

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

FORM 20-F

REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR (g) OF THE SECURITIES EXCHANGE ACT OF 1934

OR

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2005

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

OR

SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

Date of event requiring this shell company report _____

For the transition period from _____ to _____

Commission file number 0-30070



AUDIOCODES LTD.

(Exact name of Registrant as specified in its charter and translation of Registrant's name into English)

ISRAEL

(Jurisdiction of incorporation or organization)

1 Hayarden Street, Airport City Lod 70151, Israel

(Address of principal executive offices)

Securities registered or to be registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
None	

Securities registered or to be registered pursuant to Section 12(g) of the Act:

Ordinary Shares, nominal value NIS 0.01 per share

(Title of Class)

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act:

None

(Title of Class)

Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the annual report.

As of December 31, 2005, the Registrant had outstanding 40,587,804 Ordinary Shares, nominal value NIS 0.01 per share.

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act:

Yes No

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934: Yes No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of “accelerated filer and large accelerated filer” in Rule 12b-2 of the Exchange Act.

Large Accelerated filer Accelerated filer Non-accelerated filer

Indicate by check mark which financial statement item the registrant has elected to follow.

Item 17 Item 18

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act): Yes No

PART I

Unless the context otherwise requires, "AudioCodes," "us," "we" and "our" refer to AudioCodes Ltd. and its subsidiaries.

ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS

Not applicable.

ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE

Not applicable.

ITEM 3. KEY INFORMATION

A. *SELECTED FINANCIAL DATA*

We derived the consolidated statements of operations data for the years ended December 31, 2003, 2004 and 2005 and consolidated balance sheets data as of December 31, 2004 and 2005 from the audited consolidated financial statements set forth elsewhere in this Annual Report. We derived the consolidated statements of operations data for the years ended December 31, 2001 and 2002 and the consolidated balance sheets data as of December 31, 2001, 2002 and 2003 from audited consolidated financial statements that are not included in this Annual Report.

B. CAPITALIZATION AND INDEBTEDNESS

Not applicable.

C. REASONS FOR THE OFFER AND USE OF PROCEEDS

Not applicable.

D. RISK FACTORS

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

Risks Related to Our Business and Industry

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

The market for Voice over Packet, or VoP, services is currently developing. 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. In addition, limitations of VoP technology, such as the inability to make a call during a power outage and difficulty in accessing 911 services, could adversely affect the market for VoP services. Sales of our VoP products will depend on the development of packet networks and the commercialization of VoP services. If this market does not develop, or develops more slowly than we expect, we may not be able to sell our products in significant volume.

The slowdown in capital expenditures by telecommunications service providers in prior years had a material adverse effect on our results of operations. Another down turn in technology spending could 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. There was a curtailment of capital investment by telecommunications carriers and service providers as well as by businesses that use our products, referred to as the enterprise market. It also reduced our ability to forecast orders, also referred to as "low visibility". We cannot be sure whether recent increased expenditures in the telecommunications industry in general or in the voice over packet portion of the market will continue. Since a substantial portion of our operating expenses consist of salaries, we may not be able to reduce our operating expenses in line with any reduction in revenues or may elect not to do so for business reasons. As a result of this downturn and our relatively stable operating expenses, 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 continue to generate increased revenues as well as manage our costs to maintain profitability. Any future industry downturn may increase our inventories, decrease our revenues, 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.

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, such as our expanded offering of Mediant systems, or expected future products. We are involved in a continuous process of evaluating changing market demands and customer requirements in order to develop and introduce new products, features and applications to meet changing demands and requirements. We need to be able to interpret market trends and the advancement of technology in order to successfully develop and introduce new products, features and applications. If potential customers defer transition or migration to new products, our return on our investment in research and development with respect to products recently introduced or expected to be introduced in the near future will be lower than we originally anticipated and our results of our operations may suffer.

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.

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

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

Our 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 to large original equipment manufacturers, or OEM's, or network equipment providers. 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 adverse impact on our ability to sell our products and our revenues.

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

Historically, a substantial portion of our revenue has been derived from large purchases by a small number of OEMs and network equipment providers, systems integrators and distributors. For example, our top three customers accounted for approximately 24.8% of our revenues in 2005, 29.0% of our revenues in 2004 and 26.9% of our revenues in 2003. Sales to Nortel Networks accounted for 16.3% of our revenues in 2005 compared to 18.6% of our revenues in 2004 and 14.3% of our revenues in 2003. We do not enter into sales agreements in which the customer is obligated to purchase a set quantity of our products. Based on our experience, we expect that our customer base may change from period to period. If we lose a large customer and fail to add new customers there could be a material adverse effect on our results of operations.

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

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

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

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

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

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

Our principal competitors in the media server market segment are Cantata Technology, NMS Communications, Convedia, IP Unity, Cognitronics and Aculab. In addition, we face competition in software-based and hardware-based media servers from internal development at companies such as Nortel, Lucent, Siemens, Motorola, Tekelec and Sonus Networks.

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

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

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

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.

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

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

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

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

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

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

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

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

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

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

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

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

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

Our customers expect us to maintain an inventory of products available for purchase off the shelf subsequent to the initial sales cycle for these products. This may require us to incur the costs of manufacturing inventory without having a purchase order for the products. The VoP industry is subject to rapid technological change and volatile customer demands, which result in a short product commercial life before a product becomes obsolete. If we are unable to sell products that are produced to hold in inventory, we may incur write offs and write downs as a result of slow moving items, technological obsolescence, excess inventories, discontinued products and products with market prices lower than cost. Write offs and write downs could adversely affect our operating results and financial condition. We wrote off and wrote down inventory in the amount of \$835,000 in 2003, \$1.2 million in 2004 and \$1.2 million in 2005.

We are also facing pressure to deliver through customer hubs and to deliver locally from warehouses in the U.S.

Some of our U.S. customers have requested us to maintain an inventory of products in the U.S. Some of these products held in inventory may be produced only for a specific customer. Maintaining additional inventory in the U.S. requires us to incur additional manufacturing costs and increases the risk that we will incur inventory write offs. Holding in inventory products manufactured for a specific customer results in additional warehouse and carrying costs and could result in additional write-offs if that customer does not purchase inventory manufactured specifically for it. If we are unable to sell inventory held in the U.S. that was not manufactured for a specific customer, we may need to incur additional shipping costs in order to sell the inventory in another country.

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

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

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

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

Our success and ability to compete depend in part upon protecting our proprietary technology. We rely on a combination of patent, trade secret, copyright and trademark laws, nondisclosure and other contractual agreements and technical measures to protect our proprietary rights. These agreements and measures may not be sufficient to protect our technology from third-party infringement, or to protect us from the claims of others. Enforcement of intellectual property rights may be expensive and may divert attention of management and of research and development personnel away from our business. Intellectual property litigation could also call into question the ownership or scope of rights owned by us. We believe that at least one of our patents may cover technology related to the ITU G.723.1 standard. Because of our involvement in the standard setting process, we may be required to license certain of our patents on a reasonable and non-discriminatory basis to a current or future competitor, to the extent required to carry out the G.723.1 standard. Additionally, our products may be manufactured, sold, or used in countries that provide less protection to intellectual property than that provided under U.S. or Israeli laws or where we do not hold relevant intellectual property rights.

Any intellectual property claims against us, even without merit, could cost us a significant amount of money to defend and divert management's attention away from our business. We may not be able to secure a license for technology that is used in our products and we may face injunctive proceedings that prevent distribution and sale of our products even prior to any dispute being concluded. These proceedings may also have a deterrent effect on purchases by customers, who may be unsure about our ability to continue to supply their requirements. We may be forced to repurchase our products and compensate customers that have purchased such infringing products. We may be forced to redesign the product so that it becomes non-infringing, which may have an adverse impact on the results of our operations.

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. 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.

On May 19, 2005, the FCC issued an order that requires interconnected VoIP service providers to be able to deliver all 911 calls to the customer's local emergency operator. Interconnected providers are those companies that enable VoIP customers to receive calls from and make calls to the traditional public switched telephone network. The FCC also indicated that it would adopt rules in the future that would require a method for determining the location of a VoIP customer making a 911 call without the customer having to report this information. VoIP service providers may have difficulties complying with this order in the required time frame, as well as any future orders issued by the FCC. Equipment and software manufacturers may have difficulty in complying with new technical requirements.

On May 3, 2006, the FCC issued an order that requires interconnected VoIP service providers to be prepared to accommodate law enforcement wiretaps. The FCC found that VoIP services are covered by the Communications Assistance for Law Enforcement Act, or "CALEA", which requires the FCC to preserve the ability of law enforcement agencies to conduct court-ordered wiretaps in the face of technological change. The FCC established a deadline of May 14, 2007 by which covered VoIP service providers must be in full compliance with all relevant CALEA requirements. VoIP service providers may have difficulties complying with this order in the required time frame, as well as any future orders issued by the FCC. Equipment and software manufacturers may have difficulty in complying with new technical requirements.

On June 21, 2006, the FCC adopted a rule that requires VoIP service providers to help subsidize services in rural and low-income areas. The FCC rule requires contribution of 10.5% of a VoIP service provider's long-distance revenue to the universal service fund if such long-distance calls pass through traditional phone networks.

The cost of providing Internet phone service could increase as a result of these actions by the FCC which could result in slower growth and decreased profitability for this industry. The increase in regulation of VoIP services and the increase in the cost of these services could adversely affect sales of our products and adversely affect our results of operations.

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

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

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

We are subject to new regulations that will require us to use components based on environmentally friendly materials. Compliance with these regulations may increase our costs and adversely affect our results of operations.

We are affected by new telecommunications industry regulations requiring the use of environmentally-friendly materials in telecommunications equipment. For example, pursuant to a European Community directive, telecom equipment suppliers are required to stop using specified materials that are not “environmentally friendly” by July 1, 2006. In addition, telecom equipment suppliers are required under this directive to eliminate the lead solders from their products by 2010. Some of our customers may also require products that meet higher standards than those required by the directive, such as complete removal of lead from all components. We will be dependent on our suppliers for components and sub-system modules, such as semiconductors and printed circuit boards, to comply with these requirements. Some of our products may not comply with this directive in 2006. We will attempt to comply with this directive in 2007. This may harm our ability to sell our products in the European Union and in any other countries that may adopt this directive.

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

Our inability or failure to comply with these regulations could have a material adverse effect on our results of operations. In addition, manufacturers of components that we use in our products that do not comply with these regulations may decide to stop manufacturing these components prior to the July 2006 compliance date. Similarly, manufacturers of components that use lead solders may decide to stop manufacturing those components prior to the 2010 compliance date. These actions by manufacturers of components could result in a shortage of components that could adversely affect our business and results of operations.

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

We generated 28% of our revenues in 2004 and 32% of our revenues in 2005 outside of the United States and Israel. Part of our strategy is to expand our penetration in existing foreign markets and to enter new foreign markets. Our ability to penetrate some international markets may be limited due to different technical standards, protocols or product requirements in different markets. Expansion of our international business will require significant management attention and financial resources. Our international sales and operations are subject to numerous risks inherent in international business activities, including:

- economic and political instability in foreign countries;
- 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 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 use of the Euro has 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.

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. We do not carry key person insurance for Mr. Adlersberg.

The success of our business also depends upon our continuing ability to attract and retain other highly-qualified management, technical, sales and marketing personnel. We need highly-qualified technical personnel who are capable of developing technologies and products and providing the technical support required by our customers. We are experiencing increasing competitive pressure with respect to retaining and hiring employees in the high technology sector in Israel, because technology-related businesses have resumed recruitment efforts after the reduction in demand for these types of employees following the slowdown in technology-related fields that began in 2001. If we fail to hire and retain skilled employees, our business may be adversely affected.

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 2005 we invested in MailVision Ltd. and CTI Squared Ltd, and increased our investment in Natural Speech Communication. In April 2003, we purchased a product group from Nortel Networks and in May 2004 we purchased Ai-Logix Inc., now known as AudioCodes USA Inc. We have recognized losses from the investment in Natural Speech Communication in our results of operations in each of the past three years.

On May 16, 2006, we entered into an agreement to acquire Nuera Communications Inc., or Nuera, for \$85 million in cash, subject to reduction for certain expenses, plus an earn out arrangement under which we have agreed to pay up to an additional \$5 million if Nuera achieves certain revenue milestones during the first 12 months following consummation of the transaction. Nuera provides Voice over Internet Protocol (VoIP) infrastructure solutions for broadband and long distance networks. This transaction is significantly larger than our other acquisitions and investments to date. If all of the conditions to the transaction are satisfied and it is completed, we cannot be sure that we will be successful in integrating Nuera's products, employees and operations into our organization or that we will be able to operate Nuera's business in a profitable manner.

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. As Nuera is significantly larger than any other acquisition we have made, there is likely to be a greater diversion of management's time and resources in connection with the consummation of this transaction and subsequent integration and operation of Nuera's business. Acquired businesses, technologies or joint ventures may not be successfully integrated with our products and operations. We may not realize the intended benefits of any acquisition, investment or joint venture and we may incur future losses from any acquisition, investment or joint venture.

In addition, acquisitions could result in:

- substantial cash expenditures;
- potentially dilutive issuances of equity securities;
- the incurrence of debt and contingent liabilities;
- a decrease in our profit margins;
- amortization of intangibles and potential impairment of goodwill; 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. In particular, our business requires us to focus on multiple markets, including the VoIP, cable and wireless markets. In addition, we work simultaneously with a number of large OEMs and network equipment providers each of which may have different requirements for the products that we sell to them. We may not have sufficient manpower, or may be unable to devote this manpower when needed, to address the requirements of these markets and customers. If we are unable to manage our expanding operations effectively, our revenues may not increase, our cost of operations may rise and our results of operations may be adversely affected.

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

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 three years. However, our gross profit percentage is still lower than in 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 have requested that we provide a contractual commitment to support a product for a specified period of time. This period of time may exceed the working life of the product or extend past the period of time that we may intend to manufacture or support a product. We are dependent on our suppliers for the components (hardware and software) needed to provide support and may be unable to secure the components necessary to satisfy our service commitments. We do not have long term contracts with our suppliers, and they may not be obligated to provide us with products or services for any specified period of time. We may need to purchase an inventory of replacement components and parts in advance in order to try to provide for their availability when needed. This could result in increased risk of write offs with respect to our replacement component inventory to the extent that we cannot accurately predict our future requirements under our customer service contracts. If any of our component suppliers cease production, cease operations or refuse or fail to make timely delivery of orders, we may not be able to meet our contractual commitments for product support 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.

We have not yet evaluated our internal controls over financial reporting in compliance with Section 404 of the Sarbanes-Oxley Act.

We are required to comply with the internal control evaluation and certification requirements of Section 404 of the Sarbanes-Oxley Act by no later than the end of our 2006 fiscal year. We are in the process of determining whether our existing internal controls over financial reporting systems are compliant with Section 404. This process may divert internal resources and will take a significant amount of time and effort to complete. If it is determined that we are not in compliance with Section 404, we may be required to implement new internal control procedures and reevaluate our financial reporting. We may experience higher than anticipated operating expenses as well as higher independent auditor fees during the implementation of these changes and thereafter. Further, we may need to hire additional qualified personnel in order for us to be compliant with Section 404. If we are unable to implement these changes effectively or efficiently, it could harm our operations, financial reporting or financial results and could result in our being unable to obtain an unqualified report on internal controls from our independent auditors.

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 between Israel, the Palestinian Authority and other groups in the West Bank and Gaza Strip. The future of relations between the Palestinian Authority and Israel is uncertain. In January 2006, Hamas, an Islamic movement responsible for many attacks against Israelis, won the majority of the seats in the Parliament of the Palestinian Authority. The election of a majority of Hamas-supported candidates is expected to be a major obstacle to relations between Israel and the Palestinian Authority, as well as to the stability in the Middle East as a whole.

We cannot predict the effect on us of an increase in these hostilities or any future armed conflict, political instability or violence in the region. 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 or an escalation in the political situation occur. If many of our employees are called for active duty, our operations in Israel and our business may be adversely affected. Additionally, a number of countries continue to restrict or ban business with Israel or Israeli companies, which may limit our ability to make sales in those countries.

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 substantial portion of the cost of our Israeli operations, mainly personnel and facility-related, is incurred in New Israeli Shekels (NIS). In 2005, approximately 35% of our costs were incurred in NIS. 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 NIS, we maintain a foreign currency cash flow hedging program. We hedge portions of our forecasted expenses denominated in foreign currencies with forward contracts. These measures may not adequately protect us from material adverse effects due to the impact of inflation in Israel.

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

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

On April 1, 2005, an amendment to the law came into effect (“the Amendment”) which has significantly changed the provisions of the law. The Amendment limits the scope of enterprises which may be approved by the Investment Center by setting criteria for the approval of a facility as a Beneficiary Enterprise, such as provisions generally requiring that at least 25% of the Beneficiary Enterprise’s income will be derived from export. Additionally, the Amendment enacted major changes in the manner in which tax benefits are awarded under the law so that companies no longer require Investment Center approval in order to qualify for tax benefits.

In addition, the law provides that terms and benefits included in any certificate of approval already granted will remain subject to the provisions of the law as they were on the date of such approval. Therefore, our existing "Approved Enterprises" will generally not be subject to the provisions of the Amendment. As a result of the Amendment, tax-exempt income generated under the provisions of the law as amended, will subject us to taxes upon distribution or liquidation and we may be required to record a deferred tax liability with respect to such tax-exempt income.

In 2005, we recognized a grant of \$417,000 from the Government of Israel, through the Office of the Chief Scientist, or the OCS, for the financing of a portion of our research and development expenditures in Israel. The OCS budget has been subject to reductions, which may affect the availability of funds for these prospective grants and other grants in the future. As a result, we cannot be certain that we will continue to receive grants at the same rate, or at all. In addition, the terms of any future OCS grants may be less favorable than our past grant.

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

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

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

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

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

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

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

Risks Relating to our Ordinary Shares and our Notes

The price of our ordinary shares may fluctuate significantly.

The market price for our ordinary shares, as well as the prices of shares of other technology companies, has been volatile. Between January 1, 2004 and June 16, 2006, our share price has fluctuated from a low of \$8.48 to a high of \$17.00. 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 worldwide.

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

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

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

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

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

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

Our notes are general, unsecured obligations and are effectively subordinated to any existing and future secured indebtedness we may have. In addition, our notes are not guaranteed by our subsidiaries or any future subsidiaries and, accordingly, our notes are effectively subordinated to the existing and future indebtedness and other liabilities of our subsidiaries. These liabilities may include indebtedness, trade payables, guarantees, lease obligations and letter of credit obligations. Therefore, our rights and the rights of our creditors, including the holders of the notes, to participate in the assets of any subsidiary upon that subsidiary's liquidation or reorganization will be subject to the prior claims of the subsidiary's creditors, except to the extent that we may ourselves be a creditor with recognized claims against the subsidiary. However, even if we are a creditor of one of our subsidiaries, our claims would still be effectively subordinated to any security interests in, or mortgages or other liens on, the assets of that subsidiary and would be subordinate to any indebtedness of the subsidiary senior to that held by us. As of June 16, 2006, our existing subsidiaries had no outstanding indebtedness (excluding intercompany debt and other liabilities).

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

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

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

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

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

- requiring the dedication of a portion of our expected cash flow to service our indebtedness, thereby reducing the amount of our expected cash flow available for other purposes, including funding our research and development programs and other capital expenditures;
- increasing our vulnerability to general adverse economic conditions;
- limiting our ability to obtain additional financing; and

— placing us at a possible competitive disadvantage to less leveraged competitors and competitors that have better access to capital resources.

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

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

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

Our ability to make interest and principal payments on our notes when due and to satisfy our other debt obligations depends in part upon our future financial performance and upon our ability to renew or refinance any debt obligations or to raise additional equity capital. Prevailing economic conditions and financial, business and other factors, many of which are beyond our control, will affect our ability to make these payments.

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

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

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

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

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

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

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

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

Based on the composition of our gross income and the composition and value of our gross assets during 2004 and 2005, we do not believe that we would be treated as a passive foreign investment company ("PFIC") for U.S. federal income tax purposes for either the 2004 or 2005 tax year. While it is possible that we would have been classified as a PFIC in 2001, 2002 and 2003, there can be no assurance that we will not be treated as a PFIC in any future tax year. If we are a PFIC for any tax year, U.S. shareholders who owned our ordinary shares during such year may be subject to increased United States federal income tax liabilities and reporting requirements for such year and succeeding years, even if we are no longer a PFIC in such succeeding years. We urge U.S. holders of our ordinary shares to review Item 10E. – "Taxation – United States Tax Considerations – United States Federal Income Taxes – Passive Foreign Investment Company Status" in this Annual Report and to consult their own tax advisors with respect to the U.S. federal income tax consequences of an investment in our ordinary shares.

ITEM 4. INFORMATION ON THE COMPANY

A. HISTORY AND DEVELOPMENT OF THE COMPANY

AudioCodes Ltd. was incorporated in 1992 under the laws of the State of Israel. Our principal executive offices are located at 1 Hayarden Street, Airport City, Lod, 70151 Israel. Our telephone number is 972-3-976-4000.

Major Developments since January 1, 2005

Agreement to Acquire Nuera Communications Inc.

On May 16, 2006, we entered into an Agreement and Plan of Merger with Nuera Communications, Inc., or Nuera, a leading provider of Voice over Internet Protocol, or VoIP, infrastructure solutions for broadband and long distance networks. Nuera, which is headquartered in San Diego, California, designs, manufactures and sells packet voice gateways to communication service providers worldwide. Its products work over a variety of media (cable, wireless, copper and fiber). Nuera's Open Reliable Communications Architecture, or ORCA, product portfolio of VoIP gateways, softswitches and management systems provide telephony solutions for cable and digital subscriber line, or DSL, networks, international long distance networks and enterprise networks. Nuera has a broad client base in North America as well as in Asia and Europe. Nuera is headquartered in San Diego, California.

The consideration for the transaction will consist of \$85 million in cash, subject to reduction for certain expenses, plus an earn out arrangement under which we have agreed to pay up to an additional \$5 million if Nuera achieves certain revenue milestones during the first 12 months after consummation of the transaction. There will be an escrow of \$7.5 million of the purchase price paid at closing for a period of one year following closing, to secure up to \$7.5 million of certain indemnification obligations under the merger agreement. Upon the consummation of the merger, Nuera will become a wholly-owned subsidiary of AudioCodes USA.

The transaction is subject to customary conditions for transactions of this nature, including antitrust clearance under the Hart-Scott-Rodino Antitrust Improvement Act and other regulatory approvals. If these conditions are satisfied, the transaction is expected to be consummated early in the third quarter of 2006. The transaction has been approved by our board of directors and by the board of directors and stockholders of Nuera. We cannot be sure that the acquisition of Nuera will be consummated when anticipated or at all.

Other Recent Developments

Acquisition of AudioCodes USA Inc (formerly called Ai-Logix Inc.)

In May, 2004, we acquired all of the outstanding shares of capital stock of Ai-Logix Inc., now known as AudioCodes USA, a leading provider of advanced voice recording hardware technology located in Somerset, New Jersey.

AudioCodes USA is a strategic provider of voice and data hardware integration cards for the call recording and voice/data logging industry. AudioCodes USA provides a wide variety of voice processing cards to its customers, which include contact centers, public safety agencies, financial institutions, air traffic control and other government agencies. Its products include proprietary public exchange integration products as well the SmartWORKS™ family of products that are designed for all segments of the call recording industry. AudioCodes USA offers voice processing cards that support all three product segments in the call recording industry, including passive analog trunk interface cards, passive digital trunk interface cards and passive digital PBX telephone set integration cards.

Recent trends evidence a growing momentum in the use of VoP technology in new network deployments and an expected shift of communications budgets in the enterprise market towards IP-based architectures. The call recording industry is experiencing similar trends. According to Datamonitor, the contact center market and the call logging and recording industries are rapidly adopting IP-based networking solutions. A significant portion of future voice recording and call logging revenues are expected to be generated from deployments of VoIP architectures. We believe that our acquisition of AudioCodes USA will enhance our board line business and provide an entry into the call recording market and computer telephony integration (CTI) market by leveraging our VoP expertise with AudioCodes USA's technology, strategic partnerships and customer base.

Acquisition of UAS

In April 2003, we purchased from Nortel Networks Limited selected assets of its Universal Audio Server business, or UAS. As part of the transaction, Nortel Networks granted to us a license to use its UAS technology. We undertook to act as an exclusive supplier to Nortel Networks for its UAS products over a period of three years that ended in April 2006.

The UAS products provide enhanced conferencing, multi-language announcement functionality, and other regulatory media server applications for voice over packet networks. We are seeking to leverage the UAS product and technology in order to further enhance our media server products and increase related sales.

Sale of Our 2.00% Senior Convertible Notes Due 2024

In November 2004, we raised net proceeds of approximately \$120.2 million in a private placement of \$125.0 million aggregate principal amount of our 2.00% Senior Convertible Notes due 2024. These notes were issued pursuant to Rule 144A under the Securities Act of 1933. Holders of the notes are entitled to convert the notes into our ordinary shares at a conversion rate of 53.4474 ordinary shares per \$1,000 principal amount of notes, which is the equivalent to a conversion price of approximately \$18.71 per share. The conversion rate is subject to adjustment in certain circumstances, such as changes in our capital structure or upon the issuance by us of share dividends or certain cash distributions. The notes may be redeemed by us, in whole or in part at any time on or after November 9, 2009. The holders may require us to redeem the notes on November 9, 2009, November 9, 2014 or November 9, 2019, or upon certain fundamental changes.

Introduction

We design, develop and market enabling technologies and system products for the transmission of voice, data and fax communications over packet networks, which we refer to as the new voice infrastructure. Our products enable our customers to build high-quality packet networking equipment and network solutions and provide the building blocks to connect traditional telephone networks to the new voice infrastructure. Our products are sold to leading original equipment manufacturers, or OEMs, system integrators and network equipment providers in the telecommunications and networking industries.

Packet networks are data communications networks that transport information compressed into “packets” over circuits shared simultaneously by several users. Equipment based on advanced voice communications standards enables packet networks to carry voice and data more efficiently than the traditional telephone networks, which were designed principally to transmit high quality voice calls.

Our voice compression technology permits the high quality transmission of voice over packet networks using substantially less network capacity than used in traditional telephone networks. Our products enable our customers to build highly-efficient, high capacity gateways and access equipment that are used to connect traditional telephone networks to packet networks. In addition, our gateway product offering provides our customers with a substantial building block for voice over packet carrier-based solutions, as an alternative to our customers developing or building their own gateways.

Our products consist of:

- Signal processor chips, which process voice, data and fax signals and compress this information into packets so that it can be sent between traditional telephone networks and packet networks.
- Communications boards and modules for communication system products that are deployed on both access networks and enterprise networks. The carrier network applications for these boards and modules include media gateways, which terminate calls from the Public Switched Telephone Network (PSTN), packetize and compress the call and then switch the call to the packet network, and vice-versa. The enterprise applications for these products include Computer Telephony Integration (CTI) deployments for contact centers, providing call logging and recording utilizing either industry standard or proprietary protocols.
- System products, including media servers and media gateways, for access networks, trunking applications in carrier networks, and enterprise networks. These systems enable voice, data and fax to be transmitted over Internet and other protocols, and interface with third party equipment to facilitate the introduction of enhanced voice and data services. Media servers provide enhanced conferencing, multi-language announcement functionality, and other media server applications for voice over packet networks. Our media gateway products include low density analog media gateways and low, mid and high density digital media gateways.

Our products are based upon voice compression and fax detection technologies, which transform voice and fax transmissions into small digital “packets.” We were involved in the development of the voice coding standard that was adopted for use in packet networks by the Voice over IP Forum, an industry group founded to ensure the interoperability and high quality of telephone service over packet networks. We have also developed advanced technologies for processing compressed voice transmissions and have significant voice communication system design expertise.

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

- telephony over packet networks based on Internet protocols or networks based on asynchronous transfer mode standards, known as ATM standards;
- telephony over the wireless or cable television infrastructure; and
- telephone service over high speed modems operating over wireless links or data modems, known as digital subscriber line, or DSL, modems.

Customers for our products consist of OEMs, network equipment providers and systems integrators. In addition, our proprietary voice compression technology is licensed to a broad group of companies that manufacture equipment for a variety of markets. As one of the original developers of the standards for voice compression technology used in packet networks, we are positioned to take advantage of the rapidly growing demand for advanced communications components enabling high quality converged voice and data services.

Industry Background

Market Trends

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

- *Growth in data communications traffic.* The growth of the Internet has led to a surge in data communications traffic. This growth has been fueled by the increasing number of users of the Internet, as well as by the increased use of electronic mail and multimedia content and the increased volume of information retrieved from the World Wide Web. In addition, organizations are increasingly turning to the use of intranets and private networks to increase productivity and create competitive advantages. This proliferation of intranets and private networks has further contributed to the surge in data traffic.

- *Emergence of packet networks and advances in networking technologies.* Traditional voice communications networks were not designed to handle the dramatic increase in data traffic, the need for high-speed data communication and the need to serve a much larger number of users. As data traffic becomes the dominant factor in communications and as service providers begin to build and maintain converged networks for integrated voice and data services, a new generation of data-centric networks is being developed. This development has been enabled by a new generation of packet networking technologies. The capabilities to effectively carry voice and fax and preserve the quality of communications over these new networks have been made possible by the recent rapid advances in voice compression technologies, the advent of digital signal processing chips and new packet voice, fax and data networking technologies and protocols. The surge in data traffic has led to the need for new packet-based infrastructures. As a result, service providers are seeking to exploit the advances in high speed and packet voice networking technologies to build networks that are more cost effective than the traditional circuit-switched telephone networks.
- *Competition in the telecommunications industry.* Competitive local exchange carriers and alternative carriers are trying to penetrate the local telephone market with varying degrees of success by bypassing the incumbent local telephone company network through the use of emerging packet technologies in new functions like telephony transmission over cable networks and digital subscriber line networks. In addition, there is a growth of toll bypass service providers, who seek to use public or private networks in order to bypass incumbent networks. Although these new and traditional service providers are not our direct customers, they are creating market demand for equipment manufactured by our customers. The surge in data traffic and the growth in overall volume and capacity of infrastructures have also created a need for new infrastructure equipment that is capable of more efficient utilization of the available networks.
- *New technologies.* The expected extension of voice over packet technologies into wireless networks alongside the introduction of new wireless standards (referred to often as Second and Third Generations) and cable networks suggest a business opportunity for the deployment of such technologies and products in these market segments. It is possible that the introduction of Voice over Packet technologies into wireless and cable networks will then place pressure on the traditional circuit switch service providers to modernize their equipment so as to be able to compete with the new offerings, including price reductions of these alternative networks.
- *Provision of different services.* As VoIP gains wide acceptance, service providers are looking for ways to differentiate themselves other than by offering cheaper services. This has led to the emergence of wide band vocoders that use a higher sampling rate than used in legacy TDM networks, allowing service providers to offer very high quality voice and music transmission over IP networks.
- *Broadband Access.* The transmission of voice telephony is expected to increase as access to high speed broad band internet connections grows. Voice telephony over broadband depends on voice over packet technologies.

Traditionally, voice, data and fax communications have been transmitted and managed on separate networks, each with its own distinct industry standards and protocols. Voice, data and fax have been transmitted primarily over the traditional telephone network that is based on circuit-switched technology. When a call is placed on a circuit-switched network, a dedicated circuit is established between the two callers and is maintained for the duration of the call. This dedicated channel, which requires bandwidth of 64 kilobits per second, is unavailable for use by other callers on the network until the call is terminated.

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

Packet networks offer a number of advantages over circuit-switched networks. Rather than requiring a dedicated circuit for each individual call, packet networks commingle packets of voice, fax and data from several communications sources on a single physical link. This provides superior utilization of network resources, especially in dealing with information sources with bursts of information followed by periods of silence. This superior utilization means that the same amount of traffic can be carried using fewer network resources. Additionally, the integration of voice and data communications makes possible an enrichment of services and an entire range of new, value-added applications, such as unified messaging and voice enabled web sites. In addition, voice traffic over packet networks is usually compressed to provide a further reduction in the use of or demand for bandwidth. For example, the rate at which information is transmitted over packet networks is generally between 6.3 and 8 kilobits per second as compared to 64 kilobits per second over circuit-switched telephone networks.

Convergence of Voice and Data

The proliferation of data-centric networks since the mid-1990s has made the transmission of voice and fax over these networks a cost-effective alternative to existing circuit-switched telephone networks. Most of the recent growth in packet networks has taken place over networks based on Internet protocols, and, to a lesser extent, on packet networks based on other protocols. "Voice over IP", or VoIP, is the industry terminology used to describe the transmission of voice over Internet protocol-based networks.

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

Gateway equipment for Internet protocol-based packet networks has continued to experience significant development and growth. The gateway equipment can be generally divided into two key categories: open telecommunications architecture systems, built around industry-standard PC and workstation platforms for which components are available from a number of suppliers, and proprietary architecture-based gateways which are built around a custom design of a telecommunications equipment manufacturer. Voice over IP gateway equipment can be generally segmented into three classes: carrier class gateways for use in central office facilities; enterprise gateways for use by corporations and in small offices; and residential gateways for use at homes.

The Challenges

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

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

Gateway Reliability. In order for a packet network to be efficient for voice or fax transmission, the gateway equipment must be able to deliver an equivalent level of performance to that of existing switching equipment located at central offices. The telephony providers' central offices contain circuit-switching equipment that typically handles tens of thousands of lines and is built to meet severe performance criteria relating to reliability, capacity, size, power consumption and cost. To date, the gateways available for use in packet networks have not been able to cost-effectively achieve these same levels of reliability in handling similar numbers of voice and fax calls. As a result, new generation gateway equipment that meets the same performance level as current circuit-switch technologies needs to be developed.

Functionality. In order to compete effectively with incumbent circuit-switching equipment, packet network equipment must be able to deliver equivalent and improved functionality and features for the service providers and network users.

Return on Investment. With the reduction in profitability of service providers there is an even greater need for them to achieve better returns on investment from capital expenditures on new equipment. Given the evolving nature of packet technologies and capabilities, there is greater pressure to provide cost effective technological solutions.

In order to maximize the benefits of using packet networks for the transmission of voice data and fax, products must be able to address and solve these inherent problems and challenges. These products must also be standards-based to support interoperability among different equipment manufacturers and to allow operation over various networks.

AudioCodes Solution

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

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

- *Leadership in voice compression technology.* We are a leader in voice compression technology. Voice compression exploits redundancies within a voice signal to reduce the bit rate of data required to digitally represent the voice signal while still maintaining acceptable voice quality. Our key development personnel have significant experience in developing voice compression technology. We were involved in the development of the ITU G.723.1 voice coding standard that was adopted by the Voice over IP Forum and the International Telecommunications Union as the recommended standard for use in voice over IP gateways. We implement industry voice compression standards and work directly with our customers to design state-of-the-art proprietary voice compression algorithms that satisfy specific network requirements. We believe that our significant knowledge of the basic technology permits us to optimize its key elements and positions us to address further technological advances in the industry. We also believe that our technological expertise has resulted in us being sought out by leading equipment manufacturers to work with them in designing their systems and provision of solutions to their customers.

- *Digital signal processing design expertise.* Our extensive experience and expertise in designing advanced digital signal processing algorithms enables us to implement them efficiently in real time systems. Digital signal algorithms are computerized methods used to extract information out of signals. In designing our signal processors, we use minimal digital signal processing memory and processing power resources. This allows us to develop higher density solutions than our competitors. Our expertise is comprehensive and extends to all of the functions required to perform voice compression, fax and modem transmission over packet networks and telephone signaling processing.
- *Compressed voice communications systems design expertise.* We have the expertise to design and develop the various building blocks and the complete gateways and media servers required for complete voice over packet systems. In building these systems, we develop hardware architectures, voice packetization software and signaling software, and integrate them with our signal processors to develop a complete, high performance compressed voice communications system. We assist our customers in integrating our signal processors into their hardware and software systems to ensure high voice quality, high completion rate of fax and data transmissions and telephone signaling processing accuracy. Further, we are able to customize our off-the-shelf products to meet our customers' specific needs, thereby providing them with a complete, integrated solution and enabling them to market their products with a reduced time to market.

We believe that our products possess the following advantages:

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

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

Business Strategy

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

- *Maintain and extend technological leadership.* We intend to capitalize on our expertise in voice compression technology and proficiency in designing voice communications systems. In 1995, we co-authored the ITU G.723.1 voice coding standard that was adopted by the Voice over IP Forum as the recommended standard for use in voice over IP gateways. In 1998, we introduced NetCoder®, a new voice coder that was designed specifically for IP networks. In 2001, we introduced TrunkPack® 1610, a cPCI Telephony board supporting PSTN, signaling, MGCP and MEGACO call controls. In 2002, we introduced the Mediant™ Media Gateways as part of our initiative to provide complete media gateways to our network equipment provider. In 2002, we also launched our media server product family to support IP-based local access and enhanced services for wireless, cable, voice virtual private network and IP centrex markets. We continually upgrade our product lines with additional functionalities, interfaces and densities. We have invested heavily and are committed to continued investment in developing technologies that are key to providing high performance voice, data and fax transmission over packet networks and to be at the forefront of technological evolution in our industry.

