AUDIOCODES LTD. AND ITS SUBSIDIARIES

CONSOLIDATED FINANCIAL STATEMENTS

AS OF DECEMBER 31, 2007

IN U.S. DOLLARS

INDEX

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ERNST & YOUNG

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the board of directors and Shareholders of

AudioCodes LTD. and its subsidiaries

We have audited the accompanying consolidated balance sheets of AudioCodes Ltd. ("the Company") and its subsidiaries as of December 31, 2006 and 2007, 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, 2007. 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. 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 and the opinion 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, 2006 and 2007, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2007, in conformity with accounting principles generally accepted in the United States.

As discussed in Note 2r to the consolidated financial statements, in 2007 the Company adopted FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes – An Interpretation of FASB Statement No. 109", effective January 1, 2007. As discussed in Note 2v to the consolidated financial statements, in 2006 the Company adopted Statement of Financial Accounting Standards No. 123(R), "Share-Based Payment", as revised, effective January 1, 2006.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company and subsidiaries' internal control over financial reporting as of December 31, 2007, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated June 22, 2008 expressed an unqualified opinion thereon.

Tel-Aviv, Israel	KOST FORER GABBAY & KASIERER
June, 22, 2008	A Member of Ernst & Young Global

ERNST & YOUNG

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of

AudioCodes LTD. and its subsidiaries

We have audited AudioCodes Ltd’s ("AudioCodes" or "the Company") internal control over financial reporting as of December 31, 2007, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). AudioCodes’ management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on the Company’s internal control over financial reporting based on our audit.

We conducted our audit 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 effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A Company’s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A Company’s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the Company’s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, AudioCodes maintained, in all material respects, effective internal control over financial reporting as of December 31, 2007, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of AudioCodes and its subsidiaries as of December 31, 2006 and 2007 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, 2007 and our report dated June 22, 2008 expressed an unqualified opinion thereon. 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.

Tel-Aviv, Israel
June 22, 2008

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

CONSOLIDATED BALANCE SHEETS

U.S. dollars in thousands

	December 31,	
	2006	**2007**
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 25,171	$ 75,063
Short-term bank deposits and structured notes	28,658	18,065
Short-term marketable securities and accrued interest	29,422	17,244
Trade receivables (net of allowance for doubtful accounts of $ 854 and $ 521 at December 31, 2006 and 2007, respectively)	30,501	25,604
Other receivables and prepaid expenses	3,309	6,592
Deferred tax assets	1,282	1,001
Inventories	16,093	18,736
Total current assets	134,436	162,305
LONG-TERM ASSETS:		
Long-term bank deposits and structured notes	30,435	32,670
Long-term marketable securities	19,942	-
Investment in companies	3,999	1,343
Deferred tax assets	2,460	1,057
Severance pay funds	7,231	9,799
Total long-term assets	64,067	44,869
PROPERTY AND EQUIPMENT, NET	7,847	7,094
INTANGIBLE ASSETS, DEFERRED CHARGES AND OTHER, NET	21,853	19,007
GOODWILL	108,853	111,212
Total assets	$ 337,056	$ 344,487

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, 2006	December 31, 2007
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Trade payables	$ 7,522	$ 8,849
Deferred tax liabilities	1,321	-
Other payables and accrued expenses	28,139	28,780
Total current liabilities	36,982	37,629
LONG-TERM LIABILITIES:		
Deferred tax liabilities	6,459	-
Accrued severance pay	7,915	11,168
Senior convertible notes	121,015	121,198
Total long-term liabilities	135,389	132,366
COMMITMENTS AND CONTINGENT LIABILITIES		
SHAREHOLDERS' EQUITY:		
Share capital -		
Ordinary shares of NIS 0.01 par value -		
Authorized: 100,000,000 at December 31, 2006 and 2007; Issued: 46,051,867 shares at December 31, 2006 and 47,031,691 shares at December 31, 2007; Outstanding: 42,109,728 shares at December 31, 2006 and 43,089,552 shares at December 31, 2007	131	133
Additional paid-in capital	149,205	161,970
Treasury stock	(11,320)	(11,320)
Accumulated other comprehensive income	122	1,047
Retained earnings	26,547	22,662
Total shareholders' equity	164,685	174,492
Total liabilities and shareholders' equity	$ 337,056	$ 344,487

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

CONSOLIDATED STATEMENTS OF OPERATIONS

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

	Year ended December 31,		
	2005	**2006**	**2007**
Revenues	$ 115,827	$ 147,353	$ 158,235
Cost of revenues	46,993	61,242	69,185
Gross profit	68,834	86,111	89,050
Operating expenses:			
Research and development, net	24,415	35,416	40,706
Selling and marketing	25,944	37,664	42,900
General and administrative	6,004	8,766	9,637
Total operating expenses	56,363	81,846	93,243
Operating income (loss)	12,471	4,265	(4,193)
Financial income, net	2,457	3,817	2,670
Income (loss) before taxes on income	14,928	8,082	(1,523)
Taxes on income, net	799	289	1,265
Equity in losses of affiliated companies, net	693	916	1,097
Net income (loss)	$ 13,436	$ 6,877	$ (3,885)
Basic net earnings (loss) per share	$ 0.33	$ 0.16	$ (0.09)
Diluted net earnings (loss) per share	$ 0.31	$ 0.16	$ (0.09)

