

AUDIOCODES LTD
Form F-3/A
September 22, 2004

As filed with the Securities and Exchange Commission on September 22, 2004

Registration No. 333- 117703

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

PRE-EFFECTIVE AMENDMENT NO. 1 TO
FORM F-3
REGISTRATION STATEMENT
UNDER
THE SECURITIES ACT OF 1933

AUDIOCODES LTD.

(Exact Name of Registrant as Specified in its Charter)

N/A

(Translation of Registrant's Name into English)

Israel

(State of other jurisdiction of
incorporation or organization)

**1 Hayarden Street, Airport City,
Lod, 70151, Israel**

N/A

(I.R.S. Employer
Identification Number)

(972) 3-976-4000

(Address and telephone number, of registrant's principal executive offices)

AudioCodes Inc.
2890 Zanker Road, Suite 200
San Jose, California 95134

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(Name, address, and telephone number, of agent for service)

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VP Legal Affairs General Counsel and Secretary AudioCodes Ltd. 1 Hayarden Street, Airport City, Lod, 70151 Israel (972)-3-976-4000 (972)-3-976-4044

Approximate date of commencement of proposed sale to the public: From time to time after this registration statement becomes effective.

If the only securities being registered on this Form are to be offered pursuant to dividend or interest reinvestment plans, please check the following box.

If any of the securities being registered on this Form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933, check the following box.

If this Form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, please check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering.

If this Form is a post-effective amendment filed pursuant to Rule 462(b) under the Securities Act, please check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering.

If delivery of the prospectus is expected to be made pursuant to Rule 434, please check the following box.

Title of Each Class of Securities to be Registered	Amount to be Registered (1)(2)	Proposed Maximum Offering Price Per Unit	Proposed Maximum Aggregate Offering Price (3)	Amount of Registration Fee (4)
Ordinary Share, NIS 0.01 nominal value per share				
Debt Securities				
Total	\$150,000,000	100%	\$150,000,000	\$19,005.00

(1)

Pursuant to Rule 457(o) under the Securities Act of 1933, which permits the registration fee to be calculated on the basis of the maximum offering price of all securities listed, the table does not specify information as to the amount of any particular security to be registered.

(2)

There are being registered hereunder such indeterminate number of ordinary shares and such indeterminate principal amount of debt securities as may be offered from time to time, with an aggregate initial offering price not to exceed \$150,000,000. Any securities registered hereunder may be sold separately or as units with other securities registered hereunder. The securities registered also include such indeterminate amounts and numbers of ordinary shares and debt securities as may be issued upon conversion of or exchange for debt securities that provide for conversion or exchange or pursuant to the antidilution provisions of any such securities.

(3)

The proposed maximum aggregate offering price per class of security and per unit or share will be determined from time to time by the Registrant in connection with the issuance by the Registrant of the securities registered hereunder and is not specified as to each class of security pursuant to General Instruction II.C. of Form F-3 under the Securities Act of 1933.

(4)

Calculated pursuant to Rule 457(o) under the Securities Act of 1933.

The Registrant hereby amends this Registration Statement on such date or dates as may be necessary to delay its effective date until the Registrant shall file a further amendment which specifically states that this Registration Statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of 1933, as amended, or until this Registration Statement shall become effective on such date as the Securities and Exchange Commission, acting pursuant to said Section 8(a), may determine.

The information in this prospectus is not complete and may be changed. We may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus is not an offer to sell these securities, nor is it soliciting offers to buy these securities, in any state where the offer or sale is not permitted.

PROSPECTUS (Subject to Completion)

Issued 2004

AUDIOCODES LTD.

We may offer, from time to time, together or separately, up to \$150,000,000 aggregate amount, or the equivalent in one or more foreign currencies or currency units, of our ordinary shares or of debt securities.

We may offer the securities in one or more series, in amounts, at prices and on terms determined at the time of offering. We will provide the specific terms of any securities we actually offer for sale in supplements to this prospectus.

You should read this prospectus and any prospectus supplement carefully before you purchase any of our securities. This prospectus may not be used to sell securities unless accompanied by a prospectus supplement.

