**AUDIOCODES LTD. AND ITS SUBSIDIARIES**

**CONSOLIDATED FINANCIAL STATEMENTS**

**AS OF DECEMBER 31, 2009**

**IN U.S. DOLLARS**

**INDEX**


| | Page |
|---|---|
| Report of Independent Registered Public Accounting Firm | 2 - 3 |
| Consolidated Balance Sheets | 4 - 5 |
| Consolidated Statements of Operations | 6 |
| Statements of Changes in Shareholders' Equity | 7 |
| Consolidated Statements of Cash Flows | 8 - 9 |
| Notes to Consolidated Financial Statements | 10 - 44 |


- - - - - - - - - - -

ERNST & YOUNG

**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, 2008 and 2009, and the related consolidated statements of operations, changes in equity and cash flows for each of the three years in the period ended December 31, 2009. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with 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 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, 2008 and 2009, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2009, in conformity with accounting principles generally accepted in the United States.

As discussed in Note 2s and Note 10, the Company has changed its method of accounting for convertible debt instruments effective January 1, 2009, due to the adoption of FSP APB 14-1, “Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)”, as codified in ASC 470-20, “Debt with Conversion and Other Options”. The consolidated financial statements have been retrospectively adjusted to reflect the adoption of the FSP. Additionally as discussed in Note 2aa to the consolidated financial statements, effective January 1 2009 the Company changed its manner of accounting for the acquisition of non-controlling interest, due to the adoption of ASC 810 (formerly FAS 160, "Non-controlling Interest in Consolidation Financial Statements").

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, 2009, 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, 2010 expressed an unqualified opinion thereon.

Tel-Aviv, Israel
June 28, 2010

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

ERNST & YOUNG

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

**To the Board of Directors and Shareholders of**

**AudioCodes LTD.**

We have audited AudioCodes Ltd's ("AudioCodes" or "the Company") internal control over financial reporting as of December 31, 2009, 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, 2009, 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, 2008 and 2009 and the related consolidated statements of operations, changes in equity and cash flows for each of the three years in the period ended December 31, 2009 and our report dated June 28, 2010 expressed an unqualified opinion thereon.

Tel-Aviv, Israel
June 28, 2010

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

**CONSOLIDATED BALANCE SHEETS**

**U.S. dollars in thousands**

| | December 31, | |
|---|---|---|
| | **2008** | **2009** |
| ASSETS | | |
| CURRENT ASSETS: | | |
| Cash and cash equivalents | $ 36,779 | $ 38,969 |
| Short-term bank deposits | 61,870 | 13,902 |
| Short-term marketable securities and accrued interest | 16,481 | - |
| Trade receivables (net of allowance for doubtful accounts of $ 519 and $ 723 at December 31, 2008 and 2009, respectively) | 29,564 | 18,522 |
| Other receivables and prepaid expenses | 3,573 | 2,754 |
| Deferred tax assets | 972 | 1,053 |
| Inventories | 20,623 | 13,516 |
| Total current assets | 169,862 | 88,716 |
| LONG-TERM ASSETS: | | |
| Investment in companies | 1,245 | 1,510 |
| Deferred tax assets | 1,255 | 1,174 |
| Severance pay funds | 10,297 | 12,235 |
| Total long-term assets | 12,797 | 14,919 |
| PROPERTY AND EQUIPMENT, NET | 6,844 | 4,956 |
| INTANGIBLE ASSETS, DEFERRED CHARGES, NET (1) | 8,706 | 6,847 |
| GOODWILL | 32,095 | 32,095 |
| Total assets | $ 230,304 | $ 147,533 |

(1) See Note 2s and Note 10.

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

**CONSOLIDATED BALANCE SHEETS**

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

| | December 31, | |
|---|---|---|
| | **2008** | **2009** |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| CURRENT LIABILITIES: | | |
| Current maturities of long-term bank loans | $ 6,000 | $ 6,000 |
| Trade payables | 11,661 | 8,609 |
| Other payables and accrued expenses | 23,961 | 19,550 |
| Senior convertible notes (1) | 70,670 | - |
| Total current liabilities | 112,292 | 34,159 |
| LONG-TERM LIABILITIES: | | |
| Accrued severance pay | 12,174 | 13,336 |
| Senior convertible notes | - | 403 |
| Long-term banks loans | 21,750 | 15,750 |
| Total long-term liabilities | 33,924 | 29,489 |
| COMMITMENTS AND CONTINGENT LIABILITIES | | |
| EQUITY: | | |
| AudioCodes equity: | | |
| Share capital - | | |
| Ordinary shares of NIS 0.01 par value - | | |
| Authorized: 100,000,000 at December 31, 2008 and 2009; Issued: 47,574,800 shares at December 31, 2008 and 47,661,550 shares at December 31, 2009; Outstanding: 40,182,444 shares at December 31, 2008 and 40,269,194 shares at December 31, 2009 | 125 | 125 |
| Additional paid-in capital (1) | 186,998 | 189,079 |
| Treasury stock | (25,057) | (25,057) |
| Accumulated other comprehensive income (loss) | (912) | 98 |
| Accumulated deficit (1) | (77,294) | (80,116) |
| | 83,860 | 84,129 |
| Non controlling interest (2) | 228 | (244) |
| Total equity (1) (2) | 84,088 | 83,885 |
| Total liabilities and equity | $ 230,304 | $ 147,533 |

(1) See Note 2s and Note 10.
(2) See Note 2aa.

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

| June 28, 2010 | |
|---|---|
| Date of approval of the financial statements | Shabtai Adlersberg<br>Chief Executive Officer and<br>Interim Chief Financial Officer |

**CONSOLIDATED STATEMENTS OF OPERATIONS**
**U.S. dollars in thousands, except per share data**

| | Year ended December 31, | | |
|---|---|---|---|
| | **2007** | **2008** | **2009** |
| Revenues | $ 158,235 | $ 174,744 | $ 125,894 |
| Cost of revenues | 69,185 | 77,455 | 56,194 |
| Gross profit | 89,050 | 97,289 | 69,700 |
| Operating expenses: | | | |
| Research and development, net | 40,706 | 37,833 | 29,952 |
| Selling and marketing | 42,900 | 44,657 | 32,111 |
| General and administrative | 9,637 | 9,219 | 7,821 |
| Impairment of goodwill and other intangible assets | - | 85,015 | - |
| Total operating expenses | 93,243 | 176,724 | 69,884 |
| Operating loss | (4,193) | (79,435) | (184) |
| Financial expenses, net (1) | 2,167 | 3,268 | 2,744 |
| Loss before taxes on income | (6,360) | (82,703) | (2,928) |
| Taxes on income, net | 1,265 | 505 | 290 |
| Equity in losses of affiliated companies, net | 1,097 | 2,582 | 76 |
| Net loss | (8,722) | (85,790) | (3,294) |
| Net loss attributable to non-controlling interest | - | - | 472 |
| Net loss attributable to AudioCodes' shareholders | $ (8,722) | $ (85,790) | $ (2,822) |
| Basic and diluted net loss per share attributable to AudioCodes shareholders (1) | $ (0.20) | $ (2.08) | $ (0.07) |

(1) See Note 2s and Note 10.