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, 2005	$ 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
Stock compensation related to options granted to employees	-	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
Issuance of shares upon exercise of options and employee stock purchase plan	2	4,798	-	-	-	-		4,800
Stock compensation related to options granted to employees	-	7,967	-	-	-	-		7,967
Comprehensive income, net:								
Unrealized gains on foreign currency cash flow hedges	-	-	-	-	925	-	$ 925	925
Net loss	-	-	-	-	-	(3,885)	(3,885)	(3,885)
Total comprehensive loss, net							$ (2,960)	
Balance as of December 31, 2007	$ 133	$ 161,970	$(11,320)	$ -	$ 1,047	$ 22,662		$ 174,492

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,		
	2005	**2006**	**2007**
Cash flows from operating activities:			
Net income (loss)	$ 13,436	$ 6,877	$ (3,885)
Adjustments required to reconcile net income (loss) to net cash provided by operating activities:			
Depreciation and amortization	3,369	5,543	7,789
Amortization of marketable securities premiums and accretion of discounts, net	143	225	39
Equity in losses of affiliated companies, net	693	916	1,097
Stock-based compensation expenses	36	8,707	7,967
Amortization of senior convertible notes discount and deferred charges	198	199	203
Increase in accrued interest on marketable securities, bank deposits and structured notes	(736)	(130)	(519)
Decrease (increase) in deferred tax assets, net	(2,033)	(1,001)	2,390
Decrease (increase) in trade receivables, net	(3,520)	(9,751)	5,014
Decrease (increase) in other receivables and prepaid expenses	57	1,457	(1,504)
Increase in inventories	(1,503)	(1,954)	(2,643)
Increase (decrease) in trade payables	1,233	(2,671)	1,263
Increase (decrease) in other payables and accrued expenses	1,914	(2,005)	(5,181)
Increase in accrued severance pay, net	41	203	356
Other	(12)	15	-
Net cash provided by operating activities	13,316	6,630	12,386
Cash flows from investing activities:			
Investments in affiliated companies	(1,318)	(3,453)	(1,003)
Short-term loan to unrelated Company	(350)	-	-
Purchase of property and equipment	(2,393)	(3,067)	(2,629)
Proceeds from sale of property and equipment	96	-	-
Investment in short-term and long-term bank deposits	(33,969)	(20,000)	(29,065)
Proceeds from sale of short-term bank deposits	3,969	51,300	28,700
Investment in structured notes	(20,000)	-	-
Proceeds from structured notes called by the issuer	10,000	-	10,000
Investment in short-term and long-term marketable securities	(59,060)	-	-
Proceeds from marketable securities held to maturity	-	9,000	31,600
Proceeds from sale of held-to-maturity marketable securities	-	979	-
Additional payment for the acquisition of AudioCodes USA Inc.	(10,000)	-	-
Payment for acquisition of Nuera Communication Inc. (1)	-	(82,520)	-
Payment for acquisition of Netrake Corporation. (2)	-	(13,836)	-
Payment for acquisition of CTI Squared Ltd ("CTI^2") (3)	-	-	(4,897)
Net cash provided by (used in) investing activities	(113,025)	(61,597)	32,706
Cash flows from financing activities:			
Issuance costs for senior convertible notes	(84)	-	-
Proceeds from issuance of shares upon exercise of options and employee stock purchase plan	3,918	9,181	4,800
Net cash provided by financing activities	3,834	9,181	4,800
Increase (decrease) in cash and cash equivalents	(95,875)	(45,786)	49,892
Cash and cash equivalents at the beginning of the year	166,832	70,957	25,171
Cash and cash equivalents at the end of the year	$ 70,957	$ 25,171	$ 75,063

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,		
	2005	**2006**	**2007**
(1) 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 1b):			
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	$ -
(2) Payment for acquisition of Netrake Corporation.			
Net fair value of assets acquired and liabilities assumed of Netrake at the date of acquisition (see also Note 1c)			
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	$ -
(3) Payment for acquisition of CTI Squared Ltd.			
Net fair value of assets acquired and liabilities assumed of CTI^2 at the date of acquisition (see also Note 1d):			
Working capital, net (excluding cash and cash equivalents)	$ -	$ -	$ (7,519)
Technology	-	-	1,530
Backlog	-	-	41
Goodwill	-	-	10,845
	$ -	$ -	$ 4,897
(4) Supplemental disclosure of cash flow activities:			
Cash paid during the year for income taxes	$ 760	$ 1,237	$ 403
Cash paid during the year for interest	$ 2,500	$ 2,500	$ 2,500

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 1:- GENERAL

a. Business overview:

AudioCodes Ltd. ("the Company") and its subsidiaries (together "the Group") designs, develops and markets products for voice, data and video over IP networks to service providers and channels (such as distributors), OEMs, network equipment providers and systems integrators.

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

b. Acquisition of Nuera Communications Inc. (renamed: AudioCodes California Inc.):

On July 6, 2006, the Group acquired all of the outstanding common stock of Nuera Communications 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 Communications 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 Statement of Financial Accounting Standard No. 141 "Business Combinations" (SFAS 141).

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 1:- GENERAL (Cont.)

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:

	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 and Other Intangible Assets", 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 fair 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.

NOTE 1:- GENERAL (Cont.)

c. Acquisition of Netrake Corporation. (renamed: AudioCodes Texas Inc.):

On August 14, 2006, the Group acquired all of the outstanding common stock of Netrake Corporation, 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 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.

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

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's assets and liabilities, as follows:

	August 14, 2006
Trade receivables	$ 554
Inventories	1,646
Other receivables and prepaid expenses	311
	2,511
Property and equipment	528
Total tangible assets acquired	3,039
Technology (five years useful life)	5,688
Backlog (two years 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:

Current assets and liabilities are recorded at their carrying amounts. The carrying amounts of current assets and liabilities were reasonable proxies for their fair 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.

