LYDALL INC /DE/
Form 10-Q
August 03, 2009
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

Form 10-Q

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

For the quarterly period ended June 30, 2009

OR

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

For the transition period from to

Commission File Number: 1-7665

LYDALL, INC.

(Exact name of registrant as specified in its charter)

Delaware	**06-0865505**
(State or Other Jurisdiction of Incorporation or Organization)	**(I.R.S. Employer Identification No.)**
One Colonial Road, Manchester, Connecticut	**06042**
(Address of principal executive offices)	**(zip code)**

(860) 646-1233

(Registrant s telephone number, including area code)

None

(Former name, former address and former fiscal year, if changed since last report)

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

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 x Non-accelerated filer ¨ 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 x

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

Common stock $.10 par value per share.	
Total Shares outstanding July 24, 2009	**16,835,666**

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

LYDALL, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In Thousands Except Per Share Data)

	Quarter Ended June 30,	
	2009	2008
	(Unaudited)	
Net sales	$ 55,981	$ 83,958
Cost of sales	51,811	64,784
Gross margin	4,170	19,174
Selling, product development and administrative expenses	12,722	14,697
Operating (loss) income from continuing operations	(8,552)	4,477
Interest expense	198	129
Other income, net	(29)	(51)
(Loss) Income from continuing operations before income taxes	(8,721)	4,399
Income tax (benefit) expense	(2,783)	1,627
(Loss) Income from continuing operations	(5,938)	2,772
Income from discontinued operations, net of tax		126
Net (loss) income	$ (5,938)	$ 2,898
Basic (loss) earnings per share:		
Continuing operations	$ (.36)	$ .17
Discontinued operations	$	$ .01
Net (loss) income	$ (.36)	$ .18
Diluted (loss) earnings per share:		
Continuing operations	$ (.36)	$ .17
Discontinued operations	$	$ .01
Net (loss) income	$ (.36)	$ .17
Weighted average number of common shares outstanding:		
Basic	16,544	16,439
Diluted	16,544	16,610

See accompanying Notes to Condensed Consolidated Financial Statements.

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LYDALL, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In Thousands Except Per Share Data)

	Six Months Ended June 30,	
	2009	2008
	(Unaudited)	
Net sales	$ 110,314	$ 173,853
Cost of sales	100,151	133,834
Gross margin	10,163	40,019
Selling, product development and administrative expenses	25,804	30,469
Operating (loss) income from continuing operations	(15,641)	9,550
Interest expense	332	244
Other income, net	(156)	(179)
(Loss) Income from continuing operations before income taxes	(15,817)	9,485
Income tax (benefit) expense	(5,359)	3,509
(Loss) Income from continuing operations	(10,458)	5,976
Income from discontinued operations, net of tax		117
Net (loss) income	$ (10,458)	$ 6,093
Basic (loss) earnings per share:		
Continuing operations	$ (.63)	$ .36
Discontinued operations	$	$ .01
Net (loss) income	$ (.63)	$ .37
Diluted (loss) earnings per share:		
Continuing operations	$ (.63)	$ .36
Discontinued operations	$	$ .01
Net (loss) income	$ (.63)	$ .37
Weighted average number of common shares outstanding:		
Basic	16,544	16,422
Diluted	16,544	16,516

See accompanying Notes to Condensed Consolidated Financial Statements.

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LYDALL, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(In Thousands)

	June 30, 2009 (Unaudited)	December 31, 2008
ASSETS		
Current assets:		
Cash and cash equivalents	$ 8,871	$ 13,660
Accounts receivable, net	32,944	34,297
Inventories, net	37,601	40,772
Taxes receivable	4,444	1,992
Prepaid expenses and other current assets, net	6,565	5,178
Total current assets	90,425	95,899
Property, plant and equipment, at cost	243,898	240,471
Accumulated depreciation	(145,940)	(138,582)
Net, property, plant and equipment	97,958	101,889
Restricted cash		2,400
Goodwill and other intangible assets	26,352	27,099
Other assets, net	9,798	10,401
Total assets	$ 224,533	$ 237,688
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Current portion of long-term debt	$ 1,495	$ 1,455
Accounts payable	21,204	20,507
Accrued payroll and other compensation	5,724	7,566
Other accrued liabilities	6,965	7,712
Total current liabilities	35,388	37,240
Long-term debt	5,908	6,699
Deferred tax liabilities	7,258	7,398
Pension and other long-term liabilities	18,983	20,206
Stockholders equity:		
Preferred stock		
Common stock	2,328	2,317
Capital in excess of par value	52,647	52,071
Retained earnings	173,202	183,660
Accumulated other comprehensive loss	(6,198)	(6,920)
Treasury stock, at cost	(64,983)	(64,983)
Total stockholders equity	156,996	166,145
Total liabilities and stockholders equity	$ 224,533	$ 237,688

See accompanying Notes to Condensed Consolidated Financial Statements.

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LYDALL, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In Thousands)

	Six Months Ended June 30,	
	2009	2008
	(Unaudited)	
Cash flows from operating activities:		
Net (loss) income	$ (10,458)	$ 6,093
Adjustments to reconcile net (loss) income to net cash from operating activities:		
Depreciation and amortization	8,046	7,845
Deferred income taxes	(2,958)	834
Stock based compensation	588	583
Loss on disposition of property, plant and equipment	7	117
Changes in operating assets and liabilities:		
Accounts receivable	1,553	543
Inventories	3,508	816
Taxes receivable	(2,477)	1,437
Accounts payable	668	(587)
Accrued payroll and other compensation	(1,873)	1,267
Proceeds from surrender of life insurance policies	3,830	
Supplemental executive retirement settlement payments	(1,433)	
Other, net	(2,203)	(3,560)
Net cash (used for) provided by operating activities	(3,202)	15,388
Cash flows from investing activities:		
Capital expenditures	(3,584)	(5,287)
Decrease in restricted cash	2,400	
Net cash used for investing activities	(1,184)	(5,287)
Cash flows from financing activities:		
Debt proceeds	6,685	
Debt repayments	(7,434)	(710)
Common stock issued		699
Net cash used for financing activities	(749)	(11)
Effect of exchange rate changes on cash	346	809
(Decrease) Increase in cash and cash equivalents	(4,789)	10,899
Cash and cash equivalents at beginning of period	13,660	15,716
Cash and cash equivalents at end of period	$ 8,871	$ 26,615

See accompanying Notes to Condensed Consolidated Financial Statements.

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LYDALL, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Basis of Financial Statement Presentation

Lydall, Inc. designs and manufactures specialty engineered filtration media, industrial thermal insulating solutions, automotive thermal and acoustical barriers, temperature-control equipment, medical filtration media and devices and biopharmaceutical processing components for demanding filtration/separation, thermal/acoustical and biopharmaceutical applications.

The accompanying condensed consolidated financial statements include the accounts of Lydall, Inc. and its subsidiaries (collectively, the Company or Lydall). All financial information is unaudited for the interim periods reported. All significant intercompany transactions have been eliminated in the condensed consolidated financial statements. The condensed consolidated financial statements have been prepared, in all material respects, in accordance with the same accounting principles followed in the preparation of the Company s annual financial statements for the year ended December 31, 2008. The year-end condensed consolidated balance sheet was derived from the December 31, 2008 audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America. Management believes that all adjustments, which include only normal recurring adjustments necessary to fairly present the Company s consolidated financial position, results of operations and cash flows for the periods reported, have been included. For further information, refer to the consolidated financial statements and accompanying notes included in the Company s Annual Report on Form 10-K for the year ended December 31, 2008.

2. Risks and Uncertainties

For the quarter and six months ended June 30, 2009, nearly 50% of the Company s consolidated net sales were to the automotive market, which is included in the Thermal/Acoustical segment. The Company s North American and European automotive businesses continued to be impacted by global economic conditions resulting in less consumer demand for automobiles. The Company s North American automotive (NA Auto) business was also negatively impacted by the bankruptcy filings of Chrysler and General Motors. In connection with its bankruptcy filing, Chrysler temporarily idled production at most manufacturing plants in the U.S. during a significant portion of the second quarter of 2009 while the company reorganized and had its bankruptcy plan approved in U.S. Bankruptcy Court. Also, General Motors had extended shut-down periods during the second quarter of 2009. Net sales were lower to Chrysler and General Motors by $5.5 million, or 83%, and $0.4 million, or 25%, respectively, in the second quarter of 2009 as compared to the same quarter of 2008.

Both Chrysler and General Motors have advised the Company that Lydall will continue to be a supplier of thermal/acoustical automotive parts to both of the new companies that are emerging from bankruptcy. Both Chrysler and General Motors are in the process of determining which automotive platforms will resume production and the expected volume levels. Future sales volumes with Chrysler and General Motors are dependent on which automobiles are manufactured and the amount of market share attained by Chrysler and General Motors.

The Company has collected substantially all of the outstanding accounts receivable amounts from Chrysler and General Motors as of the bankruptcy filing dates and recorded an immaterial amount of bad debt expense in the second quarter of 2009. Also during the quarter, the Company assessed automobile platform release information currently available from both Chrysler and General Motors, as well as data from automotive market forecasting services available to suppliers, and the Company recorded a write-down of inventory of approximately $0.2 million during the second quarter of 2009. As more information from Chrysler and General Motors becomes available related to platform production, the Company will continue to assess the net realizable value of its finished goods inventory for Chrysler and General Motors.

During the second quarter of 2009, the Company was accepted into the federal Auto Supplier Support Program (Auto Program) that is designed to provide eligible suppliers with access to government-backed protection on those U.S. dollar receivables that are accepted into the Auto Program. The Company is participating in this Auto Program with General Motors and the Company selected the Auto Program option

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that provides government-backed protection on the collection of receivables and includes expedited payment terms, all for which a charge of 3% of the accepted receivables is applicable. The Company is not participating in the Auto Program with Chrysler as the Company was informed that the Auto Program with Chrysler became inactive upon the filing of bankruptcy by Chrysler.

3. Inventories

Inventories as of June 30, 2009 and December 31, 2008 were as follows:

In thousands	June 30, 2009	December 31, 2008
Raw materials	$ 16,732	$ 17,537
Work in process	10,820	11,080
Finished goods	11,560	13,032
	39,112	41,649
Less: Progress billings	(1,511)	(877)
Total inventories	$ 37,601	$ 40,772

Progress billings relate to tooling inventory, which is included in work in process inventory in the above table. Total tooling inventories, net of progress billings, were $4.8 million and $3.9 million at June 30, 2009 and December 31, 2008, respectively.

4. Long-term Debt and Financing Arrangements

On March 11, 2009, the Company and the Company s domestic subsidiaries, as co-borrowers or guarantors, entered into a $35 million senior secured domestic revolving credit facility (Domestic Credit Facility) with a financial institution (Lender), which replaced the Company s prior domestic revolving credit facility that expired on February 1, 2009. Subject to and upon the terms and conditions contained in the Domestic Credit Facility, the Lender agreed to make revolving loans to the Company and its domestic subsidiaries from time to time in amounts requested by the Company and its domestic subsidiaries up to the lesser of the Borrowing Base at such time or the maximum credit of $35 million. The Borrowing Base under the Domestic Credit Facility is comprised of certain percentages of eligible domestic accounts receivable, eligible domestic inventories and eligible domestic fixed assets, reduced by applicable reserves. The Company had no borrowings outstanding under the Domestic Credit Facility at June 30, 2009, or any outstanding borrowings under its previous domestic credit facility at December 31, 2008.

Interest is charged on borrowings at the Company s option of either: (i) the Prime Rate plus the Applicable Margin or (ii) the Eurodollar Rate plus the Applicable Margin. The Prime Rate is a fluctuating rate equal to the higher of the financial institution s prime rate or the federal funds rate plus .50%. The Eurodollar Rate is a fluctuating LIBOR rate offered for deposits in U.S. dollars. The Applicable Margin added to the Prime Rate ranges from 1.25% to 1.75% and the Applicable Margin added to the Eurodollar Rate ranges from 4.25% to 4.75% depending on the type of collateral that supports the outstanding borrowings. The Company also pays .50% per annum on the average daily unused portion of the Domestic Credit Facility and 4.25% per annum on the daily outstanding balance of letters of credit.

Repayment of amounts due and owing under the Domestic Credit Facility is secured by a perfected first priority lien and security interest in most of the present and future assets of the Company and its domestic subsidiaries, as well as 100% of all of the issued and outstanding shares of capital stock of the Company s domestic subsidiaries and a pledge of 65% of the issued and outstanding shares of the capital stock of certain of the Company s foreign subsidiaries. The payment of outstanding principal under the Domestic Credit Facility and accrued interest thereon may be accelerated and become immediately due and payable upon the Company s default in its payment or other performance obligations or its failure to comply with the financial and other covenants set forth in the loan agreement, subject to any applicable notice requirements and cure periods set forth in the loan agreement. The Domestic Credit Facility has a term of three years.

