Enabling Next Gen Voice Networks

AudioCodes 1999 Annual Report

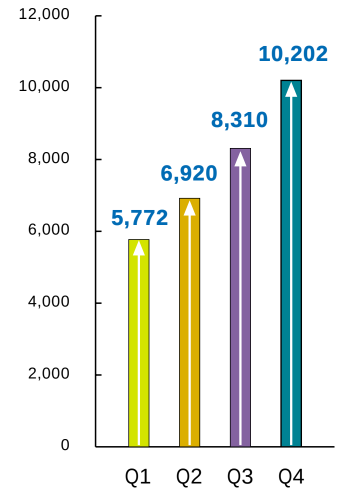
AudioCodes

Quarterly Information

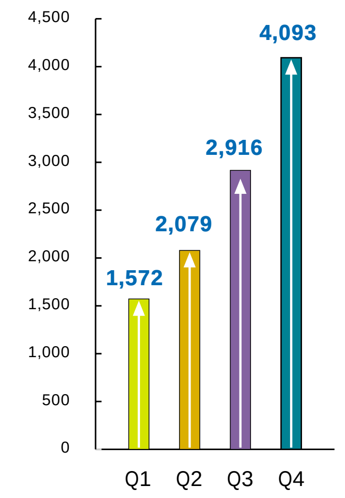
FINANCIALS

Contents

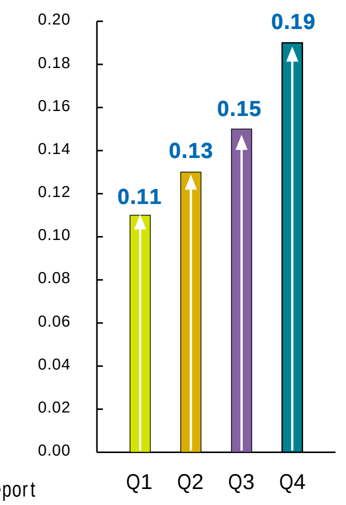
REVENUES 1999
(US $ In Thousands)



NET INCOME 1999
(US $ In Thousands)



DILUTED EARNINGS PER SHARE 1999 (US $)



Selected Consolidated Financial Data

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

Statement of Operations Data:	1995	1996	1997	1998	1999
	Year Ended December 31				
Revenues:					
Product sales	$ 90	$ 2,242	$ 3,379	$ 7,706	$ 28,920
Technology development and licensing	1,231	1,316	1,808	1,469	2,284
Total revenues	1,321	3,558	5,187	9,175	31,204
Cost of revenues:					
Product sales	89	1,416	2,306	3,121	11,632
Technology development and licensing	586	625	275	137	289
Total cost of revenues	675	2,041	2,581	3,258	11,921
Gross profit	646	1,517	2,606	5,917	19,283
Operating expense:					
Research and development, net	311	603	1,262	2,149	4,812
Sales and marketing	156	484	1,338	2,267	4,262
General and administrative	423	485	637	973	1,665
Total operating expenses	890	1,572	3,237	5,389	10,739
Operating income (loss)	(244)	(55)	(631)	528	8,544
Financial income, net	64	89	151	142	2,471
Income (loss) before income taxes	(180)	34	(480)	670	11,015
Income taxes	—	—	11	51	355
Net income (loss)	$ (180)	$ 34	$ (491)	$619	$ 10,660
Basic earnings (loss) per share	$ (0.02)	$ 0.01	$ (0.05)	$0.06	$ 0.70
Diluted earnings (loss) per share	$ (0.02)	$ 0.01	$ (0.05)	$0.05	$ 0.59
Number of shares for basic earnings per share	10,329	10,559	10,872	11,028	15,199
Number of shares for diluted earnings per share	10,329	10,963	10,872	13,037	18,081
Pro forma basic earnings (loss) per share				$ 0.05	
Pro forma diluted earnings (loss) per share				$ 0.05	

Balance Sheet Data:	1995	1996	1997	1998	1999
	Year Ended December 31				
Cash and cash equivalents	$ 120	$ 321	$ 967	$ 2,581	$ 60,500
Short-term deposits	—	—	2,050	1,029	57,052
Working capital	1,756	1,773	4,096	4,566	119,372
Total assets	2,404	2,769	5,859	8,713	129,522
Shareholders' equity	1,916	1,970	4,439	5,145	120,325

Management's Discussion and Analysis of Financial Condition and Results of Operations

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

Results of Operations

Year Ended December 31, 1999 Compared to Year Ended December 31, 1998 Revenues

We currently derive revenues principally from product sales and, to a lesser extent, from technology development and licensing. As a percentage of total revenues, product sales increased from 63.0% in 1996 to 92.7% in 1999.

Total revenues increased 239.1% to $31.2 million in 1999 from $9.2 million in 1998. This increase was attributable to a 275.3% increase in product sales, to $28.9 million in 1999 from $7.7 million in 1998. The increase in product sales was primarily due to our larger product offering and increased market penetration. Technology development and licensing revenues increased 53.3% to $2.3 million in 1999 from $1.5 million in 1998. This increase was primarily due to increased revenue in licensing of technology.

Gross Profit

Cost of revenues for product sales includes the manufacturing cost of the hardware, quality assurance, any overhead related to manufacturing activity and technology licensing fees payable to third parties. Cost of revenues for technology development and licensing revenues consists primarily of development costs. Gross profit increased 227.1% to $19.3 million in 1999 from $5.9 million in 1998. Gross margin decreased to 61.8% in 1999 from 64.5% in 1998. Gross profit on product sales increased 276.1% to $17.3 million in 1999 from $4.6 million in 1998. Gross margin on product sales was 59.8% in 1999 and 59.5% in 1998. Gross profit on technology development and licensing revenues increased 53.8% to $2.0 million in 1999 from $1.3 million in 1998 due to the increase in overall revenues. Gross margin on technology development and licensing revenues decreased to 87.3% in 1999 from 90.7% in 1998 due to a lower proportion of license revenues.

