AUDIOCODES LTD.

CONSOLIDATED FINANCIAL STATEMENTS

AS OF DECEMBER 31, 2010

IN U.S. DOLLARS

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of

AUDIOCODES LTD.

We have audited the accompanying consolidated balance sheets of AudioCodes Ltd. ("AudioCodes" or "the Company") and its subsidiaries as of December 31, 2009 and 2010, 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, 2010. 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, 2009 and 2010, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2010, in conformity with accounting principles generally accepted in the United States.

As discussed in Note 2z 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, 2010, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 10, 2011 expressed an unqualified opinion thereon.

Tel-Aviv, Israel
March 10, 2011

KOST FORER GABBAY & KASIERER
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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, 2010, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). AudioCodes' management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

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

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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, 2010, 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, 2009 and 2010 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, 2010 and our report dated March 10, 2011 expressed an unqualified opinion thereon.

Tel-Aviv, Israel	KOST FORER GABBAY & KASIERER
March 10, 2011	A Member of Ernst & Young Global

CONSOLIDATED BALANCE SHEETS

U.S. dollars in thousands

	December 31,	
	2009	**2010**
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 38,969	$ 50,311
Short-term bank deposits	13,902	13,825
Trade receivables (net of allowance for doubtful accounts of $ 723 and $ 918 at December 31, 2009 and 2010, respectively)	18,522	25,881
Other receivables and prepaid expenses	2,754	3,646
Deferred tax assets	1,053	2,287
Inventories	13,516	18,043
Total current assets	88,716	113,993
LONG-TERM ASSETS:		
Investment in affiliated company	1,510	1,317
Deferred tax assets	1,174	2,261
Severance pay funds	12,235	15,039
Total long-term assets	14,919	18,617
PROPERTY AND EQUIPMENT, NET	4,956	3,703
INTANGIBLE ASSETS AND DEFERRED CHARGES, NET	6,847	5,310
GOODWILL	32,095	32,095
Total assets	$ 147,533	$ 173,718

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,	
	2009	**2010**
LIABILITIES AND EQUITY		
CURRENT LIABILITIES:		
Current maturities of long-term bank loans	$ 6,000	$ 6,000
Trade payables	8,609	13,519
Other payables and accrued expenses	17,586	24,168
Deferred revenues	1,964	3,769
Total current liabilities	34,159	47,456
LONG-TERM LIABILITIES:		
Accrued severance pay	13,336	15,821
Senior convertible notes	403	353
Long-term banks loans	15,750	9,750
Other liabilities	-	1,038
Deferred revenues	-	120
Total long-term liabilities	29,489	27,082
COMMITMENTS AND CONTINGENT LIABILITIES		
EQUITY:		
AudioCodes equity:		
Share capital -		
Ordinary shares of NIS 0.01 par value - Authorized: 100,000,000 shares at December 31, 2009 and 2010; Issued: 47,661,550 shares at December 31, 2009 and 48,595,373 shares at December 31, 2010; Outstanding: 40,269,194 shares at December 31, 2009 and 41,203,017 shares at December 31, 2010	125	128
Additional paid-in capital	189,079	191,277
Treasury stock – 7,392,356 shares as of December 31, 2010 and 2009	(25,057)	(25,057)
Accumulated other comprehensive income	98	822
Accumulated deficit	(80,116)	(67,990)
	84,129	99,180
Non-controlling interest	(244)	-
Total equity	83,885	99,180
Total liabilities and equity	$ 147,533	$ 173,718

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

CONSOLIDATED STATEMENTS OF OPERATIONS

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

	Year ended December 31,		
	2008	2009	2010
Revenues	$ 174,744	$ 125,894	$ 150,040
Cost of revenues	77,455	56,194	66,138
Gross profit	97,289	69,700	83,902
Operating expenses:			
Research and development, net	37,833	29,952	30,189
Selling and marketing	44,657	32,111	35,024
General and administrative	9,219	7,821	8,252
Impairment of goodwill and other intangible assets	85,015	-	-
Total operating expenses	176,724	69,884	73,465
Operating income (loss)	(79,435)	(184)	10,437
Financial expenses, net	3,268	2,744	94
Income (loss) before taxes on income	(82,703)	(2,928)	10,343
Income tax expense (benefit), net	505	290	(1,885)
Equity in losses of affiliated companies, net	2,582	76	213
Net income (loss)	(85,790)	(3,294)	12,015
Net loss attributable to non-controlling interest	-	472	111
Net income (loss) attributable to AudioCodes' shareholders	$ (85,790)	$ (2,822)	$ 12,126
Basic and diluted net earnings (loss) per share attributable to AudioCodes shareholders	$ (2.08)	$ (0.07)	$ 0.30

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, 2008	$ 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	-	-	-	-	-	228		228
Comprehensive loss, net:								
Unrealized losses on foreign currency cash flow hedges	-	-	-	(1,959)	-	-	$ (1,959)	(1,959)
Net loss	-	-	-	-	(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	-	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
Issuance of shares upon exercise of options	3	2,553	-	-	-	-		2,556
Stock compensation related to options granted to employees	-	1,370	-	-	-	-		1,370
Acquisition of NSC non-controlling interest	-	(1,725)	-	-	-	355		(1,370)
Comprehensive loss, net:								
Unrealized profit on foreign currency cash flow hedges	-	-	-	724	-	-	$ 724	724
Net income (loss)	-	-	-	-	12,126	(111)	12,015	12,015
Total comprehensive income, net							$ 12,739	
Balance as of December 31, 2010	$ 128	$ 191,277	$ (25,057)	$ 822	$ (67,990)	$ -		$ 99,180