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The loan agreement evidencing the Domestic Credit Facility contains a number of affirmative and negative covenants, including financial covenants. Among others, the Company and its domestic subsidiaries at all times must maintain Excess Availability, as defined in the loan agreement, of not less than $5.0 million. In addition, if the Company s borrowings under the Domestic Credit Facility exceed $5.0 million, or Excess Availability under the Credit Facility is less than $12.5 million, the Company is subject to a minimum cash flow requirement determined as of the end of each month during the period March 31, 2009 to July 31, 2009. Thereafter, if the Company s borrowings under the Domestic Credit Facility exceed $5.0 million, or Excess Availability under the Credit Facility is less than $12.5 million, the Company is required to meet a minimum fixed charge coverage ratio. The fixed charge coverage ratio requires that, at the end of any month, the ratio of consolidated EBITDA to fixed charges may not be less than 1 to 1 for the immediately preceding 12 month period, except that prior to August 31, 2010 compliance with the fixed charge coverage ratio generally shall be measured during the period commencing as of August 1, 2009 and ending as of the last day of the month in the measuring period. During the monthly periods of the second quarter of 2009, the Company s borrowings under the Domestic Credit Facility did not exceed $5.0 million and Excess Availability was not less than $12.5 million, therefore, the Company was not subject to the minimum cash flow requirement. The Credit Facility also generally restricts the Company s ability to pay a cash dividend on its common stock or repurchase shares of common stock, subject to certain stated exceptions.

5. Restructuring and Related Costs

In September 2008, the Company announced that it would be closing its St. Johnsbury, Vermont manufacturing facility and consolidating its North American automotive parts production into its Hamptonville, North Carolina operation. This consolidation is expected to reduce operating costs significantly, increase efficiency and enhance the Company s competitive position while maintaining essentially the same level of manufacturing capacity. The Company commenced the transfer of equipment and production in the first quarter of 2009 and substantially completed the consolidation during the second quarter of 2009.

During the second quarter and first six months of 2009, the Company recorded pre-tax restructuring charges of $3.0 million and $5.1 million, respectively, with over 95% recorded in cost of sales during both periods. All such charges were included in the Thermal/Acoustical segment. These restructuring activity expenses primarily included severance related expenses, acceleration of depreciation expense on fixed assets that were not transferred to the Hamptonville, NC facility, and facility exit, moving and set-up expenses of equipment transferred from St. Johnsbury, VT to Hamptonville, NC.

Actual pre-tax expenses incurred and total estimated pre-tax expenses for the restructuring program by type are as follows:

In thousands	Severance and Related Expenses	Accelerated Depreciation	Facility Exit, Move and Set-up Expenses	Total
Expense incurred during quarter ended December 31, 2008	$ 708	$ 515	$ 344	$ 1,567
Expense incurred during quarter ended March 31, 2009	525	312	1,295	2,132
Expense incurred during quarter ended June 30, 2009	731	149	2,121	3,001
Total pre-tax expense incurred	**$ 1,964**	**$ 976**	**$ 3,760**	**$ 6,700**
Estimated remaining expense at June 30, 2009(1)			$ 600	$ 600
Total estimated pre-tax expense (2)	**$ 1,964**	**$ 976**	**$ 4,360**	**$ 7,300**

(1) The estimated remaining expenses at June 30, 2009 are primarily related to estimated lease termination costs in connection with the St. Johnsbury, VT. facility. The Company expects to record a liability at fair value when Lydall ceases using the right conveyed by the lease agreement, which is expected to occur in the second half of 2009.

(2) At March 31, 2009, the Company estimated the total pre-tax expense for the restructuring program to be approximately $7.0 million. The adjustments to the total estimated expense in the second quarter of 2009 of $0.3 million were the net of an increase in severance and related expenses of $0.3 million, an increase in the expense expected to be incurred for the lease termination in connection with the St. Johnsbury, VT. facility of $0.2 million, and lower acceleration of depreciation expense of $0.2 million.

Accrued severance and related expenses were as follows at June 30, 2009:

In thousands	Total
Balance as of December 31, 2008	$ 687
Pre-tax severance and related charges	1,256
Cash paid	(1,886)
Balance as of June 30, 2009	**$ 57**

Total cash outflows for the restructuring program were $3.4 million and $4.4 million in the second quarter and six months ended June 30, 2009 and are expected to be approximately $1.0 million over the remainder of 2009, with nearly all occurring during the third quarter of 2009.

6. Acquisitions

On December 1, 2008, the Company acquired DSM Solutech B.V., a manufacturer of micro-porous films based in Heerlen, The Netherlands. This acquisition was accounted for using the purchase method set forth in SFAS No. 141, Business Combinations, whereby the purchase consideration was allocated to the estimated fair values of the assets acquired and liabilities assumed at the effective date of the purchase. The Company made a preliminary allocation of the purchase price in the fourth quarter of 2008. This preliminary allocation was subsequently revised during the first quarter of 2009, resulting in an increase in the value of inventory by $0.2 million, a decrease in current accrued liabilities by $0.2 million and a decrease in goodwill of $0.4 million. The Company expects the final allocation of the purchase price to be completed in the third quarter of 2009.

7. Equity Compensation Plans

The Company has stock-based compensation plans under which incentive and non-qualified stock options and time or performance based restricted shares may be granted to employees and outside directors from authorized but unissued shares of common stock or treasury shares. The Company recognizes expense on a straight-line basis over the vesting period of the entire award. Options issued by the Company under its stock option plans have a term of ten years and generally vest ratably over a period of four years. Restricted stock grants are expensed over the vesting period of the award, which is typically four years. Stock-based compensation expense includes the estimated effects of forfeitures. Stock options issued under the current plan must have an exercise price that may not be less than the fair market value of the Company s common stock on the date of grant. The Company incurred compensation expense of $0.2 million for each of the quarters ended June 30, 2009 and June 30, 2008, and compensation expense of $0.6 million for each of the six month periods ended June 30, 2009 and June 30, 2008, for all stock-based compensation plans.

The Company s stockholders approved the amendment and restatement of the Lydall 2003 Stock Incentive Compensation Plan (Plan) at the Company s Annual Meeting of Stockholders held on April 24, 2009. The amendment and restatement increased the total authorized shares available for distribution under the Plan by an additional 1.0 million shares, for a total of 2.5 million authorized shares.

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Stock Options

The following table is a summary of option activity of the Company s plans during the six months ended June 30, 2009:

In thousands except per share amounts	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (years)	Aggregate Intrinsic Value
Outstanding at December 31, 2008	**832**	$ 9.72		
Granted	**23**	$ 3.67		
Exercised		$		
Forfeited/Cancelled	**(94)**	$ 9.69		
Outstanding at June 30, 2009	**761**	$ 9.54	**5.9**	**$**
Options exercisable at June 30, 2009	**493**	$ 10.21	**4.4**	**$**

There were 23,275 and 31,544 options granted during the quarter and six months ended June 30, 2009 and 2008, respectively. There were no options exercised during the quarter and six months ended June 30, 2009. The total intrinsic value of options exercised during the quarter ended June 30, 2008 was $0.2 million and the amount of cash received from the exercise of stock options was $0.6 million. The total intrinsic value of options exercised during the six months ended June 30, 2008 was $0.2 million and the amount of cash received from the exercise of stock options was $0.7 million. At June 30, 2009, the total unrecognized compensation cost related to nonvested stock option awards was approximately $0.8 million, with a weighted average expected amortization period of 2.4 years.

The grant date fair value of options is based upon the closing price on the date of grant using the Black-Scholes option pricing model. Expected volatility is based on the historical volatility of the Company s stock. The Company uses historical option exercise behavior and employee termination data to estimate expected term and forfeiture rates, which represents the period of time that the options granted are expected to remain outstanding. The risk-free rate of return for the estimated life of the option is based on the U.S. Treasury bond rate in effect at the time of grant. The fair value of each option granted was estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions for the six months ended:

	Six Months Ended June 30,	
	2009	**2008**
Risk-free interest rate	2.48%	4.91%
Expected life	6.6 years	5.8 years
Expected volatility	57%	44%
Expected dividend yield	0%	0%

Restricted Stock

At June 30, 2009, the total unrecognized compensation cost related to non-vested restricted stock awards was approximately $1.2 million, with a weighted average expected amortization period of 2.6 years. The following is a summary of the status of the Company s non-vested restricted shares as of June 30, 2009:

In thousands except per share amounts	Shares		Weighted-Average Grant-Date Fair Value
Nonvested at December 31, 2008	**191**	$	7.93
Granted	**71**	$	5.25
Vested		$	
Forfeited	**(7)**	$	7.38
Nonvested at June 30, 2009	**255**	$	7.20

8. Capital Stock

Shareholder rights plan In the second quarter of 2009, the Company s Board of Directors adopted a Shareholder Rights Plan by granting a dividend of one preferred share purchase right for each common share to shareholders of record at the close of business on July 6, 2009. Under certain conditions, each right entitles the holder to purchase one one-thousandth of a Series A Junior Participating Preferred Share of the Company, at a price of $20 per one one-thousandth of a share, subject to adjustment. The rights cannot be exercised or transferred apart from the related common shares unless a person or group acquires 15% or more of the Company s outstanding common shares. The rights will expire on June 12, 2012 unless earlier redeemed or exchanged by the Company.

9. Employer Sponsored Benefit Plans

As of June 30, 2009, the Company maintains three defined benefit pension plans (pension plans) that cover the majority of domestic Lydall employees. The pension plans are noncontributory and benefits are based on either years of service or eligible compensation paid while a participant is in a plan. Lydall closed its non-union pension plans to new employees hired after December 31, 2005 and, effective June 30, 2006, benefits under these pension plans stopped accruing for all eligible employees not covered under a collective bargaining agreement.

On May 4, 2009, the Company completed negotiations on a new collective bargaining agreement with the majority of its domestic union employees. As a result, benefits under the union employee pension plan for such employees stopped accruing effective July 1, 2009. This amendment to the pension plan resulted in a pension curtailment loss of $0.2 million during the second quarter of 2009. The measurement of pension plan liabilities for the defined benefit pension plan impacted by the amendment, resulted in the reductions of: (i) pension liabilities by $0.2 million, (ii) deferred tax assets by $0.1 million and (iv) accumulated other comprehensive loss by $0.1 million, during the quarter ended June 30, 2009.

During the second quarter of 2009, the Company terminated its unfunded Supplemental Executive Retirement Plan (SERP), which provided supplemental income payments after retirement to certain former senior executives (participants). The Company made lump-sum payments to the participants of $1.4 million during the second quarter of 2009. The termination of the SERP plan resulted in an immaterial settlement gain during the quarter ended June 30, 2009. While the SERP was unfunded, the Company owned executive life insurance policies on the participants, which the Company surrendered and received proceeds of $3.8 million in the second quarter of 2009. These Company-owned life insurance policies were previously recorded in other assets, net on the Company s Condensed Consolidated Balance Sheets.

The Company s funding policy for its pension plans is to fund not less than the ERISA minimum funding standard and not more than the maximum amount that can be deducted for federal income tax purposes. The Company expects to contribute up to $1.8 million in cash to its defined benefit pension plans in 2009 including the $1.4 million contributed to the SERP to terminate the SERP in the second quarter of 2009. Contributions of $1.5 million were made during the second quarter of 2009 and $1.6 million for the six months ended June 30, 2009. Contributions of $0.2 million were made during the second quarter of 2008 and for the six months ended June 30, 2008.

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The following is a summary of the components of net periodic benefit cost (income) for the quarters and six months ended June 30, 2009 and 2008:

In thousands	Quarter Ended June 30, 2009	Quarter Ended June 30, 2008	Six Months Ended June 30, 2009	Six Months Ended June 30, 2008
Components of net periodic benefit cost:				
Service cost	$ 22	$ 23	$ 46	$ 46
Interest cost	610	641	1,261	1,282
Expected return on assets	(507)	(787)	(1,018)	(1,574)
Curtailment loss	201		201	
Amortization of actuarial loss and prior service cost	169	45	350	91
Net periodic benefit cost (income)	$ 495	$ (78)	$ 840	$ (155)

On March 17, 2009, in response to the continued global economic decline impacting the markets that the Company serves, Lydall announced the suspension of the Company s matching contribution to its sponsored 401(k) plan, beginning with the first payroll of May 2009, for all non-union domestic employees.

10. Income Taxes

The Company and its subsidiaries file a consolidated federal income tax return, as well as returns required by various state and foreign jurisdictions. In the normal course of business the Company is subject to examination by taxing authorities, including such jurisdictions as the United States, France and Germany. With few exceptions, the Company is no longer subject to U.S. federal, state and local, or non-U.S. income tax examinations for years before 2004. As of June 30, 2009, the net amount of unrecognized tax benefits was $1.1 million. The total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate is $1.1 million. There have been no significant changes to these amounts during the quarter or six months ended June 30, 2009.

11. Comprehensive Income

Comprehensive (loss) income for the periods ended June 30, 2009 and 2008 was as follows:

In thousands	Quarter Ended June 30, 2009	Quarter Ended June 30, 2008	Six Months Ended June 30, 2009	Six Months Ended June 30, 2008
Net (loss) income	$ (5,938)	$ 2,898	$ (10,458)	$ 6,093
Changes in accumulated other comprehensive income:				
Foreign currency translation adjustments	4,141	(225)	301	5,065
Pension liability adjustment, net of tax	353	29	427	58
Unrealized gain (loss) on derivative instruments, net of tax	17	51	(6)	(1)
Total comprehensive (loss) income	$ (1,427)	$ 2,753	$ (9,736)	$ 11,215

12. Fair Value Measurements

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements (FAS 157). This Statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. This Statement was effective for the Company beginning on January 1, 2008, except that FSP 157-2 delayed the effective date of FAS 157 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis, until fiscal years beginning after November 15, 2008.

The Company adopted FAS 157 on January 1, 2008, with the exception of the application of the Statement to non-recurring nonfinancial assets and liabilities measured at fair value. The Company adopted the application of the Statement for non-recurring nonfinancial assets and liabilities measured at fair value on January 1, 2009, however, there were no non-financial assets or liabilities requiring initial measurement in the first quarter of 2009 or subsequent remeasurement during the second quarter of 2009. Therefore, the implementation of FAS 157 for non-recurring nonfinancial assets and liabilities had no effect on the Company s consolidated financial position, results of operations or cash flows during the first and second quarters of 2009.