- *Strengthen and expand strategic relationships with key customers.* Our strategy has been to sell our products to leading equipment manufacturers in the telecommunications and networking industries and to establish and maintain long-term working relationships with them. We work closely with our customers to engineer products and subsystems that meet each customer's particular needs. The long development cycles usually required to build equipment incorporating our products frequently results in close working relationships with our customers. By focusing on leading equipment manufacturers with large volume potential, we believe that we reach a substantial segment of our potential customer base while minimizing the cost and complexity of our marketing efforts.
- *Expand and enhance the development of highly-integrated products.* We plan to continue designing, developing and introducing new product lines and product features that address the increasingly sophisticated needs of our customers. We believe that our knowledge of core technologies and system design expertise enables us to offer better solutions that are more complete and contain more features than competitive alternatives. We believe that the greatest opportunities for our growth and profitability will come from the development of even more highly-integrated product lines and product features such as our recently announced digital media gateways.
- *Build upon existing technologies to penetrate new markets.* The technology we developed in connection with the IP telephony market can be used to serve similar product requirements in emerging markets utilizing similar packet networking technologies. These markets include those providing telephony over digital subscriber lines, wireless networks and the cable television infrastructure.
- *Develop a network of strategic partners.* Part of our strategy has been to sell our products through customers that can offer our products as part of a full-service solution to their customers. We expect to further develop our strategic partner relationships with system integrators and other service providers in order to increase our customer base.
- *Acquire complementary businesses and technologies.* We expect to pursue the acquisition of complementary businesses and technologies or the establishment of joint ventures to broaden our product offerings, enhance the features and functionality of our systems, increase our penetration in targeted markets and expand our marketing and distribution capabilities. As part of this strategy, we acquired the UAS business from Nortel in April 2003 and AudioCodes USA, formerly known as Ai-Logix, in May 2004. We also entered into an agreement to acquire Nuera in May 2006.

Products

Our products facilitate the transmission of voice, data and fax over packet networks. To date, we have incorporated our algorithms, technologies and systems design expertise in product lines:

- voice over packet processors;
- media gateway modules (TrunkPack® Modules);
- VoIP and VoATM communication boards (TrunkPack®);
- media processing boards for enhanced services and functionalities such as conferencing and messaging (IPmedia™);
- voice and data logging hardware integration board products;
- analog media gateways for toll bypass access and enterprise applications;
- digital media gateways with various capacities for wireless, wireline (Mediant™) and cable (Mediant™ Cable);
- media server for enhanced services and functionalities such as conferencing and messaging (IPmedia™ Media Servers); and,
- Element management system (EMS).

In addition, we continue to offer customers our professional services, which usually involve customization and development projects for customers.

Our products are designed to build on our core technology and competence extending them both vertically (chips inserted into boards, boards inserted into digital media gateways) and horizontally into different applications for different market segments, such as enterprise, wireline, cable and wireless.

Voice Over Packet Processors

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

Our signal processor chips implement a complete signal processing system, supporting voice compression, echo cancellation, fax and modem processing and telephony signaling processing. The signal processor chips also enhance gateway efficiency by supporting multiple independently processed channels of communication.

We provide a range of voice over packet processors of voice communications over different types of packet networks, such as IP and ATM. Our processors are used by original equipment manufacturers, known as OEMs, in their products enabling simple development and a significant reduction in time-to-market. Each processor constitutes a full voice band subsystem that includes standards-based low bit rate voice compression, echo cancellation, in-band signaling detection and generation fax transmission and other signaling tones handling.

Media Gateway Modules

Our media gateway modules are medium to high density, multi-protocol modules that allow OEM gateway designers to take full advantage of the complete media gateway functionality inherent in our TrunkPack[®] architecture, which is installed in millions of lines worldwide. These modules connect as daughter cards onto proprietary OEM carrier boards and convert content into low bit rate packetized voice over IP voice trunking. Their comprehensive feature set and standard interfaces make them an integral building block for high performance, carrier class media gateways by providing fast time to market and a cost effective solution.

In common with our TrunkPack[®] boards and compact peripheral component interconnect, or PCI, solutions for open standards-based platforms. These modules bridge the gap between our voice over packet processors, which offer developers maximum design flexibility, and the communication boards that fit into standard peripheral component interconnect, or PCI, or CompactPCI platforms.

The module product family performs a variety of media gateway functions such as packetization, compression, streaming and protocol processing. The module line also provides echo cancellation functionality.

VoIP and VoATM Communication Boards

Our communications boards are designed to operate in gateways connecting the circuit-switched telephone network to packet networks based on Internet protocols. Our boards comply with voice over IP and voice over ATM (AAL2) industry standards and allow for interoperability with other gateways. The boards also enable high capacity operations while fitting into a single PCI or CompactPCI platforms. Just as our signal processor chips can handle multiple channels on a single processor, our communications boards can support multiple telephony trunk processing and differing modes of operations to provide manufacturers with greater system flexibility.

Our boards support standards-based open telecommunications architecture systems and combine our signal processor chips with communications software, signaling software and proprietary hardware architecture to provide a cost efficient interoperable solution for high capacity gateways. We believe that using open architecture permits our customers to bring their systems to market quickly and to integrate our products more easily within their systems.

Our boards represent a combined functionality of both media streaming processing (voice fax and modem) and on-board telephony interfaces, along with their associated signaling protocols.

Enhanced Voice Services and Contact Center Solutions

Our Ardito™ media gateway boards offer developers of enhanced voice services and contact center solutions the capability to support PSTN infrastructure today and VoIP foundations in the future.

Analog Media Gateways for Toll Bypass Access and Enterprise Applications

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

The MediaPack™ family represents a feature rich product for streaming voice quality with a powerful analog interface supporting all major control protocols such as H323, SIP, MGCP and MEGACO.

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

Mediant™ is our family of media gateways for wireline backbone and enterprise networks. The Mediant™ product family offers scalability and functionality, providing a full suite of voice coders standard compliant control protocols and public switched telephone network, or PSTN, signaling interfaces for a variety of wireline media gateway applications in most softswitch control environments. The Mediant™ family provides carriers with a comprehensive line of different sized gateways. Small or medium-sized gateways enable cost-effective solutions for enterprise or small points of presence, as well as entry into fast growing new and emerging markets. The large gateway scales to central office capacities and is designed to meet carriers' operational requirements. The entire Mediant™ gateway family shares our same VoIP media gateway boards, assuring mature, field-proven solutions.

The Mediant™ cable access gateway family is our line of packet telephony standards-compliant cable access gateways designed for either hybrid or all IP cable network architecture. The Mediant cable access gateway enables deployment of advanced packet-based cable telephony at multiple service operators own pace, without costly hardware changes. The Mediant™ cable access gateway can be initially deployed as a V5.2 IP access terminal and then easily migrated by software upgrade to a cable telephony media gateway with external call management provided by a softswitch and an SS7 interface to the PSTN. Our Mediant wireless product line is our family of media gateways for the second and third generations of wireless networks. The Mediant™ for the wireless market is intended to enable packetization of legacy wireless networks, as well as serving as a voice media gateway in third generation packet enabled architecture. This product family is compatible with popular wireless voice coders and protocols for wireless networks such as code-division multiple access (CDMA), global system for mobile communications (GSM), CDMA2000 and universal mobile telecommunications service (UMTS), and builds on our TrunkPack® architecture, which is installed in millions of lines worldwide.

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

The IPmedia™ product family is designed to allow OEMs to provide sophisticated content and services that create revenue streams and customer loyalty through the ability to provide additional services. The IPmedia™ platforms interface both packet (IP or ATM) and switched-circuit telephony modules, while saving space. The IPmedia™ platform provides voice and fax processing capabilities to enable, together with our partners, an architecture for development and deployment of enhanced services.

IPmedia™ platforms are designed to answer the growing market demand for enhanced voice services over packet networks, particularly network-based applications like unified communications, call recording, and conferencing by carriers and application service providers. IPmedia™ enables our customers to develop and market applications such as: unified communications, interactive voice response, call-centers, conferencing and voice-activated personal assistant. IPmedia™ products are currently offered on our PCI and cCPI boards and on the 2000 series 1U media gateway box (IPmedia™ 2000) and will soon also be available in the recently announced 3000 series 2U gateway platform, featuring IP and ATM interfaces and capabilities.

Universal Audio Server (IPmedia™ Media Server)

The universal audio server is a product that we acquired from Nortel Networks in April 2003. This product has been redesigned, upgraded and integrated into our IPmedia boards and servers. The universal audio server provides enhanced conferencing, multi-language announcement functionality, lawful intercept capabilities and other media server applications for voice over packet networks.

Element Management System (EMS)

Our Element Management System (EMS), is an advanced solution for centralized, standard-based management of our VoP gateways, covering all areas vital to the efficient operations, administration, management and provisioning of our Mediant™ and MediaPack™ VoP gateways.

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

Voice and Data Logging Hardware Integration Board Products

The SmartWORKS™ family of products is our voice and data logging hardware integration board product line. SmartWORKS™ boards for the call recording and voice/data logging industry are compatible with a multitude of Private Branch Exchange, or PBX, telephone system integrations.

Core Technologies

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

Low Bit Rate Voice Compression Algorithms

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

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

Advanced Digital Signal Processing Algorithms

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

- *Echo cancellation.* Low bit rate voice compression techniques introduce considerable delay, necessitating the use of echo cancellation algorithms. The key performance criterion of an echo canceller is its ability to deal with large echo reflections, long echo delays, fast changing echo characteristics, diverse telecommunications equipment and network effects. Our technology achieves low residual echo and fast response time to render echo effects virtually unnoticeable.
- *Fax transmission.* There are two widely used techniques for real time transmission of fax over networks based on Internet protocols: fax relay and fax spoofing. Fax relay takes place when a fax is sent from a fax machine through a gateway over networks based on Internet protocols in real time to a fax machine at the other end of the network. At the gateway, the analog fax signals are demodulated back into digital data, converted into packets, routed over the packet network and reassembled at the receiving end. Fax relay is used when the round trip network delay is small (typically below one second). When the round trip network delay increases, one of the fax machines may time out while waiting for a response from the other fax machine to arrive.
- *Data modem technology.* We have developed data modem technologies that facilitate data relay over packet networks. Our data modem relay software algorithms support all existing data modem standards up to a bit rate of 14.4 kbps.
- *Telephony signaling processing.* Various telephony signaling standards and protocols are employed to route calls over the traditional telephone network, some of which use “in-band” methods, which means that the signaling tones are sent over the telephone line just like the voice signal. As a result, in-band signaling tones may have to undergo the compression process just like the voice signal. Most low bit-rate voice coders, however, are optimized for speech signals and exhibit poor tone transfer performance. To overcome this, our processors are equipped with tone detection and tone generation algorithms. To provide seamless transparency between the traditional telephone network and packet networks for signaling, we employ various digital signal processing techniques for efficient tone processing.

Voice Communications Software

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

Media Processing

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

Digital Cellular Communications Technology

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

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

VoIP for Telephony over Cable Networks

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

Hardware Architectures for High Density Multi-Trunk Voice over Packet Systems

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

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

Customers

Our customers consist of OEMs, network equipment providers and systems integrators, carriers and distributors. Historically, we have derived the majority of our revenues from sales to a small number of customers. The identities of our principal customers have changed and we expect that they will continue to change, from year to year. We expect that a small number of customers will continue to account for a large percentage of our sales. Sales to Nortel Networks accounted for 18.6% of our revenues in 2004 and 16.3% of our revenues in 2005. No other customer accounted for more than 5.0% of our revenues in 2004 or in 2005.

Sales and Marketing

Our sales and marketing strategy is to achieve design wins with industry leaders in our targeted markets. 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. For these reasons, the sales cycles of our products to new customers are often lengthy, averaging approximately six to twelve months after achieving a design win. This time may be further extended because of internal testing, field trials and requests for the addition or customization of features.

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

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

Manufacturing

Texas Instruments Incorporated supplies all of the signal processor chips used for our signal processors. The communications processor currently used on our communications boards is manufactured by Motorola. We believe that similar communications processors are available from other suppliers. Other components are generic in nature and we believe they can be obtained from multiple suppliers.

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

We utilize contract manufacturing for substantially all of our manufacturing processes. Until the third quarter of 2002, all of our boards, modules and analog media gateways were assembled by third-party subcontractors in Israel. Since the third quarter of 2002, we have extended our manufacturing capabilities through third party subcontractors in the United States and in China. Our subsidiary, AudioCodes USA, utilizes third-party subcontractors in the United States and Mexico to manufacture its products. Our internal manufacturing activities consist primarily of the production of prototypes, test engineering, materials purchasing and inspection, final product configuration and quality control and assurance.

Industry Standards and Government Regulations

Our products must comply with industry standards relating to telecommunications equipment. Before completing sales in a country, our products must comply with local telecommunications standards, recommendations of quasi-regulatory authorities and recommendations of standards-setting committees. In addition, public carriers require that equipment connected to their networks comply with their own standards. Telecommunication-related policies and regulations are continuously reviewed by governmental and industry standards-setting organizations and are always subject to amendment or change. Although we believe that our products currently meet applicable industry and government standards, we cannot be sure that our products will comply with future standards.

We are subject to telecom industry regulations and requirements set by telecommunication carriers that address a wide range of areas including quality, final testing, packaging and use of environmentally friendly components. We are making efforts to comply with the European Union's Restriction of Hazardous Substances Directive that requires telecom equipment suppliers to stop the usage of some materials that are not environmentally friendly by July 1, 2006. Some of our products may not comply with this directive in 2006. We will attempt to comply with this directive in 2007. These materials include cadmium, hexavalent chromium, lead, mercury, polybrominated biphenyls and polybrominated diphenyl ethers. Under the directive, an extension for compliance through 2010 was granted with respect to the usage of lead in solders in telecommunication equipment. We expect that other countries, including countries we operate in, will adopt similar directives or other additional regulations.

Competition

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

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

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

Our principal competitors in the media server market segment are Cantana Technology, NMS Communications, Conveda, IP Unity, Cognitronics and Aculab. In addition, we face competition in software-based and hardware-based media servers from internal development at companies such as Nortel, Lucent, Siemens, Motorola, Tekelec and Sonus Networks.

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

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

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

Intellectual Property and Proprietary Rights

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

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

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

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

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

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

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

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

We have entered into technology licensing fee agreements with third parties. We expect that in the ordinary course of business we may be required to enter into additional licensing agreements. Under one agreement, we agreed to pay a third party royalty fees until 2008, based on 0.3% - 0.9% of our revenues.

Legal Proceedings

We are not a party to any material legal proceedings.

C. ORGANIZATIONAL STRUCTURE

List of Significant Subsidiaries

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

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

AudioCodes USA Inc. formerly known as Ai-Logix, a wholly owned subsidiary of AudioCodes Inc., is a Delaware corporation

AudioCodes Europe Limited, our wholly-owned subsidiary, is incorporated in England.

D. PROPERTY, PLANTS AND EQUIPMENT

We lease our main facilities, located in Airport City, Lod, Israel, which currently occupy approximately 111,000 square feet. We moved into these facilities in February 2004 which enabled us to consolidate all of our operations in Israel into one location.

Our U.S. subsidiary leases a 7,356 square foot facility in San Jose, California. Our subsidiary has additional offices in Raleigh, Chicago, Boston and Dallas. We also have a leased representative office in Beijing, China and in Tokyo, Japan.

Our U.S. subsidiary, AudioCodes USA, Inc., leases a 29,000 square foot facility in Somerset, New Jersey.

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

ITEM 4A. UNRESOLVED STAFF COMMENTS

None.

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

Critical Accounting Estimates

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

On an on-going basis, management evaluates its estimates and judgments, including those related to revenue recognition and allowance for sales returns, allowance for doubtful accounts, inventories, investment in an affiliated companies, goodwill and income taxes and valuation allowance. Management bases its estimates and judgments on historical experience and on various other factors that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources.

Our management has reviewed these critical accounting policies and related disclosures with our Audit Committee. See Note 2 to the Consolidated Financial Statements, which contain additional information regarding our accounting policies and other disclosures required by US GAAP.

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

- Revenue recognition and allowance for sales returns;
- Inventories;
- Investment in affiliated companies;
- Goodwill; and
- Income taxes and valuation allowance.

Revenue Recognition and Allowance for Sales Returns

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

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

We maintain a provision for product returns and exchanges. This provision is based on historical sales returns, analysis of credit memo data and other known factors. This provision amounted to \$294,000 in 2003, \$619,000 in 2004 and \$545,000 in 2005.

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

Inventories

Inventories are stated at the lower of cost or market value. Cost is determined using the “moving average cost” method for raw materials and on the basis of direct manufacturing costs for finished products. We periodically evaluate the quantities on hand relative to current and historical selling prices and historical and projected sales volume and technological obsolescence. Based on these evaluations, inventory write-offs and write-down provisions are provided to cover risks arising from slow moving items, technological obsolescence, excess inventories, discontinued products and for market prices lower than cost. We wrote-off and wrote-down inventory in a total amount of \$835,000 in 2003, \$1.2 million in 2004 and \$1.2 million in 2005.

Investment in Affiliated Companies

Through December 31, 2005, we had invested an aggregate of \$2.5 million in a privately-held company engaged in speech recognition. In addition, during 2005, we granted convertible loans in the amount of \$611,000. We currently own approximately 41% of the equity in this company. This investment is accounted for by the equity method and is reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the investment may not be recoverable. As of December 31, 2005, based on management’s most recent analyses, no impairment losses have been identified in connection with this investment.

In July, 2005, we had invested \$707,000 in an unrelated privately-held company and currently own 19.5% of its Ordinary shares. This investment is accounted for by the equity method and is reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the investment may not be recoverable. As of December 31, 2005, based on management's most recent analyses, no impairment losses have been identified in connection with this investment.

Goodwill

SFAS No.142 requires goodwill to be tested for impairment at least annually or between annual tests in certain circumstances, and written down when impaired, rather than being amortized as previous accounting standards required. Goodwill is tested for impairment at the reporting unit level by comparing the fair value of the reporting unit with its carrying value. We operate in one operating segment, and this segment comprises our only reporting unit. In connection with our acquisition of selected assets of UAS, we recorded \$4.3 million of goodwill in 2003 and \$1.0 million of goodwill in 2004. We recorded \$3.8 million of goodwill in 2004 in connection with our acquisition of AudioCodes USA, formerly Ai-Logix. We paid an additional \$10 million in March 2005 based on the achievement of revenue milestones and additional terms by AudioCodes USA during 2004 and 2005. This contingent was recorded as part of the acquisition cost as additional goodwill during 2005. The Goodwill was reduced in the amount of \$ 456,000 upon utilization of pre-acquisition carry forward tax losses in accordance with SFAS No. 141. Goodwill in connection with the UAS and AudioCodes USA acquisitions was reviewed for impairment during the fourth quarter of 2005. No impairment losses have been identified in connection with these acquisitions.

Income taxes and valuation allowance

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

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

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

A. OPERATING RESULTS

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

Overview

We design, develop and market enabling technologies and products for the transmission of high quality voice, data and fax over packet networks. Newly developed equipment based on advanced voice communications standards enables packet networks to carry voice and data more efficiently and at a lower cost than traditional telephone networks by using substantially less network capacity. Our products are designed to enable our customers to build packet voice networking equipment that provides comparable communication quality to that of traditional telephone networks. Our communication boards are the building blocks for connecting traditional telephone networks with packet voice networks and provide high performance and large capacity on open telecommunications platform-based gateways. We have continued to broaden our offerings as we have expanded in the last few years from selling chips to boards, subsystems, media gateway systems and media servers.

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

Effective January 1, 2006, we account for stock-based compensation in accordance with Statement of Financial Accounting Standards No. 123R- "Share-Based Payments". SFAS No. 123(R) requires the fair value of all equity-based awards granted to employees to be recognized in financial statements beginning in the first quarter of 2006. The result is that we are required to record an expense with respect to stock option grants, even if the exercise price of the stock options is equal to the market price of the underlying shares on the date of grant. The adoption of SFAS No. 123(R) is expected to have a material adverse effect on our results of operations, although it will have no impact on our overall financial position or cash flows. SFAS No. 123(R) also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as required under accounting principles in effect through 2005. This requirement will reduce net operating cash flows and increase net financing cash flows in periods after adoption.

Nortel Networks accounted for 14.3% of our total revenues in 2003, 18.6% of our total revenues in 2004 and 16.3% of our revenues in 2005. Our top five customers accounted for 34.2% of our total revenues in 2003, 35.7% of our total revenues in 2004 and 31.1% of our revenues in 2005. Based on our experience, we expect that our largest customers may change from period to period. If we lose a large customer and fail to add new customers to replace lost revenue our operating results may be materially adversely affected.

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

	2003	2004	2005
Americas	56.9%	62.3%	57.5%
Far East	23.7	14.3	12.5
Europe	12.6	13.3	19.4
Israel	6.8	10.1	10.6
Total	100.0%	100.0%	100.0%

Part of our strategy involves the acquisition of complementary businesses and technologies. Our first strategic acquisition involved the purchase of the UAS product group from Nortel Networks in April 2003. This acquisition added new media server technology and products that we could offer to our customers and provided us with research and development capability in the United States. As a result of our supply agreement with Nortel in connection with this transaction, we significantly increased our sales to Nortel from the relatively small amount of sales in 2002 prior to the acquisition, with sales to Nortel accounting for 16.3% of our revenues in 2005 compared to 18.6% of our revenues in 2004 and 14.3% of our revenues in 2003. We expect that sales to Nortel will continue to account for a high percentage of our revenues in 2006.

We completed a second acquisition in May 2004, acquiring AudioCodes USA formerly Ai-Logix, a leading provider of advanced voice recording hardware technology. We believe that this acquisition has enhanced our board line business and provides an entry into the call recording market and the computer telephony integration, or CTI, market by leveraging our VoP expertise with the technology, strategic partnerships and customer base of AudioCodes USA. We paid \$10.0 million in cash at the closing of the transaction. We paid an additional \$10.0 million in March 2005 based on the achievement of revenue milestones and additional terms by the AudioCodes USA during 2004 and 2005. The payment was recorded as part of the acquisition cost as additional goodwill in accordance with the provisions of SFAS No. 141 in 2005.

The increase in the percentage of our revenues in 2005 from customers located in Europe was due to increased sales in Eastern Europe. The increase in the percentage of our revenues from customers located in the Americas during 2004 was primarily the result of our increased sales in the United States due to increased sales to Nortel and inclusion of sales by AudioCodes USA.

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

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

The accelerated demand for Voice over IP, or VoIP, technology has impacted our business during the last three years. Over the past three years, the shift from traditional circuit-switched networks to next generation packet-switched networks continued to gain momentum. As data traffic becomes the dominant factor in communications, service providers are building and maintaining converged networks for integrated voice and data services. In addition, underdeveloped markets without basic wireline service in countries such as China and India and certain countries in Eastern Europe are beginning to use VoP technology to deliver voice and data services that were previously unavailable. These trends are helping to overcome the downturn in the telecommunications industry that affected us during previous years.

Unfavorable economic conditions affected the communications sector during the period from 2000 to 2003. This caused a decrease in our revenues from 2000 to 2001 and from 2001 to 2002. It also resulted in our net losses in 2001, 2002 and 2003. Sales of products, particularly for applications in converged networks, to OEMs for use by large service providers declined significantly during these periods. In response to our revenue decreases, we implemented expense control programs to reduce operating expenses, while at the same time we continued to invest in developing products that we believe our customers will need as the market for telecommunications equipment improves. Many companies that had reduced their capital expenditures during the recent economic downturn have begun to invest again in their communications networks. The acceptance of next generation packet-switched networks is contributing to these infrastructure investments as enterprises and service providers begin to increase their use of IP networks for data traffic, such as fax transmissions, and VoIP. These improving market conditions helped our revenues to increase in 2003, 2004 and 2005, and we expect our revenues in 2006 to exceed our revenues in 2005.

Results of Operations

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

	2003	2004	2005
Statement of Operations Data:			
Revenues	100.0%	100.0%	100.0%
Cost of revenues	45.3	41.5	40.6
Gross profit	54.7	58.5	59.4
Operating expenses:			
Research and development, net	35.0	24.2	21.1
Selling and marketing	32.9	24.0	22.4
General and administrative	9.2	5.9	5.2
Total operating expenses	77.1	54.1	48.7
Operating income (loss)	(22.4)	4.4	10.7
Financial income, net	4.3	2.6	2.1
Equity in losses of affiliated companies, net	1.0	0.6	0.6
Income (loss) before taxes on income	(19.1)	6.4	12.2
Taxes on income	-	0.3	0.7
Net income (loss)	(19.1)%	6.1%	11.5%

Year Ended December 31, 2005 Compared to Year Ended December 31, 2004

Revenues. Revenues increased 40.0% to \$115.8 million in 2005 from \$82.8 million in 2004. The increase in revenues was primarily due to an increase of \$15.0 million in sales in the United States derived mainly from the inclusion of the results of AudioCodes USA for all of 2005. In 2004, the results of AudioCodes USA were included only beginning with its acquisition in May 2004. Sales in Europe increased by \$11.5 million primarily as a result of higher demand in Eastern Europe for our products. Our increase in revenues in 2005 also reflected the increased interest and activity in the market for packet-based VoIP products.

Gross Profit. Cost of revenues includes the manufacturing cost of hardware, quality assurance, overhead related to manufacturing activity and technology licensing fees payable to third parties. Gross profit increased to \$68.8 million in 2005 from \$48.4 million in 2004. Gross profit as a percentage of revenues increased to 59.4% in 2005 from 58.5% in 2004. The increase in our gross profit percentage was primarily a result of higher sales volume that allowed us to leverage our operations as our manufacturing overhead was spread over a larger sales base. In addition, the improvement in gross margin was due to favorable product mix in 2005. The increase in gross profit percentage was also due to our ability to offset the continued decline in average selling prices of our products with a reduction in manufacturing costs. The reduction in manufacturing costs was primarily due to a reduction in our raw material costs.

Research and Development Expenses. Research and development expenses consist primarily of compensation and related costs of employees engaged in ongoing research and development activities, development-related raw materials and the cost of subcontractors. Research and development expenses increased 22.0% to \$24.4 million in 2005, from \$20.0 million in 2004 and decreased as a percentage of revenues to 21.1% in 2005 from 24.2% in 2004. The increase in net research and development expenses was primarily due to additions to our research and development personnel resulting from the acquisition of AudioCodes USA during the second quarter of 2004. We expect that research and development expenses will continue to increase in absolute dollar terms as a result of our continued development of new products.

Selling and Marketing Expenses. Selling and marketing expenses consist primarily of compensation for selling and marketing personnel, as well as exhibition, travel and related expenses. Selling and marketing expenses increased 30.4% in 2005 to \$25.9 million from \$19.9 million in 2004. As a percentage of revenues, selling and marketing expenses decreased to 22.4% in 2005 from 24.0% in 2004. The increase in selling and marketing expenses was primarily due to an increase in selling and marketing personnel and associated expenses, as well as additional personnel as a result of the acquisition of AudioCodes USA. We expect that selling and marketing expenses will continue to increase in absolute dollar terms as a result of an expected increase in our sales force and marketing activities.

General and Administrative Expenses. General and administrative expenses consist primarily of compensation for finance, human resources, general management, rent, network and bad debt reserve, as well as insurance and professional services expenses. General and administrative expenses increased 23.8% to \$6.0 million in 2005 from \$4.9 million in 2004. As a percentage of revenues, general and administrative expenses decreased to 5.2% in 2005 from 5.9% in 2004. The increase in general and administrative expenses in 2005 was primarily the result of consolidating the expenses of our AudioCodes USA subsidiary, which was acquired in May 2004. We expect that general and administrative expenses will increase in absolute dollar terms to support our expected growth.

Equity in Losses of Affiliated Companies. Equity in losses of affiliated companies were \$693,000 in 2005 compared to \$516,000 in 2004. We believe that the products being developed by affiliated companies may enable us to enter new markets and to offer new products.

Financial Income, Net. Financial income consists primarily of interest derived on cash and cash equivalents, short-term and long-term marketable securities, short-term and long-term bank deposits and structured notes, net of interest accrued in connection with our senior convertible notes and bank charges. Financial income, net, in 2005 was \$2.5 million compared with financial income of \$2.2 million in 2004. The increase in financial income during 2005 was primarily due to higher interest rates and interest income, net, on the \$120.2 million of net proceeds from our sale of senior convertible notes in November 2004.

Taxes on Income Our effective tax rate was 5.2% in 2004 and 5.6% in 2005. These relatively low tax rates were mainly achieved as a result of the Approved Enterprise status granted to our production facilities in Israel.

Year Ended December 31, 2004 Compared to Year Ended December 31, 2003

Revenues. Revenues increased 87.1% to \$82.8 million in 2004 from \$44.2 million in 2003. The increase in revenues was primarily due to an increase in sales in the United States, derived mainly from the inclusion of a full year of sales by our UAS product group, which was acquired in April 2003, and from sales generated as a result of our acquisition of AudioCodes USA in May 2004. Our increase in revenues in 2004 also reflected the increased interest and activity in the market for packet-based VoIP products.

Gross Profit. Cost of revenues includes the manufacturing cost of hardware, quality assurance, overhead related to manufacturing activity and technology licensing fees payable to third parties. Gross profit increased to \$48.4 million in 2004 from \$24.2 million in 2003. Gross profit as a percentage of revenues increased to 58.5% in 2004 from 54.7% in 2003. The increase in our gross profit percentage was primarily a result of higher sales volume that allowed us to leverage our operations as our manufacturing overhead was spread over a larger sales base. In addition, gross profit percentage increased because of higher sales of integrated systems which usually have higher margins than sub-systems and chips. In the first quarter of 2004, we completed product integration and started shipping UAS platforms based on our hardware which allowed us to achieve better margins on these products. The increase in gross profit percentage was also due to our ability to offset the continued decline in average selling prices of our products with a reduction in manufacturing costs. The reduction in manufacturing costs was primarily due to a reduction in our raw material costs.

Research and Development Expenses. Research and development expenses consist primarily of compensation and related costs of employees engaged in ongoing research and development activities, development-related raw materials and the cost of subcontractors. Research and development expenses increased 29.3% to \$20.0 million in 2004, from \$15.5 million in 2003 and decreased as a percentage of revenues to 24.2% in 2004 from 35.0% in 2003. The increase in net research and development expenses was primarily due to additions to our research and development personnel resulting from the acquisition of the UAS product group from Nortel Networks during the second quarter of 2003 and the acquisition of AudioCodes USA during the second quarter of 2004. We expect that research and development expenses will continue to increase in absolute dollar terms as a result of our continued development of new products.

Selling and Marketing Expenses. Selling and marketing expenses consist primarily of compensation for selling and marketing personnel, as well as exhibition, travel and related expenses. Selling and marketing expenses increased 36.8% in 2004 to \$19.9 million from \$14.5 million in 2003. As a percentage of revenues, selling and marketing expenses decreased to 24.0% in 2004 from 32.9% in 2003. The increase in selling and marketing expenses was primarily due to an increase in selling and marketing personnel and associated expenses, as well as additional personnel as a result of the acquisition of AudioCodes USA. We expect that selling and marketing expenses will continue to increase in absolute dollar terms as a result of an expected increase in our sales force and marketing activities.

General and Administrative Expenses. General and administrative expenses consist primarily of compensation for finance, human resources, general management, rent, network and information systems and bad debt reserve, as well as insurance and professional services expenses. General and administrative expenses increased 19.3% to \$4.9 million in 2004 from \$4.1 million in 2003. As a percentage of revenues, general and administrative expenses decreased to 5.9% in 2004 from 9.2% in 2003. The increase in general and administrative expenses in 2004 was primarily the result of consolidating the expenses of our AudioCodes USA subsidiary, which was acquired in May 2004. During 2003, we recorded \$924,000 of expenses in connection with our moving into our new premises in Israel. We did not have similar expenses in 2004. We expect that general and administrative expenses will increase in absolute dollar terms to support our expected growth.

Equity in Losses of Affiliated Company. Equity in losses of an affiliated company were \$516,000 in 2004 compared to \$429,000 in 2003. We believe that the products being developed by the affiliated company may enable us to enter new markets and to offer new products.

Financial Income, Net. Financial income consists primarily of interest derived on cash and cash equivalents and long term bank deposits and structured notes, net of interest accrued in connection with our senior convertible notes and bank charges. Financial income, net, in 2004 was \$2.2 million compared with financial income of \$1.9 million in 2003. The increase in financial income during 2004 was primarily due to higher interest rates and interest income, net, on the \$120.2 million of net proceeds from our sale of senior convertible notes in November 2004.

Approved Enterprises and Corporate Taxes in Israel

We have elected the alternative package of tax exemptions and reduced tax rates for our production facilities that have received Approved Enterprise status. Accordingly, income derived from these facilities is generally entitled to a tax-exemption period of two to four years and a reduced corporate tax rate of 10% to 25% for an additional period of six to eight years, based on our percentage of foreign investment. The tax benefits for our existing Approved Enterprise programs are scheduled to gradually expire by 2013. The period of tax benefits for each capital investment plan expires upon the earlier of: (1) twelve years from completion of the investment under the approved plan, or (2) fourteen years from receipt of approval.

Out of our retained earnings as of December 31, 2005, approximately \$540,000 are tax-exempt. If we were to distribute this tax-exempt income before our complete liquidation, it would be taxed at the reduced corporate tax rate applicable to these profits (10% to 25%), and an income tax liability of up to approximately \$135,000 would be incurred. Our board of directors has determined that we will not distribute any amounts of our undistributed tax exempt income as dividend. We intend to reinvest our tax-exempt income and not to distribute such income as a dividend. Accordingly, no deferred income taxes have been provided on income attributable to our Approved Enterprise.

If we fail to meet the requirements of an Approved Enterprise we would be subject to corporate tax in Israel at the regular statutory rate. We could also be required to refund tax benefits, with interest and adjustments for inflation based on the Israeli consumer price index.

On April 1, 2005, an amendment to the law came into effect (“the Amendment”) and has significantly changed the provisions of the law. The Amendment limits the scope of enterprises which may be approved by the Investment Center by setting criteria for the approval of a facility as a Beneficiary Enterprise, such as provisions generally requiring that at least 25% of the Beneficiary Enterprise’s income will be derived from export. Additionally, the Amendment enacted major changes in the manner in which tax benefits are awarded under the law so that companies no longer require Investment Center approval in order to qualify for tax benefits.

In addition, the law provides that terms and benefits included in any certificate of approval already granted will remain subject to the provisions of the law as they were on the date of such approval. Therefore, the Company’s existing “Approved Enterprises” will generally not be subject to the provisions of the Amendment. As a result of the Amendment, tax-exempt income generated under the provisions of the law has amended, will subject the Company to taxes upon distribution or liquidation and the Company may be required to record a deferred tax liability with respect to such tax-exempt income.

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

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

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

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

Year ended December 31,	Israeli inflation rate %	NIS Devaluation Rate %	Israeli inflation adjusted for devaluation %
2003	(1.9)	(7.6)	5.7
2004	1.2	(1.6)	2.8
2005	2.4	6.8	(4.4)

Recent Accounting Pronouncements

On December 16, 2004, the Financial Accounting Standards Board (“FASB”) issued Statement No. 123 (revised 2004), “Share-Based Payment” (“SFAS No. 123(R)”), which is a revision of SFAS No. 123. Generally, the approach in SFAS No. 123(R) is similar to the approach described in SFAS No. 123. However, SFAS No. 123 permitted, but did not require, share-based payments to employees to be recognized based on their fair values while SFAS No. 123(R) requires all share-based payments to employees including grants of employee stock options and shares issued under the ESPP to be recognized based on their fair values. SFAS No. 123(R) also revises, clarifies and expands guidance in several areas, including measuring fair value, classifying an award as equity or as a liability and attributing compensation cost to reporting periods. SFAS No. 123(R) is effective for us for periods commencing January 1, 2006. SFAS No. 123(R) permits public companies to adopt its requirements using either the modified prospective or modified retrospective method. We adopted SFAS No. 123(R), using the modified prospective method of adoption in which compensation cost is recognized beginning with the effective date (a) based on the requirements of Statement SFAS No. 123(R) for all share-based payments granted after the effective date and (b) based on the requirements of SFAS No. 123 for all awards granted to employees prior to the effective date of SFAS No. 123(R) that remain unvested on the effective date.

In March 2005, the Securities and Exchange Commission (“SEC”) released SEC Staff Accounting Bulletin No. 107, “Share-Based Payment” (“SAB 107”). SAB 107 provides the SEC staff’s position regarding the application of SFAS No. 123(R) and contains interpretive guidance related to the interaction between SFAS No. 123(R) and certain SEC rules and regulations, and also provides the SEC staff’s views regarding the valuation of share-based payment arrangements for public companies. The adoption of SFAS No. 123(R) and SAB 107 have a material effect on our results of operations.

