

**AUDIOCODES LTD. AND ITS SUBSIDIARIES**

**CONSOLIDATED FINANCIAL STATEMENTS**

**AS OF DECEMBER 31, 2008**

**IN U.S. DOLLARS**

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

**To the board of directors and Shareholders of**

**AudioCodes LTD.**

We have audited the accompanying consolidated balance sheets of AudioCodes Ltd. ("AudioCodes" or "the Company") and its subsidiaries as of December 31, 2007 and 2008, 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, 2008. 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 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, 2007 and 2008, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2008, 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.

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, 2008, 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 28, 2009 expressed an unqualified opinion thereon.

Tel-Aviv, Israel  
June 28, 2009

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

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

**To the Board of Directors and Shareholders of  
AudioCodes LTD.**

We have audited AudioCodes Ltd's ("AudioCodes" or "the Company") internal control over financial reporting as of December 31, 2008, 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 and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's Annual Report on Internal Control over Financial Reporting included in the accompanying Management's Annual Report on 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, 2008, 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, 2007 and 2008 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, 2008 and our report dated June 28, 2009 expressed an unqualified opinion thereon. We did not audit the financial statements of a wholly-owned subsidiary, which statements reflect 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.

**CONSOLIDATED BALANCE SHEETS**

**U.S. dollars in thousands**

	December 31,	
	2007	2008
<b>ASSETS</b>		
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents	\$ 75,063	\$ 36,779
Short-term bank deposits	18,157	61,870
Short-term marketable securities and accrued interest	17,244	16,481
Trade receivables (net of allowance for doubtful accounts of \$ 521 and \$ 519 at December 31, 2007 and 2008, respectively)	25,604	29,564
Other receivables and prepaid expenses	6,500	3,373
Deferred tax assets	1,001	972
Inventories	18,736	20,623
<u>Total current assets</u>	<u>162,305</u>	<u>169,662</u>
<b>LONG-TERM ASSETS:</b>		
Long-term bank deposits	32,670	-
Investment in companies	1,343	1,245
Deferred tax assets	1,057	1,255
Severance pay funds	9,799	10,297
<u>Total long-term assets</u>	<u>44,869</u>	<u>12,797</u>
<b>PROPERTY AND EQUIPMENT, NET</b>	<u>7,094</u>	<u>6,844</u>
<b>INTANGIBLE ASSETS, DEFERRED CHARGES AND OTHER, NET</b>	<u>19,007</u>	<u>9,084</u>
<b>GOODWILL</b>	<u>111,212</u>	<u>32,095</u>
<u>Total assets</u>	<u>\$ 344,487</u>	<u>\$ 230,482</u>

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

**CONSOLIDATED BALANCE SHEETS**

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

	<b>December 31,</b>	
	<b>2007</b>	<b>2008</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>CURRENT LIABILITIES:</b>		
Current maturities of long-term bank loans	\$ -	\$ 6,000
Trade payables	8,849	11,661
Other payables and accrued expenses	28,780	24,189
Senior convertible notes	-	71,374
<u>Total current liabilities</u>	<u>37,629</u>	<u>113,224</u>
<b>LONG-TERM LIABILITIES:</b>		
Accrued severance pay	11,168	12,174
Senior convertible notes	121,198	-
Long-term banks loans	-	21,750
<u>Total long-term liabilities</u>	<u>132,366</u>	<u>33,924</u>
<b>COMMITMENTS AND CONTINGENT LIABILITIES</b>		
<b>SHAREHOLDERS' EQUITY:</b>		
Share capital -		
Ordinary shares of NIS 0.01 par value -		
Authorized: 100,000,000 at December 31, 2007 and 2008; Issued:		
47,031,691 shares at December 31, 2007 and 47,574,800 shares at		
December 31, 2008; Outstanding: 43,089,552 shares at December 31, 2007		
and 40,182,444 shares at December 31, 2008	133	125
Additional paid-in capital	161,970	167,856
Treasury stock	(11,320)	(25,057)
Accumulated other comprehensive income (loss)	1,047	(912)
Retained earnings (accumulated deficit)	22,662	(58,678)
<u>Total shareholders' equity</u>	<u>174,492</u>	<u>83,334</u>
<u>Total liabilities and shareholders' equity</u>	<u>\$ 344,487</u>	<u>\$ 230,482</u>

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

June 28, 2009

Date of approval of the  
financial statements

Nachum Falek  
Vice President and  
Chief Financial Officer

Shabtai Adlersberg  
Chief Executive Officer

**CONSOLIDATED STATEMENTS OF OPERATIONS**

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

	<b>Year ended December 31,</b>		
	<b>2006</b>	<b>2007</b>	<b>2008</b>
Revenues	\$ 147,353	\$ 158,235	\$ 174,744
Cost of revenues	<u>61,242</u>	<u>69,185</u>	<u>77,455</u>
Gross profit	<u>86,111</u>	<u>89,050</u>	<u>97,289</u>
Operating expenses:			
Research and development, net	35,416	40,706	37,833
Selling and marketing	37,664	42,900	44,657
General and administrative	8,766	9,637	9,219
Impairment of goodwill and other intangible assets	-	-	85,015
<u>Total operating expenses</u>	<u>81,846</u>	<u>93,243</u>	<u>176,724</u>
Operating income (loss)	4,265	(4,193)	(79,435)
Financial income, net	<u>3,817</u>	<u>2,670</u>	<u>1,182</u>
Income (loss) before taxes on income	8,082	(1,523)	(78,253)
Taxes on income, net	289	1,265	505
Equity in losses of affiliated companies, net	<u>916</u>	<u>1,097</u>	<u>2,582</u>
Net income (loss)	<u>\$ 6,877</u>	<u>\$ (3,885)</u>	<u>\$ (81,340)</u>
Basic and diluted net earnings (loss) per share	<u>\$ 0.16</u>	<u>\$ (0.09)</u>	<u>\$ (1.97)</u>

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 (accumulated deficit)	Total comprehensive income (loss)	Total shareholders' equity
Balance as of January 1, 2006	\$ 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	6,877
Total comprehensive income, net							<u>\$ 6,915</u>	
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							<u>\$ (2,960)</u>	
Balance as of December 31, 2007	133	161,970	(11,320)	-	1,047	22,662		174,492
Purchase of treasury stock	(10)	-	(13,737)	-	-	-		(13,747)
Issuance of shares upon exercise of options and employee stock purchase plan	2	1,545	-	-	-	-		1,547
Stock compensation related to options granted to employees	-	4,341	-	-	-	-		4,341
Comprehensive income, net:								
Unrealized losses on foreign currency cash flow hedges	-	-	-	-	(1,959)	-	\$ (1,959)	(1,959)
Net loss	-	-	-	-	-	(81,340)	(81,340)	(81,340)
Total comprehensive loss, net							<u>\$ (83,299)</u>	
Balance as of December 31, 2008	<u>125</u>	<u>\$ 167,856</u>	<u>\$ (25,057)</u>	<u>\$ -</u>	<u>\$ (912)</u>	<u>\$ (58,678)</u>		<u>\$ 83,334</u>