The following table provides a summary of assets carried at fair value as of June 30, 2009:

In thousands	Total Carrying Value at June 30, 2009	Fair Value measurements at June 30, 2009 using Quoted prices In active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Forward exchange contracts	$ 553	$	$ 553	$

The following table provides the assets carried at fair value measured on a recurring basis as of December 31, 2008:

In thousands	Total Carrying Value at December 31, 2008	Fair Value measurements at December 31, 2008 using Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Forward exchange contracts	$ 453	$	$ 453	$

Derivative valuations are based on observable inputs to a valuation model including interest rates and foreign currency exchange rates and are classified within Level 2 of the valuation hierarchy.

13. Derivative Instruments and Hedging Activities

In March 2008, the FASB issued SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities-an amendment of FASB Statement No. 133 (FAS 161). FAS 161 requires enhanced disclosures about how and why an entity uses derivative instruments, how they are accounted for under SFAS No. 133 and how they affect an entity s financial position, results of operations and cash flows. The Statement was adopted as of January 1, 2009. The adoption of FAS 161 had no effect on the Company s consolidated financial position, results of operations or cash flows.

In general, the types of risks being hedged by the Company are related to the variability of future cash flows caused by changes in foreign currency exchange rates and forward foreign exchange contracts to manage exposure to certain inter-company loans with the Company s foreign affiliates. Occasionally, the Company will also hedge the variability of future cash flows related to expected purchases of inventory and property, plant and equipment in a non-functional currency. All such contracts limit exposure to both favorable and unfavorable currency

fluctuations. The Company does not engage in derivative instruments for speculative purposes.

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For derivative instruments that are designated and qualify as a fair value hedge, the gain or loss on the derivative as well as the offsetting loss or gain on the hedged item attributable to the hedged risk are recognized in current earnings. The Company includes the gain or loss on the derivative in the same line item as the offsetting gain or loss on the related hedged item.

For derivative instruments that are designated and qualify as a cash flow hedge, the effective portion of the gain or loss on the derivative is reported as a component of other comprehensive income and reclassified into earnings in the same period or periods in which the hedge transaction affects earnings. Gain or loss from derivatives designated as cash flow hedging instruments during the quarter and six months ended June 30, 2009 was immaterial.

All derivatives are recognized at fair value in the balance sheet and recorded in either current or noncurrent other assets or other accrued liabilities or other long-term liabilities depending upon maturity and commitment. The amounts noted in the tables below for other income, net do not include any adjustments for the impact of deferred income taxes.

The fair value of derivative instruments at June 30, 2009 is summarized in the following table:

	Asset Derivatives		Liability Derivatives	
In thousands	**Balance Sheet Location**	**Fair Value**	**Balance Sheet Location**	**Fair Value**
Derivatives designated as hedging instruments under SFAS 133:				
Foreign exchange contracts	Other non-current assets	$ 553	Other liabilities	$
Total Derivatives		**$ 553**		**$**

The effect of derivative instruments on the consolidated statement of operations for fair value hedging instruments for the quarter and six months ended June 30, 2009:

		Gain (Loss) Recognized in Earnings	
In thousands	**Location of Gain (Loss) Recognized in Earnings**	**Quarter Ended June 30, 2009**	**Six Months Ended June 30, 2009**
Foreign exchange contracts	Other income, net	$ 323	$ 110
Total		**$ 323**	**$ 110**

The effect of derivative instruments on the consolidated statement of operations for cash flow hedging instruments was immaterial for the quarter and six months ended June 30, 2009.

14. Earnings Per Share

Basic and diluted earnings per common share are calculated in accordance with the provisions of Statement of Financial Accounting Standards (SFAS) No. 128, Earnings per Share. Basic earnings per common share are equal to net income divided by the weighted average number of common shares outstanding during the period. Diluted earnings per common share are equal to net income divided by the weighted average number of common shares outstanding during the period, including the effect of stock options and stock awards, where such effect is dilutive.

The following table provides a reconciliation of weighted-average shares used to determine basic and diluted earnings per share.

In thousands	Quarter Ended June 30, 2009	Quarter Ended June 30, 2008	Six Months Ended June 30, 2009	Six Months Ended June 30, 2008
Basic average common shares outstanding	16,544	16,439	16,544	16,422
Effect of dilutive options and restricted stock awards		171		94
Diluted average common shares outstanding	16,544	16,610	16,544	16,516

For the quarter ended June 30, 2009 and June 30, 2008, stock options and restricted stock awards for 1.0 million and 0.2 million shares of common stock, respectively, were not considered in computing diluted earnings per common share because they were antidilutive. For the six months ended June 30, 2009 and June 30, 2008, stock options and restricted stock awards for 1.0 million and 0.2 million shares of common stock, respectively, were not considered in computing diluted earnings per common share because they were antidilutive.

15. Segment Information

The Company s reportable segments are Performance Materials and Thermal/Acoustical. The Performance Materials segment reports the results of the filtration businesses and the industrial thermal insulation business. The Thermal/Acoustical segment reports the results of the Company s automotive businesses. All other businesses are aggregated in Other Products and Services (OPS). OPS is comprised of the Company s vital fluids business and Affinity® temperature control equipment business.

Performance Materials Segment

The Performance Materials Segment includes filtration media solutions for air, fluid power, industrial and life science applications and industrial thermal insulation solutions for building products, appliances, and energy and industrial markets.

Lydall air filtration products include LydAir®MG (Micro-Glass), LydAir®MB (Melt Blown) and LydAir®SC (Synthetic Composite) media. These products constitute the critical media component of clean-air systems for applications in clean-space, commercial, industrial and residential HVAC, power generation, industrial processes and protection/respiratory devices. Lydall has leveraged its extensive technical expertise and applications knowledge into a suite of media products covering the vast liquid filtration landscape across the Engine & Industrial and Life Science fields. The LyPore® and activated carbon containing ActiPure® media series address a variety of application needs including hydraulic filters, air-water and air-oil coalescing, industrial fluid processes, diesel filtration, biopharmaceutical pre-filtration and clarification, diagnostic tests, and drinking water filtration.

The acquisition of DSM Solutech B.V. in December 2008 allows the Company to manufacture micro-porous films (trade names Solupor® and Solufill®) using proprietary technology. Lydall Solupor® specialty microporous membranes are utilized in various markets and applications including batteries, fuel cells and supercapacitors, air and liquid filtration, and transdermal drug delivery. Solupor® membranes are based on ultra-high molecular weight polyethylene and incorporate an uncommon combination of mechanical strength, chemical inertness, and high porosity in a unique open structure.

The Company s industrial thermal insulation business develops unique high performance non-woven veils, papers, mats and specialty composites for the building products, appliance, and energy and industrial markets. The Manniglas® brand is diverse in its product application ranging from high temperature seals and gaskets in ovens and ranges to specialty veils for HVAC and cavity wall insulation. Apply Mat has been developed to expand Lydall s high temperature technology portfolio for broad application into the appliance market and supplements the Lytherm product brand, traditionally utilized in the Industrial market for kilns

and furnaces used in metal processing. CryoTherm®, a super insulation product, is an industry standard used by manufacturers of cryogenic equipment for liquid gas storage and transportation.

Thermal/Acoustical Segment

The Thermal/Acoustical segment primarily provides automotive thermal and acoustical barriers, including ZeroClearance®, AMS®, dB-Lyte® , dBCore® and LyTherm® products, which are comprised of organic and inorganic fiber composites, fiber and metal combinations and all metal components that are used in cars, trucks, sport utility vehicles and vans. The Company holds patents on several of these products that can be employed on both the interior and exterior of vehicle passenger cabins and within the engine compartment and around such components as exhaust systems, fuel systems, heat and air-conditioning ducts, power trains, batteries and electronic components.

Other Products and Services

The components of OPS are Lydall s vital fluids business and Affinity® temperature control equipment business.

The Company s vital fluids business serves the life science industry offering specialty products for blood transfusion and cell therapy applications as well as Bio-Pak® single-use bioprocessing containers for containment of media, buffers and bulk intermediates used in Biotech, Pharmaceutical and Diagnostic reagent manufacturing processes. Additionally, its medical filter materials products are utilized in traditional blood filtration devices such as cardiotomy reservoirs and autotransfusion filters.

Lydall s Affinity® temperature control equipment business designs and manufactures high precision, specialty engineered temperature-control equipment for demanding semiconductor, pharmaceutical, life sciences and industrial applications.

The table below presents net sales and operating income by segment for the quarters and six months ended June 30, 2009 and 2008 and also a reconciliation of total segment net sales and operating income to total consolidated net sales and operating income.

In thousands	Quarter Ended June 30, 2009	Quarter Ended June 30, 2008	Six Months Ended June 30, 2009	Six Months Ended June 30, 2008
Performance Materials:				
Filtration	$ 15,869	$ 19,856	$ 30,580	$ 38,819
Industrial Thermal Insulation	7,349	11,335	15,015	22,154
Performance Materials Segment net sales	$ 23,218	$ 31,191	$ 45,595	$ 60,973
Thermal/Acoustical:				
Automotive parts	$ 23,454	$ 41,239	$ 46,812	$ 84,155
Automotive tooling	4,085	3,743	7,601	12,127
Thermal/Acoustical Segment net sales	$ 27,539	$ 44,982	$ 54,413	$ 96,282
Other Products and Services:				
Vital Fluids	$ 3,845	$ 4,220	$ 6,928	$ 8,381
Affinity® temperature control equipment	1,414	3,892	3,725	8,908
Other Products and Services net sales	$ 5,259	$ 8,112	$ 10,653	$ 17,289
Eliminations and Other	(35)	(327)	(347)	(691)
Consolidated Net Sales	$ 55,981	$ 83,958	$ 110,314	$ 173,853

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Operating income by segment was as follows:

In thousands	Quarter Ended June 30, 2009	Quarter Ended June 30, 2008	Six Months Ended June 30, 2009	Six Months Ended June 30, 2008
Performance Materials	$ 1,119	$ 4,864	$ 2,375	$ 9,476
Thermal/Acoustical	(5,758)	2,854	(10,067)	7,520
Other Products and Services	(861)	(340)	(1,661)	(568)
Corporate Office Expenses	(3,052)	(2,901)	(6,288)	(6,878)
Consolidated Operating Income	$ (8,552)	$ 4,477	$ (15,641)	$ 9,550

Total assets by Segment and for OPS and the Corporate Office were as follows at June 30, 2009 and December 31, 2008:

Total Assets		
In thousands	**June 30, 2009**	**December 31, 2008**
Performance Materials Segment	$ 78,495	$ 83,357
Thermal/Acoustical Segment	112,084	118,921
Other Products and Services	18,249	18,386
Corporate Office	15,705	17,024
Consolidated Total Assets	$ 224,533	$ 237,688

16. Commitments and Contingencies

As of June 30, 2009, the Company s global automotive operation had unconditional purchase obligations to acquire aluminum of approximately $3.5 million, $11.5 million and $10.9 million in 2009, 2010 and 2011, respectively.

17. Recently Issued Accounting Standards

In December 2007, the FASB issued SFAS No. 141R, Business Combinations (FAS 141R). FAS 141R amends FAS 141 and provides revised guidance requiring the acquirer to recognize and measure, at fair value on the acquisition date, identifiable assets and goodwill acquired, liabilities assumed, and any non-controlling interest in the acquiree. Transaction and restructuring costs generally will be expensed as incurred. The Statement also provides disclosure requirements to enable users of the financial statements to evaluate the nature and financial effects of the business combination. The Company adopted FAS 141R on January 1, 2009 and the adoption did not impact the Company s financial statements.

In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements an amendment of Accounting Research Bulletin (ARB) No. 51 (FAS 160). FAS 160 requires that ownership interests in subsidiaries held by parties other than the parent, and the amount of consolidated net income, be clearly identified, labeled, and presented in the consolidated financial statements. It also requires once a subsidiary is deconsolidated, any retained noncontrolling equity investment in the former subsidiary be initially measured at fair value. The adoption of FAS 160 did not impact the Company s consolidated financial position, results of operations or cash flows upon adoption on January 1, 2009.

In May 2008, the FASB issued SFAS No. 162, The Hierarchy of Generally Accepted Accounting Principles (FAS 162), which became effective on November 13, 2008. FAS 162 identified the sources of accounting principles and the framework for selecting the principles used in preparing the financial statements of nongovernmental entities that are presented in conformity with Generally Accepted Accounting Principles (GAAP). FAS 162 arranged these sources of GAAP in a hierarchy for users to apply accordingly. This

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statement documents the hierarchy of the various sources of accounting principles and the framework for selecting the principles used in preparing financial statements. FAS 162 was replaced by the issuance of SFAS No. 168, The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles a replacement of FASB Statement No. 162 (FAS 168) in June 2009. FAS 168 will become the source of authoritative GAAP recognized by the FASB to be applied by nongovernmental entities. Rules and interpretive releases of the Securities and Exchange Commission (SEC) under authority of federal securities laws are also sources of authoritative GAAP for SEC registrants. On the effective date of this Statement, the Codification will supersede all then-existing non-SEC accounting and reporting standards. All other nongrandfathered non-SEC accounting literature not included in the Codification will become nonauthoritative. This Statement is effective for financial statements issued for interim and annual periods ending after September 15, 2009. The adoption of FAS 168 is not expected to have a material effect on the Company s consolidated financial position, results of operations or cash flows.

