ANNUAL REPORT 1997

The eBusiness People.

INTERSHOP

FINANCIAL SUMMARY

In thousands US $

	1997	1996
RESULTS OF OPERATIONS		
REVENUES	5,711	612
Licenses	3,342	32
Services	1,725	404
Other	644	176
GROSS MARGIN	2,663	-127
RESEARCH AND DEVELOPMENT EXPENSE	1,141	388
SALES AND MARKETING EXPENSE	5,345	1,391
GENERAL AND ADMINISTRATIVE EXPENSE	3,909	1,029
OPERATING LOSS	-7,732	-2,935
NET LOSS	-7,956	-3,020
ASSETS AND LIABILITIES AS OF DEC. 31		
PROPERTY, EQUIPMENT AND OTHER ASSETS	2,576	668
CURRENT ASSETS	9,070	1,329
CASH AND CASH EQUIVALENTS	5,520	269
TOTAL ASSETS	11,646	1,997
SHAREHOLDERS' EQUITY	-5,299	-1,207
LONG-TERM DEBT	1,956	2,157
CURRENT LIABILITIES AND DEFERRED INCOME	14,989	1,047
CASH FLOW AND INVESTMENT		
CASH FLOW FROM OPERATING ACTIVITIES	2,817	-2,549
INVESTMENT IN EQUIPMENT	2,043	680
EMPLOYEES AS OF DEC. 31	179	43

CONTENTS

The difference between too early and too late is almost always only a single moment.

Franz Werfel

The Internet is changing the world. The gradual evolution of a worldwide marketplace without regional or chronological borders is revolutionizing the way manufacturers, merchants and customers do business.

INTERSHOP is a industry leader in the development of visionary business models for retailing across the Internet. We develop and market turnkey electronic commerce software worldwide. Our technology has become today's benchmark in terms of functionality, versatility and customer benefits.

Entering an exciting future

INTRODUCTION

Dear Investors, Customers, Business Partners and Employees,

The use of electronic networks to do business, which is generally referred to as »electronic commerce«, is one of today's »hottest« new trends and is currently experiencing a major breakthrough worldwide. In the wake of the explosive expansion of the Internet, business and industry are looking for ways to take advantage of this new phenomenon. Advertising represented the first commercial use of the Internet. However, advertising cannot take full advantage of the potential offered by the Internet, and the requisite investment cannot be justified. Electronic commerce, on the other hand, is a logical extension of the growing popularity of the Internet and, in addition to the Internet's role as an inexhaustible source of information, is the one activity for which it was from the very beginning predestined.

In the not too far removed future, virtually every company and every business will offer its products and services on the Internet. The motives will, however, vary. Some will simply want to cut costs. Others will see this as a way to streamline distribution structures. Some will want to reach more potential customers. And, finally, there will be those who will simply want to do what their competitors are doing. For consumers, electronic commerce means savings in terms of time and money. It will also give them a better overview of what is available on the market and eliminate geographical barriers. The advantages of electronic commerce over conventional business channels will ultimately result in a thoroughgoing change in retailing structures, and in only five to ten years, most business will be transacted electronically.

INTERSHOP Communications develops business models and software for the information society, which means electronic retailing via the Internet. Our products feature innovative technology based upon a visionary business model.

STEPHAN SCHAMBACH, *President and CEO*

INTERSHOP Communications was among the first to realize that the technical infrastructure for electronic commerce will chiefly consist of »managed services«, which means that projects will be outsourced to telecommunications companies and Internet providers. We developed the dedicated products required for these applications and were the first to explain the possibilities of this new business model to potential users. Today, INTERSHOP Communications occupies a position of leadership in this market, and our customers include the world's largest telecommunications companies and Internet service providers.

The ultimate goal of our corporate strategy is to establish an even stronger presence in the market for electronic commerce software in the short term in order to be able to take maximum advantage of the potential for growth offered by this market. We intend to achieve this through continued emphasis upon leadership in technology, a global presence, strong strategic alliances and appropriate acquisitions.

The year 1997 was one of impressive progress in terms of achieving our overall objectives. For example, we substantially reinforced our presence in the USA and thereby demonstrated that we have the resources required to compete successfully in the extremely competitive American market. In addition to our Jena and San Francisco locations, we also established subsidiaries and offices in Hamburg, Stuttgart, London and Paris in the course of the year.

Our products represent the optimum response to our customers' needs, which was once again confirmed in 1997. In the course of the year, our technology captured various prestigious awards for the best electronic commerce software on the market. However, the fact that so many new customers opted for INTERSHOP in 1997 was of course even more important for us. All in all, over 2,000 customers worldwide have opted for INTERSHOP technology to date.

We are also proud of the fact that we were able to attract additional major corporations as strategic partners, including leading telecommunications companies. For example, we concluded a six-figure agreement with Deutsche Telekom AG in 1997.

Our successful performance in 1997 can also be expressed in facts and figures. For example, 1997 sales were ten times as high as the comparable figure for the previous year, and our workforce quadrupled in the course of the year. And we will continue to expand. With the introduction of our new-generation INTERSHOP 3 in early 1998, we set a new industry benchmark for technical performance in the area of electronic commerce. In addition, new locations in Toronto, Melbourne and Sydney in early 1998 marked our entry into new regional markets, and we are planning to establish a presence in Tokyo, Singapore and São Paulo soon.

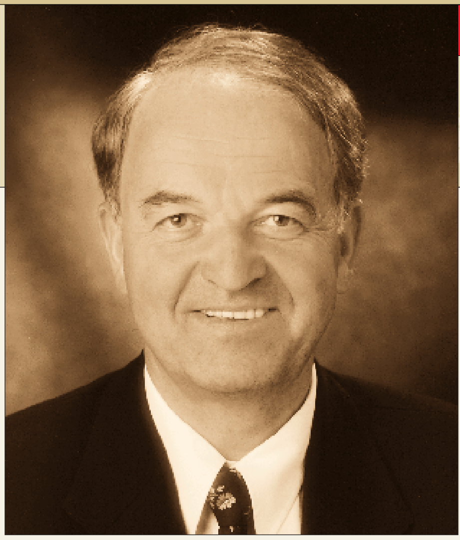
Our offensive market strategy requires large-scale investment – to develop, market and sell products and to create a worldwide structure designed to permit effective corporate management over the long term. In order to finance our expansion, we have decided to go public. This of course means subjecting ourselves to public scrutiny, which is in the interest of our shareholders, the companies we work with and our employees. We plan to have our shares listed on Frankfurt's Neuer Markt, which is an ideal exchange for young, growth-oriented companies. Compliance with the stringent US generally accepted accounting principles will give investors access to maximum information.

In order to create optimum conditions for our stock market debut, we revamped our corporate structure in June 1998 by integrating the former parent company, INTERSHOP Communications, Inc., into a German stock company, INTERSHOP Communications AG, which now functions as the financial holding company for the group.

We are convinced that our decision to go public will represent a further chapter in the INTERSHOP Communications success story. However, for us, going public is not an end in itself, but a new beginning – and a milestone that marks our entry into an exciting future.

Stephan Schambach
President and Chief Executive Officer of INTERSHOP Communications, Inc.
President of INTERSHOP Communications AG

GUEST ADDRESS



LADIES AND GENTLEMEN, DEAR FRIENDS AND COLLEAGUES AT INTERSHOP,

You are one of those companies – actually the word »entrepreneurs« would be a better choice – that Germany so urgently needs. Entrepreneurs are business animals who like to experiment, make fast decisions, think creatively and flexibly and work hard. Plus they're also not afraid of making money.

Your company's curriculum vita is as impressive as it is exemplary:

- ∑ *established in 1992 in Jena,*
- ∑ *1996: the world's first complete electronic commerce package for the Internet,*
- ∑ *last year: strategic alliances with Deutsche Telekom and France Telecom, to mention only two,*
- ∑ *various awards: »Best of Show« at Systems in Munich, »Solutions of the Year 1997« from IBM, »Rated Best« by Software Digest.*

Even we at Hewlett-Packard have to be envious. And not only that, you started to operate at the international level in just about no time at all. You're present in Europe and the USA and, as I've heard, also in Australia. That's really the sort of thing that makes hearts beat faster in the IT industry, which is used to success.

If I'm correct, you're only lacking one thing from our point of view – you didn't start out in a garage, which is more or less standard practice in our industry! On the other hand, you've beaten us out in one respect because your company has already received venture capital after only four years of existence.

All in all, that adds up to a list of first-class highlights. Congratulations! We at Hewlett-Packard can't help but being a little proud of the fact that we have not only witnessed your spectacular growth; we also participated in it from the very beginning, as »godfathers« in a sense. And now we're benefiting from that in the business-to-business area with what in my opinion is the leading concept in the area of indirect sales. Our declared goal is to use the extranet to more and more of our business partners and customers involved in our business activities online. That means the virtual marketplace has become reality.

We know from experience that so-called »small businesses«, which means small companies like yours, are often the real pioneers! When everyone was talking about doing business on the Internet, you simply took chance risk and did it! We'll be watching your debut on the stock market with interest.

Finally, a one last remark – and a personal one: Hewlett-Packard's success is more than anything else a result of mutual cooperation. And you, the young entrepreneurs of INTERSHOP, have made an impressive contribution in that respect.

We at Hewlett-Packard are looking forward to continuing to work with you, the pioneers in the area of business on the web.

My sincere thanks and best wishes for continued success.

Jörg Menno Harms

Managing Director of Hewlett-Packard GmbH

Member of the Board of Directors of INTERSHOP Communications, Inc.

Member of the Supervisory Board of INTERSHOP Communications AG

Except from an address at the INTERSHOP Communications press conference held at CeBIT on March 21, 1998, in Hanover, Germany.

FOUNDERS

The founders of INTERSHOP Communications , Stephan Schambach, Wilfried Beeck and Karsten Schneider, are all involved at the operational level and continue to represent the managerial backbone of INTERSHOP. They are responsible for long-term strategic and technological planning, international coordination and negotiations with potential strategic partners.

OPERATIONAL MANAGEMENT

Operational management at the international level is based upon the model used by US high-tech companies.