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

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

**U.S. dollars in thousands**

	<b>Year ended December 31,</b>		
	<b>2006</b>	<b>2007</b>	<b>2008</b>
<b>Cash flows from operating activities:</b>			
Net income (loss)	\$ 6,877	\$ (3,885)	\$ (81,340)
Adjustments required to reconcile net income (loss) to net cash provided by operating activities:			
Depreciation and amortization	5,543	7,789	7,441
Impairment of goodwill, other intangible assets and investment in affiliate	-	-	86,111
Amortization of marketable securities premiums and accretion of discounts, net	225	39	112
Equity in losses of affiliated companies, net	916	1,097	1,486
Stock-based compensation expenses	8,707	7,967	4,341
Amortization of senior convertible notes discount and deferred charges	199	203	142
Increase in accrued interest on marketable securities, bank deposits and structured notes	(130)	(611)	125
Decrease (increase) in deferred tax assets, net	(1,001)	2,390	(169)
Decrease (increase) in trade receivables, net	(9,751)	5,014	(3,960)
Decrease (increase) in other receivables and prepaid expenses	1,457	(1,412)	450
Increase in inventories	(1,954)	(2,643)	(1,840)
Increase (decrease) in trade payables	(2,671)	1,263	2,728
Increase (decrease) in other payables and accrued expenses	(2,005)	(5,181)	333
Increase in accrued severance pay, net	203	356	451
Other	15	-	-
Net cash provided by operating activities	<u>6,630</u>	<u>12,386</u>	<u>16,411</u>
<b>Cash flows from investing activities:</b>			
Investments in affiliated companies	(3,453)	(1,003)	(1,330)
Purchase of property and equipment	(3,067)	(2,629)	(3,158)
Purchase of marketable securities	-	-	(16,795)
Investment in short-term and long-term bank deposits	(20,000)	(29,065)	(100,864)
Proceeds from short-term bank deposits	51,300	28,700	90,142
Proceeds from structured notes called by the issuer	-	10,000	-
Proceeds from redemption of marketable securities upon maturity	9,000	31,600	17,000
Proceeds from sale of held-to-maturity marketable securities	979	-	-
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 <sup>2</sup> ") (3)	-	(4,897)	(5,000)
Net cash provided by (used in) investing activities	<u>(61,597)</u>	<u>32,706</u>	<u>(20,005)</u>
<b>Cash flows from financing activities:</b>			
Purchase of treasury stock	-	-	(13,747)
Purchase of senior convertible note	-	-	(50,240)
Proceeds from long-term bank loans	-	-	30,000
Repayment of long-term bank loans	-	-	(2,250)
Proceeds from issuance of shares upon exercise of options and employee stock purchase plan	9,181	4,800	1,547
Net cash provided by (used in) financing activities	<u>9,181</u>	<u>4,800</u>	<u>(34,690)</u>
Increase (decrease) in cash and cash equivalents	(45,786)	49,892	(38,284)
Cash and cash equivalents at the beginning of the year	<u>70,957</u>	<u>25,171</u>	<u>75,063</u>
Cash and cash equivalents at the end of the year	<u>\$ 25,171</u>	<u>\$ 75,063</u>	<u>\$ 36,779</u>

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

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

U.S. dollars in thousands

	<b>Year ended December 31,</b>		
	<b>2006</b>	<b>2007</b>	<b>2008</b>
<b>(1) <u>Payment for acquisition of Nuera Communication Inc.</u></b>			
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	-	-
	<u>\$ 82,520</u>	<u>\$ -</u>	<u>\$ -</u>
<b>(2) <u>Payment for acquisition of Netrake Corporation.</u></b>			
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	-	-
	<u>\$ 13,836</u>	<u>\$ -</u>	<u>\$ -</u>
<b>(3) <u>Payment for acquisition of CTI Squared Ltd.</u></b>			
Net fair value of assets acquired and liabilities assumed of CTI <sup>2</sup> 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	-
	<u>\$ -</u>	<u>\$ 4,897</u>	<u>\$ -</u>
<b>(4) <u>Supplemental disclosure of cash flow activities:</u></b>			
Cash paid during the year for income taxes	<u>\$ 1,237</u>	<u>\$ 403</u>	<u>\$ 646</u>
Cash paid during the year for interest	<u>\$ 2,500</u>	<u>\$ 2,500</u>	<u>\$ 2,455</u>

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") design, develop and market 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, Europe, Asia, Latin America and Israel.

During 2008, the Group faced an adverse change in its business as a result of the current economic and credit crisis. As a result, the Company concluded that an impairment test for the Company's goodwill and intangible assets was required based on the annual impairment test conducted during the fourth quarter of 2008.

As a result, in the fourth quarter of 2008, the Company recorded a non-cash impairment charge with respect to goodwill and intangible assets as follows:

Goodwill – \$ 79,117 (see also Note 2m).

Intangible assets – \$ 5,898 (see also Note 2m).

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 provider of Voice over Internet Protocol ("VoIP") infrastructure solutions for broadband and long distance with a 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 ("SFAS") No. 141 "Business Combinations" ("SFAS No. 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 allocated the total acquisition cost of Nuera Communication Inc.'s assets and liabilities as follows:

	<u>July 6, 2006</u>
Trade receivables	\$ 2,213
Inventories	931
Other receivables and prepaid expenses	356
Deferred tax asset	1,201
Property and equipment	<u>673</u>
<u>Total tangible assets acquired</u>	<u>5,374</u>
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	<u>78,782</u>
<u>Total intangible assets acquired</u>	<u>94,223</u>
<u>Total tangible and intangible assets acquired</u>	<u>99,597</u>
Trade payables	(1,292)
Deferred tax liability	(6,176)
Other current liabilities and accrued expenses	<u>(9,609)</u>
<u>Total liabilities assumed</u>	<u>(17,077)</u>
Net assets acquired	<u>\$ 82,520</u>

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 is not amortized (see Note 2m with respect to the impairment recorded relating to goodwill).

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

Current assets and liabilities were 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.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**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 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.

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:

	<b>August 14, 2006</b>
Trade receivables	\$ 554
Inventories	1,646
Other receivables and prepaid expenses	311
	<u>2,511</u>
Property and equipment	528
<u>Total</u> tangible assets acquired	<u>3,039</u>
Technology (ten years useful life)	5,688
Backlog (two years useful life)	87
Goodwill	10,373
<u>Total</u> intangible assets acquired	<u>16,148</u>
<u>Total</u> tangible and intangible assets acquired	<u>19,187</u>
Trade payables	(1,127)
Deferred tax liability	(2,310)
Other current liabilities and accrued expenses	(1,914)
<u>Total</u> liabilities assumed	<u>(5,351)</u>
Net assets acquired	<u>\$ 13,836</u>

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

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**NOTE 1:- GENERAL (Cont.)**

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 is not amortized (see Note 2m with respect to the impairment recorded relating to goodwill).