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,		
	2008	**2009**	**2010**
Cash flows from operating activities:			
Net income (loss)	$ (85,790)	$ (3,294)	$ 12,015
Adjustments required to reconcile net income (loss) to net cash provided by operating activities:			
Depreciation and amortization	7,441	4,969	4,359
Impairment of goodwill, other intangible assets and investment in affiliate	86,111	-	-
Amortization of marketable securities premiums and accretion of discounts, net	112	252	-
Equity in losses of affiliated companies, net	1,486	76	213
Stock-based compensation expenses	4,341	1,991	1,370
Amortization of senior convertible notes discount and deferred charges and gain from redemption	4,592	2,930	-
Decrease (increase) in accrued interest on loans, marketable securities, bank deposits and structured notes	125	2,312	(20)
Increase in deferred tax assets, net	(169)	-	(2,321)
Decrease (increase) in trade receivables, net	(3,960)	11,042	(7,359)
Decrease (increase) in other receivables and prepaid expenses	450	908	(168)
Decrease (increase) in inventories	(1,840)	7,107	(4,527)
Increase (decrease) in trade payables	627	(3,052)	4,910
Increase (decrease) in other payables and accrued expenses and other liabilities	333	(1,760)	6,324
Increase (decrease) in deferred revenues	2,101	(1,731)	1,925
Increase (decrease) in accrued severance pay, net	451	(776)	(319)
Net cash provided by operating activities	16,411	20,974	16,402
Cash flows from investing activities:			
Investments in affiliated companies	(6,330)	(341)	-
Purchase of property and equipment	(3,158)	(1,271)	(1,569)
Purchase of marketable securities	(16,795)	-	-
Investment in short-term and long-term bank deposits	(100,864)	(49,318)	(57,879)
Proceeds from short-term bank deposits	90,142	95,203	57,956
Proceeds from redemption of marketable securities upon maturity	17,000	16,000	-
Net cash provided by (used in) investing activities	(20,005)	60,273	(1,492)

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

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

	Year ended December 31,		
	2008	**2009**	**2010**
Cash flows from financing activities:			
Purchase of treasury stock	(13,747)	-	-
Redemption of senior convertible notes	(50,240)	(73,147)	(50)
Proceeds from long-term bank loans	30,000	-	-
Repayment of long-term bank loans	(2,250)	(6,000)	(6,000)
Payment for acquisition of NSC non controlling interest	-	-	(74)
Proceeds from issuance of shares upon exercise of options and employee stock purchase plan	1,547	90	2,556
Net cash used in financing activities	(34,690)	(79,057)	(3,568)
Increase (decrease) in cash and cash equivalents	(38,284)	2,190	11,342
Cash and cash equivalents at the beginning of the year	75,063	36,779	38,969
Cash and cash equivalents at the end of the year	$ 36,779	$ 38,969	$ 50,311
Supplemental disclosure of cash flow activities:			
Cash paid during the year for income taxes	$ 646	$ 363	$ 261
Cash paid during the year for interest	$ 2,455	$ 2,238	$ 317
Supplemental disclosures of non cash operational, financing and investing activities			
Net change in profit on foreign currency cash flow hedges	$ (1,959)	$ 1,010	$ 724
Conversion of loan to affiliated company into additional equity investment	$ -	$ -	$ 588
Total commitment for future payments for NSC acquisition which reduced the Company's shareholders' equity	$ -	$ -	$ 1,296

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 1:- GENERAL

a. Business overview:

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

The Company operates through its wholly-owned subsidiaries in the United States, Europe, Asia, Latin America and Israel.

During 2008, the Group faced an adverse change in its business as a result of the global economic slowdown and credit crisis. In the fourth quarter of 2008, the Company recorded a non-cash impairment charge with respect to goodwill and intangible assets as follows:

Goodwill - $ 79,117 (see also Note 2k).
Intangible assets – $ 5,898 (see also Notes 2j and 6).

b. Acquisition of Natural Speech Communication Ltd.:

Through December 31, 2009, the Company had invested an aggregate of $ 8,418 in Natural Speech Communication Ltd. ("NSC"), a privately-held company engaged in speech recognition. As of December 31, 2009, the Group owned 59.74% of the outstanding share capital of NSC, which had been consolidated into the financial results of AudioCodes since December 2008.

In January 2010, the Company entered into an agreement to acquire all of the outstanding equity of NSC that did not own as of December 31, 2009. The closing of the transaction occurred in May 2010. Pursuant to the agreement, the Company purchased the remaining 40.26% of the shares from NSC’s non-controlling shareholders for a maximum total consideration of $ 1,733, which also includes payments to employees, who were also former NSC's shareholders, that exceeded the fair value of NSC's shares. As a result, the payments in excess of fair value were treated as payroll expenses. The payment of the total consideration, is in any combination of cash and the Company’s shares at the Company’s option, of which $ 224 was paid in cash in 2010 and $ 1,009 is payable in three annual installments commencing in March 2011. Additional consideration of up to $ 500 is payable in 2013, if certain aggregate revenue milestones are met for 2010, 2011 and 2012. The obligation to pay the total consideration to the former NSC's shareholders is recorded as a liability.

NOTE 1:- GENERAL (Cont.)

The liability is comprised of two components: (1) The contingent payments for which the Company recorded a contingent consideration liability of $ 329 in its estimated fair value as of the closing of the transaction, which was estimated by utilizing an income approach, taking into account the potential cash payments based on expectation as to NSC's future revenues in each of the years 2010-2012, and was discounted to arrive at a present value amount. The discount rate was based on the market interest rate and NSC's estimated operational capitalization rate. The contingent consideration liability is marked to market at fair value at each reporting date based on the Company's policy with subsequent changes in the value of the liability recorded in the statement of operations in finance expenses, and (2) A liability with respect to the commitment for future payments was recorded at present value which amounted to $ 967. Such obligation is not re-measured at subsequent periods and only adjusted to changes in time value.