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

NOTE 1:- GENERAL (Cont.)

d. Acquisition of CTI Squared Ltd.:

On April 1, 2007, the Group acquired the remaining outstanding common stock of CTI Squared Ltd ("CTI^2"), a leading provider of enhanced messaging and communications platforms deployed globally by service providers and enterprises. CTI^2's platforms integrate data and voice messaging services over internet, intranet, PSTN, cellular, cable and enterprise networks. Prior to this acquisition, the Group had an investment in CTI^2 in the amount of $1,565.

In consideration for the acquisition the Group paid $4,897 in cash at the closing of the transaction in April 2007 and committed to pay additional $5,000 by April, 2008. In February 2008 the Group paid the additional amount of $5,000.

CTI^2 became a wholly-owned subsidiary of the Company 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.

	April 2, 2007
Trade receivables	$ 117
Other receivables and prepaid expenses	134
Property and equipment	10
Total tangible assets acquired	261
Technology (six years useful life)	1,530
Backlog (one year useful life)	41
Goodwill	10,845
Total intangible assets acquired	12,416
Total tangible and intangible assets acquired	12,677
Trade payables	(64)
Other current liabilities and accrued expenses	(822)
Accrued severance pay, net	(329)
Total liabilities assumed	(1,215)
Net assets acquired	$ 11,462

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 1:- GENERAL (Cont.)

Based upon an independent valuation of tangible and intangible assets acquired, the Group has allocated the total acquisition cost of CTI^2's assets and liabilities, as follows:

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 fair 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.

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 CTI^2 been consummated on January 1, 2006, nor does it purport to represent the results of operations of the Group for any future period.

	Year ended December 31,	
	2006	2007
Revenues	$ 148,323	$ 158,349
Net income (loss)	$ 4,742	$ (4,698)
Basic net loss per share	$ 0.11	$ (0.11)
Diluted net loss per share	$ 0.11	$ (0.11)

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 are 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 Company's revenues is generated in dollars. In addition, most of the Company's costs are denominated and determined in U.S. dollars and in New Israeli Shekels. The Company's management believes that the dollar is the currency in the primary economic environment in which the Company operates. Thus, the functional and reporting currency of the Company is the dollar.

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, including profits from intercompany sales not yet realized outside the Company, have been eliminated upon consolidation.

d. Cash equivalents:

Cash equivalents are short-term highly liquid investments that are readily convertible into cash with original 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% and 4.57% for 2006 and 2007, respectively. Short-term deposits are presented at their cost. The accrued interest is included in other receivables and prepaid expenses.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

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.

FASB Staff Position ("FSP") No. 115-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investment" ("FSP 115-1") and SAB Topic 5M "Other Than Temporary Impairment Of Certain Investments In Debt And Equity Securities" provides guidance for determining when an investment is considered impaired, whether impairment is other-than temporary, and measurement of an impairment loss. An investment is considered impaired if the fair value of the investment decreased below its cost in an other-than temporary manner. If, after consideration of all available evidence to evaluate the realizable value of its investment, impairment is determined to be other than - temporary, then an impairment loss should be recognized equal to the difference between the investment’s cost and its fair value. FSP 115-1 nullifies certain provisions of Emerging Issues Task Force ("EITF") Issue No. 03-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments" ("EITF 03-1") while retaining the disclosure requirements of EITF 03-1 which the Company adopted in 2003.

g. Inventories:

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

Raw materials - using the "moving average" method.
Finished products - using the "moving average" 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 are taken based on slow moving items, technological obsolescence, excess inventories, discontinued products and for market prices lower than cost.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

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% for 2006 and 2007. Long-term deposits are presented at their cost. Accrued interest is included in other receivables and prepaid expenses.

i. Structured notes:

The Group accounts for investments in structured notes in accordance with 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, 2007 the Company did not have any structured notes.

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 are 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.

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 and 2007, based on management's most recent analyses, no impairment losses have been identified.

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

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

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 (mainly 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. 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".

m. Impairment of long-lived assets:

The Group's long-lived assets and identifiable intangibles which are subject to amortization 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 and 2007, no impairment losses have been identified.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

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 each year. The test was done in the forth quarter of 2007 based on the Group's single operating segment and reporting unit structure. As of December 31, 2006 and 2007, 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.

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 on 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 $545, $636 and $559 as of December 31, 2005, 2006 and 2007, 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.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

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 government grants received, are charged to the statement of operations 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.

In June 2006, the FASB issued FIN 48, "Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109" ("FIN 48"). FIN 48 clarifies the accounting for uncertainty in income taxes recognized under SFAS No. 109. FIN 48 prescribes a recognition threshold and measurement attribute for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return and also provides guidance on various related matters such as derecognition, interest and penalties, and disclosure. On January 1, 2007, the Company adopted FIN 48. The initial application of FIN 48 to the Company’s tax positions did not have a material effect on the Company’s Shareholders’ Equity.

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.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

The majority of the Group's cash and cash equivalents and bank deposits 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.

As a result of the recent turmoil in capital markets the Company tightened its control and monitoring over its marketable securities portfolio in order to minimize potential risks stemming from the current capital markets environment. Such measures included among others: the Company's investment policy approved by the Investment Committee that limits the amount the Company may invest in any one type of investment or issuer and the grade of the security with the intent of, reducing credit risk concentrations.

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 with respect to its trade receivables. 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 within one year of 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.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

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".

