The tax benefits derived from any certificate of approval relate only to taxable income derived from growth in manufacturing revenues attributable to the specific Approved Enterprise. If a company has more than one approval or only a portion of its capital investments are approved, its effective tax rate is the result of a weighted combination of the applicable rates.

Taxable income of a company derived from an Approved Enterprise is subject to tax at the maximum rate of 25%, rather than the usual rate of 36%, for the benefit period. This period is ordinarily 7 years beginning with the year in which the Approved Enterprise first generates taxable income, and is limited to 12 years from when production begins or 14 years from the date of approval, whichever is earlier. A company owning an Approved Enterprise may elect to receive an alternative package of benefits, which allows the company to receive tax exemptions rather than grants. Under the alternative package, the company's undistributed income derived from an Approved Enterprise will be exempt from tax for a period of between two and ten years from the first year of taxable income, depending on the geographic location of the Approved Enterprise within Israel, and the company will be eligible for the tax benefits under the law for the remainder of the benefit period.

The Investment Center bases its decision of whether to approve or reject a company's application for designation as an Approved Enterprise on criteria described in the law and related regulations, the then prevailing policy of the Investment Center and the specific objectives and financial criteria of the applicant. Therefore, a company cannot be certain in advance whether its application will be approved. In addition, the benefits available to an approved enterprise are conditional upon compliance with the conditions stipulated in the law and related regulations and the criteria described in the specific certificate of approval. If a company violates these conditions, in whole or in part, it would be required to refund the amount of tax benefits and any grants received plus an amount linked to the Israeli consumer price index and interest.

Our Israeli subsidiary, GuruNet Israel Ltd., currently has two capital investment programs both of which were granted Approved Enterprise status. Income arising from our Approved Enterprise is tax-free under the alternative package of

benefits described above and entitled to reduced tax rates based on the level of foreign ownership for a period of 10 years from the first year in which our Israeli subsidiary generates taxable income from such Approved Enterprise, but not later than certain specified periods. We have begun to generate taxable income for purposes of this law and we have utilized these tax benefits beginning 2000. The law also provides that an Approved Enterprise is entitled to accelerated depreciation on its property and equipment that are included in an approved investment program.

**Legal Proceedings**

We are not presently a party to any legal proceedings.

## MANAGEMENT

### Directors and Executive Officers

The following table sets forth certain information regarding the directors and executive officers of GuruNet Corporation as of April 6, 2005:

Name	Age	Position
Robert S. Rosenschein	51	Chief Executive Officer, President and Chairman of the Board
Steven Steinberg	44	Chief Financial Officer and Secretary
Jeff Schneiderman	41	Chief Technical Officer
Jeffrey S. Cutler	41	Chief Revenue Officer
Mark A. Tebbe	43	Director
Edward G. Sim	34	Director
Yehuda Sternlicht	50	Director
Jerry Colonna	41	Director
Michael Eisenberg	33	Director
Mark B. Segall	42	Director

**Robert S. Rosenschein** has been Chairman of our board and President since he founded GuruNet in December 1998. From December 1998 to April 2000 and since May 2001, Mr. Rosenschein has served as our Chief Executive Officer. From May 2000 to April 2001, Mr. Rosenschein served our Chairman. From 1988 to 1997, Mr. Rosenschein was Chief Executive Officer of Accent Software International Ltd. (formerly Kivun), a company that developed multi-lingual software tools, and from 1997 to 1998, Mr. Rosenschein was Chief Technical Officer of Accent Software International Ltd. Mr. Rosenschein graduated with a B.Sc. in Computer Science from the Massachusetts Institute of Technology and received the Prime Minister of Israel's Award for Software Achievement in 1997.

**Steven Steinberg** joined GuruNet in December 2002 as Vice President of Finance and became our Chief Financial Officer and Secretary in January 2004. From January 2001 to November 2002, he was Vice President of Finance at Percite Information Technologies, Ltd., a supply-chain software company. From November 1998 to December 2000, Mr. Steinberg was Controller of Albar Financial Services Ltd., an automobile finance and leasing company. Previously, he was the Chief Financial Officer of the New York Operations of Health Partners, Inc., and worked for ten years at the New York offices of the accounting firm Coopers and Lybrand where he was an audit manager. Mr. Steinberg graduated with a B.B.A. from Florida International University.

**Jeff Schneiderman** has been our Chief Technical Officer since March 2003. From January 1999 until February 2003, Mr. Schneiderman was our Vice President of Research and Development. From November 1991 to November 1998, Mr. Schneiderman was employed at Accent Software International Ltd., where he served as Vice President of Engineering from October 1996 to March 1998 and as Vice President of Product Development from March 1998 to November 1998. Mr. Schneiderman also has held development positions at AT&T Bell Labs and the Whitewater Group. Mr. Schneiderman graduated with a B.S. in Computer Science from the University of Illinois at Urbana/Champaign and a M.S. in Computer Science from Illinois Institute of Technology.

**Jeffrey S. Cutler** has been our Chief Revenue Officer since March 15, 2005. From July 2003 to March 2005 he served as General Manager of the Software Information and Industry Association's Content Division. Prior to that, between October 2001 and January 2003, Mr. Cutler served as President and Chief Executive Officer for Inlumen, Inc. From April 1999 to October 2001 Mr. Cutler was Senior Vice President, General Manager and Chief Operating

Officer of Office.com, a leading online business service co-owned by Winstar Communications and CBS/Viacom, where he also served as Vice President Business Development between March 1998 and April 1999. Prior to that, between March 1997 and March 1998 he was Vice President of Sales and Marketing for Winstar Telebase, a leading channel for premium business content. Between September 1996 and March 1997, he served as Director of Sales for N2K Telebase, prior to its acquisition by Winstar. Mr. Cutler also spent two years as Director of Trading Services at Thomson Financial Services' CDA/Spectrum between December 1994 and August 1996, and worked at CompuServe from March 1986 to July 1994, managing the distribution of information, network and email/intranet services to the financial services industry. Mr. Cutler graduated with a BA in Computer Science and Finance from Rutgers College, Rutgers University in May 1985.

**Mark A. Tebbe** has served as a director since December 1998. He currently serves as a member of our Audit Committee, Compensation Committee and Nominations and Governance Committee. Since February 2002, Mr. Tebbe has been Chairman of Techra Networks LLC, a technology-oriented consulting firm. From August 1984 to January 2002, Mr. Tebbe founded and served as Chairman of Lante Corporation, a technology consulting firm. Besides several non-profit and civic organizations, Mr. Tebbe is a board member of SBI Group, Elexos Corp. and Selective Search. Mr. Tebbe is a former director of Octus Inc. and Accent Software International Ltd. Mr. Tebbe graduated with a B.S. in Computer Science from the University of Illinois at Urbana/Champaign.

**Edward G. Sim** has served as a director since August 1999. He currently serves as a member of our Audit Committee, Compensation Committee and Nominations and Governance Committee. Mr. Sim is a member and Managing Director of the Dawntreader Group and Dawntreader Funds, which he co-founded in 1998. From April 1996 to April 1998, Mr. Sim worked with Prospect Street Ventures, a New York-based venture capital firm, where he worked on software and technology investments like 24/7 Media (Nasdaq: TFSM). From June 1994 to April 1996, Mr. Sim worked with J.P. Morgan's Structured Derivatives Group on the development of a real-time trading application for global asset allocation. Mr. Sim currently serves as a director of Deepnines Technologies, netForensics, Metapa, and Moreover Technologies. Mr. Sim served as a director of LivePerson (NasdaqSC: LPSN) from October 2000 to July 2001, Flashbase (acquired by DoubleClick, Nasdaq: DCLK) from June 1999 to June 2000, and Expertcity/GoToMyPC (acquired by Citrix, Nasdaq: CTXS) from August 1999 to March 2004. Mr. Sim graduated with a B.A. in Economics from Harvard University.

**Yehuda Sternlicht** has served as a director since June 2004. He currently serves as the Chairman of our Audit Committee. Since November 2003, Mr. Sternlicht has been self-employed as an independent financial consultant. From July 1992 until November 2003 he was employed by Savient Pharmaceuticals, Inc. (Nasdaq: SVNT) as financial manager and in January 1993 was appointed Chief Financial Officer of SVNT. In June 1995 he was appointed Vice President-Finance and Chief Financial Officer of SVNT, and in December 2002 he was appointed Vice President-Chief Accounting Officer of SVNT. Mr. Sternlicht is qualified as a Certified Public Accountant in the State of Israel and has a B.A. degree in Accounting and Economy from The Hebrew University.

**Jerry Colonna** has served as a director since June 2004. From January 2002 until December 2002, Mr. Colonna was a partner with JP Morgan Partners, LLC, the private equity arm of JP Morgan Chase & Co. Since August 1996, Mr. Colonna has been a partner with Flatiron Partners, an investment company which he co-founded. Mr. Colonna is a member of the board of directors of a number of private companies including PlanetOut Inc., as well as a number of non-profit organizations including PENCIL—Public Education Needs Civic Involvement in Learning, NYPower NY and NYC2012. Mr. Colonna holds a B.A. in English Literature from Queens College at the City University of New York.

**Michael Eisenberg** has served as a director since June 2004. Mr. Eisenberg has been a partner in Israel Seed Partners since July 1997. From 1995 to 1997, he worked for Jerusalem Global, a leading Israeli technology investment bank, as Vice President of investment banking. From 1993 to 1995, he was Director of Israel Operations at Marttila & Kiley Inc., a U.S. consulting firm. Mr. Eisenberg currently serves as a director of Shopping.com Ltd., Finjan Software Inc. and Digital Fuel, Inc. Mr. Eisenberg holds a B.A. in Political Science from Yeshiva University.

**Mark B. Segall** has served as a director since December 2004. Mr. Segall is the founder and Chief Executive Officer of Kidron Corporate Advisors, LLC, a New York based mergers and acquisitions corporate advisory boutique serving emerging growth companies primarily in the technology and financial services sectors. Prior to forming Kidron in 2003, Mr. Segall was the Chief Executive Officer of Investec, Inc., the U.S. investment banking operations of the Investec Group, a U.K. and African based specialist bank. Previously he was a partner at the law firm of Kramer, Levin and Naftalis LLP, specializing in cross-border mergers and acquisitions and capital markets activities. Mr. Segall currently serves as a director of Greg Manning Auctions Inc., the Comtech Group and Integrated Asset Management. Mr. Segall was also a director of Siliconix Inc. until June 2004. Mr. Segall received his B.A. from



Columbia University and a J.D. from New York University Law School. Mr. Segall is a designee of Maxim Group LLC.

Our Amended and Restated Certificate of Incorporation provides that the number of directors shall be not less than five or more than nine directors. Our board of directors is divided into three classes with only one class of directors being elected in each year and each class serving a three-year term. The following chart sets forth the term of office of each class of directors and which director are assigned to each class:

<b>Class</b>	<b>Term</b>	<b>Members</b>
Class I	Expires at our annual meeting in 2005	Mark A. Tebbe and Michael Eisenberg
Class II	Expires at our annual meeting in 2006	Edward G. Sim and Jerry Colonna
Class III	Expires at our annual meeting in 2007	Robert S. Rosenschein, Yehuda Sternlicht and Mark B. Segall

## Director Compensation

Non-employee directors receive an annual fee of \$15,000, plus \$500 for attendance at each full board meeting of our board of directors and reimbursement for reasonable travel expenses. In January 2004, our board authorized the grant of options to purchase 28,671 shares of common stock under our existing stock option plan to each of Mr. Tebbe and Mr. Sim. In June 2004, our board authorized the grant of options to purchase 28,700 shares of common stock under our existing stock option plan to each of Mr. Sternlicht, Mr. Colonna and Mr. Eisenberg. In December 2004, our board authorized the grant of options to purchase 28,700 shares of common stock under our existing stock option plan to Mr. Segall. Additionally, the members of the board's audit committee will be paid an additional annual fee of \$5,000 plus reimbursement for reasonable travel expenses, and the Chairman of the audit committee will be paid an additional annual fee of \$10,000 plus reimbursement for reasonable travel expenses.

## Director Independence

The American Stock Exchange requires that a majority of our board must be composed of "independent directors," which is defined generally as a person other than an officer or employee of the company or its subsidiaries or any other individual having a relationship, which, in the opinion of the company's board of directors would interfere with the director's exercise of independent judgment in carrying out the responsibilities of a director. Currently, we have a majority of independent directors on our board. Our independent directors will have regularly scheduled meetings at which only independent directors are present.

Any affiliated transactions will be on terms no less favorable to us than could be obtained from independent parties. Any affiliated transactions must be approved by a majority of our independent and disinterested directors.

## Committees of the Board

**Audit Committee.** In May 2004, we established an audit committee of the board of directors, which consists of Mr. Sternlicht, as Chairman, Mr. Tebbe and Mr. Sim, each of whom is an independent director under the American Stock Exchange's listing standards. The audit committee's duties, which are specified in our Audit Committee Charter, include, but are not limited to:

- reviewing and discussing with management and the independent accountants our annual and quarterly financial statements;
  - directly appointing, compensating, retaining, and overseeing the work of the independent auditor;
- approving, in advance, the provision by the independent auditor of all audit and permissible non-audit services;
- establishing procedures for the receipt, retention, and treatment of complaints received by us regarding accounting, internal accounting controls, or auditing matters and the confidential, anonymous submissions by our employees of concerns regarding questionable accounting or auditing matters;
- the right to engage and obtain assistance from outside legal and other advisors as the audit committee deems necessary to carry out its duties;
- the right to receive appropriate funding from us to compensate the independent auditor and any outside advisors engaged by the committee and to pay the ordinary administrative expenses of the audit committee that are necessary or appropriate to carrying out its duties; and
-

unless assigned to a comparable committee or group of independent directors, they must review and approve all related party transactions.

**Financial Experts on Audit Committee**

The audit committee will at all times be composed exclusively of “independent directors” who are “financially literate” as defined under the American Stock Exchange listing standards. The current American Stock Exchange listing standards define an “independent director” generally as a person other than an officer or employee of the company or its subsidiaries or any other individual having a relationship, which, in the opinion of the company’s board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director. The American Stock Exchange listing standards define “financially literate” as being able to read and understand fundamental financial statements, including a company’s balance sheet, income statement and cash flow statement.

In addition, we must certify to the American Stock Exchange that the committee has, and will continue to have, at least one member who has past employment experience in finance or accounting, requisite professional certification in accounting, or other comparable experience or background that results in the individual's financial sophistication. The board of directors believes that Mr. Sternlicht satisfies the American Stock Exchange's definition of financial sophistication and also qualifies as an "audit committee financial expert," as defined under rules and regulations of the Securities Exchange Commission, or SEC.

**Compensation Committee.** In May 2004, we established a compensation committee of the board of directors, which consists of Mr. Sim, Mr. Colonna and Mr. Eisenberg, each of whom is an independent director. The compensation committee reviews and approves our salary and benefits policies, including compensation of executive officers. The compensation committee also administers our stock option plan, and recommends and approves grants of stock options under that plan.

**Nominations and Governance Committee.** In May 2004, we established a nominations and governance committee of the board of directors, which consists of Mr. Tebbe, Mr. Sim and Mr. Colonna, each of whom is an independent director. The purpose of the nominations and governance committee is to select, or recommend for our entire board's selection, the individuals to stand for election as directors at the annual meeting of stockholders and to oversee the selection and composition of committees of our board. The nominations and governance committee's duties, which are specified in our Nominating/Corporate Governance Committee Charter, include, but are not limited to:

- establishing criteria for the selection of new directors;
- considering stockholder proposals of director nominations;
  - committee selection and composition;
- considering the adequacy of our corporate governance;
- overseeing and approving management continuity planning process; and
- and reporting regularly to the board with respect to the committee's duties.

### **Code of Ethics**

In May 2004, we adopted a Code of Ethics and Business Conduct that applies to all of our executive officers, directors and employees. The Code of Ethics and Business Conduct codifies the business and ethical principles that govern all aspects of our business. A copy of our Code of Ethics and Business Conduct is available, free of charge, on our corporate Website at <http://www.gurunet.com>.

### **Director Designation Rights**

Under the terms of our underwriting agreement in connection with our IPO, Maxim Group LLC, one of the underwriters involved in our IPO, has the right to designate one candidate to our nominating committee for nomination for election to our board of directors at each annual or special meeting of our stockholders at which directors are to be elected during the three-year period following our IPO in October 2004. Mark B. Segall, Maxim Group LLC's initial director nominee, was appointed by our board of directors to fill a vacancy created by an increase in the size of our board, to serve until the next annual meeting of stockholders or until his successor is duly elected and qualified. We have agreed to use our best efforts to obtain the election of Maxim Group LLC's nominee to our board of directors at each annual or special meeting at which directors are to be elected, provided that nomination of such nominee is made by our nominating committee in accordance with its charter, the rules and regulations of the

American Stock Exchange and applicable law. Such nominee will be entitled to receive the same compensation, expenses, reimbursements and other benefits as any other non-employee director.

### **Employment Agreements**

Mr. Rosenschein is employed as our President and Chief Executive Officer pursuant to a five-year employment agreement that commenced on January 1, 2002 and was amended and restated as of January 8, 2004. The amended agreement provides for an annual base salary of \$198,000 with 10% annual increases and an annual bonus to be determined at the discretion of our board of directors. If we terminate Mr. Rosenschein for any reason other than cause, we are required to pay him a lump sum of \$150,000 regardless of how much time remains in the term of his employment agreement less the severance pay portion of his Manager's Insurance Policy (the "Policy"). If the Policy is greater than \$150,000, then Mr. Rosenschein will be entitled to the entire amount payable under the Policy. At the time Mr. Rosenschein's employment agreement was amended and restated, 241,964 options were granted to Mr. Rosenschein under the 2003 Stock Option Plan. In the event of a change in control, we will accelerate the vesting of 50% of any options granted to Mr. Rosenschein that have not vested as of the effective date of the change of control. If, within 12 months after such change in control, Mr. Rosenschein is terminated without cause, any unvested options that were granted to Mr. Rosenschein will vest immediately upon the effective date of the termination. Mr. Rosenschein has agreed to refrain from competing with us for a period of two years following the termination of his employment.

Mr. Steinberg is employed as our Chief Financial Officer pursuant to an employment agreement that commenced on April 1, 2004. The agreement provides for a base annual salary of \$130,800. We or Mr. Steinberg may terminate the employment agreement by providing three months written notice. If we terminate Mr. Steinberg without cause, we shall extend the period during which Mr. Steinberg may exercise his options granted after the date of his employment agreement by one year from the effective date of Mr. Steinberg's termination. In the event of a change in control, we will accelerate the vesting of 50% of any options granted to Mr. Steinberg that have not vested as of the effective date of the change of control. If, within 12 months after such change in control, Mr. Steinberg is terminated without cause, Mr. Steinberg is entitled to four months written notice and any unvested options that were granted to Mr. Steinberg will vest immediately upon the effective date of the termination. Mr. Steinberg has agreed to refrain from competing with us for a period of twelve months following the termination of his employment.