STEPHAN SCHAMBACH

AL POWELL

JEFF WATTS

PETRA VORSTEHER

USA

STEPHAN SCHAMBACH, *President and Chief Executive Officer*

Stephan Schambach abandoned the study of physics in Jena in 1990 at the age of 19 to turn his ideas into reality with his own company. In 1992, he and his partners founded INTERSHOP Communications (originally NetConsult). In 1996, Schambach established INTERSHOP's US subsidiary and now heads the company from its US location as its President and CEO. Schambach pioneered commercial use of the Internet and is today considered an authority on the subject of electronic commerce. In 1997, he received the »California Governors IT Entrepreneurial Excellence Award« in recognition of his success in the area of marketing innovative IT technology at the international level.

AL POWELL, *Vice President Sales*

Al Powell can look back upon many years of sales experience in the computer industry. After holding various positions with IBM, he spent 12 years with Hewlett-Packard in upper-level positions in channel and market management. Today, Powell is in charge of sales activities for INTERSHOP Communications in the USA. He graduated from San José State University with a degree in business and also holds an MBA from San Francisco's Golden Gate University.

JEFF WATTS, *Vice President Marketing*

Jeff Watts is in charge of marketing and strategic planning at INTERSHOP Communications. He holds a BA in economics and has had many years of experience in technology and mass marketing.

PETRA VORSTEHER, *Vice President Strategic Alliances and Business Development*

With 12 years of international experience in sales and marketing, Petra Vorsteher is currently responsible for business development and strategic alliances at INTERSHOP Communications. She was previously president of an international consulting firm specialized in founding and building up young technology companies.

EUROPE

WILFRIED BEECK, *Chief Executive Officer Europe*

One of the three co-founders of INTERSHOP Communications, Wilfried Beeck can look back upon over 15 years of experience in the software industry in both Europe and the USA. Beeck, who studied mathematics and computer science at the University of Kiel, now heads the European INTERSHOP organization.

WILFRIED BEECK

KARSTEN SCHNEIDER, *Vice President Professional Services*

Like Wilfried Beeck and Stephan Schambach, Karsten Schneider is one of the co-founders of INTERSHOP Communications. Schneider came to INTERSHOP from Carl Zeiss in Jena, where he was a development engineer. He graduated from the Institute for Mechanical & Electrical Engineering in Sofia with honors and is now in charge of professional services with INTERSHOP Communications.

KARSTEN SCHNEIDER

FRANK GESSNER, *Vice President Research and Development*

Frank Gessner joined INTERSHOP Communications in 1994 and has had a major influence on INTERSHOP's line of products. Gessner studied at Bolton University in England and then went on to earn an honors degree from the University of Leipzig.

FRANK GESSNER

BERNHARD MARBACH, *Vice President Sales Europe*

Bernhard Marbach has had over 15 years of experience in software sales. He was with PINK Software GmbH in Hamburg, where he was in charge of worldwide sales of publishing house products. Before he came to INTERSHOP Communications in 1996, he was Central European sales manager of NeXT Software Inc. Marbach studied business administration and computer science at the University of Hamburg.

BERNHARD MARBACH

DIRK REICHE, *Director Finance Europe*

Dirk Reiche is the business manager of the European INTERSHOP organization. Following his studies of business administration, he joined Hamburg's publishing-house Gruner + Jahr. Before coming to INTERSHOP Communications, he spent several years as manager of a start-up company involved in new media and a telecommunications firm in Berlin-Brandenburg.

DIRK REICHE

BOARD OF DIRECTORS

The Board of Directors is responsible for advising and monitoring management and also arbitrates in conflict situations. The Board makes strategic decisions and consults on the appointment of managerial personnel. Members of the Board include representatives of the company, experienced senior managers from industry and representatives of investors.


STEPHAN SCHAMBACH

STEPHAN SCHAMBACH, *President and CEO of INTERSHOP Communications, Inc.*


DR. GERT KÖHLER

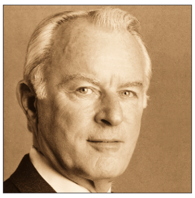
DR. GERT KÖHLER, *Managing Director of Technologieholding VC GmbH*

Dr. Gert Köhler, who holds degrees in mathematics, physics and business administration, is the founder and managing director of Technologieholding VC GmbH. After holding various positions in industry, Köhler spend many years as a management consultant with McKinsey & Company and was also president of a technology holding company. In 1987, he and a partner founded Technologieholding VC GmbH, a company that specializes in supporting young, technology companies with venture capital.


JÖRG MENNO HARMS

JÖRG MENNO HARMS, *Managing Director of Hewlett-Packard GmbH*

Jörg Menno Harms has been a member of the executive board of Hewlett-Packard GmbH since 1988 and managing director of the company since 1993. Harms, who studied electrical engineering at the Technical University in Stuttgart, is a member of the boards of directors of various companies. In addition, he plays an important role in various German professional associations.


TED SMITH

TED SMITH, *Chairman of FileNet Corp.*

Ted Smith, Chairman of FileNet, has been involved in the computer industry since 1960. After holding various upper-level managerial positions in the software industry, Smith founded FileNet in 1982. Today, FileNet is the world's largest producer of software for business automation and electronic document management. Smith was named »Entrepreneur of the Year« for southern California by the Institute of American Entrepreneurs in 1987.

INTERSHOP 3

Toronto

98

•ΣIntroduction of new-generation INTERSHOP 3

•ΣPreparations for going public

•ΣCreation of INTERSHOP Communications AG, the German holding company

Sydney

Melbourne

Stuttgart

97

•Σ Acquisition of INTERSHOP Communications GmbH by INTERSHOP Communications, Inc. and transfer of the group's international headquarters to the USA

•Σ Introduction of turnkey software INTERSHOP Mall

•Σ Cooperation and license agreement with Deutsche Telekom AG

Hamburg

London

Paris

96

•Σ Change of company name to INTERSHOP Communications GmbH

•Σ Introduction of turnkey software INTERSHOP Online

•Σ First German Internet company to receive venture capital

San Francisco

95

•Σ First 100% viable Internet sales system – a catalogue with order-entry and search functions plus inventory control – goes online with 13,000 items

94

•Σ Specialization in Internet applications and electronic commerce

Jena

92

•Σ Establishment of NetConsult Computersysteme GmbH in Jena

The future is now

MARKETS

INTERSHOP COMMUNICATIONS DEVELOPS AND MARKETS SOFTWARE FOR ELECTRONIC COMMERCE APPLICATIONS.

As more and more people start to use the Internet, electronic commerce will also assume new importance as a way of transacting business. Today, companies are already handling a substantial percentage of their transactions with other companies via the Internet. However, the volume of products and services offered to consumers on the Internet is growing every day. In the early days of electronic commerce, typical mail-order products like books and CDs dominated the Internet market, but today companies in more and more branches of business and industry are offered their products and services on the Internet. Worldwide 1997 Internet sales are estimated to represent a total of US $ 21.8 billion (Source: ActiveMedia). And that's only the beginning. Annual electronic sales are expected to reach US $ 1.2 trillion by the year 2002. The current driving force behind this global trend, the USA, generated three-quarters of all Internet sales in 1996 but will account for roughly half by the year 2000 (Source: JP Morgan).

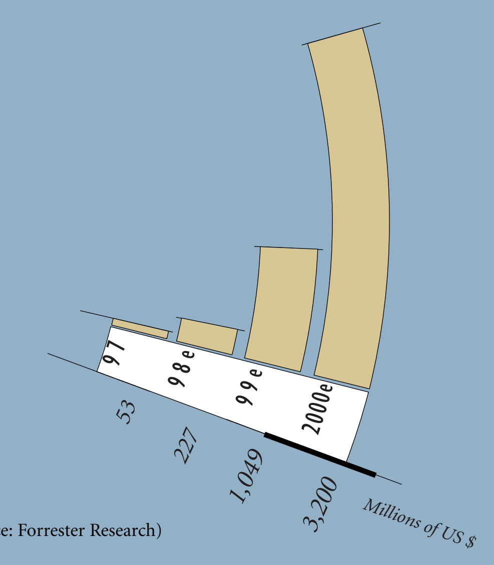
The future is now

Throughout the world, the increase in the commercial use of the Internet will automatically generate demand for electronic commerce software that makes it possible to handle business transactions electronically. The first electronic commerce applications were individual one-of-kind solutions, but the current trend is toward the use of turnkey software products. Customers include manufacturers and merchants with their own Web servers who operate their own shops. On the other hand, telcos and service providers are acquiring electronic commerce solutions that enable them to rent shops to manufacturers and merchants as »managed services«. The advantage of this option is that merchants incur no installation or operating costs.

Today's electronic commerce solutions include everything from simple turnkey solutions to one-of-a-kind custom-configured products. In the next few years, the medium-range segment consisting of high-performance turnkey solutions costing between US $ 5,000 and US $ 50,000 will dominate the market and account for approximately three-quarters of the total market by the year 2000 according to the Meta Group, a market research organization.

It is estimated that 1997 worldwide sales of electronic commerce products came to US $ 53 million (Source: Forrester Research). Sales of US $ 3.2 billion are projected for the year 2000, 20 to 30% of which will go for turnkey software and 70 to 80% for custom applications and services.

GROWTH OF MARKET FOR ELECTRONIC COMMERCE SOFTWARE



(Source: Forrester Research)

What is electronic commerce?