As of December 31, 2010 the contingent consideration liability estimated fair value amounted to $ 355 and the liability with regards to the commitment for future payments amounted to $ 958. An amount of the total liability equal to $ 1,038 was classified as long term liability. As this was an equity transaction between AudioCodes and NSC's non-controlling shareholders, the Company reduced its shareholders' equity by $ 1,370 for the excess costs over book value related to the minority interest in NSC, as required in accordance with ASC 810, "Consolidation".

c. 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.

d. The Group's major customer in 2008 and 2009, accounting for 14.4% and 15.6%, respectively, of the Group's revenues in those years filed for bankruptcy in January 2009. Such customer accounted for 3.9% of the Group's revenues in 2010. No other customer accounted for more than 10% of the Group's revenues in 2008, 2009 or 2010. See also Note 11e.

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 revenue recognition and allowance for sales returns , allowance for doubtful accounts, inventories, intangible assets, goodwill, income taxes and valuation allowance: stock-based compensation and contingent liabilities. 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, "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.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

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 0.35% and 1.01% for 2009 and 2010, 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 10).

f. 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, discontinuation of products lines and for market prices lower than cost.

g. Investment in affiliated company:

The Company accounts for investment in affiliated company 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.

Investment in affiliated company represents investment in ordinary shares, preferred shares and convertible loans. According to ASC 323, additional losses of such company in excess of the carrying amount of the equity investment are recognized based on the seniority level (priority in liquidation) of the particular type of investment held by the Company.
The Company's investment is 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, 2009 and 2010, no impairment losses had been identified. During 2008, based on management's most recent analysis, the Company recognized an impairment loss of $ 1,096 relating to its investment in NSC, which was accounted under the equity method prior to December 2008.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

h. Property and equipment:

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

	%
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

i. 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 the expected maturity which occurred in November 2009, in accordance ASC 470. See also Note 2r, Note 6 and Note 9.

j. Impairment of long-lived assets:

The Group's long-lived assets are reviewed for impairment in accordance with ASC 360-10-35, "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 will not reduce the carrying amount of that asset below its fair value whenever that fair value is determinable As of December 31, 2008, 2009 and 2010, no impairment losses had 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.

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.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

During 2009 and 2010, 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).

k. 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, "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 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 performed an annual impairment analysis as of December 31, 2008, 2009 and 2010 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 2009 and 2010, 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.

l. Revenue recognition:

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

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Revenues from products are recognized in accordance with Staff Accounting 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 accounts for multiple element arrangements in accordance with ASC 605-25, "Revenue Arrangements with Multiple Deliverables", to determine if those deliverables constitute separate units. Revenue on arrangements that include multiple elements is allocated to each element based on the residual method. Each element’s allocated revenue is recognized when the revenue recognition criteria for that element have been met. Fair value is generally determined by vendor specific objective evidence (“VSOE”), which is based on the price charged when each element is sold separately. If the Company cannot objectively determine the fair value of any undelivered element included in a multiple-element arrangement, the Company defers revenue until all elements are delivered and services have been performed, or until fair value can objectively be determined for any remaining undelivered elements.

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 and other incentives based on its experience with historical sales returns, analysis of credit memo data and other known factors, in accordance with SAB 104. The provision was deducted from revenues and amounted to $ 754, $ 656 and $ 1,387 as of December 31, 2008, 2009 and 2010, 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.

m. 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. As of December 31, 2009 and 2010 the provision for warranty amounted to $ 753 and $ 870, respectively.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

n. Research and development costs:

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

o. Income taxes:

The Group accounts for income taxes in accordance with ASC 740, "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.

In addition, 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. The first step is to evaluate the tax position taken or expected to be taken in a tax return. This is done by determining if the weight of available evidence indicates that it is more likely than not that, on an evaluation of the technical merits, the tax position will be sustained on audit, including resolution of any related appeals or litigation processes. The second step is to measure the tax benefit as the largest amount that is more than 50% likely to be realized upon ultimate settlement.

The Group accrues interest and penalties, if any, related to unrecognized tax benefits in tax expenses.

p. Comprehensive income (loss):

The Group accounts for comprehensive income (loss) in accordance with ASC 220 "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 Group determined that its items of comprehensive income (loss) relates to gains and losses on hedging derivatives instruments.

q. 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, trade receivables and foreign currency derivative contracts.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

The majority of the Group's cash and cash equivalents and bank deposits are invested in U.S. dollar instruments with major banks in Israel and the United States. Such investments in the United States may be in excess of insured limits and are not insured in other jurisdictions. Management believes that the financial institutions that hold the Group's investments are in corporations with high credit standing. Accordingly, management believes that low 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. Allowance for doubtful accounts amounted to $ 723 and $ 918 as of December 31, 2009 and 2010, respectively

r. Senior convertible notes:

Effective January 1, 2009, the Company adopted an amendment to ASC 470-20, "Debt with Conversion and Other Options". ASC 470-20 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 Company applied this amendment retrospectively to all periods presented and comparative figures have been adjusted accordingly. See also Note 9.

The Company presents the outstanding principal amount of its senior convertible notes as a long-term liability, in accordance with ASC 210-10-45 (based on its expected redemption, taking into consideration redemption options of the holders). 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. See also Note 9.