We may sell the securities directly to you, through agents we select, or through underwriters or dealers we select. If we use agents, underwriters or dealers to sell the securities, we will name them and describe their compensation in a prospectus supplement. The net proceeds we expect to receive from such sales will be set forth in the prospectus supplement.

Our ordinary shares are traded on the Nasdaq National Market and The Tel Aviv Stock Exchange under the symbol "AUDC." On , 2004, the reported last sale price of our ordinary shares on the Nasdaq National Market was \$ per share. We have no debt securities that are publicly traded.

Investing in our securities involves risks. See "Risk Factors" beginning on page 5.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved these securities or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

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You should rely only on the information contained or incorporated by reference into this prospectus or any applicable prospectus supplement. We have not authorized anyone to provide you with different information. We are not making an offer of the securities to be sold under this prospectus in any jurisdiction where the offer or sale is not permitted. You should not assume that the information contained in this prospectus or any applicable prospectus supplement is accurate as of any date other than the date on the front cover of this prospectus or the prospectus supplement, or that the information contained in any document incorporated by reference is accurate as of any date other than the date of the document incorporated by reference, regardless of the time of delivery of this prospectus or any sale of a security.

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ABOUT THIS PROSPECTUS

This prospectus is part of a registration statement that we filed with the Securities and Exchange Commission, or SEC, using a shelf registration process. Under this shelf registration process, we may sell ordinary shares and debt securities, in one or more offerings, up to a total dollar amount of \$150 million. This prospectus provides you with a general description of the securities we may offer. Each time we sell any securities under this prospectus, we will provide a prospectus supplement that will contain more specific information about the terms of those securities. We may also add, update or change in a prospectus supplement any of the information contained in this prospectus or in documents we have incorporated by reference into this prospectus. This prospectus, together with the applicable prospectus supplements and the documents incorporated by reference into this prospectus, includes all material information relating to this offering. You should carefully read both this prospectus and the applicable prospectus supplement together with the additional information described under [Where You Can Find More Information](#) before buying securities in this offering.

References to dollars or \$ are to United States dollars. All references to ordinary shares refer to our ordinary shares, par value 0.01 New Israeli Shekel per share. References to NIS are to New Israeli Shekels.

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PROSPECTUS SUMMARY

This summary highlights some information appearing elsewhere in this prospectus or incorporated by reference into this prospectus. Because it is a summary, it does not contain all the information that you should consider before investing in our ordinary shares. You should read the following summary together with the information set forth in this prospectus under the heading **Risk Factors**, the applicable prospectus supplement for the securities being offered and the documents incorporated into this prospectus by reference under the heading **Incorporation of Documents by Reference**. In particular, we incorporate important business and financial information in this prospectus by reference.

Unless we indicate otherwise in this prospectus, references to **AudioCodes**, **we**, **us** or **our** mean AudioCodes Ltd. and our subsidiaries.

Our Business

We design, develop and market enabling technologies and system products for the transmission of voice, data and fax 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 provide the building blocks to connect traditional telephone networks with the new voice infrastructure. Our products are sold to leading original equipment manufacturers, or OEMs, system integrators and network equipment providers in the telecommunications and networking industries.

Our products, which enable the transmission of high quality voice, data and fax over packet networks, include:

- signal processor chips, which process voice and fax signals and compress the information into packets so that they can be sent between the traditional telephone networks and the packet networks;
- communications boards and modules for access and enterprise applications, which enable voice, data and fax communications through gateway equipment employing Internet and other protocols, as well as the possibility of addition of third party equipment to provide enhanced services;
- communication boards for CTI applications (Computer Telephony Integration) for enterprise applications, which provide call logging and recording enabling technologies utilizing either industry standard or proprietary protocols;
- system products for access and enterprise applications, such as low density analog media gateways and high density digital media gateways, which enable voice, data and fax communications employing Internet and other protocols (typically such equipment is sold by our customers in conjunction with their own or third party solutions such as call management applications), as well as the possibility of addition of third party equipment to provide enhanced services;
- communications software used to process and format compressed voice and fax information into packets;
- media and audio servers that provide enhanced conferencing, multi-language announcement functionality, and other media server applications for voice over packet networks; and

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element management software to manage our system products.

