

**AUDIOCODES LTD. AND ITS SUBSIDIARY**

**CONSOLIDATED FINANCIAL STATEMENTS**

**AS OF DECEMBER 31, 2001**

**IN U.S. DOLLARS**

**INDEX**

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**REPORT OF INDEPENDENT AUDITORS****To the Shareholders of****AUDIOCODES LTD.**

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

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

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

Tel-Aviv, Israel  
January 22, 2002**KOST FORER & GABBAY**  
A Member of Ernst & Young International

**CONSOLIDATED BALANCE SHEETS**

**U.S. dollars in thousands**

	<b>December 31,</b>	
	<b>2000</b>	<b>2001</b>
<b>ASSETS</b>		
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents	\$ 9,575	\$ 50,086
Short-term bank deposits	135,598	79,984
Trade receivables (net of allowance for doubtful accounts of \$ 334 and \$ 1,233 at December 31, 2000 and 2001, respectively)	11,582	3,437
Other accounts receivable and prepaid expenses	1,730	1,147
Inventories (Note 3)	10,714	6,536
Total current assets	<u>169,199</u>	<u>141,190</u>
<b>LONG-TERM INVESTMENTS:</b>		
Investment in a company (Note 5)	600	450
Severance pay fund	1,201	1,772
Total long-term investments	<u>1,801</u>	<u>2,222</u>
PROPERTY AND EQUIPMENT, NET (Note 4)	<u>3,329</u>	<u>5,004</u>
Total assets	<u><u>\$ 174,329</u></u>	<u><u>\$ 148,416</u></u>

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

**CONSOLIDATED BALANCE SHEETS**

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

	<b>December 31,</b>	
	<b>2000</b>	<b>2001</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>CURRENT LIABILITIES:</b>		
Trade payables	\$ 7,923	\$ 1,634
Other accounts payable and accrued expenses (Note 6)	15,157	13,314
Total current liabilities	23,080	14,948
ACCRUED SEVERANCE PAY	1,529	2,213
<b>COMMITMENTS AND CONTINGENT LIABILITIES (Note 7)</b>		
<b>SHAREHOLDERS' EQUITY (Note 10)</b>		
Share capital		
Ordinary shares of NIS 0.01 par value:		
Authorized- 100,000,000 as of December 31, 2000 and 2001;		
Issued - 39,955,680 as of December 31, 2000 and		
40,745,588 as of December 31, 2001; Outstanding - 39,955,680 as of		
December 31, 2000 and 38,970,788 as of December 31, 2001		
	118	120
Additional paid-in capital	112,847	113,878
Treasury shares	-	(6,401)
Deferred stock compensation	(337)	(161)
Retained earnings	37,092	23,819
Total shareholders' equity	149,720	131,255
Total liabilities and shareholders' equity	\$ 174,329	\$ 148,416

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

**AUDIOCODES LTD. AND ITS SUBSIDIARY**

**CONSOLIDATED STATEMENTS OF OPERATIONS**

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

	<b>Year ended December 31,</b>		
	<b>1999</b>	<b>2000</b>	<b>2001</b>
Revenues (Note 11)	\$ 31,204	\$ 71,798	\$ 35,734
Cost of revenues	11,921	28,029	21,942
Gross profit	19,283	43,769	13,792
Operating expenses:			
Research and development	4,812	10,588	13,807
Sales and marketing	4,262	11,204	13,852
General and administrative	1,665	2,917	5,044
Total operating expenses	10,739	24,709	32,703
Operating income (loss)	8,544	19,060	(18,911)
Other expenses (Note 5)	-	-	750
Financial income, net (Note 12a)	2,471	8,057	6,388
Income (loss) before taxes on income	11,015	27,117	(13,273)
Taxes on income (Note 8)	355	438	-
Net income (loss)	<u>\$ 10,660</u>	<u>\$ 26,679</u>	<u>\$ (13,273)</u>
Basic net earnings (loss) per share (Note 12b)	<u>\$ 0.35</u>	<u>\$ 0.68</u>	<u>\$ (0.34)</u>
Diluted net earnings (loss) per share (Note 12b)	<u>\$ 0.29</u>	<u>\$ 0.62</u>	<u>\$ (0.34)</u>