According to ASC 470-20, if an instrument within its scope 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. See Note 9 for further details.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

s. 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 260, "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 12,156,728, 8,768,909 and 3,848,284 for the years ended December 31, 2008, 2009 and 2010, respectively.

t. Accounting for stock-based compensation:

The Company accounts for stock-based compensation in accordance with ASC 718, "Compensation-Stock Compensation". ASC 718 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 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, "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 the years ended December 31, 2008 and 2009, the Company extended the exercise period of certain options granted to employees by a period of 1-2 years and modified the exercise price with respect to certain employees’ awards.

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 award 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, 2008, 2009 and 2010, was $ 1.89, $ 1.22 and $ 1.96 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,		
	2008	**2009**	**2010**
Dividend yield	0%	0%	0%
Expected volatility	52.0%	48.7%	50.8%
Risk-free interest	2.6%	2.3%	1.9%
Expected life	4.8 years	5.0 years	5.1 years
Forfeiture rate	11.0%	7.0%	10.0%

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. 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. 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.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

The total equity-based compensation expense relating to all of the Company's equity-based awards recognized for the years ended December 31, 2008, 2009 and 2010 was included in items of the consolidated statements of income as follows:

	Year ended December 31,		
	2008	2009	2010
Cost of revenues	$ 318	$ 117	$ 62
Research and development, net	1,467	642	393
Selling and marketing expenses	2,026	913	1,180
General and administrative expenses	530	319	453
Total equity-based compensation expenses	$ 4,341	$ 1,991	$ *) 2,088

*) Includes also equity-based compensation that was classified as a liability.

u. 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.

v. 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, 2008, 2009 and 2010, amounted to approximately $ 2,701, $ 1,136 and $ 1,733, respectively.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

w. Employee benefit plan:

The Group has 401(k) defined contribution plans 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 2010 ($ 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% of their eligible compensation, subject to IRS limits. In 2008, 2009 and 2010, the Group matched contributions in the amount of $ 380, $ 280 and $ 240, respectively.

x. Advertising expenses:

Advertising expenses are charged to the statements of operations as incurred. Advertising expenses for the years ended December 31, 2008, 2009 and 2010 amounted to $ 407, $ 139 and $ 374, respectively.

y. Fair value of financial instruments:

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

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

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

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

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

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 Note 7.

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

In April 2009, the Group adopted an updated guidance to ASC 820-10 related to fair value measurements and disclosures, which provides additional guidance for estimating fair value when the volume and level of activity for an assets 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 update did not have a material effect on the consolidated financial statements.

In January 2010, the FASB updated the "Fair Value Measurements Disclosures". More specifically, this update requires (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.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

z. Consolidation:

On January 1, 2009, the Company adopted an amendment to ASC 810, "Consolidation". 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 will continue to be allocated to the non-controlling interests even when their investment has already been reduced to zero.

The amendment applies prospectively, except for the presentation and disclosure requirements, which are applied retrospectively to all periods presented.

According to the Company's policy, contingent consideration is presented at fair value in subsequent periods and changes in fair value of the liability will be recorded as financial income/ expense.

aa. 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. The assumptions 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.

Effective January 1, 2010, the Company adopted an updated guidance for the consolidation of variable interest entities. This new guidance replaces the prior quantitative approach for identifying which enterprise should consolidate a variable interest entity, which was based on which enterprise was exposed to a majority of the risks and rewards, with a qualitative approach, based on which enterprise has both (1) the power to direct the economically significant activities of the entity and (2) the obligation to absorb losses of, or the right to receive benefits from, the entity that could potentially be significant to the variable interest entity. Determination about whether an enterprise should consolidate a variable interest entity is required to be evaluated continuously as changes to existing relationships or future transactions occur. The adoption of this standard did not have a material impact on the Company’s financial position or results of operations.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

ab. Derivatives and hedging:

The Group accounts for derivatives and hedging based on ASC 815, "Derivatives and Hedging".

The Group 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. The changes in fair value of such instruments are included as earnings in "Financial income (expenses)" at each reporting period.

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 payroll and rent expenses. The ineffective portion of the gain or loss on the derivative instrument is recognized in current earnings and classified as financial other income or expenses. To receive hedge accounting treatment, cash flow hedges must be highly effective in offsetting changes to expected future cash flows on hedged transactions.

During 2010, the Group recorded accumulated other comprehensive income in the amount of $ 724 from its forward exchange contracts with respect to payroll and rent expenses expected to be incurred during 2011. Such amount will be reclassified into earnings during 2011. See also Note 17.

ac. 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.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

d) Require expanded disclosures of qualitative and quantitative information regarding application of the multiple-deliverable revenue arrangement guidance.

The Group adopted the standard on January 1, 2011 and will apply the provision of this accounting standard on a prospective basis to all revenue arrangements entered into or materially modified subsequent to January 1, 2011. The Group is currently evaluating the impact of this update on its consolidated results of operations and financial condition.

NOTE 3:- INVENTORIES

	December 31,	
	2009	2010
Raw materials	$ 5,923	$ 8,122
Finished products	7,593	9,921
	$ 13,516	$ 18,043

In the years ended December 31, 2008, 2009 and 2010, the Group wrote-off inventories in a total amount of $ 2,356, $ 3,421 and $1,113, respectively.

NOTE 4:- INVESTMENT IN AFFILIATED COMPANY

As of December 31, 2009 and 2010, the Company owned 20.21% and 25.61% of Mailvision's outstanding share capital, respectively.

In November 2010, the Company converted $588 of loans made to MailVision into equity and its holding increased to 25.6%.