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

## STATEMENTS OF CHANGES IN EQUITY

**U.S. dollars in thousands**

| | Share capital | Additional paid-in capital | Treasury stock | Accumulated other comprehensive income | Retained earnings (accumulated deficit) | Non-controlling interests | Total comprehensive income (loss) | Total equity |
|---|---|---|---|---|---|---|---|---|
| Balance as of January 1, 2007 | $ 131 | $ 169,456 | $ (11,320) | $ 122 | $ 17,218 | $ - | | $ 175,607 |
| 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 loss, net: | | | | | | | | |
| Unrealized gains on foreign currency cash flow hedges | - | - | - | 925 | - | - | $ 925 | 925 |
| Net loss (1) | - | - | - | - | (8,722) | | (8,722) | (8,722) |
| Total comprehensive loss, net | | | | | | | $ (7,797) | |
| Balance as of December 31, 2007 | 133 | 182,221 | (11,320) | 1,047 | 8,496 | - | | 180,577 |
| 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 |
| Early redemption of Senior Convertible Note | | (1,109) | | | | | | (1,109) |
| Acquisition of NSC (2) | - | - | - | - | - | 228 | - | 228 |
| Comprehensive loss, net: | | | | | | | | |
| Unrealized losses on foreign currency cash flow hedges | - | - | - | (1,959) | - | - | $ (1,959) | (1,959) |
| Net loss (1) | - | - | - | - | (85,790) | | (85,790) | (85,790) |
| Total comprehensive loss, net | | | | | | | $ (87,749) | |
| Balance as of December 31, 2008 | 125 | 186,998 | (25,057) | (912) | (77,294) | 228 | | 84,088 |
| Issuance of shares upon exercise of options and employee stock purchase plan | - | 90 | - | - | - | - | | 90 |
| Stock compensation related to options granted to employees | - | 1,991 | - | - | - | - | | 1,991 |
| Comprehensive loss, net: | | | | | | | | |
| Unrealized profit on foreign currency cash flow hedges | - | - | - | 1,010 | | - | $ 1,010 | 1,010 |
| Net loss | - | - | - | - | (2,822) | (472) | (3,294) | (3,294) |
| Total comprehensive loss, net | | | | | | | $ (2,284) | |
| Balance as of December 31, 2009 | $ 125 | $ 189,079 | $ (25,057) | $ 98 | $ (80,116) | $ (244) | | $ 83,885 |

(1) See Note 2s and Note 10.
(2) See Note 2aa.

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

## CONSOLIDATED STATEMENTS OF CASH FLOWS

**U.S. dollars in thousands**

| | Year ended December 31, | | |
|---|---|---|---|
| | **2007** | **2008** | **2009** |
| Cash flows from operating activities: | | | |
| Net loss (1) | $ (8,722) | $ (85,790) | $ (3,294) |
| Adjustments required to reconcile net loss to net cash provided by operating activities: | | | |
| Depreciation and amortization | 7,789 | 7,441 | 4,969 |
| Impairment of goodwill, other intangible assets and investment in affiliate | - | 86,111 | - |
| Amortization of marketable securities premiums and accretion of discounts, net | 39 | 112 | 252 |
| Equity in losses of affiliated companies, net | 1,097 | 1,486 | 76 |
| Stock-based compensation expenses | 7,967 | 4,341 | 1,991 |
| Amortization of senior convertible notes discount and deferred charges and gain from redemption (1) | 5,040 | 4,592 | 2,930 |
| Decrease (increase) in accrued interest on marketable securities, bank deposits and structured notes | (611) | 125 | 2,312 |
| Decrease (increase) in deferred tax assets, net | 2,390 | (169) | - |
| Decrease (increase) in trade receivables, net | 5,014 | (3,960) | 11,042 |
| Decrease (increase) in other receivables and prepaid expenses | (1,412) | 450 | 908 |
| Decrease (increase) in inventories | (2,643) | (1,840) | 7,107 |
| Increase (decrease) in trade payables | 1,263 | 2,728 | (3,052) |
| Increase (decrease) in other payables and accrued expenses (2) | (5,181) | 333 | (3,491) |
| Increase (decrease) in accrued severance pay, net | 356 | 451 | (776) |
| Net cash provided by operating activities | 12,386 | 16,411 | 20,974 |
| Cash flows from investing activities: | | | |
| Investments in affiliated companies | (1,003) | (6,330) | (341) |
| Purchase of property and equipment | (2,629) | (3,158) | (1,271) |
| Purchase of marketable securities | - | (16,795) | |
| Investment in short-term and long-term bank deposits | (29,065) | (100,864) | (49,318) |
| Proceeds from short-term bank deposits | 28,700 | 90,142 | 95,203 |
| Proceeds from structured notes called by the issuer | 10,000 | - | - |
| Proceeds from redemption of marketable securities upon maturity | 31,600 | 17,000 | 16,000 |
| Payment for acquisition of CTI Squared Ltd ("CTI$^2$") (3) | (4,897) | - | - |
| Net cash provided by (used in) investing activities | 32,706 | (20,005) | 60,273 |
| Cash flows from financing activities: | | | |
| Purchase of treasury stock | - | (13,747) | - |
| Redemption of senior convertible notes | - | (50,240) | (73,147) |
| Proceeds from long-term bank loans | - | 30,000 | - |
| Repayment of long-term bank loans | - | (2,250) | (6,000) |
| Proceeds from issuance of shares upon exercise of options and employee stock purchase plan | 4,800 | 1,547 | 90 |
| Net cash provided by (used in) financing activities | 4,800 | (34,690) | (79,057) |
| Increase (decrease) in cash and cash equivalents | 49,892 | (38,284) | 2,190 |
| Cash and cash equivalents at the beginning of the year | 25,171 | 75,063 | 36,779 |
| Cash and cash equivalents at the end of the year | $ 75,063 | $ 36,779 | $ 38,969 |

(1) See Note 2s and Note 10.
(2) See Note 2aa.

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

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

**U.S. dollars in thousands**

| | Year ended December 31, | | |
|---|---|---|---|
| | **2007** | **2008** | **2009** |
| (3) Payment for acquisition of CTI Squared Ltd. | | | |
| Net fair value of assets acquired and liabilities assumed of CTI[2] at the date of acquisition (see also Note 1b): | | | |
| Working capital, net (excluding cash and cash equivalents) | $ (7,519) | $ - | $ - |
| Technology | 1,530 | - | - |
| Backlog | 41 | - | - |
| Goodwill | 10,845 | - | - |
| | $ 4,897 | $ - | $ - |
| (4) Supplemental disclosure of cash flow activities: | | | |
| Cash paid during the year for income taxes | $ 403 | $ 646 | $ 363 |
| Cash paid during the year for interest | $ 2,500 | $ 2,455 | $ 2,238 |

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

**NOTE 1:- GENERAL**

a. Business overview:

AudioCodes Ltd. ("the Company") and its subsidiaries (together "the Group") 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 global economic slowdown and credit crisis. During 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 2k).
Intangible assets – $ 5,898 (see also Notes 2k and 7).

b. Acquisition of CTI Squared Ltd.:

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

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

$CTI^2$ became a wholly-owned subsidiary of the Company and, accordingly, its results of operations have been included in the consolidated financial statements of the Group since the acquisition date.

This acquisition was accounted for under the purchase method of accounting in accordance with FAS 141, "Business Combination".

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

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

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

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

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.

The value assigned to tangible and intangible assets acquired and liabilities assumed was 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.

c. Acquisition of Natural Speech Communication Ltd.:

Through December 31, 2009, the Group had invested an aggregate of $ 8,418 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 it became the primary beneficiary in accordance with FIN No. 46R, "Consolidation of Variable Interest Entities in interpretation of ARB No. 51".
As of December 31, 2009, the Group owned 59.74% of the outstanding share capital of NSC. (See also Note 19).

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

This acquisition was accounted for in accordance with the measurement guidance in FIN 46R.

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

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 NSC. Therefore, the excess was allocated and reported as a pro-rata adjustment to all of the 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.

| | Year ended December 31, | |
|---|---|---|
| | 2007 | 2008 |
| Revenues | $ 159,358 | $ 175,489 |
| Net loss | $ (5,621) | $ (83,604) |
| Basic and diluted net loss per share | $ (0.13) | $ (2.03) |

d. 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.

e. In January 2009, the Group's largest customer announced that it would seek creditor protection for itself and some of its subsidiaries. As a result from 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 future revenues and the results of operations. For the years ended December 31, 2007, 2008 and 2009, this customer accounted for 17.0%, 14.4% and 15.6%, respectively, of the Group's revenues.

