



Who will lead?

COMPUGEN ANNUAL REPORT 2001

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Compugen is a pioneer in the merging of computational technologies with biology, chemistry and medicine to enhance drug discovery and development. This unique capability is a proven basis for providing high value products and services to leading biotechnology and pharmaceutical companies, and for in-house therapeutic and diagnostic discovery.

Compugen was founded in 1993, and its shares have been publicly traded on Nasdaq (NASDAQ: CGEN) since August 2000, and on the Tel Aviv Stock Exchange since January 2002. The Company's corporate offices are in Israel with a wholly owned United States subsidiary headquartered in New Jersey.

For additional information, visit Compugen's corporate Website at **www.cgen.com** and the Company's Internet research engine for molecular biologists, www.LabOnWeb.com.

*The 21st Century:
"The Century of Life Science"*

WHY COMPUGEN?

Dear Shareholders,

We have mixed feelings as we look back on 2001 and the first half of 2002. Of course, it is difficult to think about this time period without considering the impact on the world of the tragic events that occurred. However, focusing solely on our Company, we are pleased by the continuing progress we have made and by the growing external validation of this progress. At the same time, we are deeply disappointed by the market value for our shares, currently less than cash value. Although at present, this is by no means an unusual situation, it was our hope that, in spite of the complexity of the new world of life science and the numerous competing claims from so many companies, we would have been able to communicate our unique values successfully enough that we would have begun to build a strong and growing investor base. We do have a number of shareholders that share our view of the enormous short- and long-term potential for Compugen; unfortunately, most of these shareholders currently have financial losses to show for their efforts and belief in our Company. However, we are confident that the research and medical advances, and commercial opportunities being created through our unique and rapidly expanding new life science capabilities, will very soon be much more visible to the investment community.

The twenty-first century, although just beginning, is already referred to as the century of life science, resulting from the rapid—and unstoppable—transition of molecular biology from largely observational to quantitative and predictive. It is precisely this aspect of predictability that will allow the development of entirely new types of pharmaceutical and other products and services that will bring about revolutionary advances in human health and well being, and in all other areas of life science. This new type of life science research is, and has been since the mid-90s, pioneered by Compugen, and the type of state-of-the-art capabilities in predictive biology that now exist at Compugen will soon be a core requirement for other life science organizations. We are confident that based on our early recognition of the value of this new approach to life science, our pioneering efforts and industry-leading achievements to date, and—most importantly—our experienced multidisciplinary R&D team, Compugen will play a leading role as this transition continues and accelerates.

Compugen's Year in Review

Revenues for 2001 were \$11.4 million, compared to \$7.4 million for 2000. The net loss for 2001 was \$15.1 million (including a non-cash charge of \$2.6 million for amortization of deferred compensation) or \$0.58 per share, compared with a net loss of \$13.4 million (including a non-cash charge of \$5.7 million for amortization of deferred compensation), or \$0.96 per share, for 2000. Research



Martin Gerstel
Chairman of the Board



Mor Amitai, Ph.D.
President & Chief Executive Officer

and development expenses for 2001 were \$14.3 million compared to \$10.3 million in 2000, representing 40% year-to-year growth and more than 50% of our total operating expenses in each year (not including amortization of deferred compensation). Our financial position remains strong, and we ended 2001 with \$78.5 million in cash and long-term cash investments.

In our Annual Report to Shareholders for 2000—our first as a publicly traded company—we presented our history, described the manner in which we merge computational technologies and the exact sciences with life science in

our efforts to decipher the underlying mechanisms of life, and presented some examples of the tools and platforms that we develop for our own use and also commercialize to partners and customers.

We are very proud of our solid partner and customer base, including over one hundred commercial and academic institutions, that continued to be enhanced by additional organizations during 2001. For this year's Annual Report, we asked a few of our key partners and customers to describe how they are using and benefiting from our pioneering capabilities and technologies. Of course, the core of Compugen is our unique R&D team, and in this Annual Report we will also introduce to you some of these talented people who are making it all happen.

Three important collaborations were initiated during the past year, and are discussed later in this Annual Report:

- The research collaboration with Novartis encompassing the LEADS™ computational biology platform and DNA chip design
- The alliance with Sigma-Genosys, a member of the Sigma-Aldrich family, for the design, manufacture and co-marketing of OligoLibraries™, a collection of nucleotide sequences representing genomes of various organisms
- The licensing agreement with Avalon leveraging Gencarta™, our proprietary gene and protein database, for identifying and developing drug targets and diagnostic markers

At the beginning of this letter we referred to the complexity of the new world of life science and the numerous competing claims from so many companies as significant obstacles

for potential investors in the field. This is even a challenge for leading life science-based companies, including our potential partners. The agreement with Novartis mentioned above is a good example of this. Novartis is one of the leading, and largest, research-based pharmaceutical companies in the world, with a very substantial investment in functional genomics research. Yet, it was only after a thorough evaluation of available alternatives, that Novartis was able to conclude that Compugen's technology is best suited to understand and utilize the vast amount of data represented in its proprietary sequence databases and in the public domain. Thus, it is not surprising that the investment community has had difficulty evaluating our capabilities and differentiating us from other companies.

Accelerating Drug Development

The most important medical and commercial end-points for us, and most of our corporate partners and customers, are the development and introduction of new human therapeutics. Compugen's efforts are aimed at enabling and accelerating the drug discovery and development chain from identification of new targets based on the discovery and understanding of genes and cell processes, through the creation of small molecule drugs, and the analysis and interpretation of medical and clinical data. In bringing our unique capabilities to these areas, we have chosen to focus on the key bottlenecks in this chain. This approach has already resulted in both high value products and services for leading biotechnology and pharmaceutical companies and for our own in-house therapeutic and diagnostic discovery efforts, and in the creation of a substantial and growing base of proprietary intellectual property, to date primarily in the form of genes and proteins.

As an example of applying our unique multidisciplinary capabilities to key bottlenecks in the drug discovery and development chain, we are engaged in a significant—and high risk—project combining computational and organic chemistry. The objective of this project is the development of a revolutionary new approach to the design of small molecules to be used for pharmaceutical purposes.

Another example is our effort, begun during 2001, in the field of computational medicine. This project aims at improving drug efficacy and safety using advanced drug response analysis. Compugen collects proprietary medical and molecular data and analyzes them with the aid of its computational platforms. The proprietary knowledge created in this process should be of great value as health care incorporates more personalized medicine.

Our core technologies have direct applicability in areas of life science other than human health. As an example, in early 2002 we established Evogene as a majority owned subsidiary of Compugen. Evogene, as discussed later in this report, is a plant biotechnology company creating high throughput capabilities for the design and development of superior "tailor-made" crops.

As we continue to pioneer the exciting and important new world of life science, we thank our employees, customers and shareholders for sharing our vision with us.



Martin Gerstel
Chairman of the Board



Mor Amitai, Ph.D.
President & Chief Executive Officer



Who cares?



Why? What for?

Novartis

Novartis is active in pharmaceuticals, consumer health, generics, eye care and animal health, with annual revenues of over \$17 billion. Headquartered in Basel, Switzerland, Novartis operates in 140 countries worldwide.



“ Novartis has committed significant resources to its functional genomics research. We are seeking novel proteins which can change the course of disease. Compugen’s LEADS™ platform is one of our keys to rational **drug target discovery**, and relies on advanced bioinformatic analysis to enhance and accelerate traditional purely experimental techniques which are time and resource consuming. It’s a completely new way of exploration, based on **computational technologies**. Our ultimate goal is to shorten the road to drug development, and we feel Compugen is our ally in this venture. ”

Dalia Cohen, Ph.D.

Head of Functional Genomics
Novartis Pharma AG

Avalon

Avalon Pharmaceuticals utilizes an innovative approach to drug discovery combining forward chemical genomics and the mining of the transcriptome to identify new classes of high quality compounds more efficiently. The company is currently focused on oncology.



“ After a year of productive interactions, our access to Compugen’s comprehensive proprietary gene and protein database, and its advanced **data mining and analysis** tools, is leading to quantifiable results. Avalon is focusing its efforts on isolating potential new drug targets that play key roles in the malignant transformation of cancer cells, and coupling these targets with approaches for rapid identification of **novel diagnostic markers and therapeutic compounds**. The collaboration includes Compugen’s Gencarta™ annotated genome, transcriptome and proteome database as well as cooperation on specific projects. The synergy between our two companies creates fertile ground on which Compugen’s technology accelerates the race to market with new drug discoveries. ”

Ken Carter, Ph.D.