Mr. Schneiderman is employed as our Chief Technical Officer pursuant to an employment agreement that commenced on April 1, 2004. The agreement provides for a base annual salary of \$117,480. We or Mr. Schneiderman may terminate the employment agreement by providing three months written notice. If we terminate Mr. Schneiderman without cause, we shall extend the period during which Mr. Schneiderman may exercise his options granted after the date of his employment agreement by one year from the effective date of Mr. Schneiderman's termination. In the event of a change in control, we will accelerate the vesting of 50% of any options granted to Mr. Schneiderman subsequent to his employment agreement that have not vested as of the effective date of the change of control. If, within 12 months after such change in control, Mr. Schneiderman is terminated without cause, Mr. Schneiderman is entitled to four months written notice and any unvested options that were granted to Mr. Schneiderman subsequent to the date of his employment agreement will vest immediately upon the effective date of the termination. Mr. Schneiderman has agreed to refrain from competing with us for a period of twelve months following the termination of his employment.

Mr. Cutler is employed as our Chief Revenue Officer pursuant to an employment agreement that commenced on March 15, 2005. The agreement provides for a base annual salary of \$225,000. We or Mr. Cutler may terminate the employment agreement by providing thirty days written notice. If we terminate Mr. Cutler without cause, or if Mr. Cutler resigns for certain "good reasons" enumerated in the employment agreement, we shall extend the period during which Mr. Cutler may exercise his options granted after the date of his employment agreement by one year from the effective date of Mr. Cutler's termination and pay to Mr. Cutler a lump-sum cash payment equal to between 6 and 12 months of his base salary, depending upon his length of service at the time of such termination. In the event of a change in control, we will accelerate the vesting of 50% of any options granted to Mr. Cutler subsequent to his employment agreement that have not vested as of the effective date of the change of control. If the Company terminates Mr. Cutler's employment without Cause (or if Mr. Cutler resigns for certain "good reasons" enumerated in the employment agreement) at any time during the twelve (12) months subsequent to a change of control, then, 100% of any options granted to Mr. Cutler that have not vested will immediately vest and the Company will pay to Mr. Cutler a lump-sum cash payment equal to his annual base salary at the time of the change in control. If upon a change of control the market closing price of the Company's common stock is less than 120% of the Company's market closing price on the employment commencement date, then Mr. Cutler shall have the option to forfeit 200,000 of his options and he shall receive a stock award of 50,000 shares of the Company's common stock. Mr. Cutler has agreed to refrain from competing with us following the termination of his employment for a period of between six to twelve months, depending on certain conditions enumerated in the employment agreement.

## Executive Compensation

The table below summarizes the compensation earned for services rendered to us in all capacities for the fiscal year ended December 31, 2004 by our Chief Executive Officer and any other officer whose 2004 compensation exceeded \$100,000. No other individuals employed by us received a salary and bonus in excess of \$100,000 during 2004.

Name and Principal Position	Annual Compensation			Long-term Compensation Awards Payouts		All Other Salaried Compensation (1)
	Fiscal Year	Salary (\$)	Bonus (\$)	Securities Underlying Options/ SARs (#)	LTIP Payouts (\$)	
Robert Rosenschein <i>Chief Executive Officer, President and Chairman of the Board</i>	2004	179,563		—	—	22,451
Steven Steinberg <i>Chief Financial Officer</i>	2004	111,924	30,000	—	—	26,374
Jeff Schneiderman <i>Chief Technical Officer</i>	2004	96,924	500	—	—	25,399

(1) Includes payments made for the Israeli equivalent of social security, pension and disability insurance premiums, payments made in lieu of statutory severance and payments to continuing education plans.

Our named officers routinely receive other benefits from us that are customary to similarly situated companies. We have concluded, after reasonable inquiry, that the aggregate amount of these benefits in each of the years indicated did not exceed the lesser of \$50,000 or 10% of the compensation of any named officer.

## Stock Options

We provide for direct grants or sales of common stock, and common stock options to employees and non-employees through stock option plans. Stock options are granted at an exercise price as determined by the board at the time the option is granted. The exercise price of an employee incentive stock option shall not be less than 100% of the fair market value of a share on the date of grant. The exercise price of a nonstatutory stock option shall not be less than 85% of the fair market value of a share on the date of grant. Our stock options generally vest over four years with 25% vesting after the first year and the remaining 75% vesting in equal monthly amounts over the following thirty-six month period. Each option has a term of ten years.

A summary of the status of our various Stock Option Plans and of other options as of December 31, 2004 is as follows:

	<b>Options available for grant</b>	<b>Options outstanding</b>
1999 Stock Option Plan (1)	—	60,716
2000 Stock Option Plan (2)	—	91,715
2003 Stock Option Plan (3)	—	503,277
2004 Stock Option Plan (4)	471,304	394,696
Other Stock Options (5)	—	153,151
	471,304	1,203,555

- (1) Adopted in 1999 and canceled June 2000.
- (2) Adopted in June 2000 and canceled August 2003.
- (3) Adopted in August 2003 and canceled January 2004.
- (4) Adopted in January 2004.
- (5) Issued to certain consultants and underwriters in 1999 and 2004.



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**OPTIONS GRANTED IN FISCAL YEAR 2004**

We granted a total of 819,760 options during the fiscal year ended December 31, 2004. The following table sets forth the number of stock options granted to the named executive officers in fiscal year 2004.

<b>Name</b>	<b>Number of Shares Underlying Options Granted</b>	<b>Date of Option Grant</b>	<b>% of Total Options Granted to Employees in Fiscal Year</b>	<b>Exercise Price</b>	<b>Expiration Date</b>
Robert Rosenschein	241,964	1/08/2004	35.2%	\$5.06	1/08/2014
Jeff Schneiderman					22,876
					9/11/2004
					3.3
%					\$5.25
					9/11/2014
Steven Steinberg					26,353
					9/11/2004
					3.8
%					\$5.25
					9/11/2014

**2004 FISCAL YEAR END OPTION VALUES**

The following table sets forth the value of unexercised "in-the-money" options held that represents the positive difference between the exercise price and the market price of \$8.70 at December 31, 2004. No named executive officer exercised any options during 2004.

**Name**

	<b>Number of Unexercised in the money Options at Fiscal Year End</b>	<b>Value of Unexercised in the money Options Fiscal Year end</b>
Robert Rosenschein	241,964	\$ 880,749
Jeff Schneiderman	76,311	\$ 454,830
Steven Steinberg	74,139	\$ 428,721

### Equity Compensation Plan Information

The following table sets forth certain information at December 31, 2004 with respect to our equity compensation plans that provide for the issuance of options, warrants or rights to purchase our securities:

	<b>No. of Securities to be issued upon exercise of outstanding options, warrants and rights (a)</b>	<b>Weighted-average exercise price of outstanding options, warrants and rights (b)</b>	<b>No. of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)</b>
Equity compensation plans approved by security holders	1,050,404	\$ 5.03	471,304
Equity compensation plans not approved by security holders	0	\$ 0.00	0
Total	1,050,404	\$ 5.03	471,304

**PRINCIPAL STOCKHOLDERS**

The table and accompanying footnotes set forth certain information as of April 6, 2005 with respect to the ownership of our common stock by:

- each person or group who is known to us to beneficially own more than 5% of our outstanding common stock;
- each of our directors;
- our chief executive officer and other executive officers whose total compensation exceeded \$100,000 during the year ended December 31, 2004; and
- all of our directors and executive officers as a group.

A person is deemed to be the beneficial owner of securities that can be acquired within 60 days from the exercise of options and warrants or the conversion of convertible securities. Accordingly, common stock issuable upon exercise of options and warrants that are currently exercisable or exercisable within 60 days of the date of this prospectus, have been included in the table with respect to the beneficial ownership of the person or entity owning the options and warrants, but not with respect to any other persons or entities.

Applicable percentage of ownership for each holder is based on 6,945,292 shares of common stock outstanding on the date of this prospectus, plus any presently exercisable stock options and warrants held by each such holder, and options, warrants and bridge notes held by each such holder that will become exercisable or convertible within 60 days after the date of this prospectus. Unless otherwise indicated, we believe that all persons named in the table have sole voting and investment power with respect to all shares of common stock beneficially owned by them.

Name and Address of Beneficial Owner <sup>(1)</sup>	Shares Beneficially Owned	Percentage of Common Stock
Robert S. Rosenschein	402,111 (2)	5.79%
Steven Steinberg	30,589 (3)	*
Jeff Schneiderman	61,761 (4)	*
Mark A. Tebbe	34,895 (5)	*
Edward G. Sim	130,867 (6)	1.89%
Yehuda Sternlicht	—(7)	—
Jerry Colonna	32,969 (8)	*
Michael Eisenberg	199,933 (9)	2.88%
Mark B. Segall	—(7)	—
All directors and executive officers as a group (10 individuals) <sup>(10)</sup>	893,125 (10)	12.86%

\* Represents less than 1%.

- (1) Unless otherwise indicated, the business address of each of the following is GuruNet Corporation, Jerusalem Technology Park, Building 98, Jerusalem 91481 Israel.
- (2) Excludes 161,310 shares of common stock issuable upon exercise of options that are not exercisable within 60 days of the date of this prospectus.
- (3) Includes 30,589 shares of common stock issuable upon exercise of options that are currently exercisable or are exercisable within 60 days of the date of this prospectus. Excludes 54,411 shares

of common stock issuable upon exercise of options that are not exercisable within 60 days of the date of this prospectus.

- (4) Includes 61,761 shares of common stock issuable upon exercise of options that are currently exercisable or are exercisable within 60 days of the date of this prospectus. Excludes 23,239 shares of common stock issuable upon exercise of options that are not exercisable within 60 days of the date of this prospectus.
- (5) Includes 21,721 shares of common stock owned by Mark A. Tebbe and 13,174 shares of common stock issuable upon exercise of currently exercisable options. Excludes 19,114 shares of common stock issuable upon exercise of options that are not exercisable within 60 days of the date of this prospectus.
- (6) Represents 121,310 shares of common stock owned by Dawntreader Fund I L.P., and beneficially owned by Mr. Sim. Mr. Sim in his capacity as Managing Director of the Dawntreader Group and Dawntreader Funds has voting power over the shares owned by Dawntreader Fund I L.P. Also includes 9,557 shares of common stock issuable upon exercise of currently exercisable options. Excludes 19,114 shares of common stock issuable upon exercise of options that are not exercisable within 60 days from the date of this prospectus.
- (7) Excludes 28,700 shares of common stock issuable upon exercise of options that are not exercisable within 60 days of the date of this prospectus.
- (8) Represents an aggregate of 32,969 shares of common stock owned by Flatiron Associates, LLC and Flatiron Partners 2000, LLC, and beneficially owned by Mr. Colonna as Managing Director of Flatiron Associates and Flatiron Partners 2000. Excludes 28,700 shares of common stock issuable upon exercise of options that are not exercisable within 60 days of the date of this prospectus.
- (9) Includes (i) 30,000 shares of common stock issued to Israel Seed III Annex Fund and 3,334 shares of common stock issued to Seed Management Associates, Ltd. upon conversion of 50% of their bridge notes on October 13, 2004 and (ii) 157,227 shares owned by Israel Seed III L.P. and 9,372 shares owned by Israel Seed III (Israel) L.P. Mr. Eisenberg in his capacity as principal in the investment advisor to Israel Seed III L.P. and Israel Seed III (Israel) L.P. has voting power over the shares. Mr. Eisenberg disclaims beneficial ownership of any shares held by the Israel Seed Entities (as defined in Note 12), except to the extent of his respective pecuniary interests. Excludes (i) 126,103 shares of common stock issuable upon exercise of bridge warrants and (ii) 28,700 shares of common stock issuable upon exercise of options that are not exercisable within 60 days of the date of this prospectus.
- (10) Excludes 200,000 shares of common stock issuable to Jeffrey S. Cutler, our Chief Revenue Officer as of March 15, 2005, upon exercise of options that are not exercisable within 60 days of the date of this prospectus.

**SELLING STOCKHOLDERS**

The shares of our common stock to which this prospectus relates may be reoffered and sold from time to time by the persons listed below as "Selling Stockholders". The shares offered by the Selling Stockholders were acquired in private placement transactions, including those which may be acquired upon exercise of outstanding warrants or options. The table below identifies each Selling Stockholder and his, her or its relationship to us. The table also sets forth, as of March 15, 2005, for each Selling Stockholder: (i) the number of shares of common stock beneficially owned prior to this offering, (ii) the number of shares of common stock that may be offered and sold through this prospectus, and (iii) the number of shares of common stock and the percentage of the class represented by such shares to be owned by each such Selling Stockholder, assuming the sale of all of the registered shares. There is no assurance that any of the Selling Stockholders will sell any or all of their shares of common stock. Except as otherwise noted, all shares of common stock are beneficially owned and the sole investment and voting power is held by the person named, and such person's address is c/o GuruNet Corporation, Jerusalem Technology Park, Building 98, Jerusalem 91481 Israel. Information regarding the Selling Stockholders, including the number of shares offered for sale, may change from time to time, and any changed information will be set forth in a prospectus supplement to the extent required under applicable securities laws or SEC rules and regulations.

Selling Stockholder	Beneficial Ownership Prior to this Offering	Shares That May be Offered and Sold Hereby	Beneficial Ownership After this Offering (1)(2)	
			Number of Shares	Percent of Class
Ajax Partners (3)(4)	26,422	26,422	0	0
Andrew Rosen (3)	55,423	55,423	0	0
Arthur Steinberg (3)	13,211	13,211	0	0
Barretto Pacific Corporation	7,800	7,800	0	0
Brian Daly (3)	6,607	6,607	0	0
Bruce Bernstein (3)	6,607	6,607	0	0
Chris Conway (3)	37,231	37,231	0	0
Dr. Joseph Vardi (3)(5)	94,831	73,110	21,721	*
Eli Rothman (3)	74,462	74,462	0	0
Eric Stein (3)	38,191	38,191	0	0
Hug Funding LLC (3)	26,040	26,040	0	0
Iroquois Capital, LP	26,961	26,961	0	0
Israel Seed III Annex Fund, L.P. (3)(6)	304,687	138,088	166,599	2.03%
Marc Friedman (3)	74,462	74,462	0	0
Maxim Group LLC (3)	100,000	100,000	0	0
Nanette C. Koryn and Robert H Cohen (3)(7)	12,733	12,733	0	0
Morton H. Meyerson (3)(8)	323,114	174,798	148,316	1.81%
Omicron Master Trust (3)(9)	66,055	66,055	0	0
Petrocelli Industries, Inc. (3)	29,887	29,887	0	0
Rivington Investments N.V.	2,173	2,173	0	0
Salvador Abady (3)	37,231	37,231	0	0
Scot Jason Cohen (3)	17,890	17,890	0	0
Seed Management Associates Ltd. (3)(10)	21,349	21,349	0	0
Smithfield Fiduciary LLC (3)(11)	142,108	142,108	0	0

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Stanoff Corporation (3)(12)	27,500	27,500	0	0
Startups.com	1,043	1,043	0	0
Steven and Adam Sprung (3)	37,231	37,231	0	0
Steven Landman (3)	6,655	6,655	0	0
Ted Struhl Family Partnership (3)	68,962	68,962	0	0
Vertical Ventures, LLC (3)(13)	344,372	344,372	0	0
WEC Partners, LLC (3) (14)	26,422	26,422	0	0
William Castor (3)	11,000	11,000	0	0
<b>TOTAL</b>	<b>2,068,660</b>	<b>1,732,024</b>	<b>336,636</b>	<b>4.10%</b>

41

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\* Represents less than 1%.

- (1) Percentage calculated on the basis of 8,204,099 shares of common stock to be outstanding after the offering.
- (2) Assumes the sale of all shares of common stock registered pursuant to this prospectus, although Selling Stockholders are under no obligations known to us to sell any shares of common stock at this time.
- (3) Represents stockholders who participated in our bridge financing in January and February 2004. For a detailed description of the bridge financing see the sections entitled “Description of Securities — Bridge Notes” and “Other Outstanding Securities — Bridge Warrants.”
- (4) David Stone is the managing partner of Ajax Partners and has sole voting and investment power over the shares owned by Ajax Partners.
- (5) Dr. Vardi acquired 21,721 shares of common stock from us on August 25, 1999.
- (6) Israel Seed III Annex Fund, L.P. (“the partnership”) is organized as a “blind pool” partnership in which the limited partners have no discretion over investment or sale decisions, are not able to withdraw from the partnership except under exceptional circumstances, and generally participate ratably in each investment made by the partnership. The sole General Partner of the partnership is Israel Venture Partners Ltd. (“IVP”) which has sole investment control with respect to the partnership. The sole principals of the investment advisors to IVP are Jonathan Medved, Neil Cohen and Michael Eisenberg and, as such, they may be deemed to share voting control over the shares of the Company held by the partnership. No other persons have investment control over IVP or the partnership. IVP and Jonathan Medved, Neil Cohen and Michael Eisenberg disclaim beneficial ownership of any shares held by the partnership except to the extent of their respective pecuniary interests. Israel Seed II (Israel) L.P. owns 9,372 shares of common stock from its purchase of Series C Preferred Stock on August 30, 1999 (5,358 shares) and from its purchase of Series D Preferred Stock on February 29, 2000 (4,014 shares). Israel Seed II L.P. owns 157,227 shares from its purchase of Series C Preferred Stock on August 30, 1999 (89,888 shares) and from its purchase of Series D Preferred Stock on February 29, 2000 (67,339 shares). Israel Seed II (Israel) L.P. and Israel Seed II L.P. are affiliates of the partnership.
- (7) Nanette C. Koryn and Robert H. Cohen, a shareholder in the firm Greenberg Traurig, LLP, our outside legal counsel, hold 6,667 shares of common stock and 6,066 warrants. Nanette C. Koryn and Robert H. Cohen have joint voting and investment power over the shares.
- (8) Morton H. Meyerson owns 103,236 shares of common stock from his purchase of Series A Preferred Stock on December 24, 1998, and owns 45,080 shares of common stock from his purchase of Series D Preferred Stock on February 29, 2000. Morton H. Meyerson is the President of Morton Meyerson Family Foundation and has voting and investment power over the 77,264 shares owned by the Morton Meyerson Family Foundation.
- (9) Omicron Capital, L.P. a Delaware limited partnership (“Omicron Capital”), serves as investment manager to Omicron Master Trust, a trust formed under the laws of Bermuda (“Omicron”), Omicron Capital, Inc., a Delaware corporation (“OCI”), serves as general partner of Omicron Capital, and Winchester Global Trust Company Limited (“Winchester”) serves as the trustee of Omicron. By reason of such relationships, Omicron Capital and OCI may be deemed to share dispositive power over the shares of our common stock owned by Omicron, and Winchester may be deemed to share voting and dispositive power over the shares of our common stock owned by Omicron. Omicron Capital, OCI and Winchester disclaim beneficial ownership of such shares of our common stock. Omicron Capital has delegated authority from the board of directors of Winchester regarding the portfolio management decisions with respect to the shares of common stock owned by Omicron and as of March 15, 2005, Mr. Olivier H. Morali and Mr. Bruce T. Bernstein, officers of OCI, have delegated authority from the board of directors of OCI regarding the portfolio management decisions of Omicron Capital with

respect to the shares of common stock owned by Omicron. By reason of such delegated authority, Messrs. Morali and Bernstein may be deemed to share dispositive power over the shares of our common stock owned by Omicron. Messrs. Morali and Bernstein disclaim beneficial ownership of such shares of our common stock and neither of such persons has any legal right to maintain such delegated authority. No other person has sole or shared voting or dispositive power with respect to the shares of our common stock being offered by Omicron, as those terms are used for purposes under Regulation 13D-G of the Securities Exchange Act of 1934, as amended.