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

STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

U.S. dollars in thousands

	Preferred shares	Ordinary shares	Additional paid-in capital	Treasury shares	Deferred Stock compensation	Accumulated other comprehensive income (loss)	Retained earnings (accumulated deficit)	Total comprehensive income (loss)	Total shareholders' equity
Balance as of January 1, 1999	\$ 5	\$ 38	\$ 5,509	\$ -	\$ (137)	\$ (23)	\$ (247)		\$ 5,145
Issuance of shares, net	-	12	100,912	-	-	-	-		100,924
Issuance of shares upon exercise of options and warrants	-	3	3,148	-	-	-	-		3,151
Conversion of Preferred shares into Ordinary shares	(5)	5	-	-	-	-	-		-
Amortization of compensation related to warrants granted to consultants	-	-	210	-	-	-	-		210
Deferred stock compensation	-	-	603	-	(603)	-	-		-
Amortization of deferred stock compensation	-	-	-	-	212	-	-		212
Comprehensive income:									
Unrealized gains on available for sale marketable securities	-	-	-	-	-	23	-	\$ 23	23
Net income	-	-	-	-	-	-	10,660	10,660	10,660
Total comprehensive income								\$ 10,683	
Balance as of December 31, 1999	-	58	110,382	-	(528)	-	10,413		120,325
Stock split effected as a stock dividend (100%)	-	58	(58)	-	-	-	-		-
Issuance of shares upon exercise of options and warrants	-	2	2,523	-	-	-	-		2,525
Amortization of deferred stock compensation	-	-	-	-	191	-	-		191
Comprehensive income:									
Net income	-	-	-	-	-	-	26,679	\$ 26,679	26,679
Total comprehensive income								\$ 26,679	
Balance as of December 31, 2000	-	118	112,847	-	(337)	-	37,092		149,720
Purchase of Treasury shares	-	-	-	(6,401)	-	-	-		(6,401)
Issuance of shares upon exercise of options and warrants	-	2	844	-	-	-	-		846
Deferred stock compensation	-	-	187	-	(187)	-	-		-
Amortization of deferred stock compensation	-	-	-	-	363	-	-		363
Comprehensive loss:									
Net loss	-	-	-	-	-	-	(13,273)	\$ (13,273)	(13,273)
Total comprehensive loss								\$ (13,273)	
Balance as of December 31, 2001	\$ -	\$ 120	\$ 113,878	\$ (6,401)	\$ (161)	\$ -	\$ 23,819		\$ 131,255

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

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

**U.S. dollars in thousands**

	<b>Year ended December 31,</b>		
	<b>1999</b>	<b>2000</b>	<b>2001</b>
<u>Cash flows from operating activities:</u>			
Net income (loss)	\$ 10,660	\$ 26,679	\$ (13,273)
Adjustments required to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Losses on sale of available for sale marketable securities	18	-	-
Depreciation	403	926	1,572
Impairment of investment in a company	-	-	750
Increase in accrued severance pay, net	84	12	113
Amortization of deferred stock compensation	212	191	363
Amortization of compensation related to warrants granted to consultants	210	-	-
Decrease (increase) in accrued interest on short-term bank deposits	(637)	(1,421)	459
Decrease (increase) in trade receivables	(3,861)	(5,719)	8,145
Decrease (increase) in other accounts receivable and prepaid expenses	(242)	(1,083)	583
Decrease (increase) in inventories	(2,326)	(7,149)	4,178
Increase (decrease) in trade payables	554	6,254	(6,289)
Increase (decrease) in other accounts payable and accrued expenses	4,651	8,571	(1,843)
Other	3	4	-
Net cash provided by (used in) operating activities	<u>9,729</u>	<u>27,265</u>	<u>(5,242)</u>
<u>Cash flows from investing activities:</u>			
Investment in available for sale marketable securities	(11)	-	-
Proceeds from sale of available for sale marketable securities	376	-	-
Investment in a company	-	(600)	(600)
Proceeds from sale of property and equipment	41	46	-
Purchase of property and equipment	(905)	(3,036)	(3,247)
Investment in short-term bank deposits	(55,386)	(77,125)	-
Proceeds from short-term bank deposits	-	-	55,155
Net cash provided by (used in) investing activities	<u>(55,885)</u>	<u>(80,715)</u>	<u>51,308</u>

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

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

U.S. dollars in thousands

	<b>Year ended December 31,</b>		
	<b>1999</b>	<b>2000</b>	<b>2001</b>
<u>Cash flows from financing activities:</u>			
Proceeds from issuance of Ordinary shares, net	100,924	-	-
Proceeds from issuance of shares upon exercise of options and warrants	3,151	2,525	846
Purchase of treasury shares	-	-	(6,401)
Net cash provided by (used in) financing activities	<u>104,075</u>	<u>2,525</u>	<u>(5,555)</u>
Increase (decrease) in cash and cash equivalents	57,919	(50,925)	40,511
Cash and cash equivalents at the beginning of the year	<u>2,581</u>	<u>60,500</u>	<u>9,575</u>
Cash and cash equivalents at the end of the year	<u><u>\$ 60,500</u></u>	<u><u>\$ 9,575</u></u>	<u><u>\$ 50,086</u></u>
<u>Supplemental disclosure of cash flow activities:</u>			
Cash paid during the year for income taxes	<u><u>\$ 99</u></u>	<u><u>\$ 140</u></u>	<u><u>\$ 25</u></u>

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

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 1:- GENERAL**

- a. AudioCodes Ltd. and its wholly owned subsidiary AudioCodes Inc. ("the Company") design, develop and market technologies and products for enabling the transmission of voice data and fax over packet networks. The Company's technologies enable voice over IP gateways and ATM access devices to transmit voice and data over packet networks. The Company's products are designed to enable customers to build packet voice networking equipment that provides comparable communication quality to that of the traditional telephone networks.
- b. In 1999, 2000 and 2001, one major customer generated 34%, 29% and 32% of the Company's revenues, respectively.
- c. The Company is dependent upon sole source suppliers for certain key components used in its products, including certain digital signal processing chips. Although there is a limited number of manufacturers of these particular components, management believes that other suppliers could provide similar components at comparable terms. A change in suppliers, however, could cause a delay in manufacturing and a possible loss of sales, which could adversely affect the operating results of the Company and its financial position.
- d. During 2001, the Company wrote-off and wrote-down excess inventory in a total amount of \$ 6,185. The total amount was recorded in cost of sales in the statement of operations. The excess inventory's write-down and write-off is related to specific products that were deemed obsolete and due to a significant decrease in the Company's anticipated revenues.