President and Chief Executive Officer
Avalon Pharmaceuticals

Sigma-Aldrich



Sigma-Aldrich (NASDAQ: SIAL) is a leading Life Science and High Technology company. The Company's biochemical and organic chemical products and kits are used in scientific and genomic research, biotechnology, pharmaceutical development, the diagnosis of disease and chemical manufacturing with customers in life science companies, academic and government institutions, hospitals and industry. Sigma-Genosys, Inc., a division of Sigma-Aldrich, is a global leader in custom synthetic DNA (oligos), gene arrays and synthetic peptides.

“ The joint commercialization of **whole genome OligoLibraries™** for high throughput analysis of gene function by both Sigma-Genosys and Compugen is an example of a partnership based on the complementary core competencies of our respective organizations. Compugen's computational technologies and our manufacturing and distribution capabilities were leveraged to create this high-value offering. Our established reputation in the research and pharmaceutical industries gives the new offering marketing clout from the very outset. We're pleased to have a partnership with Compugen on a product that significantly strengthens the understanding of genomes of various organisms for the analysis of **gene function**. The OligoLibraries are designed using Compugen's LEADS™ and DNA Chip Design technologies, including in-depth understanding of **alternative splicing** and Sigma-Genosys' leading edge technology for synthesis of long oligonucleotides. We are encouraged by the commercial success of our joint product so far and look forward to expanding this offering to include additional organisms.



David Julien

President Biotechnology Division
Sigma-Aldrich



***How do you progress
beyond observation?***

***Why do some
roads lead to the
future faster?***





***How do you
transform knowledge
into tangible results?***

Let's predict

“ One thing we all share, as diverse as our backgrounds are, is a keen sense of mission. Our technology is unique and it is impossible to foresee all the ways it can be applied. What we do know, simply from the journey so far, is that we're part of a community engaged in the creation of a new science, a unique **amalgamation of mathematics and biology**. This new science has let each one of us experience the excitement of learning to see the world through a different lens. The result is a **new vision for the life sciences**. This novel approach is exemplified through our LEADS™ platform used for the discovery of therapeutic and diagnostic products. LEADS creates a comprehensive view of the transcriptome, the biological bridge between the genome and the proteome, through modeling of complex biological phenomena such as alternative splicing. ”

Raveh, Sarah and **Avi** are members of the original LEADS platform development team. Today Raveh works in marketing and Sarah and Avi continue in research.



Avi Rosenberg, Executive Director of Strategic R&D Collaborations, BioApplications division, has a B.Sc. in mathematics and computer science. Avi's love for algorithms and problem solving is exceeded only by his love for his wife and three children, including their two-year old twins.



Sarah Pollock, Principal Scientist, Computational Biology, BioApplications division, has a M.Sc. in pharmacology, was previously employed at Pfizer and joined Compugen in 1997. Sarah, with wide-ranging interests in cooking and cinema, still finds time to pamper Mastik, her lovable dog.

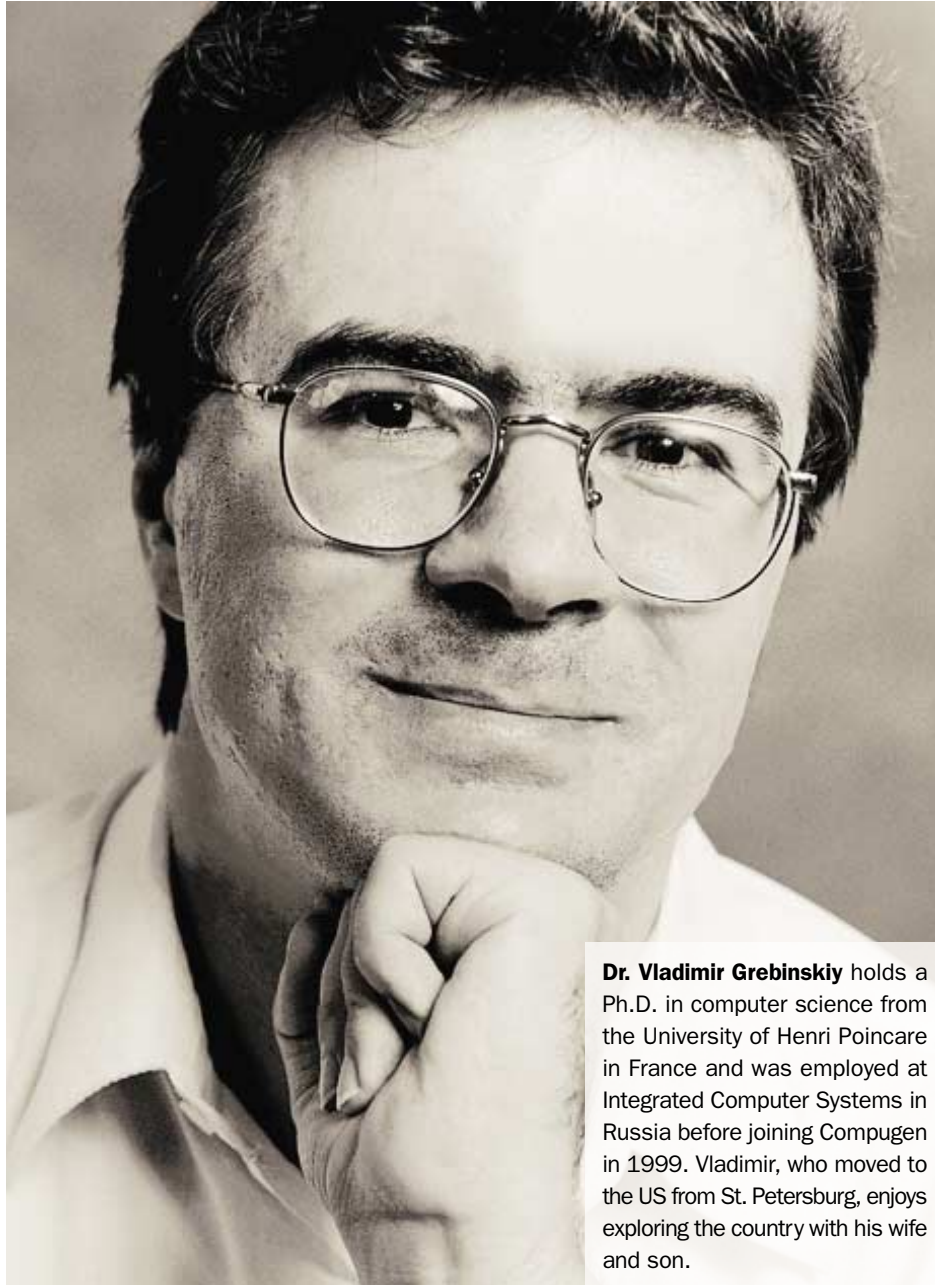


Raveh Gill-More, Vice President of Marketing, BioApplications division, has a M.Sc. in mathematics, and has been with Compugen since 1997. When not creating new algorithms or marketing ploys, Raveh likes to play with his six-year-old son and twin daughters.

Let's accelerate

“ In the long arduous process that is **functional genomic research**, any hints along the way can save considerable time and funding, and ultimately shorten the path of drug discovery. OligoLibraries™ are collections of nucleotide sequences that represent transcripts for gene expression experiments. These reagents promote reproducible results and are backed by important bioinformatics support in post-experiment analysis and interpretation. OligoLibraries are based on our LEADS™ platform, which provides a unique understanding of **alternative splicing** and an accurate and comprehensive view of the **transcriptome**, the bridge between genes and proteins. In addition to OligoLibraries, our DNA Chip Design Services also provide custom designs to cover the diverse needs of the scientific community. We are beginning to see the ramifications of our technology virtually every day in what is becoming known as the century of the life sciences. ”

Brian and **Vladimir**, together with other members of the R&D team at Compugen Inc., Compugen Ltd.'s wholly owned subsidiary, helped develop the OligoLibraries.



Dr. Vladimir Grebinskiy holds a Ph.D. in computer science from the University of Henri Poincare in France and was employed at Integrated Computer Systems in Russia before joining Compugen in 1999. Vladimir, who moved to the US from St. Petersburg, enjoys exploring the country with his wife and son.