Omicron and Winchester are not “affiliates” of one another, as that term is used for purposes of the Securities Exchange Act of 1934, as amended, or of any other person named in this prospectus as a selling stockholder. No person or “group” (as that term is used in Section 13(d) of the Securities Exchange Act of 1934, as amended, or the SEC’s Regulation 13D-G) controls Omicron and Winchester.

- (10) Michael Eisenberg, Jonathan Medved and Neil Cohen are the sole owners of Seed Management Associates Ltd.
- (11) Smithfield Fiduciary LLC is a wholly-owned subsidiary of Highbridge International LLC which is a wholly-owned subsidiary of Highbridge Capital Corporation, a broker/dealer. Highbridge Capital Management, LLC is the trading manager of Highbridge International LLC and Highbridge Capital Corporation. Glenn Dubin is a Managing Partner of Highbridge Capital Management, LLC. Henry Swieca is a Managing Partner of Highbridge Capital Management, LLC. Smithfield Fiduciary LLC is an affiliate of a broker-dealer, (ii) Smithfield purchased its securities in the ordinary course of business; and (iii) at the time of the purchase of the securities to be resold, Smithfield had no agreement or understandings, directly or indirectly, with any person to distribute the securities.
- (12) Howard Weingrow as president and Robert Lifton as chairman of Stanoff Corporation have voting and investment power over the shares owned by Stanoff Corporation.
- (13) Joshua Silverman is a managing partner of Vertical Ventures, LLC and has sole voting and investment power over the shares owned by Vertical Ventures, LLC.
- (14) Daniel Saks, Ethan Benovitz and Jaime Hartman as managing members of WEC Partners LLC, have voting and investment power over WEC Partners LLC.



## **PLAN OF DISTRIBUTION**

The shares being offered by the Selling Stockholders will be sold from time to time in one or more transactions (which may involve block transactions) that may take place in the American Stock Exchange, including ordinary brokers' transactions, privately negotiated transactions or through sales to one or more dealers for resale of such securities as principals, at market prices prevailing at the time of sale, at prices related to such prevailing market prices or at negotiated prices. Usual and customary or specifically negotiated brokerage fees or commissions may be paid by the selling stockholders. The shares may also be sold pursuant to Rule 144 under the Securities Act. The Selling Stockholders have the sole and absolute discretion not to accept any purchase offer or make any sale of shares if they deem the purchase price to be unsatisfactory at any particular time.

The selling stockholders may also sell the shares directly to market makers acting as principals and/or broker-dealers acting as agents for themselves or their customers. Such broker-dealers may receive compensation in the form of discounts, concessions or commissions from the Selling Stockholders and/or the purchasers of shares for whom such broker-dealers may act as agents or to whom they sell as principal, or both, which compensation as to a particular broker-dealer might be in excess of customary commissions. Market makers and block purchasers purchasing the shares will do so for their own account and at their own risk. It is possible that a Selling Stockholder will attempt to sell shares of common stock in block transactions to market makers or other purchasers at a price per share which may be below the then market price.

The selling stockholders and intermediaries through whom such securities are sold may be deemed "underwriters" within the meaning of the Securities Act, with respect to the securities offered hereby, and any profits realized or commissions received may be deemed underwriting compensation. We have agreed to indemnify the selling stockholders against certain liabilities, including liabilities under the Securities Act.

The selling stockholders, alternatively, may sell all or any part of the shares offered by this prospectus through an underwriter. To our knowledge, no selling stockholder has entered into an agreement with a prospective underwriter. If any selling stockholder notifies us that it has entered into an agreement or agreements with a broker-dealer or underwriter for the resale of the common stock, the relevant details will be set forth in a supplement or revision to this prospectus.

The selling stockholders and any other persons participating in the sale or distribution of the shares will be subject to applicable provisions of the Securities Exchange Act of 1934 and the rules and regulations thereunder, including, without limitation, Regulation M, which may restrict certain activities of, and limit the timing of purchases and sales of any of the shares by the selling stockholders or any other such person. Furthermore, under Regulation M, persons engaged in a distribution of securities are prohibited from simultaneously engaging in market making and certain other activities with respect to such securities for a specified period of time prior to the commencement of such distributions, subject to specified exceptions or exemptions. All of these limitations may affect the marketability of the shares.

## **CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS**

In March 2004, Mark Tebbe, one of the members of our board of directors and as agent on our behalf, purchased the Internet domain name, "www.Answers.com," from an unrelated third party for \$80,200. Immediately following such purchase, Mr. Tebbe transferred the Internet domain name to us and was reimbursed \$80,200. The terms of transaction were as favorable to us as those generally available from unaffiliated third parties. However, at the time this transaction was entered into, we lacked sufficient disinterested independent directors to ratify the transaction.

Other than the aforementioned, there have been no transactions during the last two years, or proposed transactions, to which we were or will be a party, in which any director, executive officer, beneficial owner of more than 5% of our

common stock or any member of the immediate family (including spouse, parents, children, siblings and in-laws) of any of these persons, had or is to have a direct or indirect material interest.

Any future transactions with officers, directors or 5% stockholders will be on terms no less favorable to us than could be obtained from independent parties. Any affiliated transactions must be approved by a majority of our independent and disinterested directors who have access to our counsel or independent legal counsel at our expense.

## DESCRIPTION OF SECURITIES

Our certificate of incorporation authorizes us to issue 30,000,000 shares of common stock, par value \$.001, and 1,000,000 shares of preferred stock, par value \$.01. As of April 4, 2005, 6,945,292 shares of common stock are outstanding, held by 52 record holders. No shares of preferred stock are currently outstanding.

### Common stock

Each share of common stock has one vote. Except as otherwise provided by law or by the resolution or resolutions adopted by our board of directors designating the rights, powers and preferences of any series of preferred stock, the common stock shall have the exclusive right to vote for the election of directors and for all other purposes, and holders of preferred stock shall not be entitled to receive notice of any meeting of stockholders at which they are not entitled to vote. The number of authorized shares of preferred stock may be increased or decreased (but not below the number of shares thereof then outstanding) by the affirmative vote of the holders of a majority of the outstanding common stock, without a vote of the holders of the preferred stock, or of any series, unless a vote of any such holders is required pursuant to any preferred stock designation. The holders of our common stock do not have preemptive rights. The holders of our common stock are entitled to any dividends as may be declared by our board of directors out of legally available funds. Our board of directors does not intend to declare any cash or other dividends in the foreseeable future, but intends instead to retain earnings, if any, for use in our business operations.

Provisions of our charter and bylaws make it more difficult for a third party to acquire us, even if doing so would be beneficial to our stockholders. For example, our board of directors is divided into three classes, with one class being elected each year by our stockholders, which generally makes it more difficult for stockholders to replace a majority of directors and obtain control of our board. In addition, stockholder meetings may be called only by our board of directors, the chairman of the board and the president, advanced notice is required prior to stockholder proposals, and stockholders may not act by written consent. Further, we have authorized preferred stock that is undesignated, making it possible for our board of directors to issue preferred stock with voting or other rights or preferences that could impede the success of any attempt to change control of GuruNet. Delaware law also could make it more difficult for a third party to acquire us. Specifically, Section 203 of the Delaware General Corporation Law may have an anti-takeover effect with respect to transactions not approved in advance by our board of directors, including discouraging attempts that might result in a premium over the market price for the shares of common stock held by our stockholders.

### Preferred stock

In January 2004, all of our outstanding shares of preferred stock were converted into 1,372,048 shares of common stock. Our certificate of incorporation authorizes the issuance of blank check preferred stock with such designations, rights and preferences as may be determined from time to time by our board of directors. No shares of preferred stock are being issued or registered in this offering. Accordingly, our board of directors is empowered, without stockholder approval, to issue preferred stock with dividend, liquidation, conversion, voting or other rights that could dilute the percentage equity ownership in our company, the voting power and/or other rights of the holders of common stock. We may issue some or all of the preferred stock to effect one or more business combinations (although we have no present proposals with respect to any business combinations). In addition, the preferred stock could be utilized as a method of discouraging, delaying or preventing a change in control of us. Although we do not currently intend to issue any shares of preferred stock, we cannot assure you that we will not do so in the future.

### Bridge Notes

On January 30, 2004 and February 17, 2004, we completed our bridge financing, consisting of \$5,000,000 aggregate principal amount of bridge notes bearing interest at an annual rate of 8%. The aggregate principal amount of the

bridge notes includes \$200,000 previously advanced to us by investors that was converted into bridge notes in connection with the bridge financing. The bridge notes were due on the earlier of January or February 2005 and the consummation of our initial public offering. Interest from the date of issuance was payable in cash to the noteholders until the consummation of our initial public offering.

As the initial public offering was not consummated by (i) July 28, 2004, with respect to the bridge notes issued on January 30, 2004, or (ii) August 15, 2004, with respect to the bridge notes issued on February 17, 2004, we were obligated to pay each purchaser a cash amount equal to 1% of the aggregate purchase price paid by such purchaser for the first month and 1.5% for each month thereafter on every monthly anniversary thereof until the applicable securities underlying the bridge securities were registered. In the aggregate, we paid \$287,136 in accrued interest and \$161,124 in liquidated damages.

Upon the consummation of our initial public offering, \$1,840,000 of the bridge notes were converted into 490,678 shares of common stock, at a conversion price of \$3.75, and the remaining \$3,160,000 of the bridge notes was repaid subsequent to the initial public offering closing date. The shares issued upon conversion of the bridge notes will be locked up until October 13, 2005 or earlier, subject to certain conditions. The bridge notes are secured by substantially all of our assets, other than the stock of our subsidiary, which will be pledged upon receipt of all third party consents required for such pledge.

We received net proceeds of approximately \$4,325,000 from the bridge financing, which has to date been used for general corporate purposes.

## **Other Outstanding Securities**

### ***Bridge Warrants***

In connection with the issuance of the bridge notes, we issued bridge warrants to purchase an aggregate of 1,700,013 shares of common stock, exercisable at \$7.20 per share. The bridge warrants became exercisable commencing December 31, 2004 and for a period ending on the seventh anniversary of their respective dates of issuance. In the third quarter of 2004, our board of directors authorized the issuance of an aggregate of 750,002 additional warrants to the bridge noteholders. On October 7, 2004, the date on which we filed our registration statement, each noteholder received a pro rata share of these additional warrants (approximately 0.44 warrant for each bridge warrant held). These additional warrants contain terms identical to the bridge warrants except certain expiration provisions. Any shares issued upon their exercise will be locked up until October 13, 2005 or earlier, subject to certain conditions.

In addition, Vertical Ventures, LLC, the lead purchaser in the bridge financing received a warrant to purchase 265,837 shares of common stock at an exercise price of \$3.75 per share. This warrant is identical to the bridge warrants except for the exercise price.

In October 2004, the National Association of Securities Dealers, Inc. determined that shares issuable upon conversion of bridge notes and exercise of bridge warrants held by certain bridge noteholders in our bridge financing constituted underwriter's compensation, because of the relationship between these noteholders and one of our underwriters involved in our IPO. As a result, these noteholders are contractually obligated to surrender their 648,534 warrants to us without consideration and have their \$1,350,000 aggregate principal amount of bridge notes entirely repaid instead of partially or completely converted into common stock.

### ***Warrant Reload***

On February 4, 2005, we entered into an agreement with certain holders of the bridge warrants, pursuant to which such holders of the bridge warrants exercised an aggregate of 1,871,783 bridge warrants at the exercise price of \$7.20 per share, with the exception of Vertical Ventures, LLC, whose warrant contained an exercise price of \$3.75 for aggregate proceeds of approximately \$12,220,000, net of fees and expenses. As an incentive to the holders to exercise their respective bridge warrants, we issued 1,029,488 new warrants to purchase such number of shares of common stock (equal to 55% of the number of shares of common stock underlying their respective bridge warrants) at an exercise price of \$17.27 per share. The warrants are presently exercisable and expire on February 4, 2010.

### ***Lock-Up Agreements***

Holders of the bridge warrants have entered into lock-up agreements under which they have agreed not to sell or otherwise dispose of their shares of common stock underlying the bridge warrants without the consent of the underwriters involved in our IPO, except as follows: Until April 11, 2005, sales of shares underlying the bridge warrants may be made at prices no less than \$7.50 per share; and, after April 11, 2005 through October 13, 2005, sales

of shares underlying the bridge notes and bridge warrants may be made at prices no less than \$5.00 per share. The bridge warrants became exercisable on December 31, 2004. The underwriters involved in our IPO have advised us that in determining whether to give or withhold their consent to any sale within the applicable lock-up period, they will consider the market price and volume of our stock at such time and whether such sale would have an adverse effect on the market for our common stock.

***Maxim Warrant***

On January 20, 2005, we entered into an agreement with Maxim Group LLC for the provision of general financial advisory and investment banking services. The agreement, with a minimum term of 6 months, is for a monthly retainer fee of \$5,000. In connection with the foregoing agreement, we agreed to grant Maxim Group LLC a warrant to purchase 100,000 shares of our common stock, exercisable for 5 years following the date of the agreement at an exercise price equal to \$11.00.

*Consultant Stock Options*

On May 1, 2000, we entered into an agreement with Startups.com for the provision of infrastructure requirements services. The agreement, which has expired, was for an aggregate cash amount of \$72,000. In connection with the foregoing agreement, we agreed to grant Startups.com, options to purchase up to 1,043 shares of common stock at an exercise price equal to \$9.21. The foregoing options have fully vested.

On April 27, 1999, we entered into an agreement with Rivington Investments, N.V. for the provision of investment consulting services. In connection with the agreement, which has expired, we granted Rivington Investments, N.V., options to purchase up to 2,173 shares of common stock at an exercise price equal to \$1.15. The foregoing options have fully vested.

*Common Stock Issuance*

On December 13, 2004 we entered into an agreement with Barretto Pacific Corporation for the provision of investor relations consulting services. The agreement, which terminates on December 13, 2005, is for an aggregate cash amount of \$100,000. In connection with the foregoing agreement, we issued Barretto Pacific Corporation 7,800 shares of our common stock, bearing a restrictive legend.

*Comerica Warrant*

A warrant was issued to Comerica Bank - California ("Comerica") in connection with a Loan and Security Agreement dated as of April 1, 2002. The warrant entitles Comerica to purchase 2,172 shares of our common stock at a price of \$34.53 per share. The Comerica Warrant will expire in April 1, 2009, at which time, if the Comerica has not been exercised, it shall be deemed to have been automatically exercised on the expiration date by "cashless" conversion.

**SHARES ELIGIBLE FOR FUTURE SALE**

As of April 6, 2005, 6,945,292 shares of common stock are outstanding, held by approximately 52 record holders. No shares of preferred stock are currently outstanding. After this offering, we will have 8,204,099 shares of common stock outstanding. Of these shares, the 3,698,500 shares sold in this offering will be freely tradable without restriction or further registration, other than shares owned by any of our "affiliates" as defined in Rule 144(a) under the Securities Act, which generally includes officers, directors or 10% stockholders, without restriction or registration under the Securities Act and 1,543,359 shares owned by holders who have entered into lock-up agreements that restrict their ability to transfer our stock until April 11, 2005, October 13, 2005, or April 11, 2006, as applicable.

In connection with our bridge financing, our officers and directors entered into lock-up agreements under which they have agreed not to sell or otherwise dispose of their shares of common stock prior to April 13, 2006 (except for up to an aggregate of 354,212 shares issued or issuable upon exercise of securities owned by affiliated entities of three of our directors, which shares may be sold after October 13, 2005), without the consent of the underwriters involved in our IPO, unless (i) such shares were acquired by such officer or director after October 13, 2004, (ii) the sale, transfer, or other disposition of shares is consummated in connection with a Rule 13e-3 Transaction (as such term is defined in Rule 13e-3 promulgated under the Securities Exchange Act of 1934) and (iii) the transfer is consummated without consideration to family members or a trust established for their benefit in connection with which the proposed transferee agrees in writing to be bound by all of the provisions of the lock-up agreement prior to the consummation of such transfer

In connection with our bridge financing, stockholders owning 1% or more of our outstanding shares of common stock entered into lock-up agreements under which they have agreed not to sell or otherwise dispose of their shares of common stock without the consent of the underwriters involved in our IPO, prior to October 13, 2005, except as follows: from April 12, 2005 through October 12, 2005, sales of shares may be made at prices no less than \$9.00 per share.

In addition, holders of bridge notes and bridge warrants entered into lock-up agreements under which they have agreed not to sell or otherwise dispose of their shares of common stock underlying their notes and warrants without the consent of the underwriters involved in our IPO, prior to October 13, 2005, except as follows: until April 11, 2005, sales of shares underlying the bridge warrants may be made at prices no less than \$7.50 per share; and, after April 11, 2005 through October 12, 2005, sales of shares underlying the bridge notes and bridge warrants may be made at prices no less than \$5.00 per share.

In addition, we cannot assure you that the underwriters involved in our IPO will not remove these lock-up restrictions prior to their expiration without prior notice. The underwriters involved in our IPO have advised us that in determining whether to give or withhold their consent to any sale within the applicable lock-up period, they will consider the market price and volume of our stock at such time and whether such sale would have an adverse effect on the market for our common stock.

#### **Rule 144**

In general, under Rule 144 as currently in effect, a person who has owned restricted shares of common stock beneficially for at least one year is entitled to sell, within any three-month period, a number of shares that does not exceed the greater of the then average weekly trading volume or 1% of the total number of outstanding shares of the same class. Sales under Rule 144 are also subject to manner of sale provisions, notice requirements and the availability of current public information about us. A person who has not been one of our affiliates for at least the three months immediately preceding the sale and who has beneficially owned shares of common stock for at least two years is entitled to sell the shares under Rule 144 without regard to any of the limitations described above.