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.

d. Acquisition of CTI Squared Ltd.:

On April 1, 2007, the Group acquired the remaining outstanding common stock of CTI Squared Ltd ("CTI<sup>2</sup>"), a leading provider of enhanced messaging and communications platforms deployed globally by service providers and enterprises. CTI<sup>2</sup>'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<sup>2</sup> 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 was committed to pay an additional \$ 5,000 by April, 2008. In February 2008, the Group paid the additional amount of \$ 5,000.

CTI<sup>2</sup> 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.

**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<sup>2</sup>'s assets and liabilities as follows:

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

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 is not amortized (see Note 2m with respect to the impairment recorded relating to goodwill).

The value assigned to tangible 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.

e. Acquisition of Natural Speech Communication Ltd.:

Through December 31, 2008, the Group had invested an aggregate of \$ 6,765 in Natural Speech Communication Ltd. ("NSC"), a privately-held company engaged in speech recognition. As of December 1, 2008, the Company began consolidating the financial results of NSC into AudioCodes' financial results since we became the primary beneficiary in accordance with FASB Interpretation No. 46 (Revised), or FASB Interpretation ("FIN") 46R, "Consolidation of Variable Interest Entities - An Interpretation of ARB No. 51".

As of December 31, 2008, the Group owned 56.6% of the outstanding share capital of NSC.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 1:- GENERAL (Cont.)**

This acquisition was accounted for under the consolidation method of accounting in accordance with "FIN" 46R.

	<b>December 1, 2008</b>
Other receivables and prepaid expenses	\$ 152
Inventory	47
Property and equipment	194
<u>Total tangible assets acquired</u>	<u>393</u>
Trade payables	(84)
Other current liabilities and accrued expenses	(305)
Accrued severance pay, net	(57)
Minority interest	(228)
<u>Total liabilities assumed</u>	<u>(674)</u>
Net assets acquired	<u>\$ (281)</u>

Based upon an independent valuation of tangible and intangible assets acquired, the reported amount of NSC (plus the fair value of any consideration paid) was less than the fair value of the net assets of the NSC (that is, "negative goodwill" exists). Therefore, the excess fair value was allocated and reported as a pro-rata adjustment of all of the newly consolidated assets.

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 NSC been consummated on January 1, 2007, nor does it purport to represent the results of operations of the Group for any future period.

	<b>Year ended December 31,</b>	
	<b>2007</b>	<b>2008</b>
Revenues	<u>\$ 159,358</u>	<u>\$ 175,489</u>
Net loss	<u>\$ (5,621)</u>	<u>\$ (83,604)</u>
Basic and diluted net loss per share	<u>\$ (0.13)</u>	<u>\$ (2.03)</u>

- f. 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.
- g. In January 2009, the Group's largest customer announced that it would seek creditor protection for itself and some of its subsidiaries. The loss of the this customer, a significant reduction of the amount of products purchased by this customer or the Group's inability to obtain a satisfactory replacement of this customer in a timely manner may have a significant impact on the Group's revenues and the results of operations. As of December 31, 2006, 2007 and 2008, this customer accounted for 15%, 17% and 14%, respectively, of the Group's revenues.

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

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**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 U.S. generally accepted accounting principles requires management to make estimates, judgments and assumptions that affect the amounts reported in the financial statements and accompanying notes. The Company's management believes that the estimates, judgment and assumptions used are reasonable based upon information available at the time they are made. Actual results could differ from those estimates.

b. Financial statements in U.S. dollars:

A majority of the group's revenues is generated in U.S. dollars. In addition, most of the group's costs are denominated and determined in U.S. dollars and in New Israeli Shekels. The Company's management believes that the U.S. dollar is the currency in the primary economic environment in which the group operates. Thus, the functional and reporting currency of the group is the U.S. 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 Group, 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 mainly in U.S. dollars and bear interest at an average rate of 4.57% and 4.00% for 2007 and 2008, respectively. Short-term deposits are presented at their cost, including accrued interest. (See also Notes 11)

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".

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands, except share and per share data****NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

Management determines the appropriate classification of its investments in marketable debt securities at the time of purchase and reevaluates such determinations at each balance sheet date. Marketable 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.

For the years ended December 31, 2007 and 2008, all securities covered by SFAS No. 115 were designated by the Company's management as held-to-maturity.

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 operations 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 and 124-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investment" ("FSP 115-1") and Sec Staff Accounting Bulletin 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 is less than its cost. 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.

For the year ended December 31, 2006, 2007 and 2008, no other than temporary impairment losses have been identified.

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.

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

As of December 31, 2008, the Group does not hold any long-term bank deposits.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

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

i. Investment in companies:

The Company accounts for 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 a company, the investment is stated at cost.

Investment in companies represents investments in ordinary shares, preferred shares and convertible loans. The Company applies Emerging Issues Tasks Force Issue ("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 Company.

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, 2007, no impairment losses had been identified. During 2008, based on management's most recent analyses, the Company recognized an impairment loss of \$ 1,096 relating to its investment in NSC.

j. Property and equipment:

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

	<u>%</u>
Computers and peripheral equipment	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

k. Deferred charges:

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".

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands, except share and per share data****NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

## 1. Impairment of long-lived assets:

The Group's long-lived assets are reviewed for impairment in accordance with SFAS No. 144, 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 future undiscounted cash flows expected to be generated by the asset. 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. The loss is allocated to the long-lived assets of the Group on a pro rata basis using the relative carrying amounts of those assets, except that the loss allocated to an individual long-lived asset of the Group shall not reduce the carrying amount of that asset below its fair value whenever that fair value is determinable. As of December 31, 2006, 2007 and 2008, no impairment losses have been identified for property and equipment since the fair value of those assets was higher than its carrying amounts.

Intangible assets are comprised of acquired technology, customer relations, trade names, existing contracts for maintenance and backlog. All intangible assets are amortized using the straight-line method over their estimated useful life.

During 2006 and 2007, no impairment charges were identified. During 2008, the Company recorded an impairment charge for intangible assets in the amount of \$ 5,898.

