

	December 31,				
	2003	2004	2005	2006	2007
Balance Sheet Data:					
Cash and cash equivalents	\$ 48,898	\$ 166,832	\$ 70,957	\$ 25,171	\$ 75,063
Short-term bank deposits, structured notes, marketable securities and accrued interest	—	—	71,792	58,080	35,309
Working capital	46,232	171,447	152,047	97,454	124,676
Long-term bank deposits, structured notes and marketable securities	50,270	50,195	77,572	50,377	32,670
Total assets	128,530	272,145	292,223	337,056	344,487
Senior convertible notes	—	120,660	120,836	121,015	121,198
Total shareholders' equity	106,518	121,985	139,106	164,685	174,492
Capital stock	116,639	126,826	130,744	149,336	162,103

B. CAPITALIZATION AND INDEBTEDNESS

Not applicable.

C. REASONS FOR THE OFFER AND USE OF PROCEEDS

Not applicable.

D. RISK FACTORS

We are subject to various risks and uncertainties relating to or arising out of the nature of our business and general business, economic, financing, legal and other factors or conditions that may affect us. We believe that the occurrence of any one or some combination of the following factors could have a material adverse effect on our business, financial condition, cash flows and results of operations.

Risks Related to Our Business and Industry

We reported a loss for 2007. We may experience additional losses in the future.

After reporting net income for 2004, 2005 and 2006, we reported a net loss of \$3.9 million in 2007. We may continue to report losses in 2008. Our results in 2007 were impacted by weaker than expected performance by our recent acquisitions and lower than expected sales of our boards business line. The majority of our expenses are directly and indirectly related to the number of people we employ. We may increase our expenses based on projections of revenue growth. If at any given time we do not meet our expectations for growth in revenues our expenses incurred in anticipation of projected revenues may cause us to incur a loss. We may not be able to anticipate a loss in advance and adjust our expenses accordingly. We will need to increase revenues and reduce expenses in order to return to profitability.

We are dependent on the development of the VoIP market to increase our sales.

We are dependent on the development of the Voice over Internet Protocol, or VoIP, market to increase our sales. Most existing networks are still not based on Voice over Packet technology which we use in our products designed for the VoIP market. We cannot be sure that the delivery of telephone and other communications services over packet networks will expand at significant rates, or that there will be a need to interconnect to other networks utilizing the type of technology contained in our products. For example, the need for our Media Gateway products depends on the need to inter connect VoIP networks with traditional non-packet based networks. Our session border control products depend on growth in the need to inter connect Voice over Packet networks with each other. The adaptation process of connecting packet networks and telephone networks can be time consuming and costly. Sales of our VoIP products will depend on the development of packet networks and the commercialization of VoIP services. If this market develops more slowly than we expect, we may not be able to sell our products in a significant enough volume to be profitable.

We intend to expand our business through acquisitions that could result in diversion of resources and extra expenses. This could disrupt our business and adversely affect our financial condition.

Part of our strategy is to pursue acquisitions of, or investments in, businesses and technologies or to establish joint ventures to expand our business. For example, in April 2003, we purchased a product group from Nortel Networks and in May 2004 we purchased Ai-Logix Inc., now known as AudioCodes Inc. In 2005, we invested in two Israeli-based companies, MailVision Ltd. and CTI Squared Ltd., and continued investing in Natural Speech Communication Ltd. We have recognized□

In July 2006, we acquired Nuera Communications, Inc. (now called AudioCodes Inc.), in August 2006, we acquired Netrake Corporation (now called AudioCodes Inc.), and in April 2007, we completed our acquisition of CTI Squared Ltd.

The negotiation of acquisitions, investments or joint ventures, as well as the integration of acquired or jointly developed businesses or technologies, could divert our management's time and resources. Nuera is significantly larger than any other acquisition we have made. As a result, we have experienced a diversion of our management's time and resources in connection with the integration and operation of Nuera's business.

Acquired businesses, technologies or joint ventures may not be successfully integrated with our products and operations. The markets for the products produced by the companies we acquire may take longer than we anticipated to develop and to result in increased sales and profits for us. We may not realize the intended benefits.

In addition, acquisitions could result in:

- substantial cash expenditures;
- potentially dilutive issuances of equity securities;
- the incurrence of debt and contingent liabilities;
- a decrease in our profit margins;
- amortization of intangibles and potential impairment of goodwill;
- write-offs of in-process research and development;
- reduction of management attention to other parts of the business;
- failure to invest in different areas or alternative investments;
- failure to generate expected financial results or reach business goals; and
- increased expenditures on human resources and related costs.

If acquisitions disrupt our sales or marketing efforts or operations, our business may suffer.

We may not be able to raise additional financing for our capital needs on favorable terms, or at all, which could limit our ability to grow and to continue our longer term expansion plans.

We may need to raise additional capital to continue our longer term expansion plans. To the extent that we cannot fund our activities and acquisition program through our existing cash resources and any cash we generate from operations, we may need to raise equity or debt funds through additional public or private financings. In addition, we may be required to repay all or a portion of our outstanding senior convertible notes in November 2009. We cannot be certain that we will be able to obtain additional financing on commercially reasonable terms, or at all. This could inhibit our growth, increase our financing costs or, if we are unable to repay our senior convertible notes, cause us severe financial difficulties.

A downturn in general economic conditions could adversely affect our revenues, operating results and financial condition.

Periods of economic slowdown or recession in the United States or other relevant regions or countries in which we market our products or the public perception that these periods of economic slowdown or recession may occur, may reduce corporate and consumer spending and decrease the demand for our products. The current weakness in the global economy, caused in part by the increase in energy prices, could reduce corporate and consumer spending. Furthermore, periods of economic slowdown or recession could adversely affect the financial stability of our subcontractors, partners, distributors and resellers. If general economic conditions are affected.

If new products we recently introduced or expect to introduce in the future fail to generate the level of demand we anticipated, we will realize a lower than expected return from our investment in research and development with respect to those products, and our results of operations may suffer.

Our success is dependent, in part, on the willingness of our customers to transition or migrate to new products, such as our expanded offering of Mediant and IPmedia products, the session border controller products that we now offer as a result of our acquisition of Netrake, the software application products that we now offer as a result of our acquisition of CTI Squared, or expected future products. We are involved in a continuous process of evaluating changing market demands and customer requirements in order to develop and introduce new products, features and applications to meet changing demands and requirements. We need to be able to interpret market trends and the advancement of technology in order to successfully develop and introduce new products, features and applications. If potential customers defer transition or migration to new products, our return on our investment in research and development with respect to products recently introduced or expected to be introduced in the near future will be lower than we originally anticipated and our results of our operations may suffer.

Because of the rapid technological development in the communications equipment market and the intense competition we face, our products can become outmoded or obsolete in a relatively short period of time, which requires us to provide frequent updates and/or replacements to existing products. If we do not successfully manage the transition process to the next generation of our products, our operating results may be harmed.

The communications equipment market is characterized by rapid technological innovation and intense competition. Accordingly, our success depends in part on our ability to develop next generation products in a timely and cost-effective manner. The development of new products is expensive, complex and time consuming. If we do not rapidly develop our next generation products ahead of our competitors, we may lose both existing and potential customers to our competitors. Further, if a competitor develops a new, less expensive product using a different technological approach to delivering informational services over existing networks, our products would no longer be competitive. Conversely, even if we are successful in rapidly developing new products ahead of our competitors and we do not cost-effectively manage our inventory levels of existing products when making the transition to the new products, our financial results could be negatively affected by high levels of obsolete inventory. If any of the foregoing were to occur, then our operating results would be harmed.

Our industry is rapidly evolving and we may not be able to keep pace with technological changes, which could adversely affect our business.

The transmission of multimedia over data networks is rapidly evolving. Short product life cycles place a premium on our ability to manage the transition from current products to new products. Our future success in generating revenues will depend on our ability to enhance our existing products and to develop and introduce new products and product features. These products and features must keep pace with technological developments and address the increasingly sophisticated needs of our customers. The development of new technologies and products is increasingly complex and uncertain. This increases the difficulty in coordinating the planning and production process and can result in delay in the introduction of new technologies and products.

The increase in the number of IP networks may adversely affect the demand for media gateway products.

Media gateway products are primarily intended to transcode voice from traditional telephony networks to IP networks and vice versa. Along with the growth in the number of IP networks, there has been an increase in the amount of information that is sent directly from one IP network to another IP network. This direct network communication potentially obviates the need to use a media gateway or transcoding. A reduction in the demand for media gateways may adversely affect the demand for our media gateway products and, in turn, adversely affect our results of operations.

New industry standards, the modification of our products to meet additional existing standards or the addition of features to our products may delay the introduction of our products or increase our costs.

The industry standards that apply to our products are continually evolving. In addition, since our products are integrated into networks consisting of elements manufactured by various companies, they must comply with a number of industry standards and practices established by various international bodies and industry forums. Should new standards gain broad acceptance, we will be required to adopt those standards in our products. We may also decide to modify our products to meet additional existing standards or add features to our products. Standards may be adopted by various industry interest groups or may be proprietary and nonetheless accepted broadly in the industry. It may take us a significant amount of time to develop and design products incorporating these new standards. We may also have to pay additional fees to the developers of the technologies which constitute the newly adopted standards.

Our OEM customers or potential customers may develop or prefer to develop their own technical solutions, and as a result, would not buy our products.

Our products are sold also as components or building blocks to large original equipment manufacturers, or OEM's, or network equipment providers, or NEP's. These customers incorporate our products into their product offerings, usually in conjunction with value-added services of their own or of third parties. OEM or NEP customers or potential customers may prefer to develop their own technology or purchase third party technology. They could also manufacture their own components or building blocks that are similar to the ones we offer. Large customers have already committed significant resources in developing integrated product offerings. Customers may decide that this gives them better profitability and/or greater control over supplies, specifications and performance. Customers may therefore not buy components or products from an external manufacturer such as us. This could have an adverse impact on our ability to sell our products and our revenues.

We have depended, and expect to continue to depend, on a small number of large customers. The loss of one of these customers or the reduction in purchases by a significant customer could have a material adverse effect on our revenue.

Historically, a substantial portion of our revenue has been derived from large purchases by a small number of OEMs and network equipment providers, systems integrators and distributors. For example, our top three customers accounted for approximately 24.8% of our revenues in 2005, 24.9% of our revenues in 2006 and 26.1% of our revenues in 2007. Sales to Nortel Networks, our largest customer, accounted for 17.0% of our revenues in 2007 compared to 15.2% of our revenues in 2006 and 16.3% of our revenues in 2005. We do not enter into sales agreements in which a customer is obligated to purchase a set quantity of our products. Based on our experience, we expect that our customer base may change from period to period. If we lose a large customer and fail to add new customers there could be a material adverse effect on our results of operations.

We have a limited order backlog. If revenue levels for any quarter fall below our expectations, our results of operations will be adversely affected.

We have a limited order backlog, which makes revenues in any quarter substantially dependent on orders received and delivered in that quarter. A delay in the recognition of revenue, even from one customer, may have a significant negative impact on our results of operations for a given period. We base our decisions regarding our operating expenses on anticipated revenue trends, and our expense levels are relatively fixed, or require some time for adjustment. Because only a small portion of our expenses varies with our revenues, if revenue levels fall below our expectations, our results of operations will be adversely affected.

Generally, we sell to original equipment manufacturers, or OEMs, network equipment providers or system integrator customers, as well as to distributors. As a result, we have less information with respect to the actual requirements of end users and their utilization of equipment. We also have less influence over the choice of equipment by these end users.

We typically sell to OEM customers, network equipment providers, and system integrators, as well as to distributors. Our customers usually purchase equipment from several suppliers and may be trying to fulfill one of their customers' specific technical specifications. We rely heavily on our customers for sales of our products and to inform us about market trends and the needs of their customers. We cannot be certain that this information is accurate. If the information we receive is not accurate, we may be manufacturing products that do not have a customer or fail to manufacture products that end users want. Because we are selling products to OEMs, system integrators and distributors rather than directly to end users, we have less control over the ultimate selection of products by end users.

The markets we serve are highly competitive and many of our competitors have much greater resources, which may make it difficult for us to maintain profitability.

Competition in our industry is intense and we expect competition to increase in the future. Our competitors currently sell products that provide similar benefits to those that we sell. There has been a significant amount of merger and acquisition activity and strategic alliances frequently involving major telecommunications equipment manufacturers acquiring smaller companies, and we expect that this will result in an increasing concentration of market share among these companies, many of whom are our customers.

Our principal competitors in the sale of signal processing chips are Texas Instruments, Broadcom, Infineon, Centillum, Surf and Mindspeed. Several large manufacturers of generic signal processors, such as Motorola, Agere Systems, which merged with LSI Corporation in April 2007, and Intel have begun, or are expected to begin, marketing competing processors. Our principal competitors in the communications board market are NMS Communications, Intel, Motorola, Cantata Technology, Aculab and PIKA Technologies, Inc.

Our principal competitors in the area of analog media gateways (2 to 24 ports) for access and enterprise are Cisco Systems Inc., Mediatrix Telecom, Inc., Vega Stream Limited, Samsung, Innovaphone AG, Quintum Technologies, Tainet Communication System Corp., Welltech, Ascii Corp., D-Link Systems, Inc., Multitech Inc., Inomedia, OKI and LG. In addition we face competition in low, mid and high density gateways from internal development at companies such as Nortel, Alcatel-Lucent, Nokia-Siemens, Huawei, Ericsson, UStarcom, ZTE and from Cisco Systems, Inc., Veraz Networks, Sonus Networks, General Bandwidth, Dialogic/Cantat Technologies and Commatch (Telrad).

Our principal competitors in the media server market segment are Cantata Technology, NMS Communications, Convedia/Radisys, IP Unity Glenayre, Cognitronics and Aculab. In addition, we face competition in software-based and hardware-based media servers from internal development at companies such as Hewlett-Packard, Comverse-NetCentrex, Nortel, Alcatel - Lucent, Nokia - Siemens and Ericsson.

With respect to session border controllers, we compete against Acme Packets, Nextone/Nexpoint, Juniper and Sonus Networks. In the security gateway market, we compete against private companies such as Reefpoint/Nexpoint and Azaire.

We also face significant and increasing competition in the market for products utilized in the VoIP market. Our competitors in the market for VoIP products include telecommunications companies, data communication companies and companies specializing in voice over IP products, some of which have greater name recognition, larger installed customer bases and significantly greater financial, technical, sales and marketing resources than we do.

Many of our competitors have the ability to offer complete network solutions and vendor-sponsored financing programs to prospective customers. Some of our competitors with broad product portfolios may also be able to offer lower prices on products that compete with ours because of their ability to recoup a loss of margin through sales of other products or services. Additionally, voice, audio and other communications alternatives that compete with our products are being continually introduced.

In the future, we may also develop and introduce other products with new or additional telecommunications capabilities or services. As a result, we may compete directly with our customers with respect to sales to telephone companies and other telecommunications infrastructure providers. Additional competitors may include companies that currently provide computer software products and services, such as telephone, media, publishing and cable television. The ability of some of our competitors to bundle other enhanced services or complete solutions with VoIP products could give these competitors an advantage over us.

Offering to sell system level products that compete with the products manufactured by our customers could negatively affect our business.

Our product offerings range from media gateway building blocks, such as chips and boards, to media gateways, media servers and session border control products (systems). These products could compete with products offered by our customers. These customers could decide to decrease purchases from us because of this competition. This could result in a material adverse effect on our results of operations.

Offering to sell directly to carriers or service providers may expose us to requirements for service which we may not be able to meet.

We also sell our products directly to telecommunications carriers, service providers or other end-users. We have traditionally relied on third party distributors and OEMs to test and or sell our products and inform us about the requirements of end-users. We have limited experience selling our products directly to end-user customers. Telecommunications carriers and other service providers have great bargaining power in negotiating contracts. Generally, contracts with end-users tend to be more complex and impose more obligations on us than contracts with third party distributors. Contracts with end-users may also require extensive support teams in the country where the end-user is deploying its network. We may be unable to meet the requirements of these contracts. If we are unable to meet the conditions of a contract with an end-user customer, we may be subject to liquidated damages or liabilities that could result in a material adverse effect on our results of operations.

Selling directly to end-users may adversely affect our relationship with our current third party distributors upon whom we will continue to rely for a significant portion of our sales. Loss of third party distributors and OEMs, or a decreased commitment by them to sell our products as a result of direct sales by us, could adversely affect our sales and results of operations.

We rely on third-party subcontractors to assemble our products and therefore do not directly control manufacturing costs, product delivery schedules or manufacturing quality.

Our products are assembled and tested by third-party subcontractors. As a result of our reliance on third-party subcontractors, we cannot directly control product delivery schedules. We have in the past experienced delays in delivery schedules. Any problems that occur and persist in connection with the delivery, quality or cost of the assembly and testing of our products could have a material adverse effect on our business, financial condition and results of operations. This reliance could also lead to product shortages or quality assurance problems, which, in turn, could lead to an increase in the costs of manufacturing or assembling our products.