Electronic commerce, sometimes also referred to as electronic business, is a general term used to describe business transactions made via electronic data networks such as the Internet. These transactions may involve companies, governmental authorities and consumers:

- *Manufacturers offer their products directly to end-users through the Internet. Potential customers can obtain detailed information on products, place orders and make payment through a computer. The merchandise is delivered to the customer, who not longer has to make the usual trip to the vendor's outlet.*
- *Companies conduct transactions with one another either through the Internet or through Extranets, which are closed inter-company networks. For example, they can place orders, coordinate logistics operations or transfer funds.*
- *Operating units or employees of the same company work together by using Intranets, which are closed intra-company networks.*
- *Public authorities handle administrative matters with companies and private citizens through the Internet. The possibilities include official applications, changes in data, tax returns, etc.*

Unlike conventional distribution channels, electronic commerce permits direct, inter-active multimedia business transactions between buyers and sellers. The Internet does away with national border to create an international marketplace. Transactions can be made at any time and from anywhere in the world. Manufacturers can sell their products directly to end-users without the services of intermediaries, which means they can cut costs and offer lower prices. Electronic commerce offers all the advantages of the Internet, which is not the case of other electronic purchasing avenues such as the telephone or fax transmission. The graphic interface of the World Wide Web makes it possible to present any desired quantity of product information in an attractive multi-media format. In addition, technical links with other operational information systems *such as inventory control, bookkeeping, etc., permit complete automation of a vendor's central processes and procedures. All in all, electronic commerce permits dramatic simplification and acceleration of business procedures. Both consumers and retailers can access an unlimited market and also reduce their costs substantially. Today, it has already become obvious that electronic commerce will produce a fundamental change in consumer habits in the next few years. The ultimate result will be complete integration of all parties involved to create an open, efficient marketplace.*

REASONS WHY ELECTRONIC COMMERCE WILL BE THE MARKETING CHANNEL OF THE FUTURE:

- *Increasing pressure in terms of competition and pricing is causing manufacturers and merchants to look for new ways to reach more potential customers, to offer additional services and to cut costs.*
- *The persistent increase in the popularity of the Internet as a means of mass communication. The number of Internet users will increase ten-fold, going from 100 million in 1997 to 1 billion by the year 2005 (Source: US Dept. of Commerce).*
- *Lower telecommunication costs coupled with improvements in service.*
- *The trend toward globalization on the part of organizations and markets.*
- *The increase in the demand for services and convenience.*
- *The introduction of new payment systems and improved standards of security in the Internet.*
- *Increase in the number of well-known reference applications.*
- *The development of mature high-performance software.*

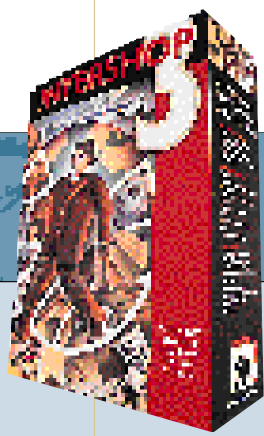
Award-winning technology

PRODUCTS AND TECHNOLOGY

INTERSHOP was not only the first complete turnkey software solution for electronic commerce, but is also today's industry benchmark. Unique in terms of versatility, the basic INTERSHOP software solution permits inexpensive installation of an individual store as well as the implementation of complex business structures in the Internet and Intra- or Extranets.

Introduced in early 1998, successful new-generation INTERSHOP 3 combines all the advantages of its predecessors, INTERSHOP Online and INTERSHOP Mall, and sets new standards of performance for electronic commerce solutions.

A high-performance off-the-shelf software solution capable of custom modification, INTERSHOP 3 covers all important segments of today's market.



INTERSHOP 3 PRODUCT LINE CONTAINS FOUR PRODUCTS:

- *The* **INTERSHOP 3 MERCHANT EDITION** *is a complete solution for the operation of a single store with options for the direct sale of products and services in the Internet, which makes it the ideal solution for manufacturers and merchants looking for an easy way to go online with their own stores.*
- *The* **INTERSHOP 3 HOSTING EDITION** *supports operation of any number of stores and is chiefly intended for service providers and telcos desiring to rent shop to manufacturers and merchants as managed services.*
- *The* **INTERSHOP 3 DEVELOPER EDITION** *is a free offline version for storefront design intended for use by multimedia agencies and web designers.*
- *The* **INTERSHOP 3 ADD-ON-***products include additional functions and interfaces with other IT systems (inventory control and payment systems, for example).*
- *In addition to turnkey software, INTERSHOP Communications also offers* **INTERSHOP PROFESSIONAL SERVICES** *to provide customized solutions based upon INTERSHOP 3 to meet specific customer needs.*

FEATURES AND FUNCTIONS OF INTERSHOP 3:

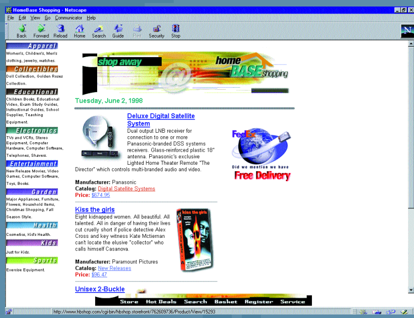
- *Simple installation without additional programming investment*
- *Complete back-office management (product management, catalog creation and editing, order processing and customer accounts)*
- *Unlimited number of stores*
- *Unique, attractive pre-defined templates for storefront design*
- *Multilingual capability*
- *Independent of server operating system (Unix or NT)*
- *Supports leading payment and inventory-management systems*
- *Can be tailored to customers requirements*
- *Maximum data security*
- *Intuitive user instructions and design*

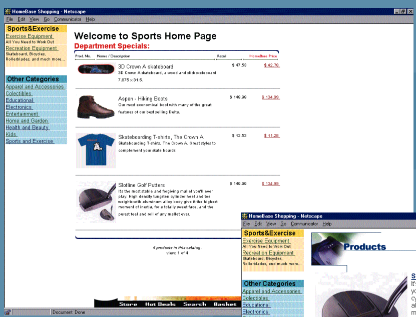
INTERSHOP products rank among the world's best-selling electronic commerce solutions. Today, over 2,000 customers have already opted for INTERSHOP's attractive technology and equally attractive price-performance ratio. Major international corporations like Hewlett-Packard and Siemens-Nixdorf turned to INTERSHOP for their electronic commerce software in 1996 and were followed by numerous medium-sized companies and leading telecommunications companies like Deutsche Telekom and France Telecom in 1997.

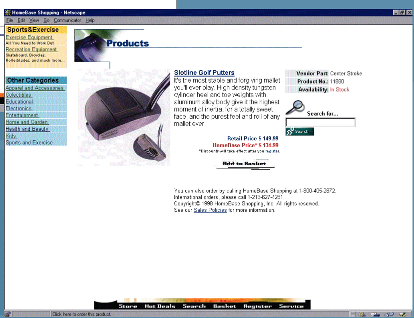
Online shopping with INTERSHOP 3 and how it works

1 INSTALLATION

With INTERSHOP 3, installation is simple and easy, and it takes only a few minutes to design a storefront and set up a back-office. As soon as the virtual store goes online, it's »open for business« to Internet users throughout the world.





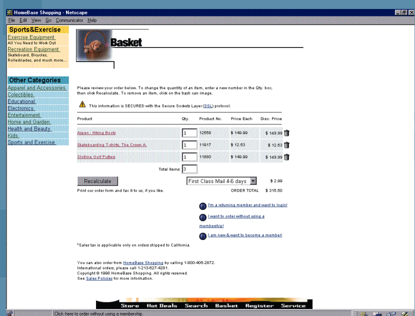


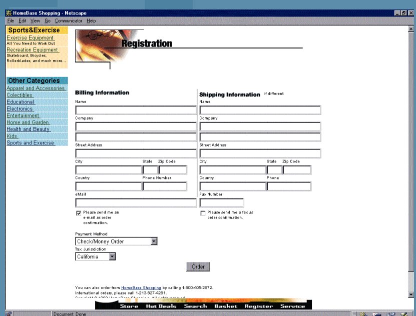
2 INFORMATION

Photos and detailed descriptions provide customers with complete information on products and services.

3 SELECTING PRODUCTS

Customers place the products they select in a virtual shopping basket. The items in the basket are automatically displayed and can be changed at any time.





4 ORDERING

All it takes is a single mouse click to order the contents in the shopping basket. Customers enter their billing and shipping address and select one of the methods of payment offered.

5 AUTOMATIC FOLLOW-UP

Depending upon the degree of integration into other IT systems, follow-up processing such as invoicing, bookkeeping, order processing, inventory control and shipment are handled automatically.

Alliances

BUSINESS PARTNERS

INTERSHOP Communications is committed to a policy of strategic alliances – in technology, in marketing and in sales. Mutually beneficial alliances represent a major pillar of corporate policy.

STATEMENTS

HEWLETT-PACKARD GMBH

Heinz Heining, Director of Information Technology

»Our partnership with INTERSHOP has been dynamic and successful since 1995. The eCommerce systems developed for Hewlett-Packard by INTERSHOP stand out because of their high degree of reliability and user acceptance. One of the things the use of INTERSHOP technology made possible was drastic shortening of the ordering cycle.«

SIEMENS-NIXDORF INFORMATIONSSYSTEME AG

Luc Loos, Sales Manager Open Enterprise Computing

»Siemens-Nixdorf views electronic commerce as one of the fastest growing markets. Our partnership with Intershop has given our customers access to preconfigured systems and solutions in the area of eCommerce. This was also impressively confirmed by our joint presence at CeBIT 1998, which generated considerable interest on the part of our customers and interested parties.«

DEUTSCHE TELEKOM AG

Lutz Völker, Managing Director Telekom Multimedia Systemhaus (TMS)

»Deutsche Telekom AG and INTERSHOP Communications signed a licensing agreement covering the use of INTERSHOP Communications eCommerce software back in 1997. INTERSHOP software gives Telekom's commercial customers a turnkey product that provides effective support for business-to-business and business-to-consumer transactions in the Internet. INTERSHOP is marketed with the use of the Shop & Mall Systems product in the new multimedia system solutions of Deutsche Telekom under the T-Mart umbrella brand.«

STRATEGIC ALLIANCES

For a young company like INTERSHOP Communications, strong partners are important, which is why INTERSHOP Communications started very early on to enter into strategic alliances and cooperative ventures with other companies to shape the future of the electronic commerce market together. We have successfully cooperated with such companies extensively and at various levels – in the execution of electronic commerce projects, for example, or in the area of distribution. Our strategic partners included some of the world's leading IT and telco companies such as Hewlett-Packard, Siemens-Nixdorf, Sun Microsystems, Deutsche Telekom and France Telecom.

SALES ALLIANCES

Worldwide, INTERSHOP Communications cooperates with over 500 qualified companies, including leading software vendors and integrators, multimedia agencies, and consultants, who that offer their customers INTERSHOP-solutions. Representatives of these companies participate in a special program and receive five days of in-depth training. These companies advise customers and handle software customization and installation on site.

TECHNOLOGY ALLIANCES

One major factor behind the success of INTERSHOP Communications is the compatibility of its products with other IT systems up- or downstream. INTERSHOP technology can be integrated into virtually all existing inventory-management and payment systems. As a result, INTERSHOP Communications also collaborates with leading vendors in the area of technology. In addition, INTERSHOP Communications has entered into alliances with company's that offer technology that complements INTERSHOP software.