## m. Goodwill and other intangible assets:

Goodwill and certain other purchased intangible assets have been recorded in the Company's financial statements as a result of acquisitions. Goodwill represents the excess of the purchase price in a business combination over the fair value of net tangible and intangible assets acquired under SFAS No. 142, "Goodwill and Other Intangible Assets". Goodwill is not amortized, but rather is subject to an annual impairment test. 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. The Company performs an annual impairment test during the fourth quarter of each fiscal year, or more frequently if impairment indicators are present. The Group operates in one operating segment, and this segment comprises its only reporting unit. In 2008, fair value was determined using discounted cash flows, market multiples and market capitalization. Significant estimates used in the methodologies include estimates of future cash-flows, future short-term and long-term growth rates, weighted average cost of capital and market multiples for the reporting unit. In 2006 and 2007, fair value was determined based on the market approach. Intangible assets that are not considered to have an indefinite useful life are amortized using the straight-line basis over their estimated useful lives, which range from one to ten years. Recoverability of these assets is measured by a comparison of the carrying amount of the asset to the undiscounted future cash flows expected to be generated by the assets. If the assets are considered to be impaired, the amount of any impairment is measured as the difference between the carrying value and the fair value of the impaired assets.

During 2006 and 2007, no impairment charges were identified. During 2008, an impairment charge to goodwill in the amount of \$ 79,117 was recorded. (See Notes 1 and 7).

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

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

## n. 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 Bulletin ("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 collectability is probable. The Group has no remaining obligation to customers after the date on which products are delivered other than pursuant to warranty obligations and right of return.

The Group grants to certain 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 limited period 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 \$ 636, \$ 559 and \$ 754, as of December 31, 2006, 2007 and 2008, respectively.

Revenues from the sale of products which were not yet determined to be final sales due to market acceptance were deferred and included in deferred revenues. In cases where collectability is not probable, revenues are deferred and recognized upon collection.

## o. 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 Group's aggregate product warranty liability was not provided due to immateriality.

## p. Research and development costs:

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

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands, except share and per share data****NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

## q. 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 liability method whereby deferred tax asset and liability account balances are determined based on differences between the financial reporting and tax bases of assets and liabilities and for carryforward losses. Deferred taxes 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 if it is more likely than not that some portion or all of the deferred tax asset will not be realized.

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. The Company recognizes interest and penalties, if any, related to unrecognized tax benefits in tax expenses.

## r. Comprehensive income (loss)

The Company accounts for comprehensive income (loss) in accordance with SFAS No. 130, "Reporting Comprehensive Income". This statement establishes standards for the reporting and display of comprehensive income and its components in a full set of general purpose financial statements. Comprehensive income generally represents all changes in shareholders' equity during the period except those resulting from investments by, or distributions to, shareholders. The Company determined that its items of comprehensive income (loss) relates to gains and losses on hedging derivatives instruments.

## 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, marketable securities, trade receivables and foreign currency derivative contracts.

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 in corporations with high credit standing. Accordingly, management believes that minimal credit risk exists with respect to these financial investments.

Marketable securities include investments in debentures of U.S corporations. Marketable securities consist of highly liquid debt instruments of corporations with high credit standing. Management believes that the portfolio is well diversified, and accordingly, minimal credit risk exists with respect to these marketable debt securities.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands, except share and per share data****NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

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

The trade receivables of the Group are derived from sales to customers located primarily in the Americas, the Far East, Israel and Europe. However, under certain circumstances, the Group may require letters of credit, other collateral, additional guarantees or advance payments. Regarding certain credit balances, the Group is covered by foreign trade risk insurance. The Group performs ongoing credit evaluations of its customers and establishes an allowance for doubtful accounts based upon a specific review.

Allowance for doubtful accounts amounted to \$ 521 and \$ 519 as of December 31, 2007 and 2008, respectively. The Group charges off receivables when they are deemed uncollectible. Actual collection experience may not meet expectations and may result in increased bad debt expense.

Total bad debt expenses (income) during 2006, 2007 and 2008 amounted to \$ 45, (\$ 73) and \$ 207, respectively.

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 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 No. 00-27, "Application of Issue No. 98-5 to Certain Convertible Industries", which is 20 years. Please refer also to Note 2 aa and Note 10.

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 income per share was 9,924,624, 11,765,438 and 12,156,728 for the years ended December 31, 2006, 2007 and 2008, respectively.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

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

v. Equity-based compensation expenses:

The Company accounts for stock-based compensation in accordance with SFAS No. 123 (revised 2004), "Share-Based Payment" ("SFAS No. 123(R)"). SFAS No. 123(R) requires companies to estimate the fair value of equity-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as an expense over the requisite service periods in the Company's consolidated statement of operations.

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

The 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.

The Company estimates the fair value of stock options granted under SFAS No. 123(R) using the Black-Scholes option-pricing model that uses the weighted-average assumptions noted in the following table.

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. In 2008, the expected term of options granted is estimated based on historical experience and represents the period of time that options granted are expected to be outstanding. In 2006 and 2007, the expected term was determined based on the simplified method in accordance with SAB 107. 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 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 has historically not paid cash dividends and has no foreseeable plans to pay cash dividends in the future.

The weighted-average estimated fair value of employee stock options granted during the years ended December 31, 2006, 2007 and 2008, was \$ 5.81, \$ 3.23 and \$ 1.89 per share, respectively, using the Black-Scholes option pricing formula. Fair values were estimated using the following weighted-average assumptions (annualized percentages):

	<b>Year ended December 31,</b>		
	<b>2006</b>	<b>2007</b>	<b>2008</b>
Dividend yield	0%	0%	0%
Expected volatility	61.9%	54.7%	52.0%
Risk-free interest	4.6%	4.6%	2.6%
Expected life	4.8 years	4.8 years	4.8 years
Forfeiture rate	5.1%	7.0%	11.0%

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

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

The Company's equity-based compensation expenses for the years ended December 31, 2006, 2007 and 2008 totaled \$ 8,707, \$ 7,967 and \$ 4,341, 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, 2007 and 2008 was included in items of the consolidated statements of income as follows:

	<b>Year ended December 31,</b>		
	<b>2006</b>	<b>2007</b>	<b>2008</b>
Cost of revenues	\$ 620	\$ 613	\$ 318
Research and development, net	3,053	3,011	1,467
Selling and marketing expenses	3,628	3,476	2,026
General and administrative expenses	1,407	867	530
<b>Total equity-based compensation expenses</b>	<b>\$ 8,707</b>	<b>\$ 7,967</b>	<b>\$ 4,341</b>

w. Treasury stock:

The Company has repurchased its ordinary shares from time to time in the open market and holds such shares as treasury stock. The Company presents the cost to repurchase treasury stock as a reduction of shareholders' equity.

x. Severance pay:

The 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 for all employees in Israel. 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 value of these deposits is recorded as an asset in the Company's balance sheet.

The deposited funds include profits accumulated up to the balance sheet date. The deposited funds may be withdrawn only upon the fulfillment of the obligation pursuant to Israel's Severance Pay Law or labor agreements.