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES**

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

a. Use of estimates:

The preparation of financial statements in conformity with 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. As applicable to these consolidated financial statements, the most significant estimates and assumptions relate to sales reserves and allowances, income taxes, valuation of goodwill and intangible assets, purchase price allocation on acquisitions, inventories, and assumptions related to the application of the amended ASC 470-20, with regards to convertible notes issues by the Company and which may be settled in cash upon conversion. 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 ASC 830 (formerly: FAS 52), "Foreign Currency Matters". 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 4.00% and 0.35% for 2008 and 2009, respectively. Short-term deposits are presented at their cost, including accrued interest. The banks have a lien on the Company's assets and the Company is required to maintain $ 7,000 of compensating balances with the banks which are included in short-term bank deposits (see also Note 11.)

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

f. Marketable securities:

The Company accounts for investments in debt securities in accordance with ASC 320 (formerly FAS 115), "Investments-Debt and Equity Securities".

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 year ended December 31, 2008, all securities covered by ASC No. 320 were designated by the Company's management as held-to-maturity. As of December 31, 2009, the Group does not hold any marketable securities.

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.

Effective January 1, 2009, the Company adopted an amendment to ASC 320 which changed the impairment and presentation model for its debt securities. The amendment had no effect on the Company.

For the years ended December 31, 2007, 2008 and 2009, 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 "weighted average cost" method.
Finished products - using the "weighted average cost" method with the addition of direct manufacturing costs.

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

h. 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 ASC 323 (formerly Accounting Principle Board ("APB") No. 18), "Investments-Equity method and Joint Ventures". 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.

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

Investment in companies represents investments in ordinary shares, preferred shares and convertible loans. According to ASC 323, 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 ASC 323. As of December 31, 2007 and 2009, 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.

i. Property and equipment:

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

| | % |
|---|---|
| Computers and peripheral equipment | 33 |
| Office furniture and equipment | 6 - 20 (mainly 15%) |
| Leasehold improvements | Over the shorter of the term of the lease or the life of the asset |

j. Deferred charges:

Costs 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 five-year-period from issuance to expected maturity in November 2009, in accordance ASC No. 470. See also Note 2s, Note 7 and Note 10.

k. Impairment of long-lived assets:

The Group's long-lived assets are reviewed for impairment in accordance with ASC 360-10-35 (formerly FAS 144), "Property, Plant and Equipment - Subsequent Measurement", 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, 2007, 2008 and 2009, 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.

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

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 2007 and 2009, no impairment charges were identified. During 2008, the Company recorded an impairment charge for intangible assets in the amount of $ 5,898 (See also Note 1).

l. Goodwill:

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 ASC 350 (formerly FAS 142), "Intangible, Goodwill and Other", Goodwill is not amortized, but rather is subject to an annual impairment test. ASC 350 requires goodwill to be tested for impairment at least annually or between annual tests in certain circumstances, and written down when impaired.

The Company performs annual impairment analysis of goodwill at December 31 of each year, or more often as applicable. The provisions of ASC No. 350 require that a two-step impairment test be performed on goodwill at the level of the reporting units. In the first step, the Company compares the fair value of each reporting unit to its carrying value. If the fair value exceeds the carrying value of the net assets, goodwill is considered not impaired, and no further testing is required to be performed. If the carrying value of the net assets exceeds the fair value, then the Company must perform the second step of the impairment test in order to determine the implied fair value of goodwill. If the carrying value of goodwill exceeds its implied fair value, then the Company would record an impairment loss equal to the difference.

The Company believes that its business activity and management structure meet the criterion of being a single reporting unit for accounting purposes. The Company has performed an annual impairment analysis as of December 31, 2007, 2008 and 2009 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.

During 2007 and 2009, no impairment charges were identified. In 2008, as the fair value of the net assets of the reporting unit was lower than the carrying value as of the valuation date, the goodwill was deemed to be impaired and step 2 analysis was required. During 2008, an impairment charge to goodwill in the amount of $ 79,117 was recorded. (See also Note 1).

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

m. 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", 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 ASC No. 605. The provision was deducted from revenues and amounted to $ 559, $ 754 and $ 656, as of December 31, 2007, 2008 and 2009, 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.

n. 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.

o. Research and development costs:

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

p. Income taxes:

The Group accounts for income taxes in accordance with ASC 740 (formerly FAS 109), "Income Taxes". ASC 740 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.

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

ASC 740 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 an amendment to ASC 740. The initial application of the amendment 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.

q. Comprehensive income (loss)

The Company accounts for comprehensive income (loss) in accordance with ASC 220 (formerly FAS 130) "Comprehensive Income". ASC 220 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.

r. 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.

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.

s. Senior convertible notes:

Effective January 1, 2009, the Company adopted an amendment to ASC 470-20, "Debt with Conversion and Other Options" (originally issued as 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 on the issuance day in a manner that will reflect the entity's nonconvertible debt borrowing rate when interest cost is recognized in subsequent periods. The amended ASC 470-20 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. The Company applied this amendment to ASC 470-20 retrospectively to all periods presented and comparative figures have been adjusted accordingly. See also Note 10.

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

The Company presents the outstanding principal amount of its senior convertible notes as a long-term liability, in accordance with ASC 210-10-45. 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 on the debt is amortized according to the interest method over the expected five-year term of the senior convertible notes in accordance with ASC 470,-20 This five-years-period ended in November 2009. Please refer also to Note 10.

According to ASC 470-20, if an instrument within the scope of this ASC is repurchased, an issuer shall allocate the consideration transferred and related transaction costs incurred, to the extinguishment of the liability component and the reacquisition of the equity component.

t. 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 ASC No. 260 (formerly FAS 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 11,765,438, 12,156,728 and 8,768,909 for the years ended December 31, 2007, 2008 and 2009, respectively.

u. Accounting for stock-based compensation:

The Company accounts for stock-based compensation in accordance with ASC 718 formerly FAS 123(R)) "Compensation-Stock Compensation" 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. ASC No. 718 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 Company applies ASC 718 and ASC 505-50 (formerly, EITF 96-18), "Equity-Based Payments to Non-Employees" with respect to options and warrants issued to non-employees. Accordingly, the Company uses option valuation models to measure the fair value of the options and warrants at the measurement date as defined in ASC 505-50.

During 2008 and 2009, the Company decided on an exceptional and ex-gratia basis to extend the validity of certain options granted to employees by a period of 1-2 years and re-priced the exercise price to certain employees.

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

The Company accounted for these changes as modification in accordance with ASC 718. A modification to the terms of an award should be treated as an exchange of the original award for a new award with total compensation cost equal to the grant-date fair value of the original award plus the incremental value measured at the same date. Under ASC 718, the calculation of the incremental value is based on the excess of the fair value of the new (modified) award based on current circumstances over the fair value of the original option measured immediately before its terms are modified based on current circumstances.

The weighted-average estimated fair value of employee stock options granted during the years ended December 31, 2007, 2008 and 2009, was $ 3.23, $ 1.89 and $ 1.22 per share, respectively, using the Black-Scholes option pricing formula. Fair values were estimated using the following weighted-average assumptions (annualized percentages):

| | Year ended December 31, | | |
|---|---|---|---|
| | **2007** | **2008** | **2009** |
| Dividend yield | 0% | 0% | 0% |
| Expected volatility | 54.7% | 52.0% | 48.7% |
| Risk-free interest | 4.6% | 2.6% | 2.3% |
| Expected life | 4.8 years | 4.8 years | 5.0 years |
| Forfeiture rate | 7.0% | 11.0% | 7.0% |

The Company used its historical volatility in accordance with ASC 718. The computation of volatility uses historical volatility derived from the Company's exchange traded shares. In 2009, 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 2008, the expected term was determined based on the simplified method in accordance with SAB 107 and SAB 110. 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 total equity-based compensation expense relating to all of the Company's equity-based awards recognized for the twelve months ended December 31, 2007, 2008 and 2009 was included in items of the consolidated statements of income as follows:

| | Year ended December 31, | | |
|---|---|---|---|
| | **2007** | **2008** | **2009** |
| Cost of revenues | $ 613 | $ 318 | $ 117 |
| Research and development, net | 3,011 | 1,467 | 642 |
| Selling and marketing expenses | 3,476 | 2,026 | 913 |
| General and administrative expenses | 867 | 530 | 319 |
| Total equity-based compensation expenses | $ 7,967 | $ 4,341 | $ 1,991 |

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

v. 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.

w. 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, 2007, 2008 and 2009, amounted to approximately $ 2,409, $ 2,701 and $1,136, respectively.

x. 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 $ 16.5 during 2009 ($ 22 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 2007, 2008 and 2009, the Group matched contributions in the amount of $ 361, $ 380 and $ 280, respectively.

y. Advertising expenses:

Advertising expenses are charged to the statements of operations as incurred. Advertising expenses for the years ended December 31, 2007, 2008 and 2009, amounted to $ 350, $ 407 and $139, respectively.

z. 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:

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

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 fair value of long-term bank loans and senior convertible loans also approximates their carrying value, since they bear interest at rates close to the prevailing market rates.