In November 2004, the FASB issued SFAS No. 151, “Inventory Costs, an Amendment of ARB No. 43, Chapter 4”. SFAS No. 151 amends Accounting Research Bulletin (“ARB”) No. 43, Chapter 4, to clarify that abnormal amounts of idle facility expense, freight handling costs and wasted materials (spoilage) should be recognized as current-period charges. In addition, SFAS No. 151 requires that the allocation of fixed production overhead to the costs of conversion be based on the normal capacity of the production facilities. SFAS No. 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The adoption of SFAS No. 151 does not have a material effect on our financial position or results of operation

In May 2005, the FASB issued SFAS No. 154, “Accounting Changes and Error Corrections”, a replacement of APB No. 20, “Accounting Changes” and SFAS No. 3, “Reporting Accounting Changes in Interim Financial Statements”. SFAS No. 154 provides guidance on the accounting for and reporting of accounting changes and error corrections. APB No. 20 previously required that most voluntary changes in accounting principles be recognized by including in net income for the period of the change, the cumulative effect of changing to the new accounting principle. SFAS No. 154 requires retroactive application to prior periods’ financial statements of a voluntary change in accounting principles unless it is impracticable. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. As of December 31, 2005, adoption of SFAS No. 154 is not expected to have a material impact on our financial position or results of operation.

In November 2005, the FASB issued FSP FAS 115-1. The FSP addresses the determination as to when an investment is considered impaired, whether that impairment is other than temporary, and the measurement of an impairment loss. The FSP also includes accounting considerations subsequent to the recognition of other than-temporary impairment and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. The guidance in this FSP amends SFAS No. 115, “Accounting for Certain Investments in Debt and Equity”. The FSP replaces the impairment evaluation guidance of EITF Issue No. 03-1, “The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments,” with references to the existing other-than-temporary impairment guidance. The FSP clarifies that an investor should recognize an impairment loss no later than when the impairment is deemed other-than-temporary, even if a decision to sell an impaired security has not been made. The guidance in this FSP is to be applied to reporting periods beginning after December 15, 2005. As of December 31, 2005, adoption of FSP FAS 115-1 is not expected to have a material impact on our financial position or results of operations.

We have financed our operations for the last three years from the remaining proceeds from prior public offerings of our Ordinary shares, as well as with cash from operations generated in 2004 and 2005. In November 2004, we raised net proceeds of approximately \$120.2 million in a private placement of \$125.0 million aggregate principal amount of our 2.00% Senior Convertible Notes due 2024. As of December 31, 2005, we had \$220.3 million in cash and cash equivalents, short-term and long-term marketable securities, short-term and long-term bank deposits and structured notes. We expect to use approximately \$85 million of cash in 2006 to pay the purchase price and related expenses in connection with our proposed acquisition of Nuera.

In connection with our acquisition of AudioCodes USA, formerly Ai-Logix, we paid an additional \$10 million in March 2005 based on the achievement of revenue milestones and additional terms by the AudioCodes USA during 2004 and 2005. This payment was recorded as part of the acquisition cost as additional goodwill during 2005.

Our operating activities provided cash in the amount of \$13.3 million in 2005, primarily due to our net income and depreciation and amortization expenses, which were partially offset by an increase in trade receivables and deferred tax assets. Our operating activities provided cash in the amount of \$3.5 million in 2004, primarily due to our net income, depreciation and amortization expenses and an increase in trade payables and other payables and accrued expenses, which were partially offset by an increase in trade receivables and inventories and other receivables and prepaid expenses. Our operating activities used cash in the amount of \$6.4 million in 2003, primarily due to our net loss and an increase in trade receivables, which were partially offset by depreciation and amortization expenses and an increase in trade payables and other payables and accrued expenses.

In 2005, our investing activities used cash in the amount of \$113.0 million, primarily due to our investment of a significant portion of the proceeds from our sale of convertible notes in short-term and long-term marketable securities, short-term and long-term bank deposits and structured notes and payments in connection with the acquisition of AudioCodes USA. In 2004, our investing activities used cash in the amount of \$15.9 million, primarily due to the acquisition of AudioCodes USA and UAS and the purchase of property and equipment. In 2003, our investing activities provided cash in the amount of \$6.1 million primarily due to proceeds from short-term bank deposits, which were partially offset by investment in long-term bank deposits and structured notes, payments of \$4.4 million in connection with the acquisition of UAS and the purchase of property and equipment. Our capital expenditures were \$2.4 million in 2005, \$4.3 million in 2004 and \$2.0 million in 2003. The majority of our capital investment has been for testing equipment, an enterprise resources planning system, computers, peripheral equipment, software, office furniture and leasehold improvements. We used working capital to finance these expenditures.

In 2005, financing activities provided \$3.8 million due to proceeds from issuance of our shares upon exercise of options and from purchases of our shares under our Employee Stock Purchase Plans. In 2004, financing activities provided \$130.4 million, due to the net proceeds of \$120.2 million from our private placement of \$125.0 million aggregate principal amount of our 2.00% Senior Convertible Notes due 2024 and \$10.2 million from the issuance of our shares upon exercise of options and from purchases of our shares under our Employee Stock Purchase Plans. In 2003, financing activities provided \$1.4 million due to issuance of shares upon exercise of options and from shares purchased under our Employee Stock Purchase Plans, partially offset by \$215,000 used to repurchase our ordinary shares.

We anticipate that our operating expenses will be a material use of our cash resources for the foreseeable future. We believe that our current working capital is sufficient to meet our present cash requirements. Part of our strategy is to pursue acquisition opportunities. If we do not have available sufficient cash to finance our operations and the completion of one or more acquisitions, 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.

C. *RESEARCH AND DEVELOPMENT, PATENTS AND LICENSES, ETC.*

Research and Development

In order to accommodate the rapidly changing needs of our markets, we place considerable emphasis on research and development projects designed to improve our existing products and to develop new ones. We are developing more advanced communications boards and analog and digital media gateways for carrier and enterprise applications. Our platforms will feature increased trunk capacity, new functionalities, enhanced signaling software and compliance with new control protocols. As of December 31, 2005, 233 of our employees were engaged primarily in research and development on a full-time basis. We also employed 9 employees on a part-time basis.

Our research and development expenses were \$24.4 million in 2005 compared to \$20.0 million in 2004 and \$15.5 million in 2003. From time to time we have received royalty-bearing grants from the Office of the Chief Scientist of the Israeli Ministry of Industry, Trade and Labor, or the OCS. As a recipient of grants from the OCS, we are obligated to perform all manufacturing activities for projects subject to the grants in Israel unless we receive an exemption. Know-how from the research and development which is used to produce products may not be transferred to third parties without the approval of the OCS and may further require material payments. The OCS approval is not required for the export of any products resulting from such research or development. Through December 31, 2005, we had obtained grants from the OCS aggregating \$1.6 million for certain of our research and development projects. We are obligated to pay royalties to the OCS, amounting to 3%-4.5% of the sales of the products and other related revenues generated from such projects, up to 100% of the grants received, linked to the U.S. dollar and bearing interest at the rate of LIBOR at the time of grant. The obligation to pay these royalties is contingent on actual sales of the products and in the absence of such sales no payment is required.

D. TREND INFORMATION

The accelerated demand for VoIP technology has impacted our business during the last three years. Over the past three years, the shift from traditional circuit-switched networks to next generation packet-switched networks continued to gain momentum. As data traffic becomes the dominant factor in communications, service providers are building and maintaining converged networks for integrated voice and data services. In addition, underdeveloped markets without basic wireline service in countries such as China and India and certain countries in Eastern Europe are beginning to use VoP technology to deliver voice and data services that were previously unavailable. These trends are helping to overcome the downturn in the telecommunications industry that affected us during previous years.

In 2005, we continued to experience pressure to shorten our lead times in supplying products to customers. Some of our customers are implementing “demand pull” programs by which they only purchase our product very close to the time, if not simultaneously with the time, they plan to sell their product. We are increasing our sales efforts in new markets, such as Latin America, Eastern Europe and Far East. We have introduced system level products, and new applications in our product lines. . We are still experiencing low visibility into customer demand for our products and our ability to predict our level of sales.

Unfavorable economic conditions affected the communications sector during the period from 2000 to 2003. This caused a decrease in our revenues from 2000 to 2001 and from 2001 to 2002. It also resulted in our net losses in 2001, 2002 and 2003. Sales of products, particularly for applications in converged networks, to OEMs for use by large service providers declined significantly during these periods. In response to our revenue decreases, we implemented expense control programs to reduce operating expenses, while at the same time we continued to invest in developing products that we believe our customers will need as the market for telecommunications equipment improves. Many companies that had reduced their capital expenditures during the recent economic downturn have begun to invest again in their communications networks. The acceptance of next generation packet-switched networks is contributing to these infrastructure investments as enterprises and service providers begin to increase their use of IP networks for data traffic, such as fax transmissions, and VoIP. These improving market conditions helped our revenues to increase in 2003, 2004 and 2005, and we expect our revenues in 2006 to exceed our revenues in 2005.

E. OFF-BALANCE SHEET ARRANGEMENTS

We do not have any “off-balance sheet arrangements” as this term is defined in Item 5E of Form 20-F.

F. TABULAR DISCLOSURE OF CONTRACTUAL OBLIGATIONS

As of December 31, 2005, our contractual obligations were as follows (in thousands):

	PAYMENTS DUE BY PERIOD				
	TOTAL	LESS THAN 1 YEAR	1-3 YEARS	3-5 YEARS	MORE THAN 5 YEARS
Senior convertible notes	125,000	-	-	-	125,000
Rental and lease commitments	18,483	2,530	4,876	4,838	6,239
Total cash obligations	143,483	2,530	4,876	4,838	131,239

Our obligation for accrued severance pay under Israel's Severance Pay Law as of December 31, 2005 was \$5.9 million, of which \$5.4 million was funded through deposits into severance pay funds, leaving a net obligation of approximately \$481,000.

ITEM 6. DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES

A. DIRECTORS AND SENIOR MANAGEMENT

The following table sets forth certain information with respect to our directors, senior executive officers and key employees at June 16, 2006:

Name	Age	Position
Shabtai Adlersberg	53	Chairman of the Board, President and Chief Executive Officer
Nachum Falek	35	Vice President, and Chief Financial Officer
Eyal Frishberg	47	Vice President, Operations
Eli Nir	39	Vice President, Research and Development
Lior Aldema	40	Vice President, Marketing and Product Management
Ben Rabinowitz	39	Vice President, Marketing and Sales, North America
Yehuda Hershkowitz	39	Vice President, Systems
Tal Dor	37	Vice President, Human Resources
Gary Drutin	45	Vice President, Channel Operations and Marketing
Moshe Tal	52	President and Chief Executive Officer, AudioCodes USA Inc.
David Perez	44	Vice President, Sales, Asia Pacific
Joseph Tenne	50	Director
Dana Gross	39	Director
Dr. Eyal Kishon	46	Director
Doron Nevo	50	Director

Shabtai Adlersberg co-founded AudioCodes in 1993, and has served as our Chairman of the Board and Chief Executive Officer since inception. Mr. Adlersberg co-founded DSP Group, a semiconductor company, in 1987. From 1987 to 1990, Mr. Adlersberg served as the Vice President of Engineering of DSP Group, and from 1990 to 1992, he served as Vice President of Advanced Technology. As Vice President of Engineering, Mr. Adlersberg established a research and development team for digital cellular communication which was spun-off in 1992 as DSP Communications. Mr. Adlersberg also serves as Chairman of the Board of Directors of Natural Speech Communication Ltd. and as a director of MailVision Ltd and CTI Squared Ltd. Mr. Adlersberg holds an M.Sc. in Electronics and Computer Engineering from Tel Aviv University and a B.Sc. in Electrical Engineering from the Technion-Israel Institute of Technology, or the Technion.

Nachum Falek joined AudioCodes in April 2000 and became our Vice President, and Chief Financial Officer in November 2003. From 2000 to 2003, he served as Director of Finance. Prior to joining AudioCodes, Mr. Falek served as Controller at ScanVec-Amiable Ltd. From 1998 to 1999, he was a Manager at Ernst & Young in Israel. Mr. Falek holds a B.A. in Accounting and Economics from Haifa University, an M.B.A. from Tel Aviv University, and is a licensed CPA in Israel.

Eyal Frishberg has served as our Vice President, Operations since October 2000. From 1997 to 2000, Mr. Frishberg served as Associate Vice President, SDH Operations in ECI Telecom Ltd., a major telecommunication company. From 1987 to 1997, Mr. Frishberg worked in various operational positions in ECI Telecom including as manager of ECI production facility and production control. Mr. Frishberg worked from 1994 until 1997 for ELTA company, part of Israeli Aircraft Industries in the planning and control department. Mr. Frishberg holds a B.Sc. in Industrial Engineering from Tel Aviv University and an M.B.A. from Ben-Gurion University of the Negev.

Eli Nir has served as our Vice President, Research and Development since April 2001. He has been employed by us since 1996, when he founded and headed our System Software Group in our research and development department. Prior to 1996, Mr. Nir served as an officer in the Technical Unit of the Intelligence Corps of the Israeli Defense Forces (Major), heading both operational units and large development groups mostly related to digital processing. Mr. Nir holds an M.B.A. and an M.Sc. from Tel Aviv University in Digital Speech Processing and a B.Sc. from the Technion.

Lior Aldema has served as our Vice President, Product Management since January 2002. Mr. Aldema has also served as our Vice President Marketing since February 2003. He has been employed by us since 1998, when he was team leader and later headed our System Software Group in our research and development department. Prior to 1998, Mr. Aldema served as an officer in the Technical Unit of the Intelligence Corps of the Israeli Defense Forces (Major), heading both operational units and large development groups related to various technologies and headed one of the largest projects conducted in the IDF and executed by the Israeli Defense industry corporations. Mr. Aldema holds an M.B.A. from Tel Aviv University and a B.Sc. from the Technion.

Ben Rabinowitz joined us in December, 1999 and became our Vice President of Marketing and Sales for North America in October 2004. Previously, Mr. Rabinowitz served as Vice President of our Systems Group. From 1998 to 1999, Mr. Rabinowitz served as Director for Product Marketing at Westell Inc., a broadband access company. From 1997 to 1998, Mr. Rabinowitz served as Senior Director within the strategy practice of Technology Solutions Company, a technology consulting firm. Mr. Rabinowitz also previously served in Ernst & Young's consulting practice from 1994 to 1997, and provided consulting services to telecommunications companies. Mr. Rabinowitz holds an M.B.A. from Georgetown University.

Yehuda Hershkovits has served as our Vice President, Systems Group since 2003. From 2001 to 2003, Mr. Hershkovits served as our Vice President, Advanced Products. From 2000 to 2001, Mr. Hershkovits served as our Director of Advanced Technologies. From 1994 to 1998 and during 1999, Mr. Hershkovits held a variety of research and development positions at Advanced Recognition Technologies, Ltd., a voice and handwriting recognition company, heading its research and development from 1999 to 2000 as Vice President, Research and Development. From 1998 to 1999, Mr. Hershkovits developed various wireless communication algorithms at Comsys, a telecommunications company. Mr. Hershkovits holds an M.Sc. and a B.Sc., from the Technion both in the area of telecommunications.

Tal Dor has served as our Vice President of Human Resources since March 2000. For more than three years prior to March 2000, Ms. Dor acted as a consultant in Israel to, among others, telephone and cable businesses, as well as health and social service organizations. Ms. Dor holds a B.A. in psychology, from Ben-Gurion University of the Negev and an M.A. in psychology from Tel Aviv University.

Moshe Tal joined us in May 2004 in connection with the acquisition of Ai-Logix, now known as AudioCodes USA, Inc. and serves as the President and CEO of our AudioCodes USA subsidiary. Mr. Tal co-founded Ai-Logix in 1991, and has served as its President and CEO since 1998. Mr. Tal has more than twenty-five years of product design and engineering experience, principally associated with analog and digital signal processing technologies. Mr. Tal holds a B.Sc. in Electronic Engineering from Tel Aviv University

Gary Drutin joined us in 2004 as Vice President of Channel Operations and Marketing. From 2001 until 2004 Mr. Drutin was Country Manager and General Manager for Cisco Israel, Cyprus and Malta and from 1997 until 2001 served as regional sales manager for service providers and enterprises for Cisco Israel. From 1990 until 1997, he served in sales management roles at Digital Equipment Corporation Israel. Mr. Drutin holds an M.B.A degree from Tel-Aviv University in Information Systems and Marketing and a B.Sc. degree in Computer Engineering from the Technion.

David E. Perez joined us in February 2002, and became our Vice President of the Asia Pacific region in January 2006. Mr. Perez served as our Vice President of Sales for Latin America, Iberia and the Mediterranean area from 2003 until January 2006. Between 1998 and 2002, Mr. Perez served as Director of the Consulting Division and member of the management team for Oracle in Israel. From 1988 to 1998 Mr. Perez led the implementation group for New Applicom , a member of the Matrix group. Mr. Perez holds a BS.c in Industrial Engineering and Information Systems from the Technion.

Joseph Tenne has served as one of our directors since June 2003. Mr. Tenne is currently the Chief Financial Officer of Ormat Technologies, Inc., a company listed on the New York Stock Exchange, which is engaged in the geothermal and recovered energy business. From 2003 to 2004 Mr. Tenne was the Chief Financial Officer of Treofan Germany GmbH & Co. KG, a German company, which is engaged in the development, production and marketing of oriented polypropylene films, which are mainly used in the food packaging industry. From 1997 until 2003, Mr. Tenne was a partner in Kesselman & Kesselman, Certified Public Accountants in Israel and a member of PricewaterhouseCoopers International Limited. Mr. Tenne holds a B.A. in Accounting and Economics and an M.B.A. from Tel Aviv University. Mr. Tenne is also a Certified Public Accountant in Israel.

Dana Gross has served as one of our directors since June 2000. Ms. Gross has served as Chief Marketing Officer of M-Systems Flash Disk Ltd. since April 2000, and as a director of M-Systems since September 2000. Prior to that, Ms. Gross served as Executive Vice President of the DiskOnChip business unit of M-Systems from 2000 and as Vice President of Worldwide Sales of M-Systems from 1998 until April 2000. Ms. Gross joined M-Systems in July 1992 as Vice President of Operations and became Chief Financial Officer in 1994, President of M-Systems Inc. in 1995 and Executive Vice President of Business Development in 1997. Ms. Gross also serves as a director of PowerDsine Ltd., a Power over Ethernet technology company that is traded on Nasdaq. Ms. Gross holds a B.Sc. in Industrial Management Engineering from Tel Aviv University and an M.B.A. from San Jose State University.

Dr. Eyal Kishon has served as one of our directors since 1997. Since 1996, Dr. Kishon has been Managing Partner of Genesis Partners, an Israel based venture capital fund. From 1993 to 1996, Dr. Kishon served as Associate Director of Dovrat-Shrem/Yozma-Polaris Fund Limited Partnership. In his capacity as Managing Partner of Genesis, Dr. Kishon serves as a director of VCON Telecommunications Ltd., a video conferencing technology company. From 1991 to 1992, Dr. Kishon was a Research Fellow in the Multimedia Department of IBM Science & Technology. From 1989 to 1991, Dr. Kishon worked in the Robotics Research Department of AT&T Bell Laboratories. Dr. Kishon holds a B.A. in Computer Science from the Technion and an M.Sc. and a Ph.D. in Computer Science from New York University.

Doron Nevo has served as one of our directors since 2000. From 1996 to 1999, Mr. Nevo served as President and CEO of NKO, Inc. Mr. Nevo established NKO in early 1995 as a startup subsidiary of Clalcom, Ltd. NKO designed and developed a full scale carrier grade IP Telephony system platform and established its own IP network. From 1992 to 1996, Mr. Nevo was President and CEO of Clalcom Ltd. Mr. Nevo established Clalcom in 1992 as a fax service provider in Israel. Mr. Nevo is President and CEO of KiloLambda Technologies Ltd. an optical subsystems company. He also serves on the board of a number of companies such as: Utility Wireless Corp. (a manufacturer of radio frequency sub-systems), Elcom Technologies (manufacturer of Satcom and Digital Radio synthesizers), Notox, Ltd. (a biotech company) and Cellaris, Ltd. (a new materials company). Mr. Nevo holds a B.Sc. in Electrical Engineering from the Technion and an M.Sc. in Telecommunications Management from Brooklyn Polytechnic.

B. COMPENSATION

The aggregate direct remuneration paid to all 15 persons who served in the capacity of director or senior executive officer during the year ended December 31, 2005 was approximately \$1.9 million, including \$212,000 which was set aside for pension and retirement benefits. This does not include amounts expended by us for automobiles made available to our officers, expenses (including business, travel, professional and business association dues and expenses) reimbursed to officers and other fringe benefits commonly reimbursed or paid by companies in Israel.

Stock options to purchase our ordinary shares granted to persons who served in the capacity of director or executive officer under our 1997 and 1999 Stock Option Plans are generally exercisable at the fair market value at the date of grant, and expire ten years (under the 1997 Plan) and seven years (under the 1999 Plan), respectively, from the date of grant. The options are generally exercisable in four or five equal annual payments, commencing one year from the date of grant.

A summary of our stock option activity and related information for the years ended December 31, 2003, 2004 and 2005 for all 15 persons who served in the capacity of director or senior executive officer during the year ended December 31, 2005 is as follows:

	2003		2004		2005	
	Number of Options	Weighted Average Exercise Price	Number of Options	Weighted Average Exercise Price	Number of Options	Weighted Average Exercise Price
Outstanding at the beginning of the year	1,235,686	\$ 7.58	1,526,702	\$ 7.48	1,909,435	\$ 9.01
Adjustments to opening balance			(39,600)		42,500	
Granted	325,500	\$ 6.64	531,250	\$ 11.77	60,000	\$ 10.17
Cancelled	-	-	-	-	-	-
Exercised	(34,484)	\$ 3.09	(108,917)	\$ 5.16	(5,250)	\$ 3.77
Outstanding at the end of the year	1,526,702	\$ 7.48	1,909,435	\$ 9.11	2,006,685	\$ 9.06

As of December 31, 2005, options to purchase 1,285,165 ordinary shares were exercisable at an average exercise price of \$8.82 per share.

Under the Israeli Companies Law, the compensation arrangements for officers who are not directors require the approval of the board of directors, unless the articles of association provide otherwise. Arrangements regarding the compensation of directors require the approval of the audit committee, the board and the shareholders, in that order.

C. BOARD PRACTICES

Independent Directors; Audit Committee; Internal Auditor

Under the Israeli Companies Law, Israeli companies that have offered securities to the public in or outside of Israel are required to appoint at least two “outside” directors. Doron Nevo and Dr. Eyal Kishon are our outside directors. Under the requirements for listing on The Nasdaq National Market, we are required to have a majority of our directors be independent as defined by Nasdaq rules. Doron Nevo, Dr. Eyal Kishon, Dana Gross and Joseph Tenne are independent directors for purposes of the Nasdaq rules.

To qualify as an outside director under Israeli law, an individual or his affiliates may not have, and may not have had at any time during the previous two years, any affiliation with the company or its affiliates, as such terms are defined in the Companies Law. In addition, no individual may serve as an outside director if the individual’s position or other activities create or may create a conflict of interest with his or her role as an outside director or are likely to interfere with his or her ability to serve as a director. For a period of two years from termination from office, a former outside director may not serve as a director or employee of the company or provide professional services to the company for consideration. Pursuant to a recent amendment to the Israeli Companies Law, at least one of the outside directors appointed by a publicly-traded company must have “financial and accounting expertise.” The other outside director should possess “professional expertise.” Regulations specifying the applicable criteria have not yet been promulgated. Both of the outside directors must serve on the company’s statutory audit committee.

The outside directors must be elected by the shareholders, including at least one-third of the shares of non-controlling shareholders voted on the matter. However, the outside directors can be elected by shareholders without this one-third approval if the total shares of non-controlling shareholders voted against the election do not represent more than one percent of the voting rights in the company. The term of an outside director is three years and may be extended for one additional three-year term. An outside director can be removed from office only under very limited circumstances. Each committee of a company's board of directors is required to include at least one outside director. If, at the time outside directors are elected, all current members of the board of directors are of the same gender, then at least one outside director must be of the other gender.

Under the Companies Law and the requirements for listing on the Nasdaq National Market, our board of directors is required to appoint an audit committee. Our audit committee must be comprised of at least three directors, including all of the outside directors. The audit committee consists of: Dr. Eyal Kishon, Doron Nevo and Joseph Tenne. Our Board of Directors has determined that Joseph Tenne is an "audit committee financial expert" and that he is independent under the applicable Securities and Exchange Commission and Nasdaq National Market rules.

The audit committee may not include the chairman of the board, a controlling shareholder and the members of his immediate family, or any director who is employed by the company or provides services to the company on a regular basis. Under Israeli law, the role of the audit committee is to examine flaws in our business management, in consultation with the internal auditor and the independent accountants, and to propose remedial measures to the board. The audit committee also reviews for approval transactions between the company and office holders or interested parties, as described below.

We have adopted an audit committee charter as required by the Nasdaq rules. Our audit committee assists the board of directors in fulfilling its responsibility for oversight of the quality and integrity of our accounting, auditing and financial reporting practices and financial statements and the independence qualifications and performance of our independent auditors. The audit committee also has the authority and responsibility to oversee our independent auditors, to recommend for shareholder approval the appointment and, where appropriate, replacement of our independent auditors and to pre-approve audit fees and all permitted non-audit services and fees.

Under the Companies Law, our board of directors is also required to appoint an internal auditor proposed by the audit committee. The internal auditor may be our employee, but may not be an interested party or office holder, or a relative of any interested party or office holder, and may not be a member of our independent accounting firm. The role of the internal auditor is to examine, among other things, whether our activities comply with the law and orderly business procedure. Eitan Hashachar CPA has been our internal auditor since January 2001.

As of July 2005, Nasdaq rules require that director nominees be selected or recommended for the board's selection either by a committee composed solely of independent directors or by a majority of independent directors. Our Nominating Committee assists the board of directors in its selection of individuals as nominees for election to the board of directors and/or to fill any vacancies or newly created directorships on the board of directors. The Nominating Committee consists of four members: Dr. Eyal Kishon, Doron Nevo, Joseph Tenne and Dana Gross. All members of the Nominating Committee are independent under the applicable Securities and Exchange Commission and Nasdaq National Market rules.

Nasdaq rules also provide that the compensation of a company's chief executive officer and other executive officers is required to be approved either by a majority of the independent directors on the board or a committee comprised solely of independent directors. Our board of directors has appointed Dr. Eyal Kishon and Dana Gross to serve on the compensation committee of the board of directors.

Pursuant to our articles of association, our directors were classified into three classes (classes I, II and III). The members of each class of directors and the expiration of the term of office is as follows:

Dana Gross	Class I	2007
Joseph Tenne	Class II	2008
Shabtai Adlersberg	Class III	2006

Our outside directors under the Companies Law, Doron Nevo and Dr. Eyal Kishon, are not members of any class and serve in accordance with the provisions of the Companies Law. Mr. Nevo's term ends in 2006 and Dr. Kishon's term ends in 2008.

D. EMPLOYEES

We had the following number of employees as of December 31, 2003, 2004 and 2005 in the areas set forth in the table below:

	As of December 31,		
	2003	2004	2005
Research and development	145	213	233
Sales & marketing, technical service & support	119	144	186
Operations	45	63	73
Management and administration	19	25	30
	<u>328</u>	<u>445</u>	<u>522</u>

Our employees were located in the following areas as of December 31, 2003, 2004 and 2005.

	As of December 31,		
	2003	2004	2005
Israel	265	320	373
United States	50	105	124
Far East	11	15	17
Europe	2	3	5
Latin America	--	2	3
	328	445	522

The growth in the number of our employees over the past three years was primarily attributable to an increase in research and development personnel, increased sales and marketing efforts and our acquisition of Ai-Logix, now known as AudioCodes USA, in 2004.

Israeli labor laws and regulations are applicable to our employees in Israel. These laws principally concern matters such as paid annual vacation, paid sick days, length of the workday, pay for overtime, insurance for work-related accidents, severance pay and other conditions of employment. Israeli law generally requires severance pay, which may be funded by Manager's Insurance, described below, upon the retirement or death of an employee or termination of employment without cause (as defined under Israeli law). Furthermore, Israeli employees and employers are required to pay predetermined sums to the National Insurance Institute. Since January 1, 1995, such amounts also include payments for national health insurance. The payments to the National Insurance Institute are approximately 16.1% of wages, of which the employee contributes approximately 65% and the employer contributes approximately 35%.

Although not legally required, we regularly contribute to a "Manager's Insurance" fund or to a privately managed pension fund on behalf of our employees located in Israel. These funds provide employees with a lump sum payment upon retirement (or a pension, in case of a pension fund) and severance pay, if legally entitled thereto, upon termination of employment. We provide for payments to a Manager's Insurance Fund and pension fund contributions in the amount of 13.3% of an employee's salary on account of severance pay and provident payment or pension, with the employee contributing 5.0% of his salary. We also pay an additional amount of up to 2.5% of certain of our employees' salaries in connection with disability payments. In addition, we administer an Education Fund for our Israeli employees and pay 7.5% of these employees' salaries thereto, with the employees contributing 2.5% of their salary.

Furthermore, our employees are subject to certain provisions of the collective bargaining agreements between the Histadrut (General Federation of Labor in Israel) and the Coordination Bureau of Economic Organizations (including the Industrialists Associations) by order of the Israeli Ministry of Labor and Welfare. These provisions principally concern cost of living increases, recreation pay and other conditions of employment. We generally provide our employees with benefits and working conditions above the required minimums. Our employees, as a group, are not currently represented by a labor union. To date, we have not experienced any work stoppages.

E. SHARE OWNERSHIP

The following table sets forth the share ownership and outstanding number of options of our directors and officers as of June 23, 2006.

Name	Total Shares Beneficially Owned	Percentage of Ordinary Shares	Number of Options
Shabtai Adlersberg	5,016,139	12.4	633,718
Nachum Falek	*		*
Eyal Frishberg	*		*
Eli Nir	*		*
Lior Aldema	*		*
Ben Rabinowitz	*		*
Yehuda Hershkowitz	*		*
Tal Dor	*		*
Gary Drutin	*		*
Moshe Tal	*		*
David Perez	*		*
Joseph Tenne	*		*
Dana Gross	*		*
Dr. Eyal Kishon	*		*
Doron Nevo	*		*

*Less than one percent.

Our officers and directors have the same voting rights as our other shareholders.

The following table sets forth information with respect to the options to purchase our ordinary shares held by Mr. Adlersberg as of June 23, 2006.

Shabtai Adlersberg

Number of Options	Grant Date	Exercise Price	Exercised	Cancelled	Vesting	Expiration Date
96,000	July 1, 1996	\$ 0.61	(96,000)	-	4 years	July 1, 2006
96,000	July 1, 1998	\$ 1.10	(72,000)	-	4 years	July 1, 2008
100,000	May 23, 2000	\$ 29.16	-	-	4 years	May 23, 2007
225,000	December 19, 2001	\$ 4.18	-	-	4 years	December 19, 2008
9,718	August 9, 2002	\$ 2.04	-	-	2 years	August 9, 2009
275,000	September 23, 2004	\$ 12.84	-	-	4 years	September 23, 2011

Employee Share Plans

We have an Employee Share Purchase Plan and Employee Share Option Plans for the granting of options to our employees, officers, directors and consultants. Most of these plans are pursuant to the Israeli Income Tax Ordinance, entitling the beneficiaries who are our employees to tax benefits under Israeli law. There are various conditions that must be met in order to qualify for these benefits, including registration of the options in the name of a trustee for each of the beneficiaries who is granted options. Each option, and any ordinary shares acquired upon the exercise of the option, must be held by the trustee at least for a period commencing on the date of grant and ending no later than 30 months after the date of grant, in accordance with the period of time specified by Section 102 of Israel's Income Tax Ordinance, and deposited in trust with the trustee. There are similar plans for our U.S. employees, which are designed to comply with the corresponding provisions of the Internal Revenue Code of 1986, as amended.

Employee Share Purchase Plans

We implemented two Employee Share Purchase Plans in May 2001. One plan is for our Israeli employees and the other for all our U.S. and other non-Israeli employees. Under these Plans an aggregate of 2,000,000 of our ordinary shares were reserved for sale to our employees at a price equal to 85% of the lesser of fair market value on the first day or last day of each offering period under the Plans. As of December 31, 2005, we had issued 966,710 of our ordinary shares pursuant to purchases under these plans.

Employee Share Option Plans

In 1999, our board restated three 1997 Employee Share Option Plans for our Israeli employees, officers, directors and consultants and two 1997 Share Option Plans for our U.S. employees, officers, directors and consultants. Additionally, in 1999 our board adopted an Employee Share Option Plan for our Israeli employees, officers, directors and consultants, and an Employee Share Option Plan for our U.S. employees, officers, directors and consultants. The terms of the 1999 Plans are substantially the same as those of the 1997 Plans, but have reduced the exercise period from 10 to 7 years. The board has the ability to grant options with longer or shorter terms. The terms of the 1999 Plans have been modified slightly since they were adopted and in 2003, the Israeli Plan was changed to conform to amendments to the Israeli Income Tax law.

As of December 31, 2005, options to purchase a total of 6,593,412 shares are outstanding under the 1997 and 1999 Israeli Plans and options to purchase a total of 1,340,960 shares are outstanding under the 1997 U.S. Plan. In addition, a reserve of 811,000 shares has been made available for grant under the 1999 Israeli Plan and a reserve of 726,000 shares has been made available for grant under the 1999 U.S. Plan. However, subject to our board deciding otherwise, each year on July 1, starting with July 1999, the number of shares that will be made available for grant under both of the 1999 Plans, will be automatically increased to that number of shares that is equal to 5% of our outstanding share capital on such a date.

The holders of options under all of the plans are responsible for all personal tax consequences relating to the options. The exercise prices of the options are based on the fair value of the ordinary shares at the time of grant as determined by our board of directors. The board considers many factors in establishing such prices, including our financial condition and operating results, investors' valuations and the market for the securities of comparable industry group companies.

ITEM 7. MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS**A. MAJOR SHAREHOLDERS**

To our knowledge, (A) we are not directly or indirectly owned or controlled (i) by another corporation or (ii) by any foreign government and (B) there are no arrangements, the operation of which may at a subsequent date result in a change in control of AudioCodes. The following table sets forth, as of December 31, 2005, the number of our ordinary shares, which constitute our only voting securities, beneficially owned by (i) all shareholders known to us to own more than 5% of our outstanding ordinary shares, and (ii) all of our directors and senior executive officers as a group.

Identity of Person or Group	Amount Owned	Percent of Class
Shabtai Adlersberg ⁽¹⁾	5,442,071	13.3%
Leon Bialik ⁽²⁾	4,014,312	9.9%
FMR Corp. ⁽³⁾	5,769,634	14.2%
Kern Capital ⁽⁴⁾	2,782,700	6.9%
All directors and senior executive officers as a group (15 persons) ⁽⁵⁾	6,542,090	15.6%

(1) Includes options to purchase 427,468 shares, which may be purchased pursuant to options exercisable within sixty days following December 31, 2005.

(2) The information is derived from a statement on Schedule 13G/A, dated February 9, 2006 of Leon Bialik filed with the Securities and Exchange Commission.

(3) The information is derived from the joint statement on Schedule 13G/A, dated January 10, 2006, of FMR Corp., Edward C. Johnson 3d, Fidelity Management & Research Company and Fid Blue Chip Growth Fund filed with the Securities and Exchange Commission. The address of FMR Corp. is 82 Devonshire Street, Boston, Massachusetts 02109.

(4) The information is derived from a statement on Schedule 13G, dated February 14, 2006 of Kern Capital Management, Robert E. Kern Jr. and David G. Kern filed with the Securities and Exchange Commission.

(5) Includes 1,304,765 ordinary shares, which may be purchased pursuant to options exercisable within sixty days following December 31, 2005.

During 2005, Mr. Adlersberg acquired 2,837 of our ordinary shares and Mr. Bialik acquired 86,090 of our ordinary shares. During 2004, Mr. Adlersberg acquired 93,421 of our ordinary shares and Mr. Bialik sold 421,500 of our ordinary shares. During 2003, Mr. Adlersberg acquired 285,130 of our ordinary shares and Mr. Bialik sold 208,000 of our ordinary shares.

FMR Corp. held 14.2% of our ordinary shares as of December 31, 2005, as compared to 8.2% of our ordinary shares as of December 31, 2004 and 7.3% of our ordinary shares as of December 31, 2003. Kern Capital held 6.9% of our ordinary shares as of December 31, 2005 as compared to 6.7% of our ordinary shares as of December 31, 2004 and less than 5% of our ordinary shares as of December 31, 2003.

As of June 23, 2006, there were approximately 24 holders of record of our ordinary shares in the United States, although we believe that the number of beneficial owners of the ordinary shares is significantly greater. The number of record holders in the United States is not representative of the number of beneficial holders nor is it representative of where such beneficial holders are resident since many of these ordinary shares were held of record by brokers or other nominees.