We may not be able to deliver our products to our customers, and substantial reengineering costs may be incurred if a small number of third-party suppliers do not provide us with key components on a timely basis.

Texas Instruments Incorporated supplies all of the chips for our signal processor product line. Our signal processor line is used both as a product line in its own right and as a key component in our other product lines. Motorola manufactures all of the communications processors currently used on our communications boards. These suppliers also supply many of our competitors.

We have not entered into any long-term supply agreements or alternate source agreements with our suppliers and, while we maintain an inventory of critical components, our inventory of chips would likely not be sufficient in the event that we had to engage an alternate supplier for these components.

Texas Instruments is also one of our major competitors in providing signal processing solutions. An unexpected termination of the supply of the chips provided by Texas Instruments or Motorola or disruption in their timely delivery, would require us to make a large investment in capital and manpower resources to shift to using signal processors manufactured by other companies and may cause a delay in introducing replacement products. Customers may not accept an alternative product design. Supporting old products or redesigning products may make it more difficult for us to support our products.

We utilize other sole source suppliers upon whom we depend without having long term supply agreements.

Some of our sole source suppliers custom produce components for us based upon our specifications and designs while other of our sole source suppliers are the only manufacturers of certain components required by our products. We have not entered into any long-term supply agreements or alternative source agreements with our suppliers and while we maintain an inventory of components from single source providers, our inventory would likely not be sufficient in the event that we had to engage an alternate supplier of these single source components. In the event of any interruption in the supply of components from any of our sole source suppliers, we may have to expend significant time, effort and other resources in order to locate a suitable alternative manufacturer and secure replacement components. If no replacement components are available, we may be forced to redesign certain of our products. Any such new design may not be accepted by our customers. A prolonged disruption in supply may force us to redesign and retest our products. Any interruption in supply from any of these sources or an unexpected technical failure or termination of the manufacture of components could disrupt production, thereby adversely affecting our ability to deliver products and to support products previously sold to our customers.

In addition, if demand for telecommunications equipment increases, we may face a shortage of components from our suppliers. This could result in longer lead times, increases in the price of components and a reduction in our margins, all of which could adversely affect the results of our operations.

Our customers may require us to produce products or systems to hold in inventory in order to meet their “just in time”, or short lead time, delivery requirements. If we are unable to sell this inventory on a timely basis, we could incur charges for excess and obsolete inventory which would adversely affect our results of operations.

Our customers expect us to maintain an inventory of products available for purchase off the shelf subsequent to the initial sales cycle for these products. This may require us to incur the costs of manufacturing inventory without having a purchase order for the products. The VoP industry is subject to rapid technological change and volatile customer demands, which result in a short product commercial life before a product becomes obsolete. If we are unable to sell products that are produced to hold in inventory, we may incur write offs as a result of slow moving items, technological obsolescence, excess inventories, discontinued products and products with market prices lower than cost. Write offs could adversely affect our operating results and financial condition. We wrote-off inventory in a total amount of \$1.8 million in 2005, \$1.9 million in 2006 and \$700,000 in 2007.

The right of our customers to return products and their right to exchange products may affect our ability to recognize revenues which could adversely affect the results of our operations.

Some of our customers expect us to permit them to return some or all of the products they purchased from us. If we contractually agree to allow a customer to return products, the customer may be entitled to a refund for the returned products or to receive a credit for the purchase of replacement products. If we agree to this type of contractual obligations, it could affect our ability to recognize revenues. In addition, we may not be able to resell any products that are returned. This could adversely affect our results of operations.

Our products generally have long sales cycles and implementation periods, which increase our costs in obtaining orders and reduce the predictability of our revenues.

Our products are technologically complex and are typically intended for use in applications that may be critical to the business of our customers. Prospective customers generally must make a significant commitment of resources to test and evaluate our products and to integrate them into larger systems. As a result, our sales process is often subject to delays associated with lengthy approval processes that typically accompany the design and testing of new communications equipment. The sales cycles of our products to new customers are approximately six to twelve months after a design win, depending on the type of customer and complexity of the product. This time may be further extended because of internal testing, field trials and requests for the addition or customization of features. This delays the time until we realize revenue and results in our investing significant resources in attempting to make sales.

Long sales cycles also subject us to risks not usually encountered in a short sales span, including customers' budgetary constraints, internal acceptance reviews and cancellation. In addition, orders expected in one quarter could shift to another because of the timing of customers' procurement decisions. The time required to implement our products can vary significantly with the needs of our customers and generally exceeds several months; larger implementations can take multiple calendar quarters. This complicates our planning processes and reduces the predictability of our revenues.

Our proprietary technology is difficult to protect, and our products may infringe on the intellectual property rights of third parties. Our business may suffer if we are unable to protect our intellectual property or if we are sued for infringing the intellectual property rights of third parties.

Our success and ability to compete depend in part upon protecting our proprietary technology. We rely on a combination of patent, trade secret, copyright and trademark laws, nondisclosure and other contractual agreements and technical measures to protect our proprietary rights. These agreements and measures may not be sufficient to protect our technology from third-party infringement, or to protect us from the claims of others.

Enforcement of intellectual property rights may be expensive and may divert attention of management and of research and development personnel away from our business. Intellectual property litigation could also call into question the ownership or scope of rights owned by us. We believe that at least one of our patents may cover technology related to the ITU G.723.1 standard. Because of our involvement in the standard setting process, we may be required to license certain of our patents on a reasonable and non-discriminatory basis to a current or future competitor, to the extent required to carry out the G.723.1 standard. Additionally, our products may be manufactured, sold, or used in countries that provide less protection to intellectual property than that provided under U.S. or Israeli laws or where we do not hold relevant intellectual property rights.

We believe that the frequency of third party intellectual claims is increasing, as patent holders, including entities that are not in our industry and that purchase patents as an investment or to monetize such rights by obtaining royalties, use infringement assertions as a competitive tactic and a source of additional revenue. Any intellectual property claims against us, even without merit, could cost us a significant amount of money to defend and divert management's attention away from our business. We may not be able to secure a license for technology that is used in our products and we may face injunctive proceedings that prevent distribution and sale of our products even prior to any dispute being concluded. These proceedings may also have a deterrent effect on purchases by customers, who may be unsure about our ability to continue to supply their requirements. We may be forced to repurchase our products and compensate customers that have purchased such infringing products. We may be forced to redesign the product so that it becomes non-infringing, which may have an adverse impact on the results of our operations.

In addition, claims alleging that the development, use, or sale of our products infringes third parties' intellectual property rights may be directed either at us or at our direct or indirect customers. We may be required to indemnify such customers against claims made against them. We may be required to indemnify them even if we believe that the claim of infringement is without merit.

Multiple patent holders in our industry may result in increased licensing costs.

There are a number of companies besides us that hold patents for various aspects of the technology incorporated in our industry's standards and our products. We expect that patent enforcement will be given high priority by companies seeking to gain competitive advantages or additional revenues. The holders of patents from which we have not obtained licenses may take the position that we are required to obtain a license from them. We cannot be certain that we would be able to negotiate a license agreement at an acceptable price or at all. Our results of operations could be adversely affected by the payment of any additional licensing costs or if we are prevented from manufacturing or selling a product.

Changes in governmental regulations in the United States or other countries could slow the growth of the VoIP telephony market and reduce the demand for our customers' products, which, in turn, could reduce the demand for our products.

VoIP and other services are not currently subject to all of the same regulations that apply to traditional telephony. Nevertheless, it is possible that foreign or U.S. federal or state legislatures may seek to impose increased fees and administrative burdens on VoIP, data, and video providers. The FCC has already required VoIP service providers to meet various emergency service requirements relating to delivery of 911 calls, known as E911, and to accommodate law enforcement interception or wiretapping requirements, such as the Communications Assistance for Law Enforcement Act, or CALEA. In addition, the FCC may seek to impose other traditional telephony requirements such as disability access requirements, consumer protection requirements, number assignment and portability requirements, and other obligations, including additional obligations regarding E911 and CALEA.

The cost of complying with FCC regulations could increase the cost of providing Internet phone service which could result in slower growth and decreased profitability for this industry, which would adversely affect our business.

The enactment of any additional regulation or taxation of communications over the public Internet in the United States or elsewhere in the world could have a material adverse effect on our customers' (and their customers') businesses and could therefore adversely affect sales of our products. We do not know what effect, if any, possible legislation or regulatory actions in the United States or elsewhere in the world may have on private telecommunication networks, the provision of VoIP services and purchases of our products.

Use of encryption technology in our products is regulated by governmental authorities and may require special development, export or import licenses. Delays in the issuance of required licenses, or the inability to secure these licenses, could adversely affect our revenues and results of operations.

Growth in the demand for security features may increase the use of encryption technology in our products. The use of encryption technology is generally regulated by governmental authorities and may require specific development, export or import licenses. Encryption standards may be based on proprietary technologies. We may be unable to incorporate encryption standards into our products in a manner that will insure interoperability. We also may be unable to secure licenses for proprietary technology on reasonable terms. If we cannot meet encryption standards, or secure required licenses for proprietary encryption technology, our revenues and results of operations could be adversely affected.

We are subject to regulations that will require us to use components based on environmentally friendly materials, and we may be subject to various regulations relating to management and disposal of waste with respect to electronic equipment. Compliance with these regulations may increase our costs and adversely affect our results of operations.

We are subject to telecommunications industry regulations requiring the use of environmentally-friendly materials in telecommunications equipment. For example, pursuant to a European Community directive, telecom equipment suppliers were required to stop using specified materials that are not "environmentally friendly" by July 1, 2006. In addition, telecom equipment suppliers that take advantage of an exemption with respect to the use of lead in solders are required by this directive to eliminate the lead in solders from their products by 2010. Some of our customers may also require products that meet higher standards than those required by the directive, such as complete removal of additional harmful substances from our products. We will be dependent on our suppliers for components and sub-system modules, such as semiconductors and purchased assemblies and goods, to comply with these requirements. This may harm our ability to sell our products in regions or to customers that may adopt such directives.

Compliance with these directives, especially with respect to the requirement that products eliminate lead solders, will require us to undertake significant expenses with respect to the re-design of our products. In addition, we may be required to pay higher prices for components that comply with this directive. We may not be able to pass these higher component costs on to our customers. We cannot at this point estimate the expense that will be required to redesign our products in order to include "environmentally friendly" components. We cannot be sure that we will be able to timely comply with these regulations, that we will be able to comply on a cost effective basis or that a sufficient supply of compliant components will be available to us. Compliance with these regulations could increase our product design costs. New designs may also require qualification testing with both customers and government certification boards. We cannot be certain of the reliability of any new designs that utilize non-lead components, in part, due to the lack of experience with the replacement materials and assembly technologies. In addition, the incorporation of new components may adversely affect equipment reliability and durability.

Some of our operations use substances regulated under various federal, state, local and international laws governing the environment, including laws governing the management and disposal of waste with respect to electronic equipment. We could incur substantial costs, including fines and civil or criminal sanctions, if we were to violate or become liable under environmental laws or if our products become non-compliant with environmental laws. We also face increasing complexity in our product design and procurement operations as we adjust to new and future requirements relating to the materials that compose our products. The EU has enacted the Waste Electrical and Electronic Equipment Directive, which makes producers of electrical goods financially responsible for specified collection, recycling, treatment and disposal of past and future covered products. Producers participating in the market became financially responsible for implementing their responsibilities under the WEEE Legislation beginning in August 2005. Implementation in certain EU member states was delayed. Simi□

Our inability or failure to comply with these regulations could have a material adverse effect on our results of operations. In addition, manufacturers of components that use lead solders may decide to stop manufacturing those components prior to the 2010 compliance date. These actions by manufacturers of components could result in a shortage of components that could adversely affect our business and results of operations.

A significant portion of our revenues is generated outside of the U.S. and Israel. We intend to continue to expand our operations internationally and, as a result, our results of operations could suffer if we are unable to manage our international operations effectively.

We generated 32% of our revenues in 2005, 35% of our revenues in 2006 and 37% of our revenues in 2007, outside of the United States and Israel. Part of our strategy is to expand our penetration in existing foreign markets and to enter new foreign markets. Our ability to penetrate some international markets may be limited due to different technical standards, protocols or product requirements in different markets. Expansion of our international business will require significant management attention and financial resources. Our international sales and operations are subject to numerous risks inherent in international business activities, including:

- economic and political instability in foreign countries;
- compliance with foreign laws and regulations;
- different technical standards or product requirements;
- staffing and managing foreign operations;
- foreign currency fluctuations;
- export control issues;
- governmental controls;
- import or currency control restrictions;
- local taxation;
- increased risk of collection; and
- burdens that may be imposed by tariffs and other trade barriers.

If we are unable to address

Currently, our international sales are denominated primarily in dollars. Therefore, any devaluation in the local currencies of our customers relative to the dollar could cause customers to decrease or cancel orders or default on payment.

The prices of our products may become less competitive due to foreign exchange fluctuations.

Foreign currency fluctuations may affect the prices of our products. Our prices in all countries are denominated primarily in dollars. If there is a significant devaluation in a specific country, the prices of our products will increase relative to the local currency and may be less competitive. We cannot be sure that our international customers will continue to place orders denominated in dollars. Our sales to European customers denominated in Euros are increasing. Sales denominated in Euros could make our revenues subject to fluctuation in the Euro/dollar exchange rate.

We may be unable to attract sales representatives who will market our products effectively.

A significant portion of our marketing and sales involves the aid of independent sales representatives that are not under our direct control. We cannot be certain that our current independent sales representatives will continue to distribute our products or that, even if they continue to distribute our products, they will do so successfully. These representatives are not subject to any minimum purchase requirements and can discontinue marketing our products at any time. In addition, these representatives often market products of our competitors. Accordingly, we must compete for the attention and sales efforts of our independent sales representatives.

Our products could contain defects, which would reduce sales of those products or result in claims against us.

We develop complex and evolving products. Despite testing by us and our customers, undetected errors or defects may be found in existing or new products. The introduction of products with reliability, quality or compatibility problems could result in reduced revenues, additional costs, increased product returns and difficulty or delays in collecting accounts receivable. The risk is higher with products still in the development stage, where full testing or certification is not yet completed. This could result in, among other things, a delay in recognition or loss of revenues, loss of market share or failure to achieve market acceptance. We could also be subject to material claims by customers that are not covered by our insurance.

Obtaining certification of our products by national regulators may be time-consuming and expensive. We may be unable to sell our products in markets in which we are unable to obtain certification.

Our customers may expect us to obtain certificates of compliance with safety and technical standards set by national regulators, especially standards set by U.S. or European regulators. There is no uniform set of standards, and each national regulator may impose and change its own standards. National regulators may also prohibit us from importing products that do not conform to their standards. If we make any change in the design of a product, we are usually required to obtain recertification of the product. The process of certification may be time-consuming and expensive and may affect the length of the sales cycle for a product. If we are unable to obtain certification of a product in a market, we may be unable to sell the product in that market.

We depend on a limited number of key personnel who would be difficult to replace.

Because our products are complex and our market is evolving, the success of our business depends in large part upon the continuing contributions of our management and key personnel. Specifically, we rely heavily on the services of Shabtai Adlersberg, our Chief Executive Officer and Chairman of our Board of Directors. If Shabtai Adlersberg is unable or unwilling to continue with us, our results of operations could be materially and adversely affected. We do not carry key person insurance for Mr. Adlersberg.

The success of our business also depends upon our continuing ability to attract and retain other highly-qualified management, technical, sales and marketing personnel. We need highly-qualified technical personnel who are capable of developing technologies and products and providing the technical support required by our customers. We are experiencing increasing competitive pressure with respect to retaining and hiring employees in the high technology sector in Israel. If we fail to hire and retain skilled employees, our business may be adversely affected.

If we do not manage our anticipated growth effectively, our results of operations could be adversely affected.

We have actively expanded our operations in the past and may continue to expand them in the future. This expansion has required, and may continue to require, the application of managerial, operational and financial resources. We cannot be sure that we will continue to expand, or that we will be able to expand our operations successfully. In particular, our business requires us to focus on multiple markets, including the VoIP, wireline, cable and wireless markets. In addition, we work simultaneously with a number of large OEMs and network equipment providers each of which may have different requirements for the products that we sell to them. We may not have sufficient manpower, or may be unable to devote this manpower when needed, to address the requirements of these markets and customers. If we are unable to manage our expanding operations effectively, our revenues may not increase, our cost of operations may rise and our results of operations may be adversely affected.

As we grow we may need new or enhanced systems, procedures or controls. The transition to such systems, procedures or controls, as well as any delay in transitioning to new or enhanced systems, procedures or controls, may seriously harm our ability to accurately forecast sales demand, manage our product inventory and record and report financial and management information on a timely and accurate basis.