Severance pay expenses for the years ended December 31, 2006, 2007 and 2008, amounted to approximately \$ 1,766, \$ 2,409 and \$ 2,701, respectively.

y. Employee benefit plan

During 2007, the Group 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 2008 (\$ 20.5 including catch-up contributions for participants age 50 or over). The Group matches employee contributions to the plan up to a limit of 3.75% of their eligible compensation, subject to IRS limits. In 2006, 2007 and 2008, the Group matched contributions in the amount of \$ 271, \$ 361 and \$ 380, respectively.

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

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

## z. Advertising expenses:

Advertising expenses are charged to the statements of operations as incurred. Advertising expenses for the years ended December 31, 2006, 2007 and 2008, amounted to \$ 402, \$ 350 and \$ 407, respectively.

## aa. Fair value of financial instruments:

The estimated fair value of financial instruments has been determined by the Group using available market information and valuation methodologies. Considerable judgment is required in estimating fair values. Accordingly, the estimates may not be indicative of the amounts the Company could realize in a current market exchange.

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

The carrying amount of senior convertible notes does not approximate its fair value which amounts to \$ 67,618 based on quoted market values.

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

Effective January 1, 2008, the Group adopted SFAS No. 157, "Fair Value Measurements" ("SFAS No. 157") and, effective October 10, 2008, adopted FASB Staff Position ("FSP") No. 157-3, "Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active" ("FSP 157-3"), except as it applies to the nonfinancial assets and liabilities subject to FSP No. 157-2 "Effective Date of FASB Statement No. 157" ("FSP 157-2"). SFAS No. 157 clarifies that fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or a liability. As a basis for considering such assumptions, SFAS No. 157 establishes a three-tier value hierarchy, which prioritizes the inputs used in the valuation methodologies in measuring fair value:

Level 1 — Observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2 — Include other inputs that are directly or indirectly observable in the marketplace.

Level 3 — Unobservable inputs which are supported by little or no market activity.

The fair value hierarchy also requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value (see also Note 3 and Note 8).

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

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

## ab. 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, rent and 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 2008, the Company recorded accumulated other comprehensive loss in the amount of \$ 912 from its currency forward and option transactions with respect to payroll and rent expenses expected to be incurred during 2008. Such amount will be recorded into earnings during 2009.

## ac. Reclassification:

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

## ad. Impact of recently issued accounting standards:

In February 2008, the FASB issued FSP No. FAS 157-1, "Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13", and FSP No. FAS 157-2, "Effective Date of FASB Statement No. 157". Collectively, the Staff Positions defer the effective date of Statement 157 to fiscal years beginning after November 15, 2008 for nonfinancial assets and nonfinancial liabilities except for items that are recognized or disclosed at fair value on a recurring basis at least annually, and amend the scope of Statement 157. As described in Note 10, the Company adopted Statement 157 and the related FASB staff positions except for those items specifically deferred under FSP No. FAS 157-2.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands, except share and per share data****NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

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 acquire 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 impact of SFAS 141R on the Company's consolidated results of operations and financial condition will depend on the nature and size of acquisitions, if any, subsequent to the effective date.

In December 2007, the FASB issued SFAS No. 160, "Non controlling Interests in Consolidated Financial Statements, an amendment of ARB No. 51" (SFAS No. 160). 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 non controlling interest be clearly identified and presented on the face of the consolidated statement of operations; 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 impact of SFAS No. 160 on the Company's consolidated results of operations and financial condition will depend on the nature and size of transactions if any, subsequent to the effective date as well as reclassification of past minority rights into equity. The Company does not expect that the adoption of SFAS No. 160 will have a material impact on its consolidated financial statements.

In November 2008, the FASB ratified Emerging Issues Task Force Issue No. 08-7, "Accounting for Defensive Intangible Assets" ("EITF 08-7"). EITF 08-7 clarifies the accounting for certain separately identifiable intangible assets which an acquirer does not intend to actively use but intends to hold to prevent its competitors from obtaining access to them. EITF 08-7 requires an acquirer in a business combination to account for a defensive intangible asset as a separate unit of accounting which should be amortized to expense over the period the asset diminishes in value. EITF 08-7 is effective for fiscal years beginning after December 15, 2008, with early adoption prohibited. The guidance is applicable to intangible assets acquired after the effective date. The impact of FSP FAS 142-3 on the Company's consolidated results of operations and financial condition will depend on the amount of intangibles acquired, if any, subsequent to the effective date.

In April 2008, the FASB issued FASB Staff Position ("FSP") FAS 142-3, "Determination of the Useful Life of Intangible Assets". FSP FAS 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142, "Goodwill and Other Intangible Assets". FSP FAS 142-3 is effective for fiscal years beginning after December 15, 2008 and early adoption is prohibited. The guidance is applicable to intangible assets acquired after the effective date. The impact of FSP FAS 142-3 on the Company's consolidated results of operations and financial condition will depend on the amount of intangibles acquired, if any, subsequent to the effective date.

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

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

Effective December 31, 2008, the Company adopted FSP APB 14-1. "Accounting for Convertible debt Instruments that may be settled in cash upon conversion". FSP APB 14-1 specifies that issuers of such instruments should separately account for the liability and equity components in a manner that will reflect the entity's nonconvertible debt borrowing rate when interest cost is recognized in subsequent periods. This FSP is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Effective January 1, 2009 the Company adopted APB 14-1. As a result of the Company's preliminary assumptions the unaudited effect of APB 14-1 on the Company's consolidated statements of operations in 2009 will be an increase in interest expense, net of tax income of between \$ 3 million and \$ 3.3 million.

In June 2008, the FASB issued EITF No. 07-5, "Determining whether an Instrument (or Embedded Feature) is indexed to an Entity's Own Stock" ("EITF 07-5"). EITF 07-5 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Early application is not permitted. Paragraph 11(a) of SFAS No. 133 specifies that a contract that would otherwise meet the definition of a derivative but is both (a) indexed to the company's own stock and (b) classified in shareholders' equity in the statement of financial position would not be considered a derivative financial instrument. EITF 07-5 provides a new two-step model to be applied in determining whether a financial instrument or an embedded feature is indexed to an issuer's own stock and thus able to qualify for the SFAS 133 paragraph 11(a) scope exception. The Company believes adopting this statement will have no impact on its consolidated financial statements.