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 sub-contractors. Research and development expenses increased 128.6% to $4.8 million in 1999, from $2.1 million in 1998 and decreased as a percentage of total revenues to 15.4% in 1999 from 23.4% in 1998. The $2.7 million increase in research and development expenses in 1999 was primarily due to the hiring of additional research and development personnel for the further development of our signal processors, TrunkPack communications board, media gateway modules, media gateways subsystems product lines and other technologies. We expect that research and development expenses in future periods will continue to increase in absolute dollar terms.

Sales and Marketing Expenses

Sales and marketing expenses consist primarily of compensation for sales and marketing personnel, as well as exhibition, travel and related expenses. Sales and marketing expenses increased 87.0%

in 1999 to $4.3 million from $2.3 million in 1998. As a percentage of total revenues, sales and marketing expenses decreased to 13.7% in 1999 from 24.7% in 1998. The $2.0 million increase in sales and marketing expenses was primarily due to the increase in sales and marketing personnel and increased participation in trade shows and exhibitions. We expect that sales and marketing expenses in future periods will continue to increase in absolute dollar terms.

General and Administrative Expenses

General and administrative expenses consist primarily of compensation for finance, human resources, general management, rent, networks and information systems and personnel, as well as insurance and professional services expenses. General and administrative expenses increased 71.1% to $1.7 million in 1999 from $973,000in 1998. As a percentage of total revenues, general and administrative expenses decreased to 5.3% in 1999 from 10.6% in 1998. The $692,000 increase in general and administrative expenses was primarily due to the increase in the bad debt reserve, general and administrative personnel and higher professional fees. We expect that general and administrative expenses in future periods will continue to increase in absolute dollar terms, primarily due to costs associated with being a public company.

Financial Income, Net

Financial income consists primarily of interest derived on cash and cash equivalents and short-term investments, net of bank charges. Financial income in 1999 was $2.5 million compared with financial income of $142,000 in 1998. The $2.3 million increase in financial income was primarily due to the increase in our cash balances as a result of the completion of our public offerings in may 1999 and october 1999.

Liquidity and Capital Resources

Since our inception, we have financed our operations through a combination of sales of equity securities and cash generated by operations. As of December 31, 1999, we had $60.5 million in cash and cash equivalents and $57.1 million in short term deposits.

In May 1999, we completed our initial public offering of 4,025,000 ordinary shares, including the exercise of the over-allotment option, from which we received net proceeds of approximately $47 million of which $3 million was received due to the exercise of warrants held by investors.

In October 1999, we completed a second public offering of 3,450,000 shares, including the exercise of the over-allotment option, of which 1,500,000 shares were sold by us and 1,950,000 shares were sold by selling shareholders. We received net proceeds of approximately $57 million from the shares sold by us.

Our operating activities provided cash in the amount of $10.4 million in 1999 primarily due to net operating profit and an increase in trade and other payables, which were partially offset by an increase in inventory and trade receivables. Our operating activities provided cash in the amount of $495,000 in 1998 and used cash in the amount of $369,000 in 1997.

In 1999 our investing activities used cash in the amount of $56.5 million primarily due to the purchase of short-term deposits and fixed assets. Our investing activities provided cash in the amount of $1.1 million in 1998 primarily due to a decrease in short term deposits and proceeds from the sale of marketable securities, which were partially offset by purchases of fixed assets, principally computers in the amount and peripheral equipment for our expanding employee base. Our investing activities used cash in the amount of $1.9 million in 1997.

In 1999 financing activities provided $104.1 million from the net proceeds of our two public offerings in 1999. There was no cash provided or used by financing activities in 1998. Our financing activities provided $3.0 million in 1997 from the net proceeds of a private placement of our equity securities in July 1997.

Our capital expenditures were $905,000 in 1999, $524,000 in 1998 and $340,000 in 1997. The majority of our capital investments have been for computers, peripheral equipment and software.

We anticipate that we will continue to experience significant growth in our operating expenses for the foreseeable future and that our operating expenses will be a material use of our cash resources. If we do not have available sufficient cash to finance our operations, we may be required to obtain additional debt or equity financing. We cannot be certain that we will be able to obtain, if required, additional financing on acceptable terms or at all.

Report of Independent Auditors

ERNST & YOUNG
KOST FORER & GABBAY

We have audited the accompanying consolidated balance sheets of AudioCodes Ltd. and its subsidiary as of December 31, 1998 and 1999 and the related consolidated statements of operations, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 1999. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant†estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above, present fairly, in all material respects, the consolidated financial position of AudioCodes Ltd. and its subsidiary as of December 31, 1998 and 1999 and the consolidated results of their operations and cash flows for each of the three years in the period ended December 31, 1999, in conformity with generally accepted accounting principles in the United States.

Kost, Forer and Gabbay

Tel-Aviv, Israel
January 17, 2000

KOST FORER & GABBAY
A Member of Ernst & Young International

AudioCodes Ltd.

Consolidated Balance Sheets

U.S. dollars in thousands

	December 31, 1998	December 31, 1999
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 2,581	$ 60,500
Short-term deposits	1,029	57,052
Marketable securities (Note 3)	360	–
Trade receivables	2,002	5,863
Other receivables and prepaid expenses (Note 4)	405	647
Inventories (Note 5)	1,239	3,565
Total current assets	7,616	127,627
SEVERANCE PAY FUND (Note 8)	286	626
FIXED ASSETS, NET (Note 6)	811	1,269
Total assets	$ 8,713	$129,522

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

Consolidated Balance Sheets

U.S. dollars in thousands

	December 31,	
	1998	1999
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Trade payables	$ 1,115	$ 1,669
Other payables and accrued expenses (Note 7)	1,935	6,586
Total current liabilities	3,050	8,255
ACCRUED SEVERANCE PAY (Note 8)	518	942
SHAREHOLDERS' EQUITY (Note 12):		
Preferred shares of NIS 0.01 par value:		
Authorized - 2,500,000 shares as of December 31, 1998 and 1999;		
Issued and Outstanding – 1,722,480 shares as of December 31, 1998 and none as of December 31, 1999	5	–
Ordinary shares of NIS 0.01 par value:		
Authorized - 37,500,000 shares as of December 31, 1998 and 1999;		
Issued and Outstanding - 11,112,000 shares, as of December 31, 1998; and 19,207,353 as of December 31, 1999	38	58
Additional paid-in capital	5,509	110,382
Deferred compensation	(137)	(528)
Accumulated other comprehensive income (loss)	(23)	–
Retained earnings (accumulated deficit)	(247)	10,413
Total shareholders' equity	5,145	120,325
Total liabilities and shareholders' equity	$ 8,713	$ 129,522

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

AudioCodes Ltd.