Technology for the future

RESEARCH AND DEVELOPMENT

The technological leadership of our products represents the basis for the success of INTERSHOP Communications. In order to maintain and increase its competitive edge, INTERSHOP Communications is working on the technology for the future today.

Technology for the futu

»BEST OF CLASS«
Internet Commerce Expo (April 1997)

»RATED BEST«
National Software Testing Laboratories (1997)

Finalist
»BEST OF SHOW«
CeBIT 98

»BEST OF BYTE«
Byte Magazine (April 1997)

2nd Place
»BEST eCOMMERCE«
IBM Solutions of the Year (October 1997)

INTERSHOP Communications product technology was rated the best electronic commerce software on the market by various prominent magazines and testing institutes.

The purpose of the R&D activities of INTERSHOP Communications is not only to improve existing technology, but also to pursue visionary business models for the future – appealing virtual marketplaces with flexible infrastructures, interactive shopping, entertainment and services as cross-connectivity at many different levels.

INTERSHOP Communications maintains its own development center in Jena, Germany, which provides ideal prerequisites for achieving its ambitious goals. As a result of the many institutions of higher learning in the immediate vicinity, Jena offers impressive resources in terms of highly qualified software engineers. Due to the lack of competition in the local employment market and the availability of governmental subsidies, development costs are relatively low in Jena. This gives INTERSHOP Communications an important cost advantage over comparable companies in the US. Nevertheless, 1997 research and development expense came to 20% of INTERSHOP's revenues.

Worldwide, nearly half of our employees are involved in the development of new products and projects, most of whom in Jena. The »Advanced Technology Group« in the USA gives INTERSHOP Communications a »brain trust« created to anticipate new developments in the very competitive American market and originate concepts for future products.

The strategy of INTERSHOP Communications also involves the use of cooperative ventures or acquisitions to complement its own basis technology with software solutions developed by others whenever this permits substantial product improvements.

Room for personal development

HUMAN RESOURCES

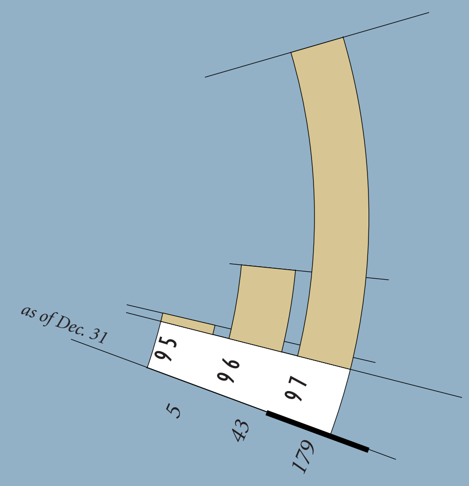
The success of INTERSHOP Communications is based upon the qualifications and commitment of its employees. They are the ones who supply the intellectual input, develop new ideas for electronic commerce software, create the software and sell our products.

An efficient, attractive working environment for employees has always been a major priority for INTERSHOP Communications, which promotes dialog within the company and cultivates a corporate culture that gives each individual the opportunity to realize his potential. Employees can access information on all important matters through an extensive intranet. Special events held twice a year also give employees an opportunity to get to know one another personally and reinforce their feeling identification with the company. A policy of active personnel management makes it possible to provide opportunities for advancement and training for specific individuals wherever appropriate.

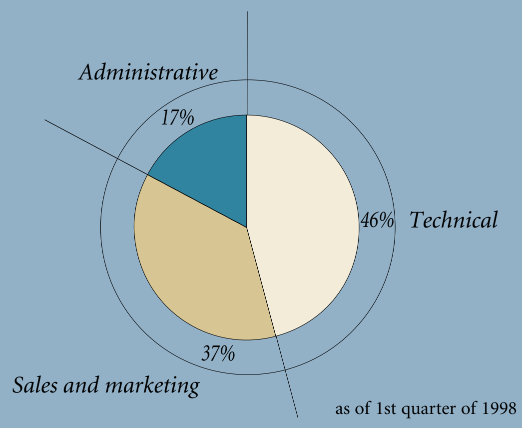
From the very beginning, employee participation in the success of the company has been a cornerstone of personnel management. All employees can acquire stock in the company, which allows them to share in the results of their work. This not only helps to retain and motivate present employees but is also an important means of attracting new personnel.

The various measures intended to promote a feeling of identification on the part of its employees has resulted in a high degree of loyalty to the company. Since the company was founded, employee fluctuation has been near negligible.

NUMBER OF EMPLOYEES



BREAKDOWN ACCORDING TO ACTIVITIES IN %



As INTERSHOP Communications expanded, the number of employees increased substantially, going from five in late 1995 to 179 at year-end 1997 and then 265 in the first quarter of 1998. Most – 46% – are involved in technical areas (R&D, professional services, support), which reflects the company's strong commitment to product development. On the other hand, INTERSHOP Communications recognized very early on that offensive marketing represents an essential prerequisite for ongoing success and therefore added substantial personnel in this area. As a result, almost as many employees – 38% – are active in sales and marketing. Due to the company's European origins and the concentration of product development resources in Jena, the majority of the company's employees – 65% – are located in Europe and almost a third in the USA.

INTERSHOP Communications is also well -prepared to face the challenges of the future in terms of managerial resources. All key positions are held by experienced managerial personnel with track records of success either in the software industry or with prominent companies in industry. The company's versatile technical and organizational structures were planned to permit expansion to keep up with the company's growth in the years to come.

Given its potential in terms of highly qualified, motivated personnel, experienced management and a corporate infrastructure created with future needs in mind, INTERSHOP Communications has the internal resources to ensure continued growth and expansion.

Financial information

CONTENTS

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

The following discussion and analysis of the results of operations and financial condition of INTERSHOP Communications should be read in connection with the consolidated financial statements of INTERSHOP Communications, Inc. for the fiscal years ended 31 December, 1995, 1996, and 1997 (including the combined notes thereto and the consolidated cash-flow statements).

Overview

INTERSHOP Communications was originally founded in 1992 as NetConsult Communications GmbH in Germany as a limited liability company. NetConsult Communications GmbH established a wholly owned subsidiary, NetConsult Communications, Inc., a Delaware corporation, in March 1996. On December 31, 1996, NetConsult Communications, Inc., NetConsult Communications GmbH and the shareholders of NetConsult Communications GmbH entered into a Share Exchange Agreement, whereby NetConsult Communications, Inc. acquired all outstanding interest in NetConsult Communications GmbH in exchange for preferred and common stock in NetConsult Communications, Inc. As a result, NetConsult Communications GmbH became a wholly owned subsidiary of NetConsult Communications, Inc. and certain debt in NetConsult Communications GmbH was converted into preferred stock in NetConsult Communications, Inc. In December 1996, NetConsult Communications, Inc. changed its name to INTERSHOP Communications, Inc.

INTERSHOP Communications develops and distributes applications software offering on-line shopping solutions which enable merchants, businesses, Internet service providers and others to create and host fully interactive business-to-business or business-to-consumer electronic commerce storefronts, supply-chain management systems and shopping centers (virtual malls) over the Internet, Intranet or Extranet. INTERSHOP Communications began licensing its INTERSHOP Online and Mall products in commercial quantities in December 1996. INTERSHOP Communications combined such products into its INTERSHOP 3 Product Line in March 1998. INTERSHOP Communications derives most of its revenue from licenses of its software products. The remaining revenues are primarily attributable to service revenues, which include consulting, customer support and training revenue.

As INTERSHOP Communications, Inc. was formed in 1996, the Company's 1995 financial figures include only the results of INTERSHOP Communications GmbH. Amounts for 1996 include only the results of INTERSHOP Communications GmbH (including a branch opened in France during that year) and of INTERSHOP Communications, Inc. Amounts for 1997 include the results of INTERSHOP Communications GmbH, INTERSHOP Communications, Inc. and two new subsidiaries opened in France and the United Kingdom during that year.

Unless otherwise indicated, any reference to the »Financial Statements« is to the consolidated financial statements of INTERSHOP Communications (including the respective combined notes thereto and the consolidated cash-flow statements) for the fiscal years 1995, 1996 and 1997, prepared in accordance with U.S. GAAP.

Seasonality

Similar to other software companies, licensing of the INTERSHOP Communications' software is characterized by a strong seasonal increase of orders in the fourth quarter caused by the desire among purchasers and vendors of software to complete transactions prior to the close of each calendar year.

Results of Operations

The following tables show the selected condensed consolidated profit and loss statements of INTERSHOP Communications for the fiscal years ended 31 December, 1995, 1996 and 1997:

(in thousands of US $)	1997	1996	1995
REVENUES			
LICENSES	3,342	32	59
SERVICES	1,725	404	183
OTHER	644	176	967
TOTAL REVENUES	5,711	612	1,209
OPERATING EXPENSES			
COST OF REVENUES	3,048	739	913
RESEARCH AND DEVELOPMENT	1,141	388	41
SALES AND MARKETING	5,345	1,391	107
GENERAL AND ADMINISTRATIVE	3,909	1,029	172
TOTAL OPERATING EXPENSES	13,443	3,547	1,233
OPERATING LOSS	(7,732)	(2,935)	(24)
OTHER INCOME (EXPENSE)			
INTEREST INCOME	138	26	-
INTEREST EXPENSE	(332)	(181)	(14)
OTHER EXPENSE	(30)	70	33
TOTAL OTHER INCOME (EXPENSE)	(224)	(85)	19
NET LOSS	(7,956)	(3,020)	(5)

COMPARISON OF 1997 AND 1996

REVENUES

License revenues increased from US $ 32,000 for the year ended December 31, 1996 to US $ 3.3 million in the year ended 31 December, 1997. This increase was due to the launch of INTERSHOP Communications' INTERSHOP Online version 2.0 product in April 1997 and its INTERSHOP Mall version 1.0 product in May 1997, and a significant increase in INTERSHOP Communications' sales and marketing organization during the year.

Service revenues are primarily comprised of fees from consulting, post-contract support and, to a lesser extent, training services. Service revenues increased by 327% from US $ 404,000 in the year ended December 31, 1996 to US $ 1.7 million in the year ended December 31, 1997. INTERSHOP Communications' software license agreements often provide for maintenance, consulting and training. Accordingly, increases in licensing activity have resulted in increases in revenues from services related to maintenance, consulting and training.

