AUDIOCODES LTD. AND ITS SUBSIDIARIES

CONSOLIDATED FINANCIAL STATEMENTS

AS OF DECEMBER 31, 2006

IN U.S. DOLLARS

INDEX

	Page
Report of Independent Registered Public Accounting Firm	2
Consolidated Balance Sheets	3 - 4
Consolidated Statements of Income	5
Statements of Changes in Shareholders' Equity	6
Consolidated Statements of Cash Flows	7 - 8
Notes to Consolidated Financial Statements	9 - 48

\- - - - - - - - - - -

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the board of directors and Shareholders of

AudioCodes LTD.

We have audited the accompanying consolidated balance sheets of AudioCodes Ltd. ("the Company") and its subsidiaries as of December 31, 2005 and 2006, 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, 2006. 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 did not audit the financial statements of a wholly-owned subsidiary, which statements reflect total assets of 2% as of December 31, 2006, and total revenues of 5% for the period from July 6, 2006 through December 31, 2006. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for this subsidiary, is based solely on the report of the other auditors.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (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. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purposes of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits and the report of other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits and the report of the other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company and its subsidiaries at December 31, 2005 and 2006, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2006, in conformity with U.S generally accepted accounting principles.

As discussed in Note 2 v to the consolidated financial statement, in 2006 the company adopted Statement Financial Accounting Statements Standards Board No. 123(Revised 2004) "Share Base Payment".

Tel-Aviv, Israel
March 28, 2007

KOST FORER GABBAY & KASIERER
A Member of Ernst & Young Global

CONSOLIDATED BALANCE SHEETS

U.S. dollars in thousands

	December 31,	
	2005	**2006**
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 70,957	$ 25,171
Short-term bank deposits and structured notes	61,929	28,658
Short-term marketable securities and accrued interest	9,863	29,422
Trade receivables (net of allowance for doubtful accounts of $ 553 and $ 854 at December 31, 2005 and 2006, respectively)	17,990	30,501
Other receivables and prepaid expenses	4,891	3,309
Deferred tax assets	1,249	1,282
Inventories	11,562	16,093
Total current assets	178,441	134,436
LONG-TERM ASSETS:		
Long-term bank deposits and structured notes	27,781	30,435
Long-term marketable securities	49,791	19,942
Investment in companies	1,112	3,999
Deferred tax assets	1,240	2,460
Severance pay funds	5,406	7,231
Total long-term assets	85,330	64,067
PROPERTY AND EQUIPMENT, NET	6,494	7,847
INTANGIBLE ASSETS, DEFERRED CHARGES AND OTHER, NET	3,279	21,853
GOODWILL	18,679	108,853
Total assets	$ 292,223	$ 337,056

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

	December 31,	
	2005	2006
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Trade payables	$ 7,774	$ 7,522
Deferred tax liabilities	-	1,321
Other payables and accrued expenses	18,620	28,139
Total current liabilities	26,394	36,982
LONG-TERM LIABILITIES:		
Deferred tax liabilities	-	6,459
Accrued severance pay	5,887	7,915
Senior convertible notes	120,836	121,015
Total long-term liabilities	126,723	135,389
COMMITMENTS AND CONTINGENT LIABILITIES		
SHAREHOLDERS' EQUITY:		
Share capital -		
Ordinary shares of NIS 0.01 par value -		
Authorized: 100,000,000 at December 31, 2005 and 2006; Issued: 44,529,943 shares at December 31, 2005 and 46,051,867 shares at December 31, 2006; Outstanding: 40,587,804 shares at December 31, 2005 and 42,109,728 shares at December 31, 2006	128	131
Additional paid-in capital	130,616	149,205
Treasury stock	(11,320)	(11,320)
Deferred stock compensation	(72)	-
Accumulated other comprehensive income	84	122
Retained earnings	19,670	26,547
Total shareholders' equity	139,106	164,685
Total liabilities and shareholders' equity	$ 292,223	$ 337,056

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

CONSOLIDATED STATEMENTS OF INCOME

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

	Year ended December 31,		
	2004	**2005**	**2006**
Revenues	$ 82,756	$ 115,827	$ 147,353
Cost of revenues	34,375	46,993	61,242
Gross profit	48,381	68,834	86,111
Operating expenses:			
Research and development, net	20,009	24,415	35,416
Selling and marketing	19,891	25,944	37,664
General and administrative	4,851	6,004	8,766
Total operating expenses	44,751	56,363	81,846
Operating income	3,630	12,471	4,265
Financial income, net	2,165	2,457	3,817
Equity in losses from investments in companies, net	516	693	916
Income before taxes on income	5,279	14,235	7,166
Taxes on income	273	799	289
Net income	$ 5,006	$ 13,436	$ 6,877
Basic net earnings per share	$ 0.13	$ 0.33	$ 0.16
Diluted net earnings per share	$ 0.12	$ 0.31	$ 0.16

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

STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

U.S. dollars in thousands

	Share Capital	Additional paid-in capital	Treasury stock	Deferred stock compensation	Accumulated other comprehensive income	Retained earnings	Total comprehensive income (loss)	Total shareholders' equity
Balance as of January 1, 2004	$ 121	$ 116,518	$ (11,320)	$ (174)	$ 145	$ 1,228		$ 106,518
Issuance of shares upon exercise of options and employee stock purchase plan	5	10,182	-	-	-	-		10,187
Amortization of deferred stock compensation	-	-	-	66	-	-		66
Comprehensive income, net:								
Unrealized gain on forward contracts, net	-	-	-	-	208	-	$ 208	208
Net income	-	-	-	-	-	5,006	5,006	5,006
Total comprehensive income, net							$ 5,214	
Balance as of December 31, 2004	126	126,700	(11,320)	(108)	353	6,234		121,985
Issuance of shares upon exercise of options and employee stock purchase plan	2	3,916	-	-	-	-		3,918
Amortization of deferred stock compensation	-	-	-	36	-	-		36
Comprehensive income, net:								
Unrealized loss on forward contracts, net	-	-	-	-	(269)	-	$ (269)	(269)
Net income	-	-	-	-	-	13,436	13,436	13,436
Total comprehensive income, net							$ 13,167	
Balance as of December 31, 2005	128	130,616	(11,320)	(72)	84	19,670		139,106
Issuance of shares upon exercise of options and employee stock purchase plan	3	9,178	-	-	-			9,181
Amortization of deferred stock compensation	-	8,707	-	-	-			8,707
Excess tax benefit from net operating loss utilization	-	776	-	-	-			776
Reclassification of deferred stock compensation due to implementation of SFAS 123R	-	(72)	-	72	-	-		
Comprehensive income, net:								
Unrealized gain on forward contracts, net	-	-	-	-	38	-	$ 38	38
Net income	-	-	-	-	-	6,877	6,877	6877
Total comprehensive income, net							$ 6,915	
Balance as of December 31, 2006	$ 131	$ 149,205	$ (11,320)	$ -	$ 122	$ 26,547		$ 164,685

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

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

	Year ended December 31,		
	2004	2005	2006
Cash flows from operating activities:			
Net income	$ 5,006	$ 13,436	$ 6,877
Adjustments required to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	2,979	3,369	5,543
Amortization of marketable securities premiums and accretion of discounts, net	-	143	225
Equity in losses of affiliated companies, net	516	693	916
Stock-based compensation expenses	66	36	8,707
Amortization of senior convertible notes discount and deferred charges	28	198	199
Decrease (increase) in accrued interest on marketable securities, bank deposits and structured notes	75	(736)	(130)
Increase in deferred tax assets, net	-	(2,033)	(1,001)
Increase in trade receivables, net	(4,907)	(3,520)	(9,751)
Decrease (increase) in other receivables and prepaid expenses	(1,248)	57	1,457
Increase in inventories	(3,712)	(1,503)	(1,954)
Increase (decrease) in trade payables	1,329	1,233	(2,671)
Increase (decrease) in other payables and accrued expenses	3,155	1,914	(2,005)
Increase in accrued severance pay, net	68	41	203
Other	98	(12)	15
Net cash provided by operating activities	3,453	13,316	6,630
Cash flows from investing activities:			
Investments in affiliated companies	(512)	(1,318)	(3,453)
Short-term loan to unrelated company	-	(350)	
Purchase of property and equipment	(4,257)	(2,393)	(3,067)
Proceeds from sale of property and equipment	6	96	
Investment in short-term and long-term bank deposits	-	(33,969)	(20,000)
Proceeds from sale of short-term bank deposits	-	3,969	51,300
Investment in structured notes	(18,000)	(20,000)	-
Proceeds from structured notes called by the issuer	18,000	10,000	-
Investment in short-term and long-term marketable securities	-	(59,060)	-
Proceeds from marketable securities held to maturity	-	-	9,000
Proceeds from sale of held-to-maturity marketable securities	-	-	979
Payment for acquisition of Universal Audio Server ("UAS") (1)	(2,500)	-	-
Payment for acquisition of AudioCodes USA Inc. (2)	(8,684)	(10,000)	-
Payment for acquisition of Nuera Communication Inc. (3)	-	-	(82,520)
Payment for acquisition of Netrake Corporation Inc. (4)	-	-	(13,836)
Net cash used in investing activities	(15,947)	(113,025)	(61,597)
Cash flows from financing activities:			
Proceeds from issuance of senior convertible notes	125,000	-	-
Issuance costs for senior convertible notes	(394)	(84)	-
Initial purchasers discount in respect of senior convertible notes	(4,365)	-	-
Proceeds from issuance of shares upon exercise of options and employee stock purchase plan	10,187	3,918	9,181
Net cash provided by financing activities	130,428	3,834	9,181
Increase (decrease) in cash and cash equivalents	117,934	(95,875)	(45,786)
Cash and cash equivalents at the beginning of the year	48,898	166,832	70,957
Cash and cash equivalents at the end of the year	$ 166,832	$ 70,957	$ 25,171