Consolidated Statements of Operations

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

	Year ended December 31,		
	1997	1998	1999
Revenues:			
Product sales	$ 3,379	$ 7,706	$ 28,920
Technology development and licensing	1,808	1,469	2,284
Total revenues	5,187	9,175	31,204
Cost of revenues:			
Product sales	2,306	3,121	11,632
Technology development and licensing	275	137	289
Total cost of revenues	2,581	3,258	11,921
Gross profit	2,606	5,917	19,283
Operating expenses:			
Research and development, net	1,262	2,149	4,812
Sales and marketing	1,338	2,267	4,262
General and administrative	637	973	1,665
Total operating expenses	3,237	5,389	10,739
Operating income (loss)	(631)	528	8,544
Financial income, net (Note 13c)	151	142	2,471
Income (loss) before income taxes	(480)	670	11,015
Income taxes (Note 10)	11	51	355
Net income (loss)	$ (491)	$ 619	$ 10,660
Basic earnings (loss) per share (Note 13d)	$ (0.05)	$ 0.06	$ 0.70
Diluted earnings (loss) per share (Note 13d)	$ (0.05)	$ 0.05	$ 0.59

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

Statements of Changes in Shareholers' Equity

U.S. dollars in thousands

	Preferred Shares	Ordinary Shares	Additional paid-in capital	Deferred compensation from stock to employees	Accumulated other comprehensive income (loss)	Retained earnings (accumulated defecit)	Total comprehensive incom (loss)	Total shareholders' equity
Balance as of January 1, 1997	$ –	$ 38	$ 2,213	$ (15)	$ 108	$ (375)		$ 1,969
Issuance of Preferred shares, net	5	–	2,957	–	–	–		2,962
Deferred compensation from issuance of restricted shares to employees	–	–	175	(175)	–	–		–
Amortization of deferred compensation	–	–	–	70	–	–		70
Unrealized losses on available for sale marketable securities	–	–	–	–	(71)	–	$ (71)	(71)
Total other comprehensive loss							(71)	
Net loss	–	–	–	–	–	(491)	(491)	(491)
Total comprehensive loss							$ (562)	
Balance as of December 31, 1997	5	38	5,345	(120)	37	(866)		4,439
Compensation expense recorded on issuance of warrants	–	–	65	–	–	–		65
Deferred compensation related to grant of options	–	–	99	(99)	–	–		–
Amortization of deferred compensation	–	–	–	82	–	–		82
Unrealized losses on available for sale marketable securities	–	–	–	–	(60)	–	$ (60)	(60)
Total other comprehensive loss							(60)	
Net income	–	–	–	–	–	619	619	619
Total comprehensive income							$ 559	
Balance as of December 31, 1998	5	38	5,509	(137)	(23)	(247)		5,145
Issuance of shares, net	–	12	100,912	–	–	–		100,924
Stock options and warrants exercised	–	3	3,148	–	–	–		3,151
Conversion of Preferred shares into Ordinary shares	(5)	5	–	–	–	–		–
Deferred compensation related to grant of options and warrants	–	–	813	(813)	–	–		–
Amortization of deferred compensation	–	–	–	422	–	–		422
Unrealized gains on available for sale marketable securities	–	–	–	–	23	–	$ 23	23
Total other comprehensive income							23	
Net income	–	–	–	–	–	10,660	10,660	10,660
Total comprehensive income							$10,683	
Balance as of December 31, 1999	$ –	$ 58	$110,382	$ (528)	$ –	$10,413		$120,325

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

AudioCodes Ltd.

Consolidated Statement of Cash Flows

U.S. dollars in thousands

	Year ended December 31,		
	1997	1998	1999
Cash flows from operating activities:			
Net income (loss)	$ (491)	$ 619	$10,660
Adjustments required to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Loss (gain) from marketable securities	(120)	23	18
Depreciation	142	242	403
Accrued severance pay, net	36	9	84
Amortization of deferred compensation from stock to employees and warrants	70	147	422
Increase in trade receivables	(472)	(1,397)	(3,861)
Decrease (increase) in other receivables and prepaid expenses	58	(170)	(242)
Increase in inventories	(73)	(1,009)	(2,326)
Increase in trade payables	149	775	554
Increase in other payables and accrued expenses	330	1,249	4,651
Other	2	7	3
Net cash provided by (used in) operating activities	(369)	495	10,366
Cash flows from investing activities:			
Purchase of marketable securities	(1,259)	(1,005)	(11)
Proceeds from sale of marketable securities	1,690	1,597	376
Proceeds from sale of fixed assets	12	30	41
Purchase of fixed assets	(340)	(524)	(905)
Purchase of short-term deposits	(2,050)	(1,099)	(56,023)
Proceeds from short-term deposits	–	2,120	–
Net cash provided by (used in) investing activities	(1,947)	1,119	(56,522)

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

Consolidated Statement of Cash Flows

U.S. dollars in thousands

	Year ended December 31,		
	1997	1998	1999
Cash flows from financing activities:			
Proceeds from issuance of Preferred shares, net	2,962	–	–
Proceeds from issuance of Ordinary shares, net	–	–	103,840
Stock options and warrants exercised	–	–	235
Net cash provided by financing activities	2,962	–	104,075
Increase in cash and cash equivalents	646	1,614	57,919
Cash and cash equivalents at the beginning of the year	321	967	2,581
Cash and cash equivalents at the end of the year	$ 967	$ 2,581	$60,500
Supplemental disclosure of cash flow information:			
(a) Non-cash transaction:			
Unrealized (gains) losses on available-for-sale securities	$ 71	$ 60	$ (23)
(b) Cash paid during the year for:			
Income taxes	$ 11	$ 61	$ 99