We sell our products to leading original equipment manufacturers and system integrators in the telecommunications and networking industries for use in markets providing:

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telephony over packet networks based on Internet protocols or networks based on asynchronous transfer mode standards, known as ATM standards;

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telephony over the wireless or cable television infrastructure; and

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telephone service over new generation high speed modems operating over wireless links or data modems, known as digital subscriber line, or DSL, modems.

Our Address and Telephone Number

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.

The Securities We May Offer

We may offer our ordinary shares and various series of debt securities, with a total value of up to \$150 million, from time to time under this prospectus at prices and on terms to be determined by market conditions at the time of offering. This prospectus provides you with a general description of the securities we may offer. Each time we offer a type or series of securities, we will provide a prospectus supplement that will describe the specific amounts, prices and other important terms of the securities, including, to the extent applicable:

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designation or classification;

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aggregate principal amount or aggregate offering price;

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maturity;

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original issue discount, if any;

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rates and times of payment of interest, or other payments, if any;

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redemption, conversion, exchange, settlement or sinking fund terms, if any;

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conversion, exchange or settlement prices or rates, if any, and, if applicable, any provisions for changes to or adjustments in the conversion, exchange or settlement prices or rates and in the securities or other property receivable upon conversion, exchange or settlement;

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ranking;

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restrictive covenants, if any;

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voting or other rights, if any; and

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important U.S. and Israeli income tax considerations.

The prospectus supplement also may add, update or change information contained in this prospectus or in documents we have incorporated by reference into this prospectus.

We may sell the securities directly to you or through underwriters, dealers or agents. We, and our underwriters or agents, reserve the right to accept or reject all or part of any proposed purchase of securities. If we do offer securities through underwriters or agents, we will include in the applicable prospectus supplement:

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the names of those underwriters or agents;

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applicable fees, discounts and commissions to be paid to them;

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details regarding over-allotment options, if any; and

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the net proceeds to us.

Ordinary shares. We may issue our ordinary shares from time to time. Holders of our ordinary shares are entitled to one vote per share for the election of directors and on all other matters that require shareholder approval. Currently, we do not pay any dividends on our ordinary shares. Subject to any preferential rights of any outstanding preferred shares that we may issue in the future, in the event of our liquidation, dissolution or winding up, holders of our ordinary shares are entitled to share ratably in the assets remaining after payment of liabilities and the liquidation preferences of any outstanding preferred shares. Our ordinary shares do not carry any preemptive rights enabling a holder to subscribe for, or receive shares of, any class of our ordinary shares or any other securities convertible into shares of any class of our ordinary shares, or any redemption rights.

Debt Securities. We may issue debt securities from time to time, in one or more series, as either senior or subordinated debt or as senior or subordinated convertible debt. The senior debt securities will rank equally with any other unsubordinated debt that we may have and may be secured or unsecured. The subordinated debt securities will be subordinate and junior in right of payment, to the extent and in the manner described in the instrument governing the debt, to all or some portion of our indebtedness. Any convertible debt securities that we issue will be convertible into or exchangeable for our ordinary shares or other securities of ours. Conversion may be mandatory or at your option and would be at prescribed conversion rates.

The debt securities will be issued under one or more documents called indentures, which are contracts between us and a trustee for the holders of the debt securities. In this prospectus, we have summarized certain general features of the debt securities. We urge you, however, to read the prospectus supplements related to the series of debt securities being offered, as well as the complete indentures that contain the terms of the debt securities. Indentures have been filed as exhibits to the registration statement of which this prospectus is a part, and supplemental indentures and forms of debt securities containing the terms of debt securities being offered will be incorporated by reference into the registration statement of which this prospectus is a part from reports we file with the SEC.