COST OF REVENUES

Cost of service revenues primarily comprise employee-related costs incurred in providing consulting, post-contract support and training services. Cost of license revenues includes the Sybase database royalties, costs of product media and packaging, product duplication and manuals, as well as allocated labor and overhead costs associated with the preparation and shipment of products. The largest component of cost of license revenue is royalties paid to Sybase. During 1997, the Company incurred royalties payable to Sybase at a rate of 22% of license revenue. The Company's arrangement with Sybase was renegotiated for 1998 such that future royalties to Sybase will be payable at a rate of 10% of license revenue with a minimum amount for each quarter.

Cost of revenues increased from US $ 739,000 in the year ended December 31, 1996 to US $ 3.0 million in the year ended December 31, 1997. The majority of cost of revenues, approximately 70%, consists of service-related costs. The increase in service revenue costs was due primarily to increases in consulting, support and training personnel, and increases in overhead costs associated with travel, computer equipment and facilities. The cost of service revenues as a percentage of service revenues may vary between periods due to the mix of services provided by INTERSHOP Communications and the resources used to provide these services. The increase in license costs on an absolute dollar basis relates primarily to an increase in the volume of products shipped by INTERSHOP Communications, and the resulting increase in royalties paid to Sybase, documentation material costs and personnel necessary to assemble and ship the products. Costs of packaging as a percentage of license revenue declined in 1997 as a result of larger deal sizes and initial packaging design costs incurred in 1996 which did not recur in 1997. Packaging costs as a percentage of license revenue are expected to decline in the future due to increasing deal sizes.

OPERATING EXPENDITURES

Research and development expenses of US $ 388,000 or 63.4% of total revenues in 1996 increased to US $ 1.1 million or 20% of total revenues in 1997. These expenses increased in absolute dollar amounts primarily as a result of an increase in personnel to support INTERSHOP Communications' product development activities. INTERSHOP Online 2.0 was launched in April 1997 and INTERSHOP Mall 1.0 in May 1997. The Company expects that research and development expenditures will continue to increase in absolute dollar amounts and intends to invest a similar amount in 1998 as a percent of revenue as it did in 1997. Research and development expenses are charged to operations as incurred.

Sales and marketing expenses of US $ 1.4 million or 227.3% of total revenues in 1996 increased to US $ 5.3 million or 93.6% of total revenues in 1997. These expenses increased in absolute dollar amounts primarily due to INTERSHOP Communications' investment in building a direct sales force in North America and in Europe, and the investment in expanding its channel sales force in North America, Europe and Asia Pacific. In addition, INTERSHOP Communications incurred increased marketing expenses associated with its expanding product line, including trade shows and promotional expenses. INTERSHOP Communications expects to continue to expand its direct sales and marketing efforts and to develop a significant channel sales organization, and therefore, anticipates sales and marketing expenditures will continue to increase significantly in absolute dollar amounts.

General and administrative expenses of US $ 1.0 million or 168.1% of total revenues in 1996 increased to US $ 3.9 million or 68.4% of total revenues in 1997. These expenses increased in absolute dollar amounts during these periods principally due to the addition of executive officers, significant additions of staff and a significant investment in information systems to support the growth of INTERSHOP Communications' business during these periods. INTERSHOP Communications expects to continue to increase its general and administrative staff and to incur other costs necessary to manage a growing organization, and, accordingly, it expects general and administrative expenses to continue to increase in absolute dollars. However, general and administrative costs as a percentage of revenue are expected to decline in future periods.

COMPARISON OF 1996 AND 1995

Prior to 1996, the Company's primary business was as a system integrator for NeXT workstations. Revenues consisted primarily of hardware resold to customers along with integration services at low margins. The Company began to migrate its business to development of Internet products and related services such that by the beginning of 1996 the Company was no longer performing any significant integration services for NeXT products. Results for 1996 primarily consist of consulting services for Internet solutions and development of products based on such solutions.

REVENUES

License revenues were nominal in 1996 and 1995 as INTERSHOP Communications was primarily a systems integrator and did not have significant sales of software licenses. The Company began the licensing of its own products in commercial quantities in December 1996.

Service revenues primarily consisted of consulting in both 1996 and 1995 as the Company had not yet begun to license its current products. Service revenues increased from US $ 183,000 in the year ended December 31, 1995, to US $ 404,000 in the year ended December 31, 1996. This increase resulted primarily from an increase in the volume of consulting projects due to the increasing popularity of electronic commerce.

COST OF REVENUES

Cost of revenues in 1996 and 1995 primarily consisted of employee-related costs incurred in providing consulting services. Cost of revenues declined from US $ 913,000 in the year ended December 31, 1995 to US $ 739,000 in the year ended December 31, 1996. The decline in cost of revenues in 1996 resulted from a change in the types of consulting that INTERSHOP Communications performed. In 1995, INTERSHOP Communications performed systems integration consulting projects for third-party products. In 1996, consulting services consisted primarily of implementing INTERSHOP Communications' own electronic commerce products and services.

OPERATING EXPENDITURES

Research and development expenses increased from US $ 41,000 in 1995 to US $ 388,000 in 1996. This increase relates to the transition from being primarily a system integrator of third-party products in 1995 to a consulting and software development and marketing organization in 1996.

Sales and marketing expenses increased from US $ 107,000 in 1995 to US $ 1.4 million in 1996. This increase related primarily to the hiring of personnel to begin marketing INTERSHOP Communications' upcoming products. This included the formation of an organization in the United States during 1996 which comprised US $ 833,000 of sales and marketing expenses during that year.

General and administrative expenses increased from US $ 172,000 in 1995 to US $ 1,029,000 in 1996. This increase related primarily to the formation of an administrative staff at the Company's new United States operation in 1996. These expenses comprised US $ 730,000 of general and administrative expenses during 1996.

Liquidity, Capital Resources and Investments

INTERSHOP Communications has financed its operations to date principally through private placements of preferred stock and bridge loans from investors which were ultimately converted to preferred stock and, to a lesser extent, common stock and loans received from Technologie-Beteiligungsgesellschaft mbH der Deutschen Ausgleichsbank (»tbg«), a venture capital fund of an agency of the German government. Through December 31, 1997, the Company has raised approximately

US $ 5.8 million from the sale of preferred and common stock. As of December 31, 1997, INTERSHOP Communications had negative working capital of US $ 219,000 and a cash and cash equivalent balance of US $ 5.5 million.

As of May 31, 1998, INTERSHOP Communications has unsecured loans with tbg totaling approximately US $ 1.7 million. Interest is payable twice a year at 6%. In addition, tbg is entitled to a royalty of 6% of net income on an annual basis. This amount is payable within two weeks of the end of each year. As the Company has recorded net losses in 1996 and 1997, no royalty amounts have been payable to tbg for either of those years. All principal and unpaid interest is due and payable on December 31, 2006. In the event that the loan is repaid prior to December 31, 2006, then tbg is entitled to a 30% premium on the principal amount outstanding. In the event of a public offering, the Company expects to immediately pay off this loan along with the 30% interest premium.

In April 1998, the Company obtained US $ 2 million of Series D preferred stock financing from a division of an investment bank. The financing was on similar terms to previous preferred equity financings which the Company has done.

COMPARISON OF THE FISCAL YEARS 1995, 1996 AND 1997

INTERSHOP Communications' operating activities generated cash of US $ 2.8 million in 1997 and US $ 124,000 in 1995. Operating activities used cash of US $ 2.5 million in 1996. The positive cash flow in 1997 primarily related to a payment of US $ 11.4 million received from a customer during the year, most of which was included in deferred revenue at December 31, 1997. This was partially offset by an increase in the Company's net loss from US $ 3.0 million in 1996 to US $ 8.0 million in 1997 and an increase in accounts receivable of US $ 2.5 million during 1997.

Cash flow from operations during 1996 declined from 1995 due to increasing net losses in 1996 as INTERSHOP Communications began to build up its infrastructure.

The Company used US $ 2.0 million, US $ 680,000 and US $ 69,000 of net cash during 1997, 1996 and 1995, respectively, to purchase property and equipment. Financing activities provided US $ 4.5 million in 1997 and US $ 3.4 million in 1996. Financing activities were insignificant in 1995. Financing activities in 1997 consisted primarily of US $ 3.8 million received from the issuance of preferred stock and US $ 1.9 million received from the issuance of debt, offset by US $ 1.2 million of principal payments on the Company's capital lease liabilities. Financing activities in 1996 consisted primarily of the issuance of US $ 3.1 million of debt, which was converted to preferred stock at December 31, 1996.

The Company anticipates that the proceeds from the Offering, together with existing sources of liquidity and cash expected to be generated from operations, will satisfy the Company's working capital requirements at least through 1998.

Recent Accounting Pronouncements

In February 1997, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 128, »Earnings Per Share« (»SFAS No. 128«), which was adopted by INTERSHOP Communications in the quarter ended December 31, 1997, and in accordance with this standard all prior periods presented have been restated to conform to its provisions. Under the new requirements for calculating earnings per share, basic net income (loss) per share is computed using the weighted average number of common shares outstanding during the period. Diluted net income (loss) per share is computed using the weighted average of common and common equivalent shares outstanding during the period. Common equivalent shares consist of stock options and warrants (using the treasury stock method). Common equivalent shares are excluded from the dilutive computation only if their effect is anti-dilutive. As the Company recorded a net loss in each of the three years in the period ended December 31, 1997, no common equivalent shares are included in diluted weighted average common shares outstanding.

In June 1997, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 130, »Reporting Comprehensive Income« (»SFAS No. 130«). This statement establishes standards for reporting and displaying comprehensive income and its components (revenue, expenses, gains and losses) in a full set of general purpose financial statements and is effective for fiscal years beginning after December 15, 1997. The Company will adopt the requirements of this statement in 1998.

In June 1997, the Financial Accounting Standard's Board issued Statement of Financial Accounting Standards No. 131, »Disclosures About Segments of an Enterprise and Related Information« (»SFAS No. 131«). This statement establishes standards for reporting selected segment information quarterly and to report entity-wide disclosures about products and services, geographic areas and major customers. This statement is effective for fiscal years beginning after December 15, 1997. The Company will adopt the requirements of this statement in 1998.