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

Notes to Consolidated Financial Statements

U.S. dollars in thousands

Note 1 General

AudioCodes Ltd. (the "Company") designs, develops and markets enabling technologies and products for the transmission of voice and fax over packet networks. Packet networks include those based on Frame Relay, Asynchronous Transfer Mode and Internet Protocol. The products enable customers to build highly efficient, high capacity gateways, which are used to connect the traditional circuit-switched telephony networks with the emerging packet networks for voice and fax transmission. Unless otherwise indicated, the "Company" shall refer to the Company and its wholly-owned subsidiary, AudioCodes Inc.

A majority of the Company's sales are made in North America and Israel.

In 1997, three customers generated 57% of the Company's revenues; and in 1998 four customers generated 50% of the Company's revenues, and in 1999 one customer generated 34% of the Company's revenues.

The Company is dependent upon sole source suppliers for certain key components used in its products, including certain digital signal processing chips. Although there is a limited number of manufacturers of these particular components, management believes that other suppliers could provide similar components at comparable terms. A change in suppliers, however, could cause a delay in manufacturing and a possible loss of sales, which could adversely effect the operating results of the Company.

Note 2 Significant Accounting Policies

The consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States.

a. Financial statements in U.S. dollars:

The Company's transactions are recorded in new Israeli shekels; however, the majority of the Company's sales are made outside Israel in U.S. dollars, and a substantial portion of the Company's costs are incurred in U.S. dollars. Accordingly, the Company has determined the U.S. dollar as the currency of its primary economic environment and thus its functional and reporting currency.

The Company's transactions and balances denominated in U.S. dollars are presented at their original amounts. Non-dollar transactions and balances have been remeasured to U.S. dollars in accordance with Statements No. 52 of the Financial Accounting Standards Board ("FASB"). All transaction gains and losses from remeasurement of monetary balance sheet items denominated in non-dollar currencies are reflected in the statements of operations as financial income or expenses, as appropriate.

b. Principles of consolidation:

The consolidated financial statements include the accounts of AudioCodes Ltd. and its wholly-owned subsidiary, AudioCodes Inc., which commenced operations in 1997.
Intercompany transactions and balances have been eliminated in consolidation.

c. Use of estimates:

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

d. Cash equivalents:

The Company considers unrestricted highly liquid investments originally purchased with maturities of three months or less to be cash equivalents.

e. Short-term deposits:

The Company classified deposits with maturities of more than three months and less than one year as short-term deposits. The short-term deposits are presented at their cost including accrued interest.

f. Marketable securities:

The Company accounts for its investments using Statements of Financial Accounting Standard Board No. 115, “Accounting for Certain Investments in Debt and Equity Securities” (SFAS No. 115). This standard requires that certain debt and equity securities be adjusted to market value at the end of each accounting period. Unrealized market value gains and losses are charged or credited to earnings if the securities are traded for short-term profit. Otherwise, such unrealized gains and losses are charged or credited to a separate component of shareholders’ equity.

Management determines the proper classifications of investments in obligations with fixed maturities and marketable equity securities at the time of purchase and reevaluates such designations as of each balance sheet date. At December 31, 1999 and 1998, all securities covered by SFAS No. 115 were designated as available-for-sale. Accordingly, these securities are stated at fair value, with unrealized gains and losses reported in a separate component of shareholders’ equity - “Accumulated other comprehensive income (loss).” Realized gains and losses on sales of investments, as determined on a specific identification basis, are included in the consolidated statement of operations.

U.S. dollars in thousands

g. Inventories:

Inventories are stated at the lower of cost or market value. Cost is determined as follows:
Raw materials - using the “average cost” method.
Finished goods - on the basis of direct manufacturing costs.

h. Fixed assets:

Fixed assets are stated at cost. Depreciation is calculated using the straight-line method over the estimated useful lives of the assets, at the following annual rates:

	%
Computers and peripheral equipment	20 – 33
Office furniture and equipment	6 – 20
Motor vehicles	15
Leasehold improvements	Over the term of the lease

i. Revenue recognition:

Revenues from product sales are recognized according to SOP 97-2 (as amended by SOP 98-4), when delivery has occurred, persuasive evidence of an arrangement exists, the vendor’s fee is fixed or determinable and collectability is probable.

Revenues from development contracts are recognized upon completion of milestones as set forth in a specific contract. Royalties earned from technology licensing are recognized when the Company receives quarterly reports which indicate the amount of revenues earned in the period.

In December 1998, the AICPA issued Statements Of Position 98-9 (”SOP 98-9”), “Modification of SOP 97-2, Software Revenue Recognition, with Respect to Certain Transactions”. SOP 98-9 amends SOP 98-4 to extend the deferral to the application of certain passages of SOP 97-2 provided by SOP 98-4 through fiscal years beginning on or before March 15, 1999. All other provisions of SOP 98-9 are effective for transactions entered into in fiscal years beginning after March 15, 1999.

The Company does not expect the impact of this new statement on the Company’s consolidated balance sheet or results of operations, to be material.

j. Research and development costs:

Research and development costs are charged to the consolidated statement of operations as incurred. Statements of Financial Accounting Standard Board No. 86 “Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed”, requires capitalization of certain software development costs subsequent to the establishment of technological feasibility.

Based on the Company's product development process, technological feasibility is established upon completion of a working model. Costs incurred by the Company between completion of the working model and the point at which the product is ready for general release have been immaterial.

k. Income taxes:

The Company accounts for income taxes in accordance with Statements of Financial Accounting Standard Board No. 109, "Accounting for Income Taxes". This Statements prescribes the use of the liability method whereby deferred tax assets and liability account balances are determined based on differences between financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse.

l. Concentrations of credit risk:

Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of trade receivables, cash and cash equivalents, marketable securities and short-term deposits. The majority of the Company's cash and cash equivalents and short-term deposits are invested in dollar and dollar linked instruments with major Israeli banks. Marketable securities are Government of Israel debentures. Management believes that the financial institutions that hold the Company's investments are financially sound, and accordingly, minimal credit risk exists with respect to these investments.