Securities issued in reliance on Rule 701 are also restricted and may be sold by stockholders other than affiliates of ours subject only to manner of sale provisions of Rule 144 and by affiliates under Rule 144 without compliance with its on-year holding period requirement.

#### **Rule 144(k)**

Under Rule 144(k), a person who is not deemed to have been one of our affiliates at the time of or at any time during the three months preceding a sale, and who has beneficially owned the restricted shares proposed to be sold for at least two years, including the holding period of any prior owner other than an affiliate, is entitled to sell their shares without complying with the manner of sale, public information, volume limitation or notice provisions of Rule 144.

#### **American Stock Exchange Listing**

We are listed on the American Stock Exchange under the symbol GRU.

#### **Our Transfer Agent**

The transfer agent for our securities is American Stock Transfer & Trust Company, 59 Maiden Lane, Plaza Level, New York, NY 10038.





## CONDITIONS IN ISRAEL

### General

Our operating subsidiary is incorporated under the laws of the State of Israel, and our research and development, manufacturing and executive facilities are located in Israel. Accordingly, we are directly affected by political, economic and military conditions in Israel. Our operations could be materially adversely affected if major hostilities involving Israel occur or if trade between Israel and its present trading partners is curtailed or interrupted.

### Political Conditions

Since the establishment of the State of Israel in 1948, a number of armed conflicts have taken place between Israel and its neighbors. A state of hostility, varying from time to time in intensity and degree, has led to security and economic problems for Israel. Additionally, Israel is currently experiencing intense violence and terrorism and from time to time in the past, Israel has experienced civil unrest, primarily in the West Bank and in the Gaza Strip administered by Israel since 1967. However, a peace agreement between Israel and Egypt was signed in 1979, a peace agreement between Israel and Jordan was signed in 1994 and, since 1993, several agreements between Israel and Palestinian representatives have been signed, pursuant to which certain territories in the West Bank and Gaza Strip were handed over to the Palestinian administration, known as the Palestinian Authority. The implementation of these agreements with the Palestinian representatives has been subject to difficulties and delays and a resolution of the differences between the parties remains uncertain. Recently, the political conflict with the Palestinians has worsened, which has resulted in terror attacks against Israeli targets and citizens both in Israel and in the areas administered by the Palestinian Authority. Since October 2000, there has been a significant increase in violence primarily in the West Bank and Gaza Strip, as well as in Israel itself, which intensified during 2001 and 2002. Negotiations between the parties have almost entirely ceased.

As of the date of this prospectus, Israel has not entered into any peace agreement with Syria or Lebanon.

We cannot predict whether any other agreements will be entered into between Israel and its neighboring countries, whether a final resolution of the area's problems will be achieved, the nature of any resolution of this kind, or whether the current violence will continue and the extent to which this violence will have an adverse impact on Israel's economic development, on our operations in the future or what other effects it may have upon us.

Despite the progress towards peace between Israel and its Arab neighbors, there are certain countries, companies and organizations that continue to participate in a boycott of Israeli firms and others doing business with Israel or with Israeli companies. Although we are restricted from marketing our products in these countries, we do not believe that the boycott has had a material adverse effect on our business. However, a prolonged continuation of the increased hostilities in the region could lead to increased boycotts and further restrictive laws, policies or practices directed towards Israel or Israeli businesses, and these could have a material adverse impact on our business.

Our key employees and executive officers all reside in Israel. Many of our executive officers and employees in Israel are obligated, currently until age 45, and at the end of 2004 generally up to age 40, to perform up to 36 days of annual military reserve duty. The term of their reserve service depends on their rank and position. Further, these individuals are subject to being called for active duty under emergency circumstances for extended periods of time. Our operations could be disrupted by the absence for a significant period of one or more of our directors, officers or key employees due to military service. Any such disruption could adversely affect our business, results and financial condition.

The September 11, 2001 terror attacks on the U.S. and the military response by the U.S. and its international allies in Afghanistan, have created uncertainty regarding the state of the U.S. and world economy. In addition, the U.S.

military operation against Iraq increased interest in fighting terrorist activities in the Middle East and around the world, and the effects of the military operation against Iraq on the State of Israel could directly affect our business.

**Economic Conditions**

Israel's economy has been subject to numerous destabilizing factors, including a period of rampant inflation in the early to mid-1980s, low foreign exchange reserves, fluctuations in world commodity prices, military conflicts and civil unrest. The Israeli government has intervened in various sectors of the economy, employing fiscal and monetary policies, import duties, foreign currency restrictions and controls of wages, prices and foreign currency exchange rates. The Israeli government has periodically changed its policies in all of these areas.

## **Trade Agreements**

Israel is a member of the United Nations, the International Monetary Fund, the International Bank for Reconstruction and Development and the International Finance Corporation. Israel is also a signatory to the General Agreement on Tariffs and Trade, which provides for reciprocal lowering of trade barriers among its members. In addition, Israel has been granted preferences under the Generalized System of Preferences from the United Nations, Australia, Canada and Japan. These preferences allow Israel to export the products covered by such programs either duty-free or at reduced tariffs. Israel and the European Economic Community, known now as the European Union, concluded a free trade agreement in July 1975, which confers various advantages on Israeli exports to most European countries and obligates Israel to lower its tariffs on imports from these countries over a number of years. In November 1995, Israel entered into a new agreement with the European Union, which includes redefinition of rules of origin and other improvements, including providing for Israel to become a member of the research and technology programs of the European Union. In 1985, Israel and the United States entered into an agreement to establish a free trade area. The free trade area has eliminated all tariff and specified non-tariff barriers on most trade between the two countries. On January 1, 1993, Israel and the European Free Trade Association entered into an agreement establishing a free-trade zone between Israel and the European Free Trade Association. In recent years, Israel has established commercial and trade relations with a number of the other nations, including Russia, China, Turkey, India and other nations in Eastern Europe and Asia.

## **DISCLOSURE OF COMMISSION POSITION ON INDEMNIFICATION FOR SECURITIES ACT LIABILITIES**

Our certificate of incorporation provides that all directors, officers, employees and agents of the registrant shall be entitled to be indemnified by us to the fullest extent permitted by Section 145 of the Delaware General Corporation Law. Insofar as indemnification for liabilities arising under the Securities Act may be permitted to our directors, officers, and controlling persons pursuant to the foregoing provisions, or otherwise, we have been advised that in the opinion of the SEC such indemnification is against public policy as expressed in the Securities Act and is, therefore, unenforceable. In the event that a claim for indemnification against such liabilities (other than the payment of expenses incurred or paid by a director, officer or controlling person in a successful defense of any action, suit or proceeding) is asserted by such director, officer or controlling person in connection with the securities being registered, we will, unless in the opinion of its counsel the matter has been settled by controlling precedent, submit to the court of appropriate jurisdiction the question whether such indemnification by it is against public policy as expressed in the Securities Act and will be governed by the final adjudication of such issue.

## **LEGAL MATTERS**

The validity of the securities offered in this prospectus are being passed upon for us by our counsel, Greenberg Traurig, LLP, New York, New York. As of the date of this prospectus, a shareholder of Greenberg Traurig, LLP beneficially owns 6,667 shares of our common stock and warrants to purchase 6,066 shares of our common stock.

## **EXPERTS**

The consolidated financial statements of GuruNet Corporation as of December 31, 2004 and 2003 and for the years then ended have been included herein and in the registration statement in reliance upon the reports of Somekh Chaikin, a member firm of KPMG International, and an Independent Registered Public Accounting Firm, appearing elsewhere herein and upon the authority of said firm as experts in auditing and accounting.

### **WHERE YOU CAN FIND MORE INFORMATION**

We have filed a registration statement on Form SB-2 with the Securities and Exchange Commission, or SEC, for the securities we are offering by this prospectus. This prospectus does not contain all of the information set forth in the registration statement and the exhibits and schedules to that registration statement. A copy of the registration statement may be inspected by anyone without charge at the SEC's principal office in Washington, D.C., and copies of all or any part of the registration statement may be obtained from the SEC's Public Reference Room at 450 Fifth Street, N.W., Washington, D.C. 20549, upon payment of certain fees prescribed by the SEC. Please call the SEC at 1-800-SEC-0330 for further information on the operation of the public reference rooms.

We also file annual, quarterly and current reports, proxy statements and other information with the SEC. You may read and copy any reports, statements or other information on file as the public reference rooms. You can also request copies of these documents, for a copying fee, by writing to the SEC.

Our SEC filings and registration statement can also be reviewed by accessing the SEC's Internet site at <http://www.sec.gov>, which contains reports, proxy and information statements and other information regarding registrants that are filed electronically with the SEC.

Copies of our filings with the SEC are also available, free of charge, on our corporate Website at <http://www.gurunet.com>. The information found on our Website is not incorporated by reference into this prospectus.

You should rely only on the information provided in this prospectus, any prospectus supplement or as part of the registration statement filed on Form SB-2 of which this prospective is a part, as such registration statement is amended and in effect with the Securities and Exchange Commission. We have not authorized anyone else to provide you with different information. We are not making an offer of these securities in any state where the offer is not permitted. You should not assume that the information in this prospectus, any prospectus supplement or any document incorporated by reference is accurate as of any date other than the date of those documents.

**INDEX TO CONSOLIDATED FINANCIAL INFORMATION**

	<b>Page</b>
REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM	F-2
CONSOLIDATED FINANCIAL STATEMENTS AS OF DECEMBER 31, 2004	
Consolidated Balance Sheets	F-3
Consolidated Statements of Operations	F-5
Consolidated Statements of Changes in Stockholders' Equity, Deficit, and Comprehensive Income (Loss)	F-6
Consolidated Statements of Cash Flows	F-8
Notes to Consolidated Financial Statements	F-10

F-1

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**GuruNet Corporation and Subsidiary**  
(Formerly Atomica Corporation)  
(A Development Stage Enterprise)

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**Report of Independent Registered Public Accounting Firm to  
the Stockholders of GuruNet Corporation**

**To the Stockholders of GuruNet Corporation:**

We have audited the accompanying consolidated balance sheets of GuruNet Corporation, formerly Atomica Corporation (a Development Stage Enterprise), and Subsidiary (collectively referred to as “the Company”) as of December 31, 2004 and 2003, and the related consolidated statements of operations, changes in stockholders’ equity (deficit) and comprehensive income (loss), and cash flows for the years then ended, and the period from December 22, 1998 (inception) to December 31, 2004. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the Standards of the Public Company Accounting Oversight Board (United States). Such auditing 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 the Board of Directors and 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 financial position of the Company as of December 31, 2004 and 2003, and the results of their operations, changes in stockholders’ equity (deficit) and comprehensive income (loss), and their cash flows for the years then ended and for the period from December 22, 1998 (inception) to December 31, 2004, in conformity with generally accepted accounting principles in the United States of America.

/s/ Somekh Chaikin

Somekh Chaikin  
Certified Public Accountants (Israel)  
A member of KPMG International

Jerusalem, Israel  
March 31, 2005

GuruNet Corporation (Formerly Atomica Corporation)  
and Subsidiary  
(A Development Stage Enterprise)

**Consolidated Balance Sheets**

	<b>December 31 2004 \$</b>	<b>December 31 2003 \$</b>
<b>Assets</b>		
<b>Current assets:</b>		
Cash and cash equivalents (Note 3)	1,565,415	123,752
Investment securities (Note 3)	5,850,000	--
Receivables (Note 2 e)	18,145	11,934
Prepaid expenses	259,674	20,481
Deferred charges (Note 4)	--	155,116
<b>Total current assets</b>	<b>7,693,234</b>	<b>311,283</b>
<b>Long-term deposits (restricted)</b> (Note 5)	<b>167,304</b>	<b>165,449</b>
<b>Deposits in respect of employee severance obligations</b> (Note 9)	<b>462,735</b>	<b>339,651</b>
<b>Property and equipment, net</b> (Note 6)	<b>305,804</b>	<b>206,408</b>
<b>Other assets:</b>		
Intangible assets, net (Note 7)	111,289	--
Prepaid expenses, long-term	147,000	--
Deferred tax asset, long-term (Note 11)	19,817	20,501
<b>Total other assets</b>	<b>278,106</b>	<b>20,501</b>
<b>Total assets</b>	<b>8,907,183</b>	<b>1,043,292</b>





GuruNet Corporation (Formerly Atomica Corporation)  
and Subsidiary  
(A Development Stage Enterprise)

**Consolidated Balance Sheets**

	<b>December 31 2004</b>	<b>December 31 2003</b>
	\$	\$
<b>Liabilities and stockholders' equity</b>		
<b>Current liabilities:</b>		
Accounts payable	172,029	215,684
Accrued expenses	422,465	326,186
Accrued compensation	259,872	293,113
Advances on account of shares and stock warrants (Note 8)	--	200,000
Deferred revenues, short-term (Note 2 g)	150,147	29,234
<b>Total current liabilities</b>	<b>1,004,513</b>	<b>1,064,217</b>
<b>Long-term liabilities:</b>		
Liability in respect of employee severance obligations (Note 9)	531,224	431,025
Deferred tax liability, long-term (Note 11)	94,965	55,092
Deferred revenues, long-term (Note 2 g)	452,359	537,404
<b>Total long-term liabilities</b>	<b>1,078,548</b>	<b>1,023,521</b>
<b>Commitments and contingencies (Note 12)</b>		
<b>Stockholders' equity (deficit) (Note 10):</b>		
Convertible preferred stock:		
Series A; \$0.01 par value; 0 shares authorized, issued and outstanding as of December 31, 2004; 130,325 shares authorized, issued, and outstanding as of December 31, 2003; aggregate liquidation preference of \$300,000	--	1,303
Series B; \$0.01 par value; 0 shares authorized, issued and outstanding as of December 31, 2004; 217,203 shares authorized; 181,112 shares issued and outstanding as of December 31, 2003; aggregate liquidation preference of \$1,350,000	--	1,811
Series C; \$0.01 par value; 0 shares authorized, issued and outstanding as of December 31, 2004; 260,643 shares authorized; 238,119 shares issued and outstanding as of December 31, 2003; aggregate liquidation preference of \$2,750,000	--	2,381

Series D; \$0.01 par value; 0 shares authorized, issued and outstanding as of December 31, 2004; 824,646 shares authorized as voting stock and 21,721 shares authorized as non-voting stock; 807,468 shares of voting stock and 15,024 shares of non-voting stock issued and outstanding as of December 31, 2003; aggregate liquidation preference of \$28,400,000	--	8,225
Common stock; \$0.001 par value; 30,000,000 and 2,856,937 shares authorized as of December 31, 2004 and 2003, 4,920,551 and 355,325 shares issued and outstanding as of December 31, 2004 and 2003, respectively	4,921	355
Additional paid-in capital	47,488,072	33,100,368
Deferred compensation	(45,146)	(125,873)
Accumulated other comprehensive loss	(27,608)	(27,418)
Deficit accumulated during development stage	(40,596,117)	(34,005,598)
<b>Total stockholders' equity (deficit)</b>	<b>6,824,122</b>	<b>(1,044,446)</b>
<b>Total liabilities and stockholders' equity (deficit)</b>	<b>8,907,183</b>	<b>1,043,292</b>

GuruNet Corporation (Formerly Atomica Corporation)  
and Subsidiary  
(A Development Stage Enterprise)

### Consolidated Statements of Operations

	Years ended December 31		Cumulative from
	2004	2003	December 22, 1998
	\$	\$	(inception) through
			December 31, 2004
			\$
<b>Revenue</b>	<b>193,283</b>	28,725	1,421,797
Cost of revenue	<b>647,055</b>	723,349	3,551,768
<b>Gross margin</b>	<b>(453,772)</b>	(694,624)	(2,129,971)
<b>Operating expenses:</b>			
Research and development	<b>1,033,521</b>	910,114	18,579,110
Sales and marketing	<b>932,455</b>	478,942	9,581,042
General and administrative	<b>1,125,064</b>	678,645	7,514,785
Loss in connection with shut-down of operations	--	--	1,048,446
<b>Total operating expenses</b>	<b>3,091,040</b>	2,067,701	36,723,383
<b>Operating loss</b>	<b>(3,544,812)</b>	(2,762,325)	(38,853,354)
Interest expense, net	<b>(4,382,583)</b>	719	(2,574,865)
Gain on extinguishment of debt	<b>1,493,445</b>	--	1,493,445
Other expense, net (Note 14)	<b>(116,012)</b>	(12,586)	(586,195)
<b>Loss before income taxes</b>	<b>(6,549,962)</b>	(2,774,192)	(40,520,969)
Income taxes (Note 11)	<b>(40,557)</b>	(34,591)	(75,148)
<b>Net loss</b>	<b>(6,590,519)</b>	(2,808,783)	(40,596,117)
<b>Basic and diluted net loss per common share</b>	<b>(2.90)</b>	(7.93)	(53.81)
<b>Weighted average shares used in computing basic and diluted net loss per common share</b>	<b>2,273,675</b>	354,112	754,378

GuruNet Corporation (Formerly Atomica Corporation)  
and Subsidiary  
(A Development Stage Enterprise)

**Consolidated Statement of Changes in Stockholders' Equity (Deficit) and Comprehensive Income (Loss)**

	Convertible preferred stock		Common stock		Additional paid-in capital	Deferred compensation	Accumulated other comprehensive income (loss)	Deficit during development stage	Total stockholders' equity (deficit)	Comprehensive income (loss)
	Shares	Amount	Shares	Amount						
<b>Balance as of January 1, 2003</b>	1,372,048	\$ 13,720	353,876	\$ 354	32,958,424	--	(64,047)	(31,196,815)	1,711,636	(31,196,815)
Issuance of stock options to a non-employee for services rendered	--	--	--	--	1,225	(1,225)	--	--	--	--
Issuance of stock options to employees	--	--	--	--	139,720	(139,720)	--	--	--	--
Amortization of deferred compensation	--	--	--	--	--	15,072	--	--	--	15,072
Exercise of common stock options	--	--	1,449	1	999	--	--	--	--	1,000
Loss on foreign currency translation	--	--	--	--	--	--	36,629	--	--	36,629
Net loss for year	--	--	--	--	--	--	--	(2,808,783)	(2,808,783)	(2,808,783)
<b>Balance as of December 31, 2003</b>	<b>1,372,048</b>	<b>13,720</b>	<b>355,325</b>	<b>355</b>	<b>33,100,368</b>	<b>(125,873)</b>	<b>(27,418)</b>	<b>(34,005,598)</b>	<b>(1,044,446)</b>	<b>(34,005,598)</b>
Conversion of preferred stock into common stock	(1,372,048)	(13,720)	1,372,048	1,372	12,348	--	--	--	--	--
Discounts on convertible promissory	--	--	--	--	1,577,373	--	--	--	--	1,577,373

notes and warrants									
Issuance expenses in private placement relating to warrants	--	--	--	--	(147,080)	--	--	--	(147,080)
Warrants of common stock issued as finder's fee in private placement	--	--	--	--	232,202	--	--	--	232,202
Warrants of common stock issued to holders of convertible promissory notes	--	--	--	--	262,488	--	--	--	262,488
Issuance of common stock, net of issuance costs of \$2,726,209	--	--	2,702,500	2,703	10,713,214	--	--	--	10,715,917
Conversion of convertible promissory notes into common stock, net of issuance costs of \$134,255	--	--	490,678	491	1,705,254	--	--	--	1,705,745
Issuance of stock options to underwriters	--	--	--	--	70,374	--	--	--	70,374
Issuance of stock options to non-employees for services rendered	--	--	--	--	16,571	--	--	--	16,571
Amortization of deferred compensation	--	--	--	--	--	25,687	--	--	25,687
Forfeiture of stock options granted to an employee	--	--	--	--	(55,040)	55,040	--	--	--
Unrealized loss on securities	--	--	--	--	--	--	(190)	--	(190)