The major shareholders have the same voting rights as the other shareholders.

B. RELATED PARTY TRANSACTIONS

None.

C. INTERESTS OF EXPERTS AND COUNSEL

Not applicable.

ITEM 8. FINANCIAL INFORMATION

See Item 18.

ITEM 9. THE OFFER AND LISTING

A. OFFER AND LISTING DETAILS

Our ordinary shares are listed on the Nasdaq National Market and The Tel Aviv Stock Exchange under the symbol "AUDC."

In accordance with Rule 4350(a)(1) of the Rules of Corporate Governance of The Nasdaq Stock Market, Inc., we have received an exemption from the requirement to distribute an annual report to our shareholders prior to our annual meeting of shareholders. The basis for the exemption is that the generally accepted business practice in Israel, where we are incorporated, is not to distribute an annual report to shareholders. We post our Annual Report on Form 20-F on our web site (www.audiocodes.com) as soon as practical following the filing of the Annual Report on Form 20-F with the Securities and Exchange Commission.

The following table sets forth, for the periods indicated, the high and low sales prices of our ordinary shares as reported by the Nasdaq National Market.

Calendar Year	Price Per Share	
	High	Low
2005	\$ 17.00	\$ 8.67
2004	\$ 16.88	\$ 8.48
2003	\$ 11.74	\$ 2.10
2002	\$ 5.91	\$ 1.61
2001	\$ 25.75	\$ 1.60

Calendar Period	Price Per Share	
	High	Low
2006		
Second quarter (through June 23, 2006)	\$ 14.33	\$ 10.38
First quarter	\$ 14.64	\$ 11.36
2005		
Fourth quarter	\$ 11.90	\$ 9.62
Third quarter	\$ 11.20	\$ 8.95
Second quarter	\$ 12.18	\$ 8.67
First quarter	\$ 17.00	\$ 10.66
2004		
Fourth quarter	\$ 16.88	\$ 11.85
Third quarter	\$ 13.97	\$ 9.51
Second quarter	\$ 12.98	\$ 8.48
First quarter	\$ 16.10	\$ 10.35

Calendar Month	Price Per Share	
	High	Low
2006		
May	\$ 14.00	\$ 11.91
April	\$ 14.33	\$ 13.25
March	\$ 14.64	\$ 11.57
February	\$ 13.02	\$ 11.36
January	\$ 13.28	\$ 11.37
2005		
December	\$ 11.85	\$ 10.01

The following table sets forth, for the periods indicated, the high and low sales prices of our ordinary shares as reported by The Tel Aviv Stock Exchange. Our shares commenced trading on The Tel Aviv Stock Exchange on October 21, 2001. All share prices shown in the following table are in NIS. As of December 31, 2005, the exchange rate was equal to approximately 4.603 NIS per U.S. \$1.00.

Calendar Year	Price Per Share	
	High	Low
2005	NIS 73.80	NIS 40.20
2004	NIS 74.90	NIS 39.10
2003	NIS 53.50	NIS 10.42
2002	NIS 26.94	NIS 7.41
2001 (commencing October 21, 2001)	NIS 26.90	NIS 10.25

Calendar Period	Price Per Share	
	High	Low
2006		
Second quarter (through June 23, 2006)	NIS 65.27	NIS 46.98
First quarter	NIS 66.27	NIS 50.52
2005		
Fourth quarter	NIS 53.70	NIS 46.55
Third quarter	NIS 50.05	NIS 41.06
Second quarter	NIS 53.97	NIS 40.20
First quarter	NIS 73.80	NIS 46.91
2004		
Fourth quarter	NIS 70.00	NIS 52.12
Third quarter	NIS 57.93	NIS 43.00
Second quarter	NIS 57.10	NIS 39.10
First quarter	NIS 74.90	NIS 46.01

Calendar Month	Price Per Share	
	High	Low
2006		
May	NIS 62.29	NIS 55.00
April	NIS 65.27	NIS 60.22
March	NIS 66.27	NIS 53.31
February	NIS 60.50	NIS 53.38
January	NIS 61.75	NIS 50.52
2005		
December	NIS 53.70	NIS 47.21

B. PLAN OF DISTRIBUTION

Not applicable.

C. MARKETS

Our ordinary shares are listed for trading on the Nasdaq National Market under the symbol "AUDC". Our ordinary shares are also listed for trading on The Tel-Aviv Stock Exchange under the symbol "AUDC". In addition, we are aware of our ordinary shares being traded on the following markets: Frankfurt Stock Exchange, Berlin Stock Exchange, Munich Stock Exchange and XETRA.

D. SELLING SHAREHOLDERS

Not applicable.

E. DILUTION

Not applicable.

F. EXPENSES OF THE ISSUE

Not applicable.

ITEM 10. ADDITIONAL INFORMATION

A. SHARE CAPITAL

Not applicable.

B. MEMORANDUM AND ARTICLES OF ASSOCIATION

Objects and Purposes

Our registration number with the Israeli Registrar of Companies is 520044132. Our objects and purposes, set forth in Section 2 of our memorandum of association, are:

- to plan, develop and market voice signal systems;
- to purchase, import, market and wholesale and retail distribute, in Israel and abroad, consumption goods and accompanying products;
- to serve as representatives of bodies, entrepreneurs and companies from Israel and abroad with respect to their activities in Israel and abroad; and
- to carry out any activity as determined by the lawful management.

Borrowing Powers

The board of directors has the power to cause us to borrow money and to secure the payment of borrowed money. The board of directors specifically has the power to issue bonds or debentures, and to impose mortgages or other security interests on all or any part of our property.

Amendment of Articles of Association

Shareholders may amend our articles of association by a resolution adopted at a shareholders meeting by the holders of 50% of voting power represented at the meeting in person or by proxy and voting thereon.

Dividends

Under the Israeli Companies Law, we may pay dividends only out of our profits. The amount of any dividend to be distributed among shareholders is based on the nominal value of their shares. Our board of directors has determined that we will not distribute any amounts of our undistributed tax exempt income as dividend. We intend to reinvest our tax-exempt income and not to distribute such income as a dividend. Accordingly, no deferred income taxes have been provided on income attributable to our Approved Enterprise program as the undistributed tax exempt income is essentially permanent in duration.

Voting Rights and Powers

Unless any shares have special rights as to voting, every shareholder has one vote for each share held of record. A shareholder is not entitled to vote at any shareholders meeting unless all calls then payable by him in respect of his shares have been paid (this does not apply to separate meetings of the holders of a particular class of shares with respect to the modification or abrogation of their rights).

Under our articles of association, we may issue preferred shares from time to time, in one or more series. However, in connection with our listing on The Tel-Aviv Stock Exchange in 2001, we agreed that for such time as our ordinary shares are traded on The Tel-Aviv Stock Exchange, we will not issue any of the 2,500,000 preferred shares, nominal value NIS 0.01, authorized in our articles of association. Notwithstanding the foregoing, we may issue preferred shares if the preference of those shares is limited to a preference in the distribution of dividends and such preferred shares have no voting rights.

Business Combinations

Our articles of association impose restrictions on our ability to engage in any merger, asset or share sale or other similar transaction with a shareholder holding 15% or more of our voting shares.

Winding Up

Upon our liquidation, our assets available for distribution to shareholders will be distributed to them in proportion to the nominal value of their shares.

Redeemable Shares

We may issue and redeem redeemable shares.

Modification of Rights

Subject to the provisions of our memorandum of association, and without prejudice to any special rights previously conferred upon the holders of our existing shares, we may, from time to time, by a resolution approved by the holders of 50% voting power represented at the meeting in person or by proxy and voting thereon, provide for shares with such preferred or deferred rights or rights of redemption, or other special rights and/or such restrictions, whether in regard to dividends, voting repayment of share capital or otherwise, as may be stipulated in such resolution.

If at any time our share capital is divided into different classes of shares, we may modify or abrogate the rights attached to any class, unless otherwise provided by the articles of association, by a resolution approved by the holders of 50% voting power represented at the meeting in person or by proxy and voting thereon, subject to the consent in writing of the holders of 75% of the issued shares of that class.

The provisions of our articles of association relating to general meetings also apply to any separate general meeting of the holders of the shares of a particular class, except that two or more members holding not less than 75% of the issued shares of that class must be present in person or by proxy at that separate general meeting for a quorum to exist.

Unless otherwise provided by our articles of association, the increase of an authorized class of shares, or the issuance of additional shares thereof out of the authorized and unissued share capital, shall not be deemed to modify or abrogate the rights attached to previously issued shares of that class or of any other class.

Shareholders Meetings

An annual meeting of shareholders is to be held once a year, within 15 months after the previous annual meeting. The annual meeting may be held in Israel or outside of Israel, as determined by the board of directors.

The board of directors may, whenever it thinks fit, convene a special shareholders meeting. The board must convene a special shareholders meeting at the request of:

- at least two directors;
- at least one-quarter of the directors in office; or
- shareholders who hold at least 5% of the outstanding equity and at least 1% of the voting rights, or at least 5% of the outstanding voting rights.

A special shareholders meeting may be held in Israel or outside of Israel, as determined by the board of directors.

Notice of General Meetings; Omission to Give Notice

The provisions of the Companies Law and the related regulations override the provisions of our articles of association, and provide for notice of a meeting of shareholders to be sent to each registered shareholder at least 21 days in advance of the meeting. Notice of a meeting of shareholders must also be published in two Israeli newspapers prior to the record date for the meeting.

Notice of a meeting of shareholders must specify the type of meeting, the place and time of the meeting, the agenda, a summary of the proposed resolutions, the majority required to adopt the proposed resolutions, and the record date for the meeting. The notice must also include the address and telephone number of our registered office, and a list of times at which the full text of the proposed resolutions may be examined at the registered office.

The accidental omission to give notice of a meeting to any shareholder, or the non-receipt of notice sent to such shareholder, does not invalidate the proceedings at the meeting.

Limitations on Foreign Shareholders to Hold or Exercise Voting Rights

There are no limitations on foreign shareholders in our articles of association. Israeli law restricts the ability of citizens of countries that are in a state of war with Israel to hold shares of Israeli companies.

Indemnification of Directors and Officers

We have entered into agreements with each of our directors and senior officers to insure, indemnify and exculpate them against some types of claims, subject to dollar limits and other limitations. These agreements provide, subject to Israeli law, for us to indemnify each of these directors and senior officers for any of the following obligations or expenses that they may incur:

- § monetary liability imposed on the director or senior officer in favor of a third party in a judgment, including a settlement or an arbitral award confirmed by a court, for an act that the director or senior officer performed by virtue of being our director or senior officer,
- § reasonable legal costs, including attorneys' fees, expended by a director or senior officer as a result of an investigation or proceeding instituted against the director or senior officer by a competent authority, provided that such investigation or proceeding concludes without the filing of an indictment against the director or senior officer and either:
 - o no financial liability was imposed on the director or senior officer in lieu of criminal proceedings, or
 - o financial liability was imposed on the director or senior officer in lieu of criminal proceedings but the alleged criminal offense does not require proof of criminal intent, and
- § reasonable legal costs, including attorneys' fees, expended by the director or senior officer or for which the director or senior officer is charged by a court:
 - o in an action brought against the director or senior officer by us, on our behalf or on behalf of a third party,
 - o in a criminal action in which the director or senior officer is found innocent, or
 - o in a criminal action in which the director or senior officer is convicted but in which proof of criminal intent is not required.

Approval of Transactions under Israeli Law

The Companies Law imposes fiduciary duties that “office holders,” including directors and executive officers, owe to their company. An office holder’s fiduciary duties consist of a duty of care and a duty of loyalty. The duty of care generally requires an office holder to act with the level of care which a reasonable office holder in the same position would have acted under the same circumstances. The duty of loyalty generally requires an office holder to act in good faith and for the good of the company. Specifically, an office holder must avoid any conflict of interest between the office holder’s position in the company and his or her other positions or personal affairs. In addition, an office holder must avoid competing against the company or exploiting any business opportunity of the company for his or her own benefit or the benefit of others. An office holder must also disclose to the company any information or documents relating to the company’s affairs that the office holder has received due to his or her position in the company. The term “office holder” includes any person who, either formally or in substance, serves as a director, general manager or chief executive officer, or who reports directly to the general manager or chief executive officer. Each person listed in the table under “Item 6. Directors, Senior Management and Employees—A. Directors and Senior Management” above is an “office holder” of AudioCodes.

Under the Companies Law, all arrangements as to compensation of office holders who are not directors require approval of the board of directors and, in certain cases, the prior approval of the audit committee. Arrangements as to compensation of directors also require audit committee and shareholder approval.

The Companies Law requires that an office holder promptly disclose any personal interest that he or she may have, and all related material information known to him or her, in connection with any existing or proposed transaction by the company. A personal interest of an office holder includes a personal interest of the office holder’s relative or a corporation in which the office holder or the office holder’s relative is a 5% or greater shareholder, director or general manager or has the right to appoint at least one director or the general manager. The office holder’s duty to disclose shall not apply in the event that the personal interest only results from a personal interest of the office holder’s relative in a transaction that is not an extraordinary transaction. An extraordinary transaction is a transaction not in the ordinary course of business, not on market terms, or likely to have a material impact on the company’s profitability, assets or liabilities.

For a transaction that is not an extraordinary transaction, under the Companies Law, once the office holder complies with the above disclosure requirement, the board of directors is authorized to approve the transaction, unless the articles of association provide otherwise. A transaction that is adverse to the company’s interest may not be approved. If the transaction is an extraordinary transaction, then it also must be approved by the company’s audit committee and board of directors, and, under certain circumstances, by the shareholders of the company. Generally, when an extraordinary transaction is considered by the audit committee and board of directors, the interested directors may not be present or vote.

Duties of Shareholders

Under the Companies Law, the disclosure requirements that apply to an office holder also apply to a controlling shareholder of a public company. A controlling shareholder is a shareholder who has the ability to direct the activities of a company, including a shareholder that owns 25% or more of the voting rights if no other shareholder owns more than 50% of the voting rights, but excluding a shareholder whose power derives solely from his or her position on the board of directors or any other position with the company. Two or more shareholders with a personal interest in the approval of the same transaction are deemed to be one shareholder for the purpose of being a “controlling shareholder.” Extraordinary transactions with a controlling shareholder or in which a controlling shareholder has a personal interest, and the engagement of a controlling shareholder as an office holder or employee, generally require the approval of the audit committee, the board of directors and the shareholders. The shareholder approval must include at least one-third of the shares of non-interested shareholders voted on the matter. However, the transaction can be approved by shareholders without this one-third approval if the total shares of non-interested shareholders voted against the transaction do not represent more than one percent of the voting rights in the company.

In addition, under the Companies Law, each shareholder has a duty to act in good faith toward the company and other shareholders and to refrain from abusing his or her power in the company, such as in shareholder votes. In addition, specified shareholders have a duty of fairness toward the company. These shareholders include any controlling shareholder, any shareholder who knows that it possesses the power to determine the outcome of a shareholder vote and any shareholder who, pursuant to the provisions of the articles of association, has the power to appoint an office holder or any other power with respect to the company. A recent amendment to the Companies Law provides that a breach of the duty of fairness will be governed by the laws governing breach of contract, *mutatis mutandis*. However, the Companies Law does not define the substance of this duty of fairness.

Israeli law permits a company to insure an office holder in respect of liabilities incurred by the office holder as a result of:

- the breach of his or her duty of care to the company or to another person, or
- the breach of his or her fiduciary duty to the company,

to the extent that the office holder acted in good faith and had reasonable cause to believe that the act would not prejudice the company. A company can also insure an office holder against monetary liabilities as a result of an act or omission that the office holder committed in connection with his or her serving as an office holder.

Moreover, a company can indemnify an office holder for any of the following obligations or expenses incurred in connection with his or her acts or omissions as an office holder:

- monetary liability imposed upon the office holder in favor of other persons pursuant to a court judgment, including a compromise judgment or an arbitrator’s decision approved by a court;
- reasonable litigation expenses, including attorney’s fees, incurred by the office holder as a result of an investigation or proceeding instituted against the office holder by a competent authority, provided that such investigation or proceeding concluded without the filing of an indictment against the office holder or the imposition of any financial liability in lieu of criminal proceedings, or concluded without the filing of an indictment against the office holder and a financial liability was imposed on the office holder in lieu of criminal proceedings with respect to a criminal offense that does not require proof of criminal intent; and

— reasonable litigation expenses, including attorneys' fees, actually incurred by the office holder or imposed upon the office holder by a court, in an action, suit or proceeding brought against the office holder by or on behalf of the company or other persons; in a criminal action in which the office holder was acquitted; or in a criminal action which does not require criminal intent in which the office holder was convicted. A company may also exculpate an office holder in advance, in whole or in part, from liability for damages sustained by a breach of duty of care to the company.

Furthermore, a company can, with one limited exception, exculpate an office holder in advance, in whole or in part, from liability for damages sustained by a breach of duty of care to the company.

Our articles of association allow us to insure, indemnify and exculpate office holders to the fullest extent permitted by law, provided such insurance or indemnification is approved in accordance with law.

We have entered into an undertaking to indemnify our office holders in specified limited categories of events and in specified amounts, subject to certain limitations. This undertaking has been ratified by our audit committee, board of directors and shareholders. We have acquired directors' and officers' liability insurance covering our officers and directors and the officers and directors of our subsidiaries against certain claims.

C. MATERIAL CONTRACTS

On November 3, 2004, we entered into a purchase agreement with Merrill Lynch & Co., Merrill Lynch, Pierce, Fenner & Smith Incorporated, Lehman Brothers Inc. and CIBC World Markets Corp., with respect to the issue and sale of \$100.0 million aggregate principal amount of our 2.00% Senior Convertible Notes due 2024 and the grant of an option for the purchase of an additional \$25.0 million aggregate principal amount of our notes, which was exercised in full on November 16, 2004.

On November 9, 2004, we entered into an indenture with U.S. Bank National Association in connection with the issuance of our 2.00% Senior Convertible Notes due 2024. The indenture provides that the notes are senior, unsecured obligations of AudioCodes Ltd. Pursuant to the indenture, the notes accrue interest at a rate of 2.00% per annum, payable semi-annually on May 9 and November 9 of each year, with a final maturity on November 9, 2024. The indenture provides that the notes may be redeemed by us, in whole or in part, at any time after November 9, 2009, and that the holders of the notes may require us to redeem the notes on November 9, 2009, November 9, 2014 or November 9, 2019, or upon certain fundamental changes. If any notes are redeemed prior to November 9, 2009 based on certain fundamental changes, we will also be required to make a 'make-whole' premium payment to the redeeming note holders. Under the terms of the indenture and the notes, holders of the notes are entitled to convert the notes into our ordinary shares at a conversion rate of 53.4474 ordinary shares per \$1,000 principal amount of notes, which is the equivalent to a conversion price of approximately \$18.71 per share. The conversion rate is subject to adjustment in certain circumstances, such as changes in our capital structure or upon the issuance by us of share dividends or certain cash distributions.

On November 9, 2004, we also entered into a registration rights agreement with Merrill Lynch & Co., Merrill Lynch, Pierce, Fenner & Smith Incorporated, Lehman Brothers Inc. and CIBC World Markets Corp., pursuant to which we agreed to file with the U.S. Securities and Exchange Commission within 150 days of November 9, 2004, a shelf registration statement covering our 2.00% Senior Convertible Notes due 2024 and shares issuable upon conversion of the notes, and to maintain the effectiveness of the registration statement until the earlier of the date on which all the shares have been resold under the registration statement, the date of expiration of the holding period under applicable law that would enable the resale of the shares without restriction or registration under applicable law, or November 16, 2006. Under the terms of the registration rights agreement, if either (i) on the day following the filing deadline, the shelf registration statement has not been filed with the SEC; (ii) on the 211th day following the earliest date of original issuance of any of the notes, the shelf registration statement is not declared effective, (iii) the registration statement ceases to be effective or fails to be usable without being succeeded within five business days by a post-effective amendment or a report filed with the SEC pursuant to the Exchange Act that cures the failure of the registration statement to be effective or usable or (iv) the prospectus has been suspended for more than 60 days (or more than 90 days in any twelve month period), then additional interest will accrue on our notes beginning on the day following such triggering event through the day on which the triggering event has been cured. The additional interest will accrue at a rate of 0.25% for the first ninety days of the triggering event, and 0.5% thereafter.

On May 12, 2004, we acquired the outstanding shares of capital stock of Ai-Logix, now known as AudioCodes USA, Inc. pursuant to a between us, AudioCodes Inc., Ai-Logix and AI Technologies N.V. We paid \$10 million in cash at the closing and an additional \$10 million in March 2005 based on the achievement of revenue milestones and additional terms by the acquired business during 2004 and 2005.

On May 16, 2006, we entered into an Agreement and Plan of Merger with Nuera Communications, Inc., or Nuera. The consideration for the transaction will consist of \$85 million in cash, subject to reduction for certain expenses, plus an earn out arrangement under which we have agreed to pay up to an additional \$5 million if Nuera achieves certain revenue milestones during the first 12 months after consummation of the transaction. There will be an escrow of \$7.5 million of the purchase price paid at closing for a period of one year following closing, to secure up to \$7.5 million of certain indemnification obligations under the merger agreement. Upon the consummation of the merger, Nuera will become a wholly-owned subsidiary of AudioCodes USA. The transaction is subject to customary conditions for transactions of this nature, including antitrust clearance under the Hart-Scott-Rodino Antitrust Improvement Act and other regulatory approvals. If these conditions are satisfied, the transaction is expected to be consummated early in the third quarter of 2006. The transaction has been approved by our board of directors and by the board of directors and stockholders of Nuera. We cannot be sure that the acquisition of Nuera will be consummated when anticipated or at all.

D. EXCHANGE CONTROLS

Since January 1, 2003, all exchange control restrictions imposed by the State of Israel have been removed, although there are still reporting requirements for foreign currency transactions. However, legislation remains in effect pursuant to which currency controls can be imposed by administrative action at any time. Nonresidents of Israel who purchase our ordinary shares are able to receive any dividends thereon (and any amounts payable upon the dissolution, liquidation and winding up of our affairs) freely repatriable in non-Israeli currency, provided that Israeli income tax has been paid or withheld on such amounts (see “Item 10. Additional Information—E. Taxation—Israeli Tax Considerations—Tax on Dividends”).

Non-residents of Israel may freely hold and trade our ordinary shares, and the proceeds of sale thereof are not subject to Israeli currency control restrictions. Our memorandum of association and articles of association do not restrict in any way the ownership of ordinary shares by non-residents of Israel and neither our memorandum of association and articles of association nor Israeli law restricts the voting rights of non-residents, except with respect to citizens of countries that are in a state of war with Israel.

E. TAXATION

The following is a summary of the material Israeli and United States federal tax consequences, Israeli foreign exchange regulations and certain Israeli government programs affecting us. To the extent that the discussion is based on new tax or other legislation that has not been subject to judicial or administrative interpretation, there can be no assurance that the views expressed in the discussion will be accepted by the tax or other authorities in question. The discussion is not intended, and should not be construed, as legal or professional tax advice, is not exhaustive of all possible tax considerations and should not be relied upon for tax planning purposes. Potential investors are urged to consult their own tax advisors as to the Israeli tax, United States federal income tax and other tax consequences of the purchase, ownership and disposition of ordinary shares, including, in particular, the effect of any foreign, state or local taxes.

Israeli Tax Considerations

General Corporate Tax Structure

On July 25, 2005 the Israeli parliament passed the Law for the Amendment of the Income Tax Ordinance (No.147 and Temporary Order) - 2005 (hereinafter - the Amendment).

Under the amendment, a gradual decrease in the corporate tax rate in Israel will be in effect as follows: in 2006 - 31%, in 2007 - 29%, in 2008 - 27%, in 2009 - 26% and in 2010 and thereafter - 25%. Furthermore, beginning in 2010, upon reduction of the corporate tax rate to 25%, capital gains will be subject to a tax of 25%.

Tax Benefits Under the Law for the Encouragement of Capital Investments, 1959

Our facilities have been granted approved enterprise status pursuant to the Law for the Encouragement of Capital Investments, 1959 or the Investment Law, which provides certain tax and financial benefits to investment programs that have been granted such status.

The Investment Law provides that a proposed capital investment in eligible facilities may be designated as an “approved enterprise.” Until recently, the designation required advance approval from the Investment Center of the Israel Ministry of Industry, Trade and Labor (the Investment Center). Each certificate of approval for an approved enterprise relates to a specific investment program delineated both by its financial scope, including its capital sources, and by its physical characteristics, such as the equipment to be purchased and utilized pursuant to the program. The tax benefits under the Investment Law are not available for income derived from products manufactured outside of Israel.

A company owning an approved enterprise may elect to receive either governmental grants or an alternative package of tax benefits. Under the alternative package, a company’s undistributed income derived from an approved enterprise will be exempt from corporate tax for a period of two to ten years (depending on the geographic location of the approved enterprise within Israel). The exemption commences in the first year of taxable income, and the company is taxed at a reduced corporate rate of 10% to 25% for the following five to eight years, depending on the extent of foreign shareholders’ ownership of the company’s ordinary shares. The benefits period is limited to twelve years from completion of the investment under the approved plan or fourteen years from the date of approval, whichever is earlier. A Foreign Investors Company, or FIC, defined in the Investment Law as a company of which more than 25% of its shareholders are non-Israeli residents, may enjoy benefits for a period of up to ten years, or twelve years if it complies with certain export criteria stipulated in the Investment Law (the actual length of the benefits period is graduated based on the percentage of foreign ownership).

The tax benefits derived from any certificate of approval relate only to taxable income attributable to the specific approved enterprise. If a company has more than one approval or only a portion of its capital investments are approved, its effective tax rate is the result of a weighted combination of the applicable rates.

Our production facilities have been granted the status of approved enterprise. Income arising from our approved enterprise facilities is tax-free under the alternative package of benefits described above and entitled to reduced tax rates based on the level of foreign ownership for specified periods. We have derived, and expect to continue to derive, a substantial portion of our operating income from our approved enterprise facilities. The tax benefits attributable to our current approved enterprises are scheduled to expire gradually from 2007 to 2013.

Distribution of earnings derived from approved enterprise which were previously taxed at reduced tax rates, would not result in additional tax consequences to us. However, if retained tax-exempt income is distributed in a manner, we would be taxed at the reduced corporate tax rate applicable to such profits (between 10%-25%). We are not obliged to distribute exempt retained earnings under the alternative package of benefits, and may generally decide from which source of income to declare dividends. We currently intend to reinvest the amount of our tax-exempt income and not to distribute such income as a dividend. Dividends from approved enterprises are generally taxed at a rate of 15% (which is withheld and paid by the company paying the dividend) if such dividend is distributed during the benefits period or within twelve years thereafter. The twelve-year limitation does not apply to an FIC.

Future approved enterprises will be reviewed separately, and the decisions whether to approve or reject a designation as an approved enterprise will be based, among other things, on the criteria set forth in the Investment Law and related regulations, the then prevailing policy of the Investment Center, and the specific objectives and financial criteria of the company. Accordingly, there can be no assurance that any new investment programs will be approved as approved enterprises. In addition, the benefits available to an approved enterprise are conditional upon the fulfillment of conditions stipulated in the Investment Law and related regulations and the criteria set forth in the specific certificate of approval. In the event that a company does not meet these conditions, it will be subject to corporate tax at the rate then in effect under Israeli law for such tax year. As of December 31, 2005, management believes that we meet all of the aforementioned conditions.

On April 1, 2005, an amendment to the law came into effect (“the Amendment”) and has significantly changed the provisions of the law. The Amendment limits the scope of enterprises which may be approved by the Investment Center by setting criteria for the approval of a facility as a Beneficiary Enterprise, such as provisions generally requiring that at least 25% of the Beneficiary Enterprise’s income will be derived from export. Additionally, the Amendment enacted major changes in the manner in which tax benefits are awarded under the law so that companies no longer require Investment Center approval in order to qualify for tax benefits.

In addition, the law provides that terms and benefits included in any certificate of approval already granted will remain subject to the provisions of the law as they were on the date of such approval. Therefore, our existing “Approved Enterprises” will generally not be subject to the provisions of the Amendment. As a result of the Amendment, tax-exempt income generated under the provisions of the law has amended, will subject us to taxes upon distribution or liquidation and we may be required to record a deferred tax liability with respect to such tax-exempt income.

Law for the Encouragement of Industrial Research and Development, 1984

Under the Law for the Encouragement of Industrial Research and Development, 1984 and the related regulations, or the Research Law, research, development and pre-manufacturing programs that meet specified criteria and are approved by a governmental committee (the Research Committee) of the Office of Chief Scientist (OCS) are eligible for grants of up to 50% of the expenditures on the program. Each application to the OCS is reviewed separately, and grants are based on the program approved by the Research Committee. Expenditures supported under other incentive programs of the State of Israel are not eligible for OCS grants. As a result, we cannot be sure that applications to the OCS will be approved or, if approved, that we will receive the amounts for which we apply.

Recipients of these grants are required to pay royalties on the revenues derived from the sale of product developed in accordance with the program. The royalties are payable at the rate of 3% of revenues during the first three years, 4% of revenues during the following three years, and 5% of revenues in the seventh year and thereafter, with the total royalties not to exceed 100% of the dollar value of the OCS grant.

The terms of the Israeli government participation require that products developed with OCS grants must generally be manufactured in Israel. If we receive OCS approval for any portion of this manufacturing to be performed outside of Israel, the royalty rate would be increased and the repayment schedule would be accelerated, based on the extent of the manufacturing conducted outside of Israel. Depending upon the extent of the manufacturing volume that is performed outside of Israel, the ceiling on royalties would increase to 120%, 150% or 300% of the grant. Under an amendment to the Research Law effective June 7, 2005, the authority of the Research Committee to approve the transfer of manufacture outside of Israel was expanded.

The technology developed pursuant to the terms of these grants may not be transferred to third parties without the prior approval of the Research Committee. This approval is required only for the export of the technology, and not for the export of any products that incorporate the sponsored technology. Approval of the transfer of technology may be granted only if the recipient agrees to abide by all the provisions of the Research Law, including the restrictions on the transfer of know-how and the obligation to pay royalties in an amount that may be increased. The amendment to the Research Law effective June 7, 2005 granted authority to the Research Committee to approve the transfer of sponsored technology outside of Israel, subject to various conditions.

We have received grants from the OCS, and therefore we are subject to various restrictions under the Research Law on the transfer of technology or manufacturing. These restrictions do not terminate upon the full payment of royalties.

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

Tax Benefits Under the Law for the Encouragement of Industry (Taxation), 1969

According to the Law for the Encouragement of Industry (Taxation), 1969, or the Industry Encouragement Law, an “industrial company” is a company resident in Israel, that at least 90% of its income, in any tax year (determined in Israeli currency, exclusive of income from certain government loans, capital gains, interest and dividends) is derived from an industrial enterprise owned by it. An industrial enterprise is defined as an enterprise whose major activity in a given tax year is industrial production activity. We currently believe that we qualify as an industrial company within the definition of the Industry Encouragement Law. Under the Industry Encouragement Law, industrial companies are entitled to the following preferred corporate tax benefits:

- deduction of purchases of know-how and patents over an eight-year period for tax purposes;
- the right to elect, under specified conditions, to file a consolidated tax return with related Israeli industrial companies; and
- accelerated depreciation rates on equipment and buildings.

Eligibility for the benefits under the Industry Encouragement Law is not subject to receipt of prior approval from any governmental authority. The Israeli tax authorities may determine that we do not qualify as an industrial company, which would entail our loss of the benefits that relate to this status. In addition, no assurance can be given that we will continue to qualify as an industrial company, in which case the benefits described above will not be available in the future.

Special Provisions Relating to Measurement of Taxable Income

Commencing in taxable year 2003, we elected to measure our taxable income and file our tax return under the Israeli Income Tax Regulations (Principles Regarding the Management of Books of Account of Foreign Invested Companies and Certain Partnerships and the Determination of Their Taxable Income), 1986. Such an elective obligates the Company for three years. Accordingly, commencing taxable year 2003, results for tax purposes are measured in terms of earnings in dollars. We elected to extend the term of the above mentioned tax measurement by another year.

Capital Gains Tax Applicable to Resident and Non-Resident Shareholders

Israeli law generally imposes a capital gains tax on the sale of capital assets located in Israel, including shares in Israeli resident companies, by both residents and non-residents of Israel, unless a specific exemption is available or unless a treaty between Israel and the country of the non-resident provides otherwise. Regulations promulgated under the Israeli Income Tax Ordinance provided for an exemption from Israeli capital gains tax for gains accrued before January 1, 2003 and derived from the sale of shares of an industrial company, as defined by the Industry Encouragement Law, that are traded on specified non-Israeli markets, including The Nasdaq National Market, provided that the sellers purchased their shares either in the company's initial public offering or in public market transactions thereafter. This exemption does not apply to shareholders who are in the business of trading securities, or to shareholders that are Israeli resident companies subject to the Inflationary Adjustments Law. We believe that we are currently an industrial company, as defined by the Industry Encouragement Law. The status of a company as an industrial company may be reviewed by the tax authorities from time to time. There can be no assurance that the Israeli tax authorities will not deny our status as an industrial company, possibly with retroactive effect.

On January 1, 2003, the Tax Reform came into effect thus imposing capital gains tax at a rate of 15% on gains derived on or after January 1, 2003 from the sale of shares in Israeli companies:

- publicly traded on The Tel Aviv Stock Exchange, or the TASE;
- publicly traded on Nasdaq or a recognized stock exchange or regulated market in a country that has a treaty for the prevention of double taxation with Israel; or
- companies dually traded on both the TASE and on Nasdaq or a recognized stock exchange or a regulated market outside of Israel.

This tax rate does not apply to the sale of shares:

- to a relative (as defined in the tax reform);
- by dealers in securities;
- by shareholders that report in accordance with the Inflationary Adjustments Law; or
- by shareholders who acquired their shares prior to an initial public offering (that are subject to a different tax arrangement).

This tax rate is contingent upon the shareholder not claiming a deduction for financing expenses in connection with such shares.

Regulations adopted in connection with the Tax Reform deal with the taxation of the gain on securities acquired prior to the effectiveness of the Tax Reform and sold subsequent to the effectiveness of the Tax Reform (allocation of the gain as between the exempt period and the taxable period).

Non-Israeli residents are exempt from Israeli capital gains tax on any gains derived from the sale of shares publicly traded on the TASE, provided such gains do not derive from a permanent establishment of such shareholders in Israel. Non-Israeli residents are also exempt from Israeli capital gains tax on any gains derived from the sale of shares of Israeli companies publicly traded on a recognized stock exchange or regulated market outside of Israel, provided that such capital gains are not derived from a permanent establishment in Israel and that such shareholders did not acquire their shares prior to the issuer's initial public offering. However, non-Israeli corporations will not be entitled to the exemption with respect to gains derived from the sale of shares of Israeli companies publicly traded on the TASE, if an Israeli resident (i) has a controlling interest of 25% or more in such non-Israeli corporation, or (ii) is the beneficiary or is entitled to 25% or more of the revenues or profits of such non-Israeli corporation, whether directly or indirectly.

In some instances where our shareholders may be subject to Israeli tax on the sale of their ordinary shares, the payment of the consideration may be subject to the withholding of Israeli tax at the source.

United States-Israel Tax Treaty

Pursuant to the Convention Between the Government of the United States of America and the Government of Israel with respect to Taxes on Income, as amended, or the United States-Israel Tax Treaty, the sale, exchange or disposition of ordinary shares by a person who holds the ordinary shares as a capital asset and who qualifies as a resident of the United States within the meaning of the United States- Israel Tax Treaty and who is entitled to claim the benefits afforded to such person by the United States-Israel Tax Treaty, or a Treaty United States Resident, generally will not be subject to the Israeli capital gains tax unless such Treaty United States Resident holds, directly or indirectly, shares representing 10% or more of the voting power of our company during any part of the twelve-month period preceding such sale, exchange or disposition, subject to certain conditions. A sale, exchange or disposition of shares by a Treaty United States Resident who holds, directly or indirectly, shares representing 10% or more of the voting power of our company at any time during such preceding twelve-month period would be subject to such Israeli tax, to the extent applicable; however, under the United States-Israel Tax Treaty, such Treaty United States Resident would be permitted to claim a credit for such taxes against the United States federal income tax imposed with respect to such sale, exchange or disposition, subject to the limitations in United States laws applicable to foreign tax credits. The United States-Israel Tax Treaty does not relate to state or local taxes.

Tax on Dividends

Non-residents of Israel are subject to Israeli income tax on income accrued or derived from sources in Israel or received in Israel. These sources of income include passive income such as dividends, royalties and interest, as well as non-passive income from services rendered in Israel. On distributions of dividends, other than bonus shares and stock dividends, income tax at the rate of 25% is withheld at the source, unless a different rate is provided in a treaty between Israel and the shareholder's country of residence. If the dividends are distributed out of approved enterprise earnings, the applicable tax rate would be 15%. Under the U.S.-Israel Tax Treaty, the maximum tax on dividends paid to a holder of ordinary shares who is a Treaty United States Resident will be 25%, however that tax rate is reduced to 12.5% for dividends not generated by an approved enterprise to a corporation which holds 10% or more of the voting power of our company during a certain period preceding distribution of the dividend. Dividends derived from an approved enterprise will still be subject to 15% tax withholding.