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES**

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

- a. 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 amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

- b. Financial statements in U.S. dollars:

A majority of the revenues of the Company is generated in U.S. dollars ("dollar"). In addition, a substantial portion of the Company's costs is incurred in dollars. The Company's management believes that the dollar is the primary currency of the economic environment in which the Company operates. Thus, the functional and reporting currency of the Company is the dollar.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

Accordingly, monetary accounts maintained in currencies other than the dollar are remeasured into U.S. dollars in accordance with Statement of the Financial Accounting Standard No. 52 "Foreign Currency Translation" ("SFAS No. 52"). All transaction gains and losses from the remeasurement of monetary balance sheet items are reflected in the statements of operations as financial income or expenses, as appropriate.

c. Principles of consolidation:

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

d. Cash equivalents:

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

e. Short-term bank deposits:

Bank deposits with maturities of more than three months and less than one year are included in short-term bank deposits. Deposits are presented at their cost, including accrued interest. The short-term bank deposits are in U.S. dollars and bear an average annual interest of 3.9%.

f. Investment in a company:

The investment in this company is stated at cost, since the Company does not have the ability to exercise significant influence over operating and financial policies of the investees. Any decrease in value of the investment, which is other than temporary, is recorded when it becomes known.

g. Inventories:

Inventories are stated at the lower of cost or market value. Cost is determined as follows:

Raw materials - using the "average cost" method.

Finished products - on the basis of direct manufacturing costs.

The Company periodically evaluates the quantities on hand relative to current and historical selling prices and historical and projected sales volume. Based on these evaluations, inventories write-offs and write-down provisions are provided to cover risks arising from slow moving items (see Note 1d).

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

h. Property and equipment:

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

	<u>%</u>
Computers and peripheral equipment	20 - 33
Office furniture and equipment	6 - 20
Motor vehicles	15
Leasehold improvements	Over the term of the lease

The Company periodically assesses the recoverability of the carrying amount of property and equipment and provides for any possible impairment loss based upon the difference between the carrying amount and fair value of such assets in accordance with Statement of Financial Accounting Standards No.121 "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of ("SFAS No. 121)". As of December 31, 2001, no impairment losses have been identified.

i. Revenue recognition:

The Company generates its revenues from the sale of products, technology development contracts and licensing. The Company sells its products through a direct sales force and sales representatives. The Company's products are generally a bundled hardware and software solution that is delivered together to original equipment manufacturers (OEMs) of a variety of telecommunications and networking products who are considered end users.

Revenues from products are recognized in accordance with Staff Accounting Bulletin No. 101 "Revenue Recognition in Financial Statements" ("SAB No. 101") when the following criteria are met: persuasive evidence of an arrangement exists, delivery of the product has occurred, the fee is fixed or determinable and collectibility is probable. The Company has no obligation to customers after the date in which products are delivered other than pursuant to warranty obligations and right of return.

The Company maintains provision for product returns in accordance with Statement of Financial Accounting Standards No. 48 "Revenue Recognition When Right of Return Exists" ("SFAS No. 48"). The provision was deducted from revenues, and amounted to \$ 357 for the year ended December 31, 2001.

Revenues from technology development contracts are recognized upon completion of milestones as set forth in a specific contract. Royalties earned from technology licensing are recognized as payments become due from customers, provided that all other revenue recognition criteria have been met. The Company receives quarterly reports which indicate the amount of revenues earned in the period.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

j. Warranty costs:

The Company generally provides a warranty of 12 months, at no extra charge. Provisions are made at the time revenues are recognized for estimated material warranty costs based on the Company's past experience. The provision for warranty costs amounted to \$ 344 and \$194 as of December 31, 2000 and 2001, respectively. Warranty costs for the years ended December 31, 1999, 2000 and 2001, amounted to \$ 304, \$ 130 and \$ 168, respectively.

k. Research and development costs:

All research and development costs are charged to the statement of operations, as incurred.

l. Income taxes:

The Company accounts for income taxes in accordance with Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes" ("SFAS No. 109"). This Statement prescribes the use of the liability method whereby account balances of deferred tax assets and liabilities are determined based on differences between financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. The Company and its subsidiary provide a valuation allowance if necessary, to reduce deferred tax assets to their estimated realizable value.

m. Concentrations of credit risk:

Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of cash and cash equivalents, short-term bank deposits and trade receivables.

Cash and cash equivalents and short-term bank deposits are invested in U.S. dollar deposits with major banks in Israel and the United States. Such deposits in the United States may be in excess of insured limits and are not insured in other jurisdictions. Management believes that the financial institutions that hold the Company's investments are financially sound and, accordingly, minimal credit risk exists with respect to these investments.

The trade receivables of the Company are derived from sales to customers located primarily in the United States, Israel, Europe and the Far East. In management's opinion, the allowance for doubtful accounts adequately covers anticipated losses in respect of its accounts receivable credit risks. An allowance for doubtful accounts is determined with respect to those amounts that the Company has determined to be doubtful of collection. The Company usually does not require collateral on trade receivables because most of its sales are to large and well-established companies.

The Company has no off-balance sheet concentration of credit risk such as foreign exchange contracts, option contracts or other foreign currency hedging arrangements.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

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

Basic net earnings (loss) per share are computed based on the weighted average number of Ordinary shares outstanding during each year. Diluted net earnings per share are computed based on the weighted average number of Ordinary shares outstanding during each year, plus dilutive potential Ordinary shares considered outstanding during the year, in accordance with Statement of Financial Accounting Standards No. 128, "Earnings per Share" ("SFAS 128").