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 8,598,556, 9,924,624 and 11,765,438 for the years ended December 31, 2005, 2006 and 2007, 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 Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB No. 25"), for periods beginning in fiscal year 2006. In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 107 ("SAB 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).

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 years ended December 31, 2006 and 2007, 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 in accordance with the modified prospective transition method.

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.

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

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Pro forma information regarding the Group's net income and net earnings 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:

	2005
Dividend yield	0%
Expected volatility	75%
Risk-free interest	4%
Expected life	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, 2005
Net income as reported	$ 13,436
Add: stock-based compensation expenses determined under the intrinsic value based method included in the reported net income	36
Deduct: stock-based compensation expenses determined under the fair value based method for all awards	(8,869)
Pro forma net income	$ 4,603
Basic net earnings per share as reported	$ 0.33
Diluted net earnings per share as reported	$ 0.31
Pro forma basic net earning per share	$ 0.11
Pro forma diluted net earning per share	$ 0.11

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.

As of December 31, 2007, the total unrecognized estimated compensation cost related to non-vested stock options granted prior to that date was $8,003, which is expected to be recognized over a weighted-average period of 1.5 years. The total intrinsic value of stock options exercised during 2007 was $613. The Company recorded cash received from the exercise of stock options of $1,189 during the year ended December 31, 2007.

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

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

The weighted-average estimated fair value of employee stock options granted during the years ended December 31, 2006 and 2007, was $5.81 and $3.23 per share, respectively, using the Black-Scholes option pricing formula. Fair values were estimated using the following weighted-average assumptions (annualized percentages):

	Year ended December 31,	
	2006	2007
Dividend yield	0%	0%
Expected volatility	61.9%	54.7%
Risk-free interest	4.6%	4.6%
Expected life	4.8 years	4.8 years
Forfeiture rate	5.1%	7.0%

The dividend yield assumption is based on the Company's historical experience and expectation of no future dividend payouts and may be subject to substantial change in the future.

The Company used its historical volatility in accordance with SFAS No. 123(R). The computation of volatility uses historical volatility derived from the Company's exchange traded shares.

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 of the Company’s options.

The Company determined the expected life of the options according to the simplified method based on the average of vesting and the contractual term of the Company’s stock options.

The Company's compensation cost for the years ended December 31, 2006 and 2007 totaled $8,707 and $7,967, respectively.

The total equity-based compensation expense relating to all of the Company's equity-based awards recognized for the twelve months ended December 31, 2006 and 2007 was included in items of the consolidated statements of income as follows:

	Year ended December 31	
	2006	2007
Cost of revenues	$ 620	$ 613
Research and development, net	3,053	3,011
Selling and Marketing expenses	3,628	3,476
General and administrative expenses	1,406	867
Total equity-based compensation expenses	$ 8,707	$ 7,967

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

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 surrendered value of these policies and includes immaterial profits.

Severance pay expenses for the years ended December 31, 2005, 2006 and 2007, amounted to approximately $1,514, $1,766 and $2,409, respectively.

x. Employees benefit plan

During 2007, the Company merged its separate 401(k) defined contribution plans into one plan covering employees in the U.S. All eligible employees may elect to contribute a portion of their annual compensation to the plan through salary deferrals, subject to the IRS limit of $15.5 during 2007 ($20.5 including catch-up contributions for participants age 50 or over). The Company matches employee contributions to the plan up to a limit of 3.75% of their eligible compensation, subject to IRS limits. In 2005, 2006 and 2007, the Company matched contributions in the amount of $236, $271 and $361, respectively.

y. Advertising expenses:

Advertising expenses are charged to the statements of income as incurred. Advertising expenses for the years ended December 31, 2005, 2006 and 2007, amounted to $371, $402 and $350, 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 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.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

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 in the amount of $ 107, 500.

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

aa. Derivative instruments:

Statement of Financial Accounting Standard No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("SFAS No. 133"), requires companies to recognize all of its derivative instruments as either assets or liabilities in the statement of financial position at fair value.

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.

For 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 period or periods during which the hedged transaction affects earnings. The remaining gain or loss on the derivative instrument in excess of the cumulative change in the present value of future cash flows of the hedged item, if any, is recognized in current earnings during the period of change. For derivative instruments not designated as hedging instruments, the gain or loss is recognized in current earnings during the period of change.

Cash flow hedging strategy - To hedge against the risk of overall changes in cash flows resulting from forecasted foreign currency salary payments during the year, the Company hedges portions of its forecasted expenses denominated in NIS with currency forwards and options. 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.

During 2007, the Company recorded accumulated other comprehensive income in the amount of $ 925 from its currency forward and option transactions with respect to payroll expenses expected to be incurred during 2008. Such amount will be recorded into earnings during 2008.

ab. Reclassification:

Certain amounts in prior years’ financial statements have been reclassified to conform to the current year’s presentation.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

ac. Impact of recently issued accounting standards:

In September 2006, the Financial Accounting Standards Board ("FASB") issued SFAS No. 157, "Fair Value Measurements" ("SFAS No. 157"). This Standard defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. The provisions of SFAS No. 157 are effective for the Company beginning January 1, 2008. The FASB issued a FASB Staff Position (FSP 157-2) to defer the effective date of SFAS No. 157 for one year for all nonfinancial assets and nonfinancial liabilities, except for those items that are recognized or disclosed at fair value in the financial statements on a recurring basis. The Company does not expect the adoption of SFAS No. 157 will have material impact on its consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities" (SFAS No. 159). SFAS No. 159 permits companies to choose to measure certain financial instruments and other items at fair value. The standard requires that unrealized gains and losses are reported in earnings for items measured using the fair value option. SFAS No. 159 is effective for the Company beginning in the first quarter of fiscal year 2008. The company has determined that the adoption of SFAS 159 will not have an impact on its consolidated financial statements since it has not elected the fair value option for any of its existing assets or liabilities as of FAS 159 effective date.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), "Business Combinations" ("SFAS 141R"). SFAS 141R establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, any non controlling interest in the acquiree and the goodwill acquired. SFAS 141R also establishes disclosure requirements to enable the evaluation of the nature and financial effects of the business combination. SFAS 141R is effective for fiscal years beginning after December 15, 2008. Earlier adoption is prohibited. The adoption of SFAS 141R might have a material effect if and when the Company enters into a business combination after December 31, 2008.

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51". SFAS No. 160 establishes accounting and reporting standards that require that the ownership interests in subsidiaries held by parties other than the parent be clearly identified, labeled, and presented in the consolidated statement of financial position within equity, but separate from the parent’s equity; the amount of consolidated net income attributable to the parent and to the noncontrolling interest be clearly identified and presented on the face of the consolidated statement of income; and changes in a parent’s ownership interest while the parent retains its controlling financial interest in its subsidiary be accounted for consistently. SFAS No. 160 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. The adoption of the provisions of Statement No. 160 is not anticipated to materially impact the Company’s consolidated financial position and results of operations.

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

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

In December, 2007 the SEC staff issued Staff Accounting Bulletin No. 110 (SAB 110), which, effective January 1, 2008, amends and replaces SAB 107, Share-Based Payment. SAB 110 expresses the views of the SEC staff regarding the use of a "simplified" method in developing an estimate of the expected term of "plain vanilla" share options in accordance with FASB Statement No. 123(R), Share-Based Payment. Under the "simplified" method, the expected term is calculated as the midpoint between the vesting date and the end of the contractual term of the option.

The use of the "simplified" method, which was first described in Staff Accounting Bulletin No. 107, was scheduled to expire on December 31, 2007. SAB 110 extends the use of the "simplified" method for "plain vanilla" awards in certain situations. The SEC staff does not expect the "simplified" method to be used when sufficient information regarding exercise behavior, such as historical exercise data or exercise information from external sources, becomes available.

NOTE 3:- BANK DEPOSITS AND STRUCTURED NOTES

Bank deposits and structured notes are composed as follows:

	December 31,			
	2006	2007	2006	2007
	Weighted average interest			
Short-term bank deposits (in U.S. dollars)	5.18%	4.57%	$ 10,700	$ 18,065
Structured notes (1)	-	-	17,958	-
			28,658	18,065
Long-term bank deposits (in U.S. dollars)	5.10%	5.10%	20,287	32,670
Structured notes (2)	5.51%	-	10,148	-
			30,435	32,670
			$ 59,093	$ 50,735

(1) As of December 31, 2006, the Group had 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 ranged 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 approximated their market value.

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

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

(2) As of December 31, 2006, the Group had 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 ranged 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 approximated their market value.

During 2007, structured note at par amount of $10,000 was called by the bank.

As of December 31, 2007, the Company did not have any structured notes.

NOTE 4:- MARKETABLE SECURITIES AND ACCRUED INTEREST

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

	December 31,					
	2006			2007		
	Amortized cost	Net unrealized losses	Market Value	Amortized cost	Net unrealized losses	Market Value
Corporate debentures:						
Maturing within one year	$ 19,682	$ 84	$ 19,598	$ 12,985	$ 21	$ 12,964
Maturing within one to three years	12,943	126	12,817	-	-	-
	32,625	210	32,415	12,985	21	12,964
U.S. Government and agencies debts						
Maturing within one year	9,000	49	8,951	4,000	-	4,000
Maturing within one to three years	6,999	48	6,951	-	-	-
	15,999	97	15,902	4,000	-	4,000
Accrued interest	740	-	740	259	-	259
	$ 49,364	$ 307	$ 49,057	$ 17,244	$ 21	$ 17,223

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, 2007.

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

NOTE 5:- INVENTORIES

	December 31, 2006	December 31, 2007
Raw materials	$ 5,431	$ 9,879
Finished products	10,662	8,857
	$ 16,093	$ 18,736

In the years ended December 31, 2005, 2006 and 2007, the Group wrote-off inventory in a total amount of $1,800, $1,900 and $700, respectively.

NOTE 6:- INVESTMENT IN COMPANIES

a. Through December 31, 2007, the Group had invested an aggregate of $4,600 in Natural Speech Communication Ltd., a privately-held Company engaged in speech recognition, which is in a development stage, in order for the Company to achieve substantive technological milestone. As of December 31, 2007, the Group owned 45.2% of the outstanding share capital of this Company and 41.5% of the share capital of this Company on a fully diluted basis.

	December 31, 2006	December 31, 2007
Equity, net (1)	$ 33	$ 435
Convertible loans	558	-
Total investments	$ 591	$ 435

(1) Net equity as follows:

Net equity as of purchase date	$ 93	$ 93
Unamortized goodwill	3,511	4,972
Accumulated net losses	(3,571)	(4,630)
	$ 33	$ 435

During 2006 and 2007 the investee's net loss was $1,780 and $1,736, respectively.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 6:- INVESTMENT IN COMPANIES (Cont.)