Foreign Exchange Regulations

Dividends, if any, paid to the holders of the ordinary shares, and any amounts payable upon dissolution, liquidation or winding up, as well as the proceeds of any sale in Israel of the ordinary shares to an Israeli resident, may be paid in non-Israeli currency or, if paid in Israeli currency, may be converted into freely repatriable dollars at the rate of exchange prevailing at the time of conversion, provided that Israeli income tax has been paid or withheld on such amounts.

United States Federal Income Taxes

The following summary describes the material U.S. federal income tax consequences to “U.S. holders” (as defined below) arising from the purchase, ownership and disposition of our ordinary shares. This summary is based on current provisions of the Internal Revenue Code of 1986, as amended, or the “Code,” the final, temporary and proposed U.S. Treasury Regulations promulgated thereunder and administrative and judicial interpretations thereof, all of which are subject to change, possibly with retroactive effect. For purposes of this summary, a “U.S. holder” will be deemed to refer only to any of the following holders of our ordinary shares:

- an individual who is either a U.S. citizen or a resident of the U.S. for U.S. federal income tax purposes;
- a corporation (or an entity taxable as a corporation) created or organized under the laws of the U.S. or any political subdivision thereof;
- an estate, the income of which is subject to U.S. federal income tax regardless of the source of its income; and
- a trust, if either (a) a U.S. court is able to exercise primary supervision over the administration of the trust and one or more U.S. persons have the authority to control all the substantial decisions of the trust, or (b) the trust has a valid election in effect under applicable U.S. Treasury regulations to be treated as a U.S. person.

This summary does not consider all aspects of U.S. federal income taxation that may be relevant to particular U.S. holders by reason of their particular circumstances, including potential application of the alternative minimum tax, or any aspect of state, local or non-U.S. federal tax laws. In addition, this summary is directed only to U.S. holders that hold our ordinary shares as capital assets and does not address the considerations that may be applicable to particular classes of U.S. holders, including financial institutions, insurance companies, broker-dealers, tax-exempt organizations, holders whose functional currency is not the U.S. dollar, holders who acquired our ordinary shares through exercise of options or otherwise as compensation, holders of our ordinary shares as part of a “straddle,” “hedge” or “conversion transaction,” holders, directly, indirectly or through attribution, of 10% or more of our outstanding ordinary shares and persons who own our ordinary shares through a partnership or other pass-through entity.

Each U.S. holder should consult with its own tax advisor as to the particular tax consequences to it of the purchase, ownership and sale of our ordinary shares, including the effects of applicable state, local, foreign or other tax laws and possible changes in the tax laws.

Distributions With Respect to Our Ordinary Shares

The amount of a distribution with respect to our ordinary shares will equal the amount of cash and the fair market value of any property distributed and will also include the amount of any Israeli taxes withheld, as described below under “Israeli Tax Considerations – Tax on Dividends.” Other than distributions in liquidation and distributions in redemption of stock that are treated as exchanges, a distribution paid by us with respect to our ordinary shares to a U.S. holder generally will be treated as a dividend to the extent that the distribution does not exceed our current and accumulated earnings and profits, as determined for U.S. federal income tax purposes. The amount of any distribution that exceeds these earnings and profits will be treated first as a non-taxable return of capital, reducing the U.S. holder’s tax basis in its ordinary shares, and then generally as capital gain. Currently, an individual U.S. holder’s “qualified dividend income” is subject to tax at a reduced rate of 15%.

For this purpose, “qualified dividend income” generally includes dividends paid by a foreign corporation to an individual holder if such U.S. holder meets certain minimum holding period requirements and either (a) the stock of such corporation is readily tradable on an established securities market in the U.S., including the Nasdaq National Market, or (b) such corporation is eligible for the benefits of a comprehensive income tax treaty with the U.S. which includes an information exchange program and is determined to be satisfactory by the U.S. Secretary of the Treasury. The U.S. Secretary of the Treasury has indicated that the income tax treaty between the U.S. and Israel is satisfactory for this purpose. Dividends paid by a foreign corporation will not qualify for the 15% U.S. federal income tax rate, however, if such corporation is treated, for the tax year in which the dividends are paid or the preceding tax year, as a “passive foreign investment company” for U.S. federal income tax purposes.

As discussed in more detail below under “Passive Foreign Investment Company Status,” we do not believe that we currently would be classified as a “passive foreign investment company” for U.S. federal income tax purposes. Accordingly, dividend distributions with respect to our ordinary shares should be treated as “qualified dividend income” and, subject to U.S. holders’ satisfaction of certain minimum holding period requirements, should be eligible for the reduced 15% U.S. federal income tax rate. Corporate holders of our ordinary shares generally will not be allowed a deduction for dividends received on our ordinary shares.

A dividend paid by us in NIS will be included in the income of U.S. holders at the dollar amount of the dividend, based on the “spot rate” of exchange in effect on the date the distribution is includable in the U.S. holders’ income, regardless of whether the payment is in fact converted into dollars. The “spot rate” generally refers to a rate that reflects a fair market rate of exchange available to the public for currency under a “spot contract” in a free market and involving representative amounts. A “spot contract” is a contract to buy or sell a currency no more than two business days following the date of the execution of the contract. If a spot rate cannot be demonstrated, the U.S. Internal Revenue Service has the authority to determine the spot rate. U.S. holders will have a tax basis in the NIS for U.S. federal income tax purposes equal to that dollar value. Any subsequent gain or loss on NIS arising from exchange rate fluctuations during the period from the date a U.S. holder includes the dividend payment in income to the date such U.S. holder converts the payment to dollars will be taxable as ordinary income or loss and will be U.S.-source income or loss for U.S. foreign tax credit purposes.

Dividend income derived with respect to our ordinary shares will constitute “portfolio income” for purposes of the limitation on the use of passive activity losses and, therefore, generally may not be offset by passive activity losses, and generally will be treated as “investment income” for purposes of the limitation on the deduction of investment interest expense. Dividends paid by us generally will be foreign-source passive income for U.S. foreign tax credit purposes or, in the case of a U.S. holder that is a financial services entity, financial services income. Subject to certain limitations, U.S. holders may elect to claim as a foreign tax credit against their U.S. federal income tax liability any Israeli income tax withheld from dividends received on our ordinary shares. U.S. holders that do not elect to claim a foreign tax credit may instead claim a deduction for Israeli income tax withheld. In addition, special rules may apply to the computation of foreign tax credits relating to qualified dividend income. The calculation of foreign tax credits and, in the case of a U.S. holder that elects to deduct foreign income taxes, the availability of deductions is complex and involves the application of rules that depend on a U.S. holder’s particular circumstances. U.S. holders are urged to consult their own tax advisors regarding the availability to them of foreign tax credits or deductions in respect of any Israeli tax withheld or paid.

Disposition of Our Ordinary Shares

Subject to the discussion below under “Passive Foreign Investment Company Status,” a U.S. holder’s sale or exchange of our ordinary shares generally will result in the recognition by such U.S. holder of capital gain or loss in an amount equal to the difference between the United States dollar value of the amount realized and the U.S. holder’s tax basis in the ordinary shares sold. This gain or loss will be long-term capital gain or loss if the ordinary shares sold have been held for more than one year at the time of the sale or exchange. If the U.S. holder’s holding period on the date of the sale or exchange is one year or less, such gain or loss will be a short-term capital gain or loss. Individual U.S. holders currently are subject to a maximum tax rate of 15% on long-term capital gains for tax years beginning on or before December 31, 2008. Short-term capital gains generally are taxed at the same rates applicable to ordinary income. See “Israeli Tax Considerations -- Capital Gains Tax Applicable to Resident and Non-Resident Shareholders” for a discussion of taxation by Israel of capital gains realized on sales of capital assets. Any capital loss realized upon the sale, exchange or other disposition of our ordinary shares generally will be deductible only against capital gains and not against ordinary income, except that in the case of non-corporate U.S. holders, a capital loss is deductible in any year to the extent of capital gains plus ordinary income up to \$3,000. In general, any capital gain recognized by a U.S. holder upon the sale or exchange of our ordinary shares will be treated as U.S.-source income for U.S. foreign tax credit purposes. Under the tax treaty between the United States and Israel, gain derived from the sale, exchange or other disposition of ordinary shares by a holder who is a resident of the United States for purposes of the treaty and who sells the ordinary shares within Israel may be treated as foreign-source income for U.S. foreign tax credit purposes.

A U.S. holder’s tax basis in its ordinary shares generally will be equal to the purchase price paid therefore by such U.S. holder. The holding period of each ordinary share owned by a U.S. holder will begin on the day following the date of the U.S. holder’s purchase of such ordinary share and will include the day on which the ordinary share is sold by such U.S. holder.

In the case of a U.S. holder who uses the cash basis method of accounting and who receives NIS in connection with the sale or taxable disposition of ordinary shares, the amount realized will be based on the spot rate as determined on the settlement date of such exchange. If such U.S. holder subsequently converts NIS into dollars at a conversion rate other than the spot rate in effect on the settlement date, such U.S. holder may have a foreign currency exchange gain or loss that would be treated as ordinary income or loss. A U.S. holder who uses the accrual method of accounting may elect the same treatment required of cash basis taxpayers with respect to a sale or taxable disposition of ordinary shares, provided that the election is applied consistently from year to year. Such election may not be changed without the consent of the U.S. Internal Revenue Service. If an accrual basis U.S. holder does not elect to be treated as a cash basis taxpayer (pursuant to the Treasury regulations applicable to foreign currency transactions), such U.S. holder may be deemed to have realized an immediate foreign currency gain or loss for U.S. federal income tax purposes because of differences between the dollar value of the NIS on the date of sale or other taxable disposition and on the settlement date. Any such currency gain or loss generally would be treated as U.S. source ordinary income or loss and would be in addition to gain or loss, if any, recognized by such U.S. holder on the sale or taxable disposition of ordinary shares.

Passive Foreign Investment Company Status

Generally, a foreign corporation is treated as a passive foreign investment company ("PFIC") for U.S. federal income tax purposes for any tax year if, in such tax year, either (i) 75% or more of its gross income, including its pro rata share of the gross income of any company in which it is considered to own 25% or more of the shares by value, is passive in nature (the "Income Test"), or (ii) the average percentage of its assets during such tax year, including its pro rata share of the assets of any company in which it is considered to own 25% or more of the shares by value, which produce, or are held for the production of, passive income (determined by averaging the percentage of the fair market value of its total assets which are passive assets as of the end of each quarter of such year) is 50% or more (the "Asset Test").

Based on the composition of our gross income and the composition and value of our gross assets during 2005, we do not believe that we were a PFIC in 2005. While it is possible that we would have been classified as a PFIC under the Asset Test in 2001, 2002 and 2003 principally because a significant portion of our assets continued to consist of the cash raised in connection with the two public offerings of our ordinary shares in 1999, and the public market value of our ordinary shares declined significantly during 2001, 2002 and the first half of 2003, we do not believe we would have been treated as a PFIC in 2004. The tests for determining whether we are a PFIC for any tax year are applied annually, and it is difficult to make accurate predictions regarding the composition of our future income and assets, the factors which are relevant to this determination. In addition, there is no definitive method prescribed in the Code, United States Treasury Regulations or administrative or judicial interpretations thereof for determining the value of a foreign corporation's assets for purposes of the Asset Test. While the legislative history of the United States Taxpayer Relief Act of 1997 indicates that "the total value of a publicly-traded foreign corporation's assets generally will be treated as equal to the sum of the aggregate value of its outstanding stock plus its liabilities," there remains substantial uncertainty regarding the valuation of a publicly-traded foreign corporation's assets for purposes of the Asset Test. Moreover, certain factors relevant to the PFIC determination, such as declines in the market value of our stock, are not within our control and can cause us to become a PFIC. Accordingly, there can be no assurance that we will not be deemed a PFIC in any future tax year.

In view of the uncertainty regarding our use of the net proceeds realized from our sale of notes in November 2004, the valuation of our assets for purposes of the Asset Test and the complexity of the issues regarding our treatment as a PFIC, U.S. holders are urged to consult their own tax advisors for guidance as to our status as a PFIC. For those U.S. holders who determine that we were a PFIC in 2005 or in any subsequent tax year and notify us in writing of their request for the information required in order to effectuate the QEF Election described below, we will promptly make such information available to them.

If we are treated as a PFIC for U.S. federal income tax purposes for any year during a U.S. holder's holding period of our ordinary shares and the U.S. holder does not make a QEF Election or a "mark-to-market" election (both as described below):

- "Excess distributions" by us to a U.S. holder would be taxed in a special way. "Excess distributions" with respect to any U.S. holder are amounts received by such U.S. holder with respect to our ordinary shares in any tax year that exceed 125% of the average distributions received by such U.S. holder from us during the shorter of (i) the three previous years, or (ii) such U.S. holder's holding period of our ordinary shares before the then-current tax year. Excess distributions must be allocated ratably to each day that a U.S. holder has held our ordinary shares. A U.S. holder must include amounts allocated to the current tax year in its gross income as ordinary income for that year. A U.S. holder must pay tax on amounts allocated to each prior tax year in which we were a PFIC at the highest rate in effect for such prior year on ordinary income and the tax is subject to an interest charge at the rate applicable to deficiencies for income tax.
- The entire amount of any gain realized by a U.S. holder upon the sale or other disposition of our ordinary shares also would be treated as an excess distribution subject to tax as described above.
- The tax basis in ordinary shares acquired from a decedent who was a U.S. holder would not receive a step-up to fair market value as of the date of the decedent's death but would instead be equal to the decedent's basis, if lower.

Although we generally will be treated as a PFIC as to any U.S. holder if we are a PFIC for any year during the U.S. holder's holding period, if we cease to satisfy the requirements for PFIC classification, the U.S. holder may avoid the consequences of PFIC classification for subsequent years by electing to recognize gain based on the unrealized appreciation in the notes or ordinary shares through the close of the tax year in which we cease to be a PFIC. Additionally, if we are treated as a PFIC, a U.S. holder who acquires ordinary shares from a decedent would be denied the normally available step-up in tax basis for these ordinary shares to fair market value at the date of death and instead would have a tax basis equal to the decedent's tax basis.

A U.S. holder who beneficially owns shares of a PFIC must file Form 8621 (Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund) with the IRS for each tax year in which the U.S. holder holds shares in a PFIC. This form describes any distributions received with respect to these shares and any gain realized upon the disposition of these shares.

For any tax year in which we are treated as a PFIC, a U.S. holder may elect to treat its ordinary shares as an interest in a qualified electing fund (a “QEF Election”), in which case, the U.S. holder would be required to include in income currently such U.S. holder’s proportionate share of our earnings and profits in years in which we are a PFIC regardless of whether distributions of our earnings and profits are actually distributed to the U.S. holder. Any gain subsequently recognized upon the sale or other disposition by the U.S. holder of the ordinary shares, however, generally would be taxed as capital gain and the denial of the basis step-up at death described above would not apply.

A U.S. holder may make a QEF Election with respect to a PFIC for any tax year of the U.S. holder. A QEF Election is effective for the year in which the election is made and all subsequent tax years of the U.S. holder. Procedures exist for both retroactive elections and the filing of protective statements. An additional election is available to defer the payment of taxes that may result from a QEF Election, although interest must be paid on any deferred taxes. A U.S. holder making the QEF Election must make the election on or before the due date, as extended, for the filing of the U.S. holder’s income tax return for the first tax year to which the election will apply. A U.S. holder must make a QEF Election by completing Form 8621 and attaching it to its U.S. federal income tax return, and must satisfy additional filing requirements each year the election remains in effect.

As an alternative to a QEF Election, a U.S. holder generally may elect to mark its ordinary shares to market annually, recognizing ordinary income or loss (subject to certain limitations) equal to the difference, as of the close of the taxable year, between the fair market value of the ordinary shares and their adjusted tax basis. Losses would be allowed only to the extent of net mark-to-market gain accrued under the election. If a mark-to-market election with respect to ordinary shares is in effect on the date of a U.S. holder’s death, the normally available step-up in tax basis to fair market value will not be available. Rather, the tax basis of the ordinary shares in the hands of a U.S. holder who acquired them from a decedent will be the lesser of the decedent’s tax basis or the fair market value of the ordinary shares. Once made, a mark-to-market election generally continues, unless revoked with the consent of the IRS.

The implementation of many aspects of the Code’s PFIC rules requires the issuance of regulations which in many instances have yet to be promulgated and which may have retroactive effect. We cannot be sure that any of these regulations will be promulgated or, if so, what form they will take or what effect they will have on the foregoing discussion. Accordingly, and due to the complexity of the PFIC rules, U.S. holders should consult their own tax advisors regarding our status as a PFIC and the eligibility, manner and advisability of making a QEF Election or a mark-to-market election.

Information Reporting And Backup Withholding

Any dividends paid on our ordinary shares to U.S. holders may be subject to U.S. federal tax information reporting requirements and the U.S. backup withholding tax (the backup withholding rate currently is 28%). In addition, the proceeds of a U.S. holder’s sale of ordinary shares may be subject to tax information reporting and the U.S. backup withholding tax. Backup withholding will not apply if the U.S. holder (i) is a corporation or other exempt recipient, and demonstrates the fact when so required, or (ii) the U.S. holder provides a U.S. taxpayer identification number, certifies as to no loss of exemption from backup withholding and complies with any other applicable backup withholding requirements. U. S. holders required to establish their exemption from backup withholding generally must provide a certification on the U.S. Internal Revenue Service Form W-9. Any amounts withheld under the U.S. backup withholding tax rules will be allowed as a refund or a credit against the U.S. holder’s U.S. federal income tax liability, provided the required information is furnished to the U.S. Internal Revenue Service.

The foregoing discussion of certain U.S. federal income tax considerations is for general information only and is not tax advice. Accordingly, each U.S. holder should consult with his, her or its own tax adviser regarding U.S. federal, state, local and non-U.S. income and other tax consequences of the acquisition, ownership and disposition of ordinary shares.

F. *DIVIDENDS AND PAYING AGENTS*

Not applicable.

G. *STATEMENT BY EXPERTS*

Not applicable.

H. *DOCUMENTS ON DISPLAY*

We are subject to the informational requirements of the Securities Exchange Act of 1934, as amended, applicable to foreign private issuers and fulfill the obligations with respect to such requirements by filing reports with the Securities and Exchange Commission, or SEC. You may read and copy any document we file, including any exhibits, with the SEC without charge at the SEC's public reference room at 100 F Street, N.E., Washington, D.C. 20549. Copies of such material may be obtained by mail from the Public Reference Branch of the SEC at such address, at prescribed rates. Please call the SEC at 1-800-SEC-0330 for further information on the public reference room. Certain of our SEC filings are also available to the public at the SEC's website at <http://www.sec.gov>.

As a foreign private issuer, we are exempt from the rules under the Exchange Act prescribing the furnishing and content of proxy statements, and our officers, directors and principal shareholders are exempt from the reporting and "short-swing" profit recovery provisions contained in Section 16 of the Exchange Act. In addition, we are not required under the Exchange Act to file periodic reports and financial statements with the SEC as frequently or as promptly as United States companies whose securities are registered under the Exchange Act. We have obtained an exemption from Nasdaq's requirement to send an annual report to shareholders prior to our annual general meetings. We file annual reports on Form 20-F electronically with the SEC and post a copy on our website, www.audiocodes.com.

I. *SUBSIDIARY INFORMATION*

Not applicable.

ITEM 11. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our exposure to market risk for changes in interest rates relates primarily to our investment in marketable securities. Our marketable securities portfolio includes U.S. government debt instruments and corporate debt instruments. The fair value of our long and short-term securities is based upon their market values as of December 31, 2005. In addition, we have contracted several structured note deals that are sensitive to changes in interest rates. Due to the nature of our investments, we do not believe that there is any material market risk exposure. Therefore, no quantitative tabular disclosures are required. However, we may in the future undertake hedging or other similar transactions or invest in market risk sensitive instruments if management determines that it is necessary to offset these risks. See “Item 3. Key Information—D. Risk Factors—Risks Relating to Operations in Israel.”

To protect against the changes in value of forecasted foreign currency cash flows resulting from salary payments, we have instituted a foreign currency cash flow hedging program. We hedge portions of our forecasted expenses denominated in foreign currencies with forward contracts.

During 2003, we entered into forward contracts to hedge a portion of the anticipated NIS payroll payments for periods of one to six months. These forward contracts are designated as cash flows hedges, as defined by SFAS No. 133, as amended, and are all highly effective as hedges of these expenses when the salary is recorded. The effective portion of the hedged instruments is included in payroll expenses in the statement of operations. During the year ended December 31, 2003, we recognized net income of \$426,000 related to the forward contracts hedging salary payments. At December 31, 2003, we expected to reclassify \$145,000 of net profit on derivative instruments from accumulated other comprehensive income to earnings during the next twelve months.

During the year ended December 31, 2004, we recognized net income of \$87,000 related to the forward contracts hedging salary payments. At December 31, 2004, we expected to reclassify \$353,000 of net profit on derivative instruments from accumulated other comprehensive income to earnings during the next twelve months.

During the year ended December 31, 2005, we recognized net loss of \$151,000 related to the forward contracts hedging salary payments. At December 31, 2005, we expected to reclassify \$84,000 of net profit on derivative instruments from accumulated other comprehensive income to earnings during the next twelve months.

ITEM 12. DESCRIPTION OF SECURITIES OTHER THAN EQUITY SECURITIES

Not applicable.

ITEM 13. DEFAULTS, DIVIDEND ARREARAGES AND DELINQUENCIES

Not applicable.

ITEM 14. MATERIAL MODIFICATIONS TO THE RIGHTS OF SECURITY HOLDERS AND USE OF PROCEEDS

Not applicable

ITEM 15. CONTROLS AND PROCEDURES

As of the end of the period covered by this report, we performed an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures (as such term is defined in Rule 15d-15(e) under the Exchange Act). The evaluation was performed with the participation of our key corporate senior management and under the supervision and with the participation of our chief executive officer and chief financial officer. Based on this evaluation, our principal executive officer and principal financial officer have concluded that our disclosure controls and procedures are designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Securities Exchange Act of 1934 is (i) recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms and (ii) accumulated and communicated to our management, including our principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure.

In addition, no changes in our internal control over financial reporting have occurred during the period covered by this Annual Report that have materially affected our internal controls over financial reporting.

ITEM 16. [RESERVED]

ITEM 16A. AUDIT COMMITTEE FINANCIAL EXPERT

Our Board of Directors has determined that Joseph Tenne is an "audit committee financial expert" as defined in Item 16A of Form 20-F and is "independent" as defined in the applicable regulations.

ITEM 16B. CODE OF ETHICS

In 2004, we adopted a Code of Conduct and Business Ethics that applies to our chief executive officer, chief financial officer and other senior financial officers. This Code has been posted on our website, www.audiocodes.com.

ITEM 16C. PRINCIPAL ACCOUNTANT FEES AND SERVICES

Kost Forer Gabbay & Kasierer, a member of Ernst & Young Global, has served as our independent public accountants for each of the years in the three-year period ended December 31, 2005. The following table presents the aggregate fees for professional audit services and other services rendered by Kost Forer Gabbay & Kasierer in 2004 and 2005.

	Year ended December 31, (Amounts in thousands)	
	2004	2005
Audit Fees	80	115
Audit Related Fees	230	51
Tax Fees	53	65
All Other Fees	—	4
Total	363	235

Audit Fees consist of fees billed for the annual audit of the company's consolidated financial statements and the statutory financial statements of the company. They also include fees billed for other audit services, which are those services that only the external auditor reasonably can provide, and include the provision of consents and the review of documents filed with the SEC.

Audit Related Fees consist of fees billed for assurance and related services that are reasonably related to the performance of the audit or review of the company's financial statements and include operational effectiveness of systems. They also include fees billed for other services in connection with merger and acquisition due diligence, as well as our offering of convertible notes and our filing of a registration statement on Form F-3 with respect to the convertible notes.

Tax Fees include fees billed for tax compliance services, including the preparation of tax returns and claims for refund; tax consultations, such as assistance and representation in connection with tax audits and appeals, transfer pricing, and requests for rulings or technical advice from taxing authorities; tax planning services; and expatriate tax compliance, consultation and planning services.

Audit Committee Pre-approval Policies and Procedures

The Audit Committee of AudioCodes' Board of Directors is responsible, among other matters, for the oversight of the external auditor subject to the requirements of Israeli law. The Audit Committee has adopted a policy regarding pre-approval of audit and permissible non-audit services provided by our independent auditors (the "Policy").

Under the Policy, proposed services either (i) may be pre-approved by the Audit Committee without consideration of specific case-by-case services as "general pre-approval"; or (ii) require the specific pre-approval of the Audit Committee as "specific pre-approval". The Audit Committee may delegate either type of pre-approval authority to one or more of its members. The appendices to the Policy set out the audit, audit-related, tax and other services that have received the general pre-approval of the Audit Committee, including those described in the footnotes to the table, above; these services are subject to annual review by the Audit Committee. All other audit, audit-related, tax and other services must receive a specific pre-approval from the Audit Committee.

The Audit Committee establishes budgeted fee levels annually for each of the four categories of audit and non-audit services that are pre-approved under the Policy, namely, audit, audit-related, tax and other services. Requests or applications to provide services that require specific approval by the Audit Committee are submitted to the Audit Committee by both the external auditor and the chief financial officer. At each regular meeting of the Audit Committee, the external auditor provides a report in order for the Audit Committee to review the services that the external auditor is providing, as well as the status and cost of those services.

During 2005, no services provided to AudioCodes by Kost Forer Gabbay & Kasierer were approved by the Audit Committee pursuant to the de minimis exception to the pre-approval requirement provided by paragraph (c)(7)(i)(C) of Rule 2-01 of Regulation S-X.

ITEM 16D. EXEMPTIONS FROM THE LISTING STANDARDS FOR AUDIT COMMITTEES

Not applicable.

ITEM 16E. PURCHASES OF EQUITY SECURITIES BY THE ISSUER AND AFFILIATED PURCHASERS

Not applicable.

PART III

ITEM 17. FINANCIAL STATEMENTS

Not applicable.

ITEM 18. FINANCIAL STATEMENTS

Reference is made to pages F-1 to F-39 hereto.

ITEM 19.

The following exhibits are filed as part of this Annual Report:

<u>Exhibit No.</u>	<u>Exhibit</u>
1.1	Memorandum of Association of Registrant.*†
1.2	Articles of Association of Registrant, as amended.**
2.1	Indenture, dated November 9, 2004, between AudioCodes Ltd. and U.S. Bank National Association, as Trustee, with respect to the 2.))% Senior Convertible Notes due 2024.*****
4.1	AudioCodes Ltd. 1997 Key Employee Option Plan (C).*
4.2	AudioCodes Ltd. 1997 Key Employee Option Plan, Qualified Stock Option Plan—U.S. Employees (D).*
4.3	Founder’s Agreement between Shabtai Adlersberg and Leon Bialik, dated January 1, 1993.*†
4.4	License Agreement between AudioCodes Ltd. and DSP Group, Inc., dated as of May 6, 1999.*†
4.5	Lease Agreement between AudioCodes Inc. and Spieker Properties, L.P., dated January 26, 2000.**
4.6	Shareholders Agreement by and among DSP Group, Inc., Shabtai Adlersberg, Leon Bialik, Genesis Partners I, L.P., Genesis Partners I (Cayman) L.P., Polaris Fund II (Tax Exempt Investors) L.L.C., Polaris Fund II L.L.C., Polaris Fund II L.P., DS Polaris Trust Company (Foreign Residents) (1997) Ltd., DS Polaris Ltd., Dovrat, Shrem Trust Company (Foreign Funds) Ltd., Dovrat Shrem-Skies 92 Fund L.P. and Chase Equity Securities CEA, dated as of May 6, 1999.*
4.7	AudioCodes Ltd. 1997 Key Employee Option Plan (D).*
4.8	AudioCodes Ltd. 1997 Key Employee Option Plan (E).*
4.9	AudioCodes Ltd. 1999 Key Employee Option Plan (F), as amended.***
4.10	AudioCodes Ltd. 1997 Key Employee Option Plan, Qualified Stock Option Plan—U.S. Employees (E).*

- 4.11 AudioCodes Ltd. 1999 Key Employee Option Plan, Qualified Stock Option Plan—U.S. Employees (F).***
- 4.12 AudioCodes Ltd. 2001 Employee Stock Purchase Plan—Global Non U.S.§
- 4.13 AudioCodes Ltd. 2001 U.S. Employee Stock Purchase Plan.§
- 4.14 Lease Agreement between AudioCodes Ltd. and Nortel Networks (Marketing and Sales) Israel Ltd., effective as of December 31, 2002.**††
- 4.15 Sublease Agreement between AudioCodes USA, Inc. and Continental Resources, Inc., dated December 30, 2003. §§
- 4.16 Stock Purchase Agreement by and among AudioCodes Ltd., AudioCodes Inc., Ai-Logix, Inc. and AI Technologies N.V, dated as of May 12, 2004. §§
- 4.17 OEM Purchase and Sale Agreement No. 011449 between AudioCodes Ltd and Nortel Networks Ltd., dated as of April 28, 2003 *****§§
- 4.18 Amendment No. 1 to OEM Purchase and Sale No. 011449 between AudioCodes Ltd and Nortel Networks Ltd., dated as of May 1, 2003 *****§§
- 4.19 Purchase and Sale Agreement by and among Nortel Networks, Ltd., AudioCodes Inc. and AudioCodes Ltd., dated as of April 7, 2003. §§
- 4.20 Purchase Agreement, dated as of November 9, 2004, between AudioCodes Ltd. and Merrill Lynch & Co., Merrill Lynch, Pierce, Fenner & Smith Incorporated and Lehman Brothers Inc., as representatives of the initial purchasers of AudioCodes' 2.00% Senior Convertible Notes due 2024. ****
- 4.21 Registration Rights Agreement, dated as of November 9, 2004, between AudioCodes Ltd. and Merrill Lynch, Pierce, Fenner & Smith Incorporated, Lehman Brothers Inc. and CIBC World Markets Corp. ****
- 4.22 Amendment No. 2 to OEM Purchase and Sale No. 011449 between AudioCodes Ltd and Nortel Networks Ltd., dated as of January 1, 2005 *****§§§
- 4.23 Amendment No. 3 to OEM Purchase and Sale No. 011449 between AudioCodes Ltd and Nortel Networks Ltd., dated as of February 15, 2005 *****§§§
- 4.24 Amendment No. 5 to OEM Purchase and Sale No. 011449 between AudioCodes Ltd and Nortel Networks Ltd., dated as of January 1, 2005 *****§§§
- 4.25 Amendment No. 6 to OEM Purchase and Sale No. 011449 between AudioCodes Ltd and Nortel Networks Ltd., dated as of April 1, 2005 §§§

- 4.26 Lease Agreement between AudioCodes Inc. and CA-Gateway Office Limited Partnership, effective as of December, 2004. §§§
- 4.27 Amendment No. 4 to OEM Purchase and Sale No. 011449 between AudioCodes Ltd and Nortel Networks Ltd., dated as of April 28, 2005 #
- 4.28 Agreement and Plan of Merger, dated as of May 16, 2006, among Audiocodes Ltd., Audiocodes, Inc., Green Acquisition Corp., Nuera Communications, Inc. and Robert Wadsworth, as Sellers' Representative.
- 8.1 Subsidiaries of the Registrant.
- 12.1 Certification of Shabtai Adlersberg, President and Chief Executive Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 12.2 Certification of Nachum Falek, Vice President and Chief Financial Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 13.1 Certification by Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 13.2 Certification by Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 14.1 Consent of Kost Forer Gabbay & Kasierer, a member of Ernst & Young Global.

* Incorporated herein by reference to Registrant's Registration Statement on Form F-1 (File No. 333-10352) .

† Hebrew original and English summary of Hebrew original.

†† English summary of Hebrew original.

‡ Incorporated herein by reference to Registrant's Registration Statement on Form S-8 (File No. 333-13268) .

§ Incorporated herein by reference to Registrant's Registration Statement on Form S-8 (File No. 333-13378) .

** Incorporated herein by reference to Registrant's Form 20-F for the fiscal year ended December 31, 2000.

*** Incorporated herein by reference to Registrant's Form 20-F for the fiscal year ended December 31, 2002.

**** Incorporated by reference herein to Registrant's Registration Statement on Form F-3 (File No. 333-123859).

***** Confidential treatment has been granted for certain portions of the indicated document. The confidential portions have been omitted and filed separately with the Securities and Exchange Commission as required by Rule 24b-2 promulgated under the Securities Exchange Act of 1934.

§§ Incorporated herein by reference to Registrant's Form 20-F for the fiscal year ended December 31, 2003.

§§§ Incorporated herein by reference to Registrant's Form 20-F for the fiscal year ended December 31, 2004

A request for confidentiality has been filed for certain portions of the indicated document. Confidential portions have been omitted and filed separately with the Securities and Exchange Commission as required by Rule 24b-2 promulgated under the Securities Exchange Act of 1934.

SIGNATURES

The registrant hereby certifies that it meets all of the requirements for filing on Form 20-F and that it has duly caused and authorized the undersigned to sign this Annual Report on Form 20-F on its behalf.

AUDIOCODES LTD.

By: /s/ NACHUM FALEK

Nachum Falek
Vice President Finance and
Chief Financial Officer

Date: June 29, 2006

EXHIBIT INDEX

<u>Exhibit No.</u>	<u>Exhibit</u>
4.27	Amendment No. 4 to OEM Purchase and Sale No. 011449 between AudioCodes Ltd and Nortel Networks Ltd., dated as of April 28, 2005 *
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AUDIOCODES LTD. AND ITS SUBSIDIARIES

CONSOLIDATED FINANCIAL STATEMENTS

AS OF DECEMBER 31, 2005

IN U.S. DOLLARS

INDEX

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**To the Board of Directors and Shareholders of****AUDIOCODES LTD.**

We have audited the accompanying consolidated balance sheets of AudioCodes Ltd. (“the Company”) and its subsidiaries as of December 31, 2004 and 2005, 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, 2005. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Company’s internal control over financial reporting. Our audits includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company’s internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above, present fairly, in all material respects, the consolidated financial position of the Company and its subsidiaries at December 31, 2004 and 2005, and the related consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2005, in conformity with U.S. generally accepted accounting principles.