RISK FACTORS

An investment in our securities is risky. Prior to making a decision about investing in our securities, you should carefully consider the specific risks discussed under Risk Factors in both the prospectus and the applicable prospectus supplement, together with all of the other information contained in this prospectus and the prospectus supplement or incorporated by reference in this prospectus. The risks and uncertainties described below are not the only ones facing us. Additional risks and uncertainties not presently known to us, or that we currently see as immaterial, may also harm our business. If any of the risks or uncertainties described below or any such additional risks and uncertainties actually occur, our business, results of operations and financial condition could be materially and adversely affected. In that case, the trading price of the securities being offered by this prospectus and the applicable prospectus supplements could decline, and you might lose all or part of your investment.

You should carefully consider the following risk factors before you decide to invest in our Company and our business because these risk factors may have a significant impact on our business, operating results, financial condition, and cash flows. If any of these risks actually occurs, our business, financial condition, operating results and/or cash flows could be harmed.

Risks Related to Our Business and Industry

The slowdown in capital expenditures by telecommunications service providers has had and could continue to have a material adverse effect on our results of operations.

A deterioration of economies around the world and economic uncertainty in the telecommunications market began in 2000 and continued through 2003. This resulted in a curtailment of capital investment by telecommunications carriers and service providers as well as users in the enterprise market (businesses who use the equipment). It also reduced our ability to forecast orders, also referred to as low visibility. We cannot be sure whether increased expenditures will continue to be made in the telecommunications industry in general or in the voice over packet portion of the market. The decline in capital expenditures has reduced our sales compared to the year 2000, and may increase our inventories, result in additional pressure on the price of our products and prolong the time until we are paid, all of which would have a material adverse effect on the results of our operations and on our cash flow from operations.

We have incurred losses for the past three years and may incur losses in the future.

We have incurred losses in each of the last three years. We incurred a net loss of \$13.3 million in 2001, \$14.2 million in 2002 and \$8.4 million in 2003. We will need to generate increased revenues as well as manage our costs to return to and maintain profitability. We cannot be sure that we will be able to achieve or maintain profitability.

If new products we recently introduced or expect to introduce in the near future fail to generate the level of demand we originally 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 we recently introduced, such as our expanded offerings of Mediant and Stretto systems, or expect to introduce in the near future. We are involved in a continuous process to evaluate changing market demands and customer requirements and 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.

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 voice, data and fax 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.

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

The market for Voice over Packet, or VoP, services is currently being developed. A significant number of our new products are being offered to companies that provide products or services that utilize VoP. We cannot be sure that the delivery of telephone and other communications services over packet networks rather than over traditional telephone networks will expand. We cannot be sure that packet based voice networks will become widespread or that connections between packet networks and telephone networks will become commonplace. The adaptation process of connecting packet networks and telephone networks can be time consuming and costly. Sales of our VoP products will depend on the development of packet networks and the commercialization of VoP services. Commercialization of VoP services may also be impacted by changes, if any, in the regulatory environment affecting the provision or use of such services.

We may not be able to keep pace with emerging industry standards, which may make our products unacceptable to potential customers.

The failure to comply with evolving standards will limit acceptance of our products by market participants. Since our products are integrated into networks consisting of elements manufactured by various companies, they must comply with a number of current and future industry standards and practices established by various international bodies and industry forums.

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. 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 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 primarily sold as components or building blocks. Our customers incorporate our products into their product offerings, usually in conjunction with value-added services of their own or of third parties. 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 greater control over supplies, specifications and performance. Customers may therefore not buy components from an external manufacturer such as us. This could have an impact on the competition we face, our ability to sell our products and our revenues from operations.

We have depended on a few 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 come from large purchases by a small number of original equipment manufacturers, known as OEMs, network equipment providers, systems integrators and distributors. For example, our top three customers accounted for approximately 26.9% of our total revenues in 2003, 22.4% of our total revenues in 2002 and 43.0% of our total revenues in 2001. Sales to Nortel Networks accounted for 14.3% of our revenues in 2003 compared to 1.4% of our revenues in 2002 and less than 1% of our revenues in 2001. Sales to Clarent Corporation (now part of Verso Corporation) accounted for 31.7% of our total revenues in 2001. Sales to Clarent accounted for less than 1% of our total revenues in 2002 and 2003. Our future operating results may depend, in part, on the success of our largest OEM customers in selling products incorporating our components and on our success in selling large quantities of our products to them. We generally do not enter into sales agreements in which the customer is obligated to purchase a set quantity of our products. We also do not generally enter into long term supply contracts with our customers.