Our gross profit percentage could be negatively impacted by amortization expenses in connection with acquisitions, increased manufacturing costs and other factors. This could adversely affect our results of operations.

Our gross profit percentage increased in 2005, but decreased in 2006 and 2007. The decrease in our gross profit percentage in 2006 and 2007 was primarily attributable to amortization expenses related to the acquisitions of Nuera and Netrake beginning in the third quarter of 2006 and CTI Squared beginning in the second quarter of 2007, as well as expenses related to equity-based compensation resulting from the adoption of SFAS 123(R) beginning in 2006. Our gross profit percentage could also be negatively affected by an increase in manufacturing costs, a shift in our sales mix towards our less profitable products, increased customer demand for longer product warranties and increased cost pressures as a result of increased competition. Acquisitions of new businesses could also negatively affect our gross profit percentage, which could cause an adverse effect on our results of operations.

The growth in our product portfolio means that we have to service and support more products. This may result in an increase in our expenses and an adverse effect on our results of operations.

The size of our product portfolio has increased and continues to increase. As a result, we are required to provide to our customers sales support. Customers have requested that we provide a contractual commitment to support a product for a specified period of time. This period of time may exceed the working life of the product or extend past the period of time that we may intend to manufacture or support a product. We are dependent on our suppliers for the components (hardware and software) needed to provide support and may be unable to secure the components necessary to satisfy our service commitments. We do not have long term contracts with our suppliers, and they may not be obligated to provide us with products or services for any specified period of time. We may need to purchase an inventory of replacement components and parts in advance in order to try to provide for their availability when needed. This could result in increased risk of write offs with respect to our replacement component inventory to the extent that we cannot accurately predict our future requirements under our customer service contracts. If any of our component suppliers cease production, cease operations or refuse or fail to make timely delivery of orders, we may not be able to meet our contractual commitments for product support. We may be required to supply enhanced components or parts as substitutes if the original versions are no longer available. Product support may be costly and any extra service revenues may not cover the hardware and software costs associated with providing long-term support.

We are subject to ongoing costs and risks associated with complying with extensive corporate governance and disclosure requirements.

As a foreign private issuer subject to U.S. federal securities laws, we spend a significant amount of management time and resources to comply with laws, regulations and standards relating to corporate governance and public disclosure, including the Sarbanes-Oxley Act of 2002, SEC regulations and Nasdaq rules. Section 404 of the Sarbanes-Oxley Act requires management's annual review and evaluation of our internal control over financial reporting and attestations of the effectiveness of these controls by our management and by our independent registered public accounting firm. There is no guarantee that these efforts will result in management assurance or an attestation by our independent registered public accounting firm that our internal control over financial reporting is adequate in future periods. In connection with our compliance with Section 404 and the other applicable provisions of the Sarbanes-Oxley Act, our management and other personnel devote a substantial amount of time, and may need to hire additional accounting and financial staff, to assure that we comply with these requirements. The additional management attention and costs relating to compliance with the Sarbanes-Oxley Act could materially and adversely affect our growth and financial results.

Terrorist attacks, or the threat of such attacks, may negatively impact the global economy which may materially adversely affect our business, financial condition and results of operation and may cause our share price to decline.

The financial, political, economic and other uncertainties following terrorist attacks throughout the world have led to a worsening of the global economy. As a result, many of our customers and potential customers have become much more cautious in setting their capital expenditure budgets, thereby restricting their telecommunications procurement. Uncertainties related to the threat of terrorism have had a negative effect on global economy, causing businesses to continue slowing spending on telecommunications products and services and further lengthen already long sales cycles. Any escalation of these threats or similar future events may disrupt our operations or those of our customers, distributors and suppliers, which could adversely affect our business, financial condition and results of operations.

A continuing decline in interest rates and worsening of the credit crisis affecting capital markets could reduce our interest-income, decrease the value of financial assets held by us and adversely affect our profitability.

Our investment portfolio consists of held-to-maturity marketable securities. Our investments are exposed to market risk due to fluctuation in interest rates, which may affect our interest income.

Additionally, the performance of the capital markets affects the values of funds that are held in marketable securities. These assets are subject to market fluctuations and the credit worthiness of the institutions issuing the securities. This could result in uncertain returns for these securities, which may fall below our projected return rates and could affect the fair market value of our investment portfolio. Due to recent credit crises and other market developments, including a series of rating agency downgrades, the fair value of these marketable securities may decline which may adversely affect our profitability.

Conditions in Israel affect our operations and may limit our ability to produce and sell our products.

We are incorporated under the laws of the State of Israel, and our principal executive offices and principal research and development facilities are located in the State of Israel. Political, economic and military conditions in Israel directly affect our operations. There has been an increase in unrest and terrorist activity in Israel, which began in September 2000 and which has continued with varying levels of severity through the current period of time. This has led to ongoing hostilities between Israel, the Palestinian Authority and other groups in the West Bank and Gaza Strip. The future effect of this deterioration and violence on the Israeli economy and our operations is unclear. Recently, there has been an escalation in violence among Israel, Hamas, the Palestinian Authority and other groups. There also was extensive hostilities along Israel's northern border with Lebanon in the summer of 2006, which involved rocket attacks on populated areas in the northern parts of Israel. Since June 2007, when Hamas effectively took control of the Gaza Strip, there have been extensive hostilities along Israel's border with the Gaza Strip, which have intensified since February 2008. Ongoing violence between Israel and the Palestinians, as well as tension between Israel and the neighboring Syria and Lebanon, may have a material adverse effect on our business, financial conditions and results of operations.

We cannot predict the effect on us of an increase in these hostilities or any future armed conflict, political instability or violence in the region. Additionally, some of our officers and employees in Israel are obligated to perform annual military reserve duty and are subject to being called for additional active duty under emergency circumstances. We cannot predict the full impact of these conditions on us in the future, particularly if emergency circumstances or an escalation in the political situation occur. If many of our employees are called for active duty, our operations in Israel and our business may be adversely affected. Additionally, a number of countries continue to restrict or ban business with Israel or Israeli companies, which may limit our ability to make sales in those countries.

We are adversely affected by the devaluation of the dollar against the New Israeli Shekel and could be adversely affected by the rate of inflation in Israel.

Substantially all of our revenues are generated in U.S. dollars and, in 2007, 33% of our expenses, primarily salaries, related personnel expenses and the leases of our buildings in Israel, were incurred in New Israeli Shekels (NIS). We anticipate that a significant portion of our expenses will continue to be denominated in NIS.

Our NIS related costs, as expressed in US dollars, are influenced by the exchange rate between the dollar and the NIS. During 2006 and 2007, the NIS appreciated against the U.S. dollar, which resulted in a significant increase in the U.S. dollar cost of our operations in Israel. If this continues, we could continue to experience an increase in the cost of our operations, which are based in dollars in our financial statements, which could adversely affect our results of operations. In addition, in periods in which the U.S. dollar appreciates against the NIS, we bear the risk that the rate of inflation in Israel will exceed the rate of such devaluation of the NIS in relation to the dollar or that the timing of such devaluations were to lag considerably behind inflation, which will increase our costs as expressed in dollars.

As a result, the devaluation of the U.S. dollar in relation to the NIS has and may continue to have the effect of increasing the cost in dollars of these expenses. As a result, our dollar-measured results of operations are and may continue to be adversely affected. In order to manage the risks imposed by foreign currency exchange rate fluctuations, from time to time, we enter into currency forward contracts and put and call options to hedge some of our foreign currency exposure. We can provide no assurance that our hedging arrangements will be effective. In addition, if we wish to maintain the dollar-denominated value of our products in non-U.S. markets, devaluation in the local currencies of our customers relative to the U.S. dollar may cause our customers to cancel or decrease orders or default on payment.

Because exchange rates between the NIS and the dollar fluctuate continuously, exchange rate fluctuations have an impact on our profitability and period-to-period comparisons of our results of operations. In 2007, the value of the dollar decreased in relation to the NIS by 9.0%, and the inflation rate in Israel was 3.4% and, as a result, adversely affected our results of operations in 2007. If this trend continues, it will continue to adversely affect our result of operations.

The Israeli government programs and tax benefits that we currently participate in, or receive, require us to meet several conditions and may be terminated or reduced in the future, which would increase our costs.

We benefit from certain government programs and tax benefits, particularly as a result of exemptions and reductions resulting from the “approved enterprise” status of our existing production facilities and programs in Israel. Until recently, the designation required advance approval from the Investment Center of the Israel Ministry of Industry, Trade and Labor (the Investment Center). To be eligible for these programs and tax benefits, we must continue to meet conditions relating principally to adherence to the approved programs and to periodic reporting obligations. We believe that we are currently in compliance with these requirements. However, if we fail to meet these conditions, we will be subject to corporate tax at the rate then in effect under Israeli law for such tax year.

In April 2005, an amendment to the law came into effect (the “Amendment”) which significantly changed the provisions of the law. The Amendment limited the scope of enterprises which may be approved by the Investment Center by setting criteria for the approval of a facility as a Privileged Enterprise, such as provisions generally requiring that at least 25% of the Privileged Enterprise’s income be derived from export. Additionally, the Amendment enacted major changes in the manner in which tax benefits are awarded under the law so that companies no longer require Investment Center approval in order to qualify for tax benefits.

In addition, the law provides that terms and benefits included in any certificate of approval granted prior to December 31, 2004 will remain subject to the provisions of the law as they were on the date of such approval. Therefore, our 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 law as amended, will subject us to taxes upon distribution or liquidation and we may be required to record a deferred tax liability with respect to such tax-exempt income.

In 2007, we recognized a grant of \$791,000 from the Government of Israel, through the Office of the Chief Scientist, or the OCS, for the financing of a portion of our research and development expenditures in Israel. The OCS budget has been subject to reductions, which may affect the availability of funds for these prospective grants and other grants in the future. As a result, we cannot be certain that we will continue to receive grants at the same rate, or at all. In addition, the terms of any future OCS grants may be less favorable than our past grant.

The government grants we have received for research and development expenditures limit our ability to manufacture products and transfer technologies outside of Israel and require us to satisfy specified conditions. If we fail to satisfy these conditions, we may be required to refund grants previously received together with interest and penalties.

In connection with research and development grants received from the OCS, we must pay royalties to the OCS on the revenue derived from the sale of products, technologies and services developed with the grants from the OCS. The terms of the OCS grants and the law pursuant to which grants are made restrict our ability to manufacture products or transfer technologies developed outside of Israel if OCS grants funded the development of the products or technology. An amendment to the relevant law may facilitate the transfer of technology or know-how developed with the funding of the OCS to third parties outside of Israel, but any future transfer would still require the approval of the OCS, which may not be granted, and is likely to involve a material payment to the OCS. This restriction may limit our ability to enter into agreements for those products or technologies without OCS approval. We cannot be certain that any approval of the OCS will be obtained on terms that are acceptable to us, or at all.

In order to meet specified conditions in connection with the grants and programs of the OCS, we have made representations to the Government of Israel about our Israeli operations. From time to time the conduct of our Israeli operations has deviated from our representations. If we fail to meet the conditions related to the grants, including the maintenance of a material presence in Israel, or if there is any material deviation from the representations made by us to the Israeli government, we could be required to refund the grants previously received (together with an adjustment based on the Israeli consumer price index and an interest factor) and would likely be ineligible to receive OCS grants in the future. The inability to receive these grants would result in an increase in our research and development expenses.

It may be difficult to enforce a U.S. judgment against us, our officers and directors, assert U.S. securities law claims in Israel or serve process on substantially all of our officers and directors.

We are incorporated in Israel. Substantially all of our executive officers and directors are nonresidents of the United States, and a majority of our assets functional currency and the assets of these persons are located outside the United States. Therefore, it may be difficult to enforce a judgment obtained in the United States against us or any such persons or to effect service of process upon these persons in the United States. Israeli courts may refuse to hear a claim based on a violation of U.S. securities laws because Israel is not the most appropriate forum to bring such a claim. In addition, even if an Israeli court agrees to hear a claim, it may determine that Israeli law and not U.S. law is applicable to the claim. If U.S. law is found to be applicable, the content of applicable U.S. law must be proved as a fact which can be a time-consuming and costly process. Certain matters of procedure will also be governed by Israeli law. There is little binding case law in Israel addressing these matters. Additionally, there is doubt as to the enforceability of civil liabilities under the Securities Act and the Securities Exchange Act in original actions instituted in Israel.

Israeli law may delay, prevent or make difficult a merger with or an acquisition of us, which could prevent a change of control and therefore depress the price of our shares.

Provisions of Israeli law may delay, prevent or make undesirable a merger or an acquisition of all or a significant portion of our shares or assets. Israeli corporate law regulates acquisitions of shares through tender offers and mergers, requires special approvals for transactions involving significant shareholders and regulates other matters that may be relevant to these types of transactions. These provisions of Israeli law could have the effect of delaying or preventing a change in control and may make it more difficult for a third party to acquire us, even if doing so would be beneficial to our shareholders. These provisions may limit the price that investors may be willing to pay in the future for our ordinary shares. In addition, our articles of association contain certain provisions that may make it more difficult to acquire us, such as a staggered board and the ability of our board of directors to issue preferred stock. Furthermore, Israel tax considerations may make potential transactions undesirable to us or to some of our shareholders.

Risks Relating to the Ownership of our Ordinary Shares and our Notes

The price of our ordinary shares may fluctuate significantly.

The market price for our ordinary shares, as well as the prices of shares of other technology companies, has been volatile. Between January 1, 2006 and June 10, 2008, our share price has fluctuated from a low of \$2.50 to a high of \$14.64. The following factors may cause significant fluctuations in the market price of our ordinary shares:

- fluctuations in our quarterly revenues and earnings or those of our competitors;
- shortfalls in our operating results compared to levels forecast by securities analysts;
- announcements concerning us, our competitors or telephone companies;
- announcements of technological innovations;
- the introduction of new products;
- changes in product price policies involving us or our competitors;
- market conditions in the industry;
- integration of acquired businesses, technologies or joint ventures with our products and operations;
- the conditions of the securities markets, particularly in the technology and Israeli sectors; and
- political, economic and other developments in the State of Israel and worldwide.

In addition, stock prices of many technology companies fluctuate significantly for reasons that may be unrelated or disproportionate to operating results. The factors discussed above may depress or cause volatility of our share price, regardless of our actual operating results.

Our quarterly results of operations have fluctuated in the past and we expect these fluctuations to continue. Fluctuations in our results of operations may disappoint investors and result in a decline in our share price.

We have experienced and expect to continue to experience significant fluctuations in our quarterly results of operations. In some periods, our operating results may be below public expectations or below revenue levels and operating results reached in prior quarters or in the corresponding quarters of the previous year. If this occurs, the market price of our ordinary shares could decline.

The following factors have affected our quarterly results of operations in the past and are likely to affect our quarterly results of operations in the future:

- size, timing and pricing of orders, including order deferrals and delayed shipments;
- launching of new product generations;
- length of approval processes or market testing;
- technological changes in the telecommunications industry;
- competitive pricing pressures;
- the timing and approval of government research and development grants;
- accuracy of telecommunication company, distributor and original equipment manufacturer forecasts of their customers' demands;
- changes in our operating expenses;
- disruption in our sources of supply; and
- general economic conditions.

Therefore, the results of any past periods may not be relied upon as an indication of our future performance.

Our actual financial results might vary from our publicly disclosed financial forecasts.

From time to time, we publicly disclose financial forecasts. Our forecasts reflect numerous assumptions concerning our expected performance, as well as other factors which are beyond our control and which might not turn out to be correct. As a result, variations from our forecasts could be material. Our financial results are subject to numerous risks and uncertainties, including those identified throughout this "Risk Factors" section and elsewhere in this Annual Report. If our actual financial results are worse than our financial forecasts, the price of our ordinary shares may decline. For example, during the first quarter of 2007 we lowered our forecast for the quarter which resulted in a decrease in the price of our ordinary shares.

We announced last year that we will not be providing quarterly forecasts of the results of our operations. This change could affect the willingness of analysts to provide research with respect to our ordinary shares which could affect the trading market for our ordinary shares.

We announced last year that we will not be providing quarterly forecasts of the results of our operations. This could result in the reduction of research analysts who cover our ordinary shares. Any reduction in research coverage could affect the willingness of investors, particularly institutional investors, to invest in our shares which could affect the trading market for our ordinary shares and the price at which our ordinary shares are traded.

Our ordinary shares are listed for trading in more than one market and this may result in price variations.

Our ordinary shares are listed for trading on the Nasdaq Global Select Market, or Nasdaq, and on The Tel-Aviv Stock Exchange, or TASE. Trading in our ordinary shares on these markets is made in different currencies (U.S. dollars on Nasdaq and New Israeli Shekels on TASE), and at different times (resulting from different time zones, different trading days and different public holidays in the United States and Israel). Actual trading volume on the TASE is generally lower than trading volume on Nasdaq, and as such could be subject to higher volatility. The trading prices of our ordinary shares on these two markets often differ resulting from the factors described above, as well as differences in exchange rates. Any decrease in the trading price of our ordinary shares on one of these markets could cause a decrease in the trading price of our ordinary shares on the other market.