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

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

	Year ended December 31,		
	2004	**2005**	**2006**
(1) Payment for acquisition of UAS			
Net fair value of assets acquired of UAS at the date of acquisition:			
Goodwill	$ 1,000	- $	$ -
Paid accrued liability	1,500	-	-
	$ 2,500	$ -	$ -
(2) Payment for acquisition of AudioCodes USA Inc.			
Net fair value of assets acquired and liabilities assumed of AudioCodes USA Inc. at the date of acquisition (see also Note 1b):			
Working capital, net (excluding cash and cash equivalents)	$ 1,440	$ -	$ -
Property and equipment	329	-	-
Technology	3,100	-	-
Goodwill	3,815	10,000	-
	$ 8,684	$ 10,000	$ -
(3) Payment for acquisition of Nuera Communication Inc.			
Net fair value of assets acquired and liabilities assumed of Nuera at the date of acquisition (see also Note 1c):			
Working capital, net (excluding cash and cash equivalents)	$ -	$ -	$ (6,728)
Technology	-	-	6,020
Backlog	-	-	750
Customer relationship	-	-	8,001
Trade name	-	-	466
Deferred tax liability	-	-	(6,176)
Existing contracts	-	-	204
Deferred tax assets	-	-	1,201
Goodwill	-	-	78,782
	$ -	$ -	82,520
(4) Payment for acquisition of Netrake Corporation Inc.			
Net fair value of assets acquired and liabilities assumed of Netrake at the date of acquisition (see also Note 1d)			
Working capital, net (excluding cash and cash equivalents)	$ -	$ -	$ (2)
Core technology	-	-	5,688
Backlog	-	-	87
Deferred tax liability	-	-	(2,310)
Goodwill	-	-	10,373
	$ -	$ -	$ 13,836
(5) Supplemental disclosure of cash flow activities:			
Cash paid during the year for income taxes	$ 91	$ 760	$ 1,237
Cash paid during the year for interest	$ -	$ 2,500	$ 2,500

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

NOTE 1:- GENERAL

a. Business overview:

AudioCodes Ltd. ("the Company") and its subsidiaries (together "the Group") designs, develops and markets Voice over Packet (VOP) technology, voice network products, and applications to original equipment manufacturers, network equipment providers, service providers and system integrators worldwide.

The Company operates through its wholly-owned subsidiaries in the United States, United Kingdom, France, Germany, Argentina, Brazil, India, Japan and Korea.

b. Acquisition of AudioCodes USA Inc. (Formerly known as AI-Logix Inc.)

On May 12, 2004, the Group acquired all of the outstanding common stock of AudioCodes USA Inc., a provider of advanced voice and data recording hardware integration cards for the call recording and voice or data logging industry.

The Group paid $10,000 in cash at the closing of the transaction. An additional payment of $10,000 in cash was made in March 2005 based on the achievement of revenue milestones and additional terms by the AudioCodes USA Inc. business during 2004 and 2005. This payment was recorded as part of the acquisition cost as additional goodwill in accordance with the provisions of Statement of Financial Accounting Standards ("SFAS") No. 141 "Business Combination".

The results of AudioCodes USA Inc. have been included in the consolidated financial statements of the Group since the acquisition date.

NOTE 1:- GENERAL (Cont.)

Based upon an independent valuation of tangible and intangible assets acquired, the Group has allocated the total acquisition cost of AudioCodes USA Inc.'s assets and liabilities, as follows:

	May 12, 2004
Trade receivables	$ 1,846
Inventories	1,680
Prepaid expenses	180
Property and equipment	329
Total tangible assets acquired	4,035
Technology (five years useful life)	3,100
Goodwill	13,815
Total intangible assets acquired	16,915
Total tangible and intangible assets acquired	20,950
Trade payables	(1,015)
Accrued expenses	(1,045)
Other current liabilities	(206)
Total liabilities assumed	(2,266)
Net assets acquired	$ 18,684

Goodwill includes, but is not limited to, the synergistic value and potential competitive benefits that could be realized by the Company from the acquisition. Goodwill is not deductible for tax purposes. In accordance with SFAS No. 142, goodwill arising from this acquisition will not be amortized (see also Note 2n).

The value assigned to tangible assets, intangible assets and liabilities has been determined as follows:

Current assets and liabilities are recorded at their carrying amounts. The carrying amounts of current assets and liabilities were reasonable proxies for their market value due to their short-term maturity. Property and equipment are presented at current replacement cost. The fair value of technology was determined using the income approach.

The following unaudited pro forma information does not purport to represent what the Group's results of operations would have been had the acquisition of AudioCodes USA Inc. been consummated on January 1, 2004, nor does it purport to represent the results of operations of the Group for any future period.

NOTE 1:- GENERAL (Cont.)

	Year ended December 31, 2004
	Unaudited
Revenues	$ 88,125
Net income	$ 4,831
Basic net earnings per share	$ 0.13
Diluted net earnings per share	$ 0.11

c. Acquisition of Nuera Communication Inc.:

On July 6, 2006, the Group acquired all of the outstanding common stock of Nuera Communication Inc, a leading provider of Voice over Internet Protocol (VoIP) infrastructure solutions for broadband and long distance with an extensive client base in North America as well as in Asia and Europe.

The Group paid $ 82,520 in cash at the closing of the transaction including acquisition costs in the amount of $2,376.

Nuera Communication Inc. became a wholly-owned subsidiary of AudioCodes Inc. and accordingly, its results of operations have been included in the consolidated financial statements of the Group since the acquisition date.

This acquisition was accounted for under the purchase method of accounting in accordance with SFAS No. 141.

Based upon an independent valuation of tangible and intangible assets acquired, the Group has allocated the total acquisition cost of Nuera Communication Inc.'s assets and liabilities, as follows:

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
U.S. dollars in thousands, except share and per share data

NOTE 1:- GENERAL (Cont.)

	July 6, 2006
Trade receivables	$ 2,213
Inventories	931
Other receivables and prepaid expenses	356
Deferred tax asset	1,201
Property and equipment	673
Total tangible assets acquired	5,374
Technology (five years useful life)	6,020
Backlog (one year useful life)	750
Customer relationship (nine years useful life)	8,001
Existing contracts (three years useful life)	204
Trade name (three years useful life)	466
Goodwill	78,782
Total intangible assets acquired	94,223
Total tangible and intangible assets acquired	99,597
Trade payables	(1,292)
Deferred tax liability	(6,176)
Other current liabilities and accrued expenses	(9,609)
Total liabilities assumed	(17,077)
Net assets acquired	$ 82,520

Goodwill includes, but is not limited to, the synergistic value and potential competitive benefits that could be realized by the Company from the acquisition. Goodwill is not deductible for tax purposes. In accordance with SFAS No. 142, goodwill arising from this acquisition will not be amortized (see also Note 2n).

The value assigned to tangible assets, intangible assets and liabilities has been determined as follows:

Deferred tax liabilities in the amount of $6,176 were recorded for the difference between the assigned values and the tax bases of the intangible assets acquired in the acquisition.

Current assets and liabilities are recorded at their carrying amounts. The carrying amounts of current assets and liabilities were reasonable proxies for their market value due to their short-term maturity. Property and equipment are presented at current replacement cost. The fair value of intangible assets was determined using the income approach.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
U.S. dollars in thousands, except share and per share data

NOTE 1:- GENERAL (Cont.)

The following unaudited pro forma information does not purport to represent what the Group's results of operations would have been had the acquisition of Nuera Communication Inc. been consummated on January 1, 2005, nor does it purport to represent the results of operations of the Group for any future period.

	Year ended December 31,	
	2005	2006
	Unaudited	Unaudited
Revenues	$ 132,488	$ 159,390
Net income (loss)	$ 12,267	$ (5,679)
Basic net earnings (loss) per share	$ 0.30	$ (0.14)
Diluted net earnings (loss) per share	$ 0.28	$ (0.14)

d. Acquisition of Netrake Corporation Inc.:

On August 14, 2006, the Group acquired all of the outstanding common stock of Netrake Corporation Inc, a leading provider of Session Border Controller (SBC) and Security Gateway solutions. SBC'S enable connectivity, policies and security for real-time applications such as VoIP and video when traversing IP to IP networks. Security Gateways enable secure real-time session across wifi, broadband and wireless networks in Field Mobile Convergence (FMC) deployments.