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

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, ASC 820 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 - Observable inputs, other than quoted prices included in Level 1, such as quoted prices for similar assets and liabilities in active markets; quoted prices for identical or similar assets and liabilities in markets that are not active; or other inputs that are observable or can be corroborated by observable market data

Level 3 - Unobservable inputs which are supported by little or no market activity and that are significant to the fair value of the assets and liabilities. This includes certain pricing models, discounted cash flow methodologies and similar techniques that use significant unobservable inputs

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 Notes 3 and 8).

The Company adopted the provisions of ASC 820-10, "Fair Value Measurements and Disclosures" (formerly FAS 157, "Fair Value Measurements"), with respect to non-financial assets and liabilities effective January 1, 2009. The adoption of ASC 820-10 did not have a material impact on the Company’s consolidated financial statements.

In April 2009, the Company adopted the FASB's updated guidance ASC 820-10 (formerly, FSP FAS 157-4), related to fair value measurements and disclosures, which provides additional guidance for estimating fair value in accordance with the guidance related to fair value measurements when the volume and level of activity for an asset or liability have significantly decreased. The amended ASC 820-10 also includes guidance on identifying circumstances that indicate a transaction is not orderly. The adoption of this guidance did not have a material effect on the consolidated financial statements.

aa. Consolidation

On January 1, 2009, the Company adopted an amendment to ASC 810, "Consolidation" (originally issued as FAS 160). According to the amendment, non-controlling interest in a subsidiary is an ownership interest in the consolidated entity that should be reported as a separate component of equity in the consolidated financial statements. As such, changes in the parent's ownership interest with no change of control are treated as equity transactions, rather than step acquisitions or dilution gains or losses. The amendment clarifies that losses of partially owned consolidated subsidiaries shall continue to be allocated to the non-controlling interests even when their investment was already reduced to zero.

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

The amendment applies prospectively, except for the presentation and disclosure requirements, which are applied retrospectively to all periods presented. As a result, upon adoption, the Company retroactively reclassified the "Minority interests" balance to be presented in a new caption in total shareholders' equity, "Non-controlling interest". The adoption also impacted certain captions previously used in the consolidated statement of operations, largely identifying net loss including the portion attributable to non-controlling interest and net loss attributable to AudioCodes' shareholders. This amendment required the Company to include the accumulated amount of non-controlling interest as part of shareholders' equity ($ 228 at December 31, 2008).

The net loss amounts the Company has previously reported are now presented as "Net loss attributable to AudioCodes' shareholders," and, as required, net loss per share continue to reflect amounts attributable only to AudioCodes' shareholders. Similarly, in the statements of changes in shareholders' equity, the Company distinguished between equity amounts attributable to AudioCodes' shareholders and amounts attributable to the non-controlling interest.

ab. Variable interest entities

ASC 810-10, "Consolidation" provides a framework for identifying Variable Interest Entities ("VIEs") and determining when a company should include the assets, liabilities, non-controlling interests and results of activities of a VIE in its consolidated financial statements.

The Company's assessment of whether an entity is a VIE and the determination of the primary beneficiary is judgmental in nature and involves the use of estimates and assumptions. Those include, among others, forecasted cash flows, their respective probabilities and the economic value of certain preference rights. In addition, such assessment also involves estimates of whether a group entity can finance its current activities, until it reaches profitability, without additional subordinated financial support.

ac. Derivatives and hedging:

The Company accounts for derivatives and hedging based on ASC 815 (formerly FAS 133), "Derivatives and Hedging" ("ASC No. 815").

The Company accounts for its derivative instruments as either assets or liabilities and carries them at fair value. Derivative instruments that are not designated and qualified as hedging instruments must be adjusted to fair value through earnings.

For derivative instruments that hedge the exposure to variability in expected future cash flows that are designated as cash flow hedges, the effective portion of the gain or loss on the derivative instrument is reported as a component of accumulated other comprehensive income (loss) in equity and reclassified into earnings in the same period or periods during which the hedged transaction affects earnings and is classified as finance income (expense), net. The ineffective portion of the gain or loss on the derivative instrument is recognized in current earnings and classified as finance income. To receive hedge accounting treatment, cash flow hedges must be highly effective in offsetting changes to expected future cash flows on hedged transactions.

During 2009, the Company recorded accumulated other comprehensive income in the amount of $ 1,010 from its currency forward with respect to payroll and rent expenses expected to be incurred during 2009. Such amount will be recorded into earnings during 2010. See also Note 18.

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

ad. Codification:

In June 2009, the Financial Accounting Standards Board ("FASB") issued a standard that established the FASB Accounting Standards Codification ("ASC") and amended the hierarchy of generally accepted accounting principles ("GAAP") such that the ASC became the single source of authoritative U.S. GAAP. Rules and interpretive releases issued by the SEC under authority of federal securities law are also sources of the authoritative GAAP for SEC registrants. All other literature is considered non-authoritative. New accounting standards issued subsequent to June 30, 2009 are communicated by the FASB through Accounting Standards Updates ("ASUs"). The ASC is effective for the Company from September 1, 2009. Throughout the notes to the consolidated financial statements references that were previously made to former authoritative U.S. GAAP pronouncements have been changed to coincide with the appropriate section of the ASC.

ae. Impact of recently issued accounting pronouncements:

(1) In October 2009, the FASB issued an update to ASC No. 605-25, "Revenue recognition - Multiple-Element Arrangements", that provides amendments to the criteria for separating consideration in multiple-deliverable arrangements to:

a) Provide updated guidance on whether multiple deliverables exist, how the deliverables in an arrangement should be separated, and how the consideration should be allocated;
b) Require an entity to allocate revenue in an arrangement using estimated selling prices ("ESP") of deliverables if a vendor does not have vendor-specific objective evidence of selling price ("VSOE") or third-party evidence of selling price ("TPE");
c) Eliminate the use of the residual method and require an entity to allocate revenue using the relative selling price method.
d) Require expanded disclosures of qualitative and quantitative information regarding application of the multiple-deliverable revenue arrangement guidance.

The mandatory adoption date is January 1, 2011. The Company may elect to adopt the update prospectively, to new or materially modified arrangements beginning on the adoption date, or retrospectively, for all periods presented. The Company is currently evaluating the impact of this update on its consolidated results of operations and financial condition.

(2) In January 2010, the FASB updated the "Fair Value Measurements Disclosures". More specifically, this update will require (a) an entity to disclose separately the amounts of significant transfers in and out of Level 1 and 2 fair value measurements and to describe the reasons for the transfers; and (b) information about purchases, sales, issuances and settlements to be presented separately (i.e. present the activity on a gross basis rather than net) in the reconciliation for fair value measurements using significant unobservable inputs (Level 3 inputs). This update clarifies existing disclosure requirements for the level of disaggregation used for classes of assets and liabilities measured at fair value, and requires disclosures about the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements using Level 2 and Level 3 inputs. As applicable to the Company, this will become effective as of the first interim or annual reporting period beginning after December 15, 2009, except for the gross presentation of the Level 3 roll forward information, which is required for annual

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

reporting periods beginning after December 15, 2010 and for interim reporting periods within those years. The Company does not expect that the adoption of the new guidance will have a material impact on its consolidated financial statements.