Consolidated Financial Statements

INTERSHOP COMMUNICATIONS, INC. AND SUBSIDIARIES

Report of independent accountants

TO INTERSHOP COMMUNICATIONS, INC.:

We have audited the accompanying consolidated balance sheets of INTERSHOP Communications, Inc. (a Delaware corporation) and subsidiaries as of December 31, 1997, 1996, and 1995, and the related consolidated statements of operations, shareholders' deficit and cash flows for each of the three years in the period ended December 31, 1997. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of INTERSHOP Communications, Inc. and subsidiaries as of December 31, 1997, 1996, and 1995, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 1997 in conformity with United States generally accepted accounting principles.

San Jose, California
June 18, 1998

ARTHUR ANDERSEN LLP

INTERSHOP COMMUNICATIONS, INC. AND SUBSIDIARIES

Consolidated Balance Sheets

as of December 31, 1997, 1996, and 1995 (in thousands, except per share amounts)

ASSETS	1997	1996	1995
CURRENT ASSETS			
Cash and cash equivalents	$ 5,520	$ 269	$ 78
Restricted cash	133	-	-
Trade receivables, net of allowance for doubtful accounts of US $ 77, US $ 3, and US $ 3, respectively	2,475	182	76
Prepaid expenses and other current assets	942	878	88
Total current assets	9,070	1,329	242
PROPERTY AND EQUIPMENT, NET	2,271	668	144
OTHER ASSETS	305	-	-
Total assets	$ 11,646	$ 1,997	$ 386

LIABILITIES AND SHAREHOLDERS' EQUITY	1997	1996	1995
CURRENT LIABILITIES			
SHORT-TERM DEBT			
Current maturities of long-term debt	$ 40	$ -	$ 138
Accounts payable	2,545	460	167
Accrued liabilities	1,378	587	14
Deferred revenue	5,326	-	-
Total current liabilities	9,289	1,047	319
LONG-TERM DEBT	1,956	2,157	4
DEFERRED INCOME	5,700	-	-
Total liabilities	16,945	3,204	323
COMMITMENTS (NOTE 4)			
SHAREHOLDERS' EQUITY			
Convertible redeemable preferred stock, US $ 0.001 par value, and additional paid-in capital – authorized, 14,000 shares			
Series A Preferred Stock, designated – 5,000 shares; outstanding: 5,000 shares in 1997 and 1996; liquidation preference – US $ 532	575	532	-
Series B Preferred Stock, designated – 6,200 shares; outstanding: 6,200 shares in 1997 and 1996; liquidation preference – US $ 1,227	1,325	1,226	-
Series C Preferred Stock, designated – 2,000 shares; outstanding: 2,000 shares in 1997 and – 0 – shares in 1996; liquidation preference – US $ 3,830	3,856	-	-
Common stock, par value US $ 0.001 – authorized, 36,000 shares; outstanding: 11,046 shares in 1997 and 10,000 shares in 1996 and – 0 – shares in 1995	11	10	-
Paid-in capital	455	47	57
Notes receivable	(390)	-	-
Accumulated deficit	(11,152)	(3,028)	(8)
Cumulative translation adjustment	21	6	14
Total shareholders' equity	(5,299)	(1,207)	63
Total liabilities and shareholders' equity	$ 11,646	$ 1,997	$ 386

INTERSHOP COMMUNICATIONS, INC. AND SUBSIDIARIES

Consolidated Statements of Operations

for the years ended December 31, 1997, 1996, and 1995 (in thousands, except per share amounts)

	1997	1996	1995
REVENUES			
Licenses	$ 3,342	$ 32	$ 59
Services		1,725	404
183			
Other	644	176	967
Total revenues	5,711	612	1,209
OPERATING EXPENSES			
Cost of revenues	3,048	739	913
Research and development	1,141	388	41
Sales and marketing	5,345	1,391	107
General and administrative	3,909	1,029	172
Total operating expenses	13,443	3,547	1,233
OPERATING LOSS	(7,732)	(2,935)	(24)
OTHER INCOME (EXPENSE)			
Interest income	138	26	-
Interest expense	(332)	(181)	(14)
Other	(30)	70	33
Total other income (expense)	(224)	(85)	19
NET LOSS	$ (7,956)	$ (3,020)	$ (5)
ACCRETION OF REDEEMABLE PREFERRED STOCK	$ (168)	$ -	$ -
NET LOSS ATTRIBUTABLE TO COMMON SHAREHOLDERS	$ (8,124)	$ (3,020)	$ (5)
NET LOSS PER SHARE ATTRIBUTABLE TO COMMON SHAREHOLDERS *basic and diluted*	$ (0,78)	n/a	n/a
WEIGHTED AVERAGE COMMON AND COMMON EQUIVALENT SHARES OUTSTANDING *basic and diluted*	10,446	n/a	n/a

INTERSHOP COMMUNICATIONS, INC. AND SUBSIDIARIES

Consolidated Statements of Shareholders' Equity (Deficit)

for the years ended December 31, 1997, 1996, and 1995 (in thousands, except per share amounts)

	Series A Convertible Redeemable Preferred Stock		Series B Convertible Redeemable Preferred Stock	
	Shares	Amount	Shares	Amount
Balance, December 31, 1994	-	$ -	-	$ -
Net loss	-	-	-	-
Balance, December 31, 1995	-	-	-	-
Contribution of capital	-	-	-	-
Conversion of debt and contributed capital to Series A and Series B preferred stock and common stock	5,000	532	6,200	1,226
Foreign currency translation adjustments	-	-	-	-
Net loss	-	-	-	-
Balance, December 31, 1996	5,000	532	6,200	1,226
Issuance of common stock	-	-	-	-
Exercise of stock options	-	-	-	-
Issuance of Series C preferred stock	-	-	-	-
Accretion of redeemable convertible preferred stock	-	43	-	99
Foreign currency translation adjustments	-	-	-	-
Net loss	-	-	-	-
Balance, December 31, 1997	5,000	$ 575	6,200	$ 1,325

Series C Convertible Redeemable Preferred Stock Shares	Amount	Common Stock Shares	Par Value	APIC	Notes Receivable	Accumulated Deficit	Foreign Currency Translation Adjustment	Total Stockholders' Equity (Deficit)
-	$ -	-	$ -	$ 57	$ -	$ (3)	$ 14	$ 68
-	-	-	-	-	-	(5)	-	(5)
-	-	-	-	57	-	(8)	14	63
-	-	-	-	281	-	-	-	281
-	-	10,000	10	(291)	-	-	-	1,477
-	-	-	-	-	-	-	(8)	(8)
-	-	-	-	-	-	(3,020)	-	(3,020)
-	-	10,000	10	47	-	(3,028)	6	(1,207)
-	-	37	-	19	-	-	-	19
-	-	1,009	1	389	(390)	-	-	-
2,000	3,830	-	-	-	-	-	-	3,830
-	26	-	-	-	-	(168)	-	-
-	-	-	-	-	-	-	15	15
-	-	-	-	-	-	(7,956)	-	(7,956)
2,000	$ 3,856	11,046	$ 11	$ 455	$ (390)	$ (11,152)	$ 21	$ (5,299)

INTERSHOP COMMUNICATIONS, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows

for the years ended December 31, 1997, 1996, and 1995 (in thousands)

	1997	1996	1995
CASH FLOWS FROM OPERATING ACTIVITIES			
Net loss	$ (7,956)	$ (3,020)	$ (5)
Adjustments to reconcile net loss to cash provided by (used in) operating activities			
Depreciation	571	111	5
Provision for doubtful accounts	76	3	-
Gain on equipment disposal	-	1	-
Change in: Restricted cash	(133)	-	-
Accounts receivable	(2,538)	(223)	8
Prepaid expenses and deposits	(931)	(48)	34
Other assets	(44)	(19)	-
Accounts payable	2,131	309	76
Deferred revenue	11,014	-	-
Accrued expenses and other liabilities	627	337	6
Net cash provided by (used in) operating activities	2,817	(2,549)	124
CASH FLOWS FROM INVESTING ACTIVITIES			
Proceeds from sale of property	-	6	-
Purchases of equipment, net of capital leases	(2,043)	(680)	(69)
Net cash used in investing activities	(2,043)	(674)	(69)
CASH FLOWS FROM FINANCING ACTIVITIES			
Proceeds from sale of preferred stock	3,830	-	-
Proceeds from debt issuance	1,861	3,140	-
Contribution of capital	-	281	-
Repayments of indebtedness	(1,168)	(3)	(1)
Net cash provided by (used in) financing activities	4,523	3,418	(1)
Effect of change in exchange rates on cash	(46)	(4)	-
Net change in cash and cash equivalents	5,251	191	54
Cash and cash equivalents, beginning of period	269	78	24
Cash and cash equivalents, end of period	$ 5,520	$ 269	$ 78

Notes to Consolidated Financial Statements

for the years ended December 31, 1997, 1996, 1995

1. Organization and Operations of the Company

INTERSHOP Communications, Inc. (the »Company«) was originally founded in 1992 as NetConsult Communications GmbH (»GmbH«) in Germany as a limited liability company. GmbH established a wholly owned subsidiary, NetConsult Communications, Inc. (»U.S. Inc.,«), a Delaware corporation, in March 1996. On December 31, 1996, U.S. Inc., GmbH, and the shareholders of GmbH entered into a Share Exchange Agreement, whereby U.S. Inc. acquired all outstanding interest in GmbH in exchange for preferred and common stock in U.S. Inc. As a result, GmbH became a wholly owned subsidiary of U.S. Inc. and certain debt in NetConsult GmbH was converted into preferred stock in U.S. Inc. Thus with the completion of the share exchange, the parent entity converted from being a limited liability company to a corporation. In December 1997, the Company changed its name to INTERSHOP Communications, Inc.

The Company develops and distributes applications software offering on-line shopping solutions which enable merchants, businesses, Internet service providers and others to create and host fully interactive business-to-business or business-to-consumer electronic commerce storefronts, supply-chain management systems and shopping centers (virtual malls) over the Internet, Intranet, or Extranet.