The Group paid $13,836 in cash at the closing of the transaction including acquisition costs in the amount of $649.

Netrake Corporation Inc. became a wholly-owned subsidiary of AudioCodes Inc. and accordingly, its results of operations have been included in the consolidated financial statements of the Group since the acquisition date.

This acquisition was accounted for under the purchase method of accounting in accordance with SFAS No. 141.

NOTE 1:- GENERAL (Cont.)

Based upon an independent valuation of tangible and intangible assets acquired, the Group has allocated the total acquisition cost of Netrake Corporation Inc.'s assets and liabilities, as follows:

	August 14, 2006
Trade receivables	$ 554
Inventories	1,646
Other receivables and prepaid expenses	311
Property and equipment	528
Total tangible assets acquired	3,039
Technology (five years useful life)	5,688
Backlog (one year useful life)	87
Goodwill	10,373
Total intangible assets acquired	16,148
Total tangible and intangible assets acquired	19,187
Trade payables	(1,127)
Deferred tax liability	(2,310)
Other current liabilities and accrued expenses	(1,914)
Total liabilities assumed	(5,351)
Net assets acquired	$ 13,836

Goodwill includes, but is not limited to, the synergistic value and potential competitive benefits that could be realized by the Company from the acquisition. Goodwill is not deductible for tax purposes. In accordance with SFAS No. 142, goodwill arising from this acquisition will not be amortized (see also Note 2n).

The value assigned to tangible assets, intangible assets and liabilities has been determined as follows:

Deferred tax liabilities in the amount of $2,310 were recorded for the difference between the assigned values and the tax bases of the intangible assets acquired in the acquisition.

Current assets and liabilities are recorded at their carrying amounts. The carrying amounts of current assets and liabilities were reasonable proxies for their market value due to their short-term maturity. Property and equipment are presented at current replacement cost. The fair value of intangible assets was determined using the income approach.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
U.S. dollars in thousands, except share and per share data

NOTE 1:- GENERAL (Cont.)

The following unaudited pro forma information does not purport to represent what the Group's results of operations would have been had the acquisition of Netrake Corporation Inc. been consummated on January 1, 2005, nor does it purport to represent the results of operations of the Group for any future period.

	Year ended December 31,	
	2005	2006
	Unaudited	Unaudited
Revenues	$ 121,201	$ 151,690
Net loss	$ (1,274)	$ (8,311)
Basic net loss per share	$ (0.03)	$ (0.20)
Diluted net loss per share	$ (0.03)	$ (0.20)

e. The Group 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 Group and its financial position.

f. As to a major customer data, see Note 16b.

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 Group is generated in U.S. dollars ("dollar"). In addition, a substantial portion of the Group's costs is incurred in dollars. The Group's management believes that the dollar is the primary currency of the economic environment in which all the Group's entities operate. Thus, the functional and reporting currency of each of the Group's entities is the dollar.

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 SFAS No. 52, "Foreign Currency Translation". All transaction gains and losses of the remeasured 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 subsidiaries. Intercompany transactions and balances have been eliminated upon consolidation.

d. Cash equivalents:

Cash equivalents are short-term highly liquid investments that are readily convertible into cash with maturities of three months or less, at the date acquired.

e. Short-term bank deposits:

Short-term bank deposits are deposits with maturities of more than three months but less than one year. The deposits are in U.S. dollars and bear interest at an average rate of 5.18%. The short-term deposits are presented at their cost. The accrued interest is included in other receivables and prepaid expenses.

f. Marketable securities:

The Company accounts for investments in debt securities in accordance with SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities".

Management determines the appropriate classification of its investments in marketable debt securities at the time of purchase and evaluates such determinations at each balance sheet date. Debt securities are classified as held-to-maturity since the Company has the intent and ability to hold the securities to maturity and, accordingly, debt securities are stated at amortized cost.

The amortized cost of held-to-maturity securities is adjusted for amortization of premiums and accretion of discounts to maturity. Such amortization and interest are included in the consolidated statement of income as financial income or expenses, as appropriate. The accrued interest on short-term and long-term marketable securities is included in the balance of short-term marketable securities.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

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 – using the "average cost" method with the addition of direct manufacturing costs.

The Group periodically evaluates the quantities on hand relative to current and historical selling prices and historical and projected sales volume and technological obsolescence. Based on these evaluations, inventory write-offs and write-down provisions are provided due to slow moving items, technological obsolescence, excess inventories, discontinued products and for market prices lower than cost.

h. Long-term bank deposits:

Bank deposits with maturities of more than one year are included in long-term investments and presented at their cost including accrued interest. The deposits are in U.S. dollars and bear interest at an average rate of 5.10%. The Long-term deposits are presented at their cost. The accrued interest is included in other receivables and prepaid expenses.

i. Structured notes:

The Group accounts for investments in structured notes in accordance with SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities" and Emerging Issues Task Force ("EITF") Issue No. 96-12, "Recognition of Interest Income and Balance Sheet Classification of Structure Notes". Management determines the appropriate classification of its investments in debt securities at the time of purchase and reevaluates such determinations at each balance sheet date. Debt securities are classified as held-to-maturity when the Group has the intent and ability to hold these securities to maturity and are stated at amortized cost. As of December 31, 2005 and 2006, investments in structured notes approximate their market value.

j. Investment in companies:

The Company accounts for its investments in companies in which it has the ability to exercise significant influence over the operating and financial policies, using the equity method of accounting in accordance with the requirements of Accounting Principle Board ("APB") No. 18, "The Equity Method of Accounting for Investments in Common Stock". If the Company does not have the ability to exercise significant influence over operating and financial policies of these companies, the investment in these companies is stated at cost.

Investment in companies represents investments in Ordinary shares, Preferred shares and convertible loans. The Company applies EITF No. 99-10, "Percentage Used to Determine the Amount of Equity Method Losses". Accordingly, losses of such companies are recognized based on the ownership level of the particular security held by the investor.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

The Company's investments are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the investment may not be recoverable, in accordance with APB No. 18. As of December 31, 2006, based on management's most recent analyses, no impairment losses have been identified.

k. 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:

	%
Computers and peripheral equipment	33
Office furniture and equipment	6 - 20
Motor vehicles	15
Leasehold improvements	Over the shorter of the term of the lease or the life of the asset

l. Intangible assets and deferred charges:

Intangible assets are amortized over their useful life using a method of amortization that reflects the pattern in which the economic benefits of the intangible assets are consumed or otherwise used up, in accordance with SFAS No. 142 "Goodwill and Other Intangible Assets". Amortization is calculated by the straight-line method over the estimated useful lives of the assets as follows:

	Years
Acquired technology	5-10
Customer relationship	9
Backlog	1-2
Trade name	3
Existing contracts for maintenance	3

Cost incurred in respect of issuance of senior convertible notes are deferred and amortized using the effective interest method and classified as a component of interest expense, over the period from issuance to maturity, which is 20 years, in accordance with APB No. 21 "Interest on Receivables and Payables".

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

m. Impairment of long-lived assets:

The Group's long-lived assets and certain identifiable intangibles are reviewed for impairment in accordance with SFAS No. 144 "Accounting for the Impairment or Disposal of Long-Lived Assets", whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to the undiscounted future cash flows expected to be generated by the assets. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. As of December 31, 2006, no impairment losses have been identified.

Under SFAS No. 144, a long-lived group of assets that is to be abandoned is considered disposed of when it ceases to be used. Thus, an entity that intends to abandon a group of long-lived assets in operations should evaluate that group of assets as "held and used" and should determine whether it should revise its depreciation estimates to reflect a useful life that is shorter than initially expected and a salvage value consistent with the intention to abandon.

n. Goodwill:

Goodwill represents an excess of costs over the fair value of the net assets of businesses acquired under SFAS No. 142.

SFAS No. 142 requires goodwill to be tested for impairment at least annually or between annual tests in certain circumstances, and written down when impaired, rather than being amortized as previous accounting standards required. Goodwill is tested for impairment at the reporting unit level by comparing the fair value of the reporting unit with its carrying value.

Fair value is determined using market capitalizations. The Company elected to perform its analysis of goodwill impairment during the fourth quarter of 2006. The test was based on the Group's single operating segment and reporting unit structure. As of December 31, 2006, no impairment losses had been identified.

o. Revenue recognition:

The Group generates its revenues primarily from the sale of products, through a direct sales force and sales representatives. The Group's products are delivered to its customers, which include original equipment manufacturers, network equipment providers, systems integrators and distributors in the telecommunications and networking industries, all of whom are considered end-users.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Revenues from products are recognized in accordance with Staff Accounting Bulleting ("SAB") No. 104, "Revenue Recognition in Financial Statements", 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 Group has no obligation to customers after the date in which products are delivered other than pursuant to warranty obligations and right of return.

The Group generally grants to its customers a right of return or the ability to exchange a specific percentage of the total price paid for products they have purchased over a period of three months for other products. The Group maintains a provision for product returns and exchanges based on its experience with historical sales returns, analysis of credit memo data and other known factors, in accordance with SFAS No. 48, "Revenue Recognition When Right of Return Exists". The provision was deducted from revenues and amounted to $619, $545 and $636 as of December 31, 2004, 2005 and 2006, respectively.