	December 31,	
	2009	2010
Invested in equity	$ 993	$ 1,581
Loans	642	74
Accumulated net loss	(125)	(338)
Total investment	$ 1,510	$ 1,317

NOTE 5:- PROPERTY AND EQUIPMENT

	December 31, 2009	December 31, 2010
Cost:		
Computers and peripheral equipment	$ 19,852	$ 20,424
Office furniture and equipment	9,458	10,151
Leasehold improvements	2,354	2,291
	31,664	32,866
Accumulated depreciation:		
Computers and peripheral equipment	17,359	19,213
Office furniture and equipment	8,276	8,665
Leasehold improvements	1,073	1,285
	26,708	29,163
Depreciated cost	$ 4,956	$ 3,703

Depreciation expenses amounted to $ 3,602, $ 3,159 and $2,822 for the years ended December 31, 2008, 2009 and 2010, respectively.

NOTE 6:- INTANGIBLE ASSETS, DEFERRED CHARGES

	Useful life (years)	December 31, 2009	December 31, 2010
a. Impaired Cost:			
Acquired technology	5-10	$ 15,517	$ 15,517
Customer relationship	9	4,172	4,172
Trade name	3	415	415
Existing contracts for maintenance	3	181	181
		20,285	20,285
Accumulated amortization:			
Acquired technology		10,321	11,554
Customer relationship		2,521	2,825
Trade name		415	415
Existing contracts for maintenance		181	181
		13,438	14,975
Amortized cost		$ 6,847	$ 5,310

NOTE 6:- INTANGIBLE ASSETS, DEFERRED CHARGES (Cont.)

b. Amortization expenses related to intangible assets amounted to $ 3,839, $ 1,810 and $ 1,537 for the years ended December 31, 2008, 2009 and 2010, respectively.

c. Amortization expenses related to deferred charges amounted to $ 94, $ 49 and $ 0 for the years ended December 31, 2008, 2009 and 2010, respectively.

d. Expected amortization expenses are as follows:

Year ending December 31,		
2011	$	1,327
2012	$	1,124
2013	$	933
2014	$	869
2015	$	717
2016 and thereafter	$	340

NOTE 7:- FAIR VALUE MEASUREMENTS

In accordance with ASC No. 820, the Group measures its foreign currency derivative instruments, the contingent consideration to NSC's former shareholders and the liability related to equity based compensation 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. The contingent consideration to NSC's former shareholders and the liability related to equity based compensation are classified within Level 3 value hierarchy because these liabilities are based on present value calculations and an externally valuation models whose inputs include market interest rates, estimated operational capitalization rates, volatilities and illiquidity. Unobservable inputs used in these models are significant to the fair value of the investments.

The Group's financial assets and liabilities measured at fair value on a recurring basis, consisted of the following types of instruments as of the following dates:

	December 31, 2009		
	Fair value measurements using input type		
	Level 2	**Level 3**	**Total**
Foreign currency derivative contracts	$ 98	$ -	$ 98
Total financial assets	$ 98	$ -	$ 98

NOTE 7:- FAIR VALUE MEASUREMENTS (Cont.)

	December 31, 2010		
	Fair value measurements using input type		
	Level 2	Level 3	Total
Foreign currency derivative contracts	$ 822	$ -	$ 822
Contingent consideration related to NSC's former shareholders	-	355	355
Liability related to equity based compensation	-	718	718
Total financials assets	$ 822	$ 1,073	$ 1,895

NOTE 8:- OTHER PAYABLES AND ACCRUED EXPENSES

	December 31,	
	2009	2010
Employees and payroll accruals	$ 6,947	$ 9,670
Royalties provision	696	596
Government authorities	1,301	1,153
Accrued expenses	8,172	12,241
Others	470	508
	$ 17,586	$ 24,168

NOTE 9:- 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 9:- SENIOR CONVERTIBLE NOTES (Cont.)

Effective January 1, 2009, the Company adopted the amendment to ASC 470-20 "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 in additional $ 2,775 interest expense in 2009.

The cumulative effect of the change in accounting principle in the amount of $ 9,329 was recognized, as an offsetting adjustment to the retained earnings as of January 1, 2007. In addition, an increase of $ 20,251 was recorded to additional paid in capital as of January 1, 2007.

During 2008, 2009 and 2010, the Company repurchased $ 51,500, $73,100 and $ 50, respectively, in principal amount of the notes for a total cost, including accrued interest, of $ 50,200 $ 73,147 and $ 50, 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 and 2010. As of December 31, 2010, there are $ 353 in principal amount of the notes outstanding.

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, 2009 and 2010:

	December 31,	
	2009	**2010**
Net carrying amount of liability component	$ 403	$ 353
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,		
	2008	**2009**	**2010**
Contractual interest expense	$ 2,308	$ 1,260	$ 17
Amortization of discount	4,868	2,828	-
Total interest expense	$ 7,176	$ 4,088	$ 17
Effective interest rate	3.35%	3.35%	2.00%

NOTE 10:- LONG-TERM BANK LOANS

In April and July 2008, the Company entered into loan agreements with Israeli commercial banks 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 $ 7,000. 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 and 2010, the Company was in compliance with its covenants to the banks.

NOTE 11:- COMMITMENTS AND CONTINGENT LIABILITIES

a. Lease commitments:

The Group's facilities are rented under several lease agreements in Israel, Europe and the U.S. for periods ending in 2016.

Future minimum rental commitments under non-cancelable operating leases, are as follows:

Year ending December 31,	
2011	$ 4,775
2012	4,081
2013	544
2014	559
2015	39
2016 and thereafter	39
Total minimum lease payments *)	$ 10,037

*) Minimum payments have been reduced by minimum sublease rental of $ 1,933 due in the future under non-cancelable subleases.