In May 2009, the FASB issued SFAS No. 165, Subsequent Events (FAS 165). This statement establishes principles and requirements for subsequent events. The statement sets forth the period after the balance sheet date and the circumstances under which an entity shall evaluate events or transactions for potential recognition or disclosure in the financial statements. The Statement also requires entities to disclose the date through which an entity has evaluated subsequent events and the basis for that date, that is, whether the date represents the date the financial statements were issued or were available to be issued. FAS 165 was effective for interim and financial periods ending after June 15, 2009. The Company adopted FAS 165 on June 30, 2009 and the adoption did not impact the Company s financial statements. The subsequent events review performed by the Company was completed on August 3, 2009 which was the date the financial statements were issued.

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Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations
Cautionary Note Concerning Factors That May Affect Future Results

In the interest of more meaningful disclosure, Lydall and its management make statements regarding the future outlook of the Company, which constitute forward-looking statements under the securities laws. These forward-looking statements are intended to provide management s current expectations for the future operating and financial performance of the Company, based on assumptions and estimates currently believed to be valid. Forward-looking statements are included under the Overview and Outlook section of this Item and elsewhere within this report and are generally identified through the use of language such as believes, expects, may, plans, projects, estimates, anticipates, targets, fore words of similar meaning in connection with the discussion of future operating or financial performance. All forward-looking statements involve risks and uncertainties that could cause actual results to differ materially from those expressed or implied in the forward-looking statements.

Some of the factors that might cause such a difference include risks and uncertainties which are detailed in the Management s Discussion and Analysis of Financial Condition and Results of Operations-Cautionary Note Concerning Factors That May Affect Future Results and Risk Factors sections of the Company s Annual Report on Form 10-K for the year ended December 31, 2008, as well as in Note 2 and this section of this Quarterly Report on Form 10-Q. Such risks include, among others: the global credit and financial markets that have been experiencing extreme disruptions in recent months, including severely diminished liquidity and credit availability, declines in consumer confidence, declines in economic growth, increases in unemployment rates and uncertainty about economic stability. There can be no assurance that there will not be further deterioration in the credit and financial markets and in economic conditions. These economic uncertainties affect businesses such as the Company s in a number of ways, making it difficult to accurately forecast and plan our future business activities.

Also, the banking system and financial markets have experienced significant disruption in recent months, including bank failures and consolidations and diminished liquidity and credit availability. The Company has credit agreements with various financial institutions. If any of the financial institutions were unable to honor their funding commitments it could have a material adverse effect on the Company.

In addition, as set forth in the Company s Domestic Credit Facility, the Company is subject to a number of affirmative and negative covenants, including financial covenants, which may impact the Company s ability to borrow funds under the Domestic Credit Facility. Among others, the Company and its domestic subsidiaries at all times must maintain Excess Availability, as defined in the loan agreement, of not less than $5.0 million. In addition, if the Company s borrowings under the Domestic Credit Facility exceed $5.0 million, or Excess Availability under the Credit Facility is less than $12.5 million, the Company is subject to a minimum cash flow requirement determined as of the end of each month during the period March 31, 2009 to July 31, 2009. Thereafter, if the Company s borrowings under the Domestic Credit Facility exceed $5.0 million, or Excess Availability under the Credit Facility is less than $12.5 million, the Company is required to meet a minimum fixed charge coverage ratio. The fixed charge coverage ratio requires that, at the end of any month, the ratio of consolidated EBITDA to fixed charges may not be less than 1 to 1 for the immediately preceding 12 month period, except that prior to August 31, 2010 compliance with the fixed charge coverage ratio generally shall be measured during the period commencing as of August 1, 2009 and ending as of the last day of the month in the measuring period.

The Company s borrowings under the Domestic Credit Facility have not exceeded $5.0 million at any time since the creation of the Domestic Credit Facility and the Excess Availability under the Domestic Credit Facility has not been less than $12.5 million. However, the Company did not meet the minimum cash flow requirement that would have been applicable for the months ended April 2009 through June 2009 if such borrowings had exceeded $5.0 million or the Excess Availability had been less than $12.5 million. As a result, the Company is effectively limited to borrowing the lesser of $5.0 million, or an amount that does not reduce Excess Availability below $12.5 million, under the Domestic Credit Facility until such time as it meets the required minimum cash flow requirement or fixed charge coverage ratio set forth in the Loan Agreement. As of June 30, 2009, the Company was limited to borrowing up to $5.0 million under the Domestic Credit Facility.

There can be no assurance that the Company will be able to meet the minimum cash flow requirement or the fixed charge coverage ratio set forth in the Loan Agreement. In such event, the Company s borrowing capacity under the Domestic Credit Facility would be limited to the lesser of $5.0 million, or an amount that does not reduce Excess Availability below $12.5 million, in order to avoid the creation of an Event of Default. Whether or not the Company is able to meet the minimum cash flow requirement or minimum fixed charge coverage ratio set forth in the Loan Agreement, the Company believes that its currently available resources and its accessibility to debt financing sources are sufficient to satisfy its cash requirements for the foreseeable future.

In the second quarter of 2009, the Company s North American automotive (NA Auto) business was negatively impacted by the bankruptcy filings of Chrysler and General Motors. Both Chrysler and General Motors have advised the Company that Lydall will continue to be a supplier of thermal/acoustical automotive parts to both of the new companies that are emerging from bankruptcy. Both Chrysler and General Motors are in the process of determining which automotive platforms will commence production and at what volume levels. Future sales volumes with Chrysler and General Motors are dependent on which automobiles are manufactured and the amount of market share attained by Chrysler and General Motors. The Company assessed automobile platform release information currently available from both Chrysler and General Motors, as well as data from automotive market forecasting services available to suppliers, and recorded a write-down of inventory of approximately $0.2 million during the second quarter of 2009. As more information from Chrysler and General Motors becomes available related to platform production, the Company will continue to assess the net realizable value of its finished goods inventory for Chrysler and General Motors.

In addition to the foregoing, doing business in the North American and European automotive markets also contains other risks, including: a continued reduction in consumer demand for automobiles; further financial difficulties faced by automakers and other automotive customers; the potential impact thereof on labor unrest, supply chain disruptions, and the collectibility of any accounts receivable due to the Company from such automakers and other automotive customers. Also, consolidation among automotive parts suppliers and customers, pricing for automotive products and dependence on large customers, could impact the Company s ability to compete. The Company typically has significant amounts of accounts receivable from automakers and other automotive customers outstanding at any point in time.

Other risk factors that can impact the Company s businesses include: unforeseen changes in raw material pricing and supply, specifically, aluminum and other metals used in most of the Company s heat-shield products and various fibers used in thermal/acoustical and performance materials products; increases in energy pricing; inherent risks at international operations; including fluctuations in foreign exchange rates; expansion into new geographic regions; the timing and performance of new-product introductions; realizing savings from Lean Six Sigma Initiatives; compliance with environmental laws and regulations; outcomes of legal contingencies or assertions by or against the Company relating to intellectual property rights; changes in tax laws and rates; strategic transactions, including restructurings; and other disruptions such as a natural disaster or terrorism can impact Lydall s projected results.

Lydall does not undertake to update any forward-looking statement made in this report or that may from time to time be made by or on behalf of the Company.

Overview and Outlook

Lydall designs and manufactures specialty engineered filtration media, industrial thermal insulating solutions, automotive thermal and acoustical barriers, temperature-control equipment, medical filtration media and devices and biopharmaceutical processing components for demanding thermal/acoustical, filtration/separation and biopharmaceutical applications.

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Business Environment Overview

Lydall s second quarter of 2009 and year-to-date financial results were adversely impacted by the ongoing global economic recession. In most markets that the Company s businesses serve, Lydall experienced significant reductions in revenues in the second quarter of 2009, as compared to the second quarter of the prior year, due to the continued economic recession. Specifically, the Company s North American and European automotive businesses continued to be impacted by global economic conditions resulting in less consumer demand for automobiles. The Company s North American automotive (NA Auto) business was also negatively impacted by the bankruptcy filings of Chrysler and General Motors. In connection with its bankruptcy filing, Chrysler temporarily idled production at most manufacturing plants in the U.S. during a significant portion of the second quarter of 2009 while the company reorganized and had its bankruptcy plan approved in U.S. Bankruptcy Court. Also, General Motors had extended shut-down periods during the second quarter of 2009. Net sales were lower to Chrysler and General Motors by $5.5 million, or 83%, and $0.4 million, or 25%, respectively, in the second quarter of 2009 as compared to the same quarter of 2008.

According to CSM Worldwide, an automotive market forecasting service available to suppliers, in the second quarter of 2009, production of cars and light trucks in North America and Europe was estimated to be approximately 48% and 27%, respectively, less than the comparable period of 2008. In the Company s Performance Materials segment, demand for the Company s filtration and industrial thermal insulation products continued to be negatively impacted by customers maintaining lower production schedules due to reduced demand for their products. Lydall expects this weak demand with respect to the automotive industry as well as with other markets in which the Company operates to persist in the second half 2009, adversely affecting the Company s revenues and profitability. Given the nature of the global economic recession and its effects on the markets in which the Company operates, Lydall is unable to predict the likely duration and severity of the current economic recession, or its impact on the Company s financial results.

Operational Matters

Performance Materials Segment

During the second quarter of 2009, the Company s filtration and industrial thermal insulation businesses continued to be impacted by negative global economic conditions. Many of the Company s filtration media customers maintained lower production schedules due to reduced demand for their products. In addition, the Company s industrial thermal insulation business continued to be negatively impacted by the lower construction of new home and commercial buildings in the U.S., as well as lower demand for the Company s industrial and energy products. As a result of these conditions, for the quarter ended June 30, 2009, net sales and operating income for the Performance Materials Segment were $23.2 million and $1.1 million, respectively, compared to net sales and operating income of $31.2 million and $4.9 million, respectively, in the second quarter of 2008. For the remainder of 2009, the Company expects overall demand for its filtration and industrial thermal insulation products to be negatively impacted by the continued global economic recession as compared to the second half of 2008.

Thermal/Acoustical Segment

For the quarter ended June 30, 2009, net sales for the Thermal/Acoustical Segment were $27.5 million or approximately 33% lower than second quarter of 2008 after excluding the impact of foreign currency translation. The Thermal/Acoustical segment reported an operating loss of $5.8 million in the second quarter of 2009, as compared to operating income of $2.9 million in the quarter ended June 30, 2008. The second quarter of 2009 included restructuring charges attributable to the consolidation of the NA Auto operations of $3.0 million.

The Company s Thermal/Acoustical Segment is comprised of Lydall s global automotive parts business, and global automotive net sales represented approximately 50% of the Company s net sales in the second quarter of 2009. The Company s NA Auto and European automotive (Euro Auto) businesses continued to be severely impacted by less demand for automobiles by consumers, which resulted in lower production of automobiles by automakers in the U.S. and Europe. Net sales from the Company s NA Auto business were also negatively impacted by the bankruptcy filings of Chrysler and General Motors. The Company has collected substantially all of the outstanding accounts receivable amounts from Chrysler and General Motors as of the bankruptcy filing dates and recorded an immaterial amount of bad debt expense in the second quarter of 2009.

During the second quarter of 2009, the Company was accepted into the federal Auto Supplier Support Program (Auto Program) that is designed to provide eligible suppliers with access to government-backed protection on those U.S. dollar receivables that are accepted into the Auto Program. The Company is participating in this Auto Program with General Motors and the Company selected the Auto Program option that provides government-backed protection on the collection of the receivables and includes expedited payment terms, all for which a charge of 3% of the accepted receivables is applicable. The Company is not participating in the Auto Program with Chrysler as the Company was informed that the Auto Program with Chrysler became inactive upon the filing of bankruptcy by Chrysler.

During the second quarter of 2009, the Company substantially completed its previously announced plan to close its St. Johnsbury, Vermont facility and consolidate its North American automotive parts production into its Hamptonville, North Carolina operation. This consolidation is expected to reduce operating costs, increase efficiency, and enhance the Company s competitive position, while maintaining essentially the same level of manufacturing capacity. Beginning in the third quarter of 2009, the Company expects to start to benefit from reduced costs. On an annualized basis, the Company expects to save approximately $3.5 million to $4.0 million in costs as a result of this consolidation.

Looking forward into the second half of 2009, current global economic conditions, including consumer credit restrictions, are expected to continue to negatively impact consumers demand for automobiles, and the Company s automotive parts sales are expected to be adversely impacted. According to CSM Worldwide, production of automobiles in North America and Europe in 2009 are expected to be approximately 27% lower than 2008 production and approximately 34% lower than 2007 production levels. As a result, the Company expects lower net sales from the Company s global automotive businesses in 2009 as compared to 2008.

Other Products and Services

The Company s vital fluids business, which serves the life science industry, reported net sales of $3.8 million and operating income of $0.1 million in the second quarter of 2009 as compared to $4.2 million of net sales and $0.2 million of operating income in the comparable period of 2008. The Company is taking steps to increase its market share in the bioprocessing market and expects to invest approximately $2.2 million in new capital equipment in 2009. During the first six months of 2009, the Company invested $1.0 million in new capital equipment that is expected to be placed in service in the latter part of 2009.

Market conditions in the semiconductor industry continue to negatively impact capital equipment spending by that industry. As a result, the Company s Affinity® temperature control equipment business (Affinity) which primarily serves the semiconductor industry reported net sales of $1.4 million and an operating loss of $1.0 million in the second quarter of 2009. Affinity reported net sales of $3.9 million and an operating loss of $0.5 million in the second quarter of 2008. The Company expects the depressed capital equipment spending to continue to negatively impact the Company s Affinity business during the remainder of 2009.