The Company's trade receivables are derived from sales to customers located primarily in North America and Israel. The Company performs ongoing credit evaluations of its customers and to date has not experienced any material losses. An allowance for doubtful accounts is provided with respect to those amounts that the Company has determined to be doubtful of collection. No allowance was deemed necessary for the years ended December 31, 1997, 1998. As of December 31, 1999, the Company recorded an allowance of $ 137.

m. Earnings (loss) per share:

Basic earnings (loss) per share are computed based on the weighted average number of Ordinary shares outstanding during each year. Diluted earnings per share are computed based on the weighted average number of Ordinary shares outstanding during each year, plus the dilutive potential of equivalent Ordinary shares considered outstanding during the year, in accordance with FASB Statements No. 128, "Earnings per Share".

All convertible Preferred shares, outstanding stock options, and warrants have been excluded from the calculation of the diluted loss per Ordinary share because all such securities are anti-dilutive for the year 1997. The total numbers of convertible Preferred shares, shares related to the outstanding options and warrants excluded from the calculations of diluted net loss per share were 1,051,593, for the year ended December 31, 1997.

U.S. dollars in thousands

n. Stock-based compensation:

The Company has elected to follow Accounting Principles Board Opinion No. 25, “Accounting for Stock Issued to Employees” (”APB 25”), in accounting for its employee stock based compensation. Under APB 25, when the exercise price of the Company’s employee stock options is less than the market value of the underlying stock on the date of grant, compensation expense is recognized.

The Company applies SFAS No. 123, “Accounting for Stock-Based Compensation” with respect to warrants issued to persons other than employees. SFAS No. 123 requires the use of option valuation models to measure the fair value of the warrants at the grant date.

o. Severance pay:

The Company’s liability for severance pay is calculated pursuant to Israeli severance pay law based on the most recent salary of the employees multiplied by the number of years of employment as of balance sheet date. Employees are entitled to one month’s salary for each year of employment, or a portion thereof. The Company’s liability is fully provided by monthly deposits with severance pay funds, insurance policies and by an accrual.

The deposited funds include profits accumulated up to the balance sheet date. The deposited funds may be withdrawn only upon the fulfillment of the obligation pursuant to Israeli severance pay law or labor agreements. The value of the deposited funds are based on the cash surrendered value of these policies, and include immaterial profits.

p. Fair value of financial instruments:

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

   Cash and cash equivalents and short-term deposits - the carrying amounts of these items approximate their fair value due to the short-term maturity of such instruments. The carrying amounts of marketable securities are based on quoted market price.

2. The carrying amounts and fair values of the Company’s financial instruments are as follows:

	Carrying amount		Fair value	
	December 31,		December 31,	
	1998	1999	1998	1999
Cash and cash equivalents	$ 2,581	$ 60,500	$ 2,581	$ 60,500
Short-term deposits	$ 1,029	$ 57,052	$ 1,029	$ 57,052
Marketable securities	$ 360	$ –	$ 360	$ –

U.S. dollars in thousands

q. In June 1998, the Financial Accounting Standards Board issued SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("SFAS No. 133"). This Statements establishes accounting and reporting standards requiring that every derivative instrument (including certain derivative instruments embedded in other contracts) be recorded in the balance sheet as either an asset or liability measured at its fair value. The Statements also requires that changes in the derivative's fair value be recognized currently in earnings unless specific hedge accounting criteria are met. Special accounting for qualifying hedges allows a derivative gains and losses to offset related results of the hedged item in the statement of operations, and requires that a company must formally document, designate and assess the effectiveness of transactions that receive hedge accounting. SFAS No. 133 is effective for fiscal years beginning after June 15, 2000 and must†be applied to instruments issued, acquired, on substantively modified after December 31, 1998. The company does not expect the adoption of the accounting pronouncement to have a material effect on its financial position or results of operations.

Note 3 Marketable Securities

	December 31,	
	1998	1999
Cost	$ 383	$ –
Gross unrealized losses	(23)	–
Fair value	$ 360	$ –

All marketable securities were issued by the Government of Israel and will mature within one year.

The net gross realized gains (losses) on sales of available-for-sale securities totaled $ 120, $ (23) and $ 18 in 1997, 1998 and 1999, respectively. The net adjustment to unrealized holding gains (losses) on available-for-sale securities included as a separate component of shareholders' equity totaled $ (71), $ (60) and $ 23 for the year ended December 31, 1997, 1998 and 1999, respectively.

The proceeds from sales of available-for-sale securities totaled $ 1,690, $ 1,597 and $ 376 for the year ended December 31, 1997, 1998 and 1999, respectively.

U.S. dollars in thousands

Note 4
Other Receivables and Prepaid Expenses

	December 31, 1998	December 31, 1999
Government authorities	$ 137	$ –
Prepaid expenses	126	434
Employees	132	167
Other	10	46
	$ 405	$ 647

Note 5
Inventories

	1998	1999
Raw materials	$ 1,173	$ 2,780
Finished goods	66	785
	$ 1,239	$ 3,565

Note 6
Fixed Assets

	1998	1999
Cost:		
Computers and peripheral equipment	$ 835	$ 1,486
Office furniture and equipment	212	310
Motor vehicles	228	179
Leasehold improvements	75	203
	1,350	2,160
Accumulated depreciation:		
Computers and peripheral equipment	399	679
Office furniture and equipment	61	115
Motor vehicles	65	46
Leasehold improvements	14	51
	539	891
Depreciated cost	$ 811	$ 1,269

Depreciation expenses amounted to $ 142, $ 242 and $ 403 for the years ended December 31, 1997, 1998 and 1999, respectively.