Tel-Aviv, Israel
February 1, 2006

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

CONSOLIDATED BALANCE SHEETS

U.S. dollars in thousands

	December 31,	
	2004	2005
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 166,832	\$ 70,957
Short-term bank deposits and structured note	-	61,929
Short-term marketable securities and accrued interest	-	9,863
Trade receivables (net of allowance for doubtful accounts of \$685 and \$553 as of December 31, 2004 and 2005, respectively)	14,470	17,990
Other receivables and prepaid expenses	4,608	4,891
Inventories	10,059	11,562
Total current assets	195,969	177,192
LONG-TERM INVESTMENTS:		
Long-term bank deposits and structured notes	50,195	27,781
Long-term marketable securities	-	49,791
Investment in affiliated companies	487	1,112
Deferred tax assets	-	2,489
Severance pay funds	4,538	5,406
Total long-term investments	55,220	86,579
PROPERTY AND EQUIPMENT, NET	6,694	6,494
INTANGIBLE ASSETS, DEFERRED CHARGES AND OTHER, NET	5,127	3,279
GOODWILL	9,135	18,679
Total assets	\$ 272,145	\$ 292,223

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

CONSOLIDATED BALANCE SHEETS

U.S. dollars in thousands, except share and par value data

	December 31,	
	2004	2005
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Trade payables	\$ 6,541	\$ 7,774
Other payables and accrued expenses	17,981	18,620
Total current liabilities	24,522	26,394
ACCRUED SEVERANCE PAY	4,978	5,887
SENIOR CONVERTIBLE NOTES	120,660	120,836
COMMITMENTS AND CONTINGENT LIABILITIES		
SHAREHOLDERS' EQUITY:		
Share capital -		
Ordinary shares of NIS 0.01 par value-		
Authorized: 100,000,000 as of December 31, 2004 and 2005;		
Issued: 43,808,132 shares as of December 31, 2004 and 44,529,943 shares as of December 31, 2005; Outstanding:		
39,865,993 shares as of December 31, 2004 and 40,587,804 shares as of December 31, 2005	126	128
Additional paid-in capital	126,700	130,616
Treasury stock	(11,320)	(11,320)
Deferred stock compensation	(108)	(72)
Accumulated other comprehensive income	353	84
Retained earnings	6,234	19,670
Total shareholders' equity	121,985	139,106
Total liabilities and shareholders' equity	\$ 272,145	\$ 292,223

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

CONSOLIDATED STATEMENTS OF OPERATIONS

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

	Year ended December 31,		
	2003	2004	2005
Revenues	\$ 44,228	\$ 82,756	\$ 115,827
Cost of revenues	20,037	34,375	46,993
Gross profit	24,191	48,381	68,834
Operating expenses:			
Research and development, net	15,476	20,009	24,415
Selling and marketing	14,537	19,891	25,944
General and administrative	4,066	4,851	6,004
Total operating expenses	34,079	44,751	56,363
Operating income (loss)	(9,888)	3,630	12,471
Financial income, net	1,883	2,165	2,457
Equity in losses of affiliated companies, net	429	516	693
Income (loss) before taxes on income	(8,434)	5,279	14,235
Taxes on income	-	273	799
Net income (loss)	\$ (8,434)	\$ 5,006	\$ 13,436
Basic net earnings (loss) per share	\$ (0.22)	\$ 0.13	\$ 0.33
Diluted net earnings (loss) per share	\$ (0.22)	\$ 0.12	\$ 0.31

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

STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

U.S. dollars in thousands

	Share capital	Additional paid-in capital	Treasury stock	Deferred stock compensation	Accumulated other comprehensive income	Retained earnings	Total comprehensive income (loss)	Total shareholders' equity
Balance as of January 1, 2003	\$ 120	\$ 114,635	\$ (11,105)	\$ -	\$ 72	\$ 9,662		\$ 113,384
Purchase of treasury stock	-	-	(215)	-	-	-		(215)
Issuance of shares upon exercise of options and employee stock purchase plan	1	1,659	-	-	-	-		1,660
Deferred stock compensation	-	224	-	(224)	-	-		-
Amortization of deferred stock compensation	-	-	-	50	-	-		50
Comprehensive loss, net:								
Unrealized gain on forward contracts, net	-	-	-	-	73	-	\$ 73	73
Net loss	-	-	-	-	-	(8,434)	(8,434)	(8,434)
Total comprehensive loss, net							\$ (8,361)	
Balance as of December 31, 2003	121	116,518	(11,320)	(174)	145	1,228		106,518
Issuance of shares upon exercise of options and employee stock purchase plan	5	10,182	-	-	-	-		10,187
Amortization of deferred stock compensation	-	-	-	66	-	-		66
Comprehensive income, net:								
Unrealized gain on forward contracts, net	-	-	-	-	208	-	\$ 208	208
Net income	-	-	-	-	-	5,006	5,006	5,006
Total comprehensive income, net							\$ 5,214	
Balance as of December 31, 2004	126	126,700	(11,320)	(108)	353	6,234		121,985
Issuance of shares upon exercise of options and employee stock purchase plan	2	3,916	-	-	-	-		3,918
Amortization of deferred stock compensation	-	-	-	36	-	-		36
Comprehensive income, net:								
Unrealized loss on forward contracts, net	-	-	-	-	(269)	-	\$ (269)	(269)
Net income	-	-	-	-	-	13,436	13,436	13,436
Total comprehensive income, net							\$ 13,167	
Balance as of December 31, 2005	\$ 128	\$ 130,616	\$ (11,320)	\$ (72)	\$ 84	\$ 19,670		\$ 139,106

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

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

	Year ended December 31,		
	2003	2004	2005
Cash flows from operating activities:			
Net income (loss)	\$ (8,434)	\$ 5,006	\$ 13,436
Adjustments required to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Depreciation and amortization	3,040	2,979	3,369
Amortization of marketable securities premiums and accretion of discounts, net	-	-	143
Equity in losses of affiliated companies, net	429	516	693
Amortization of deferred stock compensation	50	66	36
Amortization of senior convertible notes discount and deferred charges	-	28	198
Decrease (increase) in accrued interest on marketable securities, bank deposits and structured notes	(270)	75	(736)
Increase in trade receivables, net	(3,274)	(4,907)	(3,520)
Decrease (increase) in other receivables and prepaid expenses	(940)	(1,248)	57
Decrease (increase) in inventories	10	(3,712)	(1,503)
Increase in deferred tax assets	-	-	(2,033)
Increase in trade payables	1,795	1,329	1,233
Increase in other payables and accrued expenses	1,145	3,155	1,914
Increase in accrued severance pay, net	20	68	41
Other	-	98	(12)
Net cash provided by (used in) operating activities	(6,429)	3,453	13,316
Cash flows from investing activities:			
Investments in affiliated companies	(621)	(512)	(1,318)
Short-term loan to unrelated company	-	-	(350)
Purchase of property and equipment	(1,997)	(4,257)	(2,393)
Proceeds from sale of property and equipment	-	6	96
Investment in short-term bank deposits	-	-	(33,969)
Proceeds from sale of short-term bank deposits	63,074	-	3,969
Investment in long-term bank deposits and structured notes	(50,000)	(18,000)	(20,000)
Proceeds from structured notes called by the issuer	-	18,000	10,000
Investment in short-term and long-term marketable securities	-	-	(59,060)
Payment for acquisition of Universal Audio Server ("UAS") (1)	(4,373)	(2,500)	-
Payment for acquisition of Ai-Logix (2)	-	(8,684)	(10,000)
Net cash provided by (used in) investing activities	6,083	(15,947)	(113,025)
Cash flows from financing activities:			
Proceeds from issuance of senior convertible notes	-	125,000	-
Issuance costs for senior convertible notes	-	(394)	(84)
Initial purchasers discount in respect of senior convertible notes	-	(4,365)	-
Proceeds from issuance of shares upon exercise of options and employee stock purchase plan	1,660	10,187	3,918
Purchase of treasury stock	(215)	-	-
Net cash provided by financing activities	1,445	130,428	3,834
Increase (decrease) in cash and cash equivalents	1,099	117,934	(95,875)
Cash and cash equivalents at the beginning of the year	47,799	48,898	166,832
Cash and cash equivalents at the end of the year	\$ 48,898	\$ 166,832	\$ 70,957
Supplemental disclosure of cash flow activities:			
Cash paid during the year for income taxes	\$ 120	\$ 91	\$ 760
Cash paid during the year for interest	\$ -	\$ -	\$ 2,500

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

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

	Year ended December 31,		
	2003	2004	2005
(1) <u>Payment for acquisition of UAS</u>			
Net fair value of assets acquired of UAS at the date of acquisition (see also Note 1b):			
Property and equipment	\$ 380	\$ -	\$ -
Technology	1,173	-	-
Goodwill	4,320	1,000	-
	<u>5,873</u>	<u>1,000</u>	<u>-</u>
Paid (unpaid) accrued liability	(1,500)	1,500	-
	<u>\$ 4,373</u>	<u>\$ 2,500</u>	<u>\$ -</u>
(2) <u>Payment for acquisition of Ai-Logix</u>			
Net fair value of assets acquired and liabilities assumed of Ai-Logix at the date of acquisition (see also Note 1c):			
Working capital, net (excluding cash and cash equivalents)	\$ -	\$ 1,440	\$ -
Property and equipment	-	329	-
Technology	-	3,100	-
Goodwill	-	3,815	10,000
	<u>\$ -</u>	<u>\$ 8,684</u>	<u>\$ 10,000</u>

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

U.S. dollars in thousands

NOTE 1: – GENERAL

a. Business overview:

AudioCodes Ltd. (“the Company”) and its subsidiaries (together “the Group”) design, develop and market enabling technologies and system products for the transmission of voice data and fax communications over packet network. The Group’s products are designed to enable the new voice infrastructure and are sold to original equipment manufacturers, network equipment providers, systems integrators and distributors in the telecommunications and networking industries.

The Company operates through its wholly-owned subsidiaries in the United States, United Kingdom, Germany, Argentina, Brazil, India and Korea.

b. Acquisition of the Universal Audio Server (“UAS”) business from Nortel Networks Limited (“Nortel”):

On April 7, 2003, the Group purchased from Nortel selected assets of its UAS business. As part of the transaction, Nortel granted the Group a license to use its UAS technology and the Group has undertaken to act as an exclusive supplier to Nortel for its UAS products over a period of three years from the acquisition. In addition, the parties have entered into a development agreement in relation to future platforms.

The consideration for the transaction amounted to \$5,500 in cash, of which: \$2,000 was paid at the closing date, \$2,000 was paid nine months after the closing date, and \$1,500 was paid twelve months after the closing date. Under the terms of the acquisition agreement (“the Agreement”), the Group was also required to pay \$1,000 as a contingent payment, upon Nortel completing product integration under the development agreement. In March 2004, product integration was completed and the \$1,000 contingent payment was paid and recorded as part of the acquisition cost as additional goodwill in accordance with the provisions of Statement of Financial Accounting Standards (“SFAS”) No. 141, “Business Combination”.

The acquisition was accounted for under the purchase method of accounting in accordance with SFAS No. 141. The results of UAS operations have been included in the consolidated financial statements since the acquisition date.

Pro forma information in accordance with SFAS No. 141 has not been provided, since the revenues and net income of the UAS business, were not material in relation to total consolidated revenues and net loss.

U.S. dollars in thousands

NOTE 1: – GENERAL (Cont.)

Based upon an independent valuation of tangible and intangible assets acquired, the Group has allocated the total acquisition cost of the UAS assets, as follows:

	April 7, 2003
Property and equipment	\$ 380
Technology (five years useful life)	1,173
Goodwill *)	5,320
	<hr/>
Total assets acquired	\$ 6,873
	<hr/>

*) Including \$1,000 of the total acquisition cost which was allocated to goodwill in March 2004.

Goodwill includes but is not limited to the synergistic value and potential competitive benefits that could be realized by the Company from the acquisition. Goodwill is not deductible for tax purposes. In accordance with SFAS No. 142, "Goodwill and Other Intangible Assets", goodwill arising from this acquisition will not be amortized (see also Note 2n).

The value assigned to tangible assets and intangible assets has been determined as follows:

Property and equipment are presented at current replacement cost.

The value assigned to technology amounted to \$1,173. The fair value of technology was determined using the income approach.

In accordance with the agreement, contingent payments in the maximum aggregate amount of \$12,500 was to be paid to Nortel based on net orders for UAS products placed by Nortel over the 18 month period following the closing date. These contingent payments were not considered part of the acquisition cost and, as they accrued, were offset against related revenues earned by the Group from orders by Nortel for each respective period. The Group periodically assessed the expected earn out payments, based on net sales from orders placed by Nortel. In 2003, the Group accrued earn-out payments in the amount of \$1,600, which was included in other payables and accrued expenses in the net amount. In 2004, the Group paid Nortel \$4,917 in cash with respect to actual sales for the relevant 18 month period. As of December 31, 2004, no further obligation for contingent payments to Nortel remains.

c. Acquisition of Ai-Logix Inc. ("Ai-Logix"):

On May 12, 2004, the Group acquired all of the outstanding Ordinary shares of Ai-Logix, a provider of advanced voice and data recording hardware integration cards for the call recording and voice or data logging industry. The Group has undertaken to apply Ai-Logix's technology, strategic partnerships and customer base to expand its business into the call recording and computer telephony integration markets.

U.S. dollars in thousands

NOTE 1: – GENERAL (Cont.)

The Group paid \$10,000 in cash at the closing of the transaction. An additional payment of \$10,000 in cash was made in March 2005 based on the achievement of revenue milestones and additional terms by the Ai-Logix business during 2004 and 2005. This payment was recorded as part of the acquisition cost as additional goodwill in accordance with the provisions of SFAS No. 141.

Ai-Logix became a wholly-owned subsidiary of AudioCodes Inc. and accordingly, its results of operations have been included in the consolidated financial statements of the Group since the acquisition date.

This acquisition was accounted for under the purchase method of accounting in accordance with SFAS No. 141.

Based upon an independent valuation of tangible and intangible assets acquired, the Group has allocated the total acquisition cost of Ai-Logix's assets and liabilities, as follows:

	<u>May 12, 2004</u>
Trade receivables	\$ 1,846
Inventories	1,680
Prepaid expenses	180
Property and equipment	329
	<hr/>
Total tangible assets acquired	4,035
	<hr/>
Technology (five years useful life)	3,100
Goodwill *)	13,359
	<hr/>
Total intangible assets acquired	16,459
	<hr/>
Total tangible and intangible assets acquired	20,494
	<hr/>
Trade payables	(1,015)
Accrued expenses	(1,045)
Other current liabilities	(206)
	<hr/>
Total liabilities assumed	(2,266)
	<hr/>
Net assets acquired	\$ 18,228
	<hr/>

*) During 2005, the Company paid an additional payment in the amount of \$10,000 out of the total acquisition cost which was allocated to goodwill. The goodwill was reduced in the amount of \$456 upon utilization of pre-acquisition carryforward tax losses in accordance with SFAS No. 141 (see also Note 14).

Goodwill includes, but is not limited to, the synergistic value and potential competitive benefits that could be realized by the Company from the acquisition. Goodwill is not deductible for tax purposes. In accordance with SFAS No. 142, goodwill arising from this acquisition will not be amortized (see also Note 2n).

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

NOTE 1: – GENERAL (Cont.)

The value assigned to tangible assets, intangible assets and liabilities has been determined as follows:

Current assets and liabilities are recorded at their carrying amounts. The carrying amounts of current assets and liabilities were reasonable proxies for their market value due to their short-term maturity. Property and equipment are presented at current replacement cost.

The value assigned to technology amounted to \$3,100. The fair value of technology was determined using the income approach.

The following unaudited pro forma information does not purport to represent what the Group's results of operations would have been had the acquisition of Ai-Logix been consummated on January 1, 2003 and 2004, respectively, nor does it purport to represent the results of operations of the Group for any future period.

	Year ended December 31,	
	2003	2004
	Unaudited	
Revenues	\$ 57,532	\$ 88,125
Net income (loss)	\$ (8,045)	\$ 4,831
Basic net earnings (loss) per share	\$ (0.21)	\$ 0.13
Diluted net earnings (loss) per share	\$ (0.21)	\$ 0.11

- d. The Group is dependent upon sole source suppliers for certain key components used in its products, including certain digital signal processing chips. Although there 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 affect the operating results of the Group and its financial position.
- e. As to a major customer data, see Note 17b.

U.S. dollars in thousands

NOTE 2: – SIGNIFICANT ACCOUNTING POLICIES

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

a. Use of estimates:

The preparation of financial statements in conformity with 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.

b. Financial statements in U.S. dollars:

A majority of the revenues of the Group is generated in U.S. dollars (“dollar”). In addition, a substantial portion of the Group’s costs is incurred in dollars. The Group’s management believes that the dollar is the primary currency of the economic environment in which all the Group’s entities operate. Thus, the functional and reporting currency of each of the Group’s entities is the dollar.

Accordingly, monetary accounts maintained in currencies other than the dollar are remeasured into U.S. dollars in accordance with SFAS No. 52, “Foreign Currency Translation”. All transaction gains and losses of the remeasured monetary balance sheet items are reflected in the statements of operations as financial income or expenses, as appropriate.

c. Principles of consolidation:

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. Intercompany transactions and balances have been eliminated upon consolidation.

d. Cash equivalents:

Cash equivalents are short-term highly liquid investments that are readily convertible into cash with maturities of three months or less, at the date acquired.

e. Short-term bank deposits:

Short-term bank deposits are deposits with maturities of more than three months but less than one year. The deposits are in U.S. dollars and bear interest at an average rate of 3.23%. The short-term deposits are presented at their cost. The accrued interest is included in other receivables and prepaid expenses.

f. Marketable securities:

The Company accounts for investments in debt securities in accordance with SFAS No. 115, “Accounting for Certain Investments in Debt and Equity Securities”.

U.S. dollars in thousands

NOTE 2: – SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Management determines the appropriate classification of its investments in marketable debt securities at the time of purchase and evaluates such determinations at each balance sheet date. Debt securities are classified as held-to-maturity since the Company has the intent and ability to hold the securities to maturity and, accordingly, debt securities are stated at amortized cost.

The amortized cost of held-to-maturity securities is adjusted for amortization of premiums and accretion of discounts to maturity. Such amortization and interest are included in the consolidated statement of operations as financial income or expenses, as appropriate. The accrued interest on short-term and long-term marketable securities is included in the balance of short-term marketable securities.

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 products – using the “average cost” method with the addition of direct manufacturing costs.

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

h. Long-term bank deposits:

Bank deposits with maturities of more than one year are included in long-term investments and presented at their cost including accrued interest.

i. Structured notes:

The Group accounts for investments in structured notes in accordance with SFAS No. 115, “Accounting for Certain Investments in Debt and Equity Securities” and Emerging Issues Task Force (“EITF”) No. 96-12, “Recognition of Interest Income and Balance Sheet Classification of Structure Notes”. Management determines the appropriate classification of its investments in debt securities at the time of purchase and reevaluates such determinations at each balance sheet date. Debt securities are classified as held-to-maturity when the Group has the intent and ability to hold these securities to maturity and are stated at amortized cost. As of December 31, 2004 and 2005, investments in structured notes approximate their market value.

U.S. dollars in thousands

NOTE 2: – SIGNIFICANT ACCOUNTING POLICIES (Cont.)

j. Investment in affiliated companies:

The Company accounts for its investments in affiliated companies in which it has the ability to exercise significant influence over the operating and financial policies, using the equity method of accounting in accordance with the requirements of Accounting Principle Board (“APB”) No. 18, “The Equity Method of Accounting for Investments in Common Stock”.

Investment in affiliated companies represent investments in Ordinary shares, Preferred shares and convertible loans. The Company applies EITF No. 99-10, “Percentage Used to Determine the Amount of Equity Method Losses”. Accordingly, losses of the affiliated companies are recognized based on the ownership level of the particular investee security held by the investor.

The Company’s investments are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the investment may not be recoverable, in accordance with APB No. 18. As of December 31, 2005, based on management’s most recent analyses, no impairment losses have been identified.

k. Property and equipment:

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

	%
Computers and peripheral equipment	33
Office furniture and equipment	6 - 20
Motor vehicles	15
Leasehold improvements	Over the shorter of the term of the lease or the life of the asset

l. Intangible assets and deferred charges:

Intangible assets are amortized over their useful life using a method of amortization that reflects the pattern in which the economic benefits of the intangible assets are consumed or otherwise used up, in accordance with SFAS No. 142. Accordingly, acquired technology is amortized over five years.

Cost incurred in respect of issuance of senior convertible notes are deferred and amortized using the effective interest method and classified as a component of interest expense, over the period from issuance to maturity, which is 20 years, in accordance with APB No. 21 “Interest on Receivables and Payables”.

U.S. dollars in thousands

NOTE 2: – SIGNIFICANT ACCOUNTING POLICIES (Cont.)

m. Impairment of long-lived assets:

The Group's long-lived assets and certain identifiable intangibles are reviewed for impairment in accordance with SFAS No. 144 "Accounting for the Impairment or Disposal of Long-Lived Assets", whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to the undiscounted future cash flows expected to be generated by the assets. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. As of December 31, 2005, no impairment losses have been identified.

Effective October 1, 2003, as a result of the expected relocation of the Company's facilities in Israel, the Group changed the estimated useful life of certain leasehold improvements and other equipment to four months. The effect of the change in estimated useful life on the net loss and net loss per share for the year ended December 31, 2003 was \$(689) and \$(0.02). The annual expected effect of this change of estimated useful life for the following years is immaterial.

Under SFAS No. 144, a long-lived group of assets that is to be abandoned is considered disposed of when it ceases to be used. Thus, an entity that intends to abandon a group of long-lived assets in operations, should evaluate that group of assets as "held and used" and should determine whether it should revise its depreciation estimates to reflect a useful life that is shorter than initially expected and a salvage value consistent with the intention to abandon.

n. Goodwill:

Goodwill represents an excess of costs over the fair value of the net assets of businesses acquired under SFAS No. 142, "Goodwill and Other Intangible Assets".

SFAS No. 142 requires goodwill to be tested for impairment at least annually or between annual tests in certain circumstances, and written down when impaired, rather than being amortized as previous accounting standards required. Goodwill is tested for impairment at the reporting unit level by comparing the fair value of the reporting unit with its carrying value. Fair value is determined using market capitalizations. The Company elected to perform its analysis of goodwill impairment during the fourth quarter of 2005. The test was based on the Group's single operating segment and reporting unit structure. As of December 31, 2005, no impairment losses had been identified.

o. Revenue recognition:

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

U.S. dollars in thousands

NOTE 2: – SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Revenues from products are recognized in accordance with Staff Accounting Bulletin (“SAB”) No. 104, “Revenue Recognition in Financial Statements”, when the following criteria are met: persuasive evidence of an arrangement exists, delivery of the product has occurred, the fee is fixed or determinable, and collectibility is probable. The Group has no obligation to customers after the date in which products are delivered other than pursuant to warranty obligations and right of return.

The Group generally grants to its customers a right of return or the ability to exchange a specific percentage of total price paid for products they have purchased over a period of three months for other products. The Group maintains a provision for product returns and exchanges based on their experience with historical sales returns, analysis of credit memo data and other known factors, in accordance with SFAS No. 48, “Revenue Recognition When Right of Return Exists”. The provision was deducted from revenues and amounted to \$294, \$619 and \$545 as of December 31, 2003, 2004 and 2005, respectively.

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

p. Warranty costs:

The Group generally provides a warranty period of 12 months, at no extra charge. The Group estimates the costs that may be incurred under its basic limited warranty and records a liability in the amount of such costs at the time product revenue is recognized. Factors that affect the Group’s warranty liability include the number of installed units, historical and anticipated rates of warranty claims, and cost per claim. The Group periodically assesses the adequacy of its recorded warranty liability and adjusts the amount as necessary. A tabular reconciliation of the changes in the Company’s aggregate product warranty liability was not provided due to immateriality.

q. Research and development costs:

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

U.S. dollars in thousands

NOTE 2: – SIGNIFICANT ACCOUNTING POLICIES (Cont.)

r. Income taxes:

The Group accounts for income taxes in accordance with SFAS No. 109, "Accounting for Income Taxes". This Statement prescribes the use of the liability method whereby account balances of deferred tax assets and liabilities 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. The Group provides a valuation allowance, if necessary, to reduce deferred tax assets to their estimated realizable value.

s. Concentrations of credit risk:

Financial instruments that potentially subject the Group to concentrations of credit risk consist principally of cash and cash equivalents, bank deposits, structured notes, marketable securities and trade receivables.

The majority of the Group's cash and cash equivalents, bank deposits and structured notes are invested in U.S. dollar instruments with major banks in Israel and the United States. Such investments in the United States may be in excess of insured limits and are not insured in other jurisdictions. Management believes that the financial institutions that hold the Group's investments are financially sound and, accordingly, minimal credit risk exists with respect to these financial investments.

Marketable securities include investments in debentures of corporations, U.S. government and agencies. Management believes that those corporations and agencies are financially sound, the portfolio is well diversified, and accordingly, minimal credit risk exists with respect to these marketable debt securities.

The trade receivables of the Group are derived from sales to customers located primarily in the Americas, the Far East, Israel and Europe. The Group performs ongoing credit evaluations of its customers and to date has not experienced any material losses. An allowance for doubtful accounts is determined with respect to those amounts that the Group has determined to be doubtful of collection. The Group usually does not require collateral on trade receivables because most of its sales are to large and well-established companies.

t. Senior convertible notes:

The Company presents the outstanding principal amount of its senior convertible notes as a long-term liability, in accordance with APB No. 14 "Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants". The debt is classified as a long-term liability until the date of conversion on which it would be reclassified to equity, or at the first contractual redemption date, on which it would be reclassified as a short-term liability. Accrued interest on the senior convertible notes is included in "other payables and accrued expenses". The Initial Purchasers discount is recorded as a discount to the debt and amortized according to the interest method over the term of the senior convertible notes in accordance with EITF No. 00-27 "Application of Issue No. 98-5 to Certain Convertible Industries", which is 20 years.

U.S. dollars in thousands, except share data

NOTE 2: – SIGNIFICANT ACCOUNTING POLICIES (Cont.)

u. Basic and diluted net earnings (loss) per share:

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

Senior convertible notes and certain outstanding stock options and warrants have been excluded from the calculation of the diluted net earnings (loss) per Ordinary share since such securities are anti-dilutive for all periods presented. The total weighted average number of shares related to the senior convertible notes and outstanding options and warrants that have been excluded from the calculations of diluted net earnings (loss) per share was 7,836,696, 4,972,991 and 8,598,556 for the years ended December 31, 2003, 2004 and 2005, respectively.

v. Accounting for stock-based compensation:

The Group has elected to follow APB No. 25, "Accounting for Stock Issued to Employees" and FIN No. 44, "Accounting for Certain Transactions Involving Stock Compensation", in accounting for its employee stock option plans and its non-compensatory Employee Share Purchase Plan ("ESPP"). Under APB No. 25, when the exercise price of the Company's share options is less than the market price of the underlying shares on the date of grant, compensation expense is recognized.

The Group adopted the disclosure provisions of SFAS No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure", which amended certain provisions of SFAS No. 123 "Accounting for Stock-Based Compensation" to provide alternative methods of transition for an entity that voluntarily changes to the fair value based method of accounting for stock-based employee compensation, effective as of the beginning of the prior year. The Group continues to apply the provisions of APB No. 25, in accounting for stock-based compensation.

Pro forma information regarding the Group's net income (loss) and net earnings (loss) per share is required by SFAS No. 123 and has been determined as if the Group had accounted for its employee stock options under the fair value method prescribed by SFAS No. 123.

The fair value for these options was estimated at the date of grant using the Black and Scholes option pricing model and amortized over the vesting period. Fair values were estimated using the following weighted-average assumptions:

	2003	2004	2005
Dividend yield	0%	0%	0%
Expected volatility	108%	87%	75%
Risk-free interest	3%	3%	4%
Expected life	4 years	4 years	4.5 years

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

NOTE 2: – SIGNIFICANT ACCOUNTING POLICIES (Cont.)

The Black-Scholes pricing-model was used to estimate the fair value of the ESPP compensation. Assumptions are not provided due to immateriality.

Pro forma information under SFAS No. 123 is as follows:

	Year ended December 31,		
	2003	2004	2005
Net income (loss) as reported	\$ (8,434)	\$ 5,006	\$ 13,436
Add: stock-based compensation expenses determined under the intrinsic value based method included in the reported net income (loss)	50	66	36
Deduct: stock-based compensation expenses determined under the fair value based method for all awards	(10,865)	(8,509)	(8,869)
Pro forma net income (loss)	\$ (19,249)	\$ (3,437)	\$ 4,603
Basic net earnings (loss) per share as reported	\$ (0.22)	\$ 0.13	\$ 0.33
Diluted net earnings (loss) per share as reported	\$ (0.22)	\$ 0.12	\$ 0.31
Pro forma basic net earning (loss) per share	\$ (0.51)	\$ (0.09)	\$ 0.11
Pro forma diluted net earning (loss) per share	\$ (0.51)	\$ (0.09)	\$ 0.11

The Group applies SFAS No. 123 and EITF No. 96-18 "Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services", with respect to options and warrants issued to non-employees. SFAS No. 123 requires the use of option valuation models to measure the fair value of the options and warrants at the measurement date.

w. Severance pay:

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

The deposited funds include profits accumulated up to the balance sheet date. The deposited funds may be withdrawn only upon the fulfillment of the obligation pursuant to Israel's Severance Pay Law or labor agreements. The value of the deposited funds is based on the cash surrender value of these policies and includes immaterial profits.

Severance expenses for the years ended December 31, 2003, 2004 and 2005, amounted to approximately \$1,127, \$1,182 and \$1,514, respectively.

U.S. dollars in thousands

NOTE 2: – SIGNIFICANT ACCOUNTING POLICIES (Cont.)

x. Advertising expenses:

Advertising expenses are charged to the statements of operations as incurred. Advertising expenses for the years ended December 31, 2003, 2004 and 2005, amounted to \$211, \$359 and \$371, respectively.

y. Fair value of financial instruments:

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

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

The carrying amounts of bank deposits and structured notes are estimated by discounting the future cash flows using current interest rates for deposits of similar terms and maturities. The carrying amount of long-term deposits approximates their fair value.

The fair value of marketable securities is based on quoted prices and do not differ significantly from the carrying amount (see Notes 3 and 6).

The fair value of senior convertible notes is based on quoted market values and prevailing market rates, and approximates their carrying amount.

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

z. Derivative instruments:

SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities", requires a company to recognize all of its derivative instruments as either assets or liabilities in the statement of financial position at fair value. The accounting for changes in the fair value (i.e., gains or losses) of a derivative instrument depends on whether it has been designated and qualifies as part of a hedging relationship and further, on the type of hedging relationship. For those derivative instruments that are designated and qualify as hedging instruments, a company must designate the hedging instrument, based upon the exposure being hedged, as a fair value hedge, cash flow hedge or a hedge of a net investment in a foreign operation.

The Group uses derivatives instruments to manage exposures to foreign currency related to salary payments denominated in New Israeli Shekel ("NIS"). The Group's objectives for holding derivatives are to minimize risks.

For those derivative instruments that are designated and qualify as a cash flow hedge (i.e., hedging the exposure to variability in expected future cash flows that is attributable to a particular risk), the effective portion of the gain or loss on the derivative instrument is reported as a component of other comprehensive income and reclassified into earnings in the same line item associated with the forecasted transaction in the same period or periods during which the hedged transaction affects earnings.

U.S. dollars in thousands

NOTE 2: – SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Since the amounts of forward transactions do not exceed salary payments, those transactions are all highly effective and the results are recorded as payroll expenses, at the time that the hedged expense is recorded. When the Group hedges payrolls for following periods, then the results as of the balance sheet date are recorded in other comprehensive income.

At December 31, 2005, the Group expects to reclassify \$84 of net gains on derivative instruments from accumulated other comprehensive income to income during the next nine months due to actual payment of variable interest associated with the floating rate debt.

aa. Impact of recently issued accounting standards:

On December 16, 2004, the Financial Accounting Standards Board (“FASB”) issued Statement No. 123 (revised 2004), “Share-Based Payment” (“SFAS No. 123(R)”), which is a revision of SFAS No. 123. Generally, the approach in SFAS No. 123(R) is similar to the approach described in SFAS No. 123. However, SFAS No. 123 permitted, but did not require, share-based payments to employees to be recognized based on their fair values while SFAS No. 123(R) requires all share-based payments to employees including grants of employee stock options and shares issued under the ESPP to be recognized based on their fair values. SFAS No. 123(R) also revises, clarifies and expands guidance in several areas, including measuring fair value, classifying an award as equity or as a liability and attributing compensation cost to reporting periods. SFAS No. 123(R) will be effective for periods commencing January 1, 2006. SFAS No. 123(R) permits public companies to adopt its requirements using either the modified prospective or modified retrospective method. The Company currently expects to adopt SFAS No. 123(R), using the modified prospective method of adoption in which compensation cost is recognized beginning with the effective date (a) based on the requirements of Statement SFAS No. 123(R) for all share-based payments granted after the effective date and (b) based on the requirements of SFAS No. 123 for all awards granted to employees prior to the effective date of SFAS No. 123(R) that remain unvested on the effective date.

In March 2005, the Securities and Exchange Commission (“SEC”) released SEC Staff Accounting Bulletin No. 107, “Share-Based Payment” (“SAB 107”). SAB 107 provides the SEC staff’s position regarding the application of SFAS No. 123(R) and contains interpretive guidance related to the interaction between SFAS No. 123(R) and certain SEC rules and regulations, and also provides the SEC staff’s views regarding the valuation of share-based payment arrangements for public companies. SAB 107 highlights the importance of disclosures made relating to the accounting for share-based payment transactions. The Company is currently reviewing the effect of SAB 107 and SFAS No. 123(R) on its financial position, results of operations and cash flows. The Company expects that the adoption of SFAS No. 123(R) and SAB 107 will have a material effect on its financial position and results of operations.

U.S. dollars in thousands

NOTE 2: – SIGNIFICANT ACCOUNTING POLICIES (Cont.)

In November 2004, the FASB issued SFAS No. 151, "Inventory Costs, an Amendment of ARB No. 43, Chapter 4". SFAS No. 151 amends Accounting Research Bulletin ("ARB") No. 43, Chapter 4, to clarify that abnormal amounts of idle facility expense, freight handling costs and wasted materials (spoilage) should be recognized as current-period charges. In addition, SFAS No. 151 requires that the allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. SFAS No. 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The Company does not expect that the adoption of SFAS No. 151 will have a material effect on its financial position or results of operations.

In May 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections", a replacement of APB No. 20, "Accounting Changes" and SFAS No. 3, "Reporting Accounting Changes in Interim Financial Statements". SFAS No. 154 provides guidance on the accounting for and reporting of accounting changes and error corrections. APB No. 20 previously required that most voluntary changes in accounting principles be recognized by including in net income for the period of the change, the cumulative effect of changing to the new accounting principle. SFAS No. 154 requires retroactive application to prior periods' financial statements of a voluntary change in accounting principles unless it is impracticable. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. As of December 31, 2005, adoption of SFAS No. 154 will not have a material impact on the Company's financial position or results of operation.

In November 2005, the FASB issued FSP FAS 115-1. The FSP addresses the determination as to when an investment is considered impaired, whether that impairment is other than temporary, and the measurement of an impairment loss. The FSP also includes accounting considerations subsequent to the recognition of other than-temporary impairment and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. The guidance in this FSP amends SFAS No. 115, "Accounting for Certain Investments in Debt and Equity". The FSP replaces the impairment evaluation guidance of EITF Issue No. 03-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments," with references to the existing other-than-temporary impairment guidance. The FSP clarifies that an investor should recognize an impairment loss no later than when the impairment is deemed other-than-temporary, even if a decision to sell an impaired security has not been made. The guidance in this FSP is to be applied to reporting periods beginning after December 15, 2005. As of December 31, 2005, adoption of FSP FAS 115-1 will not have a material impact on the Company's financial position or results of operations.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 3: – SHORT-TERM MARKETABLE SECURITIES AND ACCRUED INTEREST

During 2005, the Company invested in marketable debt securities which are classified as held-to-maturity investments.

	December 31, 2005		
	Amortized cost	Net unrealized losses	Market Value
<u>Held-to-maturity - matures within one year:</u>			
Corporate debentures	\$ 8,040	\$ 53	\$ 7,987
U.S. government and agencies debts	1,000	4	996
Accrued interest	823	-	823
	<u>\$ 9,863</u>	<u>\$ 57</u>	<u>\$ 9,806</u>

The unrealized losses on the Company's investments in all types of securities are due to interest rate increases. The contractual cash flows of these investments are either guaranteed by the U.S. government or an agency of the U.S. government or were issued by highly rated corporations. Accordingly, it is expected that the securities would not be settled at a price less than the amortized cost of the Company's investment. Since the Company has the ability and intent to hold these investments until a recovery of fair value, which may be until maturity, the Company does not consider these investments to be other-than-temporarily impaired as of December 31, 2005. In addition, the unrealized losses are for periods not longer than twelve months.

NOTE 4: – INVENTORIES

	December 31,	
	2004	2005
Raw materials	\$ 4,384	\$ 4,598
Finished products	5,675	6,964
	<u>\$ 10,059</u>	<u>\$ 11,562</u>

In the years ended December 31, 2003, 2004 and 2005, the Group wrote-off and wrote-down inventory in a total amount of \$835, \$1,237 and \$1,168, respectively. These amounts are included in cost of revenues.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 5: – LONG-TERM BANK DEPOSITS AND STRUCTURED NOTES

Long-term bank deposits and structured notes are composed as follows:

	December 31,			
	2004	2005	2004	2005
	Weighted average interest			
Long-term bank deposits (in U.S. dollars)	2.7%	-	\$ 25,195	\$ -
Structured notes (1)	3.8%	3.0%	25,000	27,781
			\$ 50,195	\$ 27,781

- (1) As of December 31, 2005, the Group purchased callable structured notes at par value totaling \$28,000 for settlement during 2006 to 2010 from several banks. Under the arrangements with the banks, whether or not the structured notes bear interest depends upon the three month to one year LIBOR rate.

For each day in which the relevant LIBOR rate is below an agreed annual fixed rate, which ranges from 2.5% to 6% the structured notes bear interest at the rate of 3.2% to 5.75% per annum. On all other days, the structured notes do not bear any interest. As of December 31, 2005, investments in structured notes securities approximate their market value.

NOTE 6: – LONG-TERM MARKETABLE SECURITIES

During 2005, the Company invests in marketable debt securities which are classified as held-to-maturity investments.

	December 31, 2005		
	Amortized cost	Net unrealized losses	Market Value
<u>Held-to-maturity - matures after one year through three years:</u>			
Corporate debentures	\$ 33,792	\$ 265	\$ 33,527
U.S. government and agencies debts	15,999	130	15,869
	\$ 49,791	\$ 395	\$ 49,396

The unrealized losses on the Company's investments in all types of securities are due to interest rate increases. The contractual cash flows of these investments are either guaranteed by the U.S. government or an agency of the U.S. government or were issued by highly rated corporations. Accordingly, it is expected that the securities would not be settled at a price less than the amortized cost of the Company's investment. Since the Company has the ability and intent to hold these investments until a recovery of fair value, which may be until maturity, the Company does not consider these investments to be other-than-temporarily impaired as of December 31, 2005. In addition, the unrealized losses are for periods not longer than twelve months.