All outstanding options have been excluded from the calculation of the diluted loss per share because all such options are antidilutive for the year ended December 31, 2001. The weighted average number of shares related to the outstanding options excluded from the calculation of the diluted net loss per share were 387,625 and 6,064,305 for the years ended December 31, 2000 and 2001, respectively.

- o. Accounting for stock-based compensation:

The Company has elected to follow Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25") and FASB Interpretation No. 44 "Accounting for Certain Transactions Involving Stock Compensation" ("FIN 44"), in accounting for its employee stock option plans. Under APB 25, when the exercise price of the Company's share options is less than the market price of the underlying shares on the date of grant, compensation expense is recognized. The pro forma disclosures required by Statement of Financial Accounting Standards No. 123 "Accounting for Stock-Based Compensation" ("SFAS No. 123"), are provided in Note 10f.

The Company applies SFAS No. 123 and EITF 96-18 "Accounting for Equity Instruments that are Issued to Other than Employees for Acquiring, or in Conjunction with Selling, Goods or Services" with respect to options issued to non-employees. SFAS No. 123 requires use of option valuation models to measure the fair value of the options at the grant date.

- p. Severance pay:

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

The deposited funds include profits accumulated up to the balance sheet date. The deposited funds may be withdrawn only upon the fulfillment of the obligation pursuant to Israeli severance pay law or labor agreements. The value of the deposited funds is based on the cash surrender value of these policies and includes immaterial profits.

Severance expenses for the years ended December 31, 1999, 2000 and 2001, amounted to approximately \$ 322,\$ 604 and \$ 997, respectively.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

q. Advertising expenses:

Advertising expenses are charged to the statements of operations as incurred. Advertising expenses for the years ended December 31, 1999, 2000 and 2001, amounted to \$ 201, \$ 259 and \$ 296, respectively.

r. Fair value of financial instruments:

The following methods and assumptions were used by the Company in estimating its fair value disclosures for financial instruments:

The carrying amounts of cash and cash equivalents, short-term bank deposits, trade receivables and trade payables approximate their fair value due to the short-term maturity of such instruments.

s. Reclassification:

Certain amounts from prior years have been reclassified to conform to the current year's presentation.

t. Impact of recently issued accounting standards:

1. In June 2001, the Financial Accounting Standards Board issued SFAS No. 141, "Business Combinations" and No. 142, "*Goodwill and other Intangible Assets*", effective for fiscal years beginning after December 15, 2001. Under the new rules, goodwill and intangible assets deemed to have indefinite lives will no longer be amortized but will be subject to annual impairment tests in accordance with the Statements. Other intangible assets will continue to be amortized over their useful lives.

The Company will apply the new rule beginning in the first quarter of 2002 and does not expect the adoption to have a material effect, if any, on the Company's financial position and results of operations.

2. In August 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" (FAS144), which addresses financial accounting and reporting for the impairment or disposal of long-lived assets and superseded SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of", and the accounting and reporting provisions of APB Opinion No. 30, "Reporting the Results of Operations for a disposal of a segment of a business". FAS 144 is effective for fiscal years beginning after December 15, 2001, with earlier application encouraged. The Company expects to adopt FAS 144 as of January 1, 2002 and it does not expect that the adoption of the statement will have a significant impact, if any, on the Company's financial position and results of operations.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 3:- INVENTORIES**

	December 31,	
	2000	2001
Raw materials	\$ 8,929	\$ 4,771
Finished products	1,785	1,765
	\$ 10,714	\$ 6,536

**NOTE 4:- PROPERTY AND EQUIPMENT, NET**

Cost:		
Computers and peripheral equipment	\$ 3,593	\$ 5,571
Office furniture and equipment	876	1,651
Motor vehicles	111	111
Leasehold improvements	548	1,042
	5,128	8,375
Accumulated depreciation:		
Computers and peripheral equipment	1,314	2,636
Office furniture and equipment	237	372
Motor vehicles	52	69
Leasehold improvements	196	294
	1,799	3,371
Depreciated cost	\$ 3,329	\$ 5,004

Depreciation expenses amounted to \$ 403, \$ 926 and \$ 1,572 for the years ended December 31, 1999, 2000 and 2001, respectively.

**NOTE 5:- INVESTMENT IN A COMPANY**

In December 2000, the Company signed an agreement to invest in an unrelated privately - held company ("unrelated company"). Under this agreement, the Company purchased in two equal installments, an aggregate of 47,152 Series B Preferred shares for a total consideration of \$ 1,200. The first installment was paid in December 2000 and the second installment was paid in June 2001. The total investment represents 8.88% of the unrelated company's share capital.

In addition, under this agreement, the Company received warrants to purchase 47,152 Series B Preferred shares at an exercise price of \$ 36.90 per share. The warrants are exercisable at the earlier of December 22, 2002 or the completion of an initial public offering by the unrelated company.