In April 2009, the FASB issued FSP, No. FAS 115-2 and FAS 124-2, Recognition and Presentation of Other-Than-Temporary Impairments, or the FSP. The FSP is intended to provide greater clarity to investors about the credit and noncredit component of an other-than-temporary impairment event and to more effectively communicate when an other-than-temporary impairment event has occurred. The FSP applies to fixed maturity securities only and requires separate display of losses related to credit deterioration and losses related to other market factors. When an entity does not intend to sell the security and it is more likely than not that an entity will not have to sell the security before recovery of its cost basis, it must recognize the credit component of an other-than-temporary impairment in earnings and the remaining portion in other comprehensive income. upon adoption of the FSP, an entity will be required to record a cumulative-effect adjustment as of the beginning of the period of adoption to reclassify the noncredit component of a previously recognized other-than-temporary impairment from retained earnings to accumulated other comprehensive income. The FSP will be effective for us for the quarter ending June 30, 2009. The Company is currently evaluating the impact of adopting the FSP.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 3:- MARKETABLE SECURITIES AND ACCRUED INTEREST**

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

	December 31,					
	2007			2008		
	Amortized cost	Net unrealized losses	Fair Value	Amortized cost	Net unrealized losses	Fair Value
Corporate debentures: Maturing within one year	12,985	\$ 21	\$ 12,964	\$ 16,253	\$ 1	\$ 16,252
	12,985	21	12,964	16,253	1	16,252
U.S. government and agencies debts: Maturing within one year	4,000	-	4,000	-	-	-
	4,000	-	4,000	-	-	-
Accrued interest	259	-	259	228	-	228
	<u>\$ 17,244</u>	<u>\$ 21</u>	<u>\$ 17,223</u>	<u>\$ 16,481</u>	<u>\$ 1</u>	<u>\$ 16,480</u>

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 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 and 2008.

**NOTE 4:- INVENTORIES**

	December 31,	
	2007	2008
Raw materials	\$ 9,879	\$ 9,346
Finished products	8,857	11,277
	<u>\$ 18,736</u>	<u>\$ 20,623</u>

In the years ended December 31, 2006, 2007 and 2008, the Group wrote-off inventory in a total amount of \$ 1,900, \$ 700 and \$ 1,200, respectively.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 5:- INVESTMENT IN COMPANIES**

- a. In July 2005, the Company signed a share purchase agreement with an 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. Until December 31, 2008, the Company extended convertible loans in the aggregate amount of \$303 to this company. The loans bear interest at the rate of 9% per annum and are convertible into shares. The loans are payable during 2009. As of December 31, 2008, the Company owned 20.2% of the company's outstanding share capital.

	<b>December 31,</b>	
	<b>2007</b>	<b>2008</b>
Net equity as of purchase date	\$ (106)	\$ (106)
Unamortized goodwill	1,085	1,400
Accumulated net loss	(71)	(49)
<b>Total investment</b>	<b>\$ 908</b>	<b>\$ 1,245</b>

- b. In December 2006, the Company extended 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 December, 2007, the Company requested repayment of loan. During 2008, the Company received \$ 870 in cash and shares of another unrelated privately-held company. The remaining balance of the loan in the amount of \$ 130 was written off.

**NOTE 6:- PROPERTY AND EQUIPMENT**

	<b>December 31,</b>	
	<b>2007</b>	<b>2008</b>
Cost:		
Computers and peripheral equipment	\$ 16,073	\$ 18,645
Office furniture and equipment	8,515	9,466
Leasehold improvements	1,731	2,437
	<u>26,319</u>	<u>30,548</u>
Accumulated depreciation:		
Computers and peripheral equipment	12,848	15,507
Office furniture and equipment	5,733	7,154
Leasehold improvements	644	1,043
	<u>19,225</u>	<u>23,704</u>
<b>Depreciated cost</b>	<b>\$ 7,094</b>	<b>\$ 6,844</b>

Depreciation expenses amounted to \$ 2,920, \$ 3,392 and \$ 3,602 for the years ended December 31, 2006, 2007 and 2008, respectively.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 7:- INTANGIBLE ASSETS, DEFERRED CHARGES AND OTHER**

	Useful life (years)	December 31,	
		2007	2008
a. Cost:			
Acquired technology	5 - 10	\$ 17,512	\$ 17,512
Customer relationship	9	8,001	8,001
Trade name	3	466	466
Existing contracts for maintenance	3	204	204
Backlog	1 - 2	878	878
Deferred charges	20	478	478
Other		200	200
		<u>27,739</u>	<u>27,739</u>
Accumulated amortization:			
Acquired technology		6,146	8,847
Customer relationship		1,333	2,222
Trade name		234	389
Existing contracts for maintenance		102	170
Backlog		852	878
Deferred charges		65	251
		<u>8,732</u>	<u>12,757</u>
Impairment:			
Acquired technology		-	1,995
Customer relationship		-	3,829
Trade name		-	51
Existing contracts for maintenance		-	23
		<u>-</u>	<u>5,898</u>
Amortized cost		<u>\$ 19,007</u>	<u>\$ 9,084</u>

**NOTE 7:- INTANGIBLE ASSETS, DEFERRED CHARGES AND OTHER (Cont.)**

- b. Amortization expenses amounted to \$ 2,623, \$ 4,397 and \$ 3,839 for the years ended December 31, 2006, 2007 and 2008, respectively.
- c. Amortization expenses related to deferred charges amounted to \$ 20, \$ 20 and \$ 19 for the years ended December 31, 2006, 2007 and 2008, respectively.
- d. Expected amortization expenses for the years ended December 31:
- |                     |          |
|---------------------|----------|
| 2009                | \$ 3,281 |
| 2010                | \$ 1,642 |
| 2011                | \$ 846   |
| 2012                | \$ 846   |
| 2013                | \$ 655   |
| 2014 and thereafter | \$ 1,814 |

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 8:- FAIR VALUE MEASUREMENTS**

In accordance with SFAS No. 157, the Company measures its foreign currency derivative contracts at fair value. Foreign currency derivative contracts are classified within Level 2 value hierarchy, as the valuation inputs are based on quoted prices and market observable data of similar instruments.

As of December 31, 2008, the fair value of foreign currency derivative liability, measured on a recurring, basis, was \$ 854.

**NOTE 9:- OTHER PAYABLES AND ACCRUED EXPENSES**

	<b>December 31,</b>	
	<b>2007</b>	<b>2008</b>
Employees and payroll accruals	\$ 8,047	\$ 7,537
Royalties provision	1,786	1,066
Government authorities	420	184
Accrued expenses	15,506	11,570
Deferred revenues	1,594	3,695
Others	1,427	137
	<u>\$ 28,780</u>	<u>\$ 24,189</u>

**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) principal amount of its 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. As of December 31, 2008, the Notes are presented as a short-term liability since the Company believes that the holders will choose to redeem the Notes on November 9, 2009.

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 prior to November 9, 2009. 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, 2007 and 2008 the Company did not record a separate derivative in the financial statements since the value of that derivative was 0.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 10:- SENIOR CONVERTIBLE NOTES (Cont.)**

During 2008, the Company repurchased \$ 51,500 in principal amount of its 2% Senior Convertible Notes for a total cost, including accrued interest, of \$ 50,200. As a result of the repurchase, the Company recorded a gain in the amount of \$ 50 in its statements of operations.