Results of Continuing Operations

The following table presents selected statement of operations line items for the quarter and six months ended June 30, 2009 on a comparative basis with the quarter and six months ended June 30, 2008 expressed as a relative percentage of consolidated net sales:

	Quarter Ended		Six Months Ended	
In thousands	June 30, 2009	June 30, 2008	June 30, 2009	June 30, 2008
Net sales	100.0%	100.0%	100.0%	100.0%
Cost of sales	92.6%	77.2%	90.8%	77.0%
Gross margin	7.4%	22.8%	9.2%	23.0%
Selling, product development and administrative expenses	22.7%	17.5%	23.4%	17.5%
Operating (loss) income from continuing operations	(15.3)%	5.3%	(14.2)%	5.5%
Net (loss) income	(10.6)%	3.5%	(9.5)%	3.5%

Note: All of the following tabular comparisons, unless otherwise indicated, are for the three month periods ended June 30, 2009 (Q2-09) and June 30, 2008 (Q2-08) and for the six months ended June 30, 2009 (YTD-09) and June 30, 2008 (YTD-08). In addition, all of the results of operations within this Item exclude the results of the Transport business, a discontinued operation.

Net Sales

	Quarter Ended		Percent	Six Months Ended		Percent
In thousands	Q2-09	Q2-08	Change	YTD-09	YTD-08	Change
Net sales	$ 55,981	$ 83,958	(33.3)%	$ 110,314	$ 173,853	(36.5)%

Excluding the impact of foreign currency translation, net sales for the current quarter decreased by $24.6 million, or 29.3%, when compared to the second quarter of 2008. In the Thermal/Acoustical segment, net sales decreased by $15.0 million, or 33.4%, excluding the impact of foreign currency translation, as automotive parts net sales decreased by $15.8 million and tooling net sales increased by $0.8 million. Excluding the impact of foreign currency translation, Performance Materials segment net sales decreased by $7.0 million, or 22.4%, in the second quarter of 2009, as compared to the second quarter of 2008. Filtration and industrial thermal insulation product net sales decreased by $3.0 million and $4.0 million, respectively. Net sales of Other Products and Services (OPS) in the second quarter of 2009 decreased by $2.9 million, or 35.2%, as compared to the same quarter a year ago. The Affinity® temperature control equipment business posted decreased net sales of $2.5 million and net sales from the Company s vital fluids business were lower by $0.4 million compared to the second quarter of 2008.

Excluding the impact of foreign currency translation, net sales for the six months ended June 30, 2009 decreased by $57.0 million, or 32.8%, when compared to the first six months of 2008. In the Thermal/Acoustical segment, net sales decreased by $37.4 million, excluding the impact of foreign currency translation, as automotive parts net sales decreased by $33.7 million and tooling net sales decreased by $3.7 million. Excluding the impact of foreign currency translation, Performance Materials segment net sales decreased by $13.3 million, or 21.9%, in the first six months of 2009, as compared to the same period of 2008. Filtration and industrial thermal insulation product net sales decreased by $6.2 million and $7.1 million, respectively. Year-to-date net sales of OPS decreased by $6.6 million compared to the first six months of 2008. Net sales from the Company s vital fluids business decreased by $1.4 million and net sales from the Company s Affinity® temperature control equipment business decreased by $5.2 million in the first half of 2009 as compared to the first six months of 2008.

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Gross Margin

In thousands	Quarter Ended Q2-09	Q2-08	Percent Change	Six Months Ended YTD-09	YTD-08	Percent Change
Gross margin	$ 4,170	$ 19,174	(78.3)%	$ 10,163	$ 40,019	(74.6)%
Percentage of sales	7.4%	22.8%		9.2%	23.0%	

The decrease in gross margin percentage in the second quarter of 2009, as compared to the same period a year ago, was caused by lower gross margin percentage from the Thermal Acoustical and Performance Materials segments as well as from OPS, all of which were negatively impacted by global economic conditions. Lower net sales resulted in higher per-unit manufacturing costs, as each unit absorbed a greater amount of fixed costs. The most significant reduction in gross margin percentage occurred in the Company s automotive business, included in the Thermal/Acoustical segment, as a result of lower net sales of $15.0 million, when excluding the impact of foreign currency translation. Also, restructuring related charges of $3.0 million in the second quarter of 2009, associated with the consolidation of the Company s St. Johnsbury, VT automotive parts plant into the Company s Hamptonville, NC plant, negatively impacted gross margin percentage by approximately 540 basis points.

The decrease in gross margin percentage in the first six months of 2009, as compared to the same period a year ago, was caused by lower gross margin percentage from all businesses included in the Thermal Acoustical and Performance Materials segments as well as from OPS, which were negatively impacted by global economic conditions. Lower net sales resulted in higher per-unit manufacturing costs, as each unit absorbed a greater amount of fixed costs. The most significant reduction in gross margin percentage occurred in the Company s automotive business, included in the Thermal/Acoustical segment, as a result of lower net sales of $37.4 million, when excluding the impact of foreign currency translation. Also, restructuring related charges of $5.1 million in first half of 2009, associated with the consolidation of the Company s St. Johnsbury, VT automotive parts plant into the Company s Hamptonville, NC plant, negatively impacted gross margin percentage by approximately 450 basis points.

Selling, Product Development and Administrative Expenses

In thousands	Quarter Ended Q2-09	Q2-08	Percent Change	Six Months Ended YTD-09	YTD-08	Percent Change
Selling, product development and administrative expenses	$ 12,722	$ 14,697	(13.4)%	$ 25,804	$ 30,469	(15.3)%
Percentage of sales	22.7%	17.5%		23.4%	17.5%	

Selling, product development and administrative expenses decreased by $2.0 million, or $1.5 million when excluding the impact of foreign currency translation, in the current quarter as compared to the second quarter of 2008. This reduction was primarily due to decreases in incentive compensation expense of $0.8 million, salaries and benefits expense of $0.3 million, and sales commission expense of $0.3 million, as well as reductions in other discretionary spending. Lower salaries and benefits expense was due to reductions in workforce that occurred during the last half of 2008 and into 2009 as well as the Company suspending its matching contribution to its sponsored 401(k) plan, beginning with the first payroll of May 2009, for all non-union domestic employees. Lower incentive compensation was due to the Company not recording any incentive compensation expense in the second quarter of 2009, because no bonuses were earned under the Company s bonus program based on year-to-date results. Lower sales commission expenses were due to lower sales in the second quarter of 2009 as compared to the second quarter of 2008.

Selling, product development and administrative expenses decreased by $4.7 million, or $3.8 million when excluding the impact of foreign currency translation, in the first six months of 2009 as compared to the same period in 2008. This reduction was primarily due to decreases in incentive compensation expense of $1.5

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million, salaries and benefits expense of $0.8 million, and sales commission expense of $0.8 million, as well as reductions in other discretionary spending. Lower salaries and benefits expense was due to reductions in workforce that occurred during the last half of 2008 and into 2009 as well as the Company suspending its matching contribution to its sponsored 401(k) plan, beginning with the first payroll of May 2009, for all non-union domestic employees. The total number of selling, product development and administrative employees for the Company has decreased by approximately 15% since June 30, 2008. Lower incentive compensation was due to the Company not recording any incentive compensation expense in the first half of 2009, because no bonuses were earned under the Company s bonus program based on year-to-date results. Lower sales commission expenses were due to lower sales in the first six months of 2009 as compared to the comparable period of 2008.

Interest Expense

In thousands	Quarter Ended Q2-09	Q2-08	Percent Change	Six Months Ended YTD-09	YTD-08	Percent Change
Interest expense	$ 198	$ 129	53.5%	$ 332	$ 244	36.1%
Weighted average interest rate	4.8%	5.2%		5.0%	5.2%	

The increase in interest expense for the quarter and six months ended June 30, 2009, as compared to the same periods from 2008, was primarily due to increased interest expense related to the amortization of debt financing costs associated with the Company entering into a new credit facility in March, 2009.

Other Income/Expense

Other income and expense for the quarters and six months ended June 30, 2009 and 2008 consisted of insignificant activity related to foreign exchange transaction gains and losses and investment income.

Income Taxes

The effective tax rate from continuing operations for the quarter ended June 30, 2009 was a benefit of 31.9% compared with expense of 37.0% for the second quarter of 2008. The second quarter of 2009 included income tax expense of $0.4 million associated with a taxable gain recognized on the surrender of Company owned life insurance policies. The effective tax rate for the six months ended June 30, 2009 was a benefit of 33.9% compared with expense of 37.0% for the same period of 2008. For 2009, the Company expects its effective tax rate to be approximately 34% to 36% from continuing operations.

As of June 30, 2009, the net amount of unrecognized tax benefits was $1.1 million. The total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate is $1.1 million. There have been no significant changes to these amounts during the quarter or six months ended June 30, 2009.

Consolidation, Restructuring and Related Charges

In September 2008, the Company announced the closing of its St. Johnsbury, Vermont manufacturing facility and the consolidation of its North American automotive parts production into its Hamptonville, North Carolina operation. This consolidation is expected to reduce operating costs significantly, increase efficiency, and enhance the Company s competitive position, while maintaining essentially the same level of manufacturing capacity. The Company commenced the transfer of equipment and production in the first quarter of 2009 and substantially completed the consolidation during the second quarter of 2009. Beginning in the third quarter of 2009, the Company expects to start to benefit from reduced fixed overhead and selling, product development and administrative expenses as a result of the consolidation. On an annualized basis, the Company expects to save approximately $3.5 million to $4.0 million in costs as a result of this consolidation with approximately 90% of the savings impacting gross margins and the remainder reducing selling, product development and administrative expenses. Actual results could differ from these estimates.

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During the second quarter of 2009, the Company recorded pre-tax restructuring charges related to the consolidation of $3.0 million, all of which were included in cost of sales in the Thermal/Acoustical segment. Year-to-date, the Company recorded pre-tax restructuring charges of $5.1 million in the Thermal/Acoustical segment related to the consolidation, including $5.0 million in cost of sales and $0.1 million in selling, product development and administrative expenses. These restructuring activity costs primarily included severance related costs, acceleration of depreciation expense on fixed assets that were not transferred to the Hamptonville, NC facility, and facility exit, moving and set-up costs of equipment transferred from St. Johnsbury, VT. to Hamptonville, NC.

In total, the Company expects to record pre-tax charges of approximately $7.3 million, or approximately $.28 per diluted share, over the period of consolidation, including pre-tax charges of $6.7 million, or $.26 per diluted share, already incurred by the Company through June 30, 2009. The estimated remaining costs under this restructuring program of approximately $0.6 million are primarily related to estimated lease termination costs in connection with the St. Johnsbury, VT. facility. The Company expects to record a liability at fair value when Lydall ceases using the right conveyed by the lease agreement, which is expected to occur in the second half of 2009.

Total cash outflows are expected to be approximately $5.7 million, with approximately $4.7 million already paid by the Company as of June 30, 2009, and approximately $1.0 million to be paid primarily in the third quarter of 2009. Actual results could differ from these estimates. See Note 5 to the Condensed Consolidated Financial Statements for additional discussion of this restructuring.

Segment Results

The following table presents sales information for the key product and service groups included within each operating segment for the quarter and six months ended June 30, 2009 compared with the quarter and six months ended June 30, 2008:

In thousands	**Quarter Ended June 30, 2009**	**Quarter Ended June 30, 2008**	**Dollar Change**	**Percentage Change**
Performance Materials:				
Filtration	$ 15,869	$ 19,856	$ (3,987)	(20.1)%
Industrial Thermal Insulation	7,349	11,335	(3,986)	(35.2)%
Performance Materials Segment net sales	$ 23,218	$ 31,191	$ (7,973)	(25.6)%
Thermal/Acoustical:				
Automotive parts	$ 23,454	$ 41,239	$ (17,785)	(43.1)%
Automotive tooling	4,085	3,743	342	9.1

Non-cash investing and financing activities:			
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)
Amortization of deferred charges relating to warrants	-	**147,080**	147,080
Discount on convertible promissory notes	-	-	1,577.373
Conversion of convertible promissory notes into common stock	-	**13,720**	1,840,000

Issuance costs related to the converted promissory notes	-	**232,202**	134,255

See accompanying notes to the interim consolidated financial statements.

Notes to the Interim Consolidated Financial Statements as of June 30, 2005

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, Answers.com, containing practically all the content that it used to sell via subscriptions and ceased selling subscriptions to individual consumers. The Company generates advertising revenue from Answers.com. 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”*.

The accompanying unaudited interim consolidated financial statements were prepared in accordance with the instructions for Form 10-QSB and, therefore, do not include all disclosures necessary for a complete presentation of financial condition, results of operations, and cash flows in conformity with generally accepted accounting principles. All adjustments, which are, in the opinion of management, of a normal recurring nature and are necessary for a fair presentation of the interim financial statements, have been included. Nevertheless, these financial statements should be read in conjunction with the consolidated financial statements and related notes included in the Company’s Annual Report on Form 10-KSB for the year ended December 31, 2004. The results of operations for the period ended June 30, 2005 are not necessarily indicative of the results that may be expected for the entire fiscal year or any other interim period

Note 2 - Revenue Recognition

The Company generates advertising revenues, mostly, 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.

The Company continues to recognize revenues generated from subscriptions that were sold in prior years since such subscribers will continue to be fully supported through their subscription periods (see Note 1).