As a result of assessing the recoverability of the carrying amount of the investment, the Company's management decided to write down \$ 750 of this investment in 2001, based on a market conditions. The impairment has been recorded in other expenses.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 6:- OTHER ACCOUNTS PAYABLE AND ACCRUED EXPENSES**

	<b>December 31,</b>	
	<b>2000</b>	<b>2001</b>
Employees and payroll accruals	\$ 3,622	\$ 3,623
Technology licensing fee	9,071	7,878
Government authorities	727	566
Customer advances	70	14
Accrued expenses	1,282	1,023
Warranty	344	194
Other	41	16
	<u>\$ 15,157</u>	<u>\$ 13,314</u>

**NOTE 7:- COMMITMENTS AND CONTINGENT LIABILITIES**

a. Lease commitments:

The Company's facilities are rented under several rental agreements in Israel and U.S. for periods ending in 2005.

The Company has leased various motor vehicles under operating lease agreements. These leases will expire in fiscal year 2004.

Future minimum rental and lease commitments under non-cancelable leases for and the years ended December 31, are as follows:

2002	\$ 3,005
2003	1,829
2004	1,095
2005	473
	<u>\$ 6,402</u>

Rent expenses for the years ended December 31, 1999, 2000 and 2001, were approximately \$ 323, \$ 1,000 and \$ 1,652, respectively. Motor vehicles leasing expenses for the years ended December 31, 1999, 2000 and 2001, were \$ 198, \$ 613 and \$ 1,034, respectively.

b. Royalty commitments:

The Company entered into two patents license agreements with third parties. Under the first agreement, the Company committed to pay the sum of \$352 in several installments during 2002. Under the second agreement, the Company agreed to pay a quarterly royalty fees until 2008.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 7:- COMMITMENTS AND CONTINGENT LIABILITIES (cont.)**

- c. In January 2002, the Company entered into a development agreement with a third party, under which that third party will develop extensions to the Company's digital media gateway products. The expected development cost in 2002 is approximately \$1,750. In the second half of 2002, upon delivery after successfully passing acceptance tests, a success fee of up to approximately \$800 will be payable to that third party. A second success fee in an amount up to \$3,000 is to be paid to that third party, based on the Company's sales of the product extensions that the third party develops for the Company. The second success fee will be paid at the earliest to occur of either the Company's sales of those product extensions reaching \$3,000 or about March 2004. The Company is entitled to pay either or both of the success fees by issuance of its shares or in cash or combination thereof.

**NOTE 8:- INCOME TAXES**

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

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

- b. Tax benefits under the Law for the Encouragement of Capital Investments, 1959 ("the law"):

AudioCodes Ltd. production facilities have been granted the status of an "Approved Enterprise" in accordance with the law under four separate investment programs which were approved in October 1993, January 1996, March 1999 and February, 2002. The Company is also a "foreign investors' Company", as defined by that law and as such, is entitled to a ten-year period of benefit and to an additional reduction in tax rates of 10% to 25% (based on the percentage of foreign ownership in each taxable year), currently 20%.

According to the provisions of the law, the Company has elected the "alternative benefits" - waiver of Government grants in return for a tax exemption. Income derived from the first program was tax-exempt for the two-year period ended December 31, 1999 and is eligible for a reduced tax rate of 10% to 25% (currently 20%) for the eight year period ending December 31, 2007.

Income derived from the second "Approved Enterprise" program will be tax-exempt for a period of four years, and is subject to a corporate tax at the reduced rate of 10% to 25% for an additional period of six years. The benefit period will commence when the Company realizes taxable income from this enterprise.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 8:- INCOME TAXES (cont.)**

Income derived from the third and fourth "Approved Enterprise" programs will be tax-exempt for a period of two years, and is subject to a corporate tax at the reduced rate of 10% to 25% for an additional period of eight years. The benefit period will commence when the Company realizes taxable income from this enterprise.

The period of tax benefits detailed above is subject to limits of the earlier of 12 years from commencement of production or 14 years from receiving the approval.

The entitlement to the above benefits is conditional upon AudioCodes' Ltd. fulfilling the conditions stipulated by the above law, regulations published thereunder and the instruments of approval for the specific investments in "approved enterprises". In the event of failure to comply with these conditions, the benefits may be canceled and AudioCodes Ltd. may be required to refund the amount of the benefits, in whole or in part, including interest.

The tax-exempt income attributable to the "Approved Enterprise" can be distributed to shareholders without imposing tax liability on the Company only upon the complete liquidation of the Company. As of December 31, 2001, retained earnings included approximately \$ 540 in tax-exempt income earned by AudioCodes' Ltd. "Approved Enterprise".

In the event of a distribution of such tax-exempt income as a cash dividend, in a manner other than upon the complete liquidation of the Company, AudioCodes Ltd. will be required to pay tax at the rate of 25% on the amount distributed and an income tax liability would be incurred of approximately \$ 135 as of December 31, 2001.

The Company's Board of Directors has determined that such tax-exempt income will not be distributed as dividends. Accordingly, no deferred income taxes have been provided on income attributable to the Audiocodes' Ltd. "Approved Enterprise".

The law also grants entitlement to claim accelerated depreciation on equipment used by the "Approved Enterprise" during five tax years.

If AudioCodes Ltd. derives income from sources other than the "Approved Enterprise" during the relevant period of benefits, such income will be taxable at the regular corporate tax rate of 36%.

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

AudioCodes Ltd. currently qualifies as an "industrial company" under the above law and as such is entitled to certain tax benefits, including accelerated depreciation and the deduction of public offering expenses in three equal annual payments.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 8:- INCOME TAXES (Cont.)**

- d. Net operating losses carryforwards:

AudioCodes Ltd. has accumulated losses for tax purposes as of December 31, 2001, in the amount of approximately \$ 78,000, which may be carried forward and offset against taxable income in the future for an indefinite period.