U.S. dollars in thousands

Note 7 Other Payables and Accrued Expenses

	December 31, 1998	December 31, 1999
Employees and payroll accruals	$ 648	$ 1,370
Technology licensing fees	646	3,106
Government authorities	317	78
Customer advances	113	116
Accrued expenses	87	648
Deferred income	–	661
Warranty	40	344
Other	84	263
	$ 1,935	$ 6,586

Note 8 Severance Pay

The Company's liability for severance pay pursuant to Israeli law is fully provided by an accrual. Part of the liability is funded through insurance policies which are designated only for severance payments. The value of these policies is recorded as an asset in the Company's balance sheets.

Severance pay expenses for the years ended December 31, 1997, 1998 and 1999 amounted to $ 56, $ 100 and $ 322, respectively.

Note 9 Commitment and Contingent Liabilities

a. Lease commitments:

The Company's facilities are leased under several operating lease agreements for periods including renewal options ending in 2003.

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

2000	$ 701
2001	759
2002	739
2003	717
2004	301
	$ 3,217

Lease expenses for the years ended December 31, 1997, 1998 and 1999 were approximately $ 122, $ 170 and $ 323, respectively.

b. The Company and its legal advisors have received correspondence in which the Company has not paid royalties for using certain patented technology.

The Company and its legal advisors are unable to assess or comment on the implications of such demand.

The Company and its legal advisors are seeking to resolve this dispute.

As of December 31, 1999, the Company and its legal advisors are not aware of legal proceedings having been initiated.

Note 10 Income Taxes

a. Tax benefits under the Law for the Encouragement of Capital Investments, 1959 (”the law”):

The Company’s production facilities have been granted the status of an “Approved Enterprise” under the law under two separate investment programs which were approved in October 1993 and January 1996.

According to the provisions of the law, the Company has chosen the “alternative benefits” - waiver of Government grants in return for tax exemption. Income derived from the first program will be tax-exempt for a period of two years, commencing 1998, after utilizing its carryforward losses at the rate of zero, in respect of “Approved Enterprise” status, and is subject to a corporate tax at the reduced rate of 25%, for an additional period of eight years.

Income derived from the second “Approved Enterprise” program will be tax-exempt for a period of four years, commencing 1999, and is subject to a corporate tax at the reduced rate of 25%, for an additional period of six years. The benefit period will commence when the Company will realize profit from this enterprise.

In October, 1999, the Company’s third “Approved Enterprise” program was approved.

In the event of a distribution of such tax-exempt income as cash dividend in a manner other than in the complete liquidation of the Company, the Company will have to pay tax at the rate of 25% on the amount distributed and an income tax liability would be incurred of approximately $ 135 as of December 31, 1999. The tax-exempt income attributable to the “Approved Enterprise” can be distributed to shareholders without subjecting the Company to taxes only upon the complete liquidation of the Company. As of December 31, 1999, retained earnings included approximately $ 540 in tax-exempt income earned by the Company’s “Approved Enterprise”.

The Company’s Board of Directors has determined that such tax-exempt income will not be distributed as dividends. Accordingly, no deferred taxes have been provided on income attributable to the Company’s “Approved Enterprise”.

U.S. dollars in thousands

The law also grants entitlement to claim accelerated depreciation on equipment used by the "Approved Enterprise" during five tax years.

The period of tax benefits detailed above is subject to limits of the earlier of 12 years from commencement of production or 14 years from receiving the approval.

If the Company derives income from sources other than the "Approved Enterprise" during the relevant period of benefits, such income will be taxable at the regular corporate tax rate of 36%.

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

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

c. Net operating losses carryforwards:

In 1999, the Company accumulated tax losses, in the amount of approximately $ 279, which may be carried forward (linked to the Israeli CPI) and offset against taxable income in the future for an indefinite period. The Company expects that, during the period in which these tax losses are utilized, its income would be substantially tax exempt. Accordingly, there will be no tax benefit available from such losses, and no deferred income taxes have been included in these financial statements.

d. A reconciliation between the theoretical tax expense, assuming all income is taxed at the statutory tax rate applicable to the income of the Company and the actual tax expense as reported in the consolidated statements of operations, is as follows:

	Year ended December 31		
	1997	1998	1999
Theoretical tax expense (benefit) computed at the statutory rate (36%)	$ (173)	$ 241	$ 3,965
"Approved Enterprise" benefit (1)	–	(194)	–
Tax adjustments in respect of inflation in Israel	39	214	413
Issuance expenses and tax benefits in respect of options to employees that were allowed as an expense in respect of which deferred taxes were not provided	–	–	(4,172)
Utilization of tax loss carryforwards previously not recognized	–	(266)	–
Loss and other items for which deferred taxes were not provided	128	37	138
Other non-deductible expenses	17	19	11
Income tax expense	$ 11	$ 51	$ 355
(1) Benefit of approved enterprise per share:			
Basic	$ –	$0.01	$ –
Diluted	$ –	$0.01	$ –

U.S. dollars in thousands

e. Income (loss) before income taxes consists on the following:

	Year ended December 31		
	1997	1998	1999
Domestic	$ (528)	$ 602	$ 10,908
Foreign	48	68	107
	$ (480)	$ 670	$ 11,015

f. Income taxes consist of the following

	Year ended December 31		
	1997	1998	1999
Domestic	$ –	$ 31	$ 324
Foreign	11	20	31
	$ 11	$ 51	$ 355

Note 11 Related Parties

The following transactions with DSP Group, Inc., a 15.23% shareholder of the Company, are included in the financial statements as follows:

	Year ended December 31		
	1997	1998	1999
Revenues from technology development and licensing	$ 954	$ 701	$ 677
Cost of revenues	$ 1,727	$ 1,041	$ 866
Payables at December 31	$ 83	$ 8	$ 25

In 1994, the Company entered into a development and license agreement with DSP Group Inc. Under the agreement, the Company performed certain research and development services for the DSP Group Inc. Upon development of the technology, the DSP Group Inc. paid a service fee and additional royalty fees based upon the net revenue and the gross margin realized from the sale of the technology incorporated in DSP Group Inc. products.