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

Rent expenses for the years ended December 31, 2008, 2009 and 2010, were approximately $ 6,432, $ 4,558 and $ 4,790, respectively.

b. Inventory commitments:

The Group is obligated under certain agreements with its suppliers to purchase specified items of excess inventory which is expected to be utilized in 2011. Non- cancelable obligations as of December 31, 2010, were approximately $ 930.

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

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

Under the research and development agreements of the Company and its Israeli subsidiaries 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 and 2010, the Company has a contingent obligation to pay royalties in the amount of approximately $ 8,715 and $ 12,463 respectively. The Israeli subsidiaries of the Company have a contingent obligation to pay royalties in the amount of approximately $ 10,252 and $ 10,894 as of December 31, 2009 and 2010, respectively

As of December 31, 2010, the Company has paid or accrued royalties to the OCS in the amount of $ 416, which was recorded to cost of revenues. The Israeli subsidiaries of the Company has paid or accrued royalties to OCS in the amount of $ 465, 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. See Note 8.

e. Legal proceedings:

The Group's major customer in 2008 and 2009 has asserted that the Group received approximately $2.6 million in payments from them during the ninety day period prior to their bankruptcy filing in January 2009 that constitute avoidable preferential transfers. The Group has entered into an agreement with the customer that tolls the statute of limitations with respect to these claims until April 14, 2011. The Group expects to engage in discussions with the customer with respect to these claims. Management believes that the Group has valid defenses to these claims. However, it is unable to estimate the likelihood of a settlement with the customer being reached, or to estimate the range of loss if such a settlement is reached. In addition, if a settlement with the customer is not reached, the Group is unable to estimate the likelihood of an unfavorable outcome if the customer commences a formal proceeding, nor is it able to estimate the range of loss if the outcome of such formal proceeding is unfavorable.

In May 2007, the Company entered into an agreement with respect to property adjacent to its headquarters in Israel, pursuant to which a building of approximately 145,000 square feet has been erected and was expected to be leased to the Company for a period of eleven years.

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

This new building was substantially completed on a structural level in May 2010. The landlord claimed that the Company should have taken delivery of the building at that time and started paying rent. The Company disagreed with the landlord's interpretation of the relevant agreement. As a result, the landlord terminated the agreement and leased the property to a third party. This dispute has been referred to arbitration where the Company claims that due to the landlord's failure the Company lost significant potential revenues. The landlord counterclaimed alleging that it sustained losses equal to approximately one year's rent and management fees in the amount of approximately NIS 14 million (approximately $ 3.9 million). The claim is at an early stage and it is not possible at this stage to predict the outcome of these proceedings. The Company believes that it has valid defenses to the counterclaim.

In September 2009, Network Gateway Solutions LLC filed a complaint in the United States District Court for the District of Delaware against the Company and 19 other defendants alleging the infringement of certain patents owned by Network Gateway. The Company agreed to defend Patton Electronics, a customer of the Company who was also a defendant in this litigation. The Company settled the proceedings against Patton and itself in 2010 and the litigation has been dismissed.

NOTE 12:- EQUITY

a. Treasury stock:

In January 2008, the Company's Board of Directors approved a share repurchase plan pursuant to which the Company was authorized to purchase up to an aggregate amount of 4,000,000 of its outstanding ordinary shares. During the year ended December 31, 2008, the Company purchased 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 nonemployees:

Warrants to purchase 10,000 shares at a weighted average exercise price of $ 4.82 per share were granted in the year ended December 31, 2008 and warrants to purchase 25,000 shares at a weighted average exercise price of $ 2.92 per share were granted in the year ended December 31, 2010, in each case expiring seven years from the date of grant. The Company recorded immaterial compensation expenses in accordance with ASC 505. As of December 31, 2010, 30,000 warrants issued to consultants are outstanding and exercisable.

NOTE 12:- EQUITY (Cont.)

c. Employee Stock Purchase Plan:

In May 2001, the Company's Board of Directors adopted the Employee Stock Purchase Plan ("ESPP" or "the Purchase Plan"), which was amended, in July 2007. The Purchase Plan, as amended, provides for the issuance of up to 6,500,000 ordinary shares. During 2008, the Company's Board of Directors decided to suspend operation of the Purchase Plan. In the year ended December 31, 2010, the Company's Board of Directors decided to reinstate the Purchase Plan.
As of December 31, 2010, 4,004,683 shares were available for future issuance under the Purchase Plan. Eligible employees can have up to 10% of their wages, up to certain maximums, used to purchase ordinary shares. The Purchase Plan is implemented with purchases every six months. 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 records compensation expense in accordance with ASC 718, "Compensation - Stock Compensation", with respect to purchase under the Purchase Plan.

d. Employee Stock Option Plans:

In the year ended December 31, 2008, the Board of Directors approved the 2008 Equity Incentive Plan that became effective in January 2009. As of December 31, 2010, the total number of shares authorized for grant under this Plan is 2,028,746.

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 12:- EQUITY (Cont.)

The following is a summary of the Group's stock option activity and related information for the year ended December 31, 2010:

	Amount of options	Weighted average exercise price	Weighted average remaining contractual term (in years)	Aggregate intrinsic value
Outstanding at beginning of year	*) 6,165,867	$ 6.93		
Changes during the year:				
Granted	990,924	$ 3.35		
Exercised	(934,823)	$ 2.74		
Forfeited	(568,750)	$ 7.26		
Expired	(868,332)	$ 6.38		
Options outstanding at end of year	**) 4,784,886	$ 7.06	3.7	$ 6,174
Vested and expected to vest	4,306,397	$ 7.06	3.7	$ 5,557
Options exercisable at end of year	2,920,925	$ 9.52	2.23	$ 1,004

*) Including 40,269 restricted share units ("RUS's") granted in 2009.