(3) In June 2009, the FASB issued an update to ASC 810, "Consolidation," which, among other things, (i) requires ongoing reassessments of whether an entity is the primary beneficiary of a variable interest entity and eliminates the quantitative approach previously required for determining the primary beneficiary of a variable interest entity; (ii) amends certain guidance for determining whether an entity is a variable interest entity; and (iii) requires enhanced disclosure that will provide users of financial statements with more transparent information about an entity’s involvement in a variable interest entity. The update is effective for interim and annual periods beginning after November 15, 2009. The Company does not expect the adoption of the update to have a material impact on its financial condition or results of operations.

af. Reclassification:

Certain 2008 figures have been reclassified to conform to the 2009 presentation. The reclassification had no effect on previously reported net income (loss), shareholders' equity or cash flows.

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

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

| | December 31, 2008 | | |
|---|---|---|---|
| | Amortized cost | Net unrealized losses | Fair Value |
| Corporate debentures: | | | |
| Maturing within one year | $ 16,253 | $ 1 | $ 16,252 |
| | 16,253 | 1 | 16,252 |
| Accrued interest | 228 | - | 228 |
| | $ 16,481 | $ 1 | $ 16,480 |

The unrealized losses on the Company's investments are due to interest rate increases. The contractual cash flows of these investments were issued by highly rated corporations. Accordingly, it was expected that the securities would not be settled at a price less than the amortized cost of the Company's investment. Since the Company had the ability and intent to hold these investments until a recovery of fair value, the Company did not consider these investments to be other-than-temporarily impaired as of December 31, 2008.

During 2009, all marketable securities were redeemed upon contractual maturity.

## NOTE 4:- INVENTORIES

| | December 31, 2008 | December 31, 2009 |
|---|---|---|
| Raw materials | $ 9,346 | $ 5,923 |
| Finished products | 11,277 | 7,593 |
| | $ 20,623 | $ 13,516 |

In the years ended December 31, 2007, 2008 and 2009, the Group wrote-off inventories in a total amount of $ 973, $ 2,356 and $ 3,421, respectively.

## NOTE 5:- INVESTMENT IN COMPANIES

a. As of December 31, 2009 the Company owns 20.21% of Mailvision's outstanding share capital.

| | December 31, 2008 | December 31, 2009 |
|---|---|---|
| Invested in equity | $ 993 | $ 993 |
| Loans | 301 | 642 |
| Accumulated net loss | (49) | (125) |
| Total investment | $ 1,245 | $ 1,510 |

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 this loan. During 2008, the Company received back shares of another unrelated privately-held company and $ 870 in cash. The remaining balance of the loan in the amount of $ 130 and received shares were written off.

## NOTE 6:- PROPERTY AND EQUIPMENT

| | December 31, 2008 | December 31, 2009 |
|---|---|---|
| Cost: | | |
| Computers and peripheral equipment | $ 18,645 | $ 19,852 |
| Office furniture and equipment | 9,466 | 9,458 |
| Leasehold improvements | 2,437 | 2,354 |
| | 30,548 | 31,664 |
| Accumulated depreciation: | | |
| Computers and peripheral equipment | 15,507 | 17,359 |
| Office furniture and equipment | 7,154 | 8,276 |
| Leasehold improvements | 1,043 | 1,073 |
| | 23,704 | 26,708 |
| Depreciated cost | $ 6,844 | $ 4,956 |

Depreciation expenses amounted to $ 3,392, $ 3,602 and $ 3,159 for the years ended December 31, 2007, 2008 and 2009, respectively.

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

| | | Useful life (years) | December 31, 2008 | December 31, 2009 |
|---|---|---|---|---|
| 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 |
| | Deferred charges | 5 | 478 | 478 |
| | | | 26,661 | 26,661 |
| | Accumulated amortization: | | | |
| | Acquired technology | | 8,847 | 10,321 |
| | Customer relationship | | 2,222 | 2,521 |
| | Trade name | | 389 | 415 |
| | Existing contracts for maintenance | | 170 | 181 |
| | Deferred charges | | 429 | 478 |
| | | | 12,057 | 13,916 |
| | Impairment: | | | |
| | Acquired technology | | 1,995 | 1,995 |
| | Customer relationship | | 3,829 | 3,829 |
| | Trade name | | 51 | 51 |
| | Existing contracts for maintenance | | 23 | 23 |
| | | | 5,898 | 5,898 |
| | Amortized cost | | $ 8,706 | $ 6,847 |

b. Amortization expenses related to intangible assets amounted to $ 4,397, $ 3,839 and $ 1,810 for the years ended December 31, 2007, 2008 and 2009, respectively.

c. Amortization expenses related to deferred charges amounted to $ 96, $ 94 and $ 49 for the years ended December 31, 2007, 2008 and 2009, respectively.

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

| | |
|---|---|
| 2010 | $ 1,530 |
| 2011 | $ 1,327 |
| 2012 | $ 1,124 |
| 2013 | $ 933 |
| 2014 | $ 869 |
| 2015 and thereafter | $ 1,064 |

**NOTE 8:- FAIR VALUE MEASUREMENTS**

In accordance with ASC No. 820, the Company measures its foreign currency derivative instruments at fair value. Investments in foreign currency derivative instruments are classified within Level 2 value hierarchy. This is because these assets are valued using alternative pricing sources and models utilizing market observable inputs.

| | December 31, 2008 | December 31, 2009 |
|---|---|---|
| Foreign currency derivative instruments | (912) | 98 |

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

| | December 31, 2008 | December 31, 2009 |
|---|---|---|
| Employees and payroll accruals | $ 7,537 | $ 6,947 |
| Royalties provision | 1,066 | 1,403 |
| Government authorities | 184 | 594 |
| Accrued expenses | 11,342 | 8,172 |
| Deferred revenues | 3,695 | 1,964 |
| Others | 137 | 470 |
| | $ 23,961 | $ 19,550 |

**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. Upon such conversion in lieu of the delivering of ordinary shares, the Company may elect to pay the holders cash or a combination of cash and ordinary shares. The Notes are subject to redemption at any time on or after November 9, 2009, in whole or in part, at the option of the Company, at a redemption price of 100% of the principal amount plus accrued and unpaid interest. The Notes are subject to repurchase, at the holders' option, on November 9, 2009, November 9, 2014 or November 9, 2019, at a repurchase price equal to 100% of the principal amount plus accrued and unpaid interest, if any, on such repurchase date. The Company may choose to settle in cash upon conversion.

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

Effective January 1, 2009, the Company adopted the amendment to ASC 470-20 (formerly FSP APB 14-1) "Debt with Conversion and Other Options". The amendment 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. As a result, the Company recorded an additional $ 2,775 interest expense in 2009.

The cumulative effect of the change in accounting principle on periods prior to these presented in the amount of $ 9,329 is recognized as of the beginning of the first period presented, as an offsetting adjustment to the opening balance of retained earnings for that period. In addition, an increase of $ 20,251 was recorded to additional paid in capital as of January 1, 2007.

During 2008 and 2009, the Company repurchased $ 51,500 and $73,100, respectively, in principal amount of its 2% Senior Convertible Notes for a total cost, including accrued interest, of $ 50,200 and $ 73,147, respectively. Based on the amended ASC-470-20 and as a result of the repurchase, the Company recorded a gain in the amount of $ 372 related to the liability component and a decrease of additional paid-in capital in the amount of $ 1,109 related to the equity component in its 2008 statements of operations. There was no gain or loss in connection with the repurchase in 2009. As of December 31, 2009, $ 403 in the principal amount of the notes remained outstanding.