We do not anticipate declaring any cash dividends on our ordinary shares.

We have never declared or paid cash dividends on our ordinary shares and do not plan to pay any cash dividends in the near future. Our current policy is to retain all funds and earnings for use in the operation and expansion of our business.

U.S. shareholders face certain income tax risks in connection with their acquisition, ownership and disposition of our ordinary shares. In any tax year, we could be deemed a passive foreign investment company, which could result in adverse U.S. federal income tax consequences for U.S. shareholders.

Based on the composition of our gross income and the composition and value of our gross assets during 2004, 2005, 2006 and 2007, we do not believe that we were a passive foreign investment company, or PFIC, for U.S. federal income tax purposes during any of such tax years. It is likely, however, that we would be deemed to have been a PFIC in 2001, 2002 and 2003. In addition, there can be no assurance that we will not be deemed a PFIC for any future tax year in which, for example, the value of our assets, as measured by the public market valuation of our ordinary shares, declines in relation to the value of our passive assets (generally, cash, cash equivalents and marketable securities). If we are a PFIC for any tax year, U.S. shareholders who own our ordinary shares during such year may be subject to increased U.S. federal income tax liabilities and reporting requirements for such year and succeeding years, even if we are no longer a PFIC in such succeeding years.

We urge U.S. holders of our ordinary shares to carefully review Item 10E. – “Taxation – United States Tax Considerations – United States Federal Income Taxes” in this Annual Report and to consult their own tax advisors with respect to the U.S. federal income tax risks related to owning and disposing of our ordinary shares and the consequences of PFIC status.

The trading prices of our notes could be significantly affected by the market price of our ordinary shares.

We believe that the trading price of our notes could be significantly affected by the market price of our ordinary shares, which may be affected by a variety of factors as set forth in these risk factors. This relationship may result in greater volatility in the trading prices of our notes than would be expected for non-convertible debt securities.

Our notes are effectively subordinated to our existing and future secured indebtedness and structurally subordinated to existing and future indebtedness and other liabilities of our subsidiaries.

Our notes are general, unsecured obligations and are effectively subordinated to any existing and future secured indebtedness we may have. In addition, our notes are not guaranteed by our subsidiaries or any future subsidiaries and, accordingly, our notes are effectively subordinated to the existing and future indebtedness and other liabilities of our subsidiaries. These liabilities may include indebtedness, trade payables, guarantees, lease obligations and letter of credit obligations. Therefore, our rights and the rights of our creditors, including the holders of the notes, to participate in the assets of any subsidiary upon that subsidiary’s liquidation or reorganization will be subject to the prior claims of the subsidiary’s creditors, except to the extent that we may ourselves be a creditor with recognized claims against the subsidiary. However, even if we are a creditor of one of our subsidiaries, our claims would still be effectively subordinated to any security interests in, or mortgages or other liens on, the assets of that subsidiary and would be subordinate to any indebtedness of the subsidiary senior to that held by us. As□

There are no restrictive covenants in the indenture for the notes relating to our ability to incur future indebtedness or complete other transactions.

The indenture governing our notes does not contain any financial covenants or restrictions on the payment of dividends. The indenture does not restrict the issuance or repurchase of securities by us or our subsidiaries. The indenture contains no covenants or other provisions to afford holders of our notes protection in the event of a highly leveraged transaction, such as a leveraged recapitalization, that would increase the level of our indebtedness, or a change in control except for the ability of the holders to require us to redeem the notes under certain circumstances. The indenture governing our notes does not restrict us from incurring senior secured debt in the future or from guaranteeing our indebtedness, nor does it limit the amount of indebtedness that we can issue that is equal to our notes in right of payment. If we or our □fected.

Our indebtedness and debt service obligations increased upon the issuance of our notes, which may adversely affect our cash flow, cash position and stock price.

We intend to fulfill our debt service obligations with respect to our notes from our existing cash, investments and operations. In the future, if we are unable to generate cash or raise additional cash financings sufficient to meet these obligations and need to use existing cash or liquidate investments in order to fund these obligations, we may have to delay or curtail research, development and commercialization programs.

Our indebtedness could have significant additional negative consequences, including, without limitation:

- requiring the dedication of a portion of our expected cash flow to service our indebtedness, thereby reducing the amount of our expected cash flow available for other purposes, including funding our research and development programs and other capital expenditures;
- increasing our vulnerability to general adverse economic conditions;
- limiting our ability to obtain additional financing; and
- placing us at a possible competitive disadvantage to less leveraged competitors and competitors that have better access to capital resources.

Holders of our notes are not entitled to any rights with respect to our ordinary shares, but they are subject to all changes made with respect to our ordinary shares.

Holders of our notes are not entitled to any rights with respect to our ordinary shares (including, without limitation, voting rights and rights to receive dividends, if any, or other distributions on our ordinary shares), but such holders are subject to all changes affecting our ordinary shares. Holders of our notes are entitled to rights on the ordinary shares if and when we deliver ordinary shares to such holders in exchange for their notes. For example, in the event that an amendment is proposed to our articles of association requiring shareholder approval and the record date for determining the shareholders of record entitled to vote on the amendment occurs prior to delivery to a converting holder of our notes of our ordinary shares, such holders will not be entitled to vote on the amendment, altho□

Our ability to fulfill our obligations under our notes is dependent upon our future financial and operating performance.

Our ability to make interest and principal payments on our notes when due depends in part upon our future financial performance and upon our ability to refinance this debt obligation or to raise additional equity capital. We may be required to pay all or a portion of our notes in November 2009. Prevailing economic conditions and financial, business and other factors, many of which are beyond our control, will affect our ability to make these payments.

If we are unable to generate sufficient cash flow to meet our debt services obligations or to repay the principal of our notes, we will have to pursue one or more alternatives, such as:

- reducing our operating expenses;
- reducing or delaying capital expenditures;
- selling assets; or
- raising additional debt or equity capital.

We cannot be sure that any of these alternatives could be accomplished on satisfactory terms, if at all, or that those actions would provide sufficient funds to retire our notes.

We may not have the ability to purchase our notes for cash if required to do so by holders on November 9, 2009, November 9, 2014 or November 9, 2019, or upon the occurrence of a fundamental change.

On November 9, 2009, November 9, 2014 or November 9, 2019, or upon specified fundamental changes relating to us, each holder of the notes may require us to purchase for cash all or a portion of such holder's notes at a price equal to 100% of the principal amount, plus accrued and unpaid interest, if any, on such notes to but excluding the date of purchase. In addition, in the case of certain fundamental changes occurring before November 9, 2009, we may be required to pay a make-whole premium to holders of the notes. We cannot be sure that we will have sufficient financial resources to purchase the notes for cash, or will be able to raise debt financing if we are required to purchase the notes at the option of the holders of such notes or upon the occurrence of a fundamental change. This repurchase requirement may also delay or make it harder for others to obtain control of us.

ITEM 4. INFORMATION ON THE COMPANY

A. HISTORY AND DEVELOPMENT OF THE COMPANY

AudioCodes Ltd. was incorporated in 1992 under the laws of the State of Israel. Our principal executive offices are located at 1 Hayarden Street, Airport City, Lod, 70151 Israel. Our telephone number is 972-3-976-4000. Our agent in the United States is AudioCodes Inc., 2099 Gateway Plaza, San Jose, California 95134.

Major Developments since January 1, 2007

In January 2008, we merged most of our US subsidiaries into AudioCodes Inc. We did this to simplify operational and financial procedures and to save costs. As a result, most of our activities in the United States are conducted through AudioCodes Inc.

Acquisition of CTI Squared Ltd.

In April 2007, we acquired the remaining outstanding common stock of CTI Squared Ltd. Prior to this acquisition, we had an investment in CTI Squared in the amount of \$1.6 million. In consideration for the acquisition, we paid \$4.9 million in cash at the closing of the transaction in April 2007 and committed to pay an additional \$5.0 million by April 2008. In February 2008, we paid the additional amount of \$5.0 million. CTI Squared is a provider of enhanced messaging and communications platforms to service providers and enterprises. CTI Squared Ltd.'s platforms integrate data and voice messaging services over internet, intranet, PSTN, cellular, cable and enterprise networks.

Other Recent Developments

Acquisition of Nuera Communications, Inc.

In July, 2006, we purchased Nuera Communications, Inc. for \$82.5 million in cash, subject to reduction for certain expenses. Nuera designs, manufactures and sells packet voice gateways to communication service providers worldwide. These products can be transmitted over cable, wireless, copper and fiber networks. Nuera's Open Reliable Communications Architecture, product portfolio of VoIP gateways, softswitches and management systems provide telephony solutions for cable and DSL networks, international long distance networks and enterprise networks.

Acquisition of Netrake Corporation

In August, 2006, we purchased Netrake Corporation for \$13.8 million in cash. Netrake is a provider of session border controllers and security gateways to fixed and mobile service providers for real-time delivery of voice and multimedia solutions across IP networks. Utilizing Netrake's session border controllers and security gateways, service providers can leverage market leading security capabilities, reliability, scalability, and feature richness to interconnect and secure networks and users.

Investment in Other Companies

Through December 31, 2007, we had invested an aggregate of \$4.6 million in Natural Speech Communication Ltd., a privately-held company engaged in speech recognition, which is in a development stage, in order for the company to achieve substantive technological milestone. As of December 31, 2007, we owned □

In July, 2005, we invested \$707,000 in MailVision Ltd., a privately-held company engaged in developing and marketing enhanced services platforms for wireless service providers. During 2006 and 2007, we made convertible loans in the aggregate amount of \$272,000 to MailVision. The loans bear interest at the rate of 9% per annum and may be converted into shares of MailVision. As of December 31, 2007, we owned 19.5% of the outstanding share capital of this company and 17.4% of the share capital of this company on a diluted basis without taking into account shares that may be issued upon conversion of the loans. In February 2008, we invested an additional \$185,000 in shares of this company, of which \$106,000 was by converting a portion of the principal amount of the loans we had previously made to this company. This investment increased our ownership to approximately 20.1% of the share capital of this company on a diluted basis without □

In December 2006, we made a convertible loan in the amount of \$1,000,000 to Kayote Networks Inc., a privately-held company engaged in VoIP interconnectivity and interoperability services. This loan bears interest at the rate of LIBOR+2% per annum and was due and payable in December 2007. In addition, the Company received warrants to purchase shares at an exercise price of \$941.91 per share in exchange for up to \$400,000 of the principal amount of the convertible loan. In December, 2007 we requested repayment of the loan. We received payment for \$320,000 of the principal amount of the loan and expect to receive the remaining balance of the loan during 2008.

BUSINESS OVERVIEW

Introduction

We design, develop and sell products for voice, data and video over IP networks. In broad terms, VoIP networks consist of software switches, Internet protocol, or IP, phones and media gateways. Our network and technology products primarily provide the media gateway element in the network. Media gateways connect legacy and IP networks. They essentially receive one type of code and convert it to an IP code and vice versa. This is called trans-coding. Typically media gateways utilize compression algorithms to compress the amount of information and reduce the amount of packets required to convey the information (for example, a voice communication).

Gateway equipment for Internet protocol-based packet networks has continued to experience significant development and growth. Gateway equipment can generally be divided into two key categories: open telecommunications architecture systems, built around industry standard platforms (e.g., personal computers, compact personal computer interface, or PCI, advanced telecommunications computing architecture, or ATCA, and IBM BladeCenter) and workstation platforms for which components are available from a number of suppliers, and proprietary architecture-based gateways which are built around a custom design of a telecommunications equipment manufacturer. Voice over IP gateway equipment can be generally segmented into three classes: carrier class gateways for use in central office facilities; enterprise gateways for use by corporations and in small offices; and residential gateways for use in homes.

The need to re-route voice and fax traffic from the traditional circuit-switched networks onto the new packet networks has led to the development of interface equipment between the two networks, generally referred to as media gateways or access equipment, depending on the type of network. The processing of voice and fax signals in gateway and access equipment is done according to industry-wide standards. These standards are needed to ensure that all traditional telephony traffic is seamlessly switched and routed over the packet network and vice versa.

Packet networks differ fundamentally from circuit-switched networks in that the packet network's resources and infrastructure can be shared simultaneously by several users and bandwidth can be flexibly allocated. Packet-based communications systems format the information to be transmitted, such as e-mail, voice, fax and data, into a series of smaller digital packages of information called "packets." Each of these packets is then transmitted over the network and is reassembled as a complete communication at the receiving end. The various packet networks employ different network protocols for different applications, priority schemes and addressing formats to ensure reliable communication.

Packet networks offer a number of advantages over circuit-switched networks. Rather than requiring a dedicated circuit for each individual call, packet networks commingle packets of voice, fax and data from several communications sources on a single physical link. This provides superior utilization of network resources, especially in dealing with information sources with bursts of information followed by periods of silence. This superior utilization means that more traffic can be carried over the same amount of network resources.

The integration of voice and data communications makes possible an enrichment of services and an entire range of new, value-added applications, such as unified messaging and voice enabled web sites. In addition, voice traffic over packet networks is usually compressed to provide a further reduction in the use of or demand for bandwidth. For example, the rate at which information is transmitted over packet networks is generally between 6.3 and 8 kilobits per second as compared to 64 kilobits per second over circuit-switched telephone networks.

We typically categorize our products into two main business lines: Network Business Line and Technology Business Line. In 2007, sales of Network products accounted for approximately 65% of our revenues and sales of Technology products accounted for approximately 35% of our revenues. In 2007, sales of our Network products increased by 31.6% and sales of Technology products decreased by 19.4%.

Network products consist of customer premises equipment (CPE) media gateways for the enterprise and service provider (or carrier) markets and of carrier grade oriented mid and high density media gateways for service providers. Complementing our media gateways as Network products are our media server, session border controller, security gateway and value added application products.

Technology products are enabling in nature and consist of our chips and boards business products. These are sold primarily to original equipment manufactures, or OEMs, and system integrators through distribution channels. Our chips and boards serve as building blocks that our customers incorporate in their products. In contrast, our networking products are used by our customers as part of a broader technological solution and are a box level product that interacts directly with other third party products.

Our Products

Our products consist of:

- Networking products include media servers, security gateways, session border controllers and media gateways. Media gateways are deployed in access networks, trunking applications in carrier networks, and enterprise networks. Additional emerging applications or segments where we believe our media gateways could be used are unified communication and fixed mobile convergence, or FMC. Our media gateway products include low density analog media gateways and low, mid and high density digital media gateways. We are part of Microsoft solution for unified messaging and unified communications.

- Our Media Gateways enable voice, video, data and fax to be transmitted over Internet and other protocols, and interface with third party equipment to facilitate enhanced voice and data services. Media servers enable conferencing, multi-language announcement functionality, and other applications for voice over packet networks.
- Session border controllers enable connectivity, policies and security for real-time sessions such as VoIP and video when traversing IP to IP networks. In addition, security gateways enable secure real-time sessions across WIFI, broadband and wireless networks in fixed mobile convergence deployments.
- Unified communication applications offering solutions that enable the integration of voice, data, fax and messaging.
- Our signal processor chips process and compresses voice, data and fax and enable connectivity between traditional telephone networks and packet networks.
- Our communications boards and modules for communication system products are deployed on both access networks and enterprise networks. The carrier network applications for these boards and modules include media gateways, which terminate calls from the public switched telephone network (PSTN), packetize and compress the call and then switch the call to the packet network, and vice-versa. The enterprise applications for these products include computer telephony integration, or CTI, deployments for contact centers, providing call logging and recording utilizing either industry standard or proprietary protocols.

Industry Background

Market Trends

The networking and telecommunications industries have experienced rapid change over the last few years. The primary factors driving this change include the following:

- *New technologies.* The introduction of broadband access technologies alongside related technologies, such as new voice compression algorithms, quality of service mechanisms and security and encryption algorithms and protocols, have enabled delivery of voice over packet to residential and enterprise customers with more reliability, higher quality and greater security. Examples of these broadband access technologies include: third generation cellular, WiMax, WiFi, data over cable, digital subscriber line technologies and fiber networks (FTTx). Packet technologies enable delivery of real time and non-real time services by different service providers that do not necessarily own the access network or the part of the network through which the subscriber accesses the network.. This allows for the growth of alternative or virtual service providers that do not own an access network.