Through December 31, 2001, AudioCodes Inc. has U.S. federal net operating loss carryforward of approximately \$ 18,000, which can be carried forward and offset against taxable income for 15 to 20 years and expire from 2015 to 2021, respectively.

- e. A reconciliation between the theoretical tax expense (income), assuming all income is taxed at the statutory tax rate applicable to the income of the Company and the actual tax expense as reported in the consolidated statements of operations, is as follows:

	<b>Year ended December 31,</b>		
	<b>1999</b>	<b>2000</b>	<b>2001</b>
Income (loss) before taxes on income, as reported in the consolidated statements of operations	<u>\$ 11,015</u>	<u>\$ 27,117</u>	<u>\$ (13,273)</u>
Statutory tax rate in Israel	<u>36%</u>	<u>36%</u>	<u>36%</u>
Theoretical tax expense (income) calculated at the statutory rate	\$ 3,965	\$ 9,762	\$ (4,778)
Tax adjustments in respect of inflation in Israel	413	(75)	(7)
Issuance expenses, tax exempt interest income for which valuation allowance was provided	(761)	(4,474)	(2,528)
Tax benefits in respect of stock options to employees and operating carryforwards tax losses for which valuation allowance was provided	(3,411)	(5,399)	6,626
Items for which valuation allowance was provided	138	515	510
Other non-deductible expenses	<u>11</u>	<u>109</u>	<u>177</u>
Income tax expense	<u>\$ 355</u>	<u>\$ 438</u>	<u>\$ -</u>
f. Income (loss) before taxes consists of the following:			
Domestic	\$ 10,908	\$ 26,462	\$ (8,665)
Foreign	<u>107</u>	<u>655</u>	<u>(4,608)</u>
	<u>\$ 11,015</u>	<u>\$ 27,117</u>	<u>\$ (13,273)</u>

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 8:- INCOME TAXES (Cont.)**

	<b>Year ended December 31,</b>		
	<b>1999</b>	<b>2000</b>	<b>2001</b>
g. Taxes on income consist of the following:			
Current taxes	\$ 355	\$ 438	\$ -
Domestic	\$ 324	\$ 438	\$ -
Foreign	31	-	-
	<u>\$ 355</u>	<u>\$ 438</u>	<u>\$ -</u>

h. Deferred income taxes:

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of the Company's deferred tax liabilities and assets are as follows:

	<b>December 31,</b>	
	<b>2000</b>	<b>2001</b>
Deferred tax assets:		
Reserves and allowances	\$ 737	\$ 510
Net operating loss carryforwards	29,696	34,572
Net deferred tax assets before valuation allowance	30,433	35,082
Valuation allowance	(30,433)	(35,082)
Net deferred tax assets	<u>\$ -</u>	<u>\$ -</u>

As of December 31, 2001, the Company has provided valuation allowances in respect of deferred tax assets resulting from tax loss carryforwards and other temporary differences. Management currently believes that since the Company has a history of losses for tax purposes it is more likely than not that the deferred tax regarding the loss carryforwards and other temporary differences will not be realized in the foreseeable future.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 9:- RELATED PARTIES**

The following transactions and balances with DSP Group, Inc., which held 11.4% of the Company's shares as of December 31, 2001, are included in the financial statements as follows:

	<b>Year ended December 31,</b>		
	<b>1999</b>	<b>2000</b>	<b>2001</b>
Revenues from technology development and other	\$ 677	\$ 1,040	\$ 319
Purchases of raw materials	\$ 866	\$ 1,500	\$ 646
Payables at December 31	\$ 25	\$ 104	\$ 100

In 1994, the Company entered into a development and licensing agreement with DSP Group Inc. which was amended in 1999. Under the agreement, the Company performed certain research and development services for the DSP Group Inc. Upon development of the technology, the DSP Group Inc. paid a service fee and additional royalty fees based upon the net revenues and the gross margin realized from the sale of the technology incorporated in DSP Group Inc. products. The Company received royalties in the amount of \$ 51, \$ 810 and \$319 in 1999, 2000 and 2001, respectively.

In October 1999, the Company entered into a development agreement with DSP Group Ltd., a company affiliated with DSP Group Inc., and another company. Upon the development, the Company received \$ 40 and \$ 80 upon completion of milestones in 1999 and 2000, respectively. In addition, DSP Group Ltd. will pay royalties for every chip actually sold by DSP Group Ltd. to third parties. As of December 31, 2001, the Company had not received any royalties.

**NOTE 10:- SHARE CAPITAL**

a. General:

1. On May 28, 1999, the Company completed its initial public offering of 7,000,000 Ordinary shares, for net proceeds of approximately \$ 47,000, of which \$ 3,000 was received due to the exercise of warrants held by investors.
2. On October 14, 1999, the Company completed a second public offering of 3,000,000 Ordinary shares, with net proceeds of approximately \$57,000.
3. On October 6, 2000, the Company's board of directors approved a two-for-one stock split effected as a stock dividend.