The following tables shows the financial statements line items affected by retrospective application of an amendment to ASC 470-20 (formerly FSP APB 14-1), "Debt with Conversion and Other Options" on the affected financial statement line items for the periods indicated:

| | Year ended December 31, | | | | | |
|---|---|---|---|---|---|---|
| | 2007 | | | 2008 | | |
| | As previously reported | Effect of change | As adjusted under the amended ASC 470-20 | As previously reported | Effect of change | As adjusted under the amended ASC 470-20 |
| Financial income (loss) | 2,670 | (4,837) | (2,167) | 1,182 | (4,450) | (3,268) |
| Loss before income taxes | (1,523) | (4,837) | (6,360) | (78,253) | (4,450) | (82,703) |
| Net loss | (3,885) | (4,837) | (8,722) | (81,340) | (4,450) | (85,790) |
| Net loss per share: | | | | | | |
| Basic and diluted | $ (0.09) | $ (0.11) | $ (0.2) | $ (1.97) | $ (0.11) | $ (2.08) |

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

| | December 31, 2008 | | |
|---|---|---|---|
| | As previously reported | Effect of change | As adjusted under the amended ASC 470-20 |
| Intangible assets, deferred charges and other, net | $ 9,084 | $ (178) | $ 8,906 |
| Total assets | $ 230,482 | $ (178) | $ 230,304 |
| Senior convertible note | $ 71,374 | $ (704) | $ 70,670 |
| Equity: | | | |
| Additional paid-in capital | $ 167,856 | $ 19,142 | $ 186,998 |
| Accumulated deficit | $ (58,678) | $ (18,616) | $ (77,294) |
| Total equity | $ 83,334 | $ 754 | $ 84,088 |
| Total liabilities and equity | $ 230,482 | $ (178) | $ 230,304 |

The table below shows the components of the net carrying amount of the liability component and the equity component of the Notes at December 31, 2008 and at December 31, 2009:

| | December 31, | |
|---|---|---|
| | 2008 | 2009 |
| Principal amount of liability component | $ 73,498 | $ 403 |
| Unamortized discount | 2,828 | - |
| Net carrying amount of liability component | $ 70,670 | $ 403 |
| Equity component | $ 19,142 | $ 19,142 |

The following represents the components of interest expense and effective interest rates relating to the Notes:

| | Year ended December 31, | | |
|---|---|---|---|
| | 2007 | 2008 | 2009 |
| Contractual interest expense | $ 2,498 | $ 2,308 | $ 1,260 |
| Amortization of discount | 4,945 | 4,868 | 2,828 |
| Total interest expense | $ 7,443 | $ 7,176 | $ 4,088 |
| Effective interest rate | 3.35% | 3.35% | 3.35% |

## NOTE 11:- LONG-TERM BANK LOANS

In April and July 2008, the Company entered into loan agreements with banks in Israel and was provided with loans in the total amount of $ 30,000. The loans bear interest at LIBOR plus 1.3%-1.5% with respect to $ 23,000 of the loans and LIBOR plus 0.5%-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 which are included in short term bank deposits. The agreement requires the Company, among other things, to maintain 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, 2009, 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:

| | |
|---|---|
| 2010 | $ 4,686 |
| 2011 | 6,146 |
| 2012 | 5,624 |
| 2013 | 2,399 |
| 2014 | 2,414 |
| 2015 and thereafter | 12,901 |
| | $ 34,170 |

In connection with the Company's offices lease agreement in Israel, the lessor has a lien on $3,500 of short term bank deposits.

Rent expenses for the years ended December 31, 2007, 2008 and 2009, were approximately $ 4,471, $ 6,432 and $ 4,558, respectively.

b. Other commitments:

The Company is obligated under certain agreements with its suppliers to purchase specified items of excess inventory. Non- cancelable obligations as of December 31, 2009, were approximately $ 930.

**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, 2009, the Company has a contingent obligation to pay royalties in the amount of approximately $ 8,715.

As of December 31, 2009, the Company has paid or accrued royalties to the OCS in the amount of $ 360, which was recorded to cost of revenues.

d. Royalty commitments to third parties:

The Group has entered into technology licensing fee agreements with third parties. Under the agreements, the Group agreed to pay the third parties royalties, based on sales of relevant products.

e. Legal proceedings:

In September 2009, Network Gateway Solutions LLC filed a claim against AudioCodes Ltd. and AudioCodes Inc. and 19 other defendants alleging infringement of certain patents. The case is still at an early stage. The amount of monetary demand or a settlement demand of any kind was not indicated. Due to the preliminary stage of the claim, the Company and its legal advisors can not currently assess the outcome or possible adverse effect on the Company's consolidated financial position or results of operations. However, the Company believes that it has substantial legal claims to oppose these allegations.

Prior to the acquisition of Nuera Communications Inc. by the Company in 2006, one of Nuera’s customers had been named as a defendant in a patent infringement suit involving technology the customer purchased from Nuera. In the suit, the plaintiff alleged that the customer used devices to offer services that infringe upon a patent the plaintiff owns. The customer has sought indemnification from Nuera pursuant to the terms of a purchase agreement between Nuera and the customer relating to the allegedly infringing technology at issue. There were no additional developments and the Company and its legal advisors can not currently assess the outcome or possible adverse effect on the Company's financial position or results of operations. However, the Company believes that it has substantial legal claims to oppose these allegations.

**NOTE 13:- EQUITY**

a. Treasury stock:

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 2008, 10,000 warrants were granted to consultants at an exercise price of $ 4.82 per share, expiring seven years from the date of grant. The Company recorded compensation expenses in accordance with ASC 505. The amount recorded is immaterial. As of December 31, 2009, 10,000 warrants to consultants are outstanding and exercisable at an exercise price of $ 4.82 per share.

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 were 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 ASC 718, "Compensation - Stock Compensation", with respect to purchases under the Purchase Plan.

During the years ended December 31, 2007 and 2008, 649,853 and 319,453 shares, respectively, were issued under the Purchase Plan for aggregate consideration of $ 3,619 and $ 1,214, respectively. During 2008, the Company's Board of Directors decided to suspend the Purchase Plan.

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, 2009, 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. As of December 31, 2009, the total number of shares authorized for grant under this Plan is 914,545.

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.

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

The following is a summary of the Group's stock option activity and related information for the year ended December 31, 2009:

| | Year ended December 31, 2009 | | | |
|---|---|---|---|---|
| | Amount of options | Weighted average exercise price | Weighted average remaining contractual term (in years) | Aggregate intrinsic value |
| Outstanding at beginning of year | 6,346,537 | $ 7.81 | | |
| Changes during the year: | | | | |
| Granted | *) 1,094,577 | $ 1.82 | | |
| Exercised | (86,750) | $ 1.04 | | |
| Forfeited | (787,513) | $ 7.09 | | |
| Expired | (400,984) | $ 7.91 | | |
| Options outstanding at end of year | *) 6,165,867 | $ 6.93 | 3.0 | $ 192 |
| Vested and expected to vest | 5,734,256 | $ 6.93 | 3.0 | $ 178 |
| Options exercisable at end of year | 4,419,161 | $ 8.10 | 1.86 | $ 192 |

*) Including 40,269 restricted share units ("RSU'S") granted in December 2009.

The weighted-average grant-date fair value of options granted during the years ended December 31, 2007, 2008 and 2009 was $ 3.23, $ 1.80 and $ 1.22, 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, 2007, 2008 and 2009 was $ 613, $ 124 and $ 130, respectively. As of December 31, 2009, there was $ 1,840 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 0.96 years.