- Competition by alternative service providers with incumbent and traditional service providers is causing incumbents to deploy advanced broadband access technologies and increase their competitiveness by offering bundled services to their subscribers, such as voice, video and data, and online gaming. In addition, the emergence of wide band vocoders that use a higher sampling rate than used in legacy time domain multiplexing, or TDM, networks allows service providers to offer higher quality voice and music over their newly established IP network.
- *New services enabled by broadband access.* Changes in the regulatory environment affecting service providers and the availability of new technologies or standards allow service providers to compete with one another in the provision of additional services over and above the traditional telephony service of voice, fax and dial-up modem internet connectivity. New services that could be offered include internet connectivity over broadband access or access to rich multimedia content such as music, video and games.
- *Increasing need for peering between VoIP networks.* Service providers and enterprises are increasingly building out VoIP networks. As a result, there is an increasing need to connect between two VoIP networks. In order to interconnect between two VoIP networks, service providers and enterprises need session border controllers to provide connectivity and security.
- According to Infonetics 2007 worldwide service provider Market Share information, AudioCodes is ranked first for mid-density media gateway port shipments, with 20% market share, and third for low-density media gateway port shipments, with 17% market share. According to Synergy First Quarter 2008 Service Provider VoIP Forecast, the service provider Wireline VoIP Media Gateway market has grown from \$565 million in 2004, to \$953 million in 2005, \$1,277 million in 2006 and \$1,389 million in 2007, and is expected to grow at cumulative average growth rate of 25.5% to \$3,442 million in 2011, presenting a significant opportunity for VoIP Media Gateway vendors.

The Challenges

Despite the inherent advantages and the economic attractiveness of packet voice networking, the transmission of packet voice and fax poses a variety of technological challenges. These challenges relate to quality of service, reliability of equipment, functionality and features, and ability to provide a good return on investment.

- *Quality of Service.* The most critical issues leading to poor quality of service in the transmission of voice and fax over packet networks are packet loss, packet delay and packet delay jitter. For real time signals like voice, the slightest delay in the arrival of a packet may render that packet unusable and, in a voice transmission, the delayed packet is considered a lost packet. Delay is usually caused by traffic hitting congestion or a bottleneck in the network. The ability to address delay is compounded by the varying arrival times of packets, called packet-jitter, which results from the different routes taken by different packets. This “jitter” can be eliminated by holding the faster arriving packets until the slower arriving packets can catch up, but this introduces further delay. These idiosyncrasies of packet networks do not noticeably detract from the quality of data transmission since data delivery is relatively insensitive to time delay. However, even the slightest delay or packet loss in voice and fax transmission can have severe ramifications such as voice quality degradation or, in the case of a fax transmission, call interruption. Therefore, the need to compensate for lost or delayed packets without degradation of voice and fax quality is a critical issue.

- *Gateway Reliability.* In order for a packet network to be efficient for voice or fax transmission, the VoIP gateway equipment that is installed in core networks must be able to deliver a higher level of performance than existing switching equipment located at central offices. The telecommunications providers' central offices contain circuit-switching equipment that typically handles tens of thousands of lines and is built to meet severe performance criteria relating to reliability, capacity, size, power consumption and cost.
- *Connectivity and Security* In contrast with legacy circuit switched voice and video communications, Internet Protocol based communications are more susceptible to attacks, interceptions and fraud by unauthorized entities. In addition, the complexity and relative immaturity of IP networks and protocols pose significant quality of service and connectivity challenges when sessions cross between separate IP networks.
- *Functionality.* In order to effectively replace legacy circuit-switching equipment, packet network equipment must be able to deliver equivalent and improved functionality and features for the service providers and network users.
- *Return on Investment* With the reduction in profitability of service providers there is an even greater need for them to achieve better returns on investment from capital expenditures on new equipment. Given the evolving nature of packet technologies and capabilities, there is greater pressure to provide cost effective technological solutions.
- In order to maximize the benefits of using packet networks for the transmission of voice, data and fax, products must be able to address and solve these inherent problems and challenges. These products must also be standards-based to support interoperability among different equipment manufacturers and to allow operation over various networks.

AudioCodes Solution

Using our proprietary voice compression algorithms and industry standards, advanced digital signal processing techniques and voice communications system design expertise, our products address the quality of service problems posed by packet delay, packet delay jitter and packet loss. As a result, we enable our customers to build packet networking equipment that provides communication quality comparable to the traditional telephone networks. In addition, our communications boards and modules improve gateway efficiency and provide the building blocks for high performance, large capacity, open telecommunications platform-based gateways. We work closely with our customers, tailor our products to meet their specific needs, assist them in integrating our products within their systems and help them bring their systems to market on a timely basis. We also work with our customers in deploying their systems in various network environments.

Utilizing our investment in developing standards-based VoIP protocol support for our products, customers can integrate our media gateways with a large number of industry leading IP-PBXs and carrier soft switches. Our interoperability teams test our products against a variety of other products for interoperability, focusing on the leading standard VoIP protocols: SIP (Session Initiation Protocol) and MEGACO/H.248.

We believe that the following strengths have enabled us to develop our products and provide services to our customers:

- *Leadership in voice compression technology* We are a leader in voice compression technology. Voice compression exploits redundancies within a voice signal to reduce the bit rate of data required to digitally represent the voice signal while still maintaining acceptable voice quality. Our key development personnel have significant experience in developing voice compression technology. We were involved in the development of the ITU G.723.1 voice coding standard that was adopted by the Voice over IP Forum and the International Telecommunications Union as the recommended standard for use in voice over IP gateways. We implement industry voice compression standards and work directly with our customers to design state-of-the-art proprietary voice compression algorithms that satisfy specific network requirements. We believe that our significant knowledge of the basic technology permits us to optimize its key elements and positions us to address further technological advances in the industry. We also believe that our technological expertise has resulted in us being sought out by leading equipment manufacturers to work with them in designing their systems and provision of solutions to their customers.
- *Digital signal processing design expertise* Our extensive experience and expertise in designing advanced digital signal processing algorithms enables us to implement them efficiently in real time systems. Digital signal algorithms are computerized methods used to extract information out of signals. In designing our signal processors, we use minimal digital signal processing memory and processing power resources. This allows us to develop higher density solutions than our competitors. Our expertise is comprehensive and extends to all of the functions required to perform voice compression, fax and modem transmission over packet networks and telephone signaling processing.

- *Compressed voice communications systems design expertise.* We have the expertise to design and develop the various building blocks and the complete gateways and media servers required for complete voice over packet systems. In building these systems, we develop hardware architectures, voice packetization software and signaling software, and integrate them with our signal processors to develop a complete, high performance compressed voice communications system. We assist our customers in integrating our signal processors into their hardware and software systems to ensure high voice quality, high completion rate of fax and data transmissions and telephone signaling processing accuracy. Further, we are able to customize our off-the-shelf products to meet our customers' specific needs, there □
- *Media gateway protocols design expertise.* Our extensive experience in developing media gateway standard protocols, keeping ourselves up to date with new request for comments, or RFCs, and adjusting our features according to customers requirements and interoperability testing allows us to provide our customers with a single gateway that can interface with most of the leading solution providers in the VoIP market.

We believe that our products possess the following advantages:

- *Voice over Packet signal processors.* Our multi-channel signal processors enable our customers and us to create products that meet the reliability, capacity, size, power consumption and cost requirements needed for building high capacity gateways.
- *Multiple and comprehensive product lines.* We address both the standards-based open telecommunications architecture market and the proprietary system market. We can do this because we enable our customers to offer multiple applications and address different market segments. For example, our voice over IP communications boards target the open telecommunications architecture market, while our signal processors, modules and voice packetization software target the proprietary system market. Our analog and digital media gateways target access, trunking and enterprise applications and our digital media gateways target wireless, wire line, cable and fixed-mobile convergence networks. Our session border controllers target access and peering networks.
- *Extensive feature set.* Our products incorporate an extensive set of signal processing functions and features (such as coders, fax processing and echo cancellation), functionalities (such as H.323, media gateway control protocol, or MGCP, trunking gateway control protocol, or TGCP, media gateway control, or Megaco, and session initiated protocol, or SIP) and implement a complete system. We offer the ability to manage multiple channels of communications working independently of each other, with each channel capable of performing all of the functions required for voice compression, fax and modem transmission, telephone signaling processing and other functions. These functions include voice, fax or data detection, echo cancellation, telephone tone signal detection, generation and other telephony signaling processing. Our Gateway products, media server and session border controller also offer wireless/mobile features to enable fixed mobile convergence.

- *Cost effective solutions.* We are able to address different market segments and applications with the same hardware platforms thus providing our customers with efficient and cost effective solutions.
- *Open architecture.* Our voice over packet communications boards target the open architecture gateway market segment, which enables our customers to use hardware and software products widely available for standards-based open telecommunications platforms. We believe that this provides our customers with an improved time to market and the benefits of scalability, upgradeability and enhanced functionality without the need to completely redesign their systems for evolving applications. Our networking products utilize industry standard control protocols that enable them to interoperate with other vendors and easily integrate into enterprise IP telephony systems as well as carrier IMS (IP Multimedia Subsystem) networks.
- *Various entry level products.* Our wide product range (chips to media gateways, session border controllers and media servers) provides our customers with a range of entry level products. We believe that these building blocks enable our customers to significantly shorten their time to market by adding their value added solution.
- *VoIPerfect™ architecture.* Our VoIPerfect architecture serves as the underlying technology platform common to all of our products since 1998. VoIPerfect™ is regularly updated and upgraded with features and functionalities required to comply with evolving standards and protocols. VoIPerfect™ architecture comprises VoP digital signal processing, or DSP, software and media streaming embedded software, integrated public telephone switched network, or PTSN, signaling protocols and VoIP standard control protocols, provisioning and management engines. Additional features enable carrier-grade quality and high availability. VoIPerfect™ architecture components are available in AudioCodes' products at various levels of integration, from the chip level, through peripheral component interconnect mezzanine card, or PMC, modules and PCI/compact PCI (cPCI) blades, to high-availability and non-high-availability analog and digital media gateway platforms.

Business Strategy

Our goal is to be the leading provider of products and enabling technologies for the transmission of voice, video, data and fax over packet networks. The following are key elements of our strategy:

- *Maintain and extend technological leadership.* We intend to capitalize on our expertise in voice compression technology and proficiency in designing voice communications systems. We continually upgrade our product lines with additional functionalities, interfaces and densities. We have invested heavily and are committed to continued investment in developing technologies that are key to providing high perform□.

- *Strengthen and expand strategic relationships with key customers* Our strategy has been to sell our products to leading enterprise channels, regional system integrators, global equipment manufacturers and value-added resellers, or VARs, in the telecommunications and networking industries and to establish and maintain long-term working relationships with them. We work closely with our customers to engineer products and subsystems that meet each customer's particular needs. The long development cycles usually required to build equipment incorporating our products frequently results in close working relationships with our customers. By focusing on leading equipment manufacturers with large volume potential, we believe that we reach a substantial segment of our potential customer base while minimizing the cost and complexity of our marketing efforts.
- *Expand and enhance the development of highly-integrated products* We plan to continue designing, developing and introducing new product lines and product features that address the increasingly sophisticated needs of our customers. We believe that our knowledge of core technologies and system design expertise enable us to offer better solutions that are more complete and contain more features than competitive alternatives. We believe that the best opportunities for our growth and profitability will come from offering a broad range of highly-integrated network product lines and product features, such as our continuously updated analog and digital media gateways and products from our recently acquired companies, including session boarder controllers, security gateways, messaging platforms and cable telephony gateways.
- *Build upon existing technologies to penetrate new markets* The technology we developed in connection with the IP telephony market can be used to serve similar product requirements in multiple emerging markets utilizing similar packet networking technologies. These mar□
- *Develop a network of strategic partners.* Part of our strategy has been to sell our products through customers that can offer our products as part of a full-service solution to their customers. We expect to further develop our strategic partner relationships with system integrators and other service providers in order to increase our customer base.
- *Acquire complementary businesses and technologies.* We expect to pursue the acquisition of complementary businesses and technologies or the establishment of joint ventures to broaden our product offerings, enhance the features and functionality of our systems, increase our penetration in targeted markets and expand our marketing and distribution capabilities. As part of this strategy, we acquired the UAS business from Nortel in April 2003 and Ai-Logix (now part of AudioCodes Inc.), in May 2004. We also acquired Nuera (now part of AudioCodes Inc.) in July 2006, Netrake (now part of AudioCodes Inc.) in August 2006 and CTI Squared in April 2007.

Products

Our products facilitate the transmission of voice, video, data and fax over packet networks. To date, we have incorporated our algorithms, technologies and systems design expertise in product lines, which can be divided into two main product lines:

Networking products

This line of products includes products that are network level products. Our networking products include:

- analog media gateways for toll bypass access and enterprise applications;
- digital media gateways (Mediant™) with various capacities for wireless, wireline), cable, fixed mobile convergence, and unified communications;
- media servers for enhanced voice and video services and functionalities such as conferencing, video sharing and messaging (IPmedia™ Media Servers);
- session border controllers, or SBCs (nCite), that enable connectivity, contain protocol and connectivity policies, and provide security for real-time sessions such as VoIP and video when traversing from a public to a private network. In addition, security gateways enable secure real-time sessions across wifi, broadband and wireless networks in fixed mobile convergence deployments;
- element management system, or EMS; *and*
- Value Added Applications for Unified Communications.
- In addition, we continue to offer customers our professional services, which usually involve customization and development projects for customers.
- Our products are designed to build on our core technology and competence extending them both vertically (chips inserted into boards, boards inserted into digital media gateways) and horizontally into different applications for different market segments, such as enterprise, call centers, wireline, cable and wireless.

Technology products

This line of products serves as a building block for network level products. Our technology products include:

- voice over packet processors;
- VoIP communication boards (TrunkPack®);
- media processing boards for enhanced services and functionalities, such as conferencing and messaging (IPmedia™);
- voice and data logging hardware integration board products.

Analog Media Gateways for Toll Bypass Access and Enterprise Applications

MediaPack™, our analog and basic rate interface, or BRI, media gateways for toll bypass access and enterprise applications, are designed to empower the next-generation network by providing cost-effective, cutting-edge technology solutions that deliver voice and fax services to the corporate market, small businesses and home offices. Our analog media gateways for access and enterprise applications **provide media streaming functionality while being either controlled by a centralized call agent** or use on box VoIP control protocols (H.323, MGCP and SIP). Convergence of data, voice and fax is achieved by a combination of the media gateway with any IP access technology, eliminating the cost of multiple access circuits. This product family utilizes our experience and digital signal processing, or DSP, technology for echo cancellation, voice compression, silence suppression and comfort noise generation.

The MediaPack™ family represents a feature rich product for streaming voice quality with a powerful analog interface supporting all major control protocols such as H323, SIP, MGCP and is also capable of supporting some unified communication and FMC applications.

Digital Media Gateways and Various Capacities for Wireless, Wireline and Cable (Mediant™)

Mediant™ is our family of converged media gateways for wireline, cable, wireless (GSM and CDMA), fixed-mobile-convergence and enterprise networks. The Mediant™ product family offers scalability and functionality, providing a full suite of standards compliant control protocols and public switched telephone network, or PSTN, signaling interfaces for a variety of enterprise, wireline, cable and wireless media gateway applications in most softswitch controlled environments. This product family is compatible with popular wireline, cable and wireless voice coders and protocols including code-division multiple access (CDMA), global system for mobile communications (GSM), CDMA2000 and universal mobile telecommunications service (UMTS) It builds on our TrunkPack® architecture, which is installed in millions of lines worldwide. The Mediant™ family provides carriers with a comprehensive line of different sized gateways. Small or medium-sized gateways enable cost-effective solutions for enterprise or small points of presence, as well as entry into fast growing new and emerging markets. The large gateway scales to central office capacities and is designed to meet carriers' operational requirements. The Mediant family of media gateways is capable of supporting some of the unified communication and fixed mobile convergence applications which may be of increased interest to enterprises and service providers. The Mediant™ gateway family shares our same VoIP perfect architecture, designed to provide mature, field-proven solutions.

For the cable market, the Mediant™ gateway family complies with packet telephony standards and is designed for either hybrid or all IP cable network architecture. The Mediant gateway enables deployment of advanced packet-based cable telephony at multiple service operators own pace, without costly hardware changes. The Mediant™ gateway can be initially deployed as a V5.2 IP access terminal and then easily migrated by software upgrade to a cable telephony media gateway with external call management provided by a softswitch and an SS7 interface to the PSTN.

We provide the nCite session border controller, or SBC, and security gateway products that help service providers and network equipment providers enable connectivity between different VoIP networks and provide security to deployments of fixed mobile convergence, or FMC networks, for integrating wireline and wireless networks.

nCite session border controllers provide secure VoIP and multimedia traversal of firewall, or FW, and network address translation, or NAT, systems, as well as denial of service, or DoS, attack prevention at both the signaling and media layers. NAT and FW traversal are necessary to allow VoIP and multimedia session to pass from the Service Provider (“SP”) network to the residential or enterprise networks. DoS attack prevention protects the SP network from attacks that load the network until it crashes. The nCite SBCs also provide comprehensive Quality of Service, or QoS, mechanisms and protocol interworking (translation from one VoIP protocol to another, or between two variants of same VoIP protocol to enable two softswitches to communicate with each other). AudioCodes nCite solutions offer proven interoperability with major softswitches, SIP servers, application servers, IP PBXs and a large number of IP-based voice and video endpoints.