All figures for shares and per shares, options and warrants data have been retroactively adjusted for all periods presented to reflect the stock splits effected as a stock dividend.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 10:- SHARE CAPITAL (cont.)**

4. In January 2001, the Company's Board of Directors approved a share repurchase program pursuant to which the Company is authorized to purchase up to 2,000,000 of its outstanding Ordinary shares. As of December 31, 2001, the Company had purchased 1,774,800 of its outstanding Ordinary shares, at a weighted average price per share of \$ 3.606.
5. The Company's shares are listed for trade on the Nasdaq National Market. In addition, in October 2001, the Company's shares were listed for trade on the Tel-Aviv Stock Exchange.

- b. Upon completion of the Initial Public Offering, all of the shares were designated as Ordinary shares.
- c. The Ordinary shares entitle their holders to the right to receive notice to participate and vote in general meetings of the Company and the right to receive cash dividends and a share dividend if declared.
- d. Warrants issued to consultants:

During 1999, the Company issued warrants to consultants to purchase 4,000 and 50,000 Ordinary shares of NIS 0.01 par value at an exercise price of \$ 9.82 per share and \$ 18.82 per share, respectively, expiring seven years from the date of the grant. Warrants to purchase 24,000 Ordinary shares at an exercise price of \$ 18.82 per share are exercisable immediately, and warrants to purchase 30,000 Ordinary shares are exercisable in four equal annual installments commencing one year from the date of grant. As of December 31, 2001, warrants to purchase 10,000 Ordinary shares at an exercise price of \$ 18.82 had been exercised.

The Company had accounted for its warrants to consultants under the fair value method of SFAS No. 123 and EITF 96-18. The fair market value was estimated using the Black-Scholes valuation model, with the following weighted-average assumptions for 1999: risk free interest rate of 5.5%, dividend yield of 0%, volatility factor of the expected market price of the Company's Ordinary shares of 1.126, and a weighted average expected life of the warrants of seven years. Compensation expense of \$ 210 was recognized in 1999 relating to the issuance of these warrants to consultants. No compensation expense was recognized in 2000 and 2001.

- e. Employee Stock Purchase Plan:

In May 2001, the Company's Board of Directors adopted the Employee Stock Purchase Plan (the "Purchase Plan"), which provides for the issuance of a maximum of 400,000 Ordinary shares. Eligible employees can have up to 15% of their earnings withheld, up to certain maximums, to be used to purchase Ordinary shares. The Purchase Plan will be implemented with purchases every six months occurring on July 31, and January 31. The price of the Ordinary share purchased under the purchase plan will be equal to 85% of the lower of the fair market value of the Ordinary share on the commencement date of each offering period or on the semi-annual purchase date.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 10:- SHARE CAPITAL (cont.)**

During 2001, one purchase period was completed and 32,608 shares were issued for aggregate consideration of \$ 139.

f. Employee Stock Options Plans:

Under the Company's 1997 and 1999 Stock Option Plans ("the plans"), options may be granted to officers, directors, employees and consultants of the Company.

The total number of options authorized for grant under the plans amounted to 7,086,392. As of December 31, 2001, 1,000,313 options are still available for future grant.

Stock options granted under the plans are exercisable usually at the fair market value at the date of grant and expire ten years and seven years, respectively, from the date of grant, and are subject to termination of employment. The options are generally vest over four or five years, commencing one year from the date of grant. Any options, which are forfeited or cancelled before expiration, become available for future grants.

A summary of the Company's stock option activity and related information for the years ended December 31, 1999, 2000 and 2001, is as follows:

	1999		2000		2001	
	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price
Outstanding at the beginning of the year	3,244,800	\$ 0.84	4,886,654	\$ 4.52	5,536,080	\$ 13.21
Granted	1,911,600	\$ 10.35	2,298,900	\$ 24.28	3,140,146	\$ 5.37
Cancelled	(39,200)	\$ 7.00	(118,500)	\$ 20.05	(876,534)	\$ 25.14
Exercised	(230,546)	\$ 0.65	(1,530,974)	\$ 1.58	(757,300)	\$ 0.92
Outstanding at the end of the year	<u>4,886,654</u>	<u>\$ 4.52</u>	<u>5,536,080</u>	<u>\$ 13.21</u>	<u>7,042,392</u>	<u>\$ 9.50</u>
Options exercisable at the end of the year	<u>1,269,454</u>	<u>\$ 0.84</u>	<u>1,088,280</u>	<u>\$ 3.84</u>	<u>1,709,664</u>	<u>\$ 9.47</u>

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 10:- SHARE CAPITAL (cont.)**

The options outstanding as of December 31, 2001, have been separated into exercise price, as follows:

<u>Ranges of exercise price</u>	<u>Options outstanding as of December 31, 2001</u>	<u>Weighted average remaining contractual life (years)</u>	<u>Weighted average exercise price</u>	<u>Options exercisable as of December 31, 2001</u>	<u>Weighted average exercise price of exercisable options</u>
\$ 0.61	432,420	4.40	\$ 0.61	353,220	\$ 0.61
\$ 1.10 - \$ 1.73	625,300	4.40	\$ 1.23	361,300	\$ 1.24
\$ 2.25 - \$ 4.90	1,830,960	6.75	\$ 3.80	10,500	\$ 4.90
\$ 6.51 - \$ 10.00	2,886,812	5.79	\$ 8.17	586,594	\$ 8.40
\$ 14.00 - \$ 20.38	236,500	4.76	\$ 18.74	119,000	\$ 18.86
\$ 25.5 - \$ 36.53	986,400	5.37	\$ 29.36	273,050	\$ 29.17
\$ 50.50	44,000	5.5	\$ 50.50	6,000	\$ 50.5
	<u>7,042,392</u>		<u>\$ 9.50</u>	<u>1,709,664</u>	<u>\$ 9.47</u>