U.S. dollars in thousands

NOTE 7: – INVESTMENT IN AFFILIATED COMPANIES

- a. In December 2000, the Company signed an agreement to invest in an unrelated privately-held company (“affiliated company”). During 2005, the Company granted convertible loans in the amount of \$ 611. The loans bear no interest and shall be convertible into shares. The date of conversion, the type of the shares and the number of shares granted will be determined by the board of directors of the investee. As of December 31, 2005, the Company holds 41% of the affiliated company’s share capital.

	December 31,	
	2004	2005
Equity, net (1)	\$ 487	\$ (232)
Convertible loans	-	611
Total investments	\$ 487	\$ 379
(1) Net equity as follows:		
Net equity as of purchase date	\$ 93	\$ 93
Unamortized goodwill	2,389	2,389
Accumulated net losses	(1,995)	(2,714)
	\$ 487	\$ (232)

- b. In July, 2005, the Company signed a share purchase agreement with another unrelated privately-held company and certain of its shareholders to acquire 19.5% of its Ordinary shares for a total purchase price in the amount of \$707.

	December 31,	
	2004	2005
Net equity as of purchase date	\$ -	\$ (106)
Unamortized goodwill	-	813
Accumulated net income	-	26
Total investment	\$ -	\$ 733

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 8: – PROPERTY AND EQUIPMENT

	December 31,	
	2004	2005
Cost:		
Computers and peripheral equipment	\$ 10,492	\$ 11,767
Office furniture and equipment	5,244	6,333
Motor vehicles	48	48
Leasehold improvements	1,357	1,289
	<u>17,141</u>	<u>19,437</u>
Accumulated depreciation:		
Computers and peripheral equipment	8,004	9,184
Office furniture and equipment	2,127	3,327
Motor vehicles	48	48
Leasehold improvements	268	384
	<u>10,447</u>	<u>12,943</u>
Depreciated cost	\$ 6,694	\$ 6,494

Depreciation expenses amounted to \$ 2,880, \$ 2,352 and \$ 2,509 for the years ended December 31, 2003, 2004 and 2005, respectively.

NOTE 9: – INTANGIBLE ASSETS, DEFERRED CHARGES AND OTHER

	December 31,	
	2004	2005
a. Cost:		
Acquired technology	\$ 4,273	\$ 4,273
Deferred charges	1,644	478
Other	–	200
	<u>5,917</u>	<u>4,951</u>
Accumulated amortization:		
Acquired technology	787	1,647
Deferred charges	3	25
	<u>790</u>	<u>1,672</u>
Amortized cost	\$ 5,127	\$ 3,279

b. Amortization expenses related to acquired technology amounted to \$160, \$627 and \$860 for the years ended December 31, 2003, 2004 and 2005, respectively.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 9: – INTANGIBLE ASSETS, DEFERRED CHARGES AND OTHER (Cont.)

c. Expected amortization expenses related to acquired technology for the years ended December 31:

2006	\$	860
2007		860
2008		673
2009		233
		<hr/>
	\$	2,626
		<hr/>

d. Amortization expenses related to deferred charges amounted to \$ 3 and \$ 22 for the years ended December 31, 2004 and 2005, respectively.

NOTE 10: – OTHER PAYABLES AND ACCRUED EXPENSES

	December 31,	
	2004	2005
Employees and payroll accruals	\$ 6,355	\$ 8,088
Technology licensing fee provision	3,974	2,901
Government authorities	874	738
Accrued expenses	5,187	6,568
Deferred revenues	1,430	300
Others	161	25
	<hr/>	<hr/>
	\$ 17,981	\$ 18,620
	<hr/>	<hr/>

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

NOTE 11: – SENIOR CONVERTIBLE NOTES

In November 2004, the Company issued \$ 125,000 (including the exercise of the option as described below) in an aggregate principal amount of 2% Senior Convertible Notes due November 9, 2024 (“the Notes”). The Company is obligated to pay interest on the Notes semi-annually on May 9 and November 9 of each year.

The Notes are convertible, at the option of the holders at any time before the maturity date, into Ordinary shares of the Company at a conversion rate of 53.4474 Ordinary shares per \$ 1 principal amount of Notes, representing a conversion price of approximately \$ 18.71 per share. The Notes are subject to redemption at any time on or after November 9, 2009, in whole or in part, at the option of the Company, at a redemption price of 100% of the principal amount plus accrued and unpaid interest. The Notes are subject to repurchase, at the holders’ option, on November 9, 2009, November 9, 2014 or November 9, 2019, at a repurchase price equal to 100% of the principal amount plus accrued and unpaid interest, if any, on such repurchase date. The Company can choose to pay the repurchase price in cash, Ordinary shares or a combination of cash and Ordinary shares. As of December 31, 2005, the Notes are presented as a long-term liability.

The Notes also contain a provision for a “make-whole” premium to be paid by the Company to holders of the Notes in the event of certain changes in control that could occur during the life of the Notes. The premium is payable in the form of cash, the Company’s Ordinary shares, or the same form of consideration used to pay for the shares of the Company’s Ordinary shares in connection with the transaction constituting the change in control. The premium declines over time and is based upon the price of the Company’s Ordinary shares as of the effective date of the change in control. Due to immateriality, the Company did not record separate derivative in the financial statements.

The Notes were issued with a conversion price equal to \$ 18.71 per share, which reflected the closing share price on the Nasdaq on the date of the offering, which was \$ 14.12, plus a premium of 32.5%. In accordance with EITF No. 00-27, no beneficial conversion feature was recognized or recorded.

The additional amount that the Company can be required to pay in respect of the withholding taxes was recorded as a liability.

As part of the offering, the Company granted the Initial Purchasers an option to purchase at any time during 30 days from the date of the offering, up to an additional \$ 25,000 principal amount of senior convertible notes. The option, in accordance with SFAS No. 133, is not embedded and therefore should be measured on a stand-alone basis. On November 16, 2004, the option was exercised in full. Due to immateriality, the Company did not record this option and its exercise in the financial statements.

U.S. dollars in thousands

NOTE 12: – COMMITMENTS AND CONTINGENT LIABILITIES

a. Lease commitments:

The Group's facilities are rented under several lease agreements in Israel and the U.S. for periods ending in 2013.

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

2006	\$	2,530
2007		2,429
2008		2,447
2009		2,466
2010 and thereafter		8,611
		<hr/>
	\$	18,483
		<hr/>

Rent expenses for the years ended December 31, 2003, 2004 and 2005, were approximately \$ 1,829, \$ 2,927 and \$ 2,938, respectively.

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

Under the research and development agreements of the Company with the OCS and pursuant to applicable laws, the Company is required to pay royalties at the rate of 3%-4.5% of sales of products developed with funds provided by the OCS, up to an amount equal to 100% of the OCS research and development grants received, linked to the U.S. dollar plus interest on the unpaid amount received based on the 12-month LIBOR rate applicable to dollar deposits. The Company is obligated to repay the Israeli Government for the grants received only to the extent that there are sales of the funded products.

The Company did not repay or accrue royalties for the year ended December 31, 2005, relating to such grants.

As of December 31, 2005, the Company had a contingent obligation to pay royalties in the amount of approximately \$ 1,617.

c. Royalty commitments to third parties:

The Group entered into technology licensing fee agreements with third parties. Under the agreements, the Group agreed to pay the third parties royalties until 2008, based on 0.3%-0.9% of the Group's total consolidated revenues.

From time to time, the Group may be subject to patent infringement claims that arise in the ordinary course of its business activities. The Group estimates and records liabilities for those contingent claims for which it believes future expenditures will be required and for which such expenditures can be reasonably estimated.

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

NOTE 13: – SHAREHOLDERS' EQUITY

a. Treasury stock:

On January 10, 2001 and on April 28, 2002, the Company's Board of Directors approved a share repurchase program pursuant to which the Company is authorized to purchase up to an aggregate amount of 4,000,000 of its outstanding Ordinary shares. As of December 31, 2005, the Company had purchased 3,942,139 of its outstanding Ordinary shares, at a weighted average price per share of \$ 2.87.

b. Warrants issued to consultants:

During 1999, the Company issued warrants to consultants to purchase 4,000 and 50,000 Ordinary shares of NIS 0.01 par value at an exercise price of \$ 9.82 per share and \$ 18.82 per share, respectively, expiring seven years from the date of grant. Warrants to purchase 24,000 Ordinary shares at an exercise price of \$ 18.82 per share were exercisable immediately, and warrants to purchase 30,000 Ordinary shares are exercisable in four equal annual installments from the date of grant. During 2001, warrants to purchase 10,000 Ordinary shares at an exercise price of \$ 18.82 were exercised.

As of December 31, 2005, 44,000 warrants are outstanding and exercisable at a weighted average exercise price of \$ 18.

c. Employee Stock Purchase Plan:

In May 2001, the Company's Board of Directors adopted the Employee Stock Purchase Plan ("the Purchase Plan"), which provides for the issuance of a maximum of 2,000,000 Ordinary shares. As of December 31, 2005, 1,033,290 shares are still available for future issuance. Eligible employees can have up to 15% of their wages, up to certain maximums, used to purchase Ordinary shares. The Purchase Plan is implemented with purchases every six months occurring on January 31 and July 31 of each year. The price of the Ordinary shares purchased under the Purchase Plan is equal to 85% of the lower of the fair market value of the Ordinary shares on the commencement date of each offering period or on the semi-annual purchase date.

During the years ended December 31, 2003, 2004 and 2005, 290,605, 208,952 and 257,746 shares, respectively, were issued under the Purchase Plan for aggregate considerations of \$ 537, \$ 1,332 and \$ 2,134, respectively.

d. Employee Stock Option Plans:

Under the Company's 1997 and 1999 Stock Option Plans ("the Plans"), options to purchase Ordinary shares may be granted to officers, directors, employees and consultants of the Group.

The total number of shares authorized for grant of options under the Plans is 14,704,523. As of December 31, 2005, 1,536,509 shares are still available for future option grants.

Stock options granted under the Plans are exercisable usually at the fair market value of the Ordinary shares at the date of grant and expire ten or seven years from the date of grant. The options generally vest over four or five years, from the date of grant. Any options, which are forfeited or cancelled before expiration, become available for future grants.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 13: – SHAREHOLDERS' EQUITY (Cont.)

A summary of the Group's stock option activity and related information for the years ended December 31, 2003, 2004 and 2005, is as follows:

	Year ended December 31,					
	2003		2004		2005	
	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price
Outstanding at the beginning of the year	7,202,088	\$ 8.21	8,425,947	\$ 7.76	7,852,800	\$ 9.46
Granted	1,737,500	\$ 3.94	1,693,000	\$ 11.96	1,029,500	\$ 10.26
Exercised	(269,742)	\$ 4.14	(1,869,446)	\$ 4.72	(466,065)	\$ 3.86
Forfeited	(243,899)	\$ 5.92	(396,701)	\$ 6.28	(525,863)	\$ 17.18
Outstanding at the end of the year	8,425,947	\$ 7.76	7,852,800	\$ 9.46	7,890,372	\$ 9.38
Options exercisable at the end of the year	4,526,834	\$ 9.46	4,094,213	\$ 10.98	4,819,818	\$ 9.55

The options outstanding as of December 31, 2005, have been separated into ranges of exercise prices, as follows:

Range of exercise price	Options outstanding as of December 31, 2005	Weighted average remaining contractual life (Years)	Weighted average exercise price	Options exercisable as of December 31, 2005	Weighted average exercise price of exercisable options
\$ 0.61	121,000	2.16	\$ 0.61	121,000	\$ 0.61
\$ 1.1	163,600	2.51	\$ 1.10	163,600	\$ 1.10
\$ 1.73-2.51	808,393	3.81	\$ 2.29	553,893	\$ 2.26
\$ 2.67-4	590,443	3.38	\$ 3.14	405,855	\$ 3.05
\$ 4.1-6.04	1,204,680	3.51	\$ 4.45	913,847	\$ 4.36
\$ 6.51-9.24	1,278,306	2.70	\$ 7.63	1,051,556	\$ 7.53
\$ 9.32-14.76	2,888,750	5.94	\$ 11.01	814,242	\$ 10.84
\$ 15.94-20.38	141,000	2.70	\$ 17.74	101,625	\$ 18.44
\$ 25.5-36.53	670,200	1.30	\$ 29.03	670,200	\$ 29.03
\$ 50.50	24,000	1.49	\$ 50.50	24,000	\$ 50.50
	7,890,372		\$ 9.38	4,819,818	\$ 9.55

The Company has recorded deferred stock compensation for options issued with an exercise price below the fair market value of the Ordinary shares on the date of grant. The deferred stock compensation has been amortized and recorded as compensation expense ratably over the vesting period of the options. Compensation expenses of approximately \$50, \$66 and \$36 were recognized during the years ended December 31, 2003, 2004 and 2005, respectively.

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

NOTE 13: – SHAREHOLDERS' EQUITY (Cont.)

Options granted to employees in 2003, 2004 and 2005 have an exercise price equal to the fair market value of an Ordinary share at the grant date, except for options that were granted in 2003 to certain employees with an exercise price less than the share market price at the grant date. The weighted average fair values of the options granted during 2003, 2004 and 2005, were \$3.77, \$7.63 and \$6.27, respectively.

e. Dividends:

In the event that cash dividends are declared in the future, such dividends will be paid in NIS. The Company does not intend to pay cash dividends in the foreseeable future. (See also Note 14a.)

NOTE 14: – TAXES ON INCOME

a. Israeli taxation:

1. Measurement of taxable income:

Commencing in taxable year 2003, the Company has elected to measure its taxable income and file its tax return under the Israeli Income Tax Regulations (Principles Regarding the Management of Books of Account of Foreign Invested Companies and Certain Partnerships and the Determination of Their Taxable Income), 1986. Such an elective obligates the Company for three years. Accordingly, commencing taxable year 2003, results for tax purposes are measured in terms of earnings in dollars. The Company has elected to extend the term of the above mentioned tax measurement by another year.

2. 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" in accordance with the law under four separate investment programs. According to the provisions of such Israeli law, the Company has been granted the "Alternative Benefit Plan", under which the main benefits are tax exemption and reduced tax rate. Therefore, the Company's income derived from Approved Enterprise will be entitled to a tax exemption for a period of two to four years and to an additional period of six to eight years of reduced tax rates of 10% - 25% (based on the percentage of foreign ownership). The duration of tax benefits of reduced tax rates is subject to a limitation of the earlier of 12 years from commencement of production, or 14 years from the approval date. The Company utilized tax benefits from the first program in 1998 and is eligible for benefits through 2007. Tax benefits from the remaining programs are scheduled to gradually expire through 2013.

U.S. dollars in thousands

NOTE 14: – TAXES ON INCOME (Cont.)

As of December 31, 2005, retained earnings included approximately \$540 in tax-exempt income earned by the Company's "Approved Enterprise". The Company's Board of Directors has decided not to declare dividends out of such tax-exempt income. Accordingly, no deferred income taxes have been provided on income attributable to the Company's "Approved Enterprise".

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

The entitlement to the above benefits is conditional upon the Company fulfilling the conditions stipulated by the above law, regulations published thereunder and the certificate of approval for the specific investments in "Approved Enterprises". In the event of failure to comply with these conditions, the benefits may be canceled and the Company may be required to refund the amount of the benefits, in whole or in part, including interest. As of December 31, 2005, management believes that the Company is in compliance with all of the aforementioned conditions.

Income from sources other than the "Approved Enterprise" during the benefit period will be subject to tax at the regular tax rate prevailing at that time.

On April 1, 2005, an amendment to the law came into effect ("the Amendment") and has significantly changed the provisions of the law. The Amendment limits the scope of enterprises which may be approved by the Investment Center by setting criteria for the approval of a facility as a Beneficiary Enterprise, such as provisions generally requiring that at least 25% of the Beneficiary Enterprise's income will be derived from export. Additionally, the Amendment enacted major changes in the manner in which tax benefits are awarded under the law so that companies no longer require Investment Center approval in order to qualify for tax benefits.

In addition, the law provides that terms and benefits included in any certificate of approval already granted will remain subject to the provisions of the law as they were on the date of such approval. Therefore, the Company's existing "Approved Enterprises" will generally not be subject to the provisions of the Amendment. As a result of the Amendment, tax-exempt income generated under the provisions of the law has amended, will subject the Company to taxes upon distribution or liquidation and the Company may be required to record a deferred tax liability with respect to such tax-exempt income.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 14: – TAXES ON INCOME (Cont.)

3. Net operating losses carryforwards:

As of December 31, 2005, the Company has accumulated losses for tax purposes in the amount of approximately \$80 million, which can be carried forward and offset most of against taxable income in the future for an indefinite period.

4. 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.

5. Tax rates:

Under an amendment to the Israeli Income Tax Ordinance appeal on July 25, 2005, a gradual decrease in the corporate tax rate in Israel will be in effect as follows: in 2006 - 31%, in 2007 - 29%, in 2008 - 27%, in 2009 - 26% and in 2010 and thereafter - 25%.

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

	Year ended December 31,		
	2003	2004	2005
Domestic	\$ (7,338)	\$ 2,303	\$ 6,694
Foreign	(1,096)	2,976	7,541
	\$ (8,434)	\$ 5,279	\$ 14,235

c. Taxes on income are comprised as follows:

Current taxes	\$ -	\$ 273	\$ 3,048
Tax in respect of prior years	-	-	240
Deferred taxes *)	-	-	(2,489)
	\$ -	\$ 273	\$ 799

*) Including \$456 of the total deferred tax assets upon utilization of pre-acquisition carryforward tax losses derived from acquisition of Ai-Logix in accordance with SFAS No. 141 (See also Note 1c).

	Year ended December 31,		
	2003	2004	2005
Domestic	\$ -	\$ -	\$ 2,167
Foreign	-	273	(1,368)
	\$ -	\$ 273	\$ 799

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 14: – TAXES ON INCOME (Cont.)

d. Deferred income taxes:

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of the Group's deferred tax liabilities and assets are as follows:

	December 31,	
	2004	2005
Deferred tax assets:		
Net operating loss carryforwards	\$ 40,475	\$ 34,616
Reserves and allowances	6,544	7,071
Net deferred tax assets before valuation allowance	47,019	41,687
Valuation allowance	(47,019)	(39,198)
Net deferred tax assets	\$ -	\$ 2,489
Domestic	\$ -	\$ 2,489

The Company's U.S. subsidiaries have estimated total available carryforward tax losses of approximately \$22 million to offset against future taxable profit between 2015 and 2024. As of December 31, 2005, the Company recorded a deferred tax asset of \$2,489 relating to the available net carryforward tax losses.

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

The Company has provided valuation allowances in respect of deferred tax assets resulting from tax benefits related to employee stock option exercises, which will be credited to additional paid-in capital when realized. Management currently believes that it is more likely than not that those deferred tax deductions will not be realized in the foreseeable future.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 14: – TAXES ON INCOME (Cont.)

- e. Reconciliation of the theoretical tax expenses:

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

	Year ended December 31,	
	2004	2005
Income before taxes, as reported in the consolidated statements of income	\$ 5,279	\$ 14,235
Statutory tax rate	35%	34%
Theoretical tax expenses on the above amount at the Israeli statutory tax rate	1,848	4,840
Deferred taxes resulting from "Approved Enterprise" benefits for which a valuation allowance was provided (1)	(4,335)	(3,543)
Tax adjustment in respect of different tax rate of foreign subsidiaries	-	(84)
Non-deductible expenses	1,355	1,663
Deferred taxes on losses for which a valuation allowance was provided	1,223	(4,278)
Inter-company charges	-	1,725
Equity in losses of affiliated companies, net	182	236
Income taxes in respect of prior years	-	240
Actual tax expense	\$ 273	\$ 799
(1) Per share amounts (basic) of the tax benefit resulting from the exemption	\$ 0.11	\$ 0.09
Per share amounts (diluted) of the tax benefit resulting from the exemption	\$ 0.10	\$ 0.08

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 15: – BASIC AND DILUTED NET EARNINGS (LOSS) PER SHARE

	Year ended December 31,		
	2003	2004	2005
Numerator:			
Net income (loss) available to shareholders of Ordinary Shares	\$ (8,434)	\$ 5,006	\$ 13,436
Denominator:			
Denominator for basic earnings (loss) per share - weighted average number of Ordinary shares, net of treasury stock	37,509,000	38,613,597	40,295,591
Effect of dilutive securities:			
Employee stock options and ESPP	*) -	3,993,000	2,790,110
Senior convertible notes	-	*) -	*) -
Denominator for diluted net earnings (loss) per share - adjusted weighted average number of shares	37,509,000	42,606,597	43,085,701

*) Antidilutive.

NOTE 16: – FINANCIAL INCOME (EXPENSES), NET

	Year ended December 31,		
	2003	2004	2005
Financial expenses:			
Foreign currency translation differences	\$ (396)	\$ (403)	\$ (438)
Interest	-	(381)	(3,357)
Amortization of marketable securities premiums and accretion of discounts, net	-	-	(143)
Others	(105)	(94)	(155)
	(501)	(878)	(4,093)
Financial income:			
Foreign currency translation differences	376	310	447
Interest	2,008	2,726	6,103
Others	-	7	-
	2,384	3,043	6,550
	\$ 1,883	\$ 2,165	\$ 2,457

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 17: – MAJOR CUSTOMERS AND GEOGRAPHIC INFORMATION

a. Summary information about geographic areas:

The Group manages its business on a basis of one reportable segment (see Note 1 for a brief description of the Group's business). The data is presented in accordance with SFAS No. 131 "Disclosure About Segments of an Enterprise and Related Information". Revenues in the table below are attributed to geographical areas based on the location of the end customers.

The following presents total revenues for the years ended December 31, 2003, 2004 and 2005 and long-lived assets as of December 31, 2003, 2004 and 2005.

	2003		2004		2005	
	Total revenues	Long-lived assets	Total revenues	Long-lived assets	Total revenues	Long-lived assets
Israel	\$ 2,984	\$ 3,811	\$ 8,332	\$ 7,357	\$ 12,235	\$ 6,248
Americas	25,179	6,086	51,573	13,594	66,622	22,193
Europe	5,587	-	10,972	5	22,434	7
Far East	10,478	-	11,879	-	14,536	4
	\$ 44,228	\$ 9,897	\$ 82,756	\$ 20,956	\$ 115,827	\$ 28,452

b. Major customer's data as a percentage of total revenues:

	Year ended December 31,		
	2003	2004	2005
Customer A	14%	19%	16%

c. Product lines:

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

	Year ended December 31,		
	2003	2004	2005
Technology	\$ 28,507	\$ 48,500	\$ 62,287
Networking	15,721	34,256	53,540
	\$ 44,228	\$ 82,756	\$ 115,827

Certain portions of this exhibit have been omitted pursuant to a request for confidential treatment under Rule 24b-2 of the Securities exchange Act of 1934. The omitted materials have been filed separately with the Securities and Exchange Commission.

Execution version

CONFIDENTIAL

AMENDMENT #4

TO

OEM PURCHASE AND SALE AGREEMENT NO. 011449

BETWEEN SELLER CORPORATION AND NORTEL NETWORKS LIMITED

This Amendment #4 to OEM Purchase and Sale Agreement No. 011449 by and between Nortel Networks Limited, a Canada corporation with offices located at 8200 Dixie Road, Suite 100, Brampton, Ontario, Canada L6T 5P6 (Nortel Networks) and AudioCodes Ltd., an Israeli corporation with offices located at 1 Hayarden Street, Airport City Lod, 70151 (Seller), will be effective as of April 28, 2005.

WHEREAS, Nortel Networks and Seller entered into an OEM Purchase and Sale Agreement dated April 28, 2003, as amended (“Agreement”); and

WHEREAS, Nortel Networks and Seller wish to amend the Agreement for the purposes of adding Exhibits O and P, Exhibits A-4, A-5, A-6 and A-8 and certain general terms and conditions;

Now, therefore, the parties agree to amend the Agreement as follows:

A. Add new Subsection 6.5 to the Agreement as follows:

“6.5 Business Continuity Planning

6.5.1 Seller represents and warrants that it will implement an effective business continuity plan to be effective by January, 1st 2006 that will ensure that Seller is able to continue to provide Products when the manufacture or delivery of Products is interrupted for any reason outside of Seller’s reasonable control (“BCP”) and will maintain and update the BCP at least annually during the Term for each of its manufacturing and operations sites. Seller will perform a timely assessment after the occurrence of any event that may delay production or shipping of Products for a period of more than 10 business days. Seller will activate the BCP, if Seller determines as a result of its assessment that a Seller site will be unable to produce or ship Products for a period of more than 10 business days.

- 6.5.2 The BCP will contain, at a minimum, provisions for (a) a risk assessment and business impact analysis, (b) a prevention/mitigation plan, and (c) a resumption of services plan, including a recovery/restoration plan. The preceding will cover, but not be limited to, (i) Product documentation storage and protection (including, but not limited, to storage of design documents, tools, process and fixtures), (ii) information systems security and redundancy, and (iii) a detailed plan with relevant Contract Manufacturers to rapidly recover the loss of Product manufacturing facilities or Product delivery capability.
- 6.5.3 Seller will provide a detailed outline of the BCP within 10 business days of Nortel Networks' request for the then-current BCP. Certain details of the BCP will not be shared between the parties.
- 6.5.4 Seller's implementation of the BCP will be at no additional cost to Nortel Networks
- 6.5.5 At Nortel Networks' request and at no additional charge to Nortel Networks Seller will participate in discussions initiated by Nortel Networks for purposes of evaluating and coordinating and integrating the business continuity plans of its suppliers with Nortel Networks' overall business continuity plan.

B. Add new Subsection 23.11 to the Agreement as follows:

"23.11 *Information Systems Security* – If Nortel Networks grants Seller access to Nortel Networks' information systems, Seller will safeguard the security of Nortel Networks' information systems, as set out in Exhibit O, attached to and incorporated in this Agreement."

C. Add new Exhibit O "Information Systems Security" to the Agreement, attached to and incorporated in this Amendment 4 as Attachment 1.

D. Section 2.1.2 of Exhibit A-1 is hereby deleted in its entirety.

E. The tables labeled "Vocoders Indemnification" in Sections 2.2.1, 2.2.2, 2.2.3, and 2.2.4 of Exhibit A-1 are hereby deleted in their entirety. However, it is noted that AudioCodes only offers Products under this agreement that support G.711, G.726, G.723.1 and G.,729A. This Agreement does not cover indemnification for other vocoders. Both parties agree to discuss and mutually agree on how to handle indemnity for additional vocoders if these additional vocoders are added as part of an agreed change in the Specifications.

F. The two lines under the heading "Indemnification" appearing in the table in Section 2.2.5 of Exhibit A-1 are hereby deleted in their entirety. However, it is noted that AudioCodes only offers Products under this agreement that support G.711, G.726, G.723.1 and G.,729A. This Agreement does not cover indemnification for other vocoders. Both parties agree to discuss and mutually agree on how to handle indemnity for additional vocoders if these additional vocoders are added as part of an agreed change in the Specifications.

- G. Section 1(c) of Exhibit A-2 is hereby deleted in its entirety. However, it is noted that AudioCodes only offers Products under this agreement that support G.711, G.726, G.723.1 and G.,729A. This Agreement does not cover indemnification for other vocoders. Both parties agree to discuss and mutually agree on how to handle indemnity for additional vocoders if these additional vocoders are added as part of an agreed change in the Specifications.
- H. The two lines under the heading “Indemnification” appearing in the table in Section 1.1 of Exhibit A-2 are hereby deleted in their entirety. However, it is noted that AudioCodes only offers Products under this agreement that support G.711, G.726, G.723.1 and G.,729A. This Agreement does not cover indemnification for other vocoders. Both parties agree to discuss and mutually agree on how to handle indemnity for additional vocoders if these additional vocoders are added as part of an agreed change in the Specifications.
- I. The following paragraph in Section 1 of Exhibit A-3, which is Attachment 1 to Amendment No. 1 effective May 1, 2003, is hereby deleted in its entirety:
- “With respect to the cost reduction obligation described in Section 3 below, Seller is not obligated in its cost reduction calculations to include the cost of indemnifying Nortel Networks against third party intellectual property claims related to Nortel Networks purchase of Product A0514478, which includes Voice Codec G.723.1 and G.729A. For purposes of such cost reduction calculations the cost for Voice Codec indemnification included in the Price for A0514478 is [*] per port per Codec.”
- J. For the avoidance of doubt, the deletion of language and references to “Indemnification” as set forth in Articles D, E, F, G, H and I above in no way modifies or reduces Seller’s obligation to provide indemnification protection to Nortel Networks under Section 18 of the Agreement. However, it is noted that AudioCodes only offers Products under this agreement that support G.711, G.726, G.723.1 and G.,729A. This Agreement does not cover indemnification for other vocoders. Both parties agree to discuss and mutually agree on how to handle indemnity for additional vocoders if these additional vocoders are added as part of an agreed change in the Specifications.
- K. Add new Exhibit A-4 “Mediant 5000 Trunk Gateway Product” to the Agreement, attached to and incorporated in this Amendment 4 as Attachment 2.
- L. Add new Exhibit A-5 “M2K – CS2K DC Power Product” to the Agreement, attached to and incorporated in this Amendment 4 as Attachment 3.
- M. Add new Exhibit A-6 “IPM2000 – CS2K AC Powered Media Server Product” to the Agreement, attached to and incorporated in this Amendment 4 as Attachment 4.

[*] Confidential

- N. Add new Exhibit A-7 “Mediant 1000 (MG3100) – H.248 and Mediant 1000 (MG3100) -SIP” to the Agreement, attached to and incorporated in this Amendment 4 as Attachment 5.
- O. Added new Exhibit O “Hazardous Materials Regulations” to the Agreement, attached and incorporated in this Amendment 4 as Attachment 6.

Except for this Amendment No. 4, in all other respects the Agreement shall remain unchanged.

IN WITNESS WHEREOF, the parties have caused this Amendment No. 4 to the Agreement to be signed by their duly authorized representatives.

NORTEL NETWORKS LIMITED

AUDIOCODES LTD.

By: _____

By: /s/ Ben Rabinowitz

Name: _____
(Type/Print)

Name: Ben Rabinowitz
(Type/Print)

Title: _____

Title: Vice President

Date: _____

Date: October 10, 2005

**ATTACHMENT 1
EXHIBIT O**

INFORMATION SYSTEMS SECURITY

- 1. Access** – Seller shall ensure that access and use (either on-site or remotely) of Nortel Networks’ Technology Resources by Seller or any non-Nortel Networks party performing under the Agreement (each an *Outside Access Party*) shall be limited only to access and use needed for performance. “Technology Resources” means network systems and services (voice and/or data) such as the Inter/Intranet gateways , electronic-mail and telephony and include, but are not limited to its computer systems, all system hardware, all hard drives, electronic media, storage areas, files and desks and information services (i.e. remote access, web/file servers & services, etc.). The Outside Access Party will provide Nortel Networks with the name of each of its personnel who will access Nortel Networks’ computer system during their performance under the Agreement (*Authorized Workers*). Authorized Workers will establish and maintain a unique identifier for access and follow the same computer system security rules as Nortel Networks personnel. The security requirements will also apply to Authorized Workers’ access and use of Nortel Networks’ electronic mail system, electronic switched network, (either directly or via a direct inward service access [DISA] feature) or any other Nortel Networks property, equipment or service.

Unless explicitly authorized in writing by Nortel Networks, Outside Access Party must not (i) attempt to reverse engineer, disassemble, reverse translate, decompile or in any other manner decode any element of the Technology Resources; (ii) make modifications, enhancements, adaptations or translations, in whole or in part, to or of any element of the Technology Resources; (iii) make copies of any element of the Technology Resources; (iv) probe host computers or networks; (v) breach or examine the security controls of a host computer, network component or authentication system; (vi) monitor data on any network or system; (vii) interfere with the service of any user, host or network, or overload a server, network connected device, or network component; (viii) originate malformed data or network traffic that results in damage to, or disruption of, a service or network connected device; (ix) forge data or misrepresent the origination of a user or source.

- 1.1 *Failure of Access*- Outside Access Party understands that its access to and use of the Technology Resources may from time to time be interrupted due to circumstances within or outside the reasonable control of Nortel Networks. Nothing in this Agreement shall be considered a promise or covenant to deliver access to the Technology Resources. Aside from the access as provided herein, no license of any patent, copyright, or any other right in respect of the Technology Resources is granted to Outside Access Party by virtue of access to the Technology Resources.
- 1.2 *Waiver of Liability* – Notwithstanding any terms and conditions in this Agreement, Nortel Networks hereby excludes all representations, warranties and conditions, express or implied, including any representations, warranties or conditions of accuracy, sufficiency, suitability or non-infringement. Outside Access Party hereby waives any liability on the part of Nortel Networks for any damages, losses or expenses incurred by Outside Access Party as a result of Outside Access Party’s access to and use of the Technology Resources (including, without limitation, the inadvertent accessing of a computer virus or other harmful computer file or program) or failure to access the Technology Resources, whether arising in contract, tort or otherwise.
- 1.3 *Confidential Information and Personal Data* – All passwords, identification numbers and information obtained during the Outside Access Party’s use of Nortel Networks’ Technology Resources are Confidential Information.
- 1.4 *Unauthorized Access* – The Outside Access Party will cooperate in the investigation of any apparent unauthorized access to Nortel Networks’ customers or any activity resulting in a security breach as defined under Nortel Networks’ corporate policies, procedures or standards.

2. *Segregation Wall*– Using procedures documented for Nortel Networks by Contractor and reviewed and approved by Nortel Networks’ security team, the Outside Access Party will ensure that Authorized Workers implement effective isolation and containment procedures (for example separate password protected folders or storage media that facilitates separation and prevents open access or disclosure to non -authorized workers or third party companies) for the protection of Nortel Networks technologies and intellectual properties to ensure non-disclosure, held in confidence, by its personnel who are assigned to the account of a known or potential Nortel Networks competitor (Competitors). The Outside Access Party must implement procedures to logically segregate, by normal commercial means, all Nortel Networks information, data and communications (including, but not limited to Confidential Information) from Competitors and Outside Access Party personnel who are not Authorized Workers (Segregation Wall).
3. *Inadequate Security* – If Nortel Networks notifies the Outside Access Party that the Segregation Wall is not working and makes a reasonable request to change or replace the Segregation Wall; the Outside Access Party will comply with Nortel Networks’ request
- 3.1 *Security Audit* – Under Section 9.6 of this Agreement Nortel Networks may audit the Segregation Wall. In addition to the rights and obligations set out in Section 9.6 Outside Access Party hereby grants Nortel Networks reasonable access to those of its computer facilities that it uses or intends to use in association with the accessing the Technology Resources for the purposes of assessing the on-going adequacy of Outside Access Party’s security measures and procedures in effect on such computer facilities, and shall assist and co-operate with Nortel Networks in carrying out any such assessment. If Nortel Networks determines that Outside Access Party’s security measures and procedures are inadequate to prevent unauthorized access to or use of the Technology Resources, Nortel Networks may immediately deny further access until Outside Access Party takes such measures as Nortel Networks may reasonably require.
- 3.2 *Notice of Security Breach* – The Outside Access Party will promptly notify Nortel Networks in writing in the event (a) there is a general breach of security, the appearance of a breach or a breach attempt at the Outside Access Party’s facilities that may be involved in performing under the Agreement; or, (b) Outside Access Party personnel (that are not Authorized Workers) or third parties breach the Segregation Wall. At its expense the Outside Access Party will do whatever is necessary to preserve the integrity of the Technology Resources and Confidential Information and correct the breach and prevent it from recurring.

ATTACHMENT 2
Exhibit A-4
Mediant 5000 Trunk Gateway Product

HA Mediant 5000 VoIP in a N+1 Redundant Bearer Configuration

MG5000	Mediant 5000 Redundant Base	[*]
TP1610B	TP1610B cPCI 16 E1/T1, cPSB, IP	[*]
TP1610B/HALF	TP1610B/HALF cPCI 16 E1/T1, cPSB, IP	[*]
HW/RTM/2TELCO/CPSB/APB	RTM for TP1610,cPSB, active board (one per "N" Board)	[*]
HW/RTM/REDUNDANCY/CPSB/APB	RTM for TP1610,cPSB, standby board (one per "+1" Board)	[*]
TP6310A/2016/OC-3	TP6310, 1xOC-3, 2016 Channels	[*]
TP6310A/2016/OC-3/HALF	TP6310, 1xOC-3, Half, 2016 G711 Channels	[*]
HW/RTM/OC-3/CPSB/APB	RTM for TP-6310, 1 OC-3	[*]
HW/RTM/REDUNDANCY/6310/CPSB/APB	RTM for TP6310,cPSB,standby board ("+1" board)	[*]
SW/EMS/Server (One per EMS Server)	EMS Server s/w license.	[*]

- Cost Reduction year over year [*]

Available Software Options:

DUA	SigTran-based DUA (per active board)	[*]
SW/IP-Sec	IP-Sec for OAM/Call Control (per active board)	[*]
SW/BearerEncryption	Bearer Encryption (per active board)	[*]
SW/PacketCable	PacketCable Package (TGCP) not incl bearer encryption (per active board)	[*]
SW/M2UA/SIGTRAN/2	M2UA Sigtran Interworking SW (per 2 channels) Max of 8 links per board	[*]

Notes -AudioCodes does not provide the EMS hardware, only a license to use our EMS server software. EMS can support up to 100 Mediant 5000s.