Net loss for year	--	--	--	--	--	--	--	--	(6,590,519)	(6,590,519)	(6,590,519)
<b>Balance as of December 31, 2004</b>	--	--	4,920,551	4,921	47,488,072	(45,146)	(27,608)	(40,596,117)	6,824,122	6,824,122	(40,596,117)

F-6

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GuruNet Corporation (Formerly Atomica Corporation)  
and Subsidiary  
(A Development Stage Enterprise)

**Consolidated Statement of Changes in Stockholders' Equity (Deficit) and Comprehensive Income (Loss)**  
(cont'd)

	Convertible preferred stock		Common stock		Additional paid-in capital	Deferred compensation	Notes receivable	Other comprehensive loss	Development stage	Total equity (deficit)	Comprehensive income (loss)
	Shares	Amount	Shares	Amount							
<b>December 1998 -</b> Issuance of common stock to founders at \$0.023 per share, upon the Company's inception (no issuance costs)	--	\$ --	--	325,805	\$ 326	7,174	--	--	--	--	--
<b>April 1999 -</b> Issuance of common stock in lieu of loan repayment	--	--	--	5,649	5	6,495	--	--	--	--	--
<b>August 1999 -</b> Issuance of common stock upon exercise of stock options	--	--	--	21,721	22	49,978	--	--	--	--	--
<b>August 1999 -</b> Issuance of common stock at \$2.30 per share, for acquisition of domain name	--	--	--	652	1	1,499	--	--	--	--	--
<b>December 1998 and January 1999 -</b> Issuance of Series A convertible preferred stock	130,325	1,303	--	--	--	290,715	--	--	--	--	--



at \$2.30 per share, net of issuance costs of \$7,982

**April 1999 -**

Issuance of Series B convertible preferred stock at \$7.45 per share, net of issuance costs of \$38,678

181,112	1,811	--	--	1,309,511	--	--	--	--	1
---------	-------	----	----	-----------	----	----	----	----	---

**September**

**1999 -** Issuance of series C convertible preferred stock at \$11.55 per share, net of issuance costs of \$79,678

238,119	2,381	--	--	2,667,941	--	--	--	--	2
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**February 2000 and June 2000**

- Issuance of Series D convertible preferred stock at \$34.53 per share, net of issuance costs of \$4,359

822,492	8,225	--	--	28,387,416	--	--	--	--	28
---------	-------	----	----	------------	----	----	----	----	----

Exercise of common stock options from inception through December 31, 2004

--	--	268,353	268	1,843,633	--	(1,842,900)	--	--
----	----	---------	-----	-----------	----	-------------	----	----

Repurchase of stockholders' common stock and cancellation of note receivable from inception through December 31, 2004

--	--	(266,855)	(267)	(1,842,633)	--	1,842,900	--	--
----	----	-----------	-------	-------------	----	-----------	----	----

Issuance of stock options

--	--	--	--	683,448	(228,642)	--	--	--
----	----	----	----	---------	-----------	----	----	----

and warrants to non-employees for services rendered from inception through December 31, 2004										
Revaluation of options issued to non-employees for services rendered from inception through December 31, 2004	--	--	--	--	(126,885)	84,096	--	--	--	--
Forfeiture of stock options granted for services rendered from inception through December 31, 2004	--	--	--	--	(68,871)	68,871	--	--	--	--
Issuance of stock options to employees from inception through December 31, 2004	--	--	--	--	139,720	(139,720)	--	--	--	--
Amortization of deferred compensation from inception through December 31, 2004	--	--	--	--	--	115,209	--	--	--	--
Loss on foreign currency translation from inception through December 31, 2004	--	--	--	--	--	--	--	(27,418)	--	--
<b>January 2004 -</b>	(1,372,048)	(13,720)	1,372,048	1,372	12,348	--	--	--	--	--
Conversion of preferred stock										

into common stock										
Issuance of warrants of common stock to holders of convertible promissory notes	--	--	--	--	262,488	--	--	--	--	--
Discounts on convertible promissory notes and warrants	--	--	--	--	1,577,373	--	--	--	--	1
Issuance expenses in private placement relating to warrants	--	--	--	--	(147,080)	--	--	--	--	(
<b>October 2004 -</b>										
Issuance of common stock, net of issuance costs of \$2,726,209	--	--	2,702,500	2,703	10,713,214	--	--	--	--	10
<b>October 2004 -</b>										
Conversion of convertible promissory notes into common stock, net of issuance costs of \$134,255			490,678	491	1,705,254	--	--	--	--	1
Issuance of stock options to underwriters	--	--	--	--	70,374	--	--	--	--	--
Forfeiture of stock options granted to employees	--	--	--	--	(55,040)	55,040	--	--	--	--
Unrealized loss on securities	--	--	--	--	--	--	--	(190)	--	--
Net loss from inception through December 31, 2004	--	--	--	--	--	--	--	--	(40,596,117)	(40
<b>Balance as of December 31,</b>	<b>--</b>	<b>--</b>	<b>4,920,551</b>	<b>4,921</b>	<b>47,488,072</b>	<b>(45,146)</b>	<b>--</b>	<b>(27,608)</b>	<b>(40,596,117)</b>	<b>6</b>

**2004**

See accompanying notes to the consolidated financial statements.

F-7

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GuruNet Corporation (Formerly Atomica Corporation)  
and Subsidiary  
(A Development Stage Enterprise)

### Consolidated Statements of Cash Flows

	Years ended December 31		Cumulative from December 22, 1998 (inception) through December 31,
	2004	2003	2004
	\$	\$	\$
<b>Cash flows from operating activities:</b>			
<b>Net loss</b>	<b>(6,590,519)</b>	<b>(2,808,783)</b>	<b>(40,596,117)</b>
<b>Adjustments to reconcile net loss to net cash used in operating activities:</b>			
Depreciation and amortization	119,126	268,026	2,212,055
Deposits in respect of employee severance obligations	(123,084)	(107,871)	(462,735)
Loss on sale and write off of property and equipment in connection with shut-down of operations	--	--	780,475
Other loss on sale and write off of property and equipment	--	-	549,802
Settlement of obligations for other than cash	--	--	225,589
Increase in liability in respect of employee severance obligations	100,199	101,380	531,224
Deferred income taxes	40,557	34,591	75,148
Stock issued for domain name	--	--	1,500
Issuance of stock options and warrants to non-employees for services rendered	16,571	--	222,604
Revaluation of options issued to non-employees for services rendered	--	--	(42,789)
Amortization of deferred compensation	25,687	15,072	115,209
Amortization of deferred charges relating to convertible promissory notes	889,983	--	889,983
Amortization of discounts on promissory notes	1,577,373	--	1,577,373
Exchange rate differences	11,746	--	11,746
<b>Changes in operating assets and liabilities:</b>			
(Increase) decrease in accounts receivable and other current assets	(245,404)	372,657	(276,263)
(Increase) in long-term prepaid expenses	(147,000)	--	(147,000)
(Decrease) increase in accounts payable	(43,655)	180,413	172,029
Increase in accrued expenses and other current liabilities	63,038	28,849	694,021
Increase in short-term deferred revenues	64,985	17,234	94,219
	<b>(29,117)</b>	<b>537,404</b>	<b>508,287</b>

(Decrease) increase in long-term deferred revenues			
<b>Net cash used in operating activities</b>	<b>(4,269,514)</b>	<b>(1,361,028)</b>	<b>(32,863,640)</b>
<b>Cash flows from investing activities:</b>			
Capital expenditures	<b>(209,875)</b>	(48,454)	(4,112,901)
Proceeds from sale of property and equipment	--	--	54,415
Purchase of intangible assets	<b>(119,936)</b>	--	(119,936)
Decrease (increase) in long-term deposits	<b>(1,855)</b>	12,541	(160,437)
Purchases of investment securities	<b>(5,850,000)</b>	--	<b>(5,850,000)</b>
Other	<b>(190)</b>	--	(190)
<b>Net cash used in investing activities</b>	<b>(6,181,856)</b>	<b>(35,913)</b>	<b>(10,189,049)</b>
<b>Cash flows from financing activities:</b>			
Repayment of loan	--	--	(20,000)
Proceeds from loan	--	--	6,500
Proceeds from issuance of convertible preferred stock, net of \$130,697 issuance costs	--	--	32,669,303
Proceeds from issuance of common stock, net of \$2,726,210 issuance costs	<b>10,786,290</b>	--	10,843,790
Proceeds from issuance of promissory notes, net of issuance costs in the amount of \$521,511 and \$155,116 in 2004 and 2003, respectively	<b>4,278,489</b>	44,884	4,323,373
Repayment of convertible promissory notes	<b>(3,160,000)</b>	--	(3,160,000)
Exercise of common stock options	-	1,000	1,000
<b>Net cash provided by financing activities</b>	<b>11,904,779</b>	<b>45,884</b>	<b>44,663,966</b>
Effect of exchange rate changes on cash and cash equivalents	<b>(11,746)</b>	36,629	(45,862)
<b>Net increase (decrease) in cash and cash equivalents</b>	<b>1,441,663</b>	<b>(1,314,428)</b>	<b>1,565,415</b>
Cash and cash equivalents at beginning of period	<b>123,752</b>	<b>1,438,180</b>	--
<b>Cash and cash equivalents at end of period</b>	<b>1,565,415</b>	<b>123,752</b>	<b>1,5865,415</b>

See accompanying notes to the consolidated financial statements

GuruNet Corporation (Formerly Atomica Corporation)  
and Subsidiary  
(A Development Stage Enterprise)

**Consolidated Statements of Cash Flows**

	Years ended December 31		Cumulative from December 22, 1998 (inception) through December 31, 2004
	2004	2003	2004
	\$	\$	\$
<b>Supplemental disclosures of cash flow information:</b>			
Income taxes paid	42,859	7,661	91,591
<b>Non-cash investing and financing activities:</b>			
Stock issued for domain name	--	--	1,500
Issuance of common stock in lieu of loan repayments	--	--	6,500
Common stock issued in exchange for notes receivable	--	--	1,842,900
Repurchase of stockholders' common stock and cancellation of notes receivable	--	--	(1,842,900)
Issuance of warrants and stock options to non-employees	565,065	--	565,065
Amortization of deferred charges relating to warrants	147,080	--	147,080
Discount on convertible promissory notes	1,577,373		1,577,373
Conversion of convertible promissory notes into common stock	1,840,000		1,840,000
Issuance costs related to the converted promissory notes	134,255		134,255
Unrealized loss from securities	190	--	190

See accompanying notes to the consolidated financial statements

## **Note 1 - Business**

GuruNet Corporation (“the Parent”), formerly Atomica Corporation (a Development Stage Enterprise), was founded as a Texas corporation on December 22, 1998, and reorganized as a Delaware corporation in April 1999. On December 27, 1998, the Parent formed a subsidiary (“the Subsidiary”) based in Israel, primarily for the purpose of providing research and development services to the Parent. GuruNet Corporation and the Subsidiary are collectively referred to as “the Company”. The Company develops, markets and sells technology that intelligently and automatically integrates and retrieves information from disparate sources and delivers the result in a single consolidated view.

Prior to 2003, the Company focused primarily on enterprise systems for corporate customers and large organizations. Beginning in 2003, the Company’s primary product has been its consumer product, which, in 2003 and 2004, was sold to subscribers who paid the Company on a lifetime or annual basis. In January 2005, the Company introduced a free-to-customer product, containing practically all the content that it used to sell via subscriptions and ceased selling subscriptions to individual consumers. The Company plans to generate advertising revenue from the free-to-customer product. Notwithstanding, customers who purchased subscriptions prior to January 2005, will continue to be fully supported through the subscription periods.

As the Company has not yet earned significant revenue from its operations, it considers itself a development stage enterprise, as defined under Statement of Financial Accounting Standards No. 7, “*Accounting and Reporting by Development Stage Enterprises*”.

## **Note 2 - Summary of Significant Accounting Policies**

### **(a) Principles of Consolidation**

The accompanying consolidated financial statements include the accounts of GuruNet Corporation and the Subsidiary. All significant intercompany balances and transactions have been eliminated in consolidation.

### **(b) Foreign Currency Translation**

Prior to January 2004, the financial statements for the Subsidiary were measured using the local currency as the functional currency. Assets and liabilities of foreign operations were translated at the rate of exchange as of the balance sheet date. Expenses were translated using average exchange rates for the year. Stockholders’ equity was translated using the historical exchange rates applicable for each line item. Foreign currency translation gains and losses were included as a component of other comprehensive income or loss.

Beginning in the first quarter of 2004, due to significant changes in economic facts and circumstances, the financial statements of the Subsidiary are measured using the U.S. dollar as its functional currency. Transactions in foreign currency (primarily in New Israeli Shekels - “NIS”) are recorded at the representative exchange rate as of the transaction date, except for activities relating to balance sheet items, which are recorded at the appropriate exchange rate of the corresponding balance sheet item. Monetary assets and liabilities in foreign currency are stated on the basis of the representative rate of exchange at the balance sheet date. Non-monetary assets and liabilities in foreign currency are stated at historical exchange rates. All exchange gains and losses from remeasurement of monetary balance sheet items denominated in non-dollar currencies are reflected in the statement of operations as they arise.



**Note 2 - Summary of Significant Accounting Policies (cont'd)****(c) Use of Estimates**

The preparation of consolidated financial statements in conformity with generally accepted accounting principles in the United States of America requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported results of operations during the reporting periods. Actual results could differ from those estimates.

**(d) Cash, Cash Equivalents and Investment Securities**

All highly liquid investments with an original maturity of three months or less are considered cash equivalents.

Investment securities consist of auction rate securities with auction reset periods less than 12 months, classified as available-for-sale securities and stated at fair value.

Investment securities and marketable securities that are deemed cash and cash equivalents, are classified as available-for-sale, in accordance with SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities", and are reported at fair value, with unrealized gains and losses, net of tax, recorded in other comprehensive income (loss). Realized gains or losses and declines in value judged to be other than temporary, if any, on available-for-sale securities are reported in other income, net.

**(e) Accounts Receivable**

Accounts receivable are recorded at the invoiced amount and do not bear interest. If necessary, the Company records an allowance for doubtful accounts to reflect the Company's best estimate of the amount of probable credit losses in the Company's existing accounts receivable, computed on a specific basis. No such allowance was deemed necessary as of the balance sheet dates. The Company does not have any off-balance-sheet credit exposure related to its customers.

**(f) Property and Equipment**

Property and equipment are stated at cost, less accumulated depreciation and amortization. Depreciation is calculated using the straight-line method over the estimated useful lives of the assets. Annual depreciation rates are as follows:

Computer equipment	%
	33
Furniture and fixtures	
	7 - 15

Leasehold improvements are amortized over the shorter of the estimated useful life or the expected life of the lease.

## Note 2 - Summary of Significant Accounting Policies (cont'd)

### (g) Revenue Recognition

Revenues from subscription services are recognized over the life of the subscription, which is generally one year, in accordance with Statement of Position (SOP) No. 97-2, "*Software Revenue Recognition*", issued by the American Institute of Certified Public Accountants (AICPA). Sales that do not yet meet the criteria for revenue recognition, are classified as "Deferred Revenues" on the balance sheet.

In 2003, the Company sold lifetime subscriptions to its consumer product and did not recognize revenue from those sales since the obligation to continue serving such content had no defined termination date and adequate history to estimate the life of the customer relationship was not available. Cash received from such lifetime licenses is reflected as long-term deferred revenues on the accompanying balance sheets.

Beginning April 2004, certain users who purchased lifetime subscriptions in 2003 exchanged their lifetime subscriptions for free two-year subscriptions to a newer enhanced version of the GuruNet product. The cash previously received from such users will be recognized over the new two-year subscription. During the year 2004, the Company recognized approximately \$30,000 of such revenues.

The Company's cancellation and refund policies allow a full refund during the first month after purchase, under certain circumstances. However, past history has shown that the amounts actually refunded have been immaterial, as are the current estimated returns, and therefore have no significant effect on revenue recognition.

The Company generates advertising revenues through pay-per-click keyword advertising. When a user searches sponsored keywords, an advertiser's Website is displayed in a premium position and identified as a sponsored result to the search. Generally, the Company does not contract directly with advertisers, but rather, obtains those advertisers through the efforts of a third party that locates advertisers seeking to display sponsored links in our product. The third party is obligated to pay the Company a portion of the revenue it receives from advertisers, as compensation for the Company's sale of promotional space on its Internet properties. Amounts received from such third parties are reflected as revenue on the accompanying statement of operations in the period in which such advertising services were provided.

### (h) Research and Development

Statement of Financial Accounting Standards (SFAS) No. 86, "*Accounting for the Cost 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. The Company does not incur material costs between the establishment of technological feasibility of its products and the point at which the products are ready for general release. Therefore, research and development costs are charged to the statement of operations as incurred.

Additionally, the Company capitalizes certain internal use software and Website development in accordance with Statement of Position (SOP) 98-1, "*Accounting for the Cost of Computer Software Developed or Obtained for Internal Use*", and EITF 00-2, "*Accounting for Web Site Development Costs*". The capitalized costs are amortized over their estimated useful lives, which varies between six months and four years.

**Note 2 - Summary of Significant Accounting Policies (cont'd)****(i) Accounting for Stock-Based Compensation**

As allowed by Statement of Financial Accounting Standards (SFAS) No. 123, “*Accounting for Stock-based Compensation*”, the Company utilizes the intrinsic-value method of accounting prescribed by the Accounting Principles Board (APB) Opinion No. 25, “*Accounting for Stock Issued to Employees*”, and related interpretations, to account for stock option plans for employees and directors. Compensation cost for stock options, if any, would be measured as the excess of the estimated market price of the Company’s stock at the date of grant over the amount an employee must pay to acquire the stock.