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

Notes to the Interim Consolidated Financial Statements as of June 30, 2005

Note 3 - Accounting for Stock-Based Compensation

As allowed by Statement of Financial Accounting Standards (SFAS) No. 123, *"Accounting for Stock-based Compensation"*(SFAS No. 123), 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"* (APB 25), 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 market price of the Company's stock at the date of grant over the amount an employee or director 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 4.48%; volatility between 46.54% and 74.75%; and an expected life of between one and ten years.

The Company has adopted the disclosure requirements of SFAS No. 123 and SFAS No. 148, *"Accounting for Stock-Based Compensation - Transition and Disclosure - an amendment of FASB Statement No. 123"*, 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 (the "SEC"), in connection with its initial public offering (the "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 6.59%; 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 3.19% to 4.18%; volatility between 38.62% and 66.76%; and the expected life of the option, generally 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:

	Three months ended June 30		**Six months ended June 30**		**Cumulative from inception through June 30,**
	2005	**2004**	**2005**	**2004**	**2005**
	$	**$**	**$**	**$**	**$**
	(Unaudited)	**(Unaudited)**	**(Unaudited)**	**(Unaudited)**	**(Unaudited)**
Net loss, as reported	**(1,601,986)**	(1,874,149)	**(3,106,910)**	(3,566,861)	(43,703,027)
Add:					
Stock-based compensation expense to employees and directors included in reported net loss, net of related tax effects	**111,287**	8,781	**121,205**	17,561	161,964
Deduct:					

Stock-based compensation expense to employees and directors determined under fair value based method for all awards, net of related tax effects	**(262,131)**	(10,661)	**(335,017)**	(23,516)	(560,734)
Pro-forma net loss	**(1,752,830)**	(1,876,029)	**(3,320,722)**	(3,572,816)	(44,101,797)
Net loss per common share, basic and diluted:					
As reported	**(0.23)**	(1.08)	**(0.48)**	(2.38)	(26.18)
Pro-forma	**(0.25)**	(1.09)	**(0.51)**	(2.38)	(26.42)

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Note 3 - Accounting for Stock-Based Compensation (cont'd)

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 APB 25's intrinsic value method of accounting that was provided in SFAS No. 123 as originally issued and it instead 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. Pursuant to SFAS No. 123R, the Company will apply its provisions beginning the first quarter of 2006. 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. 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 previously 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.

Note 4 - Stockholders' Equity

(a) Common Stock

On March 13, 2005, the Company issued 7,800 shares of common stock to an investor relations firm, pursuant to a one-year agreement that began on December 13, 2004. The fair value of the shares, of $151,086, is being amortized to general and administrative expenses over the life of the service period.

(b) Stock Warrants

During 2004, in connection with the issuance of Convertible Promissory Notes in January and February of 2004, the Company issued warrants to acquire an aggregate of 2,067,316 shares of Common Stock (the "Bridge Warrants"), at an exercise price of $7.20 per share, with the exception of 265,837 bridge warrants exercisable at $3.75 per share.

During the first quarter of 2005, 69,432 of the Bridge Warrants 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 "Warrants Agreement"), with certain holders of Bridge Warrants, pursuant to which such 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, for aggregate gross consideration of $12,559,700. Under the terms of the Warrants Agreement, in order to provide incentive to the warrant 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 warrant 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 (the "New Warrants"). As a result, the Company issued 1,029,488 of New Warrants at an exercise price of $17.27 per share. The New Warrants are immediately exercisable and expire on February 4, 2010. On April 6, 2005, and as a part of the Warrants Agreement, the Company filed a Registration Statement, to register for resale the shares of common stock underlying the new warrants (the "Registration Statement") with the SEC. The Registration Statement became effective on April 21, 2005. In the Registration Statement, the Company also registered 111,016 shares, warrants and stock options that had previously not been registered.

On January 20, 2005, the Company entered into an agreement with an investment banking firm, which was also one of the underwriters of the Company's IPO, to provide general financial advisory and investment banking services for $5,000 per month, and for a minimum service period of six months. Further, upon signing of the contract, the underwriter received fully vested warrants to acquire 100,000 shares of Common Stock at an exercise price of $11.00. The fair value of the warrants, of $577,440, is being amortized to general and administrative expenses over the life of the minimum service period.

Note 4 - Stockholders' Equity (cont'd)

(c) Stock Options

During the first quarter of 2005, 75,726 of the Company's outstanding stock options were exercised, for total consideration of approximately $804,000. As a result, the Company issued an aggregate of 75,726 shares of its common stock.

During the second quarter of 2005, 81,879 of the Company's outstanding stock options were exercised, for total consideration of approximately $303,000. As a result, the Company issued an aggregate of 81,879 shares of its common stock.

During the three months and six months ended June 30, 2005, a strategic consultant of the Company earned 9,445 and 15,556 stock options, respectively, for services he rendered to the Company. In connection therewith, the Company recorded $106,347 and $213,248 of stock based compensation for the three months and six months ended on June 30, 2005, respectively. On June 5, 2005, the agreement under which these options were granted, was terminated.

On March 15, 2005, the Company granted 200,000 stock options to one of its officers. The options will vest 25% upon the first anniversary date of the option grant, with the remainder vesting in equal monthly installments over the 36 months thereafter. In the event of a change of control, as defined in the officer's employment agreement, these options may be forfeited by the officer in exchange for 50,000 shares of the Company's common stock.

On May 10, 2005, the Company accelerated the vesting of 7,100 stock options that were granted to a director, in connection with his resignation from the Company's board of directors. As a result, the Company recorded approximately $85,000 of stock based compensation, based on the intrinsic value of the options on the date they were accelerated.

All stock options that were granted in the first two quarters of 2005, were granted under the Company's 2004 Stock Plan.

(d) Other Comprehensive Income (Loss)

In January 2005, the Company reversed previously recorded unrealized loss on securities.

Note 5 - Commitments and Contingencies

(a) Future minimum lease payments under non-cancelable operating leases for office space and cars, as of June 30, 2005 are as follows:

Year ending December 31	$
2005	148,842
2006	143,379
2007	106,211
2008	85,446
2009	82,212
2010	41,400
	607,490

Rental expense under operating leases for the six months ended June 30, 2005 and 2004 was approximately $123,000 and $108,000, respectively. See Note 6 regarding commitments entered into subsequent to the balance sheet date.

(b) In April 2005, the Company entered into an operating lease for office space in New York City. The lease commenced on May 1, 2005 and ends on June 30, 2010. Under the terms of the lease, the Company shall have the right to cancel the lease commencing May 1, 2008, upon 90 days prior written notice to the Landlord. The monthly rental due under the lease begins at $5,500, with a two-month free period, and steps up at various stages throughout the lease, up to $6,223. The Company will recognize the rent expense for this lease on a straight-line basis over the minimum lease term. In addition to the base rent, the Company will be responsible for certain costs and charges specified in the lease, including real estate taxes and utility charges.

(c) As security for future rental commitments the Subsidiary provided a bank guarantee in the amount of approximately $115,000.

(d) 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 June 30, 2005, deposits at such bank amounted to $824,209, including a long-term deposit of $115,156.

(e) 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 the six months ended June 30, 2005, the Company entered into agreements with three consulting firms for the provision of services in the areas of public relations, strategic planning and investment banking. The agreements, which are for periods between six months and one year, are for an aggregate cash amount of $210,000. In connection with the aforesaid agreements, the Company also granted warrants to acquire 100,000 shares of Common Stock and 15,556 stock options (see Note 4).

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Note 5 - Commitments and Contingencies (cont'd)

(f) 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, $218,000 was paid during 2003, $22,000 was paid during 2004, $8,000 was paid during the first half of 2005 and $17,000, which relates to a lease obligation for equipment no longer in use, was outstanding as of June 30, 2005.

Note 6 - Subsequent Events

(a) In July, 2005, following the earlier adoption by the Company's board of directors, the Company's stockholders approved the 2005 Incentive Compensation Plan (the "2005 Compensation Plan"), under which the Company may grant stock options, stock appreciation rights, restricted stock, deferred stock, other stock-related awards and performance awards to officers, directors, employees, consultants and other persons who provide services to the Company. The total number of Company shares of common stock reserved and available for grant under the 2005 Plan was set at 850,000.

(b) In July 2005, each non-employee director of the Company was granted a stock option, under the Company's 2004 Stock Plan, to acquire up to 7,175 shares of the Company's Common Stock. The options vest 25% upon the first anniversary date of the option grant, and the remainder vest in equal monthly installments over the 36 months thereafter. All options have a maximum term of 10 years measured from the date of grant, subject to earlier termination, if the director's service with the Company is terminated.

(c) In July 2005, the Subsidiary entered into a supplemental agreement to its operating lease (the "Supplement") in connection with its relocation to new office space. The term of the original lease was extended by 55 additional months beyond its original date of expiration, December 31, 2005. According to the Supplement, the Subsidiary will occupy the new office space commencing September 15, 2005, through July 31, 2010. The monthly rental due under the lease will be 50,802 New Israeli Shekels ("NIS") ($11,185 based on the exchange rate on July 15, 2005) for the first year, and NIS 69,483 ($15,298 based on the exchange rate on July 15, 2005) for the remaining four years. The Company will recognize the rent expense for this lease on a straight-line basis over the minimum lease term. The rent payments will be linked to the Israeli Consumer Price Index. In addition to the base rent, the Company will be responsible for certain costs and charges specified in the lease, including maintenance and utility charges.

(d) On July 19, 2005, the Company announced that its application for listing its common stock on NASDAQ's National Market System was approved. The Company further announced its intention to change its corporate name to Answers Corporation, subject to stockholder approval. On August 2, 2005, the

Company's common stock began trading on NASDAQ under the symbol ANSW.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION OR PLAN OF OPERATION

The following discussion of our financial condition and results of operations should be read in conjunction with the financial statements and the notes to those statements included elsewhere in this filing. This discussion includes forward-looking statements that involve risks and uncertainties. Our actual results may differ materially from those anticipated in these forward-looking statements.

General

We are the creators of the Answers.com answer-based search engine. We possess technology that helps integrate and retrieve online information from disparate sources and delivers the result in a single consolidated browser view. 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 with a long list of links to more Websites that in some way relate to the query term. Our answer engine automatically delivers snapshot, multi-faceted definitions and explanations from attributable reference sources about numerous topics in our database, without requiring the user to navigate a list of hyperlinks sequentially.

We devoted the first two quarters of 2005 to launching our Answers.com service. It differed from the previous GuruNet service in five primary ways:

§ Product branding: Answers.com, instead of GuruNet.
§ Business model: free ad-supported, instead of subscription-based
§ Relative emphasis on the Website version, not the downloadable 1-click software version
§ Look and feel: use of a single page format, instead of the previous tabbed interface
§ Expanded content, including, Wikipedia, an open-source encyclopedia

A more detailed discussion regarding the impact of the launch of Answers.com service on our business model follows.

Our Business Model

On January 3, 2005, we announced the release of Answers.com, a website that had been launched in August 2004 in beta version. We 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 to 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 basic Web site does not provide the "1-Click" functionality and context analysis that we include in our "1-Click Answers" software version. Our revenue model for Answers.com and 1-Click Answers is based primarily on advertising revenue. When a user searches sponsored keywords, a link to an advertiser's Website is displayed. In contrast to GuruNet, the product we actively marketed prior to January 2005, we do not generate revenues from selling subscriptions to Answers.com.

Prior to January 2005, we sold subscriptions to our answer engine product, GuruNet. Prior to December 2003, we sold lifetime subscriptions to 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. 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, in 2004, from 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 grow revenues 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.

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In conjunction with the release of Answers.com, www.GuruNet.com began functioning primarily as a corporate website. We are no longer offering new subscriptions to GuruNet or 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. Most of our subscriptions will terminate by the end of 2005.

Recent Events

The following events have recently transpired:

- On July 19, 2005, we announced that our application for listing our common stock on NASDAQ's National Market System (NMS) was approved. Our common stock began trading on NASDAQ under the symbol ANSW on August 2nd, 2005. Additionally, we plan to change our corporate name to Answers Corporation, subject to stockholder approval.

- In June 2005 we began the implementation of our agreement with Shopping.com to integrate their extensive online product catalog into Answers.com. Whether site visitors are seeking information on clothing, electronics, jewelry, tools, books, or items in many other consumer product categories, the new arrangement enables them to identify, research, compare, and purchase products as part of their quest for answers. This partnership will help our users combine research with the purchase process, and we will receive a portion of revenues generated when consumers click through to merchants' sites.

- In June 2005, we launched a citations tool as part of Answers.com. This new feature enables students and researchers to very simply cite the information that they find at Answers.com, by automatically producing bibliography entries for the site's collection of over a million topics. We expect this new feature will help us further penetrate the education market in the fall, the start of the new school year.

- In June 2005, we established our U.S. headquarters, located in New York City. Our marketing and business development activities will be centered in the New York office.

Results of Operations

Due to the change in our business model in January 2005, our results of operations for the three months and six months ending June 30, 2005, are not easily comparable to the results for the same periods in 2004.

Revenues

Revenues during the three months ended June 30, 2005 were $424,552 compared to $44,244 for the three months ended June 30, 2004, an increase of $380,308 or 860%. Revenues for the six months ended June 30, 2005 were $600,185 compared to $63,875 for the six months ended June 30, 2004, an increase of $536,310 or 840%. Revenues during the three and six months ended June 30, 2005, resulted from advertising revenues of approximately $357,000 and $463,000, recognition of previously deferred subscription license revenue of approximately $40,000 and $89,000, and other revenues (primarily revenue from partners with whom we market co-branded products) of approximately $27,000 and $48,000, respectively. In contrast, revenues during the three and six months ended June 30, 2004 resulted primarily from recognition of previously deferred subscriptions of approximately $34,000 and $48,000, maintenance contracts on our corporate enterprise software of approximately $5,000 and $10,000, and advertising revenues of approximately $2,000 and $3,000, respectively.