**NOTE 11:- LONG-TERM BANK LOANS**

In April and July 2008, the Company entered into loan agreements with banks in Israel that provided for loans in the amount of \$ 30,000. The loans bear interest at LIBOR plus 1.5% with respect to \$ 23,000 of the loans and LIBOR plus 0.65% with respect to the remaining principal amount of \$ 7,000 of the loans. The principal amount borrowed is repayable in 20 equal quarterly payments through July 2013. The banks have a lien of the Company's assets and the Company is required to maintain \$ 7,000 of compensating balances with the banks and is disclosed as part of short term bank deposits. 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 December 31, 2008, the Company was in compliance with its covenants to the banks.

**NOTE 12:- 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 2021.

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

2009	\$ 5,085
2010	4,521
2011	2,607
2012	2,459
2013	2,479
2014 and thereafter	<u>15,181</u>
	<u>\$ 32,332</u>

Rent expenses for the years ended December 31, 2006, 2007 and 2008, were approximately \$ 3,087, \$ 4,471 and \$ 6,432, 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, 2008, were approximately \$ 2,300,

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 12:- COMMITMENTS AND CONTINGENT LIABILITIES (Cont.)**

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

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

As of December 31, 2008, the Company has a contingent obligation to pay royalties in the amount of approximately \$ 4,865.

- d. Royalty commitments to third parties:

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

- e. Legal proceedings:

As of December 31, 2008, there are no material pending legal proceedings in which any member of the Group is a party.

**NOTE 13:- 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. The Company purchased 3,942,139 of its outstanding ordinary shares, at a weighted average price per share of \$ 2.87, under that program.

In January 2008, the Company's Board of Directors approved a new 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. During 2008, the Company purchased an additional 3,450,217 of its outstanding ordinary shares under the new share repurchase plan, at a weighted average price per share of \$ 3.98.

- b. Warrants issued to consultants:

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

During 2008, 10,000 warrants were granted to consultants at an exercise price of \$ 4.82 per share. The Company recorded compensation expenses in accordance with EITF No. 96-18. The amount recorded is immaterial. As of December 31, 2008, 10,000 warrants to consultants are outstanding and exercisable at an exercise price of \$ 4.82 per share.

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

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**NOTE 13:- SHAREHOLDERS' EQUITY (Cont.)**

## c. Employee Stock Purchase Plan:

In May 2001, the Company's Board of Directors adopted the Employee Stock Purchase Plan ("the Purchase Plan"), and, in July 2007, amended the Purchase Plan. As amended, the Purchase Plan provides for the issuance of a maximum of 6,500,000 ordinary shares. As of December 31, 2008, 4,004,683 shares are still available for future issuance under the Purchase Plan. 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 with SFAS 123R with respect to purchases under the Purchase Plan.

During the years ended December 31, 2006, 2007 and 2008, 323,303, 649,853 and 319,453 shares, respectively, were issued under the Purchase Plan for aggregate consideration of \$ 2,665, \$ 3,619 and \$ 1,214, respectively.

## d. Employee Stock Option Plans:

Under the Company's 1997 and 1999 Stock Option Plans, options to purchase ordinary shares may be granted to officers, directors, employees and consultants of the Group. As of December 31, 2008, both plans had expired and no options are available for future grants under these plans.

During 2008, the board of directors approved the 2008 Equity Incentive Plan that is effective starting January 2009. The total number of shares authorized for grant under this Plan is 2,009,122.

Stock options granted under the abovementioned plans are exercisable 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 years from the date of grant. Any options that are forfeited or cancelled before expiration become available for future grants.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 13:- SHAREHOLDERS' EQUITY (Cont.)**

The following is a summary of the Group's stock option activity and related information for the year ended December 31, 2008:

	Year ended December 31, 2008			
	Amount of options	Weighted average exercise price	Weighted average remaining contractual term (in years)	Aggregate intrinsic value
Outstanding at beginning of year	7,387,260	\$ 7.85		
Changes during the year:				
Granted	269,750	\$ 3.97		
Exercised	223,550	\$ 1.54		
Forfeited	845,823	\$ 9.28		
Expired	241,100	\$ 4.39		
Options outstanding at end of year	<u>6,346,537</u>	<u>\$ 7.81</u>	<u>3.1</u>	<u>\$ 67</u>
Vested and expected to vest	<u>5,648,418</u>	<u>\$ 7.81</u>	<u>3.1</u>	<u>\$ 60</u>
Options exercisable at end of year	<u>4,621,027</u>	<u>\$ 7.88</u>	<u>2.4</u>	<u>\$ 67</u>

The total intrinsic value of stock options exercised during 2008 was \$ 124.

The weighted-average grant-date fair value of options granted during the years ended December 31, 2006, 2007 and 2008 was \$ 5.81, \$ 3.23 and \$ 1.80, respectively. 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, 2006, 2007 and 2008 was \$ 4,790, \$ 613 and \$ 124, respectively. As of December 31, 2008, there was \$ 2,908 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 0.9 years.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 13:- SHAREHOLDERS' EQUITY (Cont.)**

The options outstanding as of December 31, 2008, have been separated into ranges of exercise prices, as follows:

Range of exercise price	Options outstanding as of December 31, 2008	Weighted average remaining contractual life (Years)	Weighted average exercise price	Options exercisable as of December 31, 2008	Weighted average exercise price of exercisable options
\$ 1.1	103,800	1.51	\$ 1.10	103,800	\$ 1.10
\$ 1.73-2.51	453,318	1.61	\$ 2.24	400,318	\$ 2.29
\$ 2.67-4	398,084	1.96	\$ 3.25	343,334	\$ 3.18
\$ 4.1-6.49	1,601,525	4.20	\$ 5.19	808,240	\$ 4.85
\$ 6.51-9.24	810,410	2.29	\$ 7.55	709,910	\$ 7.66
\$ 9.32-14.76	2,949,400	3.28	\$ 10.93	2,225,425	\$ 10.99
\$ 15.94	30,000	2.99	\$ 15.94	30,000	\$ 15.94
	<u>6,346,537</u>		<u>\$ 7.81</u>	<u>4,621,027</u>	<u>\$ 7.88</u>

- e. During 2008, 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 SFAS 123R. The Company calculated the incremental value of these modifications and recorded compensation cost in a total amount of \$ 402.

- 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 14a.)

**NOTE 14:- 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.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands, except share and per share data****NOTE 14:- TAXES ON INCOME (Cont.)**

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

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

Therefore, the Company's income derived from the 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, 2008, retained earnings included approximately \$ 540 in tax-exempt income earned by the Company's "Approved Enterprise". The Company's Board of Directors has decided not to declare dividends out of such tax-exempt income. Accordingly, no deferred income taxes have been provided on income attributable to the Company's "Approved Enterprise".

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

The entitlement to the above benefits is conditional upon the Company fulfilling the conditions stipulated by the 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, 2008, 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 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.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 14:- TAXES ON INCOME (Cont.)**

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, 2008, the Company has accumulated losses for tax purposes in the amount of approximately \$ 70,000, which can be carried forward and offset against taxable income in the future for an indefinite period. As of December 31, 2008, the Company recorded a deferred tax asset of \$ 1,447 relating to the available net carry forward tax losses.