**) Including 30,202 and 142,152 restricted share units ("RUS's") granted in 2009 and 2010, respectively.

As of December 31, 2010, the Company recorded a liability based on its fair value in the amount of $ 500 relating to commitment to grant RSU's that were granted in January 2011. In addition, the Company recorded a liability in its fair value in the amount of $ 160 relating to commitment to grant RSU's subject to the Company's share price in the period in between the grant date and January 1, 2013.

The weighted-average grant-date fair value of options granted during the years ended December 31, 2008, 2009 and 2010 was $ 1.80, $ 1.22 and $ 2.00, 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.

NOTE 12:- EQUITY (Cont.)

Total intrinsic value of options exercised for the twelve months ended December 31, 2008, 2009 and 2010 was \$ 124, \$ 130 and \$ 2,946, respectively. As of December 31, 2010, there was \$ 2,949 of total unrecognized compensation cost related to non-vested share-based compensation arrangements granted under the Company's stock option plans. That cost is expected to be recognized over a weighted-average period of 1.13 years.

The options outstanding as of December 31, 2010, have been separated into ranges of exercise prices, as follows:

Range of exercise price	Options outstanding as of December 31, 2010	Weighted average remaining contractual life (Years)	Weighted average exercise price	Options exercisable as of December 31, 2010	Weighted average exercise price of exercisable options
\$ 0.00-1.10	213,172	6.70	\$ 0.00	-	\$ 0.00
\$ 1.50-2.51	673,300	5.55	\$ 2.08	174,925	\$ 2.06
\$ 2.57-4.00	569,558	6.05	\$ 3.05	68,570	\$ 2.91
\$ 4.08-6.49	1,055,956	5.06	\$ 5.38	443,405	\$ 5.82
\$ 6.51-9.24	109,000	3.31	\$ 6.85	81,750	\$ 6.85
\$ 9.32-14.76	2,138,900	1.54	\$ 11.14	2,127,275	\$ 11.15
\$ 15.94	25,000	0.99	\$ 15.94	25,000	\$ 15.94
	4,784,886	3.7	\$ 7.06	2,920,925	\$ 9.52

e. During 2008 and 2009, the Company extended the exercise period 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, \$ 208 and \$ 14 for the years ended December 31, 2008, 2009 and 2010, 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 13a.)

NOTE 13:- TAXES ON INCOME

a. Israeli taxation:

1. Measurement of taxable income:

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

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

The Company's production facilities in Israel 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.

As of December 31, 2010, retained earnings included approximately $ 540 in tax-exempt income earned by the Company's "Approved Enterprise". The Company's Board of Directors has decided not to declare dividends out of such tax-exempt income. Accordingly, no deferred income taxes have been provided on income attributable to the Company's "Approved Enterprise".

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

NOTE 13:- TAXES ON INCOME (Cont.)

The entitlement to the above benefits is conditional upon the Company fulfilling the conditions stipulated by the above Investment Law, regulations published thereunder and the 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, 2010, 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, 2010, there was no taxable income attributable to the Beneficiary Enterprise.

In December 2010, the "Knesset" (Israeli Parliament) passed the Law for Economic Policy for 2011 and 2012 (Amended Legislation), 2011, which prescribes, among others, amendments in the Investment Law. The amendment became effective as of January 1, 2011. According to the amendment, the benefit tracks in the Investment Law were modified and a flat tax rate applies to the Company's entire preferred income. The Company will be able to opt to apply (the waiver is non-recourse) the amendment and from then on it will be subject to the amended tax rates that are: 2011 and 2012 - 15% (in development area A - 10%), 2013 and 2014 - 12.5% (in development area A - 7%) and in 2015 and thereafter - 12% (in development area A - 6%).

NOTE 13:- TAXES ON INCOME (Cont.)

The Company is not in a development area A.
The Company is examining the possible effect of the amendment on the financial statements, if at all, and at this time has not yet decided whether to apply the amendment.

3. Net operating loss carryforward:

As of December 31, 2010, the Company has cumulative losses for tax purposes in the amount of approximately $ 27,000, which can be carried forward and offset against taxable income in the future for an indefinite period. As of December 31, 2010, the Company recorded a deferred tax asset of $ 3,213 in respect of such carryforward tax losses.

As of December 31, 2010, the Company's Israeli subsidiaries have estimated total available carry forward tax losses of approximately $ 66,000.

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 Exchange 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.

NOTE 13:- TAXES ON INCOME (Cont.)

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, the "Knesset" (Israeli Parliament) 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 is taxed under the Investment Law may be considerably lower (see also Note 13 a2).

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

	Year ended December 31,		
	2008	**2009**	**2010**
Domestic	$ (2,811)	$ (5,963)	$ 9,277
Foreign	(79,892)	3,035	1,066
	$ (82,703)	$ (2,928)	$ 10,343

c. Taxes on income are comprised as follows:

	Year ended December 31,		
	2008	**2009**	**2010**
Current taxes	$ 674	$ 290	$ 436
Deferred taxes	(169)	-	(2,321)
	$ 505	$ 290	$ (1,885)
Domestic	$ (1,365)	$ 484	$ (1,617)
Foreign	1,870	(194)	(268)
	$ 505	$ 290	$ (1,885)

NOTE 13:- 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,	
	2009	**2010**
Deferred tax assets:		
Net operating loss carry forward	$ 53,748	$ 50,826
Reserves and allowances	8,291	6,798
Net deferred tax assets before valuation allowance	62,039	57,624
Valuation allowance	(59,812)	(53,076)
Deferred tax asset	$ 2,227	$ 4,548
Domestic:		
Short-term deferred tax asset	$ 678	$ 1,860
Long-term deferred tax asset	765	1,353
	$ 1,443	$ 3,213
Foreign:		
Short-term deferred tax asset	$ 375	$ 427
Long-term deferred tax asset	409	908
	$ 784	$ 1,335

The Company's U.S. subsidiary has estimated total available carry forward tax losses of approximately $ 82,000 to offset against future taxable income that expire between 2020 and 2029. As of December 31, 2010, the Company’s U.S subsidiary recorded a deferred tax asset of $ 1,335 relating to the available net carry forward tax losses.