As noted earlier, on January 3, 2005, the Company announced the release of Answers.com, the primary revenue model of which is advertising. In contrast, prior to January 3, 2005, our primary source of revenue was selling subscriptions

to the GuruNet product, the forerunner to Answers.com. The launch of Answers.com, from a revenue perspective, has been a multi-tiered process. From launch date until the middle of January, we ran public service announcements on Answers.com and did not display any advertising. In the middle of January we began using and testing various advertising network providers. We reached an important milestone on February 28, 2005, when we began using Google's contextual AdSense advertising on our Answers.com information pages, as well as integrating Google search, with paid search advertising into Answers.com. In the second quarter of 2005, we continued testing various ways to monetize our answers service traffic. For example, we added Shopping.com content, through which we receive a portion of revenues generated when consumers click through to merchants' sites that are provided by Shopping.com. We expect that in the next quarter we will be testing other types of advertising revenue, including high-value display ads.

Our level of advertising revenue is a function of various factors, the most basic of which are the level of our traffic or queries, and how effectively we monetize such traffic. Our average daily queries for Answers.com and GuruNet, including weekend days, as measured by our internal statistical tools, during January, February, March, April, May and June of 2005 were approximately 220,000, 1,150,000, 1,550,000, 1,790,000, 1,850,000 and 1,720,000 respectively. Traditionally, there is less Web activity during the summer months, including June. We expect renewed growth and plan on driving new users in the back-to-school and autumn season. Our advertising revenue from such traffic, during January, February, March, April, May and June of 2005, was $2,000, $14,000, $91,000, $89,000, $131,000 and $137,000, respectively.

Cost of Revenues

Cost of revenues is comprised of fees to third party providers of content, web search service fees, data center costs (including depreciation of information technology assets), and production operations and customer support salaries, benefits and overhead costs.

Cost of revenues for the three months ended June 30, 2005 was $231,416 compared to $119,231 for the three months ended June 30, 2004, an increase of $112,185 or 94%. This increase was due to increased compensation costs of $36,000, as a result of the addition of staff that manage production operations, increases in data center (including depreciation of information technology assets required to manage more internet traffic) and content costs of $40,000, fees we began paying Google for the web search results they provide us within the Answers.com website, of $17,000, and increases in overhead costs of $16,000.

Cost of revenues for the six months ended June 30, 2005 was $439,959 compared to $275,758 for the same period in 2004, an increase of $164,201 or 60%. This increase was primarily due to increased compensation costs of $63,000, as a result of the addition of staff that manage production operations, increases in data center (including depreciation of information technology assets required to manage more internet traffic) and content costs of $44,000, fees we began paying Google for the web search results they provide us within the Answers.com website, of $26,000, and increases in overhead costs of $25,000.

Research and Development Expenses

The salaries, benefits and overhead costs of personnel, conducting research and development of software and Internet products comprise research and development expenses.

Research and development expenses for the three months ended June 30, 2005 was $397,853 compared to $254,685 for the same period in 2004, an increase of $143,168 or 56%. Research and development expenses for the six months ended June 30, 2005 was $728,322 compared to $518,473 for the same period in 2004, an increase of $209,849 or 40%. The aforesaid increases are due primarily to compensation-related expense increases as our research and development team grew in order to develop and test newer versions of our products, and due to raises in salaries, and stock-based compensation.

Sales and Marketing Expenses

The salaries, benefits and overhead costs of personnel, marketing consulting, public relations services and advertising costs, comprise sales and marketing expenses.

Sales and marketing expenses in the three months ended June 30, 2005 were $450,970 compared to $221,556 during the same period in 2004, an increase of $229,414 or 104%. The net increase is due primarily to compensation-related expense increases of $120,000 as we increased the number of employees in our sales and marketing department, including the hiring of our Chief Revenue Officer at the end of the first quarter of 2005. Additionally, in the three months ended June 30, 2005, we retained a strategic consultant who assisted us in formulating our product and

marketing strategy. In connection therewith, we recorded approximately $10,000 of cash expenses, and $106,000 in stock compensation. Further, our advertising and public relations costs during the three months ended June 30, 2005, rose by approximately $76,000, as compared to the same period in the prior year, due to various initiatives including the retention of a public relations firm. The aforementioned increases were offset to a certain degree, by decreases in sales commissions to agents, of $16,000, since we no longer retain independent sales agents. Additionally, during the three months ended June 30, 2004, we incurred approximately $67,000 in consulting costs relating to the redesign of our website and marketing strategy.

Sales and marketing expenses in the six months ended June 30, 2005 were $812,430 compared to $540,485 during the same period in 2004, an increase of $271,945 or 50%. The net increase is due primarily to compensation-related expense increases of $87,000, and recruiting fees during the six months ended June 30, 2005 of $35,000, as we increased the number of employees in our sales and marketing department, including the hiring of our Chief Revenue Officer at the end of the first quarter of 2005. Additionally, in the six months ended June 30, 2005, we retained a strategic consultant who assisted us in formulating our product and marketing strategy. In connection therewith, we recorded approximately $35,000 of cash expenses, and $213,000 in stock compensation. Further, our advertising and public relations costs during the six months ended June 30, 2005, rose by approximately $123,000, as compared to the prior year, due to various initiatives including the retention of a public relations firm and radio ads. The aforementioned increases were offset to a certain degree by various factors, including, decreases in sales commissions to agents, of $22,000, since we no longer retain independent sales agents. Additionally, during the six months ended June 30, 2004, we incurred approximately $188,000 in consulting costs relating to the redesign of our website, and marketing strategy.

General and Administrative Expenses

General and administrative expenses consist primarily of salaries, benefits and overhead costs for executive and administrative personnel, insurance fees, fees for professional services, including investor relations, legal, accounting and other consulting fees, travel costs, investment banking fees, and other general corporate expenses. Overhead costs are comprised primarily by rent, utilities and depreciation.

General and administrative expenses in the three months ended June 30, 2005 were $1,078,960 compared to $202,123 during the same period in 2004, an increase of $876,837 or 434%. The increase is comprised of many individual line expenses, as follows:

On January 20, 2005, we entered into an agreement with an investment-banking firm, which also acted as one of the underwriters of our IPO, to provide general financial advisory and investment banking services for $5,000 per month, and for a minimum term of six months. Further, upon signing of the contract, the underwriter received fully vested warrants to acquire 100,000 shares of Common Stock at an exercise price of $11.00. As a result of this agreement, in the three months ended June 30, 2005, we recorded approximately $15,000 of cash compensation and $289,000 in stock compensation, which represents the amortization, in the second quarter of 2005, of the fair value of the warrants on the date of their issuance, over the minimum term of the agreement.

In December 2004, we entered into an agreement with an investor relations firm pursuant to which they are to receive $100,000 over a one-year period for providing us with investor relation services. Additionally, pursuant to the agreement, in March 2005, we issued 7,800 shares of common stock to such firm. As a result of this agreement, in the three months ended June 30, 2005, we recorded approximately $24,000 of cash compensation and $38,000 in stock-based compensation, which represents the amortization, in the second quarter of 2005, of the fair value of the stock on the date of its issuance, over the expected life of the agreement, through December 2005.

In May 2005, the Company accelerated the vesting of 7,100 stock options that were granted to a director, in connection with his resignation from the Company's board of directors. As a result, the Company recorded $85,000 of stock based compensation; based on the intrinsic value of the options on the date they were accelerated.

The remaining increase stems primarily from increases in legal and accounting costs of approximately $202,000; costs relating to stock administration, including printing, transfer agent and American Stock Exchange fees aggregating $62,000; increases in the number of personnel, and salaries of personnel, which resulted in an increase, of $55,000; increases in director fees and expenses of $22,000; and increases in our insurance costs of $42,000. Much of the increase to our General and Administrative Expenses, including most of those mentioned previously, are directly or indirectly, related to the increased costs associated with being a public company.

General and administrative expenses in the six months ended June 30, 2005 were $1,930,575 compared to $414,530 during the same period in 2004, an increase of $1,516,045 or 366%. The increase is due primarily to cash and stock based compensation and costs in the amount of $80,000 and $681,000, respectively, that we recorded as a result of agreements with an investment-banking firm, entered into on January 20, 2005; and with an investor relations firm, entered into in December 2004; and due to the acceleration of the vesting of 7,100 stock options that were granted to a director, all described more fully above. The remaining increase stems primarily from increases in legal and accounting costs of approximately $390,000; increases in the expenses of stock administration, including printing, transfer agent and American Stock Exchange fees, of $71,000; increases in the number of personnel, and salaries of personnel, which resulted in an increase of approximately $100,000; increases in director fees and expenses of approximately $59,000; increases in our rent costs of approximately $16,000 due to the commencement of our New York office lease in May 2005; and increases in our insurance costs of approximately $70,000. Much of the increase to our General and Administrative Expenses, including most of those mentioned previously, are directly or indirectly, related to the increased costs associated with being a public company.

Interest Income (Expense), Net

Interest income (expense), net in the three months and six months ended June 30, 2005, was $144,687 and $230,594, respectively, compared to ($1,113,418) and ($1,850,452) during the same periods in 2004, representing net increases in interest income (decrease of expense) of $1,258,105 and $2,081,046, respectively. Interest income, net, in the three months and six months ended June 30, 2005 is comprised almost entirely of interest income earned from cash and cash equivalents and investment securities. Interest expense, net for the three and six months ended June 30, 2004 includes approximately $1,012,000 and $1,687,000, respectively, of amortization of note discounts and deferred charges relating to convertible promissory notes, which were issued in January and February of 2004. The remainder is comprised of 8% interest on the face of the $5.0 million convertible promissory notes, approximating $103,000 and $168,000 for the three and six months ended June 30, 2004, respectively.

Other Income (Expense), Net

Other income (expense), net for the three months ended June 30, 2005 was ($21,010) as compared to ($8,347) for the same period in 2004, representing an increase in other expenses of $12,663 or 152%. Other income (expense), net for the six months ended June 30, 2005 was ($20,728) as compared to ($4,025) for the six months ended June 30, 2004, representing an increase in other expenses of $16,703 or 415%. The changes in other income (expense) net for the three and six months ended June 30, 2005 as compared to the same periods in 2004, resulted primarily from differences in the amount of foreign exchange gains) losses) and the write-off of withholding taxes that we did not expect to realize, in the respective periods.

Income Tax Expense

Our effective tax rate differs from the statutory federal rate due to differences between income and expense recognition prescribed by the United States and Israeli tax laws and Generally Accepted Accounting Principles. We utilize different methods and useful lives for depreciating property and equipment. The recording of certain provisions results in expense for financial reporting but the amount is not deductible for income tax purposes until actually paid. Our deferred tax assets are mostly offset by a valuation allowance because realization depends on generating future taxable income, which, in our estimation, is not more likely to transpire, than to not transpire.

We had net operating loss carryforwards for federal and state income tax purposes of approximately $38 million at June 30, 2005 and $28 million at June 30, 2004. The federal net operating losses will expire if not utilized on various dates from 2019 through 2025. The state net operating losses will expire if not utilized on various dates from 2009 through 2013. Our Israeli subsidiary has capital loss carryforwards of approximately $600,000 that can be applied to future capital gains for an unlimited period of time under current tax rules.

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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, our recent Initial Public Offering and other ownership changes that have transpired, will significantly limit our ability to utilize net operating losses and credit carryforwards.

Our subsidiary had income in 2004 and 2003, resulting from its cost plus agreement with the parent company, whereby it charges us for research and development services it provides to us, plus 12.5%. However, the subsidiary is an “approved enterprise” under Israeli law, which means that 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.

As of June 30, 2005, we accrued approximately $78,000, net, to reflect the estimated taxes that our subsidiary would have to pay if it distributed its accumulated earnings to us. Should the subsidiary derive income from sources other than the approved enterprise during the relevant period of benefits, this income will be taxable at the tax rate in effect at that time (currently 34%, gradually being reduced to 30% in 2005-2008). Through June 30, 2005, our Israeli subsidiary received tax benefits of approximately $700,000.

Net Loss

Our net loss decreased to $1,601,986 and $3,106,910 in the three and six months ended June 30, 2005, respectively, from $1,874,149 and $3,566,861 for the comparable periods in 2004, as a result of the changes in our revenues, costs and expenses as described above.

Critical Accounting Estimates

While our significant accounting policies are more fully described in the notes to our audited consolidated financial statements for the year ended December 31, 2004, we believe the following accounting policies to be the most critical in understanding the judgments and estimates we use in preparing our consolidated financial statements.

Revenue Recognition

In 2003, we sold lifetime subscriptions to our 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 December 2003 and throughout 2004, we generally, sold consumers one-year subscriptions to GuruNet. We recognize the amounts we received from those subscriptions over the life of the related subscription. 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 is being recognized as revenues over the new two-year subscription. Beginning January 2005, we no longer offer subscriptions to our consumer products and/or websites. Rather, our consumer business model is now an advertising-only model. Notwithstanding, we have not terminated fixed-term and lifetime subscriptions to GuruNet that we previously sold. This means that those users will continue to receive content and will not have to upgrade their software. The software they downloaded in conjunction with their subscription will be supported. Our accounting treatment relating to those subscriptions has not changed, since we continue to honor those subscriptions.