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.

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. 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 telephone 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.

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 OEM 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 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 customers want. Because we are selling products to OEMs, system integrators and distributors rather than 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. Acquisitions and strategic alliances in our industry have further increased competition. Examples of such recent merger and acquisition activity include the following: Lucent Technologies acquired Telica, Inc., Tekelec acquired Santera Systems, Inc., UTStarcom Inc. acquired Telos Corp., Brooktrout Inc. acquired Snowshoe Networks Inc., Conexant Systems, Inc. has spun off Mindspeed Technologies, Inc. to focus on chips for Voice over Packet among other businesses, Performance Technologies Inc. has acquired MapleTree Networks, ECI Telecom Ltd. s NGTS division has merged with NextVerse Networks, Inc. to form Veraz Networks Inc., Tekelec has acquired Santera Systems, Inc., UTStarcom Inc. has acquired the Commworks division of 3Com Corp., among others. Silicon Spice, Inc. was acquired by Broadcom Corporation, Intel Corporation acquired VxTel, Inc., DSP Group acquired VoicePump and NMS Communications Corporation (formerly known as Natural MicroSystems Corporation) acquired InnoMediaLogic, Inc. (IML), Mobilee, Inc., and Lucent Technologies voice enhancement and echo cancellation business. Increased competition could result in lower prices for our products, reduced demand for our products and a corresponding reduction in our ability to recover development, engineering and manufacturing costs.

Our competitors currently sell products that provide similar benefits to those that we sell. Our principal competitors in the sale of signal processing chips include Tology Networks, a division of Texas Instruments, Broadcom Infineon, Centillium, Mindspeed, Netergy and VoicePump, a subsidiary of DSP Group. We expect that large manufacturers of generic signal processors, like Motorola and Agere Systems (formerly the microelectronics division of Lucent Technologies) and Intel (Vxtel) will market competing processors.

Competition for our module level products includes manufacturers of high density Voice over Packet processors that compete with our high density Voice over Packet TrunkPack® Module products and chips. These include semiconductor manufacturers such as Texas Instruments, Mindspeed, and Centillium. Other vendors of module products that compete with our high density module products include Mapletree Networks that was recently acquired by Performance Technologies Inc., and Spectrum Signal Processing Inc.

Our principal competitors in the communications board market include NMS Communications, Dialogic Corporation (an Intel company), Blue Wave Systems (a Motorola Computer Group company), Brooktrout, Inc., Acculab and PIKA Technologies, Inc.

Our principal competitors in the area of analog media gateways (2 to 24 ports) for access and enterprise applications include 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, OKE and LG.

Our principal competitors in the area of low density mid and high density digital media gateways include Cisco Systems, Veraz Networks, Sonus Networks, Nuera, Tekelec, General Bandwidth, Telica and Commatch. In addition we face competition in mid and high density gateways from internal development at companies such as Nortel, Lucent, Alcatel, Siemens, Huawei, UTstarcom, ZTE and others.

We expect to encounter significant competition as we seek to expand our presence and product portfolio in the market for VoIP products.

There is significant competition in the market for products utilized in the VoIP market. Our competitors include telecommunications companies, data communication companies and companies specializing in voice over IP products. Some of our current and potential competitors have greater name recognition, larger installed customer bases and significantly greater financial, technical and marketing resources than we do.

Many of our competitors have the ability to offer vendor-sponsored financing programs to prospective customers. If we do not offer vendor-sponsored financing, we will be at a competitive disadvantage. We could also be forced to lower our prices to compete successfully and effectively against competitive product offerings and with competitors with broader product offerings who may be able to lower prices on products that compete with us because of their ability to recoup this loss of margin through sales of other products or services.