The nCite security gateway enables secure (authenticated and encrypted) real-time sessions across Wi-Fi, broadband and wireless networks in FMC deployments. The nCite security gateway, or nCite SG, provides secure termination and aggregation for IP phones, dual-mode Wi-Fi and cellular-capable VoIP handsets that are used in converged wireline and wireless networks.

Element Management System

Our element management system, or EMS, is an advanced solution for centralized, standards-based management of our VoP gateways, covering all areas vital to the efficient operations, administration, management and provisioning of our Mediant™ and MediaPack™ VoP gateways.

Our EMS offers network equipment providers and system integrators fast setup of medium and large VoP networks with the advantage of a single centralized management system that configures, provisions and monitors all of AudioCodes gateways deployed, either as customer premises equipment, access or core network platforms.

CTI2 Value Added Services Applications (InTouch)

The InTouch platform is an enhanced value added services (VAS) platform for service providers, such as cable, class 5, class 4, fixed-line, mobile, multiservice virtual network operator, or MVNO, and operators. InTouch provides a suite of next generation VAS. InTouch is an IP-based, email-centric and telco-grade platform conforming to ultimate service providers’ requirements for high-availability, reliability, scalability, and security. InTouch is designed to smoothly scale from a very small system to a system with millions of subscribers based on the same software and architecture, while enabling a rich suite of applications at all sizes. InTouch’s open architecture is based on industry-standard protocols, facilitating interoperability and integration with best of breed, third-party applications. InTouch acts as a mediator between InTouch services and a large selection of clients and devices enabling service providers to offer attractive packages.

Voice Over Packet Processors

Our signal processor chips compress and decompress voice, data and fax communications. This enables these communications to be sent from circuit-switched telephone networks to packet networks. Our chips are digital signal processors on which we have embedded our algorithms. These signal processor chips are the basic building blocks used by our customers and us to enable their products to transmit voice, fax and data over packet networks. These chips may be incorporated into our communications boards, media gateway modules and analog media gateways for access and enterprise applications or they may be purchased separately and incorporated into other boards or customer products.

VoIP Communication Boards

Our communications boards are designed to operate in gateways connecting the circuit-switched telephone network to packet networks based on Internet protocols. Our boards comply with voice over IP industry standards and allow for interoperability with other gateways. Our boards support standards-based open telecommunications architecture systems and combine our signal processor chips with communications software, signaling software and proprietary hardware architecture to provide a cost efficient interoperable solution for high capacity gateways. We believe that using open architecture permits our customers to bring their systems to market quickly and to integrate our products more easily within their systems.

IPmedia™ Boards and Servers for Enhanced Services and Functionalities such as Conferencing, Video Sharing and Messaging (IPmedia™ Platforms)

The IPmedia™ product family is designed to allow OEMs and application partners to provide sophisticated content and services that create revenue streams and customer loyalty through the ability to provide additional services. The IPmedia™ platform provides voice, video and fax processing capabilities to enable, together with our partners, an architecture for development and deployment of enhanced services.

IPmedia™ platforms are designed to answer the growing market demand for enhanced voice and video services over packet networks, particularly network-based applications like unified communications, call recording, conferencing and video sharing by carriers and application service providers. IPmedia™ enables our customers to develop and market applications such as: unified communications, interactive voice response, call-centers, conferencing and voice-activated personal assistants. IPmedia™ products are currently offered on our PCI and cCPI boards and on the 2000, 3000, 5000 and 8000 series (IPmedia™ 2000, IPmedia™ 3000, IPmedia™ 5000 and IPmedia™ 8000).

Voice and Data Logging Hardware Integration Board Products

The SmartWORKSTM family of products is our voice and data logging hardware integration board product line. SmartWORKSTM boards for the call recording and voic□

Core Technologies

We believe that one of our key competitive advantages is our broad base of core technologies ranging from advanced voice compression algorithms to complex architecture system design. We have developed and continue to build on a number of key technology areas. We have named our cross platform core technology VoIPerfec□

Low Bit Rate Voice Compression Algorithms

Voice compression techniques are essential for the transmission of voice over limited bandwidth packet networks. Voice compression exploits redundancies within a voice signal to reduce the bit rate required to digitally represent the voice signal, from 64 kilobits per second, or kbps, down to low bit rates ranging from 5.3 kbps to 8 kbps, while still maintaining acceptable voice quality. A bit is a unit of data. Different voice compression algorithms, or coders, make certain tradeoffs between voice quality, bit rate, delay and complexity to satisfy various network requirements. Use of voice activity detection techniques and silence removal techniques further reduce the transmission rate by detecting the silence periods embedded in the voice flow and discarding the information packets which do not contribute to voice intelligibility.

We are one of the innovators in developing low bit rate voice compression technologies. Our patented MP-MLQTM coder was adopted in 1995 by the ITU as the basis for the G.723.1 voice coding standard for audio/visual applications over the circuit-switched telephone networks. By adhering to this standard, system manufacturers guarantee the interoperability of their equipment with the equipment of other vendors.

Advanced Digital Signal Processing Algorithms

To provide a complete voice over packet communications solution, we have developed a library of digital signal processing functions designed to complement voice compression coders with additional functionality, including: echo cancellation; voice activity detection; facsimile and data modem processing; and telephony signaling processing. Our extensive experience and expertise in designing advanced digital signal processing solutions allows us to implement algorithms using minimal processing memory and power resources. Our algorithms include:

Echo cancellation. Low bit rate voice compression techniques introduce considerable delay, necessitating the use of echo cancellation algorithms. The key performance criterion of an echo canceller is its ability to deal with large echo reflections, long echo delays, fast changing echo characteristics, diverse telecommunications equipment and network effects. Our technology achieves low residual echo and fast response time to render echo effects virtually unnoticeable.

Fax transmission. There are two widely used techniques for real time transmission of fax over networks based on Internet protocols: fax relay and fax spoofing. Fax relay takes place when a fax is sent from a fax machine through a gateway over networks based on Internet protocols in real time to a fax machine at the other end of the network. At the gateway, the analog fax signals are demodulated back into digital data, converted into packets, routed over the packet network and reassembled at the receiving end. Fax relay is used when the round trip network delay is small (typically below one second). When the round trip □

Data modem technology. We have developed data modem technologies that facilitate data relay over packet networks. Our data modem relay software algorithms support all existing data modem standards up to a bit rate of 14.4 kbps.

Telephony signaling processing. Various telephony signaling standards and protocols are employed to route calls over the traditional telephone network, some of which use “in-band” methods, which means that the signaling tones are sent over the telephone line just like the voice signal. As a result, in-band signaling tones may have to undergo the compression process just like the voice signal. Most low bit-rate voice coders, however, are optimized for speech signals and exhibit poor tone transfer performance. To overcome this, our processors are equipped with tone detection and tone generation algorithms. To provide seamless transparency between the traditional telephone network and packet networks for signaling, we employ various digital signal processing techniques for efficient tone processing.

Voice Communications Software

To transmit the compressed voice and fax over packet networks, voice packetization processes are required to construct and deconstruct each packet of data for transmission. The processing involves breaking up information into packets and adding address and control fields information according to the specifications of the appropriate packet network protocol. In addition, the software provides the interface with the signal processors and addresses packet delay and packet loss issues.

Media Processing

Our media processing products provide the enabling technology and platforms for developing enhanced voice and video service applications for legacy and next generation networks. We have developed media processing technologies such as message recording/playback, announcements, voice and video coding and mixing and call progress tone detection that enable our customers to develop and offer advanced revenue generating services such as conferencing, network announcements, voice and video mail, video share and interactive voice response.

Digital Cellular Communications Technology

Convergence of wireline and wireless networks is becoming a key driver for deployment of voice over packet networks, enabling operators to use common equipment for both networks, thus lowering capital expenditures and operating expenses, while offering enriched services.

Our voice over packet products provide a cost effective solution for these convergence needs, complying with 2G and 3G cellular standards, for GSM/UMTS, UMA, Femtocell and CDMA/CDMA2000 networks. These include support for cellular vocoders (concurrently with wireline vocoders), interfaces and protocols. These interfaces and protocols are being defined by special standardization groups (e.g., 3GPP and 3GPP2) and include capabilities such as mediation (mobile to mobile calls with no transcoding), support for handoff and lawful intercept and various other cellular-specific capabilities.

VoIP for Telephony over Cable Networks

Telephony over cable networks is characterized by technical challenges due to the intrinsic nature of the cable system which broadcasts across the subscriber network. The cable telephony market is divided into two main standards: softswitch solutions and IP access terminal, or IPAT, V5.2 solutions utilizing Class 5 switches. We have developed media gateway technology that is capable of supporting both standards while migration from IPAT solutions to softswitch solutions may be done by a software only upgrade, thus protecting the end customer's investment. Our technology complies with PacketCable standards including security/encryption technology, support for quality of service, call control and signaling.

Hardware Architectures for Dense Multi-Trunk Voice over Packet Systems

Our voice over packet product offerings include high density, multi-trunk voice over packet systems for standards-based open telecommunications platforms in access equipment. Multi-trunk processing is centered around a design encompassing two key processing elements, signal processors performing voice, fax and data processing and a communications processor. Overall system performance, reliability, capacity, size, cost and power consumption are optimized, based on our hardware architecture, which supports high throughput rates for multi-trunk processing. On-board efficient network and system interfaces relieve the system controller from extensive real time data transfer and processing of data streams.

Carrier Grade System Expertise

To provide state of the art carrier grade media gateways, we have developed a wide expertise in a number of fields essential to such a product line. We have developed or integrated the various components required to implement a full digital media gateway solution that behaves as a unified entity to the external world. This required a major investment in adapting standard cPCI platforms to our needs. Such adaptation included optimizing power supply and cooling requirements, adding centralized shelf controllers, fabric switches and alarm cards to the chassis. Another aspect of the expertise we developed relates to high availability software and hardware design. High availability is a required feature in any carrier grade media gateway platform. We have also developed a sophisticated EMS to complete our offering. Our EMS enables the user to provision and monitor a number of media gateways from a centralized location.

Customers

Our customers consist of Service Providers and channels (such as distributors), OEMs, network equipment providers and systems integrators. Historically, we have derived the majority of our revenues from sales to a small number of customers. The identities of our principal customers have changed and we expect that they will continue to change, from year to year. We expect that a small number of customers will continue to account for a large percentage of our sales. Sales to Nortel Networks accounted for 16.3% of our revenues in 2005, 15.2% of our revenues in 2006, and 17.0% of our revenues in 2007. No other customer accounted for more than 10.0% of our revenues in 2005, 2006 or 2007.

Sales and Marketing

Our sales and marketing strategy is to secure the leading channels and system integrators in each region, partner with leading application companies and achieve design wins with network equipment providers in our targeted markets. Prospective customers and channels generally must make a significant commitment of resources to test and evaluate our products and to integrate them into larger systems, networks, and applications. As a result, our sales process is often subject to delays associated with lengthy approval processes that typically accompany the design and testing of new communications equipment. For these reasons, the sales cycles of our products to new customers are often lengthy, averaging approximately six to twelve months after achieving a design win. This

We also provide our customers with reference platform designs, which enable them to achieve easier and faster transitions from the initial prototype designs we use in the test trials through final production releases. We believe this significantly enhances our customers' confidence that our products will meet their market requirements and product introduction schedules.

We market our products in the United States, Europe, Asia, Latin America and Israel primarily through a direct sales force. We have invested significant resources in setting up local sales forces giving us a presence in relevant markets. We have given particular emphasis to emerging markets such as Latin America and Eastern Europe in addition to continuing to sell our products in developed countries.

Marketing managers are dedicated to principal customers to promote close cooperation and communication. Additionally, we market our products in these areas through independent sales representatives and system integrators. We select these independent entities based on their ability to provide effective field sales, marketing communications and technical support to our customers. We have generally entered into a combination of exclusive and non-exclusive sales representation agreements with these representatives in each of the major countries in which we do business. These agreements are typically for renewable 12-month terms, are terminable at will by us upon 90 days notice, and do not commit the sales representative to any minimum sales of our products to third parties. Some of our rep

Manufacturing

Texas Instruments Incorporated supplies all of the signal processor chips used for our signal processors. Other components are generic in nature and we believe they can be obtained from multiple suppliers.

We have not entered into any long-term supply agreements. However, we have worked for years in several countries with established global manufacturing leaders such as Flextronics and have a good experience with their level of commitment and ability to deliver. To date, we have been able to obtain sufficient amounts of these components to meet our needs and do not foresee any supply difficulty in obtaining timely delivery of any parts or components. However, an interruption in supply from any of these sources, especially with regard to signal processors from Texas Instruments Incorporated, or an unexpected termination of the manufacture of certain electronic components, could disrupt production, thereby adversely affecting our results. We generally maintain an inventory of critical components used in the manufacture and assembly of our products although our inventory of signal processor chips would likely not be sufficient in the event that we had to engage an alternate supplier for these components.

We utilize contract manufacturing for substantially all of our manufacturing processes. Most of our manufacturing is carried out by third-party subcontractors in Israel and China. We have extended our manufacturing capabilities through third party subcontractors in the United States and Mexico. Our internal manufacturing activities consist primarily of the production of prototypes, test engineering, materials purchasing and inspection, final product configuration and quality control and assurance.

Industry Standards and Government Regulations

Our products must comply with industry standards relating to telecommunications equipment. Before completing sales in a country, our products must comply with local telecommunications standards, recommendations of quasi-regulatory authorities and recommendations of standards-setting committees. In addition, public carriers require that equipment connected to their networks comply with their own standards. Telecommunication-related policies and regulations are continuously reviewed by governmental and industry standards-setting organizations and are always subject to amendment or change. Although we believe that our products cur

We are subject to telecom industry regulations and requirements set by telecommunication carriers that address a wide range of areas including quality, final testing, safety, packaging and use of environmentally friendly components. We comply with the European Union's Restriction of Hazardous Substances Directive (under certain exemptions) that requires telecom equipment suppliers to stop the usage of some materials that are not environmentally friendly by July 1, 2006. These materials include cadmium, hexavalent chromium, lead, mercury, polybrominated biphenyls and polybrominated diphenyl ethers. Under the directive, an extension for compliance through 2010 was granted with respect to the usage of lead in solders in Network Infrastructure equipment. We expect that other

Competition

Competition in our industry is intense and we expect competition to increase in the future. Our competitors currently sell products that provide similar benefits to those that we sell. There has been a significant amount of merger and acquisition activity and strategic alliances frequently involving major telecommunications equipment manufacturers acquiring smaller companies, and we expect that this will result in an increasing concentration of market share among these companies, many of whom are our customers.

Our principal competitors in the area of analog media gateways (2 to 24 ports) for access and enterprise are Cisco Systems Inc., Mediatrix Telecom, Inc., Vega Stream Limited, Samsung, Innovaphone AG, Quintum Technologies, Tainet Communication System Corp., Welltech, Ascii Corp., D-Link Systems, Inc., Multitech Inc., Inomedia, OKI and LG. In addition we face competition in low, mid and high density gateways from internal development at companies such as Nortel, Alcatel-Lucent, Nokia-Siemens, Huawei, Ericsson, UTstarcom, ZTE and from Cisco Systems, Veraz Networks, Sonus Networks, General Bandwidth, Dialogic/Cantata Technologies and Commatch (Telrad).

Our principal competitors in the media server market segment are Cantata Technology, NMS Communications, Convedia/Radisys, IP Unity/Glenayre, Cognitronics and Aculab. In addition, we face competition in software-based and hardware-based media servers from internal development at companies such as Hewlett-Packard, Comverse-NetCentrex, Nortel, Alcatel - Lucent, Nokia-Siemens and Ericsson.

With respect to session border controllers, we compete against Acme Packets, Nextpoint, Covergence and Sonus. In the security gateway market, we compete against private companies such as Reefpoint and Azaire.

Our principal competitors in the sale of signal processing chips are Texas Instruments, Broadcom, Infineon, Centillum, Surf and Mindspeed. Several large manufacturers of generic signal processors, such as Motorola, Agere Systems, which merged with LSI Corporation in April 2007, and Intel have begun, or are expected to begin marketing competing processors. Our principal competitors in the communications board market are NMS Communications, Intel, Motorola, Cantata Technology, Acculab and PIKA Technologies, Inc.

We also face significant and increasing competition in the market for products utilized in the VoIP market. Our competitors in the market for VoIP products include telecommunications companies, data communication companies and companies specializing in voice over IP products, some of which have greater name recognition, larger installed customer bases and significantly greater financial, technical, sales and marketing resources than we do.

Many of our competitors have the ability to offer vendor-sponsored financing programs to prospective customers. Some of our competitors with broad product portfolios may also be able to offer lower prices on products that compete with ours because of their ability to recoup a loss of margin through sales of other products or services. Additionally, voice, audio and other communications alternatives that compete with our products are being continually introduced.