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. During 2006 and 2007, the Company made convertible loans in the aggregate amount of $ 272 to this Company. The loans bear interest at the rate of 9% per annum and are convertible into shares. The loans are payable during 2008. As of December 31, 2007, the Company owned 19.5% of the investee's outstanding share capital and 17.4% of the investee's share capital on a diluted basis without taking into account shares that may be issued upon conversion of the loans. As of December 31, 2006 and 2007 no impairment was identified.

	December 31,	
	2006	2007
Net equity as of purchase date	$ (106)	$ (106)
Unamortized goodwill	985	1,085
Accumulated net loss	(33)	(71)
Total investment	$ 846	$ 908

c. In December 2006, the Company made a convertible loan in the amount of $ 1,000 to another unrelated privately-held Company. The loan bears interest at LIBOR+2% per annum and was due and payable in December 2007. In addition, the Company received warrants valid until the consummation of an exit transaction to purchase in consideration for 40% of the principal amount ($400), in consideration of $941.91 per share. In December, 2007 the Company requested repayment of loan. The Company received part of the loan and expects to receive the remaining balance of the loan during 2008.

NOTE 7:- PROPERTY AND EQUIPMENT

	December 31,	
	2006	2007
Cost:		
Computers and peripheral equipment	$ 14,022	$ 16,073
Office furniture and equipment	8,079	8,515
Motor vehicles	48	-
Leasehold improvements	1,561	1,731
	23,710	26,319
Accumulated depreciation:		
Computers and peripheral equipment	10,868	12,848
Office furniture and equipment	4,429	5,733
Motor vehicles	48	-
Leasehold improvements	518	644
	15,863	19,225
Depreciated cost	$ 7,847	$ 7,094

Depreciation expenses amounted to $2,509, $2,920 and $3,392 for the years ended December 31, 2005, 2006 and 2007, 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

		December 31,	
		2006	**2007**
a.	Cost:		
	Acquired technology	$ 15,982	$ 17,512
	Customer relationship	8,001	8,001
	Trade name	466	466
	Existing contracts for maintenance	204	204
	Backlog	837	878
	Deferred charges	478	478
	Other	200	200
		26,168	27,739
	Accumulated amortization:		
	Acquired technology	3,322	6,146
	Customer relationship	445	1,333
	Trade name	78	234
	Existing contracts for maintenance	34	102
	Backlog	391	852
	Deferred charges	45	65
		4,315	8,732
	Amortized cost	$ 21,853	$ 19,007

b. Amortization expenses amounted to $860, $2,623 and $4,397 for the years ended December 31, 2005, 2006 and 2007, respectively.

c. Amortization expenses related to deferred charges amounted to $22, $20 and $20 for the years ended December 31, 2005, 2006 and 2007, respectively.

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

2008	$ 3,860
2009	$ 3,281
2010	$ 2,938
2011	$ 2,337
2012	$ 1,735

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

NOTE 9:- OTHER PAYABLES AND ACCRUED EXPENSES

	December 31,	
	2006	2007
Employees and payroll accruals	$ 11,614	$ 8,047
Royalties provision	2,067	1,786
Government authorities	873	420
Accrued expenses	10,857	15,506
Deferred revenues	1,753	1,594
Others	975	1,427
	$ 28,139	$ 28,780

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, 2007, 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. As of December 31, 2006 and 2007 the Company did not record a separate derivative in the financial statements due to immateriality.

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

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

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:

2008	$ 4,967
2009	4,910
2010	4,442
2011	1,160
2012	1,082
Thereafter	1,026
	$ 17,587

Rent expenses for the years ended December 31, 2005, 2006 and 2007, were approximately $2,938, $3,087 and $4,471 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, 2007, were approximately $3,000:

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, 2007, the Company has a contingent obligation to pay royalties in the amount of approximately $ 3,519.

d. Royalty commitments to third parties:

Previously, the Group has entered into technology licensing fee agreements with third party. Under the agreements, the Group agreed to pay the third parties royalties until 2008, based on 0.75%-0.9% of the Group's total consolidated revenues.

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

Periodically, 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. In January 2005, prior to the acquisition of Nuera, the Company was notified that one of Nuera's customers had been named as a defendant in a patent infringement suit involving similar technology. 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 customer relating to the allegedly infringing technology at issue.

2. Prior to the acquisition of Nuera by the Company, 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 2007, the liquidator appealed the judgment and in April 2008 the appeal was denied by the court.

As of December 31, 2007, based on the estimate of the Company's management and a legal opinion, sufficient amount has been reserved.

NOTE 12:- SHAREHOLDERS' EQUITY

a. Treasury stock:

Through January, 2001 the Company had a share repurchase program pursuant to which the Company was authorized to purchase up to an aggregate amount of 4,000,000 of its outstanding Ordinary shares.

As of December 31, 2006 and 2007, the Company had purchased 3,942,139 of its outstanding Ordinary shares, at a weighted average price per share of $2.87.

NOTE 12:- SHAREHOLDERS' EQUITY (Cont.)

b. Warrants issued to consultants:

During 2001, the Company issued warrants to consultants to purchase 50,000 Ordinary shares of NIS 0.01 par value at an exercise price of $18.82 per share, expiring seven years from the date of grant.