Voice, audio and other communications alternatives that compete with our products are being continually introduced. New communication alternatives may be based on traditional telephone lines, the Internet or cable networks and may be combined with other computing and broadcasting capabilities.

We expect that additional companies will compete in the packet based voice networks market. 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 other products, such as video images, with VoIP products could give these competitors an advantage over us.

New entrants to the market may increase competition.

The increasing market acceptance of voice over packet technology is attracting, and is expected to continue to attract, new entrants. Some of the leading communications equipment manufacturers have entered our market through acquisitions, and many of them have greater resources than we do. Combinations between semiconductor companies and companies providing software to them, such as the acquisition of Telogy Networks, Inc. by Texas Instruments Incorporated and the acquisition of HotHaus Technologies Inc. and Silicon Spice, Inc. by Broadcom Corporation, could result in further competition for us.

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

We have broadened our product offerings from chips to boards, subsystems and gateway level 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.

We rely on others 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. 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 and DSP Group, Inc. supply 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 and have entered into relationships and may enter into additional relationships with them.

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. 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 key electronic components could disrupt production, thereby adversely affecting our ability to deliver products and to support products previously sold to our customers.

As 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 produced to hold in inventory, we may be required to write off excess and obsolete inventory, which would adversely affect our operating results and financial condition. We wrote off and wrote down excess inventory that was expected to be sold at a price lower than carrying value in the amount of \$6.2 million in 2001, \$1.7 million in 2002 and \$835,000 in 2003.

We may not be able to retain a sufficient number of subcontractors to meet our production needs, which could hurt our ability to grow.

We have not entered into any long-term agreements or alternate source agreements with manufacturing subcontractors. Qualification of assembly and test subcontractors normally requires a significant investment of time. If our subcontractors are unable or unwilling to provide us with components or assembled products on a timely basis or if we need to find alternative subcontractors, our product shipments could be delayed significantly because we would have to go through the time consuming process of qualifying a new subcontractor. This could adversely affect our ability to grow. In addition, we have commenced additional manufacturing operations through sub-contractors in locations such as China and the United States. We cannot assure you that we will be able to control and oversee such operations to the same extent as we could in the past, when manufacturing, testing and shipments were conducted only in Israel.

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 we are sued for infringing the intellectual property rights of third parties.

Our success and ability to compete depend in large 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. Additionally, our products may be sold in foreign countries that provide less protection to intellectual property than that provided under U.S. or Israeli laws.

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 get 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.

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.

In the United States, changes in governmental regulation are being considered that may negatively impact the VoIP telephony market. For example, the Federal Communications Commission (FCC) has to date treated providers of telephone services over the public Internet as enhanced service providers. Enhanced service providers are currently exempt from federal and state regulations governing common carriers, including the obligation to pay access charges and contribute to the universal service fund. The FCC is examining the enactment of new regulations governing Internet telephony and the question of whether certain forms of telephone services over the Internet should be subject to the same FCC regulations as telecommunications services.

VoIP equipment can be used as a way to provide telecommunication services while bypassing the local service operator, in what is sometime referred to as toll bypass. Telecommunications traffic is diverted from traditional telephone lines to the public Internet, thus avoiding long distance call charges. As the use of VoIP to provide telecommunication services increases, phone companies are seeking the adoption of regulations that would require providers or users of such diverted calls to pay a charge to local service providers.

On March 10, 2004, the FCC released a Notice of Proposed Rule Making that seeks to establish a regulatory framework for Internet Protocol-Enabled Services, including VoIP services. The Notice of Proposed Rule Making seeks comments on how various IP-enabled services, including VoIP, should be differentiated for regulatory purposes, and whether there are technical or other characteristics of particular VoIP services that warrant differential regulatory treatment. When the FCC enacts new regulations governing VoIP, or if it determines that certain telephony providers over the public Internet, or the services they provide, are subject to current FCC regulations governing common carriers, then some of the service providers that buy equipment from our customers may be forced to pay access charges and make universal service contributions, or may be subject to other taxes, fees or restrictions under any such new regulations. The required payment of additional taxes, fees or charges for VoIP services may impact the profitability of these services and the use of VoIP services or technology.