Revenues from the sale of products which were not yet determined to be final sales due to market acceptance or technological compatibility were deferred and included in deferred revenues.

p. Warranty costs:

The Group generally provides a warranty period of 12 months, at no extra charge. The Group estimates the costs that may be incurred under its basic limited warranty and records a liability in the amount of such costs at the time product revenue is recognized. Factors that affect the Group's warranty liability include the number of installed units, historical and anticipated rates of warranty claims, and cost per claim. The Group periodically assesses the adequacy of its recorded warranty liability and adjusts the amount as necessary. A tabular reconciliation of the changes in the Company's aggregate product warranty liability was not provided due to immateriality.

q. Research and development costs:

Research and development costs, net of grants received, are charged to the statement of income as incurred.

r. Income taxes:

The Group accounts for income taxes in accordance with SFAS No. 109, "Accounting for Income Taxes". This Statement prescribes the use of the asset and 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 Group provides a valuation allowance, if necessary, to reduce deferred tax assets to their estimated realizable value.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

s. Concentrations of credit risk:

Financial instruments that potentially subject the Group to concentrations of credit risk consist principally of cash and cash equivalents, bank deposits, structured notes, marketable securities and trade receivables.

The majority of the Group's cash and cash equivalents, bank deposits and structured notes are invested in U.S. dollar instruments with major banks in Israel and the United States. Such investments 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 Group's investments are financially sound and, accordingly, minimal credit risk exists with respect to these financial investments.

Marketable securities include investments in debentures of corporations, U.S. government and agencies. Management believes that those corporations and agencies are financially sound, the portfolio is well diversified, and accordingly, minimal credit risk exists with respect to these marketable debt securities.

The trade receivables of the Group are derived from sales to customers located primarily in the Americas, the Far East, Israel and Europe. The Group performs ongoing credit evaluations of its customers and to date has not experienced any material losses. An allowance for doubtful accounts is determined with respect to those amounts that the Group has determined to be doubtful of collection. The Group usually does not require collateral on trade receivables because most of its sales are to large and well-established companies.

t. Senior convertible notes:

The Company presents the outstanding principal amount of its senior convertible notes as a long-term liability, in accordance with APB No. 14 "Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants". The debt is classified as a long-term liability until the date of conversion on which it would be reclassified to equity, or at the first contractual redemption date, on which it would be reclassified as a short-term liability. Accrued interest on the senior convertible notes is included in "other payables and accrued expenses".

The Initial Purchasers discount is recorded as a discount to the debt and amortized according to the interest method over the term of the senior convertible notes in accordance with EITF Issue No. 00-27 "Application of Issue No. 98-5 to Certain Convertible Industries", which is 20 years.

u. Basic and diluted net earnings per share:

Basic net earnings 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 potential dilutive Ordinary shares considered outstanding during the year, in accordance with SFAS No. 128, "Earnings Per Share".

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Senior convertible notes and certain outstanding stock options and warrants have been excluded from the calculation of the diluted net earnings per Ordinary share since such securities are anti-dilutive for all years presented. The total weighted average number of shares related to the senior convertible notes and outstanding options and warrants that have been excluded from the calculations of diluted net earnings per share was 4,972,991, 8,598,556 and 9,924,624 for the years ended December 31, 2004, 2005 and 2006, respectively.

v. Equity-based compensation expenses:

On January 1, 2006, the Company adopted SFAS No. 123 (revised 2004), "Share-Based Payment" ("SFAS No. 123(R)") which requires the measurement and recognition of compensation expense based on estimated fair values for all share-based payment awards made to employees and directors. SFAS No. 123(R) supersedes APB No. 25, "Accounting for Stock Issued to Employees" , for periods beginning in fiscal year 2006. In March 2005, the Securities and Exchange Commission issued SAB No. 107 relating to SFAS No. 123(R). The Company has applied the provisions of SAB No. 107 in its adoption of SFAS No. 123(R).

SFAS No. 123(R) requires companies to estimate the fair value of equity-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as an expense in the Company's consolidated income statements over the requisite service periods.

Prior to the adoption of SFAS No. 123(R), the Company accounted for equity-based awards to employees and directors using the intrinsic value method in accordance with APB No. 25 as allowed under SFAS No. 123, "Accounting for Stock-Based Compensation. The Company recognized compensation expenses, which had graded vesting, based on the accelerated attribution method over the requisite service period of each of the awards. Forfeitures were accounted for as occurred. During 2004 and 2005 the Company recorded compensation expenses in the amount of $66 and $36, respectively.

The Company adopted SFAS No. 123(R) using the modified prospective transition method, which requires the application of the accounting standard starting from January 1, 2006, the first day of the Company's fiscal year 2006. Under that transition method, compensation cost recognized in the year ended December 31, 2006, includes: (a) compensation cost for all share-based payments granted prior to, but not yet vested as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123, and (b) compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS No. 123(R). Results for prior periods have not been restated.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
U.S. dollars in thousands, except share and per share data

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

The Company recognizes compensation expenses for the value of its awards based on the accelerated method over the requisite service period of each of the awards, net of estimated forfeitures. SFAS No. 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Estimated forfeitures are based on actual historical pre-vesting forfeitures.

The effect of adopting SFAS No. 123(R) on January 1, 2006, was a decrease in the Company's income before taxes on income and net income for the year ended December 31, 2006, of $8,707 with a corresponding decrease in the basic and diluted net earnings per share of $0.21 and $0.19 respectively.

Pro forma information regarding the Group's net income (loss) and net earnings (loss) per share is required by SFAS No. 123 and has been determined as if the Group had accounted for its employee stock options under the fair value method prescribed by SFAS No. 123.

The fair value for these options was estimated at the date of grant using the Black and Scholes option pricing model and amortized over the vesting period. Fair values were estimated using the following weighted-average assumptions:

	2004	2005
Dividend yield	0%	0%
Expected volatility	87%	75%
Risk-free interest	3%	4%
Expected life	4 years	4.5 years

The Black-Scholes pricing-model was used to estimate the fair value of the Employee Stock Purchase Plan ("ESPP") compensation. Assumptions are not provided due to immateriality.

Pro forma information under SFAS No. 123 is as follows:

	Year ended December 31,	
	2004	2005
Net income as reported	$ 5,006	$ 13,436
Add: stock-based compensation expenses determined under the intrinsic value based method included in the reported net income	66	36
Deduct: stock-based compensation expenses determined under the fair value based method for all awards	(8,509)	(8,869)
Pro forma net income (loss)	$ (3,437)	$ 4,603
Basic net earnings per share as reported	$ 0.13	$ 0.33
Diluted net earnings per share as reported	$ 0.12	$ 0.31
Pro forma basic net earning (loss) per share	$ (0.09)	$ 0.11
Pro forma diluted net earning (loss) per share	$ (0.09)	$ 0.11

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

As of December 31, 2006, the total unrecognized estimated compensation cost related to non-vested stock options granted prior to that date was $12,381, which is expected to be recognized over a weighted-average period of 1.6 years. The total intrinsic value of stock options exercised during 2006 was $4,790. The Company recorded cash received from the exercise of stock options of $6,515 during the year ended December 31, 2006.

The weighted-average estimated fair value of employee stock options and Employee Stock Purchase Plan granted during the 12 months ended December 31, 2006, was $ 5.81, per share using the Black-Scholes option pricing formula with the following weighted-average assumptions (annualized percentages):

	Year ended December 31, 2006
Dividend yield	0%
Expected volatility	61.9%
Risk-free interest	4.6%
Expected life	4.8 years

The Company is required to assume a dividend yield as an input in the Black-Scholes model. The dividend yield assumption is based on the Company's historical experience and expectation of future dividend payouts and may be subject to substantial change in the future. The dividend yield used for the twelve months ended December 31, 2006 was 0%.

The computation of volatility uses historical volatility derived from the company's exchange traded shares. As a result of the above-mentioned calculations, the weighted-average volatility used for the twelve months ended December 31, 2006 was 61.9%.

The risk-free interest rate assumption is the implied yield currently available on United States treasury zero-coupon issues with a remaining term equal to the expected life term of the Company’s options. Weighted average interest rate used for the twelve months ended December 31, 2006 was 4.6%.

The Company determined the expected life of the options according to the simplified method, average of vesting and the contractual term of the Company's stock options. Expected life used for the twelve months ended December 31, 2006 was 4.8 years.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

The Company's aggregate compensation cost for the twelve months ended December 31, 2006 totaled $8,707 thousand. The total income tax benefit recognized in the income statement for the twelve months ended December 31, 2006 was $0, for the Company's equity-based compensation arrangements.

The total equity-based compensation expense related to all of the Company's equity-based awards, recognized for twelve months ended December 31, 2006, was comprised as follows:

	Year ended December 31, 2006
Cost of goods sold	$ 620
Research and development	3,053
Selling and Marketing	3,628
General and administrative	1,406
Total equity-based compensation expense before taxes	$ 8,707

The Group applies SFAS No. 123 and EITF No. 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 and warrants issued to non-employees. SFAS No. 123 requires the use of option valuation models to measure the fair value of the options and warrants at the measurement date.

w. Severance pay:

The Group's liability for severance pay for Israeli employees is calculated pursuant to Israel's 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 Group's liability for all of its Israeli employees is fully provided for by monthly deposits with severance pay funds, insurance policies and by an accrual.