As of December 31, 2006 and 2007, 34,000 and 4,000 warrants to consultants are outstanding and exercisable at a weighted average exercise price of $18.82 and $18.82, respectively.

c. Employee Stock Purchase Plan:

In May 2001 and in July 2007, the Company's Board of Directors adopted the Employee Stock Purchase Plan ("the Purchase Plan"), and amended the Purchase Plan in July 2007. As amended, the Purchase Plan provides for the issuance of a maximum of 6,500,000 Ordinary shares. As of December 31, 2007, 4,324,136 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 a compensatory plan. Therefore the Company recorded compensation expense in accordance to SFAS 123R

During the years ended December 31, 2005, 2006 and 2007, 257,746, 323,303 and 649,853 shares, respectively, were issued under the Purchase Plan for aggregate considerations of $2,134, $2,665 and $3,619, 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 17,041,864. As of December 31, 2007, 2,090,870 shares are still available for future option grants.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 12:- SHAREHOLDERS' EQUITY (Cont.)

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 that are forfeited or cancelled before expiration become available for future grants.

The following is a summary of the Group's stock option activity and related information for the years ended December 31, 2005, 2006 and 2007:

	Year ended December 31, 2007			
	Amount of options	Weighted average exercise price	Weighted average remaining contractual term (in years)	Aggregate intrinsic value
Outstanding at beginning of year	7,981,826	$ 9.92	3.8	$ 22,353
Changes during the year:				
Granted	1,254,375	$ 6.31		
Exercised	(329,971)	$ 3.60		
Forfeited	(905,970)	$ 10.31		
Expired	(613,000)	$ 29.80		
Options outstanding at end of year	7,387,260	$ 7.85	3.7	$ 3,583
Vested and expected to vest	6,870,152	$ 7.85	3.7	$ 3,332
Options exercisable at end of year	4,492,490	$ 7.19	2.5	$ 3,580

The weighted-average grant-date fair value of options granted during the year ended December 31, 2007 was $3.23. 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 the fiscal year 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 the last trading day of the fiscal year. 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, 2005, 2006 and 2007 was $ 3,373, $ 4,790 and $ 613 respectively. As of December 31, 2007, there was $ 8,003 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 1.5 years.

Cash received from exercise of options for the years ended December 31, 2005, 2006 and 2007 were approximately $ 1,800, $ 6,515 and $ 1,189 respectively.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 12:- SHAREHOLDERS' EQUITY (Cont.)

The options outstanding as of December 31, 2007, have been separated into ranges of exercise prices, as follows:

Range of exercise price	Options outstanding as of December 31, 2007	Weighted average remaining contractual life	Weighted average exercise price	Options exercisable as of December 31, 2007	Weighted average exercise price of exercisable options
		(Years)			
$ 0.61	96,000	0.30	$ 0.61	96,000	$ 0.61
$ 1.1	127,800	0.51	$ 1.10	127,800	$ 1.10
$ 1.73-2.51	440,568	1.87	$ 2.28	440,568	$ 2.28
$ 2.67-4	405,734	1.23	$ 3.10	405,734	$ 3.10
$ 4.1-6.49	1,810,150	4.21	$ 5.22	862,275	$ 4.43
$ 6.51-9.24	996,558	3.05	$ 7.55	737,808	$ 7.79
$ 9.32-14.76	3,457,950	4.39	$ 10.90	1,782,930	$ 11.01
$ 15.94-20.38	52,500	4.00	$ 15.94	39,375	$ 15.94
	7,387,260		$ 7.85	4,492,490	$ 7.19

e. During 2007, the Company decided on an exceptional and ex-gratia basis to extend the validity of certain options granted to employees by a period of 2 years and re-priced the exercise price to certain employees.

The Company accounted for these changes as modifications in accordance with FAS 123R. The Company calculated the incremental value of these modifications and recorded compensation cost in a total amount of $283.

f. 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:

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. Accordingly, results for tax purposes are measured in terms of earnings in dollars.

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 exempt and reduced tax rates.

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 five 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 no longer eligible for benefits in 2007. Tax benefits from the remaining programs are scheduled to gradually expire through 2013.

As of December 31, 2007, 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.

NOTE 13:- TAXES ON INCOME (Cont.)

The entitlement to the above benefits is conditional upon the Company fulfilling the conditions stipulated by the above 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, 2007, 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.

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, as 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, 2007, there was no taxable income attributable to the Privileged Enterprise.

3. Net operating loss carryforward:

As of December 31, 2007, the Company has accumulated losses for tax purposes in the amount of approximately $76,000, which can be carried forward and offset 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.

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

NOTE 13:- TAXES ON INCOME (Cont.)

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 2007 - 29%, in 2008 - 27%, in 2009 - 26% and in 2010 and thereafter - 25%.

b. Income (loss) before taxes on income comprised as following:

	Year ended December 31,		
	2005	2006	2007
Domestic	$ 7,387	$ 6,683	$ 3,131
Foreign	7,541	1,399	(4,654)
	$ 14,928	$ 8,082	$ (1,523)

c. Taxes on income are comprised as follows:

	Year ended December 31,		
	2005	2006	2007
Current taxes	$ 3,167	$ 1,290	$ (1,125)
Deferred taxes	(2,368)	(1,001)	2,390
	$ 799	$ 289	$ 1,265

	Year ended December 31,		
	2005	2006	2007
Domestic	$ 2,167	$ 846	$ (1,575)
Foreign	(1,368)	(557)	2,840
	$ 799	$ 289	$ 1,265

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:

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 13:- TAXES ON INCOME (Cont.)