In October 1999, the Company entered into a development agreement with DSP Group Ltd., a company affiliated with DSPG Inc., and another company. Upon development, the Company will receive a total of $ 120 upon completion of milestones.

U.S. dollars in thousands

Note 12 Share Capital

a. General:

1. On May 28, 1999, the Company completed its initial public offering of 3,500,000 Ordinary shares, for net proceeds of approximately $ 47 million, of which $ 3 million was received due to the exercise of warrants held by investors.

2. On October 14, 1999, the Company completed a second public offering of 1,500,000 Ordinary shares, with net proceeds of approximately $57 million.

b. Upon the IPO, all of the shares have been designated as Ordinary shares.

c. Composition of share capital:

	December 31,			
	Authorized		Issued and outstanding	
	1998	1999	1998	1999
Ordinary shares (1)	36,490,000	37,500,000	10,108,800	19,207,353
Ordinary A shares (2)	960,000	–	960,000	–
Management shares	40,000	–	38,400	–
Management A shares	10,000	–	4,800	–
Preferred shares	2,500,000	2,500,000	1,722,480	–
	40,000,000	40,000,000	12,834,480	19,207,353

(1) The Ordinary shares entitle their holders to the right to receive notice to participate and vote in general meetings of the Company and the right to receive dividends and bonus shares, if declared.

(2) Ordinary A shares were issued to employees and were converted automatically into Ordinary shares (on a one-to-one basis) upon the IPO.

d. On January 11, 1998, the Company issued warrants to two consultants to purchase 76,800 Ordinary A shares of NIS 0.01 par value, at an exercise price of $ 1.22, expiring ten years from the date of the grant and exercisable immediately. As of December 31, 1999, all the warrants were exercised.

During 1999, the Company issued warrants to consultants at an exercise price of $ 19.63 and $ 37.63.

The Company recorded an expense in the amount of $ 210, in accordance with FASB 123, regarding the warrants.

U.S. dollars in thousands

d. Restricted Ordinary A shares:

Restricted Ordinary A shares were granted to employees under the Company's 1994 Incentive Plan ("the plan"). The restricted Ordinary A shares generally vest between half a year to four years from the date of issuance. Compensation expenses of $ 70, $ 82 and $ 26 were recognized in 1997, 1998 and 1999, respectively, relating to the issuance of these restricted shares. The deferred compensation expenses are amortized to expense over the vesting period.

A summary of the Company's Ordinary A shares activity:

	Year ended December 31		
	1997	1998	1999
	Number of shares		
Restricted Ordinary A shares at the beginning of the year	304,800	240,000	129,600
Granted	144,000	–	–
Conversion to unrestricted Ordinary A shares	(208,800)	(110,400)	(62,400)
Conversion of restricted Ordinary A shares into restricted Ordinary shares	–	–	(67,200)
Restricted Ordinary A shares at the end of the year	240,000	129,600	–
Unrestricted Ordinary A shares at the end of the year	796,800	830,400	–
Conversion of unrestricted Ordinary A shares into Ordinary shares	(76,800)	–	–
Total Ordinary A shares at the end of the year	960,000	960,000	–
Total restricted Ordinary shares at the end of the year	–	–	67,200

All the restricted Ordinary A shares were granted at the price of NIS 0.01 per share.
On May 28 1999, all the Ordinary A shares were converted into Ordinary shares at a one to one ratio.
As of December 31, 1999, there are 67,200 restricted shares. 52,800 of the restricted shares will be vested on June 2000 and the last 14,400 will be vested on June 2001.

f. Stock options granted under the Company's 1997 and 1999 Stock Option Plans are exercisable at the fair market value at the date of grant and, subject to termination of employment, expire ten years and seven years, respectively, from the date of grant, and are generally exercisable in four equal annual payments, commencing one year from the date of grant.

U.S. dollars in thousands

A summary of the Company's stock option activity and related information for the years ended December 31, 1998 and 1999 is as follows:

	1998		1999	
	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price
Outstanding at the beginning of the year	–	–	1,622,400	$ 1.67
Granted	1,665,600	$ 1.66	955,800	$ 20.71
Cancelled	(43,200)	$ 1.22	(19,600)	$ 14.0
Exercised	–	–	(115,273)	$ 1.29
Outstanding at the end of the year	1,622,400	$ 1.67	2,443,327	$ 9.04

The number of options exerecisable as of December 31, 1999 was 634,727, at a weighted average exercise price of $ 1.67 per share.

The options outstanding as of December 31, 1999, have been separated into exercise price, as follows:

Options outstanding as of December 31,1999	Exercise price	Weighted average number of years remaining contractual life	Weighted average exercise price
1,603,127	$ 1.22 –$ 3.45	8.22	$ 1.69
449,200	$ 14 –$ 18.44	6.4	$ 14.23
159,000	$ 19.63 –$ 28	6.61	$ 19.74
170,000	$ 37.63 –$ 40.75	6.76	$ 38.58
62,000	$ 51 –$ 60.8	6.84	$ 51.9
2,443,327			

Pro forma information regarding net income (loss) and earnings (loss) per share is required (for grants issued after December 1994) by SFAS No. 123, and has been determined, under the assumption that the Company has accounted for its employee option under the fair value method prescribed by that Statements. The fair value for these options was estimated at the date of the grant using a Black-Scholes option pricing model, with the following weighted-average assumptions for 1998 and 1999, respectively average risk-free interest rates of 5.5%, dividend yields of 0% for both periods and volatility factors of the expected market price of the Company's Ordinary shares of 0.5 and 1.126 and a weighted average expected life of the options of ten and seven years.

The Black-Scholes option pricing model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option valuation models require subjective assumptions, including the expected stock price volatility.

U.S. dollars in thousands

Because the Company's employee stock options have characteristics significantly different from traded options, and because changes in the subjective assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable measure of the fair value of its employee stock options.

The options granted in 1998 and 1999 have an exercise price equal to the fair market value at the grant date.