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 Israel's 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 pay expenses for the years ended December 31, 2004, 2005 and 2006, amounted to approximately $1,182, $1,514 and $1,766, respectively.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

x. Employees benefit plan

The Company has four 401(K) defined contribution plans covering certain employees in the U.S. All eligible employees may elect to contribute up to 100%, but generally not greater than $ 15 per year ($20 including catch-up contributions for eligible participants over the age of 50), of their annual compensation to the plan through salary deferrals, subject to IRS limits. Effective from January 1, 2006 the Company matches employees contributions to the plan up to limit of 3.75% of their eligible compensation, subject to IRS limits. In 2006 the Company matched contributions in the amount of $ 271.

y. Advertising expenses:

Advertising expenses are charged to the statements of operations as incurred. Advertising expenses for the years ended December 31, 2004, 2005 and 2006, amounted to $359, $371 and $402, respectively.

z. Fair value of financial instruments:

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

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

The carrying amounts of bank deposits and structured notes are estimated by discounting the future cash flows using current interest rates for deposits of similar terms and maturities. The carrying amount of long-term deposits approximates their fair value.

The fair value of marketable securities is based on quoted prices and do not differ significantly from the carrying amount (see Note 4).

The fair value of senior convertible notes is based on quoted market values and prevailing market rates, and approximates their carrying amount.

The fair value of foreign currency contracts (used for hedging purposes) is estimated by obtaining current quotes from banks.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

aa. Derivative instruments:

SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities", requires a company to recognize all of its derivative instruments as either assets or liabilities in the statement of financial position at fair value. The accounting for changes in the fair value (i.e., gains or losses) of a derivative instrument depends on whether it has been designated and qualifies as part of a hedging relationship and also on the type of hedging relationship. For those derivative instruments that are designated and qualify as hedging instruments, a company must designate the hedging instrument, based upon the exposure being hedged, as a fair value hedge, cash flow hedge or a hedge of a net investment in a foreign operation.

The Group uses derivative instruments to manage exposures to foreign currency related to salary payments denominated in New Israeli Shekel ("NIS"). The Group's objectives for holding derivatives are to minimize risks.

For those derivative instruments that are designated and qualify as a cash flow hedge (i.e., hedging the exposure to variability in expected future cash flows that is attributable to a particular risk), the effective portion of the gain or loss on the derivative instrument is reported as a component of other comprehensive income and reclassified into earnings in the same line item associated with the forecasted transaction in the same period or periods during which the hedged transaction affects earnings.

Since the amounts of forward transactions do not exceed salary payments, those transactions are all highly effective and the results are recorded as payroll expenses at the time that the hedge against the risk of overall changes in cash flows resulting from forecasted foreign currency salary payments during the year. The Company has instituted a foreign currency cash flow hedging program. The Company hedges portions of its forecasted expenses denominated in NIS with forward and put and call options (zero - cost collar). These option contracts are designated as cash flow hedges, as defined by SFAS No. 133 and Derivative Implementation Group No. G20. Cash Flow Hedges Assessing and Measuring the Effectiveness of a Purchased option Used in a Cash Flow Hedge. ("DIG 20") and are all effective.

At December 31, 2006, the Group expects to reclassify $122 of net gains on derivative instruments from accumulated other comprehensive income to income during the next nine months due to actual payment of variable interest associated with the floating rate debt.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

ab. Impact of recently issued accounting standards:

1. FIN No 48

In July 2006, the FASB issued FASB Interpretation No. 48 "Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109" ("FIN No 48"). FIN No 48 clarifies the accounting for income taxes by prescribing the minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN 48 utilizes a two-step approach for evaluating tax positions. Recognition (step one) occurs when an enterprise concludes that a tax position, based solely on its technical merits, is more-likely-than-not to be sustained upon examination. Measurement (step two) is only addressed if step one has been satisfied (i.e., the position is more-likely-than-not to be sustained). Under step two, the tax benefit is measured as the largest amount of benefit, determined on a cumulative probability basis that is more-likely-than-not to be realized upon ultimate settlement.

FIN No 48 applies to all tax positions related to income taxes subject to the FASB No. 109, "Accounting for income taxes". This includes tax positions considered to be "routine" as well as those with a high degree of uncertainty.

FIN No 48 has expanded disclosure requirements which include a tabular roll forward of the beginning and ending aggregate unrecognized tax benefits as well as specific detail related to tax uncertainties for which it is reasonably possible the amount of unrecognized tax benefit will significantly increase or decrease within twelve months. These disclosures are required at each annual reporting period unless a significant change occurs in an interim period.

FIN No 48 is effective for fiscal years beginning after December 15, 2006. The cumulative effect of applying FIN No 48 will be reported as an adjustment to the opening balance of retained earnings.

The Company is currently evaluating the effect of the adoption of FIN 48 on its financial statements.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

2. SFAS No. 157

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements . This statement provides a single definition of fair value, a framework for measuring fair value, and expanded disclosures concerning fair value. Previously, different definitions of fair value were contained in various accounting pronouncements creating inconsistencies in measurement and disclosures. SFAS No. 157 applies under those previously issued pronouncements that prescribe fair value as the relevant measure of value, except SFAS No. 123(R) and related interpretations. The statement does not apply to accounting standards that require or permit measurement similar to fair value but are not intended to measure fair value. This pronouncement is effective for fiscal years beginning after November 15, 2007. The Company is currently evaluating the impact of adopting SFAS No 157.

3. SFAS No. 159

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities". SFAS No. 159 permits companies to choose to measure certain financial instruments and certain other items at fair value. The standard requires that unrealized gains and losses on items for which the fair value option has been elected be reported in earnings. SFAS No. 159 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years, although earlier adoption is permitted. The Company is currently evaluating the impact that SFAS No. 159 will have on its consolidated financial statements.

NOTE 3:- BANK DEPOSITS AND STRUCTURED NOTES

Bank deposits and structured notes are composed as follows:

	December 31,			
	2005	**2006**	**2005**	**2006**
	Weighted average interest			
Short-term bank deposits (in U.S. dollars)	3.42%	5.18%	$ 55,000	$ 10,700
Structured notes (1)	-	-	6,929	17,958
			61,929	28,658
Long-term bank deposits (in U.S. dollars)	-	5.10%	-	20,287
Structured notes (2)	3.0%	5.51%	27,781	10,148
			27,781	30,435
			$ 89,710	$ 59,093

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
U.S. dollars in thousands, except share and per share data

NOTE 3:- BANK DEPOSITS AND STRUCTURED NOTES (Cont.)

(1) As of December 31, 2006, the Group has callable structured notes at par value totaling $ 18,000 for settlement during 2007 from several banks. Under the arrangements with the banks, whether or not the structured notes bear interest depends upon the rate of the three months to one year LIBOR.

For each day in which the relevant LIBOR rate is below an agreed annual fixed rate, which ranges from 2.5% to 4.5% the structured notes bear interest at the rate of 3.2% to 4.5% per annum. On all other days, the structured notes do not bear any interest. As of December 31, 2006, investments in structured notes securities approximate their market value.

(2) As of December 31, 2006, the Group has callable structured notes at par value totaling $10,000 for settlement during 2010. Under the arrangements with the bank, whether or not the structured notes bear interest depends upon the six month LIBOR rate.

For each day in which the relevant LIBOR rate is below an agreed annual fixed rate, which ranges from 5.25% to 6% the structured notes bear interest at the rate of 5.75% per annum. On all other days, the structured notes bear interest at the rate of 2.5%. As of December 31, 2006, investments in structured notes securities approximate their market value.

NOTE 4:- MARKETABLE SECURITIES AND ACCRUED INTEREST

The following is a summery of held to maturity marketable securities.

	December 31,					
	2005			2006		
	Amortized cost	Net unrealized losses	Market Value	Amortized cost	Net unrealized losses	Market Value
Corporate debentures:						
Maturing within one year	$ 8,040	$ 53	$ 7,987	$ 19,682	$ 84	$ 19,598
Maturing within one to three years	33,792	265	33,527	12,943	126	12,817
	41,832	318	41,514	32,625	210	32,415
U.S. Government and agencies debts						
Maturing within one year	1,000	4	996	9,000	49	8,951
Maturing within one to three years	15,999	130	15,869	6,999	48	6,951
	16,999	134	16,865	15,999	97	15,902
Accrued interest	823	-	823	740	-	740
	$ 59,654	$ 452	$ 59,202	$ 49,364	$ 307	$ 49,057

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
U.S. dollars in thousands, except share and per share data

NOTE 4:- MARKETABLE SECURITIES AND ACCRUED INTEREST (Cont.)

The unrealized losses on the Company's investments in all types of securities are due to interest rate increases. The contractual cash flows of these investments are either guaranteed by the U.S. government or an agency of the U.S. government or were issued by highly rated corporations. Accordingly, it is expected that the securities would not be settled at a price less than the amortized cost of the Company's investment. Since the Company has the ability and intent to hold these investments until a recovery of fair value, which may be until maturity, the Company does not consider these investments to be other-than-temporarily impaired as of December 31, 2006.