	December 31,	
	2006	**2007**
Deferred tax assets:		
Net operating loss carry forward	$ 44,645	$ 58,513
Reserves and allowances	7,879	5,823
Deferred tax assets before valuation allowance	52,524	64,336
Valuation allowance	(48,782)	(62,278)
Deferred tax assets	$ 3,742	$ 2,058
Deferred tax liability, related to intangible assets	$ (7,780)	$ -
Deferred tax asset (liabilities), net	$ (4,038)	$ 2,058
Foreign:		
Current deferred tax assets	$ 1,282	$ 1,001
Current deferred tax liability	(1,321)	-
Non current deferred tax asset	2,460	1,057
Non current deferred tax liability	(6,459)	-
	$ (4,038)	$ 2,058

The Company's U.S. subsidiaries have estimated total available carry forward tax losses of approximately $80,000 to offset against future taxable income between 2015 and 2024. As of December 31, 2007, the Company recorded a deferred tax asset of $2,058 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.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

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,		
	2005	**2006**	**2007**
Income (loss) before taxes, as reported in the consolidated statements of operations	$ 14,928	$ 8,082	$ (1,523)
Statutory tax rate	34%	31%	29%
Theoretical tax expenses (benefits) on the above amount at the Israeli statutory tax rate	5,076	2,505	(442)
Income taxed at rate other than the Israeli statutory tax rate (1)	(3,543)	(4,672)	655
Non-deductible expenses including equity based compensation expenses	1,663	4,008	2,432
Deferred taxes on losses for which a valuation allowance was provided	(2,813)	(261)	3,333
Utilization of operation losses carry forward	(2,291)	(1,232)	(3,355)
Taxes in respect to prior years	-	(66)	(1,588)
State and Federal taxes	826	425	689
Inter-company charges	1,725	(299)	(430)
Other individually immaterial income tax item	156	(119)	(29)
Actual tax expense	$ 799	$ 289	$ 1,265
(1) Per share amounts (basic) of the tax benefit resulting from the exemption	$ 0.09	$ 0.11	$ 0.02
Per share amounts (diluted) of the tax benefit resulting from the exemption	$ 0.08	$ 0.11	$ 0.02

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 13:- TAXES ON INCOME (Cont.)

f. The Company adopted the provisions of FIN 48 on January 1, 2007. Prior to 2007 the Company used the provisions of SFAS 5 to determine tax contingencies. As of January 1, 2007 there was no difference in the Company's tax contingencies under the provisions of FIN 48. As a result, there was no effect on the Company's shareholders equity upon the Company's adoption of FIN 48.

A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows:

Gross unrecognized tax benefits as of January 1, 2007	$ 275
Increase in tax position for current year	13
Gross unrecognized tax benefits as of December 31, 2007	$ 288

The Company recognizes interest and penalties related to unrecognized tax benefits in tax expenses. The liability for unrecognized tax benefits included accrued interest and penalties of $130 and $113 at December 31, 2007 and January 1, 2007, respectively

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

	Year ended December 31,		
	2005	**2006**	**2007**
Numerator:			
Net income (loss) available to shareholders of Ordinary Shares	$ 13,436	$ 6,877	$ (3,885)
Denominator:			
Denominator for basic earnings per share - weighted average number of Ordinary shares, net of treasury stock	40,295,591	41,716,626	42,699,307
Effect of dilutive securities:			
Employee stock options and ESPP	2,790,110	1,972,767	*) -
Senior convertible notes	*) -	*) -	*) -
Denominator for diluted net earnings per share - adjusted weighted average number of shares	$ 43,085,701	$ 43,689,393	$ 42,699,307

*) Antidilutive.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 15:- FINANCIAL INCOME, NET

	Year ended December 31, 2005	2006	2007
Financial expenses:			
Interest	$ (3,357)	$ (2,961)	$ (2,582)
Amortization of marketable securities premiums and accretion of discounts, net	(143)	(224)	(40)
Others	(146)	(240)	(617)
	(3,646)	(3,425)	(3,239)
Financial income:			
Interest and others	6,103	7,242	5,909
	$ 2,457	$ 3,817	$ 2,670

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, 2005, 2006 and 2007 and long-lived assets as of December 31, 2005, 2006 and 2007.

	2005		2006		2007	
	Total revenues	Long-lived assets	Total revenues	Long-lived assets	Total revenues	Long-lived assets
Israel	$ 12,235	$ 6,248	$ 12,411	$ 11,463	$ 10,604	$ 23,261
Americas	66,622	22,193	83,352	127,079	89,614	113,894
Europe	22,434	7	32,704	6	40,305	105
Far East	14,536	4	18,886	5	17,712	53
	$ 115,827	$ 28,452	$ 147,353	$ 138,553	$ 158,235	$ 137,313

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

	Year ended December 31, 2005	2006	2007
Customer A	16%	15%	17%

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 16:- MAJOR CUSTOMERS AND GEOGRAPHIC INFORMATION (Cont.)

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,		
	2005	2006	2007
Technology	$ 62,287	$ 70,013	$ 56,426
Networking	53,540	77,340	101,809
	$ 115,827	$ 147,353	$ 158,235

NOTE 17:- SUBSEQUENT EVENTS (UNAUDITED)

In April 2008, the Company entered into a loan agreement with a bank in Israel that provides for borrowings of up to $15,000. The loan bears interest at LIBOR plus 1.5% with respect to $11,500 of borrowings and LIBOR plus 0.65% with respect to $3,500 of borrowings. The principal amount borrowed is repayable in 20 equal quarterly payments through May 2013. The bank has a lien of our assets and we are required to maintain $3,500 of compensating balances with the bank. The agreement requires the Company, among other things, to maintain shareholders' equity at specified levels and to achieve certain levels of operating income. The agreement also restricts the Company from paying dividends. As of June 22, 2008, there was $15,000 outstanding under this loan agreement.

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