The Company is subject to a number of risks, including, but not limited to, the need for additional financing, uncertain profitability, and competition from larger companies. The Company has incurred significant losses from operations and, as of December 31, 1997, had an accumulated deficit of US $ 11.2 million and negative working capital of US $ 219,000. Although it is difficult to predict future liquidity requirements with certainty, the Company believes that it will require additional financing to finance its operations for at least the next twelve months. The Company is in the process of attempting to raise additional financing through an initial public offering of its securities. If the Company were unsuccessful in raising such financing it would have to pursue other financing alternatives including a private offering of its securities. The Company believes that it will be successful in obtaining adequate financing to fund its operations and has obtained a commitment letter from an investor stating that the investor would finance any cash flow shortfall which may occur through March 31, 1999.

2. Summary of Significant Accounting Policies

BASIS OF FINANCIAL STATEMENTS

The consolidated financial statements, which have been prepared according to United States generally accepted accounting principles (»U.S. GAAP«), include the accounts of the Company and its subsidiaries. All significant intercompany transactions and balances between the companies have been eliminated. One of the Company's subsidiaries has a 1% minority interest, which has not been presented in the accompanying financial statements, as it is not material to the financial statements.

USE OF ESTIMATES

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

FOREIGN CURRENCY TRANSLATION

The functional currency of the Company's operations outside the United States is the local country's currency. Consequently, assets and liabilities of operations outside the United States are translated into United States dollars using exchange rates at the end of each reporting period. Revenues and expenses are translated at the average exchange rates prevailing during the period. Cumulative translation gains and losses are reported as a separate component of shareholders' equity.

STATEMENT OF CASH FLOWS

The Company paid US $ 257,000, US $ 59,000, and US $ 14,000 in cash for interest in 1997, 1996, and 1995, respectively. The Company paid US $ 10,000, US $ 1,000, and US $ 1,000 in cash for taxes in 1997, 1996, and 1995, respectively. The Company sold equipment and leased it back in 1997. The Company recognized no gain or loss on the transactions and the value of the leased equipment is US $ 133,000. The Company converted debt of US $ 1,758,000 into 5,000,000 shares of Series A Preferred Stock and 6,200,000 shares of Series B Preferred Stock in conjunction with the Share Exchange Agreement discussed in Note 1.

The Company considers all investments with original maturities of 90 days or less to be cash equivalents.

CONCENTRATION OF CREDIT RISK

Financial instruments that potentially subject the Company to concentrations of credit risk consist primarily of accounts receivable. The Company performs ongoing credit evaluations of its customer's financial condition and the risk with respect to trade receivables is further mitigated by the fact that the Company's customer based is diversified.

PROPERTY AND EQUIPMENT

Property and equipment are stated at cost. Capital leases are recorded at the present value of the future minimum lease payments at the date of acquisition. Depreciation is computed using the straight-line method over the estimated useful lives of the assets, generally three years. Capital leases and leasehold improvements are amortized on a straight-line basis over the shorter of the lease terms or their estimated useful life.

SOFTWARE DEVELOPMENT COSTS

Capitalization of software development costs begins upon the establishment of technological feasibility of the product, which the Company defines as the development of a working model and further defines as the development of a beta version of the software. The establishment of technological feasibility and the ongoing assessment of the recoverability of these costs requires considerable judgment by management with respect to certain external factors, including, but not limited to, anticipated future gross product revenue, estimated economic life and changes in technology. Such costs are reported at the lower of unamortized cost or net realizable value. To date, internal software development costs that were eligible for capitalization have not been significant and the Company has charged all software development costs to research and development as incurred.

The Company expenses all research and development expenses as incurred.

REVENUE RECOGNITION

The Company generates the following types of revenue:

LICENSE FEES: License fees are earned under software license agreements to end-users, resellers, and distributors. Revenues from licenses to end-users are recognized upon shipment of the software if collection of the resulting receivable is probable, the fee is fixed and determinable, and there are no significant post-delivery obligations. If an acceptance period is required, revenues are recognized upon the earlier of customer acceptance or the expiration of the acceptance period. Certain of the Company's sales are made to distributors under agreements allowing certain rights of return and price protection on unsold merchandise. Accordingly, the Company either defers recognition of such sales until the merchandise is sold by the distributor, or records a reserve for returns if the amount of returns is limited by the contractual terms.

SERVICE FEES: Services consist of support arrangements and consulting and education services. Support agreements generally call for the Company to provide technical support and provide certain rights to software updates to customers. Revenue on technical support and software update rights is recognized ratably over the term of the support agreement. The Company provides consulting and education services to its customers; revenue from such services is generally recognized as the services are performed.

In June 1997, the Company entered into a software license agreement with a customer for total license fees of US $ 11.4 million, which was received in cash in 1997. The Company is recognizing the revenue associated with this agreement over the three-year term of the agreement. In 1997, the Company recognized US $1.9 million of revenue associated with this agreement, representing 33% of consolidated revenue in 1997. This customer acquired 2,000,000 shares of Series C Preferred Stock at $ 1.915 per share. Management believes that this price represented the fair value of the preferred stock.

Sales to another customer represented 13% of consolidated revenue in 1997.

ACCOUNTING FOR STOCK-BASED COMPENSATION

Effective January 1, 1996, the Company adopted the disclosure provisions of SFAS No. 123, »Accounting for Stock-Based Compensation.« In accordance with the provisions of SFAS No. 123, the Company applies Accounting Principles Board (»APB«) Opinion No. 25 and related interpretations in accounting for its employee stock option plans, under which no compensation cost has been recognized. Accounting for these plans consistent with SFAS No. 123, »Accounting for Stock-Based Compensation,« would not have had a material effect on the Company's results of operations or financial position in any of the periods presented.

INCOME TAXES

Deferred income taxes are provided for timing differences in recognizing certain income, expense, and credit items for financial reporting purposes. Such deferred income taxes primarily relate to operating loss carryforwards, tax credits, timing of recognition of certain revenue items, and the timing of the deductibility of certain reserves and accruals for income tax purposes.

EARNINGS PER SHARE

In February 1997, the Financial Accounting Standards Board (»FASB«) issued Statement of Financial Accounting Standards (»SFAS«) No. 128, »Earnings per Share«. Under the new requirements for calculating earnings per share, basic net income (loss) per share is computed using the weighted-average number of common shares outstanding during the period. Diluted net loss per share is computed using the weighted-average number of common and common equivalent shares outstanding during the period. Common equivalent shares consist of stock options and warrants (using the treasury stock method). Common equivalent shares are excluded from the dilutive computation only if their effect is anti-dilutive. As the Company recorded a net loss in each of three years in the period ended December 31, 1997, no common equivalent shares are included in diluted weighted-average common shares outstanding. Prior to the Share Exchange Agreement discussed in Note 1, there was no common stock outstanding, as the parent company was a limited liability company. Therefore, no earnings per share amounts have been presented for periods prior to such exchange.

RECENT PRONOUNCEMENTS

In June 1997, the FASB issued SFAS No. 130, »Reporting Comprehensive Income.« This statement establishes standards for reporting and displaying comprehensive income and its components (revenue, expenses, gains and losses) in a full set of general-purpose financial statements and is effective for fiscal years beginning after December 15, 1997.

In June 1997, the FASB issued SFAS No. 131, »Disclosures about Segments of an Enterprise and Related Information.« This statement establishes standards for reporting selected segment information quarterly and to report entity-wide disclosures about products and services, geographic areas and major customers. This statement is effective for fiscal years beginning after December 15, 1997.

3. Property and Equipment

Property and equipment consists of the following *(in thousands):*

	1997	1996	1995
COMPUTER EQUIPMENT	$ 1,302	$ 467	$ 124
FURNITURE AND FIXTURES	1,687	411	89
LEASEHOLD IMPROVEMENTS	40	3	-
	3,029	881	213
ACCUMULATED DEPRECIATION AND AMORTIZATION	(758)	(213)	(69)
PROPERTY AND EQUIPMENT, NET	$ 2,271	$ 668	$ 144

Leased equipment under capital leases included in property and equipment as of December 31, 1997 was US $ 133,000. Accumulated amortization of leased equipment was US $ 7,000 as of December 31, 1997.

As of December 31, 1997, future minimum lease payments under capital leases together with their present value were *(in thousands)*:

YEAR ENDED DECEMBER 31,	
1998	51
1999	51
2000	45
TOTAL MINIMUM LEASE PAYMENTS	147
AMOUNTS REPRESENTING INTEREST	(20)
PRESENT VALUE OF MINIMUM LEASE PAYMENTS	127
LESS CURRENT PORTION	(40)
	$ 87

4. Commitments

Facilities and certain furniture and equipment are leased under operating leases. As of December 31, 1997, future minimum annual lease payments (excluding the lease payments relating to capitalized facilities discussed in Note 3) are as follows *(in thousands):*

YEAR ENDED DECEMBER 31,	
1998	$ 1,257
1999	1,303
2000	1,299
2001	1,312
2002	1,086
THEREAFTER	633
TOTAL	$ 6,890

Rent expense was US $ 554,000, US $ 87,000, and US $ 17,000 for the three years ended December 31, 1997, 1996, and 1995, respectively.

Subsequent to year-end, the Company entered into a minimum purchase commitment with a supplier for US $ 1.7 million of software licenses.

5. Long-term Debt

The components of long-term debt as of December 31, 1997 and 1996 are *(in thousands)*:

	1997	1996
TBG LOANS	$ 1,674	$ 1,932
LOANS FROM SHAREHOLDERS	195	225
CAPITAL LEASES (NOTE 3)	127	-
TOTAL	1,996	2,157
CURRENT MATURITIES	(40)	-
LONG-TERM DEBT	$ 1,956	$ 2,157

TBG LOANS: During 1996, the Company entered into a series of unsecured loans with Technologie-Beteiligungs-Gesellschaft mbH der Deutschen Ausgleichsbank (»tbg«). Interest is payable twice yearly at 6%. In addition, tbg is entitled to a royalty of 6% of net income on an annual basis. This amount is payable within two weeks of the end of each year. As the Company has recorded net losses in 1997 and 1996, no royalty amounts have been payable to tbg for either of those years. All principal and unpaid interest is due and payable on December 31, 2006. In the event that the loan is repaid within five years of the issue date, tbg is entitled to a 30% premium on the principal amount outstanding. The Company is recognizing the premium as additional interest expense on a straight-line basis over five years.

LOANS FROM SHAREHOLDERS: During 1996, the Company entered into a series of unsecured loans with certain shareholders. Interest is payable quarterly at 10%. The loans may be repaid at any time, but no later than February 2004.