The fair value of options and warrants granted to non-employees, are measured according to the Black-Scholes option-pricing model with the following weighted average assumptions: . no dividend yield; risk-free interest rates of 1.69% to 4.00%; volatility between 38.00% and 66.76%; and an expected life between one and seven years.

The Company has adopted the disclosure requirements of SFAS No. 123 and SFAS No. 148, “*Accounting for Stock-Based Compensation—Transition and Disclosure*”, for awards to its directors and employees. For disclosure purposes only, the fair value of options granted to employees and directors prior to May 12, 2004, the date of the Company’s first filing with the U.S. Securities and Exchange Commission, in connection with it’s IPO, was estimated on the date of grant using the minimum-value method with the following weighted average assumptions: no dividend yield; risk-free interest rates of 2.18% to 6.68%; and an expected life of three to five years. The fair value of options granted to employees and directors subsequent to May 12, 2004, are measured, for disclosure purposes only, according to the Black-Scholes option-pricing model with the following weighted average assumptions: . no dividend yield; risk-free interest rates of 2.17% to 3.78%; volatility between 61.57% and 66.76%; and an expected life of four years.

The following illustrates the effect on net loss and net loss per share if the Company had applied the fair value methods of SFAS No. 123 for accounting purposes:

	<b>Years ended December 31</b>		<b>Cumulative from inception through December 31, 2004</b>
	<b>2004</b>	<b>2003</b>	<b>2004</b>
	\$	\$	\$
Net loss, as reported	(6,590,519)	(2,808,783)	(40,596,117)
Add:			
Stock-based compensation expense to employees and directors included in reported net loss, net of related tax effects	25,382	14,995	40,377
Deduct:			
Stock-based compensation expense to employees and directors determined under fair value based method for all awards, net of related tax effects	(75,363)	(34,407)	(225,717)
<b>Pro-Forma net loss</b>	<b>(6,640,500)</b>	<b>(2,828,195)</b>	<b>(40,781,457)</b>
Net loss per common share, basic and diluted:			

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As reported	(2.90)	(7.93)	(53.81)
Pro-forma	(2.92)	(7.99)	(54.06)

F-13

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**Note 2 - Summary of Significant Accounting Policies (cont'd)****(j) Income Taxes**

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. A valuation allowance is provided for the amount of deferred tax assets that, based on available evidence, are not more likely than not to be realized.

**(k) Impairment of Long-Lived Assets and Intangible Assets**

The Company evaluates its long-lived tangible and intangible assets 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 the asset to future undiscounted net cash flows expected to be generated by the asset. 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.

**(l) Net Loss Per Share Data**

Basic and diluted net loss per common share are presented in conformity with the SFAS No. 128, *Earnings Per Share*. Diluted net loss per share is the same as basic net loss per share as the inclusion of 3,376,310 common stock equivalents would be anti-dilutive. Share and per-share data presented throughout the financial statements and notes reflect a 1-for-23 reverse stock split that the Company declared in January 2004.

**(m) Comprehensive Income (Loss)**

Comprehensive income (loss) as defined, includes all changes in equity during a period from non-owner sources. Accumulated other comprehensive income (loss), consists of net unrealized gains and losses on available-for-sale securities, net of tax, and the cumulative foreign currency translation adjustment.

**(n) Recently Issued Accounting Standards**

In March 2004, the Emerging Issues Task Force ("EITF") reached a consensus on Issue No. 03-01, *The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments* ("EITF 03-1"). EITF 03-1 provides guidance on other-than-temporary impairment models for marketable debt and equity securities accounted for under SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities* ("SFAS No. 115"), and non-marketable equity securities accounted for under the cost method. The EITF developed a basic three-step model to evaluate whether an investment is other-than-temporarily impaired. On September 30, 2004, the FASB issued FSP 03-1-1, "Effective Date of Paragraphs 10-20 of EITF Issue 03-1, 'The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments'," delaying the effective date for the recognition and measurement guidance of EITF 03-1, as contained in paragraphs 10-20, until certain implementation issues are addressed and a final FSP providing implementation guidance is issued. The disclosure requirements of the consensus remain in effect. We will examine the effect the adoption of EITF 03-01 will have on the Company's results of operations and financial condition once a final consensus will be reached. Until new guidance is issued, companies must continue to comply with the disclosure requirements of EITF 03-1 and



**Note 2 - Summary of Significant Accounting Policies (cont'd)**

**(n) Recently Issued Accounting Standards (cont'd)**

all relevant measurement and recognition requirements in other accounting literature. The Company does not expect the adoption of EITF 03-1 to have a material effect on its financial statements.

In December 2004, the FASB issued SFAS No. 153, *"Exchanges of Nonmonetary Assets - an amendment to APB No. 29."* This Statement amends Opinion No. 29 to eliminate the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. A nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. Adoption of this statement is not expected to have a material impact on the results of operations and financial condition of the Company.

In December 2004, the Financial Accounting Standards Board issued SFAS No. 123 (revised 2004), "Share-Based Payment"(SFAS No. 123R). This Statement is a revision of SFAS No. 123, "Accounting for Stock-Based Compensation", and it establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services. This Statement eliminates the option to use Opinion 25's intrinsic value method of accounting that was provided in SFAS No. 123 as originally issued and it requires a public entity to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. That cost will be recognized over the period during which an employee is required to provide service in exchange for the award which is usually the vesting period. No compensation cost is recognized for equity instruments for which employees do not render the requisite service. As determined in SFAS No. 123R, the Company will apply its rules as of the beginning of the first interim or annual reporting period that begins after December 15, 2005. SFAS 123R provides two alternative adoption methods. The first method is a modified prospective method whereby a company would recognize share-based employee costs from the beginning of the fiscal period in which the recognition provisions are first applied as if the fair-value-based accounting method had been used to account for all employee awards granted, modified, or settled after the effective date and to any awards that were not fully vested as of the effective date. Measurement and attribution of compensation cost for awards that are unvested as of the effective date of SFAS 123R would be based on the same estimate of the grant-date fair value and the same attribution method used previously under SFAS No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123"). The second adoption method is a modified retrospective transition method whereby a company would recognize employee compensation cost for periods presented prior to the adoption of SFAS 123R in accordance with the original provisions of SFAS 123; that is, an entity would recognize employee compensation costs in the amounts reported in the pro forma disclosures provided in accordance with SFAS 123. A company would not be permitted to make any changes to those amounts upon adoption of SFAS 123R unless those changes represent a correction of an error. The Company is currently considering which of the two methods it will adopt, and the effect that the adoption of SFAS 123R will have on its financial statements.

**(o) Reclassifications**

Certain prior year balances have been reclassified in order to conform to the current year presentation.

**Note 3 - Cash and Cash Equivalents and Investment Securities**

Cash and cash equivalents consist of the following:

	<b>2004</b>	<b>2003</b>
	\$	\$
<b>In US dollars</b>		
Cash	<b>340,762</b>	68,045
Cash equivalents	<b>1,107,638</b>	-
<b>In New Israeli Shekels (Cash only)</b>	<b>117,015</b>	55,707
	<b>1,565,415</b>	123,752

The Company's investment securities consist of investments in auction rate, investment grade, corporate and municipal debt instruments, and auction rate preferred shares of closed-end investment funds that invest in long-term fixed income securities, with auction reset periods of 28 days, classified as available-for-sale securities and stated at fair value.

**Note 4 - Deferred Charges**

In connection with obtaining the promissory notes and warrants that were issued in January and February, 2004 (see Note 8), the Company incurred, \$521,511 and \$494,691 of cash and non-cash issuance costs, respectively, in 2004, and \$155,116 of cash issuance costs in 2003. The costs incurred in 2003 were recorded as deferred charges on the accompanying balance sheet as of December 31, 2003. The portion of the issuance costs ascribed to the promissory notes was amortized over the life of the notes. On October 13, 2004, upon completion of the IPO, approximately \$134,000 of the unamortized balance of the deferred charges relating to the promissory notes that were converted into equity, was deducted from additional paid-in capital. The portion of the charges ascribed to the warrants in the amount of approximately \$147,000, was deducted from additional paid-in capital upon issuance of the warrants.

**Note 5 - Long-term Deposits**

Long-term deposits are comprised of restricted deposits with banks to secure a bank guarantee and credit card debt, and restricted deposits with the Company's merchant bank. The aforesaid deposits with banks are comprised of a deposit which bears interest at a rate of the London Inter-Bank Bid Rate (LIBID) less 0.69% and is automatically renewed on a monthly basis, and a money market account. The merchant bank deposit is non-interest bearing and may be held until such time that the Company terminates its relationship with the merchant bank.



**Note 6 - Property and Equipment, Net**

Property and equipment as of December 31, 2004 and 2003 consisted of the following:

	2004	2003
	\$	\$
Computer equipment	1,142,406	945,831
Furniture and fixtures	228,646	216,689
Leasehold improvements	56,355	53,162
	1,427,407	1,215,682
Less: accumulated depreciation and amortization	(1,121,603)	(1,009,274)
	305,804	206,408

The balances of property and equipment include the effect of foreign currency translation. During the years 2004 and 2003 the Company recorded \$110,479 and \$268,026 of depreciation expense, respectively.

**Note 7 - Intangible Assets, Net**

The following table summarizes the Company's intangible assets as of December 31, 2004:

	Gross carrying amount	Accumulated amortization	Net
	\$	\$	\$
Domain name	80,200	(4,010)	76,190
Capitalized software development costs	39,736	(4,637)	35,099
	119,936	(8,647)	111,289

The intangible assets are all amortizable and have original estimated useful lives as follows: Domain name - ten years; Capitalized software development costs - six months to four years. There were no intangible assets as of December 31, 2003. Based on the current amount of intangibles subject to amortization, the estimated amortization expense for each of the succeeding five years is as follows: 2005 - \$25,000; 2006 - \$16,000; 2007 - \$14,000; 2008 - \$12,000; 2009 - \$8,000.

**Note 8 - Convertible Promissory Notes**

On January 30, 2004, and February 17, 2004, the Company issued, in aggregate, \$5 million of 8% Convertible Promissory Notes (the "Notes"). The aggregate principal amount of the Notes included \$200,000 previously advanced to the Company by investors in 2003 that was converted into Notes in conjunction with the transaction. The Notes were due on the earlier of one year after their issuance or the consummation of an IPO. Upon consummation of an IPO, a minimum of 50% (and up to 100% at the election of each noteholder) of the principal amount of the Notes were to be converted into shares of Common Stock at a conversion price equal to 75% of the offering price of the IPO (the "Offering Price").

**Note 8 - Convertible Promissory Notes (cont'd)**

In connection with the issuance of the Notes, the Company also issued warrants to acquire an aggregate of 1,700,013 shares of Common Stock at an exercise price per share equal to 120% multiplied by the greater of (1) \$6.00, and (2) the Offering Price (the "Warrants"). Each noteholder received one warrant for every \$3 funded through the Notes, with the exception of the noteholders who advanced the Company \$200,000 in 2003, who received one warrant for every \$2 funded. The Company also issued a warrant to the lead purchaser in the financing, to purchase 265,837 shares of common stock at an exercise price equal to 75% of the Offering Price per share. Further, in July 2004, the Company decided to grant each holder of the Convertible Promissory Notes and Warrants 0.44 warrants for each bridge warrant previously held. Following that decision an aggregate of 750,002 additional warrants were issued (see Note 10(f)).

In October 2004, prior to the IPO Effective Date, the National Association of Securities Dealers, Inc. (the NASD) deemed that \$1,350,000 of the Convertible Promissory Notes and 648,534 Warrants, received by certain Purchasers, were underwriter's compensation, because of the relationship between those noteholders and one of the Company's underwriters. As a result of this finding, such noteholders were contractually obligated to surrender such warrants to the Company without consideration, and to surrender their Notes to the Company for repayment.

On October 13, 2004, the Company completed its IPO and \$1,840,000 of the Notes converted into 490,678 shares of common stock. The remaining \$3,160,000 of the Notes, including the \$1,350,000 of the Notes, mentioned above, were repaid subsequent to the IPO closing date. In the Company's estimation, approximately \$809,000 of the Notes related to the value of the warrants that were issued on the same date, resulting in a note discount of \$809,000. Following the NASD finding as mentioned above, the Company canceled warrants valued at approximately \$214,000 and adjusted paid-in capital accordingly. The Company also recorded an additional note discount, with a corresponding increase in paid-in capital, of approximately \$2,476,000, to account for the beneficial conversion terms that the promissory noteholders received, in comparison to the expected IPO offering price.

In accordance with EITF 00-27, the aforesaid note discounts were to be amortized to interest expense over the life of the promissory notes, which was one year. However, upon the IPO, on October 13, 2004, the unamortized discount relating to the portion of the Notes that converted into shares was immediately recognized as interest expense. Upon repayment of approximately 63% of the Notes, the same percentage of the intrinsic value of the beneficial conversion feature at the date of extinguishment was reversed in APIC in the amount of approximately \$1,493,000, and interest in the same amount, previously recorded relating to the beneficial conversion feature that was reversed in paid-in capital, was functionally reversed by the recording of a gain on extinguishment of debt.

In connection with the issuance of the Notes and warrants, the Company incurred, \$521,511 and \$494,691 of cash and non-cash issuance costs, respectively, in 2004, and \$155,116 of cash issuance costs in 2003. The amortization of such issuance costs resulted in \$889,983 of interest expense and a net decrease of \$281,335 to additional paid-in capital, and additional paid-in capital was also increased by \$262,489 upon issuance of the 750,002 additional warrants, as described. During 2004, the Company also recorded approximately \$2,750,000 of interest expense, in conjunction with the amortization of the Note discounts, and \$448,260 of interest expense relating to the face amount of interest of the Notes.

Subsequent to the balance sheet date, 1,941,215 warrants, that were issued in connection with the issuance of the Notes, were exercised (see Note 16).

**Note 9 - Deposits and Liability in Respect of Employee Severance Obligations**

Under Israeli law, employers are required to make severance payments to dismissed employees and employees leaving employment in certain other circumstances, on the basis of the latest monthly salary for each year of service. This liability is provided for by payments of premiums to insurance companies under approved plans and by a provision in these financial statements.

The Company's employees are entitled to notice periods generally ranging from thirty to ninety days in the event they are terminated. The above liability does not include a provision for such notice periods.

**Note 10 - Stockholders' Equity (Deficit)**

On October 13, 2004, the Company completed an IPO of 2.35 million shares of its common stock at \$5 per share pursuant to a Registration Statement on Form SB-2 (Registration no. 333-115424). Additionally, the underwriters exercised a portion of their over-allotment option and purchased an additional 352,500 shares of the Company's common stock, at \$5 per share, on November 18, 2004. Total proceeds of this offering, including the exercise of the over-allotment option, were approximately \$10,716,000, net of underwriting fees and offering expenses of approximately \$2,796,000. As a result of the offering, \$1,840,000 of the promissory notes converted into 490,678 shares of common stock and the remaining \$3,160,000 was repaid.

As of December 31, 2003, the Company's share capital was comprised of common stock and four separate classes of convertible preferred stock. In January 2004, the preferred stockholders, as a class, agreed to convert all of the 1,372,048 shares of the Company's issued and outstanding preferred stock into common stock. The amounts as of December 31, 2003 included in this note, describe the composition of the preferred stock, and the rights and preferences of such shares prior to such conversion.

**(a) General**

The Company's share capital at December 31, 2004 and 2003 is comprised as follows:

	<b>Authorized December 31, 2004 Number of shares</b>	<b>Issued and fully paid December 31, 2004 Number of shares</b>	<b>Authorized December 31, 2003 Number of shares</b>	<b>Issued and fully paid December 31, 2003 Number of shares</b>
Series A convertible preferred stock of \$0.01 par value	--	--	130,325	130,325
Series B convertible preferred stock of \$0.01 par value	--	--	217,203	181,112
Series C convertible preferred stock of \$0.01 par value	--	--	260,643	238,119
Series D convertible preferred stock of \$0.01 par value	--	--	824,646	807,468
Series D convertible preferred non-voting stock of \$0.01 par	--	--	21,721	15,024

value				
Preferred stock of \$0.01 par value	<b>1,000,000</b>	--	--	--
Common stock of \$0.001 par value	<b>30,000,000</b>	<b>4,920,551</b>	2,856,937	355,325
	<b>31,000,000</b>	<b>4,920,551</b>	4,311,475	1,727,373

**Note 10 - Stockholders' Equity (Deficit) (cont'd)**

The outstanding Series D convertible preferred non-voting shares were identical in all other respects to Series D convertible preferred voting shares.

**(b) Stock Option Plans**

The Company provides for direct grants or sales of common stock, and common stock options to employees and non-employees through the following: the 1999 Stock Option Plan (the 1999 Plan), the 2000 Stock Option Plan (the 2000 Plan), the 2003 Stock Option Plan (the 2003 Plan) (thereafter collectively "Prior Option Plans") and the 2004 Stock Option Plan (the 2004 Plan).

In January 2004, the Company adopted the 2004 Stock Option Plan (the 2004 Plan), authorizing 866,000 options for future grants. As of December 31, 2004, 471,304 options were available for grant under the 2004 plan and the Prior Option Plans were closed for future grants. The exercise or purchase price for common stock granted or sold to employees under the Prior Option Plans was equal to or greater than the fair market value per share on the date of grant.

Under all option plans, options generally vest 25%, with respect to the number granted, upon the first anniversary date of the option grant, and the remainder vest in equal monthly installments over the 36 months thereafter. When vested, options are exercisable immediately.

The options generally expire ten years after grant date and are forfeited if not exercised within three months of termination of employment by employees.

**(c) Other Stock Options**

On October 13, 2004, the Company issued to its underwriters 117,500 options for a total purchase price of \$100. These options were issued outside of the Company's stock option plans as compensation for services rendered in connection with the IPO. The options will be exercisable on October 13, 2005, expire five years from the date of issuance and have an exercise price of \$6.25 per share. The fair value of the options granted to the underwriters was estimated using the Black-Scholes option-pricing model with the following weighted average assumptions: no dividend yield; volatility of 49%; risk-free interest rates of 2.17%; and an expected life of one year. The fair value of the underwriters' options was determined to be \$70,374 and was recorded as part of additional paid-capital.

As of December 31, 2004, 153,151 options were issued and outstanding outside of the Company's stock option plans.