Dr. Brian Alfred Meloon has a Ph.D. in mathematics from Cornell University and held academic positions, primarily at Cornell, before joining Compugen in 2001 as a Computational Biology Researcher. In his spare time, Brian likes to write and play music.

Let's discover

“ Our unique discovery process turns the molecular biology world on its head. In contrast to the traditional process in which the discovery originates in the laboratory, our discovery process begins *in silico*. This process allows us to discover **intellectual property** that we believe would have otherwise been very difficult, if not impossible, to find using commonly practiced discovery methods. We mathematically model significant biological phenomena and then validate our results using **experimental biological methodologies**. We then improve the algorithms according to our findings in an ongoing process, thereby continually creating more accurate predictive models. We are constantly enhancing and refining our work, striving for the simplest, fastest solutions to the research challenges of discovering **new drug targets**. In the face of enormous publicly available and proprietary databases, our unique, multidisciplinary approach gives us a significant competitive advantage. Our ability to steadily fathom and analyze biological information by combining biology with mathematics and computational technologies, is critical to the pace and success of our post-genomic research. ”

Salomon, Kinneret and **Galit** are part of the Novel Genomics division's management team.

Dr. Kinneret Savitsky has a Ph.D. in human genetics from Tel Aviv University and has headed Compugen's laboratory since its founding in 1998. She manages a group of over 20 scientists but still finds time to paint the town red with her husband and friends.



Dr. Galit Rotman, Director of Biological Research, Novel Genomics division, left the halls of academia to join Compugen. She holds a Ph.D. from the School of Medicine at the Hebrew University. When away from the lab, Galit enjoys scuba diving and spending time with her children.



Dr. Salomon Langer, biologist and physician, holds a Doctor of Medicine from the University of Buenos Aires School of Medicine and an M.D. from the same university. Salomon served as President of R&D at Synthelabo Research, France and headed the Department of Pharmacology at Wellcome Research Laboratories in England. He divides his time between London and Tel Aviv, where he serves as Compugen's Senior Vice President, Drug Discovery.

Let's grow

“ Yes, Evogene is a new company, but we're certainly not new on the agricultural map. Our team has been actively at work within Compugen's framework for a few years already. We use LEADS™ and other Compugen technologies in our work, together with the 'tomato gene machine' developed at the Weizmann Institute of Science, and we have long-term experience in the most advanced aspects of classical breeding. We're doing breakthrough work that will soon benefit farmers and the food industry, and, ultimately, consumers. We are already well within sight of offering **improved seeds** and **functional genomic** products. Our methodology of accelerating natural evolutionary processes in plants means that our products are not transgenic plants, with all the debate that implies. We're introducing a new approach, integrating computational biology and plant genomics with classical breeding approaches and turning them into **high-throughput platforms**. These platforms mimic, accelerate and direct natural evolutionary processes. We see ourselves partnering with producers of crop protection products and developers of nutritionally enhanced crops and natural factories for nutraceuticals, industrial and therapeutic products. ”

Hagai and **Rafi** co-founded Evogene, a majority owned subsidiary of Compugen Ltd.



Dr. Rafael Meissner joined Compugen in 2000 with more than ten years of experience in plant genetics and breeding, and a Ph.D. in plant genetics from the Weizmann Institute of Science. In his spare time, Rafi enjoys spending time with his wife and two children.



Dr. Hagai Karchi holds a Ph.D. in plant genetics from the Weizmann Institute of Science and has more than ten years of experience in plant genetics and breeding. When he's not cultivating tomatoes, Hagai never misses the opportunity to ride his bike or curl up with a good book next to his wife and three daughters.

***We have
the will,
the way,
and the vision.***

Financial Section

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Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion should be read in conjunction with our consolidated financial statements and the related notes included in this annual report.

YEARS ENDED DECEMBER 31, 2001 AND 2000

Revenues. Total revenues increased 54% to approximately \$11.4 million for 2001 from approximately \$7.4 million for 2000. Product revenues increased 159% to approximately \$5.9 million for 2001 from approximately \$2.3 million for 2000. This increase was due to increased sales of LEADS™, sales of Gencarta™, which was introduced in the second quarter of 2001, sales of OligoLibraries™, which were introduced on an early access basis in the second quarter, and commercially launched in October, of 2001, and sales of Z3. Service revenues decreased 3% to approximately \$4.5 million for 2001 from approximately \$4.6 million for 2000. Revenues from research and development grants increased 113% to approximately \$994,000 for 2001 from approximately \$466,000 for 2000. This increase was due to an increase in applications for grants submitted to, and grants received from, the Office of Chief Scientist of the Ministry of Industry and Trade of State of Israel (OCS). Revenues from Pfizer, the United State Patent and Trademark Office and Novartis represented 64% of our products and services revenues in 2001.

Cost of Revenues. Cost of revenues increased 101% to approximately \$3.5 million for 2001 from approximately \$1.7 million for 2000. Cost of product revenues increased 288% to approximately \$1.9 million for 2001 from approximately \$477,000 in 2000. This increase was primarily due to increased costs related to the introduction of new products to the market and manufacturing costs related to our OligoLibraries, which were introduced in 2001. Cost of services revenues increased 29% to approximately \$1.6 million for 2001 from approximately \$1.2 million for 2000. This increase was primarily due to costs related to support services provided to Novartis and an increase in the support services provided to Pfizer.

Research and Development Expenses. Research and development expenses increased 26% to approximately \$16.0 million for 2001 from approximately \$12.6 million for 2000. The increase in research and development expenses was primarily due to an increase in the number of research and development personnel to support existing as well as new research and development projects and increased salaries. This increase was partially off set by a decrease in the amortization of deferred compensation to approximately \$1.6 million for 2001 from approximately \$2.4 million for 2000. Research and development expenses as a percentage of total revenues decreased from 172% in 2000 to 141% in 2001.

Sales and Marketing Expenses. Sales and marketing expenses increased 74% to approximately \$6.6 million for 2001 from approximately \$3.8 million for 2000. This increase was primarily due to an increase in the number and variety of products we market and sell, an increase in sales and marketing personnel, costs related to the launch of new products, and increased promotional costs and marketing expenses to accommodate the growth of our business. Sales and marketing expenses as a percentage of total revenues increased from 51% in 2000 to 58% in 2001.

General and Administrative Expenses. General and administrative expenses decreased 19% to approximately \$4.4 million for 2001 from approximately \$5.4 million for 2000. This decrease was primarily due to a decrease of approximately \$2.2 million in amortization of deferred compensation recorded in connection with options issued to employees and consultants. Without taking into account the amortization of deferred compensation, general and administrative

Management's Discussion and Analysis of Financial Condition and Results of Operations

expenses increased 42% to approximately \$3.9 million for 2001 from approximately \$2.8 million for 2000. This increase was primarily due to an increase in personnel to support the growth of our business, the leasing of additional office space and human resource activities. General and administrative expenses as a percentage of total revenues decreased from 73% for 2000 to 39% for 2001.

Excluding expenses related to the amortization of deferred compensation, general and administrative expenses as a percentage of total revenues decreased from 37% for 2000 to 35% for 2001.

Financing Income, Net. Financing income, net increased 40% to approximately \$3.9 million for 2001 from approximately \$2.8 million for 2000. This increase was attributable to higher levels of cash and cash equivalents available from the aggregate proceeds of approximately \$35.5 million from the sale of our Series C preferred shares in July 2000, net of issuance expenses of \$487,000, and approximately \$51.1 million from the initial public offering of our shares on the Nasdaq National Market, net of issuance expenses of approximately \$6.4 million, in August 2000. Financing income, net as a percentage of total revenues decreased from 38% for 2000 to 34% for 2001.

YEARS ENDED DECEMBER 31, 2000 AND 1999

Revenues. Total revenues increased 97% to approximately \$7.4 million for 2000 from approximately \$3.7 million for 1999. Product revenues increased 190% to approximately \$2.3 million for 2000 from approximately \$783,000 for 1999. This increase was due to an increase in Bioccelerator sales to the United States Patent and Trade Mark Office (USPTO) and from sales of Z3 which was introduced in the fourth quarter of 2000. Service revenues increased 88% to approximately \$4.6 million for 2000 from approximately \$2.5 million for 1999. This increase was due to an increase in revenues resulting from our agreement with Human Genome Sciences (HGS), our collaboration with Pfizer, increased maintenance fees from our installed base of Bioccelerators, and sales

through LabOnWeb.com, which was launched in December 1999. Research and development grants revenues decreased 8% to approximately \$466,000 for 2000 from approximately \$507,000 for 1999. Revenues from Pfizer, HGS, and the USPTO represented 81% of our products and services revenues in 2000.