Pro forma information regarding net income (loss) and net earnings (loss) per share is required (for grants issued after December 1994) by SFAS No. 123, and has been determined as if the Company has accounted for its employee options under the fair value method prescribed by that Statement. The fair value for these options was estimated at the date of the grant using a Black-Scholes option pricing model, with the following weighted-average assumptions for 1999, 2000 and 2001: risk-free interest rates of 5.5% for 1999, 6% for 2000 and 3.5% for 2001; dividend yields of 0% for each year, volatility factors of the expected market price of the Company's Ordinary shares of 1.126, 1.207 and 1.304, respectively and a weighted average expected life of the options of seven years for each year.

The Black-Scholes option pricing model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option valuation models require subjective assumptions, including the expected stock price volatility. Because the Company's employee stock options have characteristics significantly different from traded options, and because changes in the subjective assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable measure of the fair value of its employee stock options.

Options granted to employees in 2001, have an exercise price equal to the fair market value of the stock at the grant date. The weighted average fair values of the options granted during 1999, 2000 and 2001 respectively were \$20.85, \$22.01 and \$4.97, respectively.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 10:- SHARE CAPITAL (Cont.)**

Pro forma information under SFAS No. 123:

	<b>Year ended December 31,</b>		
	<b>1999</b>	<b>2000</b>	<b>2001</b>
Net income (loss) as reported	\$ 10,660	\$ 26,679	\$ (13,273)
Pro forma net income (loss)	\$ 6,856	\$ 4,692	\$ (35,944)
Pro forma basic net earnings (loss) per share	\$ 0.45	\$ 0.12	\$ (0.91)
Pro forma diluted net earnings (loss) per share	\$ 0.38	\$ 0.11	\$ (0.91)

The total compensation expense included in the proforma information for 1999, 2000 and 2001 is \$ 3,804, \$ 21,987 and \$ 22,671, respectively.

g. Dividends:

In the event that cash dividends are declared in the future, such dividends will be paid in NIS. The Company does not intend to pay cash dividends in the foreseeable future.

**NOTE 11:- SEGMENT, CUSTOMER AND GEOGRAPHIC INFORMATION**

a. Summary information about geographic areas:

The Company manages its business on a basis of one reportable segment. (See Note 1 for a brief description of the Company's businesses). The data is presented in accordance with Statement of Financial Accounting Standard No. 131 "Disclosure About Segments of an Enterprise and Related Information" ("SFAS No. 131"). The total revenues are attributed to geographic information based on the location of the end customers.

The following presents total revenues for the years ended December 31, 1999, 2000 and 2001 and long-lived assets as of December 31, 1999, 2000 and 2001.

	<b>1999</b>		<b>2000</b>		<b>2001</b>	
	<b>Total revenues</b>	<b>Long-lived assets</b>	<b>Total revenues</b>	<b>Long-lived assets</b>	<b>Total revenues</b>	<b>Long-Lived assets</b>
Israel	\$ 4,518	\$ 1,212	\$ 10,135	\$ 3,411	\$ 5,873	\$ 4,939
U.S.A.	21,016	57	44,576	518	19,845	515
Europe	3,756	-	9,055	-	3,516	-
Far East	1,686	-	7,733	-	6,405	-
Other	228	-	299	-	95	-
	<u>\$ 31,204</u>	<u>\$ 1,269</u>	<u>\$ 71,798</u>	<u>\$ 3,929</u>	<u>\$ 35,734</u>	<u>\$ 5,454</u>

b. For major customers data as a percentage of total revenues, see Note 1b.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 12:- SELECTED CONSOLIDATED STATEMENTS OF OPERATIONS DATA**

a. Financial income, net:

	<b>Year ended December 31,</b>		
	<b>1999</b>	<b>2000</b>	<b>2001</b>
Financial expenses:			
Foreign currency translation differences	\$ (42)	\$ (28)	\$ -
Interest and other bank charges	(49)	(78)	(225)
	(91)	(106)	(225)
Financial income:			
Foreign currency translation differences	-	-	67
Interest and others	2,562	8,163	6,546
	2,562	8,163	6,613
	<u>\$ 2,471</u>	<u>\$ 8,057</u>	<u>\$ 6,388</u>

b. Net earnings (losses) per share:

The following table sets forth the calculation of basic and diluted net earnings (losses) per share:

Numerator:

Net income (loss) to shareholders of Ordinary shares	<u>\$ 10,660</u>	<u>\$ 26,679</u>	<u>\$ (13,273)</u>
Numerator for diluted net earnings (loss) per share-income available to shareholders of Ordinary shares	<u>\$ 10,660</u>	<u>\$ 26,679</u>	<u>\$ (13,273)</u>

**Number of shares in thousands**

Denominator:			
Denominator for basic net earnings (loss) per share - weighted average shares	30,398	39,273	39,591
Effect of dilutive securities:			
Warrants to consultants	1,143	29	(* -
Employee stock options and unvested restricted shares	3,235	3,749	(* -
Convertible Preferred shares	1,387	-	-
Denominator for diluted and net earnings (loss) per share - adjusted weighted average shares and assumed conversions and exercises	<u>36,163</u>	<u>43,051</u>	<u>39,591</u>

\*) Undilutive.

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