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 legislative or regulatory reforms in the United States or elsewhere in the world may have on private telecommunication networks 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.

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

We generated 48% of our revenues in 2002 and 36% of our revenues in 2003 outside of the U.S. 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;
- staffing and managing foreign operations;
- increased risk of collection; and
- burdens that may be imposed by tariffs and other trade barriers.

If we are unable to address these risks, our foreign operations may be unprofitable or the value of our investment in our foreign operations may decrease.

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 threat of terrorism worldwide is impacting the global economy. Combined with the political unrest in Israel, this could have a material adverse effect on our results of operations.

The threat of the use of weapons of mass destruction and global terrorism are impacting the global economy. The future course of the unrest in Iraq and its effect on the global economy and the telecommunications industry cannot be predicted. In addition, since September 2000, the State of Israel and its inhabitants have been subjected to repeated terrorist attacks. The hostilities between the State of Israel and the Palestinians continued during the past year, with no end in sight to this intense conflict. This conflict can have both direct and indirect impacts on our business, as well as on the price of our shares. An adverse impact may occur as a result of, among other things, military service obligations of our key employees, changes in monetary and fiscal policies or the willingness of customers outside Israel to buy our products, including demands for additional assurances concerning availability of our products.

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. The introduction into circulation of the Euro in January 2002 placed pressure on us to sell to European customers in Euro rather than dollar prices. Sales denominated in Euros could make our revenues subject to fluctuation in the Euro/dollar exchange rate.

Epidemics, such as the recent SARS epidemic, could adversely affect our ability to conduct business internationally.

The spread of an epidemic and any resulting quarantines or the fear that an epidemic may be occurring can affect the willingness and ability of our customers and employees to conduct business in an affected or perceived affected region. This could have an adverse impact on our ability to sell our products and revenues from operations. For example, our employees, customers or suppliers may be reluctant to travel in or through an affected area and restrictions on movement or reduced working hours may apply.

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. If Shabtai Adlersberg is unable or unwilling to continue with us, our results of operations could be materially and adversely affected.

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. Such personnel were and may again be in great demand and we may not be successful in attracting, integrating or retaining them when and as required.

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. We also increased our holdings in a privately held speech-recognition company during 2003. We recognized losses from this investment in our results of operations in each of the past three years. 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. Acquired businesses, technologies or joint ventures may not be successfully integrated with our products and operations. If any acquisition, investment or joint venture were to occur, we may not realize the intended benefits of the acquisition, investment or joint venture and we may incur future losses from such acquisition, investment or joint venture.

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; and

write-offs of in-process research and development. If acquisitions disrupt our operations, our business may suffer.

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. 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.

We may not be able to raise additional financing for our future 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 in the future to continue our longer term expansion plans. 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 and increase our financing costs.

We extend credit to customers for purchases of our products. We could incur charges in our statement of operations if we are unable to collect these accounts receivable.

A portion of our receivables result from credit extended to customers for purchases of our products. We cannot be sure that we will be able to collect all of these accounts receivable. The failure to collect accounts receivable could adversely affect our cash flow position and results of operations.

Our gross profit percentage could be negatively impacted by increased manufacturing costs and other factors. This could adversely affect our results of operations.

Our gross profit percentage has increased in each of the past two years. However, our gross profit percentage is still lower than in 1999 and 2000. The recent increase in our gross profit percentage could 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 and maintenance. Customers may request us to 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 or maintenance. We may be required to supply upgraded 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 or maintenance.

Risks Related to Our Shares

Our stock price has fluctuated significantly and could continue to fluctuate significantly.

The market price for our ordinary shares, as well as the prices of shares of other technology companies, has been volatile. 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;

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 world-wide.

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 ordinary shares are traded on more than one market and this may result in price variations.