**Note 10 - Stockholders' Equity (Deficit) (cont'd)****(d) Option Grant Information**

A summary of the status of the 1999, 2000, 2003 and 2004 plans, and of the other options, follows:

	Options available for grant	Options outstanding	Weighted average exercise price \$
Balance as of December 31, 2002	273,562	251,119	9.90
Granted	(244,367)	244,367	1.84
Exercised	--	(1,449)	0.69
Canceled *	56,190	(66,801)	10.13
Balance as of December 31, 2003	85,385	427,236	4.37
Additional options authorized (2003 Plan)	<b>299,305</b>	--	--
Additional options authorized (2004 Plan)	<b>866,000</b>	--	--
Canceled (closing of the 2003 Plan)	<b>(77,126)</b>	--	--
Granted (2004 and 2003 Plans)	<b>(702,260)</b>	<b>702,260</b>	5.16
Granted (other options)	--	<b>117,500</b>	6.25
Exercised	--	--	--
Expired	--	<b>(43,441)</b>	2.76
Balance as of December 31, 2004	<b>471,304</b>	<b>1,203,555</b>	5.06

\* Includes canceled options from closed stock option plans

The following table summarizes information about stock options outstanding as of December 31, 2004:

Range of exercise prices	Options Outstanding			Options Vested	
	Number outstanding	Weighted average remaining contractual life (years)	Weighted average exercise price	Number outstanding	Weighted Average Exercise Price
\$0.69-1.15	169,576	7.71	\$ 0.75	146,380	\$ 0.76
2.30-2.76	87,135	6.39	2.59	61,895	2.51
4.60-6.91	828,888	9.43	5.33	39,475	5.58
9.21-11.51	117,956	6.52	11.21	108,634	11.18
0.69-11.51	1,203,555	8.68	5.06	356,384	4.78



**Note 10 - Stockholders' Equity (Deficit) (cont'd)****(e) Stock Based Compensation**

The Company measures compensation expense for its stock-based employee compensation plans using the intrinsic value method. As a result of the stock-based employee compensation, the Company recorded compensation expense in the amount of \$25,382 and \$14,995, in 2004 and 2003, respectively. As of December 31, 2004, approximately \$99,000 remains to be amortized over the remaining vesting periods of the options. If the fair value based method had been applied in measuring stock compensation expense, the pro forma effect on net loss and net loss per share would have been as follows:

	<b>Years ended December 31</b>		<b>Cumulative from inception through December 31,</b>
	<b>2004</b>	<b>2003</b>	<b>2004</b>
	\$	\$	\$
Net loss, as reported	<b>(6,590,519)</b>	(2,808,783)	(40,596,117)
Add:			
Stock-based compensation expense to employees And directors included in reported net loss, net of related tax effects	<b>25,382</b>	14,995	40,377
Deduct:			
Stock-based compensation expense to employees and directors determined under fair value based method for all awards, net of related tax effects	<b>(75,363)</b>	(34,407)	(225,717)
	<b>(6,640,500)</b>	(2,828,195)	(40,781,457)
Net loss per common share, basic and diluted:			
As reported	<b>(2.90)</b>	(7.93)	(53.81)
Pro-forma	<b>(2.92)</b>	(7.99)	(54.06)

The weighted average fair value of options where the exercise price equaled the market price on grant date was \$2.69 for grants in the year ended December 31, 2004. No such options were granted in 2003. The weighted average fair value of options where the exercise price exceeded the market price on grant date was \$0 for grants in the years ended December 31, 2004 and 2003. The weighted average fair value of options where the exercise price was less than the market price on grant date was \$1.92 for grants in the year ended December 31, 2003. No such options were granted in 2004.



**Note 10 - Stockholders' Equity (Deficit) (cont'd)**

**(f) Stock Warrants**

(i) In connection with obtaining a line of credit from a bank in 2002, the Company issued warrants to the bank to purchase 2,173 shares of Series D preferred stock for \$34.53 per share. The warrants are exercisable immediately and expire in April 2009. In January 2004, these warrants converted to common stock warrants.

(ii) In connection with the issuance of the Notes (see Note 8), the Company issued warrants to acquire an aggregate 1,700,013 shares of common stock at an exercise price per share equal to 120% multiplied by the greater of (1) \$6.00, and (2) the Offering Price (the "Bridge Warrants"). Each noteholder received one bridge warrant for every \$3 funded through the Notes, with the exception of the noteholders who advanced the Company \$200,000, in 2003, who received one Bridge Warrant for every \$2 funded. In July 2004, the Company decided to grant the holders of the Convertible Promissory Notes and Warrants an aggregate of 750,002 additional warrants. These additional warrants contained terms identical to the Bridge Warrants except for certain expiration provisions. In October 2004, following the demand of the NASD, certain noteholders were contractually obligated to surrender 648,534 warrants to the Company without consideration (see Note 8).

In connection with the original issuance of the Bridge Notes and warrants in January 2004, the Company also issued a warrant to the lead purchaser in the financing, to purchase 265,837 shares of common stock at an exercise price equal to 75% of the Offering Price per share.

The aggregate fair value of all of the warrants mentioned above was determined to be approximately \$1,090,000 using the Black-Scholes option-pricing model with the following assumptions: no dividend yield; volatility of 38%; risk free interest rate of 4%; and an expected life of seven years.

The majority of these warrants were exercised subsequent to the balance sheet date (see Note 15).

**Note 11 - Income Taxes**

The income tax expense for the years ended December 31, 2004 and 2003, differed from the amounts computed by applying the U.S. federal income tax rate of 34% to pretax income as a result of the following:

	Years ended December 31		Cumulative from inception through December 31, 2004
	2004	2003	2004
	\$	\$	\$
Computed "expected" tax benefit	2,226,987	943,225	13,777,129
Effect of State taxes	329,259	260,922	3,493,876
Effect of foreign income	(157,016)	24,739	439,876
Non-deductible expenses	(208)	(55)	(14,002)
Change in valuation allowance	(2,439,579)	(1,263,422)	(17,771,617)
	(40,557)	(34,591)	(75,148)

The types of temporary differences that give rise to significant portions of the Company's deferred tax assets and liabilities are set out below:

	Years ended December 31	
	2004	2003
	\$	\$
Deferred tax asset:		
Miscellaneous accrued expenses	40,584	29,017
Property and equipment	27,348	419,958
Deferred compensation	328,222	303,803
Capitalized start-up costs	2,418,734	3,535,073
Foreign deferred tax assets	19,817	20,501
Net operating loss	14,956,729	11,044,187
Total gross deferred tax asset	17,791,434	15,352,539
Less: Valuation allowance	(17,771,617)	(15,332,038)
Net deferred tax asset	19,817	20,501
Total gross deferred tax liability	(94,965)	(55,092)
Net deferred tax liability	(75,148)	(34,591)

**Note 11 - Income Taxes (cont'd)**

Because of the Company's lack of earnings history, as of December 31, 2004 and 2003, the U.S. deferred tax assets have been fully offset by a valuation allowance. The net change in the total valuation allowance for the years ended December 31, 2004 and 2003 was an increase of \$2,439,579 and \$1,263,422, respectively.

As of December 31, 2004 and 2003, the Company has net operating loss carryforwards for federal and state income tax purposes of approximately \$35 million and \$26 million, respectively. The federal net operating losses will expire if not utilized on various dates from 2019 through 2024. The California net operating losses will expire if not utilized on various dates from 2009 through 2013. The Israeli Subsidiary has capital loss carryforwards of approximately \$604,000 that can be applied to future capital gains for an unlimited period of time under current tax rules.

The Tax Reform Act of 1986 imposed substantial restrictions on the utilization of net operating losses and tax credits in the event of an ownership change of a corporation. Thus, in accordance with Internal Revenue Code, Section 382, the Company's recent IPO and other ownership changes that have transpired, will significantly limit the Company's ability to utilize net operating losses and credit carryforwards, although the Company has not yet determined to what extent.

During the year 2000, the Subsidiary was granted "Approved Enterprise" status under the Israeli Law for the Encouragement of Capital Investments - 1959 under the "alternative benefits" path. As an "Approved Enterprise" the Israeli Subsidiary is entitled to receive future tax benefits, which are limited to a period of ten years from the first year that taxable income is generated from the approved assets. In addition, the benefits must be utilized within: the earlier of 12 years of the year operation (as defined) of the investment program begins or 14 years of the year that approval is granted.

Under its "Approved Enterprise" status, income arising from the subsidiary's approved activities is subject to zero tax under the "alternative benefit" path for a period of ten years. In the event of distribution by the subsidiary of a cash dividend out of retained earnings which were tax exempt due to the "Approved Enterprise" status, the subsidiary would have to pay a 10% corporate tax on the amount distributed, and the recipient would have to pay a 15% tax (to be withheld at source) on the amounts of such distribution received. Should the subsidiary derive income from sources other than the Approved Enterprise during the relevant period of benefits, such income would be taxable at the tax rate in effect at that time (currently 36%). Deferred tax assets and liabilities in the financial statements result from the tax amounts that would result if the Subsidiary distributed its retained earnings to its Parent.

During 2003, the Subsidiary filed a final status report on its investment program. Final approval of the program was received from the Investment Center in March 2004. The approval has yet to be upheld by the Israeli income tax authorities. In addition, in February 2004, the Subsidiary applied for a second (expansion) investment program based on terms similar to the first investment program. Formal approval of the application in respect of the second program was received from the Investment Center in July 2004.

Under its Approved Enterprise status, the Subsidiary must maintain certain conditions and submit periodic reports. Failure to comply with the conditions of the Approved Enterprise status could cause the Subsidiary to lose previously accumulated tax benefits. The Subsidiary began claiming benefits in the 2000 tax year. Cumulative benefits received under the Subsidiary's approved enterprise status amount to approximately \$700,000 at December 31, 2004. As of the balance sheet date the Company believes that it is in compliance with the stipulated conditions.

**Note 12 - Commitments and Contingencies**

(a) Future minimum lease payments under non-cancelable operating leases for office space and cars, as of December 31, 2004 are as follows:

Year ending December 31	\$
2005	183,421
2006	55,644
2007	20,210
	259,275

Rental expense for operating leases for the years ended December 31, 2004 and 2003 was \$271,099 and \$212,680, respectively.

- (b) As security for future rental commitments the Subsidiary provided a bank guarantee in the amount of approximately \$113,000.
- (c) All of the Subsidiary's obligations to its bank, including the bank guarantee that such bank made to the Subsidiary's landlord, are secured by a lien on all of the Subsidiary's deposits at such bank. As of December 31, 2004, deposits at such bank amounted to \$364,690, including a long-term deposit of \$101,531 as mentioned in Note 5.
- (d) In the ordinary course of business, the Company enters into various arrangements with vendors and other business partners, principally for content, web-hosting, marketing and investor relations arrangements. During 2004, the Company entered into agreements to license content from two providers, through December 2006 and August 2007, for an aggregate amount of \$265,000, and entered into an agreement with an investor relations firm to provide services through December 2005 for \$8,000 per month and 7,800 shares of its common stock. Regarding commitments entered into subsequent to balance sheet date see Note 15.
- (e) In December 2002, the Company implemented a reorganization (the "December 2002 Reorganization") which substantially reduced the Company's expenditures. The December 2002 Reorganization included staff reductions of fifteen persons, or approximately 52% of the Company's work force, including senior management, professional services, sales and marketing, research and development and administrative staff. The December 2002 Reorganization also included the shutdown of the Company's California office and resulted in a loss on the disposal of fixed assets. In total, the Company incurred a loss of approximately \$1,048,000 in connection with the December 2002 Reorganization, of which \$780,000 related to the disposal of fixed assets, and \$265,000 related to an accrual for salaries, benefits and office and equipment lease obligations that the Company recorded as of December 31, 2002. Of the amount accrued, \$22,000 and \$218,000 was paid during 2004 and 2003, respectively, and \$25,000, which relates to a lease obligation for equipment no longer in use, remains outstanding as of December 31, 2004.

**Note 13 - Fair Value of Financial Instruments**

The Company's financial instruments at December 31, 2004 and 2003 consisted of cash and cash equivalents, accounts receivables, prepaid expenses, deposits in respect of employee severance obligations, security deposits in respect of the Subsidiary's office lease and the Company's merchant bank, accounts payable, accrued expenses, accrued compensation and related liabilities, liability in respect of employee severance obligations and deferred revenues.

The carrying amounts of all the financial instruments noted above, except for liability in respect of employee severance obligations, approximate fair value due to the relatively short maturity of these instruments. The carrying amount of the liability in respect of employee severance obligations reflects the approximate fair value inclusive of future salary adjustments.

**Note 14 - Other Expense, Net**

In 2004 the Company incurred approximately \$90,000 in costs relating to its plan to be listed on the Nasdaq SmallCap Market and the Boston Stock Exchange. In October 2004, the Company decided to instead list on the American Stock Exchange, and as a result the aforesaid costs were written off in the fourth quarter of 2004 and are included as other expenses in the accompanying statement of operations. The remaining balance in other expense, net, in 2004 and 2003, is comprised primarily by foreign exchange gains (losses) and the write-off of tax advances that are not expected to be realized due to the subsidiary's "approved enterprise" status.

**Note 15 - Related Parties**

In March 2004, one of the members of the Company's board of directors purchased the Internet domain name, "www.Answers.com," from an unrelated third party for \$80,200. Immediately following such purchase, the Internet domain name was transferred to the Company and the board member was reimbursed \$80,200. The terms of transaction were as favorable to the Company as those generally available from unaffiliated third parties. However, at the time this transaction was entered into, the Company lacked sufficient disinterested independent directors to ratify the transaction.

**Note 16 - Subsequent Events**

(a) Subsequent to the balance sheet date, 69,432 of the warrants that were issued in connection with the issuance of the convertible promissory notes (see Note 8) were exercised. As a result, the Company issued an aggregate of 69,432 shares of its common stock, \$0.001 par value (the "Common Stock"), for a total consideration of approximately \$500,000. Additionally, on February 4, 2005 the Company entered into an agreement (the "Agreement"), with certain holders (the "Holders") of warrants that were issued by the Company in January, February and July 2004 in connection with the bridge financing transaction (the "Bridge Warrants") (see Note 8), pursuant to which the Holders exercised an aggregate of 1,871,783 Bridge Warrants at the stated exercise price thereof. As a result, the Company issued an aggregate of 1,871,783 shares of its common stock, \$0.001 par value (the "Common Stock"), for aggregate gross consideration of \$12,559,700. Under the terms of the Agreement, in order to provide incentive to the Holders to exercise their Bridge Warrants, for every share of Common Stock purchased by the Holders through the exercise of Bridge Warrants, the Company issued to the Holders new warrants, dated February 4, 2005, to purchase such number of shares of Common Stock equal to 55% of the number of shares of Common Stock underlying their respective Bridge Warrants, at an exercise price of \$17.27 per share (the "New Warrants"). The exercise price of the New Warrants is equal to 110% of the average of the closing prices of the Common Stock as reported on the American Stock Exchange for the five trading days immediately prior to February 4, 2005. The New Warrants are immediately exercisable and expire on February 4, 2010.

The Company has agreed to file a registration statement with the SEC as promptly as reasonably practicable to register for resale the shares of Common Stock underlying the New Warrants. Upon the occurrence of certain events, including the failure by the Company to file the registration statement on or prior to April 6, 2005 and the failure of the registration statement to be declared effective by the SEC on or prior to May 5, 2005, the Holders will be entitled to certain liquidated damages equal to 1% of the aggregate exercise price of the exercised warrants, for the first month, and 1.5% for each month thereafter, prorated for any partial month.

(b) Subsequent to the balance sheet date, the Company entered into agreements with two consulting firms for the provision of services in the areas of public relations and strategic planning. The agreements, which are all for one year, the latest of which terminates in February 2006, are for an aggregate cash amount of \$180,000. In connection with the aforesaid agreements, the Company also agreed to grant one of the consulting firms 20,000 stock options that vest over the twelve-month service period.

PART II.

Information Not Required in Prospectus

Item 24. Indemnification of Directors and Officers

Our certificate of incorporation provides that all directors, officers, employees and agents of the registrant shall be entitled to be indemnified by us to the fullest extent permitted by Section 145 of the Delaware General Corporation Law.

Section 145 of the Delaware General Corporation Law concerning indemnification of officers, directors, employees and agents is set forth below.

Section 145. Indemnification of officers, directors, employees and agents; insurance.

(a) A corporation shall have power to indemnify any person who was or is a party or is threatened to be made a party to any threatened, pending or completed action, suit or proceeding, whether civil, criminal, administrative or investigative (other than an action by or in the right of the corporation) by reason of the fact that the person is or was a director, officer, employee or agent of the corporation, or is or was serving at the request of the corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise, against expenses (including attorneys' fees), judgments, fines and amounts paid in settlement actually and reasonably incurred by the person in connection with such action, suit or proceeding if the person acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or proceeding, had no reasonable cause to believe the person's conduct was unlawful. The termination of any action, suit or proceeding by judgment, order, settlement, conviction, or upon a plea of *nolo contendere* or its equivalent, shall not, of itself, create a presumption that the person did not act in good faith and in a manner which the person reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or proceeding, had reasonable cause to believe that the person's conduct was unlawful.

(b) A corporation shall have power to indemnify any person who was or is a party or is threatened to be made a party to any threatened, pending or completed action or suit by or in the right of the corporation to procure a judgment in its favor by reason of the fact that the person is or was a director, officer, employee or agent of the corporation, or is or was serving at the request of the corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise against expenses (including attorneys' fees) actually and reasonably incurred by the person in connection with the defense or settlement of such action or suit if the person acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation and except that no indemnification shall be made in respect of any claim, issue or matter as to which such person shall have been adjudged to be liable to the corporation unless and only to the extent that the Court of Chancery or the court in which such action or suit was brought shall determine upon application that, despite the adjudication of liability but in view of all the circumstances of the case, such person is fairly and reasonably entitled to indemnity for such expenses which the Court of Chancery or such other court shall deem proper.

(c) To the extent that a present or former director or officer of a corporation has been successful on the merits or otherwise in defense of any action, suit or proceeding referred to in subsections (a) and (b) of this section, or in defense of any claim, issue or matter therein, such person shall be indemnified against expenses (including attorneys' fees) actually and reasonably incurred by such person in connection therewith.

(d) Any indemnification under subsections (a) and (b) of this section (unless ordered by a court) shall be made by the corporation only as authorized in the specific case upon a determination that indemnification of the present or former director, officer, employee or agent is proper in the circumstances because the person has met the applicable

standard of conduct set forth in subsections (a) and (b) of this section. Such determination shall be made, with respect to a person who is a director or officer at the time of such determination, (1) by a majority vote of the directors who are not parties to such action, suit or proceeding, even though less than a quorum, or (2) by a committee of such directors designated by majority vote of such directors, even though less than a quorum, or (3) if there are no such directors, or if such directors so direct, by independent legal counsel in a written opinion, or (4) by the stockholders.

(e) Expenses (including attorneys' fees) incurred by an officer or director in defending any civil, criminal, administrative or investigative action, suit or proceeding may be paid by the corporation in advance of the final disposition of such action, suit or proceeding upon receipt of an undertaking by or on behalf of such director or officer to repay such amount if it shall ultimately be determined that such person is not entitled to be indemnified by the corporation as authorized in this section. Such expenses (including attorneys' fees) incurred by former directors and officers or other employees and agents may be so paid upon such terms and conditions, if any, as the corporation deems appropriate.