Cost of Revenues. Cost of revenues increased 58% to approximately \$1.7 million for 2000 from approximately \$1.1 million for 1999. Cost of product revenues decreased 22% to approximately \$477,000 for 2000 from approximately \$611,000 in 1999. This decrease was primarily due to the write down during 1999 of the net realizable value of inventory in the amount of \$300,000, and an increase in production efficiency. Cost of services revenues increased 159% to approximately \$1.2 million for 2000 from approximately \$480,000 for 1999. This increase was due to costs related to support services provided under our agreement with HGS, an increase in costs related to support services provided under our agreement with Pfizer, and costs related to our LabOnWeb.com operations.

Research and Development Expenses. Research and development expenses increased 76% to approximately \$12.6 million for 2000 from approximately \$7.2 million for 1999. The increase in research and development expenses was primarily due to an increase in the number of research and development personnel to support existing as well as new research and development projects, increased salaries due to increased competition for professional employees, and an increase in the amortization of the deferred compensation to approximately \$2.4 million for 2000 from approximately \$882,000 for 1999. Research and development expenses as a percentage of total revenues decreased from 192% in 1999 to 172% in 2000.

Sales and Marketing Expenses. Sales and marketing expenses increased 224% to approximately \$3.8 million for 2000 from approximately \$1.2 million for 1999. This increase was primarily due to an increase in the number of sales and marketing personnel, increased travel expenses, promotional costs and

Management's Discussion and Analysis of Financial Condition and Results of Operations

marketing expenses to accommodate the growth of our business, and an increase in the amortization of deferred compensation to approximately \$505,000 for 2000 from approximately \$55,000 for 1999. Sales and marketing expenses as a percentage of total revenues increased from 31% in 1999 to 51% in 2000.

General and Administrative Expenses. General and administrative expenses increased 71% to approximately \$5.4 million for 2000 from approximately \$3.2 million for 1999. This increase was primarily due to an increase of approximately \$1.5 million in amortization of deferred compensation recorded in connection with options issued to employees and consultants, and an increase in personnel to support the growth of our business. General and administrative expenses as a percentage of total revenues decreased from 84% for 1999 to 73% for 2000.

Financing Income, Net. Financing income, net increased 286% to approximately \$2.8 million for 2000 from approximately \$719,000 for 1999. This increase was attributable to higher levels of cash and cash equivalents available from the aggregate proceeds of approximately \$35.5 million from the sale of our Series C preferred shares in July 2000, net of issuance expenses of \$487,000, and approximately \$51.1 million from the initial public offering of our shares on the Nasdaq National Market, net of issuance expenses of approximately \$6.3 million, in August 2000. Financing income, net as a percentage of total revenues increased from 19% for 1999 to 38% for 2000.

Report of Independent Public Accountants

To the Shareholders of
Compugen Ltd.

We have audited the accompanying consolidated balance sheets of Compugen Ltd. (an Israeli corporation) and its subsidiaries (the Company) as of December 31, 2000 and 2001, and the related consolidated statements of operations, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2001. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards in the United States and in Israel, including those prescribed under the Auditors' Regulations (Auditor's Mode of Performance), 1973. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Compugen Ltd. and its subsidiaries as of December 31, 2000 and 2001, and the results of their operations, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2001, in conformity with accounting principles generally accepted in the United States.

Tel-Aviv, Israel
February 12, 2002


Luboshitz Kasierer
Arthur Andersen

Consolidated Balance Sheets

(U.S.\$ in thousands, except share data)

	Note	December 31	
		2000	2001
ASSETS			
CURRENT ASSETS			
Cash and cash equivalents	(3)	80,675	8,438
Short-term cash deposits	(4)	10,000	9,241
Corporate bonds	(5)	-	14,668
Trade receivables		1,203	1,122
Other receivables	(6)	1,479	1,828
Inventory		<u>385</u>	<u>343</u>
Total current assets		<u>93,742</u>	<u>35,640</u>
LONG-TERM INVESTMENTS			
Corporate bonds	(5)	-	15,953
Long-term cash deposits	(7)	<u>-</u>	<u>30,195</u>
		<u>-</u>	<u>46,148</u>
PROPERTY AND EQUIPMENT, NET	(8)	<u>3,189</u>	<u>4,272</u>
OTHER ASSETS	(10)	<u>941</u>	<u>1,229</u>
Total assets		<u>97,872</u>	<u>87,289</u>

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

		December 31	
	Note	2000	2001
LIABILITIES AND SHAREHOLDERS' EQUITY			
CURRENT LIABILITIES			
Accounts payable and accrued expenses	(9)	3,118	4,887
Deferred revenue		1,185	960
Total current liabilities		4,303	5,847
LONG-TERM LIABILITIES			
Accrued severance pay	(10)	1,059	1,380
COMMITMENTS			
	(11)		
SHAREHOLDERS' EQUITY			
	(12)		
Share capital			
Ordinary shares of NIS 0.01 par value			
Authorized - as of December 31, 2000 and 2001			
50,000,000 shares; Issued and outstanding as of			
December 31, 2000 and 2001 - 25,981,416 shares and			
26,048,384 shares, respectively			
		71	71
Additional paid-in capital		150,380	150,418
Deferred compensation		(4,697)	(2,039)
Accumulated deficit		(53,244)	(68,388)
Total shareholders' equity		92,510	80,062
Total liabilities and shareholders' equity		97,872	87,289

Mor Amitai

MOR AMITAI, Ph.D.
President & Chief Executive Officer

Nurit Benjamini

NURIT BENJAMINI
Chief Financial Officer

Consolidated Statements of Operations

(U.S.\$ in thousands, except share and per share data)

	Note	Year ended December 31		
		1999	2000	2001
Revenues	(13)			
Products		783	2,268	5,883
Services		2,454	4,623	4,483
Research and development grants		507	466	994
Total revenues		<u>3,744</u>	<u>7,357</u>	<u>11,360</u>
Cost of revenues				
Products		611	477	1,853
Services		480	1,243	1,602
Research and development expenses		7,183	12,635	15,976
Sales and marketing expenses		1,166	3,781	6,565
General and administrative expenses		3,152	5,397	4,383
Total operating expenses (*)		<u>12,592</u>	<u>23,533</u>	<u>30,379</u>
Operating loss		(8,848)	(16,176)	(19,019)
Financing income, net	(14)	719	2,772	3,875
Net loss		<u>(8,129)</u>	<u>(13,404)</u>	<u>(15,144)</u>
Dividends related to convertible preferred shares		1,886	24,923	—
Net loss available to ordinary shares		<u>(10,015)</u>	<u>(38,327)</u>	<u>(15,144)</u>
Basic and diluted net loss per ordinary share	(2L)	<u>(1.70)</u>	<u>(2.75)</u>	<u>(0.58)</u>
Weighted average number of ordinary shares outstanding		<u>5,896,780</u>	<u>13,914,485</u>	<u>26,005,784</u>

(*) Includes deferred compensation costs - see Note 12

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

Consolidated Statements of Changes in Shareholders' Equity

(U.S.\$ in thousands, except share data)

	Ordinary shares	Preferred shares	Share capital	Additional paid-in capital	Deferred compen- sation	Accumulated deficit	Total
Balance as of January 1, 1999	5,981,000	8,206,119	42	26,238	(712)	(6,788)	18,780
Employee options exercised	—	—	—	19	—	—	19
Deferred compensation	—	—	—	3,925	(3,925)	—	—
Amortization of deferred compensation	—	—	—	—	869	—	869
Compensation relating to options and warrants issued to scientific advisory board members, consultants and others	—	—	—	1,248	—	—	1,248
Net loss	—	—	—	—	—	(8,129)	(8,129)
Balance as of December 31, 1999	5,981,000	8,206,119	42	31,430	(3,768)	(14,917)	12,787
Employee options exercised	505,835	—	1	784	—	—	785
Issuance of Series C preferred shares	—	5,538,462	14	35,499(*)	—	—	35,513
Issuance of Ordinary shares in an initial public offering	5,750,000	—	14	51,134(**)	—	—	51,148
Conversion of Preferred shares	13,744,581	(13,744,581)	—	—	—	—	—
Dividend related to convertible preferred shares	—	—	—	24,923	—	(24,923)	—
Deferred compensation	—	—	—	4,680	(4,680)	—	—
Amortization of deferred compensation	—	—	—	—	3,751	—	3,751
Compensation relating to options and warrants issued to scientific advisory board members, consultants and others	—	—	—	1,930	—	—	1,930
Net loss	—	—	—	—	—	(13,404)	(13,404)
Balance as of December 31, 2000	25,981,416	—	71	150,380	(4,697)	(53,244)	92,510
Employee options exercised	66,968	—	—	104	—	—	104
Amortization of deferred compensation	—	—	—	—	2,593	—	2,593
Compensation relating to options and warrants issued to scientific advisory board members, consultants and others	—	—	—	(1)	—	—	(1)
Forfeited options	—	—	—	(65)	65	—	—
Net loss	—	—	—	—	—	(15,144)	(15,144)
Balance as of December 31, 2001	<u>26,048,384</u>	<u>—</u>	<u>71</u>	<u>150,418</u>	<u>(2,039)</u>	<u>(68,388)</u>	<u>80,062</u>