Our ordinary shares are traded primarily on the Nasdaq National Market and on The Tel Aviv Stock Exchange. Trading in our ordinary shares on these markets is made in different currencies (U.S. dollars on the Nasdaq National Market, and New Israeli Shekels on The Tel Aviv Stock Exchange), and at different times (resulting from different time zones, different trading days and hours and different public holidays in the United States and Israel). Consequently, the trading prices of our ordinary shares on these two markets generally differ, resulting from the factors described above as well as differences in exchange rates. Any change in the trading price of our ordinary shares on one of these markets could influence a change in the trading price of our ordinary shares on the other market.

There may be an adverse effect on the market price of our shares as a result of shares being available for sale in the future.

If our shareholders sell substantial amounts of our ordinary shares, including shares issued upon the exercise of outstanding options or purchased pursuant to our Employee Stock Purchase Plan, the market price of our ordinary shares may fall. These sales also might make it more difficult for us to sell equity or equity-related securities in the future at a time and place that we deem appropriate.

Our principal shareholders, executive officers and directors have substantial control over most matters submitted to a vote of the shareholders, thereby limiting the power of other shareholders to influence corporate action.

As of March 31, 2004, our officers, directors and principal shareholders beneficially owned 42.3% of our ordinary shares. As a result, these shareholders may have the power to control the outcome of most matters submitted to a vote of shareholders, including the election of members of our board and the approval of significant corporate transactions. This concentration of ownership may also have the effect of making it more difficult to obtain approval for a change in control of us.

U.S. shareholders may be subject to adverse United States federal income tax consequences as a result of our possible status as a passive foreign investment company.

We may be treated as having been a passive foreign investment company (PFIC) for United States federal income tax purposes for the 2001, 2002 and/or 2003 taxable years. If we were a PFIC for all or any of those years, U.S. shareholders who owned our shares during such years may be subject to reporting requirements for those years and succeeding years, even if in subsequent years we are no longer a PFIC. Unless specific shareholder elections are made, U.S. shareholders may be subject to increased United States federal income tax liabilities if we are classified as a PFIC, even if in subsequent years we are no longer a PFIC. We urge U.S. purchasers of our ordinary shares to consult their own United States tax advisors with respect to the United States federal income tax consequences of an investment in ordinary shares.

Risks Relating to Operations in Israel

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 offices are located in the State of Israel. Political, economic and military conditions in Israel directly affect our operations. Terrorist attacks against Israel have greatly intensified since September 2000, which have led to ongoing hostilities. We cannot predict the effect on us of the increase in the degree of violence by Palestinians against Israel. Some of our officers and employees in Israel are

obligated to perform up to 36 days of military reserve duty annually 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 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.

The Israeli rate of inflation may negatively impact our costs if it exceeds the rate of devaluation of the New Israeli Shekel against the U.S. dollar.

A portion of the cost of our Israeli operations, mainly personnel and facility-related, is incurred in New Israeli Shekels. In 2003, approximately 34% of our costs were incurred in New Israeli Shekels. As a result, we bear the risk that the rate of inflation in Israel will exceed the rate of devaluation of the New Israeli Shekel 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.

To protect against the changes in value of forecasted foreign currency cash flows resulting from payments in New Israeli Shekels, we have instituted 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 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. To be eligible for these programs and tax benefits, we must continue to meet conditions, including making specified investments in fixed assets and financing a percentage of investments with share capital. If we fail to meet such conditions in the future, the tax benefits would be canceled and we could be required to refund the tax benefits already received, together with an adjustment based on the Israeli consumer price index and an interest factor. The law and regulations prescribing the benefits provide an expiration date for the grant of new benefits. The expiration date has been extended several times in the past. The expiration date currently in effect is October 31, 2004 (which may be extended by ministerial decision until December 31, 2004), and no new benefits will be granted after that date unless the expiration date is extended again. There can be no assurance that new benefits will be available after October 31, 2004, or that existing benefits will be continued in the future at their current levels or at any level.

In 2003, we received a grant of \$435,000 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. In 2004, we applied for additional grants and we may apply for additional grants in the future. 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.