Weighted average grant date fair value for options granted at an exercise price equal to the fair market value at the grant date was $1.11, $ 20.85 for the years 1998, 1999, respectively.

	Year ended December 31	
	1998	1999
Pro forma information under FAS 123:		
Net income as reported	$ 619	$ 10,660
Pro forma income for the year	$ 284	$ 6,856
Pro forma basic earnings per share	$ 0.03	$ 0.45
Pro forma diluted earnings per share	$ 0.02	$ 0.38

g. Dividends:

In the event that cash dividends are declared in the future, such dividends will be paid in NIS. The Company does not intend to pay cash dividends in the foreseeable future.

Note 13 Selected Consolidated Statements of Operations Data

a. Summary information about geographic areas:

The Company manages its business on a basis of one reportable segment. See Note 1 for a brief description of the Company's businesses. The total revenues are attributed to geographic information based on the location of the customers.

The following presents total revenues for the year ended December 31, 1997, 1998 and 1999 and long-lived assets as of December 31, 1997, 1998 and 1999.

	1997		1998		1999	
	Total revenues	Long-Lived assets	Total revenues	Long-Lived assets	Total revenues	Long-Lived assets
Israel	$ 1,420	$ 678	$ 2,637	$ 1,038	$ 4,518	$ 1,838
U.S.A.	2,799	59	4,762	59	21,016	57
Europe	520	–	1,038	–	3,756	–
Far East	207	–	454	–	1,686	–
Other	241	–	284	–	228	–
	$ 5,187	$ 737	$ 9,175	$ 1,097	$ 31,204	$ 1,895

U.S. dollars in thousands

b. Major customers data as a percentage of total revenues:

	Year ended December 31		
	1997	1998	1999
Customer A	25%	–	2%
Customer B	19%	9%	2%
Customer C	13%	9%	3%
Customer D	–	11%	5%
Customer E	–	21%	34%

c. Financial income (expenses), net:

	Year ended December 31		
	1997	1998	1999
Financial expenses:			
Foreign currency remeasurement differences	$ 56	$ –	$ 42
Financial income:			
Foreign currency remeasurement differences	–	15	–
Interest	87	150	2,495
Gain (loss) from marketable securities	120	(23)	18
	207	142	2,513
	$ 151	$ 142	$ 2,471

d. The following table sets forth the computation of basic and diluted earnings (loss) per share:

	Year ended December 31		
	1997	1998	1999
Numerator:			
Net income (loss) to shareholders of ordinary shares	$ (491)	$ 619	$ 10,660
Numerator for diluted earnings per share-income (loss) available to shareholders of Ordinary shares	$ (491)	$ 619	$ 10,660
Denominator:			
Denominator for basic earnings per share - weighted average shares	10,871,578	11,028,000	15,198,876
Effect of dilutive securities:			
Warrants to consultant	–	20,016	571,478
Employee stock option and unvested restricted shares	–	266,496	1,617,312
Convertible Preferred shares	–	1,722,480	693,711
Denominator for diluted earnings per share - adjusted weighted average shares and assumed conversions	10,871,578	13,036,992	18,081,377

The effect of the inclusion of the dilutive securities in 1997 is anti-dilutive.

Corporate Directory

CORPORATE OFFICERS

Shabtai Adlersberg
Chairman of the Board, President and
Chief Executive Officer

Leon Bialik
Vice President, Engineering and
Chief Technical Officer and Director

Mike Lilo
Vice President, Finance and Chief Financial Officer

Benjamin Giloh
Vice President, Business Development, Wireless

Dr. Yoram Stettiner
Vice President, Advanced Technologies

Yossi Yavin
Vice President, Marketing

Bruce Gellman
President, USA

PRINCIPAL EXECUTIVES

Stephen Lin
Vice President, G.M.

John T. Lee
Vice President, Marketing

Ben Rabinowitz
Vice President, VoDSL Business Development

Shmuel Bachinsky
Vice President, Business Development
Media Servers

BOARD OF DIRECTORS

Shabtai Adlersberg, Chairman of the Board

Leon Bialik

Zvi Limon

Lawrence E. Keith

Doron Nevo

Nechemia Peres

Dr. Eyal Kishon

Dana Gross

INVESTOR RELATIONS

Ruder Finn Inc.
Magda Gagliano
301 East 57th Street
New York, NY 10022
Phone: (212) 593-6319

INDEPENDENT AUDITORS

Kost Forer & Gabbay
A Member of Ernst & Young International
3 Aminadav Street
61575 Tel-Aviv, Israel

TRANSFER AGENT

American Stock Transfer & Trust Company
40 Wall Street, 46th Floor
New York, NY 10005
Phone: (212) 936-5100

ANNUAL MEETING

The annual general meeting of stockholders is scheduled to take place at 05:00 PM (Israel time), September 3, 2000 at AudioCodes Ltd. Corporate Headquarters, Yehud, Israel.

AudioCodes Offices

Corporate Headquarters

4 Hahoresh Road
Yehud 56470, Israel
Phone: +972 (3) 5394000
Fax: +972 (3) 5394040
Website: www.audiocodes.com

North America

California
2890 Zanker Rd., Suite 200
San Jose, CA 95134
Phone: (408) 577-0488
Fax: (408) 577-0492

Massachusetts
Deerfoot Office Park
257 Turnpike Rd. Suite 300
Southborough, MA, 01772
Phone: (508) 353-9965

Illinois
8700 West Bryn Mawr, Suite 755-S
Chicago, Ill., 60631
Phone: (773) 695-9870
Fax: (773) 695-9894

Texas
101 W. Renner Road, Suite 220
Richardson, TX, 75082
Phone: (972) 238-7976
Fax: (972) 238-8038

China

No. 2721, South Tower, Kerry Center
No.1 Gaung Hua Road, Chao Yang District
Beijing 100020, P.R. China
Phone: +86 (10) 8529-9706
Fax: +86 (10) 8529-9707

Design & Production: Portnov-Mishan. Copy: Audrey Gerber

AudioCodes

www.audiocodes.com