Accounting for Stock-based Compensation

In January 2003, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No. 148, *"Accounting for Stock-Based Compensation - Transition and Disclosure - an amendment of FASB Statement No. 123"* ("SFAS 148"), which provides alternative methods of transition for a voluntary change to a fair value based method of accounting for stock-based employee compensation. In addition, SFAS 148 amends the disclosure requirements of Statement of Financial Accounting Standards No. 123 *"Accounting for Stock-based Compensation"* ("SFAS 123") to require prominent disclosures in annual financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. We account for stock-based compensation for employees under APB 25, and elect the disclosure-only alternative under SFAS 123 and provide the enhanced disclosures as required by SFAS 148.

We record deferred stock-based compensation expense for stock options granted to employees and directors if the market value of the stock at the date of grant exceeds the exercise price of the option. We recognize expenses as we amortize the deferred stock-based compensation amounts over the related vesting periods. The market value of our stock, so long as we were a private company, was determined by us based on a number of factors including comparisons to private equity investments in us. These valuations are inherently highly uncertain and subjective. If we had made different assumptions, our deferred stock-based compensation amount, our stock-based compensation expense, our net loss and our net loss per share could have been significantly different.

The fair value of stock warrants and stock options granted to non-employees are measured throughout the vesting period as they are earned, at which time we recognize a charge to stock-based compensation. The fair value is determined using the Black-Scholes option-pricing model, which considers the exercise price relative to the market value of the underlying stock, the expected stock price volatility, the risk-free interest rate and the dividend yield, and an estimate of the life of the warrant or option. As discussed above, the market value of the underlying stock was based on assumptions of matters that are inherently highly uncertain and subjective. Since, prior to our IPO there had been no public market for our stock, our assumptions about stock price volatility are based on the volatility rates of comparable publicly held companies. These rates may or may not reflect our stock price volatility following the offering. If we had made different assumptions about the fair value of our stock or stock price volatility, or our estimate of the time stock warrants and stock options will be outstanding before they are ultimately exercised, the related stock based compensation expense and our net loss and net loss per share amounts could have been significantly different.

For example, in the first quarter of 2005, we estimated that the fair value of 100,000 common stock warrants that our investment banker received in connection with an agreement pursuant to which it provides the Company with general financial advisory and investment banking services, to be $577,000. Such amount is being amortized over the minimum life of the agreement, which is six months. One of the assumptions driving the fair value of the warrants was the estimate of the date the warrants will be exercised. As required, we assumed the warrants will be exercised on the last day before they expire, which is five years after the date the warrants were issued. If, for example, we had assumed that the warrants would be exercised one year after their issuance, their value, and the charge would have been approximately $146,000, rather than $577,000.

We are required in the preparation of the disclosures required under SFAS 148 to make certain estimates when ascribing a value to employee stock options granted during the year. These estimates include, but are not limited to, an estimate of the average time option grants will be outstanding before they are ultimately exercised and converted into common stock. These estimates are integral to the valuing of these option grants. Any changes in these estimates may have a material effect on the value ascribed to these option grants. This would in turn affect the amortization used in the disclosures we make under SFAS 148, which could be material. For disclosure purposes only, the fair value of options granted in the past to employees 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 6.59%; and an

expected life of three to five years. The fair value of options granted to employees subsequent to May 12, 2004, the date of our first filing with the U.S. Securities and Exchange Commission in connection with our IPO is 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 3.19% to 4.18%; volatility between 38.62% and 66.76%, and the expected life of the option, generally four years. If we had made different assumptions than those noted above, the related disclosures under SFAS 148 could have been significantly different.

Finally, the FASB recently enacted Statement of Financial Accounting Standards 123 (revised 2004) , *"Share-Based Payment"* ("SFAS 123R"), which replaces SFAS 123, *"Accounting for Stock-Based Compensation"*. The impact of SFAS 123R on future periods is discussed in the section of this Management's Discussion & Analysis titled "Recently Issued Accounting Pronouncements".

Accounting For Income Taxes

As part of the process of preparing our consolidated financial statements, we are required to estimate our income taxes in each of the jurisdictions in which we operate. This process involves management estimating our actual current tax exposure together with assessing temporary differences resulting from differing treatment of items for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included within our consolidated balance sheet. We must then assess the likelihood that our deferred tax assets will be recovered from future taxable income and, to the extent we believe that recovery is not likely, we must establish a valuation allowance. To the extent we establish a valuation allowance or increase this allowance in a period, we must include an expense within the tax item in the statement of operations. Significant management judgment is required in determining our provision for income taxes, our deferred tax assets and liabilities and any valuation allowance recorded against our net deferred tax assets. We have fully offset our US deferred tax asset with a valuation allowance. Our lack of earnings history and the uncertainty surrounding our ability to generate taxable income prior to the expiration of such deferred tax assets were the primary factors considered by management in establishing the valuation allowance. Deferred tax assets and liabilities in the financial statements result from the tax amounts that would result if our Israeli subsidiary distributed its retained earnings to us. This subsidiary is entitled to a tax holiday, as described above, yet continues to generate taxable income in respect of services provided to us, and therefore were the subsidiary to distribute its retained earning to us, we believe that the deferred tax asset relating to the Israeli subsidiary would be realized. In the event that our subsidiary's products would not generate such taxable income, we would need to write off the deferred tax asset as an expense in the statement of operations. It should be noted that as the income is derived from us, it is eliminated upon consolidation.

Foreign Currency Translation

Beginning February 2004, our Israeli subsidiary began paying substantially all of its salaries linked to the U.S. dollar ("USD"), rather than the New Israeli Shekel ("NIS"). Based on this change, and in conjunction with all other relevant factors, our management has determined that the subsidiary's functional currency, beginning the first quarter of 2004, is the USD. SFAS 52, Appendix A, paragraph 42 cites economic factors that, among others, should be considered when determining functional currency. We determined that the cash flow, sales price and expense factors for our subsidiary, which prior to 2004 all indicated functional currency in foreign currency, have changed in 2004 to indicate the functional currency is the USD.

Our subsidiary's revenue is calculated based on costs incurred plus a profit margin. Prior to 2004, salary expense, its primary expense, was determined in the foreign currency resulting in income and expenses being based on foreign currency. However, in 2004, a triggering event occurred that, in our opinion, warranted a change of the functional currency of our subsidiary to that of our currency, USD. Salary expense, the primary expense of our subsidiary, began to be denominated in USD. This led to a change with respect to the currency of the cash flow, sales price and expense economic factors and resulted in a determination that our subsidiary's functional currency had changed to that of our functional currency.

Had we determined that our subsidiary's functional currency was different than what was actually used, we believe that the effect of such determination would not have had a material impact on our financial statements.

Recently Issued Accounting Pronouncements

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. Until new guidance is issued, companies must continue to comply with the disclosure requirements of EITF 03-1 and all relevant measurement and recognition requirements in other accounting literature. We do not expect the adoption of EITF 03-1 to have a material effect on our 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 our results of operations and financial condition.

In December 2004, the FASB issued SFAS 123R, which requires the measurement of all employee share-based payments to employees, including grants of employee stock options, using a fair-value-based method and the recording of such expense in our consolidated statements of income. 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 3 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 123 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

Our principal sources of liquidity are our cash, cash equivalents and investment securities, and to a lesser extent, the cash flow that we generate from our operations.

As of June 30, 2005, we had $21,280,754 of assets consisting of $2,630,378 in cash and cash equivalents, $16,800,000 in investment securities, $584,610 in other current assets and the remaining balance in property and equipment and other long-term assets. Total liabilities as of June 30, 2005, reflect current liabilities of $1,566,797, consisting primary of accounts payable and accrued expenses and compensation. Long-term liabilities of $1,105,295 are comprised primarily of liabilities in respect of employee severance obligations and deferred revenues, long-term.

Cash flows for the six months ended June 30, 2005 and 2004 were as follows:

	June 30, 2005		June 30, 2004	
Net cash used in operating activities	$	(1,626,917)	$	(1,697,441)
Net cash used in investing activities	$	(11,124,016)	$	(121,010)
Net cash provided by financing activities	$	13,828,281	$	3,645,519

Despite a net loss of $3,106,910 during the six months ended June 30, 2005, our net cash used in operations was $1,626,917. The primary reasons for the large difference is that $930,000 of our operating expenses was the result of non-cash, stock-based compensation, and due to various changes in our operating assets and liabilities. Despite a net loss of $3,566,861 during the six months ended June 30, 2004, our net cash used in operations was $1,697,441. This was due to many factors, the most significant of which is non-cash amortization of promissory note discounts, of $1,368,755.

Cash used in investing activities of $11,124,016, during the six months ended June 30, 2005 is attributable primarily to purchases of investment securities of $16,150,000, less proceeds from the sale of investment securities, of $5,200,000, and to capital expenditures of $161,000. 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. Cash used in investing activities of $121,010 during the six months ended June 30, 2004 resulted primarily from the purchase of the Answers.com domain name for $80,200 and capital expenditures of $39,000.

Cash flow from financing activities during the six months ended June 30, 2005 was comprised of the net proceeds, of approximately $12,225,000 from the exercise of warrants via the Warrant Reload Agreement, with the remainder resulting from other exercises of stock warrants and stock options. Cash flow from financing activities during the six months ended June 30, 2004 resulted from the net proceeds of $4.3 million of bridge notes that were issued in January and February 2004, reduced by $630,000 of issuance costs related to our IPO.

Current and Future Financing Needs

We have incurred negative cash flow from operations since our inception. We have spent, and expect to continue to spend, substantial amounts in connection with implementing our business strategy. We raised approximately $10,786,000, net of underwriting fees and offering expenses, through our IPO and the exercise of the over-allotment option in the last quarter of 2004. After repaying the portion of the bridge notes that did not convert to common shares, of $3,160,000, approximately $7.6 million remained. In February 2005 we entered into the Warrant Reload Agreement with certain holders of warrants that were issued by us 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, we raised approximately $12,225,000, net of costs relating to the exercise. Further, during the six months ended June 30, 2005, we raised approximately $1.6 million, from other exercises of warrants and options. Based on our current plans, we believe that the net proceeds of the aforementioned financings will be sufficient to enable us to meet our planned operating needs for the next twelve months. Notwithstanding, we may need to raise additional capital through future debt or equity financing to make acquisitions, license products and technologies complementary to our business or finance growth. Additional financing may not be available at all or on terms favorable to us.

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.

ITEM 3. CONTROLS AND PROCEDURES

Based on their evaluations as of the end of the period covered in this report, our principal executive officer and principal financial officer have concluded that our disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15(d)-15(e)) are effective to ensure that information required to be disclosed by us in reports that we file or submit under the Securities Exchange Act is recorded, processed, summarized and reported within the time

periods specified in the rules and forms of the SEC.

We believe that a controls system, no matter how well designed and operated, is based in part upon certain assumptions about the likelihood of future events, and therefore can only provide, reasonable, not absolute, assurance that the objectives of the controls system are met, and no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within a company have been detected.

In addition, we have reviewed our internal controls over financial reporting and have made no changes during the quarter ended June 30, 2005, that our certifying officers concluded materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

On July 14, 2005, Mr. Steven Tover (“Tover”), former Vice President, Business Development & Sales of the Company, filed a statement of claim with the Regional Labor Court in Jerusalem, Israel, against (i) the Company, (ii) Mr. Robert Rosenschein (the Company’s CEO and a Chairman of the Board), and (iii) Mr. Steven Steinberg (the Company’s CFO) in the amount of approximately US$50,000, for deferred salary, severance pay and allegedly unpaid commissions. Tover’s action further claims that he is entitled to certain additional and future commissions pursuant to various business transactions and to exercise stock options granted to him, which, according to the Company, have expired at the close of fiscal 2004. The stock options discussed in Tover’s claim consist of 43,441 options to purchase such number of shares of common stock of the Company, with an exercise price of $2.76 per share. After consultation with legal counsel, management believes that the probability of Tover’s action prevailing is low. The named defendants completely reject the validity of Tover’s claims and will file a statement of defense in the next several weeks.

ITEM 2. CHANGES IN SECURITIES

Not applicable

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not applicable.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

Not applicable.

ITEM 5. OTHER INFORMATION

Not applicable.

ITEM 6. EXHIBITS

31.1	Certification of Principal Executive Officer required under Rule 13a-14(a) or Rule 15d-14(a) of the Securities and Exchange Act of 1934, as amended.
31.2	Certification of Principal Financial Officer required under Rule 13a-14(a) or Rule 15d-14(a) of the Securities and Exchange Act of 1934, as amended.

32.1*	Certification of Principal Executive Officer required under Rule 13a-14(a) or Rule 15d-14(a) of the Securities and Exchange Act of 1934, as amended, and 18 U.S.C. Section 1350.

32.2* Certification of Principal Financial Officer required under Rule 13a-14(a) or Rule 15d-14(a) of the Securities and Exchange Act of 1934, as amended, and 18 U.S.C. Section 1350.

* The certifications attached as Exhibits 32.1 and 32.2 accompany this Quarterly Report on Form 10-QSB pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and shall not be deemed "filed" by GuruNet Corporation for purposes of Section 18 of the Securities Exchange Act of 1934, as amended.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

GURUNET CORPORATION

Date: August 4th, 2005

By: /s/ Robert S. Rosenschein

Robert S. Rosenschein
Chief Executive Officer
(Principal Executive Officer)

By: /s/ Steven Steinberg

Steven Steinberg
(Principal Financial and Accounting Officer)

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