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

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

5. Tax rates:

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

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

	<b>Year ended December 31,</b>		
	<b>2006</b>	<b>2007</b>	<b>2008</b>
Domestic	\$ 6,683	\$ 3,131	\$ 1,639
Foreign	1,399	(4,654)	(79,892)
	<u>\$ 8,082</u>	<u>\$ (1,523)</u>	<u>\$ (78,253)</u>

c. Taxes on income are comprised as follows:

	<b>Year ended December 31,</b>		
	<b>2006</b>	<b>2007</b>	<b>2008</b>
Current taxes	\$ 1,290	\$ (1,125)	\$ 674
Deferred taxes	(1,001)	2,390	(169)
	<u>\$ 289</u>	<u>\$ 1,265</u>	<u>\$ 505</u>

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 14:- TAXES ON INCOME (Cont.)**

	<b>Year ended December 31,</b>		
	<b>2006</b>	<b>2007</b>	<b>2008</b>
Domestic	\$ 846	\$ (1,575)	\$ (1,365)
Foreign	(557)	2,840	1,870
	<u>\$ 289</u>	<u>\$ 1,265</u>	<u>\$ 505</u>

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:

	<b>December 31,</b>	
	<b>2007</b>	<b>2008</b>
Deferred tax assets:		
Net operating loss carry forward	\$ 58,513	\$ 61,093
Reserves and allowances	5,823	2,351
Deferred tax assets before valuation allowance	64,336	63,444
Valuation allowance	(62,278)	(61,217)
Deferred tax asset	<u>\$ 2,058</u>	<u>\$ 2,227</u>
Domestic:		
Short term deferred tax assets	\$ -	\$ 652
Long term deferred tax asset	-	795
	<u>\$ -</u>	<u>\$ 1,447</u>
Foreign:		
Short term deferred tax assets	\$ 1,001	\$ 320
Long term deferred tax asset	1,057	460
	<u>\$ 2,058</u>	<u>\$ 780</u>

The Company's U.S. subsidiaries have estimated total available carry forward tax losses of approximately \$ 84,000 to offset against future taxable income that expire between 2015 and 2024. As of December 31, 2008, the Company recorded a deferred tax asset of \$ 780 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 14:- 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 operations is as follows:

	<b>Year ended December 31,</b>		
	<b>2006</b>	<b>2007</b>	<b>2008</b>
Income (loss) before taxes, as reported in the consolidated statements of operations	\$ 8,082	\$ (1,523)	\$ (78,253)
Statutory tax rate	31%	29%	27%
Theoretical tax expenses (benefits) on the above amount at the Israeli statutory tax rate	2,505	(442)	(21,128)
Income tax at rate other than the Israeli statutory tax rate (1)	(4,672)	655	139
Non-deductible expenses including equity based compensation expenses	4,008	2,432	970
Non-deductible expenses which results from Impairment of goodwill, other intangible assets and investment in affiliate	-	-	23,250
Deferred taxes on losses for which a valuation allowance was provided	(261)	3,333	75
Utilization of operation losses carry forward	(1,232)	(3,355)	(3,231)
Taxes in respect to prior years	(66)	(1,588)	87
State and Federal taxes	425	689	177
Inter-company charges	(299)	(430)	57
Other individually immaterial income tax item	(119)	(29)	109
Actual tax expense	\$ 289	\$ 1,265	\$ 505
(1) Per share amounts (basic) of the tax benefit resulting from the exemption	\$ 0.11	\$ 0.02	\$ 0.01
Per share amounts (diluted) of the tax benefit resulting from the exemption	\$ 0.11	\$ 0.02	\$ 0.01

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 14:- 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, 2008	\$	288
Increase in tax position for current year		23
		<u>          </u>
Gross unrecognized tax benefits as of December 31, 2008	\$	<u>311</u>

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 \$ 153 at December 31, 2007 and 2008, respectively

**NOTE 15:- BASIC AND DILUTED NET INCOME (LOSS) PER SHARE**

	<u>Year ended December 31,</u>		
	<u>2006</u>	<u>2007</u>	<u>2008</u>
Numerator:			
Net income (loss) available to shareholders of Ordinary shares	\$ <u>6,877</u>	\$ <u>(3,885)</u>	\$ <u>(81,340)</u>
Denominator:			
Denominator for basic earnings per share - weighted average number of Ordinary shares, net of treasury stock	41,716,626	42,699,307	41,200,523
Effect of dilutive securities:			
Employee stock options and ESPP	1,972,767	*) -	*) -
Senior convertible notes	*) -	*) -	*) -
Denominator for diluted net earnings per share - adjusted weighted average number of shares	\$ <u>43,689,393</u>	\$ <u>42,699,307</u>	\$ <u>41,200,523</u>

\*) Antidilutive.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 16:- FINANCIAL INCOME, NET**

	<b>Year ended December 31,</b>		
	<b>2006</b>	<b>2007</b>	<b>2008</b>
Financial expenses:			
Interest	\$ (2,961)	\$ (2,582)	\$ (2,357)
Amortization of marketable securities premiums and accretion of discounts, net	(224)	(40)	(110)
Others	(240)	(617)	(131)
	<u>(3,425)</u>	<u>(3,239)</u>	<u>(2,598)</u>
Financial income:			
Interest and others	7,242	5,909	3,780
	<u>\$ 3,817</u>	<u>\$ 2,670</u>	<u>\$ 1,182</u>

**NOTE 17:- 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, 2006, 2007 and 2008 and long-lived assets as of December 31, 2006, 2007 and 2008.

	<b>2006</b>		<b>2007</b>		<b>2008</b>	
	<b>Total revenues</b>	<b>Long-lived assets</b>	<b>Total revenues</b>	<b>Long-lived assets</b>	<b>Total revenues</b>	<b>Long-lived assets</b>
Israel	\$ 12,411	\$ 11,463	\$ 10,604	\$ 23,261	\$ 13,597	\$ 21,599
Americas	83,352	127,079	89,614	113,894	91,640	26,250
Europe	32,704	6	40,305	105	40,854	118
Far East	18,886	5	17,712	53	28,653	56
	<u>\$ 147,353</u>	<u>\$ 138,553</u>	<u>\$ 158,235</u>	<u>\$ 137,313</u>	<u>\$ 174,744</u>	<u>\$ 48,023</u>

- b. Product lines:

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

	<b>Year ended December 31,</b>		
	<b>2006</b>	<b>2007</b>	<b>2008</b>
Technology	\$ 70,013	\$ 56,426	\$ 58,484
Networking	77,340	101,809	116,260
	<u>\$ 147,353</u>	<u>\$ 158,235</u>	<u>\$ 174,744</u>

See also Note 1g.