II-1

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(f) The indemnification and advancement of expenses provided by, or granted pursuant to, the other subsections of this section shall not be deemed exclusive of any other rights to which those seeking indemnification or advancement of expenses may be entitled under any bylaw, agreement, vote of stockholders or disinterested directors or otherwise, both as to action in such person's official capacity and as to action in another capacity while holding such office.

(g) A corporation shall have power to purchase and maintain insurance on behalf of any person who is or was director, officer, employee or agent of the corporation, or is or was serving at the request of the corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise against any liability asserted against such person and incurred by such person in any such capacity, or arising out of such person's status as such, whether or not the corporation would have the power to indemnify such person against such liability under this section.

(h) For purposes of this section, references to "the corporation" shall include, in addition to the resulting corporation, any constituent corporation (including any constituent of a constituent) absorbed in a consolidation or merger which, if its separate existence had continued, would have had power and authority to indemnify its directors, officers, and employees or agents, so that any person who is or was a director, officer, employee or agent of such constituent corporation, or is or was serving at the request of such constituent corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise, shall stand in the same position under this section with respect to the resulting or surviving corporation as such person would have with respect to such constituent corporation if its separate existence had continued.

(i) For purposes of this section, references to "other enterprises" shall include employee benefit plans; references to "fines" shall include any excise taxes assessed on a person with respect to any employee benefit plan; and references to "serving at the request of the corporation" shall include any service as a director, officer, employee or agent of the corporation that imposes duties on, or involves services by, such director, officer, employee or agent with respect to an employee benefit plan, its participants or beneficiaries; and a person who acted in good faith and in a manner such person reasonably believed to be in the interest of the participants and beneficiaries of an employee benefit plan shall be deemed to have acted in a manner "not opposed to the best interests of the corporation" as referred to in this section.

(j) The indemnification and advancement of expenses provided by, or granted pursuant to, this section shall, unless otherwise provided when authorized or ratified, continue as to a person who has ceased to be a director, officer, employee or agent and shall inure to the benefit of the heirs, executors and administrators of such a person.

(k) The Court of Chancery is hereby vested with exclusive jurisdiction to hear and determine all actions for advancement of expenses or indemnification brought under this section or under any bylaw, agreement, vote of stockholders or disinterested directors, or otherwise. The Court of Chancery may summarily determine a corporation's obligation to advance expenses (including attorneys' fees)."

Insofar as indemnification for liabilities arising under the Securities Act may be permitted to our directors, officers, and controlling persons pursuant to the foregoing provisions, or otherwise, we have been advised that in the opinion of the SEC such indemnification is against public policy as expressed in the Securities Act and is, therefore, unenforceable. In the event that a claim for indemnification against such liabilities (other than the payment of expenses incurred or paid by a director, officer or controlling person in a successful defense of any action, suit or proceeding) is asserted by such director, officer or controlling person in connection with the securities being registered, we will, unless in the opinion of its counsel the matter has been settled by controlling precedent, submit to the court of appropriate jurisdiction the question whether such indemnification by it is against public policy as expressed in the Securities Act and will be governed by the final adjudication of such issue.



Article Twelve of our certificate of incorporation provides:

To the fullest extent permitted by applicable law, the Corporation is authorized to provide indemnification of (and advancement of expenses to) directors, officers, employees and other agents of the Corporation (and any other persons to which Delaware law permits the Corporation to provide indemnification), through Bylaw provisions, agreements with any such director, officer, employee or other agent or other person, vote of stockholders or disinterested directors, or otherwise, in excess of the indemnification and advancement otherwise permitted by Section 145 of the DGCL, subject only to limits created by applicable Delaware law (statutory or nonstatutory), with respect to actions for breach of duty to a corporation, its stockholders and others.

#### Item 25. Other Expenses of Issuance and Distribution.

The estimated expenses payable by us in connection with the offering described in this registration statement (other than the underwriting discount and commissions and the Underwriters' non-accountable expense allowance) will be as follows:

SEC Registration Fee	\$	2,241.10
Printing expenses		25,000.00
Accounting fees and expenses		5,000.00
Legal fees and expenses (including blue sky services and expenses)		50,000.00
Transfer Agent and Registrar fees		5,000.00
Miscellaneous		10,000.00
<b>Total</b>	<b>\$</b>	<b>97,241.00</b>

The selling stockholders do not share in the expenses of the offering.

#### Item 26. Recent Sales of Unregistered Securities.

The following is a summary of transactions by the Registrant within the last three years involving sales of its securities that were not registered under the Securities Act:

##### **Bridge Financing**

On January 30, 2004 and February 17, 2004, we completed our bridge financing, consisting of \$5,000,000 aggregate principal amount of convertible promissory notes (also referred to as "bridge notes") bearing interest at an annual rate of 8%. In the aggregate, we paid \$287,136 in accrued interest and \$161,124 in liquidated damages, representing 1% to 1.5% of the aggregate purchase price of the bridge notes, as a result of our failure to consummate our IPO by July 28, 2004 and August 15, 2004, as required under the respective bridge notes. Upon the consummation of our initial public offering, \$1,840,000 of the aggregate principal amount of the bridge notes were converted into 490,678 shares of common stock, at a conversion price of \$3.75, and the remaining \$3,160,000 of the aggregate principal amount of the bridge notes was repaid subsequent to the initial public offering closing date.

In connection with the issuance of the bridge notes, we issued bridge warrants to purchase an aggregate of 1,700,013 shares of common stock, exercisable at \$7.20 per share, commencing on December 31, 2004. In the third quarter of 2004, our board of directors authorized the issuance of an aggregate of 750,002 additional warrants to the bridge noteholders. On October 7, 2004, the date on which we filed our registration statement related to our initial public offering, each noteholder received a pro rata share of these additional warrants (approximately .44 warrant for each bridge warrant held). These additional warrants contained terms identical to the bridge warrants, except for certain expiration provisions. In October 2004, the National Association of Securities Dealers, Inc. determined that shares

issuable upon conversion of bridge notes and upon exercise of bridge warrants held by certain bridge noteholders in our bridge financing constituted underwriter's compensation, because of the relationship between these noteholders and one of our underwriters. As a result, these noteholders were contractually obligated to surrender their warrants to purchase 648,534 shares of common stock to us without consideration and had \$1,350,000 aggregate principal amount of bridge notes entirely repaid instead of converted into common stock.

II-3

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### **Warrant Reload**

On February 4, 2005, we entered into an agreement (the “Warrant Reload Agreement”) with certain holders of the bridge warrants, pursuant to which such holders of the bridge warrants exercised an aggregate of 1,871,783 bridge warrants at the exercise price of \$7.20 per share, with the exception of Vertical Ventures LLC, whose warrant contained an exercise price of \$3.75 for aggregate proceeds of approximately \$12,220,000. As an incentive to the holders to exercise their respective bridge warrants, we issued 1,029,488 new warrants to the holders new warrants to purchase such number of shares of common stock equal to 55% of the number of shares of common stock underlying their respective bridge warrants at an exercise price of \$17.27 per share. The warrants are exercisable as of February 4, 2005 until February 4, 2010.

### **Maxim Warrant**

On January 20, 2005, we entered into an agreement with Maxim Group LLC for the provision of general financial advisory and investment banking services. The agreement, with a minimum term of six months, is for a monthly retainer fee of \$5,000. In connection with the foregoing agreement, we agreed to grant Maxim Group LLC a warrant to purchase 100,000 shares of our common stock, exercisable for 5 years following the date of the agreement at an exercise price equal to \$11.00.

### **Common Stock Issuance**

On December 13, 2004 we entered into an agreement with Barretto Pacific Corporation for the provision of investor relations consulting services. The agreement, which terminates on December 13, 2005, is for an aggregate cash amount of \$100,000. In connection with the foregoing agreement, we issued Barretto Pacific Corporation 7,800 shares of our common stock, bearing a restrictive legend.

### **Comerica Warrant**

A warrant was issued to Comerica Bank - California (“Comerica”) in connection with a Loan and Security Agreement dated as of April 1, 2002. The warrant entitles Comerica to purchase 2,172 shares of our common stock at a price of \$34.53 per share. The Comerica Warrant will expire in April 1, 2009, at which time, if the Comerica has not been exercised, it shall be deemed to have been automatically exercised on the expiration date by “cashless” conversion.

With respect to each of the issuances described in the foregoing section, Recent Sales of Unregistered Securities, the securities were issued to investors in reliance upon the exemption from the registration requirements of the Securities Act, as set forth in Section 4(2) under the Securities Act and Rule 506 of Regulation D promulgated thereunder relative to sales by an issuer not involving any public offering. All purchasers of shares of the Registrant’s bridge notes and warrants described above represented to the Registrant in connection with their purchase that they were accredited investors and were acquiring the shares for investment and not distribution, that they could bear the risks of the investment and could hold the securities for an indefinite period of time. The purchasers received written disclosures that the securities had not been registered under the Securities Act and that any resale must be made pursuant to a registration or an available exemption from such registration.

Item 27. The following exhibits are filed as part of this Registration Statement:

Exhibit No.	Description
3.1	Amended and Restated Certificate of Incorporation (Previously filed as Exhibit 3.1 to the Registration Statement on Form SB-2 (File No. 333-115424) filed May 12, 2004, and incorporated

herein by reference.)

- 3.2 Amended and Restated By-laws (Previously filed as Exhibit 3.2 to the Registration Statement on Form SB-2 (File No. 333-115424 ) filed May 12, 2004, and incorporated herein by reference.)
- 4.1 Specimen Common Stock Certificate (Previously filed as Exhibit 4.1 to the Registration Statement on Form SB-2 (File No. 333-115424) filed July 16, 2004, and incorporated herein by reference.)
- 5.1 Opinion of Greenberg Traurig, LLP (filed herewith)

II-4

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- 10.1 2003 Stock Option Plan (Previously filed as Exhibit 10.1 to the Registration Statement on Form SB-2 (File No. 333-115424) filed May 12, 2004, and incorporated herein by reference.)
- 10.2 2004 Stock Option Plan (Previously filed as Exhibit 10.2 to the Registration Statement on Form SB-2 (File No. 333-115424) filed May 12, 2004, and incorporated herein by reference.)
- 10.3 Securities Purchase Agreement dated January 30, 2004 and February 17, 2004, respectively (Previously filed as Exhibit 10.3 to the Registration Statement on Form SB-2 (File No. 333-115424) filed May 12, 2004, and incorporated herein by reference.)
- 10.4 Form of 8% Senior Secured Convertible Note of the Company (Previously filed as Exhibit 10.4 to the Registration Statement on Form SB-2 (File No. 333-115424) filed May 12, 2004, and incorporated herein by reference.)
- 10.5 Form of Warrants issued in connection with the Bridge Financing (Previously filed as Exhibit 10.5 to the Registration Statement on Form SB-2 (File No. 333-115424) filed May 12, 2004, and incorporated herein by reference.)
- 10.6 Robert S. Rosenschein Employment Agreement (Previously filed as Exhibit 10.6 to the Registration Statement on Form SB-2 (File No. 333-115424) filed May 12, 2004, and incorporated herein by reference.)
- 10.7 Steven Steinberg Employment Agreement (Previously filed as Exhibit 10.7 to the Registration Statement on Form SB-2 (File No. 333-115424) filed May 12, 2004, and incorporated here by reference.)
- 10.8 Jeff Schneiderman Employment Agreement (Previously filed as Exhibit 10.8 to the Registration Statement on Form SB-2 (File No. 333-115424) filed May 12, 2004, and incorporated herein by reference.)
- 10.9 Jeffrey S. Cutler Employment Agreement. (Previously filed as Exhibit 10.9 to the Annual Report on Form 10-KSB (File No. 001-32255) filed March 31, 2005, and incorporated herein by reference.)
- 10.10 Form of Agreement dated as of February 4, 2005 between the Company and Bridge Warrant Holders (Previously filed as Exhibit 99.1 to the Current Report on Form 8-KA (File No. 001-32255) filed February 7, 2005, and incorporated herein by reference.)
- 10.11 Form of Warrants issued in connection with exercise of Bridge Warrants (Previously filed as Exhibit 99.2 to the Current Report on Form 8-KA (File No. 001-32255) filed February 7, 2005, and incorporated herein by reference.)
- 10.12 Agreement amending Agreement dated February 4, 2005 between the Company and Bridge Warrant Holders, executed by the Company and Vertical Ventures LLC (Lead Bridge Warrant Holder), dated as of February 28, 2005. (Previously filed as Exhibit 10.12 to the Annual Report on Form 10-KSB (File No. 001-32255) filed March 31, 2005, and incorporated herein by reference.)
- 10.13 Agreement between GuruNet Corporation and Maxim Group LLC dated January 20, 2005. (Previously filed as Exhibit 10.13 to the Annual Report on Form 10-KSB (File No. 001-32255) filed March 31, 2005, and incorporated herein by reference.)
- 21.1 List of Subsidiaries (Previously filed as Exhibit 21.1 to the Registration Statement on Form SB-2 (File No. 333-115424) filed May 12, 2004, and incorporated herein by reference.)
- 23.1 Consent of KPMG Somekh Chaikin, an Independent Registered Public Accounting Firm (Filed herewith.)
- 23.2 Form of Consent of Greenberg Traurig, LLP ( contained in Exhibit 5.1 filed herewith.)

Item 28. Undertakings.

- (a) The undersigned registrant hereby undertakes:
  - (1) To file, during any period in which offers or sales are being made, a post-effective amendment to this registration statement:
    - i. To include any prospectus required by Section 10(a)(3) of the Securities Act of 1933;

- ii. To reflect in the prospectus any facts or events arising after the effective date of the registration statement (or the most recent post-effective amendment thereof) which, individually or in the aggregate, represent a fundamental change in the information set forth in the registration statement. Notwithstanding the foregoing, any increase or decrease in volume of securities offered (if the total dollar value of securities offered would not exceed that which was registered) and any deviation from the low or high end of the estimated maximum offering range may be reflected in the form of prospectus filed with the Commission pursuant to Rule 424(b) if, in the aggregate, the changes in volume and price represent no more than 20 percent change in the maximum aggregate offering price set forth in the "Calculation of Registration Fee" table in the effective registration statement.
  - iii. To include any material information with respect to the plan of distribution not previously disclosed in the registration statement or any material change to such information in the registration statement.
- (2) That, for the purpose of determining any liability under the Securities Act of 1933, each such post-effective amendment shall be deemed to be a new registration statement relating to the securities offered therein, and the offering of such securities at that time shall be deemed to be the initial bona fide offering thereof.
- (3) To remove from registration by means of a post-effective amendment any of the securities being registered which remain unsold at the termination of the offering.
- (b) Insofar as indemnification for liabilities arising under the Securities Act of 1933 may be permitted to directors, officers and controlling persons of the registrant pursuant to the foregoing provisions, or otherwise, the registrant has been advised that in the opinion of the Securities and Exchange Commission such indemnification is against public policy as expressed in the Act and is, therefore, unenforceable. In the event that a claim for indemnification against such liabilities (other than the payment by the registrant of expenses incurred or paid by a director, officer or controlling person of the registrant in the successful defense of any action, suit or proceeding) is asserted by such director, officer or controlling person in connection with the securities being registered, the registrant will, unless in the opinion of its counsel the matter has been settled by controlling precedent, submit to a court of appropriate jurisdiction the question whether such indemnification by it is against public policy as expressed in the Act and will be governed by the final adjudication of such issue.



## SIGNATURES

Pursuant to the requirements of the Securities Act of 1933, the registrant has duly caused this Registration Statement to be signed on its behalf by the undersigned, thereunto duly authorized, in Jerusalem, Israel, on the 6th day of April 2005.

By: /s/ Robert S. Rosenschein  
 Robert S. Rosenschein  
 Chief Executive Officer, President and  
 Chairman of the Board

Pursuant to the requirements of the Securities Act of 1933, this Registration Statement has been signed by the following persons in the capacities and on the dates indicated.

Signature	Title	Date
/s/ Robert S. Rosenschein Robert S. Rosenschein	Chief Executive Officer, President and Chairman of the Board (Principal Executive Officer)	April 6, 2005
/s/ Steven Steinberg Steven Steinberg	Chief Financial Officer (Principal Financial and Accounting Officer)	April 6, 2005
/s/ Mark A. Tebbe Mark A. Tebbe	Director	April 6, 2005
/s/ Yehuda Sternlicht Yehuda Sternlicht	Director	April 6, 2005
/s/ Jerry Colonna Jerry Colonna	Director	April 6, 2005
/s/ Michael Eisenberg Michael Eisenberg	Director	April 6, 2005
/s/ Mark B. Segall Mark B. Segall	Director	April 6, 2005

EXHIBITS INDEX

Exhibit No.	Description
3.1	Amended and Restated Certificate of Incorporation (Previously filed as Exhibit 3.1 to the Registration Statement on Form SB-2 (File No. 333-115424) filed May 12, 2004, and incorporated herein by reference.)
3.2	Amended and Restated By-laws (Previously filed as Exhibit 3.2 to the Registration Statement on Form SB-2 (File No. 333-115424 ) filed May 12, 2004, and incorporated herein by reference.)
4.1	Specimen Common Stock Certificate (Previously filed as Exhibit 4.1 to the Registration Statement on Form SB-2 (File No. 333-115424) filed July 16, 2004, and incorporated herein by reference.)
5.1	Opinion of Greenberg Traurig LLP (filed herewith)
10.1	2003 Stock Option Plan (Previously filed as Exhibit 10.1 to the Registration Statement on Form SB-2 (File No. 333-115424) filed May 12, 2004, and incorporated herein by reference.)
10.2	2004 Stock Option Plan (Previously filed as Exhibit 10.2 to the Registration Statement on Form SB-2 (File No. 333-115424) filed May 12, 2004, and incorporated herein by reference.)
10.3	Securities Purchase Agreement dated January 30, 2004 and February 17, 2004, respectively (Previously filed as Exhibit 10.3 to the Registration Statement on Form SB-2 (File No. 333-115424) filed May 12, 2004, and incorporated herein by reference.)
10.4	Form of 8% Senior Secured Convertible Note of the Company (Previously filed as Exhibit 10.4 to the Registration Statement on Form SB-2 (File No. 333-115424) filed May 12, 2004, and incorporated herein by reference.)
10.5	Form of Warrants issued in connection with the Bridge Financing (Previously filed as Exhibit 10.5 to the Registration Statement on Form SB-2 (File No. 333-115424) filed May 12, 2004, and incorporated herein by reference.)
10.6	Robert S. Rosenschein Employment Agreement (Previously filed as Exhibit 10.6 to the Registration Statement on Form SB-2 (File No. 333-115424) filed May 12, 2004, and incorporated herein by reference.)
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