In the future, we may also develop and introduce other products with new or additional telecommunications capabilities or services. As a result, we may compete directly with telephone companies and other telecommunications infrastructure providers. Additional competitors may include companies that currently provide computer software products and services, such as telephone, media, publishing and cable television. The ability of some of our competitors to bundle other enhanced services or complete solutions with VoIP products could give these competitors an advantage over us.

Intellectual Property and Proprietary Rights

Our success is dependent in part upon proprietary technology. We rely primarily on a combination of patent, copyright and trade secret laws, as well as confidentiality procedures and contractual provisions, to protect our proprietary rights. We also rely on trademark protection concerning various names and marks that serve to identify it and our products. While our ability to compete may be affected by our ability to protect our intellectual property, we believe that, because of the rapid pace of technological change in our industry, maintaining our technological leadership and our comprehensive familiarity with all aspects of the technology contained in our signal processors and communication boards is also of primary importance.

We own U.S. patents that relate to our voice compression and session border control technologies. We also actively pursue patent protection in selected other countries of interest to us. In addition to patent protection, we seek to protect our proprietary rights through copyright protection and through restrictions on access to our trade secrets and other proprietary information which we impose through confidentiality agreements with our customers, suppliers, employees and consultants.

There are a number of companies besides us who hold or may acquire patents for various aspects of the technology incorporated in the ITU's standards or other industry standards or proprietary standards, for example, in the fields of wireless and cable. While we have obtained cross-licenses from some of the holders of these other patents, we have not obtained a license from all of the holders. The holders of these other patents from whom we have not obtained licenses may take the position that we are required to obtain a license from them. Companies that have submitted their technology to the ITU (and generally other industry standards making bodies) for adoption as an industry standard are required by the ITU to undertake to agree to provide licenses to that technology on reasonable terms. Accordingly, we believe that even if we were required to negotiate a license for the use of such technology, we would be able to do so at an acceptable price. Similarly, however, third parties who also participate with respect to the same standards-setting organizations as do we may be able to negotiate a license for use of our □

Under a pooling agreement dated March 3, 1995, as amended, between AudioCodes and DSP Group, Inc., on the one hand, and France Telecom, Université de Sherbrooke and their agent, Sipro Lab Telecom, on the other hand, we and DSP Group, Inc. granted to France Telecom and Université de Sherbrooke the right to use certain of our specified patents, and any other of our and DSP Group, Inc. intellectual property rights incorporated in the ITU G.723.1 standard. Likewise France Telecom and Université de Sherbrooke granted AudioCodes and DSP Group, Inc. the right to use certain of their patents and any other intellectual property rights incorporated in the G.723.1 standard. In each case, the rights granted are to design, make and use products developed or manufactured for joint contribution to the G.723.1 standard without any payment by any party to the other parties.

In addition, each of the parties to the agreement granted to the other parties the right to license to third parties the patents of any party included in the intellectual property required to meet the G.723.1 standard, in accordance with each licensing party's standard patent licensing agreement. The agreement provides for the fee structure for licensing to third parties. The agreement provides that certain technical information be shared among the parties, and each of the groups agreed not to assert any patent rights against the other with respect of the authorized use of voice compression products based upon the technical information transferred. Licensing by any of the parties of the parties' intellectual property incorporated in the G.723.1 standard to third parties is subject to royalties that are specified under the agreement.

Each of the parties to the agreement is free to develop and sell products embodying the intellectual property incorporated into the G.723.1 standard without payment of royalties to other parties, so long as the G.723.1 standard is implemented as is, without modification. The agreement expires upon the last expiration date of any of the AudioCodes, DSP Group, Inc., France Telecom or Universite de Sherbrooke patents incorporated in the G.723.1 standard. The parties to the agreement are not the only claimants to technology underlying the G.723.1 standard.

We are aware of parties who may be infringing our technology that is part of the G.723.1 standard. We evaluate these matters on a case by case basis, directly or through our licensing partner. Although we have not yet determined whether to pursue legal action, we may do so in the future. There can be no assurance that any legal action will be successful.

Third parties have claimed, and from time to time in the future may claim, that our past, current or future products infringe their intellectual property rights. Intellectual property litigation is complex and there can be no assurance of a favorable outcome of any litigation. Any future intellectual property litigation, regardless of outcome, could result in substantial expense to us and significant diversion of the efforts of our technical and management personnel. Litigation could also disrupt or otherwise severely impact our relationships with current and potential customers as well as our manufacturing, distribution and sales operations in countries where relevant third party rights are held and where we may be subject to jurisdiction. An adverse determination in any proceeding could subject us to significant liabilities to third parties, require disputed rights to be licensed from such parties, assuming licenses to such rights could be obtained, or require us to cease using such technology and expend significant resources to develop non-infringing technology. We may not be able to obtain a license at an acceptable price.

We have entered into technology licensing fee agreements with third parties. We expect that in the ordinary course of business we may be required to enter into additional licensing.

Legal Proceedings

We.

Prior to the acquisition of Nuera by us, one of Nuera's customers had been named as a defendant in a patent infringement suit involving technology the customer purchased from Nuera. In the suit, the plaintiff alleged that the customer used devices to offer services that infringe upon a patent the plaintiff owns. The customer has sought indemnification from Nuera pursuant to the terms of a purchase agreement between Nuera and the customer relating to the allegedly infringing technology at issue.

Prior to the acquisition of Nuera by us, eight former employees of a French subsidiary of Nuera filed a labor grievance against the subsidiary claiming they were unfairly terminated. The French subsidiary filed for bankruptcy in 2004 and, in 2005, the court appointed liquidator sought to hold Nuera liable for the obligations of its French subsidiary. In June 2006, the court ruled in favor of Nuera that it was not liable for the obligations of its French subsidiary. In March 2007, the liquidator appealed the judgment and in April 2008 the appeal was denied by the court.

B. ORGANIZATIONAL STRUCTURE

List of Significant Subsidiaries

AudioCodes Inc., our wholly-owned subsidiary, is a Delaware corporation.

AudioCodes UK Limited and AudioCodes Europe Limited, our wholly-owned subsidiaries, are incorporated in England.

CTI Squared Ltd., our wholly-owned subsidiary, is organized under the laws of Israel.

C. PROPERTY, PLANTS AND EQUIPMENT

We lease our main facilities, located in Airport City, Lod, Israel, which occupy approximately 128,000 square feet for annual lease payments (including management fees) of approximately \$2.6 million. In January 2008, we increased the amount of space we lease by approximately 74,000 square feet for annual lease payments (including management fees) of approximately \$1.4 million. In addition, we have entered into an agreement regarding the neighboring property pursuant to which a building of approximately 145,000 square feet will be erected and leased to us for period of eleven years. This new building is expected to be completed in 2010. We estimate the annual lease payments (including management fees) to be in the range of \$2.0 million to \$3.2 million, depending on the amount expended by the lessor on improvements to the building.

Our U.S. subsidiary, AudioCodes Inc., leases a 7,000 square foot facility in San Jose, California. Our subsidiary has additional offices total of 20,000 square foot in Raleigh, Chicago, Boston and Dallas. AudioCodes Inc. also leases a 29,000 square foot facility in Somerset, New Jersey, a 68,000 square foot facility in San Diego, California, and a 20,000 square foot facility in Plano, Texas. The annual lease payments (including management fees) for all our offices in the United States is approximately \$1.5 million.

We believe that these properties are adequate to meet our current needs. We may need to increase the size of our current facilities, seek new facilities, close certain facilities or sublease portions of our existing facilities in order to address our needs in the future.

ITEM 4A. UNRESOLVED STAFF COMMENTS

None.

ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Statements in this Annual Report concerning our business outlook or future economic performance; anticipated revenues, expenses or other financial items; product introductions and plans and objectives related thereto; and statements concerning assumptions made or expectations as to any future events, conditions, performance or other matters, are "forward-looking statements" as that term is defined under the United States Federal securities laws. Forward-looking statements are subject to various risks, uncertainties and other factors that could cause actual results to differ materially from those stated in such statements. Factors that could cause or contribute to such differences include, but are not limited to, those set forth under "Risk Factors" in this Annual Report, as well as those discussed elsewhere in this Annual Report and in our other filings with the Securities and Exchange Commission.

Critical Accounting Policies and Estimates

Our consolidated financial statements are prepared in accordance with U.S. generally accepted accounting principles, or US GAAP. These accounting principles require management to make certain estimates, judgments and assumptions based upon information available at the time that they are made, historical experience and various other factors that are believed to be reasonable under the circumstances. These estimates, judgments and assumptions can affect the reported amounts of assets and liabilities as of the date of the financial statements, as well as the reported amounts of revenues and expenses during the periods presented.

On an on-going basis, management evaluates its estimates and judgments, including those related to revenue recognition and allowance for sales returns, allowance for doubtful accounts, inventories, investment in an affiliated companies, goodwill and income taxes and valuation allowance. Management bases its estimates and judgments on historical experience and on various other factors that are believed to be reasonable under the circumstances, the results of which form the □

Our management has reviewed these critical accounting policies and related disclosures with our Audit Committee. See Note 2 to the Consolidated Financials □.

Management believes the significant accounting policies that affect its more significant judgments and estimates used in the preparation of its consolidated financial statements and are the most critical to aid in fully understanding and evaluating AudioCodes' reported financial results include the following:

- Revenue recognition and allowance for sales returns;
- Allowance for doubtful accounts;
- Inventories;
- Marketable securities;
- Business combinations;
- Intangible assets;
- Goodwill;
- Income taxes and valuation allowance; and
- Stock-based compensation.

Revenue Recognition and Allowance for Sales Returns

We generate our revenues primarily from the sale of products. We sell our products through a direct sales force and sales representatives. Our customers include original equipment manufacturers (OEMs), network equipment providers, systems integrators and distributors in the telecommunications and networking industries, all of whom are considered end users.

Revenues from products are recognized in accordance with Staff Accounting Bulletin (“SAB”) No. 104, “Revenue Recognition in Financial Statements” when the following criteria are met: (i) persuasive evidence of an arrangement exists, (ii) delivery of the product has occurred, (iii) the fee is fixed or determinable and (iv) collectability is probable. We have no obligation to customers after the date on which products are delivered, other than pursuant to warranty obligations and any applicable right of return. We generally grant our customers the right of return or the ability to exchange a specific percentage of the total price paid for products they have purchased over a period of three months for other products.

We maintain a provision for product returns and exchanges. This provision is based on historical sales returns, analysis of credit memo data and other known factors. This provision amounted to \$545,000 in 2005, \$636,000 in 2006 and \$559,000 in 2007.

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

Allowance for Doubtful Accounts

Our trade receivables are derived from sales to customers located primarily in the Americas, the Far East, Israel and Europe. We perform ongoing credit evaluations of our customers and to date have not experienced any material losses from uncollected receivables. An allowance for doubtful accounts is determined with respect to those amounts that we have determined to be doubtful of collection. We usually do not require collateral on trade receivables because most of our sales are to large and well-established companies.

Inventories

Inventories are stated at the lower of cost or market value. Cost is determined using the “moving average cost” method for raw materials and on the basis of direct manufacturing costs for finished products. We periodically evaluate 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 provided to cover risks arising from slow moving items, technological obsolescence, excess inventories, discontinued products and for market prices lower than cost. We wrote-off inventory in a total amount of \$1.8 million in 2005, \$1.9 million in 2006 and \$700,000 in 2007.

Marketable Securities

We account for investments in marketable debt securities in accordance with SFAS No. 115, “Accounting for Certain Investments in Debt and Equity Securities” (“SFAS 115”). Management determines the appropriate classification of its investments in marketable debt securities at the time of purchase and reevaluates such determinations at each balance sheet date.

Debt securities are classified as held-to-maturity since we have the intent and ability to hold the securities to maturity and, accordingly, debt securities are stated at amortized cost. The amortized cost of held-to-maturity securities is adjusted for amortization of premiums and accretion of discounts to maturity. Any amortization and interest is included in the consolidated statement of income as financial income or expense, as appropriate. The accrued interest on short-term and long-term marketable securities is included in the balance of short-term marketable securities.

In accordance with business combination accounting, we allocate the purchase price of acquired companies to the tangible and intangible assets acquired and liabilities assumed based on their estimated fair values. We engage third-party appraisal firms to assist management in determining the fair values of certain assets acquired and liabilities assumed. Such valuations require management to make significant estimates and assumptions, especially with respect to intangible assets.

Management makes estimates of fair value based upon assumptions it believes to be reasonable. These estimates are based on historical experience and information obtained from the management of the acquired companies and are inherently uncertain. Critical estimates in valuing certain of the intangible assets include, but are not limited to, the following: future expected cash flows from product sales, maintenance agreements, customer contracts and acquired developed technologies and patents and estimated cash flows from the projects when completed; the acquired company's brand and market position as well as assumptions about the period of time the acquired brand will continue to be used in the combined company's product portfolio; and discount rates. Unanticipated events and circumstances may occur which may affect the accuracy or validity of such assumptions, estimates or actual results. Changes to these estimates, relating to circumstances that existed at the acquisition date, are recorded as an adjustment to goodwill during the purchase price allocation period (generally within one year of the acquisition date) and as operating expenses, if otherwise.

In connection with purchase price allocations, we estimate the fair value of the support obligations assumed in connection with acquisitions. The estimated fair value of the support obligations is determined utilizing a cost build-up approach. The cost build-up approach determines fair value by estimating the costs related to fulfilling the obligations plus a normal profit margin. The sum of the costs and operating profit approximates, in theory, the amount that we would be required to pay a third party to assume the support obligation.

Intangible assets

As a result of our previous acquisitions, our balance sheet includes acquired intangible assets, such as goodwill and current technology, in the aggregate amount of approximately \$131 million as of December 31, 2006 and \$130 million as of December 31, 2007. In the course of the analysis and valuation of intangible assets, we use financial and other information, including financial projections and valuations provided by third parties. Although we evaluate our intangible assets when there is an indication of impairment, our projections are based on the information available at the respective valuation dates, and may differ from actual results.

In accordance with SFAS No. 144, as of December 31, 2007, no impairment losses were recorded.

Goodwill

In accordance with SFAS No. 142, "Goodwill and Other Intangible Assets" ("SFAS 142") goodwill acquired in a business combination that closes on or after July 1, 2001 is deemed to have indefinite life and will not be amortized. SFAS 142 requires goodwill to be tested for impairment on adoption and at least annually thereafter or bet□

As of December 31, 2007, we had total goodwill of \$120 million on our balance sheet. Goodwill is tested for impairment by comparing the fair value of the reporting unit with its carrying value. The fair value was determined based on the Company's fair value. As of December 31, 2007 no impairment losses were identified.

Income Taxes and Valuation Allowance

As part of the process of preparing our consolidated financial statements, we are required to estimate our income tax expense in each of the jurisdictions in which we operate. This process involves us estimating our actual current tax exposure, which is accrued as taxes payable, together with assessing temporary differences resulting from differing treatment of items for tax and accounting purposes. These differences result in deferred tax assets, which are included within our consolidated balance sheet. We may record a valuation allowance to reduce our deferred tax assets to the amount of future tax benefit that is more likely than not to be realized.

Although we believe that our estimates are reasonable, there is no assurance that the final tax outcome and the valuation allowance will not be different than those which are reflected in our historical income tax provisions and accruals.

We have filed or are in the process of filing federal, state and foreign tax returns that are subject to audit by the respective tax authorities. Although the ultimate outcome is unknown, we believe that adequate amounts have been provided for and any adjustments that may result from tax return audits are not likely to materially adversely affect our consolidated results of operations, financial condition or cash flows.

In June 2006, the FASB issued FIN 48, "Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109" ("FIN 48"). FIN 48 clarifies the accounting for uncertainty in income taxes recognized under SFAS No. 109. FIN 48 prescribes a recognition threshold and measurement attribute for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return and also provides guidance on various related matters such as derecognition, interest and penalties, and disclosure. On January 1, 2007, we adopted FIN 48. The initial application of FIN 48 to our tax positions had no effect on our Shareholders' equity.

Stock-based Compensation

Effective January 1, 2006, we began accounting for stock-based compensation in accordance with Statement of Financial Accounting Standards No. 123R—"Share-Based Payments". We utilize the Black-Scholes option pricing model to estimate the fair value of stock-based compensation at the date of grant. The Black-Scholes model requires subjective assumptions regarding dividend yields, expected volatility, expected life of options and risk-free interest rates. These assumptions reflect management's best estimates. Changes in these inputs and assumptions can materially affect the estimate of fair value and the amount of our stock-based compensation expenses. We recognized \$8.7 million of stock-based compensation expense in 2006 and \$8.0 million of stock-based compensation expense in 2007. As of December 31, 2007, there was approximately \$8.0 million of total unrecognized stock-based compensation expense related to non-vested stock-based compensation arrangements granted by us. As of December 31, 2007, that expense is expected to be recognized over a weighted-average period of 1.5 years.