Out of the unrecognized loss as of December 31, 2006, $174 is outstanding more than twelve months and $133 are less than twelve months.

The Company sold held-to-maturity marketable securities during the year ended December 31, 2006 in the amount of $ 979. The marketable securities were sold before their maturity, due to deterioration in their credit rating. As a result of the sale, the Company recorded an immaterial loss during the period.

NOTE 5:- INVENTORIES

	December 31,	
	2005	2006
Raw materials	$ 4,598	$ 5,431
Finished products	6,964	10,662
	$ 11,562	$ 16,093

In the years ended December 31, 2004, 2005 and 2006, the Group increased its reserve for obsolete inventory in a total amount of $1,237 $1,168 and $981 respectively. These amounts are included in cost of revenues.

NOTE 6:- INVESTMENT IN COMPANIES

a. In December 2000, the Company signed an agreement to invest in an unrelated privately-held company ("investee"). During 2005 and 2006, the Company granted convertible loans in the amount of $902 to the investee. The loans bear no interest and are convertible into shares. The date of conversion, the type of the shares and the number of shares granted will be determined by the board of directors of the investee. As of December 31, 2006, the Company holds 40.9% of the investee's share capital.

	December 31,	
	2005	2006
Equity, net (1)	$ (232)	$ (311)
Convertible loans	611	902
Total investments	$ 379	$ 591

(1) Net equity as follows:

	2005	2006
Net equity as of purchase date	$ 93	$ 93
Unamortized goodwill	2,389	3,167
Accumulated net losses	(2,714)	(3,571)
	$ (232)	$ (311)

b. In July, 2005, the Company signed a share purchase agreement with another unrelated privately-held company and certain of its shareholders to acquire 19.5% of its Ordinary shares for a total purchase price in the amount of $ 707. In November 2006, the Company granted convertible loan in the amount of $ 44. The loan bears interest at the rate of 9% per annum and is convertible into shares.

	December 31,	
	2005	2006
Net equity as of purchase date	$ (106)	$ (106)
Unamortized goodwill	813	985
Accumulated net income (loss)	26	(33)
Total investment	$ 733	$ 846

NOTE 6:- INVESTMENT IN COMPANIES (Cont.)

c. In February, 2006, the Company signed a share purchase agreement with another unrelated privately-held company to acquire 10% of its Ordinary shares for a total purchase price in the amount of $1,000. The Company received in October 2006 a call option to invest an additional $10,000 for the remaining 90% of the unrelated privately-held company's share capital. The option is valid until January 31, 2007. In November, 2006 the Company granted the unrelated privately-held company a credit line of $500 payable within 18 months. The loan bears interest at the rate of 180 day LIBOR plus 3.0% per annum. In the event that the Company consummates an equity investment in the unrelated privately-held company the principal amount of the loan would automatically be applied to pay a portion of the purchase price for the equity investment.

d. In December 2006, the Company granted convertible loan in the amount of $ 1,000 to another unrelated privately-held company. The loan bears LIBOR+2% per annum interest and shall be due and payable in December 2007 unless converted into shares. Upon affiliated company consummating a single or series of equity financial transactions no later then the repayment date, the Company shall be entitled to convert the loan amount for the lowest price per share paid by the investors participating in the financing. In addition, the Company received warrants valid until the consummation of an exit transaction to purchase in consideration for 40% of the principle amount ($400), in consideration of $941.91 per share unless the investee consummated the financing by the repayment date, then the price would be equal to the price per share paid by the Company.

NOTE 7:- PROPERTY AND EQUIPMENT

	December 31,	
	2005	**2006**
Cost:		
Computers and peripheral equipment	$ 11,767	$ 14,022
Office furniture and equipment	6,333	8,079
Motor vehicles	48	48
Leasehold improvements	1,289	1,561
	19,437	23,710
Accumulated depreciation:		
Computers and peripheral equipment	9,184	10,868
Office furniture and equipment	3,327	4,429
Motor vehicles	48	48
Leasehold improvements	384	518
	12,943	15,863
Depreciated cost	$ 6,494	$ 7,847

Depreciation expenses amounted to $2,352, $2,509 and $2,920 for the years ended December 31, 2004, 2005 and 2006, respectively.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 8:- INTANGIBLE ASSETS, DEFERRED CHARGES AND OTHER

a.

	December 31,	
	2005	**2006**
Cost:		
Acquired technology	$ 4,273	$ 15,982
Customer relationship	-	8,001
Trade name	-	466
Existing contracts for maintenance	-	204
Backlog	-	837
Deferred charges	478	478
Other	200	200
	4,951	26,168
Accumulated amortization:		
Acquired technology	1,647	3,322
Customer relationship	-	445
Trade name	-	78
Existing contracts for maintenance	-	34
Backlog	-	391
Deferred charges	25	45
	1,672	4,315
Amortized cost	$ 3,279	$ 21,853

b. Amortization expenses amounted to $627, $860 and $2,623 for the years ended December 31, 2004, 2005 and 2006, respectively.

c. Amortization expenses related to deferred charges amounted to $3, $22 and $20 for the years ended December 31, 2004, 2005 and 2006, respectively.

d. Expected amortization expenses for the years ended December 31:

2007	$ 4,183
2008	3,605
2009	3,026
2010	2,684
2011	2,082
2012-2016	6,273
	$ 21,853

NOTE 9:- OTHER PAYABLES AND ACCRUED EXPENSES

	December 31, 2005	December 31, 2006
Employees and payroll accruals	$ 8,088	$ 11,614
Technology licensing fee provision	2,901	2,067
Government authorities	738	873
Accrued expenses	6,568	10,857
Deferred revenues	300	1,753
Others	25	975
	$ 18,620	$ 28,139

NOTE 10:- SENIOR CONVERTIBLE NOTES

In November 2004, the Company issued an aggregate of $125,000 (including the exercise of the option as described below) of 2% Senior Convertible Notes due November 9, 2024 ("the Notes"). The Company is obligated to pay interest on the Notes semi-annually on May 9 and November 9 of each year.

The Notes are convertible, at the option of the holders at any time before the maturity date, into Ordinary shares of the Company at a conversion rate of 53.4474 Ordinary shares per $1 principal amount of Notes, representing a conversion price of approximately $18.71 per share. The Notes are subject to redemption at any time on or after November 9, 2009, in whole or in part, at the option of the Company, at a redemption price of 100% of the principal amount plus accrued and unpaid interest. The Notes are subject to repurchase, at the holders' option, on November 9, 2009, November 9, 2014 or November 9, 2019, at a repurchase price equal to 100% of the principal amount plus accrued and unpaid interest, if any, on such repurchase date. The Company can choose

to pay the repurchase price in cash, Ordinary shares or a combination of cash and Ordinary shares. As of December 31, 2006, the Notes are presented as a long-term liability.

The Notes also contain a provision for a "make-whole" premium to be paid by the Company to holders of the Notes in the event of certain changes in control that could occur during the life of the Notes. The premium is payable in the form of cash, the Company's Ordinary shares, or the same form of consideration used to pay for the shares of the Company's Ordinary shares in connection with the transaction constituting the change in control. The premium declines over time and is based upon the price of the Company's Ordinary shares as of the effective date of the change in control. Due to immateriality, the Company did not record separate derivative in the financial statements.

The Notes were issued with a conversion price equal to $18.71 per share, which reflected the closing share price on the Nasdaq on the date of the offering, which was $14.12, plus a premium of 32.5%. In accordance with EITF No. 00-27, no beneficial conversion feature was recognized or recorded.

NOTE 10:- SENIOR CONVERTIBLE NOTES (Cont.)

The additional amount that the Company can be required to pay in respect of the withholding taxes was recorded as a liability.

As part of the offering, the Company granted the Initial Purchasers an option to purchase at any time during 30 days from the date of the offering, up to an additional $25,000 principal amount of senior convertible notes. The option, in accordance with SFAS No. 133, is not embedded and therefore should be measured on a stand-alone basis. On November 16, 2004, the option was exercised in full. Due to immateriality, the Company did not record this option and its exercise in the financial statements.

NOTE 11:- COMMITMENTS AND CONTINGENT LIABILITIES

a. Lease commitments:

The Group's facilities are rented under several lease agreements in Israel and the U.S. for periods ending in 2013.

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

2007	$ 3,686
2008	3,447
2009	3,424
2010	3,201
2011	3,011
2012 and thereafter	3,872
	$ 20,641

Rent expenses for the years ended December 31, 2004, 2005 and 2006, were approximately $2,927, $2,938 and $3,087, respectively.

b. Other commitments:

The Company is obligated under certain agreements with its suppliers to purchase goods and under an agreement with its manufacturing subcontractor to purchase excess inventory. Non Cancelable obligations as of December 31, 2006, were approximately as follows:

2007	$ 2,726
2008	1,008
	$ 3,734

NOTE 11:- COMMITMENTS AND CONTINGENT LIABILITIES (Cont.)

c. Royalty commitment to the Office of the Chief Scientist of Israel ("OCS"):

Under the research and development agreements of the Company with the OCS and pursuant to applicable laws, the Company is required to pay royalties at the rate of 3%-4.5% of sales of products developed with funds provided by the OCS, up to an amount equal to 100% of the OCS research and development grants received, linked to the U.S. dollar plus interest on the unpaid amount received based on the 12-month LIBOR rate applicable to dollar deposits. The Company is obligated to repay the Israeli Government for the grants received only to the extent that there are sales of the funded products.