(*) Net of issuance expenses of approximately \$487

(**) Net of issuance expenses of approximately \$6,352

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

Consolidated Statements of Cash Flows

(U.S.\$ in thousands)

	Year ended December 31		
	1999	2000	2001
CASH FLOWS FROM OPERATING ACTIVITIES			
Net loss	(8,129)	(13,404)	(15,144)
Adjustments to reconcile net loss to net cash used in operating activities -			
Income and expenses not affecting operating cash flows:			
Amortization of deferred compensation	869	3,751	2,593
Compensation relating to options and warrants issued to scientific advisory board members, consultants and others	1,248	1,930	(1)
Depreciation	991	1,242	1,682
Severance pay, net	(85)	120	55
Changes in operating assets and liabilities:			
Decrease (increase) in trade receivables	284	(1,033)	81
Increase in other receivables	(89)	(939)	(349)
Decrease (increase) in inventory	165	(5)	42
Increase (decrease) in accounts payable and accrued expenses	(263)	1,481	1,769
Increase (decrease) in deferred revenue	(754)	716	(225)
Net cash used in operating activities	<u>(5,763)</u>	<u>(6,141)</u>	<u>(9,497)</u>
CASH FLOWS FROM INVESTING ACTIVITIES			
Investment in corporate bonds	-	-	(30,621)
Purchase of short-term and long-term deposits	-	(10,000)	(29,436)
Purchase of fixed assets	(1,800)	(2,034)	(2,765)
Increase in other assets	(3)	(32)	(22)
Net cash used in investing activities	<u>(1,803)</u>	<u>(12,066)</u>	<u>(62,844)</u>

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

	Year ended December 31		
	<u>1999</u>	<u>2000</u>	<u>2001</u>
CASH FLOWS FROM FINANCING ACTIVITIES			
Short-term borrowings repaid to bank	(958)	–	–
Proceeds from issuance of ordinary shares	19	51,933	104
Proceeds from issuance of preferred shares	–	35,513	–
Net cash provided by (used in) financing activities	<u>(939)</u>	<u>87,446</u>	<u>104</u>
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(8,505)	69,239	(72,237)
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	<u>19,941</u>	<u>11,436</u>	<u>80,675</u>
CASH AND CASH EQUIVALENTS AT END OF YEAR	<u>11,436</u>	<u>80,675</u>	<u>8,438</u>
NON-CASH ACTIVITY			
Dividend related to convertible preferred shares	<u>–</u>	<u>24,923</u>	<u>–</u>

Notes to the Consolidated Financial Statements

(U.S.\$ in thousands)

note **1** GENERAL

A. Compugen Ltd. (the "Company") merges computational technologies with biology and medicine to enhance drug discovery and development. The Company's innovative predictive biology technologies support two complementary product development and commercialization divisions. Compugen's BioApplications division offers high value products and services that enable and enhance the discovery and functional analysis of genes, proteins and cell processes. Compugen's Novel Genomics division is developing human therapeutic and diagnostic products based on target genes, proteins and other intellectual property discovered through the Company's innovative research activities. Currently marketed products and services include: LEADS, Gencarta, DNA Chip design, Z3, OligoLibraries, Bioccelerators and certain genes and proteins discovered by the Company. The Company's headquarters and research facilities are located in Israel, with U.S. operations, through a wholly owned subsidiary, in Jamesburg, New Jersey and Sunnyvale, California.

Subsequent to balance sheet date, the Company established a majority owned subsidiary focusing on agricultural biotechnology and plant genomics.

B. The financial statements of the Company have been prepared in U.S. dollars, as the currency of the primary economic environment in which the operations of the Company are conducted is the U.S. dollar. Most of the Company's sales are made outside Israel in foreign currencies (mainly the U.S. dollar). A majority of the purchases of materials and components are denominated in or linked to the U.S. dollar. In addition, most marketing expenses are incurred outside Israel, mainly in U.S. dollars.

Transactions and balances originally denominated in U.S. dollars are presented at their original amounts. Transactions and balances in other currencies are remeasured into U.S. dollars in accordance with the principles prescribed in Statement No. 52 of the Financial Accounting Standards Board of the United States (FASB). Accordingly, items have been remeasured as follows:

Monetary items -	at the exchange rate in effect on the balance sheet date.
Nonmonetary items -	at historical exchange rates.
Revenues and expense items -	at the exchange rates in effect as of the date of recognition of those items (excluding depreciation and other items deriving from non-monetary items).

Exchange gains and losses from the aforementioned remeasurement are reflected in the statement of operations. The representative rate of exchange of the New Israeli Shekel (NIS) at December 31, 2001, was U.S. \$1 = NIS 4.42 (December 31, 2000 - NIS 4.04; December 31, 1999 - NIS 4.15).

C. In August 2000, the Company issued 5,750,000 ordinary shares (including the exercise of the over-allotment option by the underwriters) in an initial public offering on the NASDAQ, at a price of \$10.00 per share, for an aggregate consideration of approximately \$57.5 million (\$51.1 million net of issuance expenses). Upon the closing of the offering, all outstanding preferred shares were converted into an identical number of ordinary shares. Subsequent to balance sheet date, on January 7, 2002, the Company has registered its ordinary shares for trading also on the Tel Aviv Stock Exchange.

Notes to the Consolidated Financial Statements

(U.S.\$ in thousands)

note

2

SIGNIFICANT ACCOUNTING POLICIES

The financial statements have been prepared in conformity with accounting principles generally accepted in the United States (U.S. GAAP). The significant accounting policies followed in the preparation of the financial statements, applied on a consistent basis, are:

A. BASIS OF CONSOLIDATION

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary, Compugen Inc. All material intercompany transactions and balances have been eliminated on consolidation.

B. CASH AND CASH EQUIVALENTS

The Company considers all highly liquid investments with an original maturity of three months or less as cash equivalents.

C. CORPORATE BONDS

The corporate bonds have been categorized as held to maturity securities in accordance with Statement of Financial Accounting Standards ("SFAS") No. 115 - Accounting for Certain Investments in Debt and Equity Securities. These investments are stated at cost (including accrued interest), as it is the intent of the Company to hold these securities until maturity. The Company's investment holdings have been classified in the consolidated balance sheet according to the maturity date.

These investments, which potentially subject the Company to credit risk, are placed in investment grade bonds and are limited in the amount of credit exposure to any one commercial issuer.

D. INVENTORY

Inventory is valued at the lower of cost or market, cost being determined mainly on the "first-in, first-out" method.

E. PROPERTY AND EQUIPMENT

Property and equipment are stated at cost. Costs of purchased software for internal use are capitalized in accordance with Statement of Position 98-1 "Accounting for the Cost of Computer Software Developed or Obtained for Internal Use." Depreciation is calculated using the straight-line method over the estimated useful lives of the assets, ranging from three to eight years.

F. RESEARCH AND DEVELOPMENT

Research and development costs incurred prior to the establishment of technological feasibility are included in research and development expenses. Software development costs incurred subsequent to the establishment of technological feasibility through the period of general market availability of the products are considered for capitalization. Technological feasibility is established when a working model has been completed and its completeness is confirmed by testing. To date, development costs that are eligible for capitalization have not been material and have been expensed.