6. Convertible Redeemable Preferred Stock

As of December 31, 1997, the Company has authorized 14,000,000 shares of preferred stock, of which 5,000,000 shares have been designated as Series A Preferred Stock (Series A), 6,200,000 shares have been designated as Series B Preferred Stock (Series B), and 2,000,000 shares have been designated as Series C Preferred Stock (Series C). Significant rights, restrictions, and preferences of the Series A, Series B, and Series C are as follows:

Each share of Series A, Series B, and Series C is entitled to receive, when and as declared by the Company's Board of Directors, cash dividends at a rate of 8% per annum of the Original Issue Price, as defined, on each outstanding share of preferred stock. The Original Issue Prices of Series A, Series B, and Series C are US $ 0.047, US $ 0.247, and US $ 1.915, respectively. Such dividends are only payable when, as, and if declared by the Board of Directors, are non-cumulative, and are payable in preference to any dividend payable on common stock.

In the event of liquidation, dissolution, or winding up of the Company, Series B and Series C shareholders shall be entitled to be paid out of the assets of the Company, before any payment shall be made with respect to Series A and common stock, an amount equal to the Original Issue Price plus all declared and unpaid dividends. After the full payment of the liquidation preference to the Series B and Series C shareholders, and before any payment to holders of common stock, the shareholders of Series A shall be entitled to be paid out of the assets of the Company an amount equal to the Original Issue Price plus all declared and unpaid dividends. After the full payment of the liquidation preferences to holders of preferred stock, the common stock shareholders shall be entitled to be paid out of the assets of the Company an amount equal to the Original Issue Price plus all declared and unpaid dividends. After the full payment of the liquidation preference to preferred stock and common stock shareholders, the remaining assets of the Company available for distribution, if any, shall be distributed among the holders of Series A, Series B, and Series C preferred stock and common stock pro rata on an as-if-converted to common stock basis.

Each share of Series A, Series B, and Series C is entitled to vote in an amount equivalent to the number of common shares into which it is convertible. As long as 2,000,000 shares of preferred stock are outstanding, the vote or written consent of 50% of the outstanding shares of preferred stock is necessary for effecting any amendment to the Articles of Incorporation or Bylaws of the Company; any change in the authorized number of shares of preferred stock; any authorization or designation of any new class or series of stock convertible into equity securities ranking senior to Series A, Series B, and Series C preferred stock in right of redemption, liquidation preference, or dividend; any redemption, purchase, payment of dividends or other distributions with respect to common stock; any agreement regarding the sales, lease, or other disposition of all or substantially all of the assets of the Company; or acquisition or any voluntary dissolution or liquidation of the Company.

Each share of Series A, Series B, and Series C preferred stock is convertible at the option of the holder into one share of common stock (subject to adjustment for events of dilution). The Series A, Series B, and Series C shares will be automatically converted into common shares upon the closing of a public offering of common stock that meets certain criteria.

The Company shall be obligated to redeem the shares of preferred stock in the event that the capital stock of the Company is not publicly traded or the Company has not been acquired within seven years of the original issue date. The holders of more than 50% of the shares of preferred stock may require the Company to redeem the preferred stock in two installments; the first on the eighth anniversary of the original issue date and the second on the ninth anniversary of the original issue date. The redemption amount is equal to the original issue price plus interest at 8% of the original issue prices compounded annually to the redemption date. The

	Options Outstanding	
	Number of Shares	*Weighted Average Exercise Price*
BALANCE, DECEMBER 31, 1996		
AUTHORIZED	-	-
GRANTED	*3,296*	*$ 0.41*
EXERCISED	*(1,009)*	*$ 0.39*
CANCELED	*(337)*	*$ 0.40*
BALANCE, DECEMBER 31, 1997	*1,950*	*$ 0.43*

Company has recorded the accretion of the interest on the preferred stock.

	Options Outstanding				Options Exercisable	
Range of Exercise Prices	Number Outstanding as of 12/31/97	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number Exercisable as of 12/31/97		Weighted Average Exercise Price
$ 0.05	815	9.36	$ 0.05	158		$ 0.05
$ 0.10	196	9.52	$ 0.10	25		$ 0.10
$ 0.50	376	9.65	$ 0.50	-		$ -
$ 1.00	534	9.83	$ 1.00	-		$ -
$ 2.00	29	9.95	$ 2.00	-		$ -
$ 0.05 - $ 2.00	1,950	9.57	$ 0.43	183		$ 0.06

7. Stockholders' Equity

1997 EQUITY INCENTIVE PLAN

The Company has reserved 10,000,000 shares of common stock for issuance to employees, directors and consultants under its 1997 Equity Incentive Plan (the »Plan«). The Board of Directors may grant incentive or non-statutory stock options at prices not less than 100% or 85%, respectively, of fair market value as determined by the Board of Directors, at the date of grant. Options vest ratably over periods determined by the Board, generally three years. The Board also has the authority to set exercise dates (no longer than ten years from the date of grant), payment terms, and other provisions for each grant. The Company generally has the right of first refusal for all common stock issued under the Plan should the holder desire to sell or otherwise transfer any of the shares. The Company's right of first refusal terminates upon the effective date of

SERIES A	5,000,000
SERIES B	6,200,000
SERIES C	2,000,000
1997 EQUITY INCENTIVE PLAN	7,041,000
	20,241,000

an initial public offering.

	1997	1996	1995
NET OPERATING LOSS CARRYFORWARDS	$ 4,486	$ 1,207	$ 4
TAX CREDIT CARRYFORWARDS	40	-	-
ACCRUALS NOT CURRENTLY DEDUCTIBLE	167	5	-
CAPITALIZED START-UP COSTS	9	13	-
OTHER	60	60	-
	4,762	1,285	4
VALUATION ALLOWANCE	(4,762)	(1,285)	(4)
NET DEFERRED TAX ASSET	$ -	$ -	$ -

STOCK-BASED COMPENSATION

The company applies APB Opinion No. 25 and related interpretations in accounting for the Plan. Had compensation cost for the Plan been determined based on the minimum value at the grant dates for the awards calculated in accordance with the method prescribed by SFAS No. 123, the impact on the Company's net loss would have been an increase to the loss of approximately $14,000.

	1997	1996	1995
REVENUES FROM UNAFFILIATED CUSTOMERS:			
U.S. operations	*$ 1,081*	*$ 5*	*$ -*
European operations	*4,630*	*607*	*1,209*
Consolidated	*$ 5,711*	*$ 612*	*$ 1,209*
OPERATING LOSS:			
U.S. operations	*$ (6,360)*	*$ (1,575)*	*$ -*
European operations	*(1,372)*	*(1,360)*	*(24)*
Consolidated	*$ (7,732)*	*$ (2,935)*	*$ (24)*
IDENTIFIABLE ASSETS:			
U.S. operations	*$ 7,094*	*$ 537*	*$ -*
European operations	*4,552*	*1,460*	*386*
Consolidated	*$ 11,646*	*$ 1,997*	*$ 386*

The weighted average fair value of options granted was $0.10 per share. The fair value of each option grant is based on the minimum value of the options utilizing risk-free interest rates based on U.S. government bonds on the date of grant with maturities equal to the expected option term (5.80%-6.53%) and a term of five years.

Option activity under the Plan was as follows *(in thousands, except dollar amounts):*

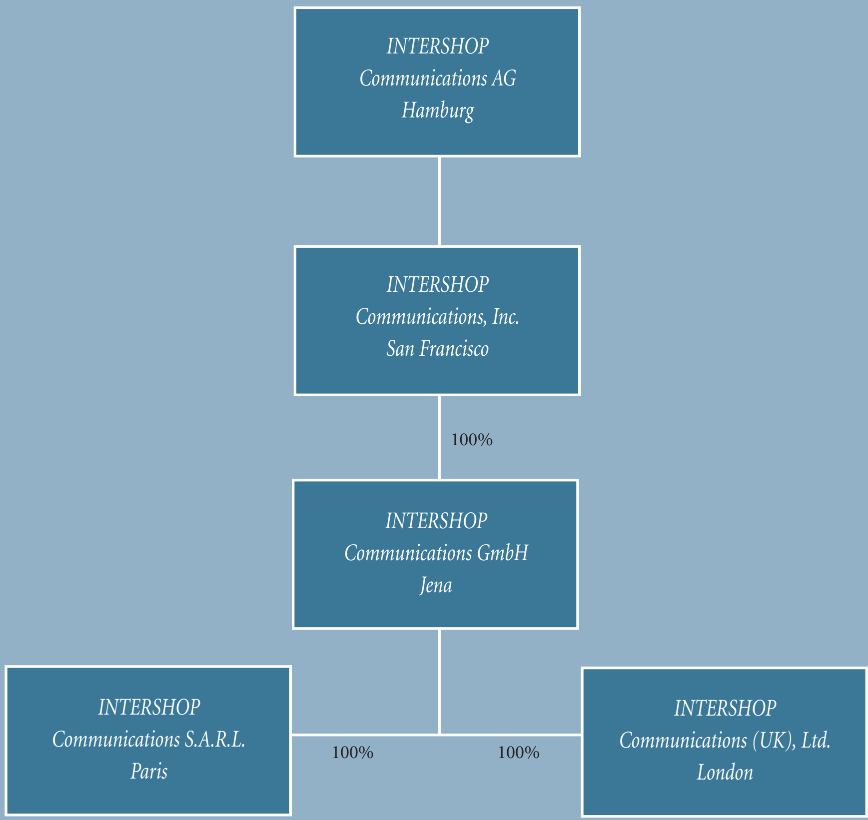
The following table summarizes information about stock options outstanding at December 31, 1997 *(in thousands, except per share data):*

The Plan allows for the issuance of options that are immediately exercisable through execution of a restricted stock purchase agreement. Shares purchased subject to a restricted stock purchase agreement generally vest over three years. In the event of termination of employment, the Company may repurchase unvested shares at a price equal to the original issuance price. As of December 31, 1997, 909,000 shares of common stock issued and outstanding were unvested and subject to repurchase by the Company at US $ 0.10 to US $ 1.00 per share.

RESERVED FOR FUTURE ISSUANCE

As of December 31, 1997, the Company has reserved the following shares of common stock for future issuance as follows:

CORPORATE STRUCTURE



● planned second half of 1998

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