As of December 31, 2006, the Company has a contingent obligation to pay royalties in the amount of approximately $ 2,728.

d. Royalty commitments to third parties:

The Group entered into technology licensing fee agreements with third parties. Under the agreements, the Group agreed to pay the third parties royalties until 2008, based on 0.3%-0.9% of the Group's total consolidated revenues.

From time to time, the Group may be subject to patent infringement claims that arise in the ordinary course of its business activities. The Group estimates and records liabilities for those contingent claims for which it believes future expenditures will be required and for which such expenditures can be reasonably estimated.

e. Legal proceedings

1. Prior to the acquisition of Nuera by the Group, one of Nuera's customers had been named as a defendant in a patent infringement suit involving technology the customer purchased from Nuera. In the suit, the plaintiff alleged that the customer uses devices to offer services that infringe upon a patent the plaintiff owns. The customer has sought indemnification from Nuera pursuant to the terms of a purchase agreement between Nuera and the Company relating to the allegedly infringing technology at issue. According to the estimate of the management, Nuera has provided an allowance in respect of the above claim.

NOTE 11:- COMMITMENTS AND CONTINGENT LIABILITIES (Cont.)

2. Prior to the acquisition of Nuera by the Group, eight former employees of a French subsidiary of Nuera filed a labor grievance against the subsidiary claiming they were unfairly terminated. The French subsidiary filed for bankruptcy in 2004 and, in 2005, the court appointed liquidator sought to hold Nuera liable for the obligations of its French subsidiary. In June 2006, the court ruled in favor of Nuera that it was not liable for the obligations of its French subsidiary. In March 2006, the liquidator decided to appeal the judgement. According to the estimate of the management, Nuera has provided an allowance in respect of the above claim.

NOTE 12:- SHAREHOLDERS' EQUITY

a. Treasury stock:

On January 10, 2001 and on April 28, 2002, the Company's Board of Directors approved a share repurchase program pursuant to which the Company is authorized to purchase up to an aggregate amount of 4,000,000 of its outstanding Ordinary shares. As of December 31, 2006, the Company had purchased 3,942,139 of its outstanding Ordinary shares, at a weighted average price per share of $2.87.

b. Warrants issued to consultants:

Between 1999 and 2001, 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 grant. Warrants to purchase 24,000 Ordinary shares at an exercise price of $18.82 per share were exercisable immediately, and warrants to purchase 30,000 Ordinary shares are exercisable in four equal annual installments from the date of grant. During 2001, warrants to purchase 10,000 Ordinary shares at an exercise price of $18.82 were exercised.

As of December 31, 2006, 34,000 warrants are outstanding and exercisable at a weighted average exercise price of $18.82

NOTE 12:- SHAREHOLDERS' EQUITY (Cont.)

c. 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 2,000,000 Ordinary shares. As of December 31, 2006, 709,987 shares are still available for future issuance. Eligible employees can have up to 15% of their wages, up to certain maximums, used to purchase Ordinary shares. The Purchase Plan is implemented with purchases every six months occurring on January 31 and July 31 of each year. The price of the Ordinary shares purchased under the Purchase Plan is equal to 85% of the lower of the fair market value of the Ordinary shares on the commencement date of each offering period or on the semi-annual purchase date. The Purchase Plan is considered as a compensatory plan. Therefore the Company recorded compensation expense in accordance to SFAS 123R (Note 12 d.).

During the years ended December 31, 2004, 2005 and 2006, 208,952, 257,746 and 323,303 shares, respectively, were issued under the Purchase Plan for aggregate considerations of $1,332, $2,134 and $2,665, respectively.

d. Employee Stock Option Plans:

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

The total number of shares authorized for grant of options under the Plans is 15,945,828. As of December 31, 2006, 1,497,740 shares are still available for future option grants.

Stock options granted under the Plans are exercisable usually at the fair market value of the Ordinary shares at the date of grant and usually expire seven or ten years from the date of grant. The options generally vest over four or five years, from the date of grant. Any options, which are forfeited or cancelled before expiration, become available for future grants.

NOTE 12:- SHAREHOLDERS' EQUITY (Cont.)

A summary of the Group's stock option activity and related information for the years ended December 31, 2006, is as follows:

	Number of options	Weighted-average exercise price	Weighted-average remaining contractual term (in years)	Aggregate intrinsic value
Outstanding at December 31, 2005	7,890,372	$ 9.38		
Granted	1,789,000	$ 10.51		
Exercised	(1,198,621)	$ 5.44		
Forfeited	(498,925)	$ 14.31		
Outstanding at December 31,2006	7,981,826	$ 9.92	3.8	$ 22,353
Exercisable at December 31,2006	4,535,767	$ 9.76	2.4	$ 18,396
Vested and expected to vest	7,607,019	$ 9.92	3.8	$ 21,213

The weighted-average grant-date fair value of options granted during the twelve months ended December 31, 2006 was $5.81. The aggregate intrinsic value in the table above represents the total intrinsic value (the difference between the Company's closing stock price on the last trading day of fiscal 2006 and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on December 31, 2006. This amount changes based on the fair market value of the Company's shares. Total intrinsic value of options exercised for the twelve months ended December 31, 2006 was $4,790. As of December 31, 2006, there was $12,381 of total unrecognized compensation cost related to non-vested share-based compensation arrangements granted under the Company's stock option plans. That cost is expected to be recognized over a weighted-average period of 1.6 years. Total fair value of options vested for the twelve months ended December 31, 2006 was $5,866.

NOTE 12:- SHAREHOLDERS' EQUITY (Cont.)

The options outstanding as of December 31, 2006, have been separated into ranges of exercise prices, as follows:

Range of exercise price	Options outstanding as of December 31, 2006	Weighted average remaining contractual life	Weighted average exercise price	Options exercisable as of December 31, 2006	Weighted average exercise price of exercisable options
		(Years)			
$ 0.61	101,000	1.27	$ 0.61	101,000	$ 0.61
$ 1.1	146,400	1.51	$ 1.10	146,400	$ 1.10
$ 1.73-2.51	548,693	2.81	$ 2.29	504,193	$ 2.29
$ 2.67-4	487,701	2.33	$ 3.13	417,567	$ 3.11
$ 4.1-6.04	936,004	2.58	$ 4.43	812,004	$ 4.39
$ 6.51-9.24	840,828	2.55	$ 7.79	716,453	$ 7.76
$ 9.32-14.76	4,247,700	5.35	$ 10.86	1,190,900	$ 11.14
$ 15.94-20.38	52,500	5.00	$ 15.94	26,250	$ 15.94
$ 25.5-36.53	597,000	0.30	$ 28.96	597,000	$ 28.96
$ 50.50	24,000	0.49	$ 50.50	24,000	$ 50.50
	7,981,826		$ 9.92	4,535,767	$ 9.76

The weighted average fair values of the options granted during 2004, 2005 and 2006, were $7.63, $6.27 and $5.81, respectively.

e. 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. (See also Note 13a.)

NOTE 13:- TAXES ON INCOME

a. Israeli taxation:

1. Measurement of taxable income:

Commencing in taxable year 2003, the Company has elected to measure its taxable income and file its tax return under the Israeli Income Tax Regulations (Principles Regarding the Management of Books of Account of Foreign Invested Companies and Certain Partnerships and the Determination of Their Taxable Income), 1986. Such an elective obligates the Company for three years. Accordingly, commencing taxable year 2003, results for tax purposes are measured in terms of earnings in dollars. The

Company has elected to extend the term of the above mentioned tax measurement by another year.

NOTE 13:- TAXES ON INCOME (Cont.)

2. Tax benefits under the Law for the Encouragement of Capital Investments, 1959 ("the Investment Law"):

   The Company's production facilities have been granted the status of an "Approved Enterprise" in accordance with the Investment Law under four separate investment programs. According to the provisions of such Israeli Investment Law, the Company has been granted the "Alternative Benefit Plan", under which the main benefits are tax exemption and reduced tax rate.

   Therefore, the Company's income derived from Approved Enterprise will be entitled to a tax exemption for a period of two to four years and to an additional period of six to eight years of reduced tax rates of 10% - 25% (based on the percentage of foreign ownership). The duration of tax benefits of reduced tax rates is subject to a limitation of the earlier of 12 years from commencement of production, or 14 years from the approval date. The Company utilized tax benefits from the first program in 1998 and is eligible for benefits through 2007. Tax benefits from the remaining programs are scheduled to gradually expire through 2013.

   As of December 31, 2006, retained earnings included approximately $540 in tax-exempt income earned by the Company's "Approved Enterprise". The Company's Board of Directors has decided not to declare dividends out of such tax-exempt income. Accordingly, no deferred income taxes have been provided on income attributable to the Company's "Approved Enterprise".