G. REVENUE RECOGNITION

Revenues from a contract to provide platform software (not including off-the-shelf software) and software development services, are recognized by the percentage of completion method. Under this method, revenues

Notes to the Consolidated Financial Statements

(U.S.\$ in thousands)

are recognized as work progresses, in the ratio that costs incurred related to contract performance bear to estimated costs of contract performance. Milestone payments are recognized only when realization is reasonably assured.

Revenues from software product licenses are recognized upon delivery of the software, provided there is persuasive evidence of an agreement, the fee is fixed and determinable and collection of the related receivable is reasonably assured.

Revenue from sales of hardware systems (including associated software) is recognized in accordance with Statement of Position 97-2, "Software Revenue Recognition", upon delivery, or at the end of the evaluation period, if applicable, and when collection is reasonably assured. The purchase price includes a prepaid maintenance fee, generally for a period of one year from the date of the sale; accordingly, this portion of the purchase price is deferred and included as income ratably over the maintenance period.

Revenue from maintenance contracts is recognized ratably over the term of the maintenance contract. Revenues related to services are recognized as the services are rendered.

Revenues from participations by the Government of Israel through the Ministry of Industry and Trade - the Office of the Chief Scientist of Israel ("OCS"), are recognized as revenues as the related research and development expenses are incurred. Prior to January 1, 2001, the participations were presented in the statement of operations as a deduction from the research and development expenses. The prior years financial statements have been changed to conform to the 2001 presentation.

H . INCOME TAXES

The Company accounts for income taxes using the asset and liability method of accounting in accordance with the provisions of Statements of Financial Accounting Standards ("SFAS") No. 109, "Accounting for Income Taxes". Under the asset and liability method, deferred taxes are determined based on the differences between the financial statements and tax basis of assets and liabilities at enacted tax rates in effect in the year in which the differences are expected to reverse. Valuation allowances are established, when necessary, to reduce deferred tax assets to amounts expected to be realized.

I . DERIVATIVE FINANCIAL INSTRUMENTS

Effective January 1, 2001, the Company adopted Statement of Financial Accounting Standards ("SFAS") No. 133 - "Accounting for Derivative Instruments and Hedging Activities". The adoption of SFAS No. 133 had no material impact on reported earnings for the year ended December 31, 2001. The Company's derivative financial instruments consist of foreign currency forward exchange contracts and option contracts. These contracts are utilized by the Company, from time to time, to manage risk exposure to movements in foreign exchange rates. None of these contracts have been designated as hedging instruments. These contracts are recognized as assets or liabilities on the balance sheet at their fair value, which is the estimated amount at which they could be settled based on market prices or dealer quote, where available, or based on pricing models. Changes in fair value are recognized currently in earnings.

J . FAIR VALUE OF FINANCIAL INSTRUMENTS

Unless otherwise noted, the carrying amount of financial instruments approximates fair value.

Notes to the Consolidated Financial Statements

(U.S.\$ in thousands)

K. SHARE-BASED COMPENSATION

According to US GAAP, the Company may account for stock option grants in accordance with Accounting Principles Board Opinion ("APB") No. 25 - "Accounting for Stock Issued to Employees" or SFAS 123 - "Accounting for Stock Based Compensation". The Company chose to account for stock option grants according to APB 25 and has made all the required proforma disclosures according to SFAS 123 for the years ended December 31, 1999, 2000 and 2001 in Note 12. Options granted to non-employees in exchange for services are recorded at fair value.

L. BASIC AND DILUTED NET LOSS PER SHARE

The Company has adopted SFAS No. 128 - "Earnings per Share". In accordance with the provisions of this Statement, basic net loss per share is computed based on the weighted average number of ordinary shares outstanding. Net loss for 1999 has been increased by the amount of cumulative unpaid dividends on the Preferred shares (\$1,886). Net loss for the year ended December 31, 2000 has been increased by \$24.9 million for the preferred share dividend representing the value of the beneficial conversion feature. Outstanding options to purchase shares (see Note 12) are not included in the computation of diluted earnings per ordinary share as their effect would be anti-dilutive for all periods presented. The total number of shares related to the outstanding options excluded from the calculations of diluted net loss per share were 2,614,486, 3,446,916 and 4,877,416 for the years ended December 31, 1999, 2000 and 2001, respectively.

M. USE OF ESTIMATES

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities

and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

N. RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In July 2001, the Financial Accounting Standards Board issued Statements of Financial Accounting Standards No. 141, Business Combinations ("SFAS 141") and No. 142, Goodwill and Other Intangible Assets ("SFAS 142"). SFAS 141 requires all business combinations initiated after June 30, 2001, to be accounted for using the purchase method. Under SFAS 142, goodwill and intangible assets with indefinite lives are no longer amortized but are reviewed annually (or more frequently if impairment indicators arise) for impairment. All other intangible assets will continue to be amortized over their estimated useful lives. The amortization provisions of SFAS 142 apply to goodwill and intangible assets acquired after June 30, 2001. With respect to goodwill and intangible assets acquired prior to July 1, 2001, the Company is required to adopt SFAS 142 effective January 1, 2002. The Company does not believe that the adoption of SFAS 142 will have a material effect on the Company's consolidated financial statements.

In August 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets ("SFAS 144"). Although SFAS 144 supersedes FASB Statement No. 121 ("FASB 121"), it retains the requirements of FASB 121 regarding recognition of impairment loss for long-lived assets to be held and used (based on undiscounted cash flows) and resolves certain implementation issues. Also, the accounting model used in FASB 121 for long-lived assets to be disposed of by sale (lower of carrying amount or fair value less cost to sell) is broadened by SFAS 144 to include discontinued

Notes to the Consolidated Financial Statements

(U.S.\$ in thousands)

operations and supersedes APB Opinion No. 30. Therefore, discontinued operations will no longer be measured on a net realizable value basis and future operating losses will no longer be recognized before they occur. SFAS 144 also broadens the presentation of discontinued operations to include a component of an entity (rather than a segment of a business).

The provisions of SFAS 144 are effective for financial statements issued for fiscal years beginning after December 15, 2001, and interim periods within those years. The Company believes that the adoption of SFAS 144 will not have a material impact on the Company's financial statements.

note **3** **CASH AND CASH EQUIVALENTS**

Bank deposits in U.S. dollars (bearing annual interest rate of 1.7% (*))
 Bank deposits in NIS (bearing annual interest rates of 3.8% to 5.6% (*))
 Cash in banks (current accounts)

(*) Rate as of December 31, 2001

December 31	
2000	2001
77,765	1,173
2,696	5,695
214	1,570
<u>80,675</u>	<u>8,438</u>

note **4** **SHORT-TERM CASH DEPOSITS**

Bank deposits in U.S. dollars (bearing annual interest rates of 3.9% - 4.0% (*))
 Bank deposits in NIS (bearing annual interest rate of 3.8% (*))

(*) Rate as of December 31, 2001

December 31	
2000	2001
10,000	5,355
–	3,886
<u>10,000</u>	<u>9,241</u>

Notes to the Consolidated Financial Statements

(U.S.\$ in thousands)

note **5** **CORPORATE BONDS**

Short-term corporate bonds (*)
 Long-term corporate bonds (*)

(*) Includes accrued interest

December 31, 2001	
Amortized cost	Market value
<u>14,668</u>	<u>14,849</u>
<u>15,953</u>	<u>16,214</u>

note **6** **OTHER RECEIVABLES**

Accrued interest
 Government participation receivables
 Government institutes receivables
 Employee loans
 Other (mainly prepaid expenses)

December 31	
2000	2001
490	807
125	106
243	459
209	75
<u>412</u>	<u>381</u>
<u>1,479</u>	<u>1,828</u>

note **7** **LONG-TERM CASH DEPOSITS**

Bank deposits in U.S. dollars (bearing annual interest rates of 4.2% to 4.9%)

December 31	
2000	2001
<u>–</u>	<u>30,195</u>

Notes to the Consolidated Financial Statements

(U.S.\$ in thousands)

note **8** **PROPERTY AND EQUIPMENT, NET**

	Annual rates of depreciation	December 31	
		2000	2001
COST			
Computers, software and related equipment	33%	4,572	6,052
Laboratory equipment	20 - 33%	810	1,916
Office furniture and leasehold improvements	7 - 15%	706	881
		<u>6,088</u>	<u>8,849</u>
ACCUMULATED DEPRECIATION			
Computers, software and related equipment		2,326	3,681
Laboratory equipment		342	575
Office furniture and leasehold improvements		231	321
		<u>2,899</u>	<u>4,577</u>
NET BOOK VALUE		<u>3,189</u>	<u>4,272</u>

The Company's property and equipment are primarily located in Israel. For the years ended December 31, 1999, 2000 and 2001, depreciation expense was approximately \$991, \$1,242 and \$1,682, respectively.

note **9** **ACCOUNTS PAYABLE AND ACCRUED EXPENSES**

	December 31	
	2000	2001
Suppliers	1,253	2,271
Employees and related expenses	1,492	2,041
Other accrued expenses	373	575
	<u>3,118</u>	<u>4,887</u>

Notes to the Consolidated Financial Statements

(U.S.\$ in thousands)

note **10** **ACCRUED SEVERANCE PAY**

Under Israeli law and labor agreements, the Company is required to make severance payments to its dismissed employees and employees leaving its employment in certain other circumstances. The Company's severance pay liability to its employees, which is calculated on the basis of the salary of each employee for the last month of the reported period multiplied by the years of such employees' employment, is reflected in the Company's balance sheet on

the accrual basis, and is partially funded by purchase of insurance policies in the name of the Company. Deposits with insurance companies in respect of the severance pay accrual are included in other assets.