A. OPERATING RESULTS

You should read this discussion with the consolidated financial statements and other financial information included in this Annual Report.

Overview

We design, develop and market enabling technologies and system products for the transmission of voice, data, fax and multimedia communications over packet networks, which we refer to as the new voice infrastructure. Our products enable our customers to build high-quality packet networking equipment and network solutions and provide the building blocks to connect traditional telephone networks to the new voice infrastructure, as well as connecting and securing multimedia communication between different packet-based networks. Our products are sold primarily to leading original equipment manufacturers, or OEMs, system integrators and network equipment providers in the telecommunications and networking industries. We have continued to broaden our offerings, both from internal development and through acquisitions, as we have expanded in the last few years from selling chips to boards, subsystems, media gateway systems, media servers, session border controllers and messaging platforms.

Our headquarters and R&D facilities are located in Israel with R&D extensions in the U.S. and in the U.K. We have other offices located in Europe, the Far East, and Latin America.

Effective January 1, 2006, we account for stock-based compensation in accordance with Statement of Financial Accounting Standards No. 123R-“Share-Based Payments”. SFAS No. 123(R) requires the fair value of all equity-based awards granted to employees to be recognized in financial statements beginning in the first quarter of 2006. The result is that we are required to record an expense with respect to stock option grants, even if the exercise price of the stock options is equal to the market price of the underlying shares on the date of grant. The adoption of SFAS No. 123(R) had a material adverse affect on our results of operations in 2006 and 2007, as we recognized \$8.7 million of stock-based compensation expense in 2006 and \$8.0 million of stock-based compensation expense in 2007.

Nortel Networks accounted for 16.3% of our total revenues in 2005, 15.2% of our revenues in 2006 and 17.0% of our revenues in 2007. Our top five customers accounted for 31.1% of our revenues in 2005, 29.1% of our revenues in 2006 and 32.8% of our revenues in 2007. Based on our experience, we expect that our largest customers may change from period to period. If we lose a large customer and fail to add new customers to replace lost revenue our operating results may be materially adversely affected.

Revenues based on the location of our customers for the last three fiscal years are as follows:

	<u>2005</u>	<u>2006</u>	<u>2007</u>
Americas	57.5%	56.6%	56.6%
Far East	12.5	12.8	11.2
Europe	19.4	22.2	25.5
Israel	10.6	8.4	6.7
Total	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>

The increase in the percentage of our revenues in 2006 and 2007 from customers located in Europe was due to demand from service providers and system integrators in Europe increasing at a higher rate compared to the other locations.

Part of our strategy over the past few years has involved the acquisition of complementary businesses and technologies. We continued implementation of this strategy with three additional acquisitions in the past two years. In July, 2006, we completed the acquisition of Nuera (merged into AudioCodes Inc. as of December 31, 2007). Nuera provides Voice over Internet Protocol infrastructure solutions for broadband and long distance networks. This transaction is significantly larger than our other acquisitions and investments to date. Nuera became a wholly-owned subsidiary of AudioCodes Inc. and, accordingly, its results of operations have been included in our consolidated financial statements since the acquisition date. We cannot be sure that we will be successful in integrating Nuera’s products, employees and operations into our organization or that we will be able to operate Nuera’s business in a profitable manner.

In August 2006, we acquired Netrake (merged into AudioCodes Inc. as of December 31, 2007), a provider of session border controller, or SBC, and security gateway solutions. SBCs enable connectivity, policies and security for real-time media sessions, such as VoIP, video or fax, between public or private IP □gence deployments.

In April 2007, we completed the acquisition of CTI Squared. CTI Squared is a provider of enhanced messaging and communications platforms deployed globally by service providers and enterprises. CTI Squared's platforms integrate data and voice messaging services over internet, intranet, PSTN, cellular, cable and enterprise networks.

We believe that prospective customers generally are required to make a significant commitment of resources to test and evaluate our products and to integrate them into their larger systems. As a result, our sales process is often subject to delays associated with lengthy approval processes that typically accompany the design and testing of new communications equipment. For these reasons, the sales cycles of our products to new customers are often lengthy, averaging approximately six to twelve months. As a result, we may incur significant selling and product development expenses prior to generating revenues from sales.

The currency of the primary economic environment in which our operations are conducted is the U.S. dollar, and as such, we use the dollar as our functional currency. Transactions and balances originally denominated in dollars are presented at their original amounts. All transaction gains and losses from the remeasurement of monetary balance sheet items denominated in non-dollar currencies are reflected in the statement of operations as financial income or expenses, as appropriate.

The demand for Voice over IP, or VoIP, technology has increased during the last three years. In recent years, the shift from traditional circuit-switched networks to next generation packet-switched networks continued to gain momentum. As data traffic becomes the dominant factor in communications, service providers are building and maintaining converged networks for integrated voice and data services. In developed countries, traditional and alternative service providers adopt bundled triple play (voice, video and data) and quadruple play (voice, video, data and mobile) offerings. This trend, enabled by voice and multimedia over IP, has fueled competition among cable, wireline, ISP and mobile operators, increasing the pressure for adopting and deploying VoIP networks. In addition, underdeveloped markets without basic wire line service in countries such as China and India and certain countries in Eastern Europe are adopting the use of VoIP technology to deliver voice and data services that were previously unavailable.

Results of Operations

The following table sets forth the percentage relationships of certain items from our consolidated statements of operations, as a percentage of total revenues for the periods indicated:

<u>Statement of Operations Data:</u>	<u>Year Ended December 31,</u>		
	<u>2005</u>	<u>2006</u>	<u>2007</u>
Revenues	100.0%	100.0%	100.0%
Cost of revenues	40.6	41.6	43.7
Gross profit	59.4	58.4	56.3
Operating expenses:			
Research and development, net	21.1	24.0	25.7
Selling and marketing	22.4	25.6	27.1
General and administrative	5.2	5.9	6.1
Total operating expenses	48.7	55.5	58.9
Operating income	10.7	2.9	(2.6)
Financial income, net	2.1	2.6	1.7
Income (loss) before taxes on income	12.8	5.5	(0.9)
Taxes on income	0.7	0.2	0.8
Equity in losses of affiliated companies, net	0.6	0.6	0.7
Net income (loss)	11.6%	4.7%	(2.4)%

Year Ended December 31, 2007 Compared to Year Ended December 31, 2006

Revenues. Revenues increased 7.4% to \$158.2 million in 2007 from \$147.4 million in 2006. The increase in revenues was primarily due to an increase in revenues from our networking business. Our results of operation include CTI Squared beginning in April 2007, Nuera beginning in July 2006 and Netrake beginning in August 2006.

Gross Profit. Cost of revenues includes the manufacturing cost of hardware, quality assurance, overhead related to manufacturing activity and technology licensing fees payable to third parties. Gross profit increased to \$89.1 million in 2007 from \$86.1 million in 2006. Gross profit as a percentage of revenues decreased to 56.3% in 2007 from 58.4% in 2006. The decrease in our gross profit percentage was primarily attributable to amortization expenses in 2007 related to the acquisitions of CTI Squared during the second quarter of 2007 and Nuera and Netrake during the third quarter of 2006. Amortization expense allocated to cost of revenues amounted to \$2.5 million in 2007 and \$1.2 million in 2006. The decrease in gross profit percentage was partially offset by the higher sales volume that allowed us to leverage our manufacturing overhead over a larger sales base. The decrease in gross profit percentage was also offset by a reduction in manufacturing costs which was primarily due to a reduction in our raw material costs.

Research and Development Expenses. Research and development expenses consist primarily of compensation and related costs of employees engaged in ongoing research and development activities, development-related raw materials and the cost of subcontractors. Research and development expenses increased 14.9% to \$40.7 million in 2007, from \$35.4 million in 2006 and increased as a percentage of revenues to 25.7% in 2007 from 24.0% in 2006. The increase in net research and development expenses, both on an absolute and a percentage basis, was primarily due to our research and development personnel resulting from the acquisitions of CTI Squared in the second quarter of 2007 and the acquisitions of Nuera and Netrake during the third quarter of 2006. We expect that research and development expenses will continue to increase in absolute dollar terms in 2008 as a result of our continued development of new products, as well as the inclusion of CTI Squared for a full year.

Selling and Marketing Expenses Selling and marketing expenses consist primarily of compensation for selling and marketing personnel, as well as exhibition, travel and related expenses. Selling and marketing expenses increased 13.9% in 2007 to \$42.9 million from \$37.7 million in 2006. As a percentage of revenues, selling and marketing expenses increased to 27.1% in 2007 from 25.6% in 2006. The increase in selling and marketing expenses was due to an increase in selling and marketing personnel and amortization expenses as a result of the acquisitions of CTI Squared, Nuera and Netrake. Amortization expense allocated to sales and marketing amounted to \$1.0 million in 2007 and \$522,000 in 2006. We expect that selling and marketing expenses will continue to increase in absolute dollar terms as a res□.

General and Administrative Expenses General and administrative expenses consist primarily of compensation for finance, human resources, general management, rent, network and bad debt reserve, as well as insurance and professional services expenses. General and administrative expenses increased 9.9% to \$9.6 million in 2007 from \$8.8 million in 2006. As a percentage of revenues, general and administrative expenses increased to 6.1% in 2007 from 5.9% in 2006. The increase in general and administrative expenses was due to consolidating the expenses of our Nuera and Netrake subsidiaries, which were acquired in July 2006 and August 2006, and consolidating the expenses of our CTI Squared subsidiary, which was acquired in April 2007. We expect that general and administrative expenses will increase in absolute dollar terms to support our expected growth.

Financial Income, Net Financial income consists primarily of interest derived on cash and cash equivalents, short-term and long-term marketable securities, short-term and long-term bank deposits and structured notes, net of interest accrued in connection with our senior convertible notes and bank charges. Financial income, net, in 2007 was \$2.7 million compared to \$3.8 million in 2006. The decrease in financial income, net in 2007 was primarily due to lower in□

Taxes on Income. Taxes on Income were \$1.3 million in 2007 compared to approximately \$289,000 in 2006. The increase is principally attributable to a decrease in our deferred tax asset.

Equity in Losses of Affiliated Companies, Net. Equity in losses of affiliated companies, net was \$1.1 million in 2007 compared to \$916,000 in 2006.

Year Ended December 31, 2006 Compared to Year Ended December 31, 2005

Revenues. Revenues increased 27.2% to \$147.4 million in 2006 from \$115.8 million in 2005. The increase in revenues was primarily due to an increase of \$16.7 million in sales in the United States and an increase of \$10.7 million in sales in Europe. Our results of operation include Nuera beginning in July 2006 and Netrake beginning in August 2006. Our increase in revenues in 2006 also reflected the increased interest and activity in the market for packet-based VoIP products.

Gross Profit. Cost of revenues includes the manufacturing cost of hardware, quality assurance, overhead related to manufacturing activity and technology licensing fees payable to third parties. Gross profit increased to \$86.1 million in 2006 from \$68.8 million in 2005. Gross profit as a percentage of revenues decreased to 58.4% in 2006 from 59.4% in 2005. The decrease in our gross profit percentage was primarily attributable to amortization expenses in 2006 related to the acquisitions of Nuera and Netrake during the third quarter of 2006. Amortization expense allocated to cost of revenues amounted to \$1.2 million in 2006. The decrease in our gross margin was also due to expenses related to equity-based compensation resulting from the adoption of SFAS 123(R). Equity-based compensation expenses allocated to cost of revenues amounted to \$620,000 in 2006. The decrease in gross profit percentage was partially offset by the higher sales volume that allowed us to leverage our manufacturing overhead over a larger sales base. The decrease in gross profit percentage was also offset by a reduction in manufacturing costs which was primarily due to a reduction in our raw material costs.

Research and Development Expenses. Research and development expenses consist primarily of compensation and related costs of employees engaged in ongoing research and development activities, development-related raw materials and the cost of subcontractors. Research and development expenses increased 45.1% to \$35.4 million in 2006, from \$24.4 million in 2005 and increased as a percentage of revenues to 24.0% in 2006 from 21.1% in 2005. The increase in net research and development expenses, both on an absolute and a percentage basis, was primarily due to expenses related to equity-based compensation resulting from the adoption of SFAS 123(R). Equity-based compensation expenses allocated to research and development expenses amounted to \$3.1 million in 2006. The increase in research and development expenses was also due to additions to our research and development personnel resulting from the acquisitions of Nuera and Netrake during the third quarter of 2006. We expect that research and development expenses will continue to increase in absolute dollar terms in 2007 as a result of our continued development of new products, as well as the inclusion of Nuera and Netrake for a full year and the inclusion of CTI Squared beginning in April 2007.

Selling and Marketing Expenses Selling and marketing expenses consist primarily of compensation for selling and marketing personnel, as well as exhibition, travel and related expenses. Selling and marketing expenses increased 45.2% in 2006 to \$37.7 million from \$25.9 million in 2005. As a percentage of revenues, selling and marketing expenses increased to 25.6% in 2006 from 22.4% in 2005. The increase in selling and marketing expenses, on an absolute and a percentage basis, was primarily due to expenses related to equity-based compensation resulting from the adoption of SFAS 123(R). Equity-based compensation expenses allocated to selling and marketing expenses amounted to \$3.6 million in 2006. The increase in selling and marketing expenses was also due to an increase in selling and marketing personnel and amortization expenses as a result of the acquisitions of Nuera and Netrake. Amortization expense allocated to sales and marketing amounted to \$ 522 thousands in 2006. We expect that selling and marketing expenses will continue to increase in absolute dollar terms as a result of an expected increase in our sales force and marketing activities, as well as the inclusion of Nuera and Netrake for a full year and the inclusion of CTI Squared beginning in April 2007.

General and Administrative Expenses General and administrative expenses consist primarily of compensation for finance, human resources, general management, rent, network and bad debt reserve, as well as insurance and professional services expenses. General and administrative expenses increased 46.0% to \$8.8 million in 2006 from \$6.0 million in 2005. As a percentage of revenues, general and administrative expenses increased to 5.9% in 2006 from 5.2% in 2005. The increase in general and administrative expenses, both on an absolute and a percentage basis, in 2006 was primarily the result of expenses related to equity-based compensation resulting from the adoption of SFAS 123(R). Equity-based compensation expenses allocated to general and administrative expenses amounted to \$1.4 million in 2006. The increase in general and administrative expenses was also due to consolidating the expenses of our Nuera and Netrake subsidiaries, which were acquired in July 2006 and August 2006. We expect that general and administrative expenses will increase in absolute dollar terms to support our operations in 2007.

Financial Income, Net Financial income consists primarily of interest derived on cash and cash equivalents, short-term and long-term marketable securities, short-term and long-term bank deposits and structured notes, net of interest accrued in connection with our senior convertible notes and bank charges. Financial income, net, in 2006 was \$3.8 million compared to \$2.5 million in 2005. The increase in financial income, net in 2006 was primarily due to higher interest income.

Taxes on Income. Our effective tax rate was 4.0% in 2006 and 5.6% in 2005. These relatively low tax rates were mainly the result of the utilization of net operating losses and the Approved Enterprise status granted to our production facilities in Israel.

Equity in Losses of Affiliated Companies, Net Equity in losses of affiliated companies, net were \$916,000 in 2006 compared to \$693,000 in 2005. We believe that the products being developed by affiliated companies may enable us to enter new markets and to offer new products.

Impact of Inflation, Devaluation and Fluctuation of Currencies on Results of Operations, Liabilities and Assets

Since the majority of our revenues are paid in or linked to the dollar, we believe that inflation and fluctuations in the NIS/dollar exchange rate have no material effect on our revenues. However, a majority of the cost of our Israeli operations, mainly personnel and facility-related, is incurred in NIS. Inflation in Israel and dollar exchange rate fluctuations, however, have some influence on our expenses and, as a result, on our net income. Our NIS costs, as expressed in dollars, are influenced by the extent to which any increase in the rate of inflation in Israel is not offset (or is offset on a lagging basis) by a devaluation of the NIS in relation to the dollar.

To protect against the changes in value of forecasted foreign currency cash flows resulting from payments in NIS, we maintain a foreign currency cash flow hedging program. We hedge portions of our forecasted expenses denominated in foreign currencies with forward contracts. These measures may not adequately protect us from material adverse effects due to the impact of inflation in Israel.

The following table presents information about the rate of inflation in Israel, the rate of devaluation of the NIS against the dollar, and the rate of inflation in Israel adjusted for the devaluation:

Year ended December 31,	Israeli inflation rate %	NIS Devaluation Rate %	Israeli inflation adjusted for devaluation %
2005	2.4	6.8	(4.4)
2006	(0.1)	(8.2)	8.1
2007	3.4	(9.0)	12.4
Five months ended May 31, 2008	2.2	(15.9)	18.2