   Tax-exempt income attributable to the "Approved Enterprise" cannot be distributed to shareholders without subjecting the Company to taxes except upon complete liquidation of the Company. If such retained tax-exempt income is distributed in a manner other than upon the complete liquidation of the Company, it would be taxed at the corporate tax rate applicable to such profits as if the Company had not elected the alternative tax benefits (currently between 10% - 25%) and an income tax liability of approximately up to $ 135 would be incurred by the Company.

   The entitlement to the above benefits is conditional upon the Company fulfilling the conditions stipulated by the Investment Law, regulations published thereunder and the certificate 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 the Company may be required to refund the amount of the benefits, in whole or in part, including interest. As of December 31, 2006, management believes that the Company is in compliance with all of the aforementioned conditions.

   Income from sources other than the "Approved Enterprise" during the benefit period will be subject to tax at the regular tax rate prevailing at that time.

NOTE 13:- TAXES ON INCOME (Cont.)

On April 1, 2005, an amendment to the Investment Law came into effect ("the Amendment") that has significantly changed the provisions of the Investment Law. The Amendment limits the scope of enterprises that may be approved by the Investment Center by setting criteria for the approval of a facility as a Privileged Enterprise including a provision generally requiring that at least 25% of the Privileged Enterprise's income will be derived from export. Additionally, the Amendment enacted major changes in the manner in which tax benefits are awarded under the Investment Law so that companies no longer require Investment Center approval in order to qualify for tax benefits.

However, the Investment Law provides that terms and benefits included in any certificate of approval already granted will remain subject to the provisions of the Investment Law as they were on the date of such approval. Therefore, the Company's existing "Approved Enterprises" will generally not be subject to the provisions of the Amendment. As a result of the Amendment, tax-exempt income generated under the provisions of the Investment Law has amended, will subject the Company to taxes upon distribution or liquidation and the Company may be required to record a deferred tax liability with respect to such tax-exempt income. As of December 31, 2006 there were no taxable income attributable to the Privileged Enterprise.

3. Net operating losses carry forward:

As of December 31, 2006, the Company has accumulated losses for tax purposes in the amount of approximately $68,000, which can be carried forward and offset most of against taxable income in the future for an indefinite period.

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

The Company 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.

5. Tax rates:

Under an amendment to the Israeli Income Tax Ordinance enacted on July 25, 2005, a gradual decrease in the corporate tax rate in Israel will be in effect as follows: in 2006 - 31%, in 2007 - 29%, in 2008 - 27%, in 2009 - 26% and in 2010 and thereafter - 25%.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
U.S. dollars in thousands, except share and per share data

NOTE 13:- TAXES ON INCOME (Cont.)

b. Income before taxes on income comprised as following:

	Year ended December 31,		
	2004	2005	2006
Domestic	$ 2,303	$ 6,694	$ 5,767
Foreign	2,976	7,541	1,399
	$ 5,279	$ 14,235	$ 7,166

c. Taxes on income are comprised as follows:

	Year ended December 31,		
	2004	2005	2006
Current taxes	$ 273	$ 4,267	$ 1,290
Deferred taxes	-	(2,368)	(1,001)
	$ 273	$ 799	$ 289

	Year ended December 31,		
	2004	2005	2006
Domestic	$ -	$ 2,167	$ 846
Foreign	273	(1,368)	(557)
	$ 273	$ 799	$ 289

d. 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 Group's deferred tax liabilities and assets are as follows:

NOTE 13:- TAXES ON INCOME (Cont.)

	December 31,	
	2005	**2006**
Deferred tax assets:		
Net operating loss carry forward	$ 34,616	$ 31,909
Reserves and allowances	7,071	7,879
Deferred tax assets before valuation allowance	41,687	39,788
Valuation allowance	(39,198)	(36,046)
Deferred tax assets *)	$ 2,489	$ 3,742
Deferred tax liability, related to intangible assets	$ -	$ (7,780)
Deferred tax asset (liabilities), net	$ 2,489	$ (4,038)
Foreign:		
Current deferred tax assets	1,249	1,282
Current deferred tax liability	-	(1,321)
Non current deferred tax asset	1,240	2,460
Non current deferred tax liability	-	(6,459)
	$ 2,489	$ (4,038)

*) Including $638 of the total deferred tax assets upon utilization of pre-acquisition carry forward tax losses derived from acquisition of AudioCodes USA Inc. in accordance with SFAS No. 141.

The Company's U.S. subsidiaries have estimated total available carry forward tax losses of approximately $ 60,000 to offset against future taxable income between 2015 and 2024. As of December 31, 2006, the Company recorded a deferred tax asset of $ 3,742 relating to the available net carry forward tax losses.

Utilization of U.S. net operating losses may be subject to substantial annual limitations due to the "change in ownership" provisions of the Internal Revenue Code of 1986 and similar state provisions. The annual limitation may result in the expiration of net operating losses before utilization.

NOTE 13:- TAXES ON INCOME (Cont.)

e. Reconciliation of the theoretical tax expenses:

A reconciliation between the theoretical tax expense, assuming all income is taxed at the statutory tax rate applicable to income of the Company and the actual tax expense as reported in the statement of income is as follows:

	Year ended December 31,		
	2004	**2005**	**2006**
Income before taxes, as reported in the consolidated statements of income	$ 5,279	$ 14,235	$ 7,166
Statutory tax rate	35%	34%	31%
Theoretical tax expenses on the above amount at the Israeli statutory tax rate	1,848	4,840	2,221
Income taxed at rate other than the Israeli statutory tax rate (1)	(4,335)	(3,543)	(4,672)
Non-deductible expenses including equity based compensation expenses	1,355	1,663	4,008
Deferred taxes on losses for which a valuation allowance was provided	1,223	(2,813)	(261)
Utilization of operation losses carry forward	-	(2,291)	(1,232)
State and Federal taxes	-	826	425
Inter-company charges	-	1,725	(299)
Other individually immaterial income tax item	182	392	99
Actual tax expense	$ 273	$ 799	$ 289
(1) Per share amounts (basic) of the tax benefit resulting from the exemption	$ 0.11	$ 0.09	$ 0.11
Per share amounts (diluted) of the tax benefit resulting from the exemption	$ 0.10	$ 0.08	$ 0.11

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 14:- BASIC AND DILUTED NET EARNINGS (LOSS) PER SHARE

	Year ended December 31,		
	2004	**2005**	**2006**
Numerator:			
Net income available to shareholders of Ordinary Shares	$ 5,006	$ 13,436	$ 6,877
Denominator:			
Denominator for basic earnings per share - weighted average number of Ordinary shares, net of treasury stock	38,613,597	40,295,591	41,716,626
Effect of dilutive securities:			
Employee stock options and ESPP	3,993,000	2,790,110	1,972,767
Senior convertible notes	*) -	*) -	*) -
Denominator for diluted net earnings per share - adjusted weighted average number of shares	42,606,597	43,085,701	43,689,393

*) Antidilutive.

NOTE 15:- FINANCIAL INCOME (EXPENSES), NET

	Year ended December 31,		
	2004	**2005**	**2006**
Financial expenses:			
Foreign currency transaction differences, net	$ (93)	$ -	$ -
Interest	(381)	(3,357)	(2,961)
Amortization of marketable securities premiums and accretion of discounts, net	-	(143)	(224)
Others	(94)	(146)	(240)
	(568)	(3,646)	(3,425)
Financial income:			
Interest and others	2,733	6,103	7,242
	2,733	6,103	7,242
	$ 2,165	$ 2,457	$ 3,817

NOTE 16:- MAJOR CUSTOMERS AND GEOGRAPHIC INFORMATION

a. Summary information about geographic areas:

The Group manages its business on a basis of one reportable segment (see Note 1 for a brief description of the Group's business). The data is presented in accordance with SFAS No. 131 "Disclosure About Segments of an Enterprise and Related Information". Revenues in the table below are attributed to geographical areas based on the location of the end customers.

The following presents total revenues for the years ended December 31, 2004, 2005 and 2006 and long-lived assets as of December 31, 2004, 2005 and 2006.

	2004		2005		2006	
	Total revenues	Long-lived assets	Total revenues	Long-lived assets	Total revenues	Long-lived assets
Israel	$ 8,332	$ 7,357	$ 12,235	$ 6,248	$ 12,411	$ 11,463
Americas	51,573	13,594	66,622	22,193	83,352	108,497
Europe	10,972	5	22,434	7	32,704	6
Far East	11,879	-	14,536	4	18,886	5
	$ 82,756	$ 20,956	$ 115,827	$ 28,452	$ 147,353	$ 119,979

b. Major customer's data as a percentage of total revenues:

	Year ended December 31,		
	2004	2005	2006
Customer A	19%	16%	15%

c. Product lines:

Total revenues from external customers divided on the basis of the Company's product lines are as follows:

	Year ended December 31,		
	2004	2005	2006
Technology	$ 48,500	$ 62,287	$ 70,013
Networking	34,256	53,540	77,340
	$ 82,756	$ 115,827	$ 147,353

\- - - - - - - - - -