The options outstanding as of December 31, 2009, have been separated into ranges of exercise prices, as follows:

| Range of exercise price | Options outstanding as of December 31, 2009 | Weighted average remaining contractual life (Years) | Weighted average exercise price | Options exercisable as of December 31, 2009 | Weighted average exercise price of exercisable options |
|---|---|---|---|---|---|
| $ 0-1.1 | 256,569 | 4.19 | $ 0.44 | 103,800 | $ 1.10 |
| $ 1.50-2.51 | 1,027,400 | 5.09 | $ 2.16 | 281,150 | $ 2.38 |
| $ 2.67-4.00 | 502,263 | 3.40 | $ 2.89 | 278,391 | $ 3.00 |
| $ 4.10-6.49 | 1,258,525 | 2.78 | $ 5.20 | 911,460 | $ 5.00 |
| $ 6.51-9.24 | 691,710 | 1.20 | $ 7.68 | 637,210 | $ 7.75 |
| $ 9.32-14.76 | 2,399,400 | 2.46 | $ 11.07 | 2,177,150 | $ 11.11 |
| $ 15.94 | 30,000 | 1.99 | $ 15.94 | 30,000 | $ 15.94 |
| | 6,165,867 | 3.0 | $ 6.93 | 4,419,161 | $ 8.10 |

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

e. During 2008 and 2009, the Company decided on an exceptional and ex-gratia basis to extend the validity of 895,138 and 231,400 options, respectively, granted to employees by a period of 1-2 years and re-priced the exercise price to certain employees. Total options that were re-priced in 2008 and 2009, were 100,000 and 50,000, respectively. The exercise price was adjusted in 2008 from a range of 5.7-6.7 to 4.17 and in 2009 from a range 4.17-14.76 to 0.

The Company accounted for these changes as modifications in accordance with ASC 718. The Company calculated the incremental value of these modifications and recorded compensation cost in a total amount of $ 402 and $ 208 for the years ended December 31, 2008 and 2009, respectively.

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.

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 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 has been no longer eligible for benefits since 2007. Tax benefits from the remaining programs are scheduled to gradually expire through 2013.

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

As of December 31, 2009, 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 letters 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, 2009, 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 Beneficiary Enterprise including a provision generally requiring that at least 25% of the Beneficiary Enterprise's income will be derived from export. Additionally, the Amendment enacted major changes in the manner in which tax benefits are awarded under the Investment Law so that companies no longer require Investment Center approval in order to qualify for tax benefits.

However, the Investment Law provides that terms and benefits included in any certificate of approval already granted will remain subject to the provisions of the Investment Law as they were on the date of such approval. Therefore, the Company's existing "Approved Enterprises" will generally not be subject to the provisions of the Amendment. As a result of the Amendment, tax-exempt income generated under the provisions of the Investment Law, as amended, will subject the Company to taxes upon distribution or liquidation and the Company may be required to record a deferred tax liability with respect to such tax-exempt income. As of December 31, 2009, there was no taxable income attributable to the Beneficiary Enterprise.

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

3. Net operating loss carryforward:

As of December 31, 2009, the Company has accumulated losses for tax purposes in the amount of approximately $ 48,000, which can be carried forward and offset against taxable income in the future for an indefinite period. As of December 31, 2009, the Company recorded a deferred tax asset of $ 1,447 relating to the available net carry forward tax losses.

As of December 31, 2009, the Company's Israeli subsidiaries have estimated total available carry forward tax losses of approximately $ 60,000.

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

The Encouragement Law, provides several tax benefits for industrial companies. An industrial company is defined as a company resident in Israel, at least 90% of the income of which in a given tax year exclusive of income from specified Government loans, capital gains, interest and dividends, is derived from an industrial enterprise owned by it. An industrial enterprise is defined as an enterprise whose major activity in a given tax year is industrial production activity.

Management believes that the Company is currently qualified as an "industrial company" under the Encouragement Law and as such, enjoys tax benefits, including: (1) Deduction of purchase of know-how and patents and/or right to use a patent over an eight-year period; (2) The right to elect, under specified conditions, to file a consolidated tax return with additional related Israeli industrial companies and an industrial holding company; (3) Accelerated depreciation rates on equipment and buildings; and (4) Expenses related to a public offering on the Tel-Aviv Stock and on recognized stock markets outside of Israel, are deductible in equal amounts over three years.

Eligibility for benefits under the Encouragement Law is not subject to receipt of prior approval from any Governmental authority. No assurance can be given that the Israeli tax authorities will agree that the Company qualifies, or, if the Company qualifies, then the Company will continue to qualify as an industrial company or that the benefits described above will be available to the Company in the future.

5. Tax rates:

Taxable income of Israeli companies is subject to tax at the rate of 27% in 2008, 26% in 2009, and 25% in 2010 and thereafter. In July 2009, Israel's Parliament (the Knesset) passed the Economic Efficiency Law (Amended Legislation for Implementing the Economic Plan for 2009 and 2010), 2009, which prescribes, among other things, an additional gradual reduction in the Israeli corporate tax rate and real capital gains tax rate starting from 2011 to the following tax rates: 2011 - 24%, 2012 - 23%, 2013 - 22%, 2014 - 21%, 2015 - 20%, 2016 and thereafter - 18%. However, the effective tax rate payable by a company which derives income from an "Approved Enterprise" may be considerably lower (see also Note 14 a2).

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

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

b. Loss before taxes on income comprised as follows:

| | Year ended December 31, | | |
|---|---|---|---|
| | 2007 | 2008 | 2009 |
| Domestic | $ (1,706) | $ (2,811) | $ (5,963) |
| Foreign | (4,654) | (79,892) | 3,035 |
| | $ (6,360) | $ (82,703) | $ (2,928) |

c. Taxes on income are comprised as follows:

| | Year ended December 31, | | |
|---|---|---|---|
| | 2007 | 2008 | 2009 |
| Current taxes | $ (1,125) | $ 674 | $ 290 |
| Deferred taxes | 2,390 | (169) | - |
| | $ 1,265 | $ 505 | $ 290 |
| Domestic | $ (1,575) | $ (1,365) | $ 484 |
| Foreign | 2,840 | 1,870 | (194) |
| | $ 1,265 | $ 505 | $ 290 |

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

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:

| | December 31, | |
|---|---|---|
| | **2008** | **2009** |
| Deferred tax assets: | | |
| Net operating loss carry forward | $ 61,093 | $ 53,748 |
| Reserves and allowances | 3,822 | 8,291 |
| | 64,915 | 62,039 |
| Deferred tax liabilities: | | |
| Senior convertible notes | 735 | - |
| Depreciation | 736 | - |
| | 1,471 | - |
| Net deferred tax assets before valuation allowance | 63,444 | 62,039 |
| Valuation allowance | (61,217) | (59,812) |
| Deferred tax asset | $ 2,227 | $ 2,227 |
| Domestic: | | |
| Short-term deferred tax asset | $ 652 | $ 678 |
| Long-term deferred tax asset | 795 | 765 |
| | $ 1,447 | $ 1,443 |
| Foreign: | | |
| Short-term deferred tax asset | $ 320 | $ 375 |
| Long-term deferred tax asset | 460 | 409 |
| | $ 780 | $ 784 |

The Company's U.S. subsidiaries have estimated total available carry forward tax losses of approximately $ 83,000 to offset against future taxable income that expire between 2020 and 2029. As of December 31, 2009, the Company recorded a deferred tax asset of $ 784 relating to the available net carry forward tax losses.

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

**NOTE 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:

| | Year ended December 31, | | |
|---|---|---|---|
| | **2007** | **2008** | **2009** |
| Loss before taxes, as reported in the consolidated statements of operations | $ (6,360) | $ (82,703) | $ (2,928) |
| Statutory tax rate | 29% | 27% | 26% |
| Theoretical tax benefits on the above amount at the Israeli statutory tax rate | $ (1,844) | $ (22,330) | $ (761) |
| Income tax at rate other than the Israeli statutory tax rate (1) | 655 | 139 | 337 |
| Non-deductible expenses including equity based compensation expenses | 3,834 | 2,172 | 1,425 |
| 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 | 3,333 | 75 | 633 |
| Utilization of operation losses carry forward | (3,355) | (3,231) | (1,469) |
| Taxes in respect to prior years | (1,588) | 87 | 90 |
| State and Federal taxes | 689 | 177 | 21 |
| Inter-company charges | (430) | 57 | - |
| Other individually immaterial income tax item | (29) | 109 | 14 |
| Actual tax expense | $ 1,265 | $ 505 | $ 290 |
| (1) Per share amounts (basic) of the tax benefit resulting from the exemption | $ 0.02 | $ 0.01 | $ 0.01 |
| Per share amounts (diluted) of the tax benefit resulting from the exemption | $ 0.02 | $ 0.01 | $ 0.01 |

f. The Company adopted the provisions of amendment to ASC 740 on January 1, 2007. Prior to 2007, the Company used the provisions of FAS 5 (as codified in ASC 450) to determine tax contingencies. As of January 1, 2007, there was no difference in the Company's tax contingencies under the provisions of the amended ASC. As a result, there was no effect on the Company's shareholders equity upon the Company's adoption of the amended ASC.