The severance pay expenses (income) for the years ended December 31, 1999, 2000 and 2001 were \$(85), \$120 and \$55, respectively.

note **11** **COMMITMENTS**

A. The Company's research and development efforts have been partially financed through both royalty bearing and non-royalty bearing programs sponsored by the Office of the Chief Scientist of Israel ("OCS"). In return for the OCS's participation, the Company is committed to pay royalties at a rate of 3% to 5% of sales of the products, up to 100% of the amount of such participation received (for grants received under programs approved subsequent to January 1, 1999 - 100% plus interest at LIBOR). The Company is entitled to the grants only upon incurring research and development expenditures. The Company is not obligated to repay any amounts received from the OCS if the research effort is unsuccessful. There are no repayment obligations relating to the funds received under the non-royalty bearing programs sponsored by the OCS. Grants received in advance of the corresponding expenditures incurred are recorded as a liability. There are no future performance obligations related to the participations received from the OCS and there are no other significant terms of these programs. The Company's potential maximum obligation for royalties, based on royalty-bearing Government participation received or accrued, net of royalties paid or accrued, totaled approximately \$165 as of December 31,

2001. The liability for royalties to the OCS is recorded at the time the related royalty-bearing sales are recognized as revenues in the statement of operations.

B. The Company's headquarters and research facilities are located in Israel, with U.S. operations in Jamesburg, New Jersey and Sunnyvale, California. Lease agreements expire in the years 2002 to 2004. Annual minimum future rental payments due under the above agreements and operating lease agreements for vehicles, at exchange rates in effect on December 31, 2001 are approximately as follows:

2002	1,502
2003	1,369
2004	<u>223</u>
	<u>3,094</u>

Rent expense was \$387, \$566 and \$1,020 for the years ended December 31, 1999, 2000 and 2001, respectively.

Notes to the Consolidated Financial Statements

(U.S.\$ in thousands)

n o t e **12** **SHARE CAPITAL**

- A.** In July 2000, the Company completed a private placement of 5,538,462 Series C convertible preferred shares at a price of \$6.50 per share, for an aggregate consideration of approximately \$36.0 million (\$35.5 million net of issuance expenses). As a result of the initial public offering in August 2000, the Company recorded a non-cash charge for preferred share dividends of approximately \$24.9 million, representing the value of the beneficial conversion feature of this issuance based on the difference between the conversion price of \$6.50 per share and the assumed offering price of \$11.00 in the initial public offering (see Note 1C).
- B.** In September 1996, the Company adopted the Compugen Ltd. Employee Share Option Plan (1996) (the "Plan"), which provides for the grant by the Company of options to purchase 559,750 ordinary shares to employees and consultants of the Company and its subsidiaries. The Company has elected to register the Plan under Section 102 of the Israeli Income Tax Ordinance. The Company does not intend to grant additional options under this plan.

In June 1998, the Company adopted the Compugen Ltd. Share Option Plan (1998) (the "1998 Plan"), which provides for the grant by the Company

of options to purchase up to an aggregate of 2,500,000 ordinary shares to directors, employees and consultants of the Company and its subsidiaries. In general, options granted under these plans vest over a four year period. The options expire ten years from the date of issuance.

In March 2000, the Company adopted the Compugen Ltd. Share Option Plan (2000) (the "2000 Plan"), which provided for the grant by the Company of options to purchase 1,500,000 ordinary shares to employees and consultants of the Company and its subsidiaries. This total number will automatically increase each January 1 by the lesser of 1,500,000 or 4% of the total number of the Company's then outstanding shares or such lower amount as shall be determined by the board of directors. The terms of the 2000 Plan are substantially identical to the terms of the 1998 Plan described above. Subject to the 1998 and 2000 plans, there were 220,909 options to purchase shares available for future grants at December 31, 2001.

Transactions related to the grant of options to employees, directors and consultants under the above plans during the years ended December 31, 1999, 2000 and 2001 were as follows:

Notes to the Consolidated Financial Statements

(U.S.\$ in thousands)

	Year ended December 31					
	1999		2000		2001	
	Shares	Weighted average exercise price \$	Shares	Weighted average exercise price \$	Shares	Weighted average exercise price \$
Options outstanding at beginning of year	1,528,000	1.34	2,614,486	1.44	3,446,916	3.66
Options granted	1,174,750	1.56	1,504,937	6.60	1,828,500	4.16
Options exercised	(14,354)	1.34	(578,981)	1.37	(66,968)	1.64
Options forfeited	(73,910)	1.35	(93,526)	3.00	(331,032)	6.04
Options outstanding at end of year	<u>2,614,486</u>	<u>1.44</u>	<u>3,446,916</u>	<u>3.66</u>	<u>4,877,416</u>	<u>3.71</u>
Exercisable at end of year	<u>1,035,890</u>	<u>1.35</u>	<u>1,337,580</u>	<u>1.79</u>	<u>2,095,792</u>	<u>2.53</u>
Weighted average fair value of options granted		<u>3.54</u>		<u>5.78</u>		<u>1.68</u>

The following table summarizes information about options outstanding at December 31, 2001:

Range of exercise prices \$	Options outstanding			Options exercisable	
	Number outstanding at December 31 2001	Weighted average remaining contractual Life	Weighted average exercise Price \$	Number outstanding at December 31 2001	Weighted average exercise Price \$
1.33 - 1.35	1,359,157	6.60	1.34	1,289,311	1.34
1.75	598,692	7.90	1.75	322,588	1.75
3.00 - 4.99	1,751,546	9.48	4.35	90,802	4.30
5.00 - 6.88	718,469	8.75	5.88	257,693	5.36
9.00 - 10.00	<u>449,552</u>	8.70	9.67	<u>135,398</u>	9.14
	<u>4,877,416</u>			<u>2,095,792</u>	

Notes to the Consolidated Financial Statements

(U.S.\$ in thousands)

According to U.S. GAAP, the Company may account for stock option grants in accordance with APB 25 or SFAS No. 123, "Accounting for Stock Based Compensation" ("SFAS 123"). The Company chooses to account for stock option grants according to APB 25. The amounts of deferred compensation recognized arising from the difference between the exercise price and the fair market value on the date of the grant, for options granted in the years ended December 31, 1999, 2000 and 2001, respectively, are included in shareholders' equity and are being amortized over the vesting periods of the respective options in accordance with APB 25. The balance of unamortized deferred compensation

at December 31, 2001 is \$2,039. Under APB 25, the deferred compensation that has been charged to operations for the year ended December 31, 2001 amounted to \$2,593 (year ended December 31, 1999 and 2000, \$869 and \$3,751, respectively).

If deferred compensation had been determined under the alternative fair value accounting method provided for under SFAS 123, the Company's net loss and basic and diluted net loss per share would have been increased or decreased to the following proforma amounts:

	<u>1999</u>	<u>2000</u>	<u>2001</u>
Net loss			
As reported	(8,129)	(13,404)	(15,144)
Pro Forma	(7,169)	(14,184)	(17,272)
Basic and diluted net loss per share			
As reported	(1.70)	(2.75)	(0.58)
Pro Forma	(1.54)	(2.81)	(0.66)

Under SFAS 123, the fair value of each option grant is estimated on the date of grant using the Black & Scholes pricing method (the minimum value method - 1999) with the following weighted-average assumptions: (1) expected life of 2.1 years (1999 - 2.5, 2000 - 2.1); (2) dividend yield of 0%; (3) expected volatility of 72% (1999 - 0%, 2000 - 68%) and (4) risk-free interest rate of 1.75% (1999 - 5%, 2000 - 6.5%).