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 13:- TAXES ON INCOME (Cont.)

e. Reconciliation of the theoretical tax expenses:

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

	Year ended December 31,		
	2008	**2009**	**2010**
Income (loss) before taxes, as reported in the consolidated statements of operations	$ (82,703)	$ (2,928)	$ 10,343
Statutory tax rate	27%	26%	25%
Theoretical tax benefits on the above amount at the Israeli statutory tax rate	$ (22,330)	$ (761)	$ 2,586
Income tax at rate other than the Israeli statutory tax rate	139	337	327
Non-deductible expenses including equity based compensation expenses	2,172	1,425	646
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	75	633	(2,914)
Utilization of operating losses carry forward	(3,231)	(1,469)	(2,846)
Taxes in respect to prior years	87	90	41
State and Federal taxes	177	21	90
Inter-company charges	57	-	-
Other individually immaterial income tax item	109	14	185
Actual tax expense (benefit)	$ 505	$ 290	$ (1,885)

NOTE 13:- TAXES ON INCOME (Cont.)

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

Gross unrecognized tax benefits as of January 1, 2010	$ 158
Increase in tax position for current year	-
Gross unrecognized tax benefits as of December 31, 2010	$ 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 $ 164 and $ 180 at December 31, 2009 and 2010, respectively.

The Company has received final tax assessment through the year 2005.

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

	Year ended December 31,		
	2008	**2009**	**2010**
Numerator:			
Net income (loss) attributed to Audiocodes shareholders	$ (85,790)	$ (2,822)	$ 12,126
Denominator:			
Denominator for basic earnings per share - weighted average number of ordinary shares, net of treasury stock	41,200,523	40,207,923	40,559,759
Effect of dilutive securities:			
Employee stock options and ESPP	*) -	*) -	401,240
Senior convertible notes	*) -	*) -	*) -
Denominator for diluted net earnings per share - adjusted weighted average number of shares	41,200,523	40,207,923	40,960,999

*) Antidilutive.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 15:- FINANCIAL EXPENSES, NET

	Year ended December 31,		
	2008	**2009**	**2010**
Financial expenses:			
Interest	$ (6,807)	$ (4,739)	$ (301)
Amortization of marketable securities premiums and accretion of discounts, net	(110)	(253)	-
Others	(131)	(232)	(393)
	(7,048)	(5,224)	(694)
Financial income:			
Interest and others	3,780	2,480	600
	$ (3,268)	$ (2,744)	$ (94)

NOTE 16:- 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, "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, 2008, 2009 and 2010 and long-lived assets as of December 31, 2008, 2009 and 2010.

	2008		**2009**		**2010**	
	Total revenues	**Long-lived assets**	**Total revenues**	**Long-lived assets**	**Total revenues**	**Long-lived assets**
Israel	$ 13,597	$ 21,599	$ 10,410	$ 20,938	$ 19,223	$ 19,867
Americas	91,640	26,250	69,960	22,799	71,538	21,128
Europe	40,854	118	27,101	87	32,566	66
Far East	28,653	56	18,423	74	26,713	47
	$ 174,744	$ 48,023	$ 125,894	$ 43,898	$ 150,040	$ 41,108

NOTE 16:- GEOGRAPHIC INFORMATION (Cont.)

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,		
	2008	2009	2010
Technology	$ 58,484	$ 34,995	$ 45,266
Networking	116,260	90,899	104,774
	$ 174,744	$ 125,894	$ 150,040

NOTE 17:- DERIVATIVE INSTRUMENTS

The Group 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 Group 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.

The Group had a net deferred gain associated with cash flow hedges of $ 98 and $ 822 recorded in other comprehensive income as of December 31, 2009 and 2010, respectively. As of December 31, 2010, the hedged transactions are expected to occur within twelve months.

The Group 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 820 at level 2. The net losses (gains) recognized in "financial and other expenses, net" during 2009 and 2010 were $ 81 and $ (200), respectively.

NOTE 17:- DERIVATIVE INSTRUMENTS (Cont.)

As of December 31, 2009 and 2010, the Group had outstanding forward contracts in the amount of $ 10,500 and $ 13,125, respectively.

The fair value of the Group'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, 2009 and 2010, are summarized below:

Foreign exchange forward and options contracts	Balance sheet	December 31, 2009	December 31, 2010
Fair value of foreign exchange forward contracts	"Other receivables and prepaid expenses"	$ 98	$ 822
Gains recognized in OCI (effective portion)	"Other comprehensive income"	$ 1,010	$ 724

The effect of derivative instruments in cash flow hedging relationship on income for the years ended December 31, 2009 and 2010 is summarized below:

Foreign exchange forward and options contracts	Statements of operations	Year ended December 31, 2009	Year ended December 31, 2010
Gain on derivatives recognized in OCI	"Operating expenses"	$ 398	$ 1,316
Gain (loss) recognized in income on derivatives (effective portion)	"Operating expenses"	$ (612)	$ 592

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