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

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

| | |
|---|---|
| Gross unrecognized tax benefits as of January 1, 2009 | $ 158 |
| Increase in tax position for current year | - |
| Gross unrecognized tax benefits as of December 31, 2009 | $ 158 |

The Company recognizes interest and penalties related to unrecognized tax benefits in tax expenses. The liability for unrecognized tax benefits does not include accrued interest and penalties of $ 153 and $ 164 at December 31, 2008 and 2009, respectively.

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

| | Year ended December 31, | | |
|---|---|---|---|
| | 2007 | 2008 | 2009 |
| Numerator: | | | |
| Net loss available to ordinary shareholders | $ (8,722) | $ (85,790) | $ (2,822) |
| Denominator: | | | |
| Denominator for basic earnings per share - weighted average number of ordinary shares, net of treasury stock | 42,699,307 | 41,200,523 | 40,207,923 |
| Effect of dilutive securities: | | | |
| Employee stock options and ESPP | *) - | *) - | *) - |
| Senior convertible notes | *) - | *) - | *) - |
| Denominator for diluted net earnings per share - adjusted weighted average number of shares | 42,699,307 | 41,200,523 | 40,207,923 |

*) Antidilutive.

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

| | Year ended December 31, | | |
|---|---|---|---|
| | 2007 | 2008 | 2009 |
| Financial expenses: | | | |
| Interest | $ (7,419) | $ (6,807) | $ (4,739) |
| Amortization of marketable securities premiums and accretion of discounts, net | (40) | (110) | (253) |
| Others | (617) | (131) | (232) |
| | (8,076) | (7,048) | (5,224) |
| Financial income: | | | |
| Interest and others | 5,909 | 3,780 | 2,480 |
| | $ (2,167) | $ (3,268) | $ (2,744) |

## 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 ASC 280 (formerly: SFAS No. 131), "Segment Reporting". 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, 2007, 2008 and 2009 and long-lived assets as of December 31, 2007, 2008 and 2009.

| | 2007 | | 2008 | | 2009 | |
|---|---|---|---|---|---|---|
| | Total revenues | Long-lived assets | Total revenues | Long-lived assets | Total revenues | Long-lived assets |
| Israel | $ 10,604 | $ 23,261 | $ 13,597 | $ 21,599 | $ 10,410 | $ 21,138 |
| Americas | 89,614 | 113,894 | 91,640 | 26,250 | 69,960 | 22,799 |
| Europe | 40,305 | 105 | 40,854 | 118 | 27,101 | 87 |
| Far East | 17,712 | 53 | 28,653 | 56 | 18,423 | 74 |
| | $ 158,235 | $ 137,313 | $ 174,744 | $ 48,023 | $ 125,894 | $ 44,098 |

b. Product lines:

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

| | Year ended December 31, | | |
|---|---|---|---|
| | 2007 | 2008 | 2009 |
| Technology | $ 56,426 | $ 58,484 | $ 34,995 |
| Networking | 101,809 | 116,260 | 90,899 |
| | $ 158,235 | $ 174,744 | $ 125,894 |

## NOTE 18:- DERIVATIVE INSTRUMENTS

The Company enters into hedge transactions with a major financial institution, using derivative instruments, primarily forward contracts and options to purchase and sell foreign currencies, in order to reduce the net currency exposure associated with anticipated expenses (primarily salaries and rent expenses) in currencies other than U.S. dollar. The Company currently hedges such future exposures for a maximum period of one year. However, the Company may choose not to hedge certain foreign currency exchange exposures for a variety of reasons, including but not limited to immateriality, accounting considerations and the prohibitive economic cost of hedging particular exposures. There can be no assurance the hedges will offset more than a portion of the financial impact resulting from movements in foreign currency exchange rates.

The Company records all derivatives in the consolidated balance sheet at fair value. The effective portions of cash flow hedges are recorded in other comprehensive income until the hedged item is recognized in earnings. The ineffective portions of cash flow hedges are adjusted to fair value through earnings in financial other income or expense. The Company does not enter into derivative transactions for trading purposes.

**NOTE 18:- DERIVATIVE INSTRUMENTS (Cont.)**

The Company had a net deferred loss associated with cash flow hedges of $ 912 and a net deferred gain associated with cash flow hedges of $ 98 recorded in other comprehensive income as of December 31, 2008 and 2009, respectively. As of December 31, 2009, the hedged transactions are expected to occur within twelve months.

The Company entered into forward contracts to hedge the fair value of assets denominated in New Israeli Shekels that did not meet the requirement for hedge accounting. The Company measured the fair value of the contracts in accordance with ASC No. 820 at level 2. The net losses recognized in "financial and other expenses, net" during 2009 were $ 81.

As of December 31, 2008 and 2009, the Company had outstanding forward contracts in the amount of $ 10,800 and $ 10,500, respectively.

The fair value of the Company's outstanding derivative instruments and the effect of derivative instruments in cash flow hedging relationship on other comprehensive income for the years ended December 31, 2008 and 2009, are summarized below:

| Foreign exchange forward and options contracts | Balance sheet | As of December 31, 2008 | As of December 31, 2009 |
|---|---|---|---|
| Fair value of foreign exchange forward contracts | "Other receivables and prepaid expenses" | $ | $ 98 |
| | "Other payables and accrued expenses" | $ (912) | $ |
| Increase (decrease) in gains recognized in OCI (effective portion) | "Other comprehensive income" | $ (1,959) | $ 1,010 |

The effect of derivative instruments in cash flow hedging relationship on income for the years ended December 31, 2009 and 2008 is summarized below:

| Foreign exchange forward and options contracts | Statements of operations | Year ended December 31, 2009 | Year ended December 31, 2008 |
|---|---|---|---|
| Gain (loss) on derivatives recognized in OCI | "Operating expenses" | $ 1,622 | $ (3,467) |
| Gain (loss) recognized in income on derivatives (effective portion) | "Operating expenses" | $ (612) | $ 1,508 |

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 19:- SUBSEQUENT EVENTS**

In January 2010, AudioCodes entered into an agreement to acquire all of the outstanding equity of NSC that it had not owned as of December 31, 2009. The closing of the transaction occurred in May 2010. Pursuant to the agreement, AudioCodes will pay an aggregate of approximately $ 1,200 for the remaining interest in NSC, payable in three annual installments commencing on the first anniversary of the closing. AudioCodes will also be required to pay an additional consolidation price of up to $ 500 in 2013 if certain aggregate revenue milestones are met for 2010, 2011 and 2012.

In May 2007, the Company entered into an agreement pursuant to which a building of approximately 145,000 square feet will be erected and leased to the Company for period of eleven years. This new building is expected to be completed in 2010. In May 2010, the constructor and owners of the building have notified the Company that it has completed a certain milestone in the construction of the building, and that in accordance with the agreement the tenure of the building should be transferred to the Company effective May 2010. Under such scenario the Company is required to pay lease starting that month. The Company rejected the claim and believes it has valid legal defenses to oppose such claim since the Company is not legally allowed to occupy the building. Due to the preliminary stage of the claim and related discussions, the Company and its legal advisors are unable currently to assess the outcome of the claim and its effect on the Company.

- - - - - - - - - - - - - - - - - - - - - - -

F:\W2000\w2000\2929\M\09\E$12.DOC