Notes to the Consolidated Financial Statements

(U.S.\$ in thousands)

Deferred compensation costs were included in the following expense categories:

	For the year ended December 31		
	1999	2000	2001
Cost of revenues	–	156	(11)
Research and development expenses	882	2,380	1,636
Sales and marketing expenses	55	505	510
General and administrative expenses	1,180	2,640	457
	<u>2,117</u>	<u>5,681</u>	<u>2,592</u>

On March 30, 2000, the Company issued 300,000 warrants to purchase Compugen ordinary shares to Genome Therapeutics Corp., as part of an internet collaboration agreement. The warrants have an exercise price of \$8.00. The warrants are accounted for at fair value using the Black & Scholes pricing model in accordance with SFAS 123 and EITF 96-18, "Accounting for equity instruments that are issued to other than employees for acquiring, or in conjunction with selling goods or services". Changes in the fair value of these warrants prior to completion of performance will be reflected as an adjustment to the expense to be recorded in future periods over the vesting period. Subsequent to balance

sheet date, the collaboration agreement was terminated and the warrants will expire in March 2002.

In May 2000, the Company issued a warrant to purchase up to 35,000 Compugen ordinary shares to Bain & Company, as part of a consulting agreement, at an exercise price of \$10.00 per share. This warrant is immediately exercisable in whole or in part and will expire in May 2005. The warrants are accounted for at fair value using the Black & Scholes pricing model in accordance with SFAS 123 and EITF 96-18.

Notes to the Consolidated Financial Statements

(U.S.\$ in thousands)

n o t e **13** **REVENUES**

The Company's revenues from services and products by geographical area are as follows:

	For the year ended December 31		
	1999	2000	2001
United States	2,904	6,469	7,061
Far East	271	144	875
Europe	38	178	2,235
Other	24	100	195
	<u>3,237</u>	<u>6,891</u>	<u>10,366</u>

Sales to a single customer exceeding 10%	%	%	%
Customer A	71	35	30
Customer B	(*)	24	17
Customer C	(*)	22	(*)
Customer D	–	(*)	17

(*) Less than 10%

The Company's business is currently comprised of one operating segment, the research, development and commercialization of products and services in the field of computational genomics and proteomics. The nature of the products and services provided by the Company and the type of customers for these products and services are similar.

Compugen's U.S. subsidiary serves as a marketing arm and customer support for products developed in Israel. The operating results in the U.S. are an integral portion of the results of operations for Israel and are not viewed by Company management as a separate operating segment.

Notes to the Consolidated Financial Statements

(U.S.\$ in thousands)

note **14** **FINANCING INCOME, NET**

	For the year ended December 31		
	1999	2000	2001
Income (expense):			
Interest income	752	2,736	4,253
Interest expense and bank fees	(15)	(24)	(30)
Other (includes exchange rate differences)	(18)	60	(348)
	<u>719</u>	<u>2,772</u>	<u>3,875</u>

note **15** **TAXES ON INCOME**

- A. The Company is subject to the Israeli Income Tax Law (Inflationary Adjustments), 1985, which provides for an adjustment to taxable income for the effects of inflation (based on the Israeli Consumer Price Index) on that portion of shareholders' equity not invested in inflation resistant assets.
- B. In 1994, the Company's investment plan for the development and production of dedicated computers for sequence analysis ("Bioaccelerators") totaling \$695 was granted "Approved Enterprise" status, through the "Alternative Benefits" program, under the Law for Encouragement of Capital Investments, 1959. In respect of this plan, the Company is entitled to a tax exemption for a period of 2 years commencing in the first year in which the Company has taxable income, and a reduced income tax rate of 25% (instead of the regular rate of 36%) on taxable income derived from the "Approved Enterprise" for an additional period of 5 to 8 years. Due to the reported losses, the benefit period has not yet commenced. In 1996 and 2000, the

Company's additional investment plan totaling \$1,080 and \$2,050, respectively in respect of an expansion of its manufacturing facilities, was granted "Approved Enterprise" status, as well.

- C. In 2000, the Company's investment plan totaling \$860 in respect of its molecular biology "wet lab" was granted "Approved Enterprise" status. The Company has chosen to receive its benefits in respect of this plan through the "Alternative Benefits" program. The benefits under this program are similar to those stated in Item B above.
- D. In 2001, the Company's investment plan totaling \$900 in respect of its manufacturing of seed species was granted "Approved Enterprise" status. The Company has chosen to receive its benefits in respect of this plan through the "Alternative Benefits" program. The benefits under this program are similar to those stated in Item B above.

Notes to the Consolidated Financial Statements

(U.S.\$ in thousands)

- E.** The Company believes it is an “Industrial Company” under the law for the Encouragement of Industry. The principal benefit is the deductibility of expenses in connection with a public offering.
- F.** Compugen Ltd. has a tax loss carryforward resulting from the years up to and including 2001 amounting to approximately \$22,400, which may be carried forward indefinitely. The Company’s tax assessments are considered final through 1997. Compugen Inc. is subject to U.S. income taxes and has a loss carryforward resulting from the years up to and including 2001 amounting to approximately \$10,300, which expires in the years 2012

to 2021. The Company has provided a valuation allowance against the full amount of the tax benefits in the amount of approximately \$9,800 due to its history of operating losses and the uncertainty as to when these benefits would be utilized.

The difference between the loss carryforward for tax purposes and the accumulated deficit as of December 31, 2001 relates mainly to non-cash dividends related to convertible preferred shares of \$24,923 and to temporary differences mainly in respect of reserves and allowances not currently deductible.

n o t e **16** **RELATED PARTY TRANSACTIONS**

Consulting fees to director and shareholder

For the year ended December 31		
1999	2000	2001
75	150	165

Corporate Directory

Directors

Martin S. Gerstel, Chairman
Chief Executive Officer (Retired)
Alza Corporation

Mor Amitai, Ph.D.
President & Chief Executive Officer
Compugen Ltd.

Rimon Ben Shaoul
Co-Chairman & President
Koonras Technologies Ltd.

Orna Berry, Ph.D.
Venture Partner
Gemini Israel Funds

Amos Goren
Director
Apax Partners Israel, Ltd.

David Haselkorn, Ph.D.
Chief Executive Officer
Clal Biotechnology Industries Ltd.

Eli Mintz
Chairman
Compugen Inc.

David Schlachet
Managing Partner
Biocom Management & Investments

Philip Young
Managing Member
U.S. Venture Partners

Officers

Mor Amitai, Ph.D.
President & Chief Executive Officer

Nurit Benjamini
Chief Financial Officer

Erez Chimovits
Executive Vice President, Marketing & Sales;
President, BioApplications Division

Salomon Z. Langer, M.D.
Senior Vice President, Drug Discovery

Lior Ma'ayan
Executive Vice President, Corporate Development

Michal Preminger, Ph.D.
Vice President, New Research Directions

Scientific Advisory Board

Richard Durbin, Ph.D.
Head of Informatics, Deputy Director of the
Wellcome Trust Sanger Institute, UK

C. Ronald Kahn, M.D., D.Sc.
Professor of Medicine, Harvard Medical School, Cambridge, MA, U.S.A.
President, Joslin Diabetes Center

Joseph Schlessinger, Ph.D.
William H. Prusoff Professor and Chairman of the Department of Pharmacology
of the Yale University School of Medicine
Member, National Academy of Sciences, U.S.A.

Arthur Weiss, M.D., Ph.D.
Ephraim P. Engleman Distinguished Professor of Rheumatology;
Investigator, Howard Hughes Medical Institute
University of California, San Francisco, CA, U.S.A.

Corporate Directory

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Shalom Towers
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Israel

Legal Counsel

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Fax: (609) 655-5114

The annual meeting of stockholders will be held at:

10:00 AM, September 3, 2002

Compugen Ltd.
72 Pinchas Rosen
Tel Aviv 69512
Israel

Shareholders may obtain, free of charge, a copy of the Company's Annual Report on Form 20-F as filed with the Securities and Exchange Commission, by writing to the Company.

NASDAQ Symbol: CGEN

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