TP 6310 in Mediant 5000 will be available in 2006 for sale to service providers

Price reductions on TP6310 will not occur until April, 2007, unless mutually agreed

In certain deployments of Mediant 5000, the fees, terms and the cap on support payments may not apply if AudioCodes is requested to provide support beyond that is required in the Agreement

M5K (MG3500) FRUs	PEC	Price
HW/ES-1/NN	NTRX51XJ	[*]
HW/RTM/LIM-1/NN	NTRX51XV	[*]
HW/SC-2/NN	NTRX51XT	[*]
HW/SA1C/RTM/ALARM/NN	NTRX51XH	[*]
HW/FM-2/NN	NTRX51XP	[*]
HW/PS-2/AC/NN	NTRX51XR	[*]
HW/PS-2/DC/NN	NTRX51XQ	[*]
HW/AF-2/NN	N/A	[*]
HW/PEM-1/DC/NN	NTRX51XK	[*]
HW/APM-2/DC/NN	NTRX51XN	[*]
HW/PEM-1/AC/NN	NTRX51XL	[*]
HW/APM-2/AC/NN	NTRX51XM	[*]
HW/RTM/TP1610/ACTIVE/NN	NTRX51XF	[*]
HW/RTM/TP1610/STDBY/NN	NTRX51XG	[*]
HW/TP1610B/480/16SPAN/NN	NTRX51XE	[*]
HW/TP1610B/480/16SPAN/G711/NN	NTRX51XD	[*]
HW/GP5000/Mediant/NN	NTRX51XC	[*]

Lab Hardware M5K– In coordination with Amendment #011449 to OEM Purchase and Sale Agreement No. between the parties, Seller will provide Nortel Networks with up to [*] lab units free for internal and external customer labs or trials at Nortel Networks' discretion. At least three (3) of these free M5K units are to be used for external customers and both parties must mutually agree on which Nortel Network customers will receive these M5K units. Any units provided for free in calendar year 2005 will be counted in meeting this obligation. For any further internal lab requirements Seller will provide an incremental [*] off Nortel contracted price. Requests for 'lab hardware' are to be made in writing by the relationship prime.

PAYMENT TERMS: [*]

ATTACHMENT 3

Exhibit A-5

M2K – CS2K DC Power Product

M2K – CS2K Pricing for DC Power:

Part Number	Description	Price
Mediant2000/1Span/DC/H248/NN	Mediant 2000, 1 span, DC power, H.248	[*]
Mediant2000/2Span/DC/H248/NN	Mediant 2000, 2 span, DC power, H.248	[*]
Mediant2000/4Span/DC/H248/NN	Mediant 2000, 4 span, DC power, H.248	[*]
Mediant2000/8Span/DC/H248/NN	Mediant 2000, 8 span, DC power, H.248	[*]
Mediant2000/16Span/DC/H248/NN	Mediant 2000, 16 span, DC power, H.248	[*]

[*] Confidential

ATTACHMENT 4

Exhibit A-6

IPM2000 – CS2K AC Powered Media Server Product

Part Number	Description	Price
IPM2K/IVR/LI/TT/120/2AC	IPMedia 2000, 120 port AC Power	[*]
IPM2K/IVR/LI/TT/240/2AC	IPMedia 2000, 240 port AC Power	[*]
IPM2K/IVR/LI/TT/CONF/120/2AC	IPMedia 2000, 120 port Conferencing AC Power	[*]
IPM2K/IVR/LI/TT/CONF/240/2AC	IPMedia 2000, 240 port AC Conferencing AC Power	[*]

[*] Confidential

ATTACHMENT 5
Exhibit A – 7

Mediant 1000 (MG 3100) - H.248	Hardware Price	SIP Charge	Total
Mediant1000/1Span/2AC/H248/NN	[*]	[*]	[*]
Mediant1000/2Span/2AC/H248/NN	[*]	[*]	[*]
Mediant1000/4Span/2AC/H248/NN	[*]	[*]	[*]
Mediant1000/1Span/DC/H248/NN	[*]	[*]	[*]
Mediant1000/2Span/DC/H248/NN	[*]	[*]	[*]
Mediant1000/4Span/DC/H248/NN	[*]	[*]	[*]

Mediant 1000 (MG 3100) - SIP			
Mediant1000/1Span/2AC/SIP/NN	[*]	[*]	[*]
Mediant1000/2Span/2AC/SIP/NN	[*]	[*]	[*]
Mediant1000/4Span/2AC/SIP/NN	[*]	[*]	[*]
Mediant1000/1Span/DC/SIP/NN	[*]	[*]	[*]
Mediant1000/2Span/DC/SIP/NN	[*]	[*]	[*]
Mediant1000/4Span/DC/SIP/NN	[*]	[*]	[*]

[*] Confidential

ATTACHMENT 6

Exhibit O

HAZARDOUS MATERIALS REGULATIONS

Seller will notify Nortel Networks about the hazardous and toxic materials, as required of it by the regulations promulgated under all applicable laws, rules and regulations of any applicable governmental entity including, without limitation, the following U.S. and E.U. laws:

- (a) U.S. laws – The Toxic Substances Control Act, Resource Conservation and Recovery Act of 1976, Hazardous Materials Transportation Act, Occupational Safety and Health Act of 1970, Comprehensive Environmental Response, Compensation and Liability Act of 1980, Consumer Product Safety Act, Radiation Control for Health and Safety Act of 1968, Clean Air Act, and Clean Water Act , and
- (b) E.U. laws – The following European Union Environmental Directives: Eco-design of Energy Using Product (EuP), Waste from Electrical and Electronic Equipment (WEEE) directive (effective August 2005) and Restriction on Use of Certain Hazardous Substances (RoHS) (effective July 2006) directive. With respect to the RoHS Directive, Seller must be able to demonstrate to Nortel Networks' satisfaction by May 30, 2006 that no lead, hexavalent chromium cadmium, mercury or polybrominated biphenyls (PBB)/polybrominated diphenyl ethers (PBDE) are present in any product covered by the ROHS Directive used or provided by Seller in providing the Products in the EU, except where exemptions allowing the use of such substances apply under applicable law. Seller shall monitor the implementation and local requirements of WEEE in relevant EU countries and shall inform and discuss with Nortel Networks on a timely basis of its plan regarding implementation and management of the WEEE and RoHS directives for Nortel Networks' review and further discussion..

AGREEMENT AND PLAN OF MERGER

DATED AS OF MAY 16, 2006

AMONG

AUDICODES LTD.,

AUDICODES, INC.,

GREEN ACQUISITION CORP.,

NUERA COMMUNICATIONS, INC.

AND

ROBERT WADSWORTH, AS SELLERS' REPRESENTATIVE

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AGREEMENT AND PLAN OF MERGER dated as of May 16, 2006 (this “Agreement”), among AUDIOCODES LTD., a company organized under the laws of the State of Israel (“AudioCodes”), AUDIOCODES, INC., a Delaware Corporation (“Parent”), GREEN ACQUISITION CORP., a Delaware corporation (“Merger Sub”), NUERA COMMUNICATIONS, INC., a Delaware corporation (the “Company”) and ROBERT WADSWORTH, as Sellers’ Representative.

INTRODUCTION

The Boards of Directors of each of the Company, AudioCodes, Parent and Merger Sub have approved the merger of Merger Sub with and into the Company (the “Merger”) on the terms and subject to the conditions set forth in this Agreement, and such Boards of Directors have approved in all respects this Agreement and the transactions contemplated hereby and the other Transaction Agreements. As a result of the Merger, each issued and outstanding share of capital stock of the Company will be converted into the right to receive the consideration provided in this Agreement.

In consideration of the foregoing and the respective representations, warranties, covenants and agreements set forth herein, the Parties agree as follows:

ARTICLE 1 THE MERGER

Section 1.1. The Merger. Upon the terms and subject to the conditions set forth in this Agreement, and in accordance with the Delaware General Corporation Law (the “DGCL”), at the Effective Time, Merger Sub shall be merged with and into the Company. At the Effective Time, the separate corporate existence of Merger Sub shall cease and the Company shall continue as the surviving corporation (the “Surviving Corporation”).

Section 1.2. Closing. The closing of the Merger (the “Closing”) shall be held at the offices of DLA Piper Rudnick Gray Cary US LLP, 4365 Executive Drive, Suite 1100, San Diego, California 92121, at 10:00 a.m. on the date as soon as practicable, and in any event not later than two (2) Business Days, following satisfaction of all conditions and taking of all other actions (other than those that by their terms are to be satisfied or taken at the Closing) set forth in Article 7 (or, to the extent permitted by Law, waived by the Parties entitled to the benefits thereof), or on such other date, and at such other time or place, as Parent and the Company may mutually agree in writing. The date on which the Closing occurs is referred to in this Agreement as the “Closing Date.”

Section 1.3. Actions at the Closing. At the Closing (a) the Parties shall cause a certificate of merger in customary form acceptable to the Parent and the Company and executed in accordance with the relevant provisions of the DGCL (the “*Certificate of Merger*”) and other required documents to be filed in the office of the Secretary of State of the State of Delaware (the “*Delaware Secretary of State*”), and Parent, Merger Sub and the Company shall make all other filings or recordings required under the DGCL and applicable Law to give effect to the Merger and the other transactions contemplated hereby; (b) Parent and AudioCodes shall deposit or cause to be deposited \$7,500,000 (the “*Escrow Amount*”) with U.S. Bank Trust National Association, in its capacity as escrow agent (the “*Escrow Agent*”) under the Escrow Agreement to be entered into on or prior to the Closing Date by Parent, the Sellers’ Representative and the Escrow Agent in substantially the form attached hereto as *Exhibit A* (the “*Escrow Agreement*”), to be administered in accordance with the Escrow Agreement; and (c) Parent and AudioCodes shall deposit or cause to be deposited \$1,000,000 (the “*Expenses Escrow Amount*”) with the Escrow Agent under the Expenses Escrow Agreement to be entered into on or prior to the Closing Date by the Parent, Sellers’ Representative and the Escrow Agent in substantially the form attached hereto as *Exhibit B* (the “*Expenses Escrow Agreement*”), to be administered in accordance with the Expenses Escrow Agreement. The Expenses Escrow Fund shall be available solely to compensate the Sellers’ Representative and the Sellers for all fees and expenses reasonably incurred by: (i) the Sellers’ Representative in performing its duties under this Agreement; and (ii) the Sellers’ Representative and the Sellers in defending against any claims for indemnification or other claims for damages by AudioCodes, Parent or any other Parent Indemnified Party pursuant to this Agreement or otherwise.

Section 1.4. Effective Time. The Merger shall become effective at such time (the “*Effective Time*”) as the Certificate of Merger is duly filed with the Delaware Secretary of State or at such later time as Parent and the Company shall agree and specify in the Certificate of Merger.

Section 1.5. Effects of the Merger. The Merger shall have the effects set forth in Section 259 of the DGCL.

Section 1.6. Certificate of Incorporation and By-laws. Subject to the provisions of Section 5.12, the Certificate of Incorporation of the Surviving Corporation shall be amended and restated, as of the Effective Time, so as to read the same as the Certificate of Incorporation of Merger Sub as in effect immediately prior to the Effective Time, except that the name of the corporation set forth therein shall be changed to the name of the Company and any references therein to the incorporator and the initial directors shall be deleted, and, as so amended, such Amended and Restated Certificate of Incorporation shall be the Certificate of Incorporation of the Surviving Corporation until thereafter changed or amended as provided therein or by applicable Law. Subject to the provisions of Section 5.12, the By-laws of Merger Sub as in effect immediately prior to the Effective Time, shall be the By-laws of the Surviving Corporation until amended, except that the name of the corporation set forth therein shall be changed to the name of the Company.

Section 1.7. Directors and Officers of Surviving Corporation. The directors of Merger Sub immediately prior to the Effective Time shall be the directors of the Surviving Corporation, until the earlier of their resignation or removal or until their respective successors are duly elected or appointed and qualified, as the case may be. The officers of Merger Sub immediately prior to the Effective Time shall be the officers of the Surviving Corporation, until the earlier of their resignation or removal or until their respective successors are duly elected or appointed and qualified, as the case may be.

ARTICLE 2
EFFECT ON THE CAPITAL STOCK OF THE CONSTITUENT CORPORATIONS;
EXCHANGE OF CERTIFICATES

Section 2.1. Conversion of Capital Stock. At the Effective Time, by virtue of the Merger and without any action on the part of the holder of any shares of Capital Stock of the Company or any shares of Capital Stock of Merger Sub:

- (a) Capital Stock of Merger Sub. Each issued and outstanding share of Capital Stock of Merger Sub shall be converted into and shall become one fully paid and nonassessable share of common stock, par value \$.001 per share, of the Surviving Corporation.
- (b) Cancellation of Treasury Stock. Each share, if any, of Capital Stock of the Company that is held by the Company as treasury stock or owned by the Company or any of its Subsidiaries shall no longer be outstanding and shall be automatically cancelled and retired and shall cease to exist and no consideration shall be delivered or deliverable in exchange therefor.
- (c) Conversion of Common Stock. Each share of Company Common Stock issued and outstanding immediately prior to the Effective Time, other than the Appraisal Shares and shares to be cancelled and retired in accordance with Section 2.1(b), shall be converted into the right to receive, without interest and subject to Section 2.5(a), the Closing Common Merger Consideration, *plus*, when payable, any amounts required to be paid in respect of such Company Common Stock pursuant to Section 2.3 of this Agreement, the Escrow Agreement and the Expenses Escrow Agreement.
- (d) Conversion of Preferred Stock. Each share of Preferred Stock issued and outstanding immediately prior to the Effective Time, other than the Appraisal Shares and shares to be cancelled and retired in accordance with Section 2.1(b), shall be converted into the right to receive, without interest and subject to Section 2.5(a), the Closing Preferred Merger Consideration, *plus*, when payable, any amounts required to be paid in respect of such Preferred Stock pursuant to Section 2.3 of this Agreement, the Escrow Agreement and the Expenses Escrow Agreement.
- (e) Effect on Capital Stock. At the Effective Time, all shares of Capital Stock of the Company shall no longer be outstanding and shall automatically be cancelled and retired and shall cease to exist, and each holder of a certificate that immediately prior to the Effective Time represented any such shares (a "*Certificate*") shall cease to have any rights with respect thereto, except the right to receive the Closing Merger Consideration upon surrender of such Certificate in accordance with Section 2.5, without interest. In no event shall the aggregate Merger Consideration, the aggregate Option Consideration and the aggregate Warrant Consideration exceed \$85,000,000 plus any increase under Section 2.3 hereof up to the Earn Out Amount.

Section 2.2. Options and Warrants.

(a) Each Option (whether vested or not) outstanding immediately prior to the Effective Time with an exercise price per share that is less than the Common Merger Consideration shall be terminated at the Effective Time in exchange for the right to receive, without interest, for each share subject to such Option (i) following the Effective Time an amount equal to the product of (A) the excess of the Common Merger Consideration over the exercise price per share of such Option *multiplied by* (B) the Closing Percentage *plus* (ii) for each share subject to such Option when payable, any amounts required to be paid in respect of a share of Company Common Stock pursuant to the Escrow Agreement and the Expenses Escrow Agreement and any Earn Out Per Share Amount (the “*Option Consideration*”). Each Warrant outstanding immediately prior to the Effective Time with an exercise price per share that is less than the Preferred Merger Consideration shall be terminated in exchange for the right to receive, without interest, for each share subject to such Warrant (i) following the Effective Time, an amount equal to the product of (A) the excess of the Preferred Merger Consideration over the exercise price per share of such Warrant *multiplied by* (B) the Closing Percentage *plus* (ii) when payable, any amounts required to be paid in respect of a share of Preferred Stock pursuant to the Escrow Agreement and the Expenses Escrow Agreement and any Earn Out Per Share Amount (the “*Warrant Consideration*”). The right of any holder of an Option to receive the Option Consideration shall be subject to and reduced by the amount of any tax or other withholding that is required under applicable Law. After the Closing, Parent will cause the Option Consideration and the Warrant Consideration that is payable following the Effective Time to be paid as soon as practicable; *provided, however*, that Parent or the Surviving Corporation, as applicable, shall be entitled to deduct and withhold from the Option Consideration such amounts as may be required to be deducted and withheld with respect to the making of such payment under the Internal Revenue Code of 1986 (the “*Code*”) or any provision of any other applicable Law.

(b) At the Effective Time, each Option outstanding as of the Effective Time with an exercise price per share that is equal to or greater than the Common Merger Consideration and each Warrant outstanding as of the Effective Time with an exercise price per share that is equal to or greater than the Common Merger Consideration or the Preferred Merger Consideration, as applicable, shall be terminated, without any consideration therefor.

(c) The Company agrees that the Board of Directors of the Company (or, if appropriate, any committee administering any stock option plan or other stock or equity-related plan of the Company (the “*Company Stock Plans*”) shall adopt such resolutions or take such other actions (including obtaining any required consents but not including the payment of any cash or non-cash consideration) as may be required to effect the transactions described in this Section 2.2 as of the Effective Time. The Company shall terminate all Company Stock Plans at the Effective Time.

Section 2.3. Earn-Out.

(a) Subject to this Section 2.3, the Merger Consideration, Option Consideration and Warrant Consideration shall be subject to an increase up to a maximum aggregate amount of \$5,000,000 if the Surviving Corporation achieves any of the levels of Net Product Sales specified on Schedule 2.3 to this Agreement, during the Earn Out Period, from sales of the specified products and the provision of services set forth on Schedule 2.3 to the specified customers set forth on Schedule 2.3 and such other customers as AudioCodes may determine in its sole and absolute discretion. The specific “*Earn Out Amount*” shall be determined in accordance with the formula set forth on Schedule 2.3 and shall be payable in accordance with this Section 2.3.

(b) Within seventy-five (75) days following each of December 31, 2006, March 31, 2007 and June 30, 2007, the Surviving Corporation shall (i) prepare a statement (the “*Statement*”) setting forth the Net Product Sales from the beginning of the Earn Out Period through the applicable date, and (ii) deliver or cause to be delivered the Statement, together with a summary of the basis for the determination set forth therein, to the Sellers’ Representative.

(c) If the Sellers’ Representative objects to the calculations set forth in the Statement for any period for which a Statement is required to be delivered under Section 2.3(b), then within thirty (30) days after the delivery to the Sellers’ Representative of such Statement, the Sellers’ Representative may deliver to the Company and Parent a written notice (the “*Objection Notice*”), describing in reasonable detail the Sellers’ Representative’s objections to the Statement and setting forth the calculation determined by the Sellers’ Representative to be correct. The failure of the Sellers’ Representative to deliver an Objection Notice in connection with a particular Statement (other than the final Statement delivered after June 30, 2007) will not constitute an acknowledgement of, or agreement to, the calculations contained in such Statement should the Sellers’ Representative deliver an Objection Notice in connection with a subsequent Statement. If the Sellers’ Representative gives the Objection Notice to the Company and Parent within such 30-day period, the Company and the Sellers’ Representative will use commercially reasonable efforts to resolve the dispute during the 45-day period commencing on the date Parent receives the Objection Notice from Sellers’ Representative. If the Sellers’ Representative and Parent do not obtain a final resolution within such 45-day period, then the items in dispute shall be submitted immediately to a nationally-recognized, independent accounting firm reasonably acceptable to the Sellers’ Representative and Parent (the “*Accounting Firm*”); provided that the Parties agree that the Accounting Firm shall not be Ernst & Young LLP. The Accounting Firm shall be required to render a determination of the applicable dispute within forty-five (45) days after referral of the matter to the Accounting Firm, which determination must be in writing and must set forth, in reasonable detail, the basis therefor. The determination of the Accounting Firm shall be conclusive and binding upon the Sellers’ Representative, the Company and the other parties hereto.

(d) In the event the Sellers’ Representative and Parent submit any unresolved objections to an Accounting Firm for resolution as provided in Section 2.3(c), the responsibility for the fees and expenses of the Accounting Firm shall be as follows:

(i) if such Accounting Firm resolves all of the remaining objections in favor of Parent’s position (the calculation so determined is referred to herein as the “*Low Value*”), then all of the fees and expenses of the Accounting Firm shall be paid by the Sellers’ Representative;

(ii) if the Accounting Firm resolves all of the remaining objections in favor of the Sellers’ Representative’s position (the calculation so determined is referred to herein as the “*High Value*”), then all of the fees and expenses of the Accounting Firm shall be paid by the Company; and

(iii) if such Accounting Firm neither resolves all of the remaining objections in favor of Parent’s position nor resolves all of the remaining objections in favor of the Sellers’ Representative’s position (the calculation so determined is referred to herein as the “*Actual Value*”), then that fraction of the fees and expenses of the Accounting Firm equal to (x) the difference between the High Value and the Actual Value over (y) the difference between the High Value and the Low Value shall be paid by the Sellers’ Representative, and the Company will be responsible for the remainder of the fees and expenses of the Accounting Firm.

(e) Within ten (10) Business Days of the later of (i) the delivery of any Statement that provides that Net Product Sales equals or exceeds any of the target levels of Net Product Sales set forth on Schedule 2.3, or (ii) a resolution of the calculation set forth in a Statement for which an Objection Notice has been given in accordance with Section 2.3(c), which resolution provides that Net Product Sales equals or exceeds any of the target levels set forth in Schedule 2.3, Parent and AudioCodes shall deliver, or shall cause to be delivered, to the Paying Agent the Earn Out Amount determined to be payable (less any portion of the aggregate Earn Out Amount previously earned and delivered to the Paying Agent), for distribution to the holders of the Earn Out Shares. The Paying Agent shall deliver to each such holder the Earn Out Per Share Amount for each Earn Out Share held by such holder. In no event shall the aggregate Earn Out Amount payable by Parent and/or AudioCodes exceed \$5,000,000. The Earn Out Per Share Amount for any holder of an Earn Out Share that holds such share by virtue of the cancellation of an Option pursuant to Section 2.2(a) shall be subject to and reduced by the amount of any tax or other withholding that is required under applicable Law.

Section 2.4. Appraisal Rights. Notwithstanding anything in this Agreement to the contrary, shares (the “*Appraisal Shares*”) of the Company’s Capital Stock issued and outstanding immediately prior to the Effective Time that are held by any holder who is entitled to demand and properly demands appraisal of such shares pursuant to, and who complies in all respects with, Section 262 of the DGCL (the “*Appraisal Statute*”) shall not be converted into the right to receive the applicable Merger Consideration as provided in Section 2.1, but instead such holder shall be entitled to payment of the fair value of such Appraisal Shares in accordance with the Appraisal Statute. At the Effective Time, the Appraisal Shares shall no longer be outstanding and shall automatically be cancelled and shall cease to exist, and each holder of Appraisal Shares shall cease to have any rights with respect thereto, except the right to receive the fair value of such shares in accordance with the provisions of the Appraisal Statute. Notwithstanding the foregoing, if any such holder shall fail to perfect or otherwise shall waive, withdraw or lose the right to appraisal under the Appraisal Statute, or a court of competent jurisdiction shall determine that such holder is not entitled to the relief provided by the Appraisal Statute, then the right of such holder to be paid the fair value of such holder’s Appraisal Shares under the Appraisal Statute shall cease and such Appraisal Shares shall be deemed to have been converted at the Effective Time into, and shall have become solely, the right to receive the Merger Consideration as provided in Section 2.1. The Company shall serve prompt notice to Parent of any demands for appraisal of any shares of the Company’s Capital Stock, withdrawals of such demands and any other related instruments served pursuant to the DGCL and received by the Company, and Parent shall have the right to participate in and direct all negotiations and proceedings with respect to such demands. Prior to the Effective Time, the Company shall not, without the prior written consent of Parent, make any payment with respect to, or settle or offer to settle, any such demands, nor shall the Company agree to or commit to making any such payment or settlement or admit to any liability with respect to such matters.

Section 2.5. Exchange Procedures.

(a) Promptly following the Effective Time, Parent and AudioCodes shall, provide or cause to be provided to U.S. Bank National Trust Association (the “Paying Agent”), cash necessary to pay for the shares of Company Capital Stock converted into the right to receive the Closing Common Merger Consideration or the Closing Preferred Merger Consideration pursuant to Section 2.1 (such cash, being hereinafter referred to as the “Exchange Fund”). Prior to or as soon as practicable after the Closing, the Company shall provide to each holder of a Certificate (i) a letter of transmittal in substantially the form attached as *Exhibit C* (a “Letter of Transmittal”) and (ii) instructions for effecting the surrender of such Certificate in exchange for the Closing Common Merger Consideration or the Closing Preferred Merger Consideration with respect to each of the shares of Capital Stock of the Company represented thereby. Following surrender of a Certificate to the Paying Agent, together with such Letter of Transmittal duly executed and completed in accordance with the instructions thereto, a properly executed substitute Form W-9 or Form W-8BEN, if applicable, from such holder in form and substance acceptable to Parent, and such other documents as may reasonably be required by Parent or the Paying Agent, the holder of such Certificate shall be entitled to receive in exchange therefor an amount equal to the Closing Common Merger Consideration or the Closing Preferred Merger Consideration (rounded up to the nearest \$0.01) for the shares of Capital Stock of the Company represented by such Certificate pursuant to Section 2.1, without interest and the Certificate so surrendered shall forthwith be cancelled. Until so surrendered, such Certificates shall upon and following the Effective Time represent solely the right to receive the Closing Common Merger Consideration or Closing Preferred Merger Consideration with respect to the shares of Capital Stock of the Company represented thereby, without interest.

(b) If any Certificate shall have been lost, stolen, mutilated, defaced or destroyed, upon the making of an affidavit of that fact by the Person claiming such Certificate to be lost, stolen, mutilated, defaced or destroyed, the holder of such Certificate shall be entitled to receive, subject to Section 2.5(a), in exchange for such lost, stolen, mutilated, defaced or destroyed Certificate, the amount of the Closing Merger Consideration with respect to the shares of Capital Stock of the Company pursuant to Section 2.1; *provided, however*, that Parent may, in its discretion and as a condition precedent to the receipt of such amount by such holder, require the owner of such lost, stolen, mutilated, defaced or destroyed Certificate to deliver a bond in such sum as it may reasonably require as indemnity against any claim that may be made against Parent or the Surviving Corporation with respect to the Certificate alleged to have been lost, stolen, mutilated, defaced or destroyed.

(c) Any portion of the Exchange Fund that remains undistributed to the holders of Capital Stock of the Company for six months after the Effective Time shall be delivered to the Surviving Corporation, upon demand, and any holder of Capital Stock of the Company who has not theretofore complied with this Article 2 shall thereafter look only to the Surviving Corporation for payment of its claim for Merger Consideration.

(d) None of Parent, Merger Sub, the Company or the Paying Agent shall be liable to any Person in respect of any cash from the Exchange Fund properly delivered to a public official pursuant to any applicable abandoned property, escheat or similar Law. If any Certificate has not been surrendered prior to five years after the Effective Time (or immediately prior to such earlier date on which Merger Consideration in respect of such Certificate would otherwise escheat to or become the property of any Governmental Entity), any such cash in respect of such Certificate shall, to the extent permitted by applicable Law, become the property of the Surviving Corporation, free and clear of all claims or interest of any Person previously entitled thereto. The Paying Agent shall invest any cash included in the Exchange Fund, as directed by Parent, and agreed to by the Sellers’ Representative. Any interest and other income resulting from such investments shall be paid to Parent.

(e) Parent or the Surviving Corporation, as applicable, shall be entitled to deduct and withhold from the consideration otherwise payable to any holder of Capital Stock of the Company pursuant to this Agreement such amounts as may be required to be deducted and withheld with respect to the making of such payment under the Code or under any provision of tax Law.

Section 2.6. No Further Ownership Rights. The Closing Merger Consideration paid in accordance with the terms of this Article 2 upon conversion of any shares of Capital Stock of the Company shall be deemed to have been paid in full satisfaction of all rights pertaining to such shares of Capital Stock, subject, however, to the obligations to pay any further Merger Consideration in accordance with the Escrow Agreement, the Expenses Escrow Agreement and Section 2.3 of this Agreement. After the Effective Time, there shall be no further registration of transfers on the stock transfer books of the Surviving Corporation of shares of Capital Stock of the Company that were outstanding immediately prior to the Effective Time. If, after the Effective Time, any certificates formerly representing shares of Capital Stock of the Company are presented to the Surviving Corporation or the Paying Agent for any reason, they shall be canceled and exchanged as provided in this Article 2.

ARTICLE 3
REPRESENTATIONS AND WARRANTIES OF THE COMPANY

The Company makes the representations and warranties set forth in this Article 3 to AudioCodes, Parent and Merger Sub as of the date of this Agreement and as of the Closing, subject to the exceptions set forth in the attached Disclosure Schedule.

Section 3.1. Organization and Standing. Each of the Company and its Subsidiaries (i) is duly organized, validly existing and in good standing under the laws of its jurisdiction or organization, (ii) has all requisite corporate power and authority to carry on its business as now being conducted and (iii) is duly qualified or licensed to do business and is in good standing in each jurisdiction in which the nature of its business or the ownership, leasing or operation of its properties makes such qualification or licensing necessary, which jurisdictions are listed in Section 3.1 of the Disclosure Schedule, except where failure to be so qualified and in good standing would not have a Material Adverse Effect. Each of the Company and its Subsidiaries has made available to Parent complete and correct copies of its Constitutive Documents, as amended. The Company is not a foreign company subject to Section 2115 of the California Corporations Code. No more than one-half of the Company's outstanding voting securities were held of record by persons having addresses in the State of California, based on the books of the Company on the record date for the latest meeting of stockholders held during its fiscal year 2006 or, if no meeting was held during that year, on March 25, 2006.

Section 3.2. Subsidiaries. The Company does not have any Subsidiaries and does not own or control, directly or indirectly, any membership interest, partnership interest, joint venture interest, other equity interest or any other Capital Stock in any Person.

Section 3.3. Power and Authority; Binding Agreement. The Company has all requisite corporate power and authority to execute and deliver this Agreement, to consummate the Merger and the other transactions contemplated hereby and to perform its obligations hereunder. The execution and delivery by the Company of this Agreement and the consummation by the Company of the Merger and the other transactions contemplated hereby have been duly authorized by all necessary corporate action on the part of the Company, subject, in the case of the Merger, to the receipt of the Stockholder Approval. This Agreement has been duly executed and delivered by the Company and, assuming due execution and delivery by the other parties thereto, constitutes a legal, valid and binding obligation of the Company, enforceable against the Company in accordance with its terms except as such enforceability may be limited by bankruptcy, insolvency or other similar laws affecting creditors' rights generally.

Section 3.4. Authorization.

(a) The Board of Directors of the Company unanimously adopted resolutions (i) approving and declaring advisable the Merger, this Agreement and the other Transaction Agreements and the other transactions contemplated hereby and thereby (ii) determining that the Merger Consideration and the other terms of this Agreement are fair to and in the best interest of the Company and the stockholders of the Company, (iii) authorizing the Company to enter into this Agreement and to consummate the Merger and the other transactions contemplated hereby, on the terms and subject to the conditions set forth in this Agreement, (iv) directing that the Merger and this Agreement be submitted to the stockholders of the Company for approval and adoption of the Merger and this Agreement and (v) recommending that the Company's stockholders adopt this Agreement.

(b) The only votes of holders of any class or series of Capital Stock of the Company, which may be taken by written consent, necessary to approve, adopt and effect the Merger, this Agreement, the other Transaction Agreements and the other transactions contemplated hereby are the affirmative votes to adopt this Agreement of holders of (i) a majority of the outstanding shares of Capital Stock of the Company, voting together as a single class and (ii) a majority of the outstanding shares of Series A Preferred, voting as a separate class (collectively, the "*Stockholder Approval*"). None of the Sellers has purported to vote under Section 251 of the DGCL (or execute or deliver an effective written consent under Section 228 of the DGCL) for the adoption of this Agreement prior to both the approval of this Agreement and the declaration of its advisability by the Company's Board of Directors and the execution and delivery of this Agreement.

Section 3.5. Capitalization.

(a) The authorized capital stock of the Company consists of 80,000,000 shares of common stock, par value \$0.001 per share (the “*Common Stock*”) and 35,650,000 shares of preferred stock, par value \$0.001 per share (the “*Preferred Stock*”), of which 35,650,000 shares are designated as Series A Preferred Stock (the “*Series A Preferred*”). At the close of business on the date hereof (i) 28,253,368 shares of Common Stock and 34,709,907 shares of Series A Preferred were issued and outstanding, (ii) 403,703 shares of Common Stock were held by the Company in its treasury, (iii) 10,567,407 shares of Common Stock were subject to outstanding Options and an additional 13,984,725 shares of Common Stock were reserved for issuance pursuant to the Company Stock Plans (iv) 123,624 shares of Series A Preferred were subject to outstanding Warrants and (v) 35,650,000 shares of Common Stock were reserved for issuance in connection with the conversion of the Series A Preferred. Except as set forth above, at the close of business on the date hereof, no shares of Capital Stock of the Company were issued, reserved for issuance or outstanding. All outstanding shares of Capital Stock of the Company and each of its Subsidiaries are, and all such shares that may be issued prior to the Effective Time will be when issued, duly authorized, validly issued, fully paid and nonassessable and not subject to or issued in violation of any purchase option, call option, right of first refusal, preemptive right, subscription right or any similar right under any provision of the DGCL or other Law, the Company’s or any of such Subsidiaries’ Constitutive Documents or any Contract to which the Company or any of such Subsidiaries are a party or otherwise bound. There are not any bonds, debentures, notes or other Indebtedness of the Company having the right to vote (or convertible into, or exchangeable for, securities having the right to vote) on any matters on which holders of Capital Stock of the Company may vote (“*Voting Company Debt*”). Except as set forth above, as of the date of this Agreement, there are not any options, warrants, rights, convertible or exchangeable securities, “phantom” stock rights, stock appreciation rights, stock-based performance units, commitments, Contracts, arrangements or undertakings of any kind to which the Company or any of its Subsidiaries is a party or by which it is bound (i) obligating the Company or any of such Subsidiaries to issue, deliver or sell, or cause to be issued, delivered or sold, additional shares of Capital Stock or other equity interests in, or any security convertible or exercisable for or exchangeable into any Capital Stock of or other equity interest in, the Company or any of its Subsidiaries or any Voting Company Debt, (ii) obligating the Company or any of its Subsidiaries to issue, grant, extend or enter into any such option, warrant, call, right, security, commitment, Contract, arrangement or undertaking or (iii) that give any person the right to receive any economic benefit or right similar to or derived from the economic benefits and rights occurring to holders of Capital Stock of the Company or any of its Subsidiaries. There are not any outstanding contractual obligations of the Company or any of its Subsidiaries to repurchase, redeem or otherwise acquire any shares of Capital Stock of the Company or any of its Subsidiaries. Since April 10, 2003, the Company has not declared or paid any dividends or distributions on any of the Capital Stock of the Company.

(b) Section 3.5(b) of the Disclosure Schedule sets forth a complete and accurate list of the holders of Capital Stock of the Company as of the date hereof, showing the number of shares of such Capital Stock, and the class or series of such shares, held by each such stockholder and, with respect to shares other than Company Common Stock, the number of shares of Company Common Stock (if any) into which such shares are convertible. There has been no adjustment to the conversion price for the Series A Preferred. All of the issued and outstanding shares of Capital Stock of the Company and its Subsidiaries have been offered, issued and sold by the Company in compliance with all applicable federal and state securities Laws.

(c) Section 3.5(c) of the Disclosure Schedule sets forth a complete and accurate list of all Company Stock Plans. Section 3.5(c) of the Disclosure Schedule sets forth a complete and accurate list of (i) all holders of outstanding Options as of the date hereof, indicating, with respect to each Option, the Company Stock Plan under which it was granted, the number of shares of Company Common Stock subject to such Option, the exercise price and the date of grant; and (ii) all holders of outstanding Warrants, indicating, with respect to each Warrant, the Contract or other document under which it was granted, the number of shares of Capital Stock of the Company, and the class or series of such shares, subject to such Warrant, the exercise price, the date of issuance and the expiration date thereof. The Company has made available to Parent complete and accurate copies of all Company Stock Plans and all Contracts evidencing Options and Warrants. No Option is exercisable for any class or series of Capital Stock of the Company other than Company Common Stock.

(d) Except as set forth in Section 3.5(d) of the Disclosure Schedule, there is no Contract between the Company or any of its Subsidiaries and any holder of its securities, or, to the Company's Knowledge, among any holders of its securities, relating to the sale or transfer (including agreements relating to rights of first refusal, co-sale rights or "drag-along" rights), registration under the Securities Act of 1933 or voting, of any Capital Stock of the Company or any of its Subsidiaries.

Section 3.6. Noncontravention.

(a) The execution and delivery by the Company of this Agreement, the other Transaction Agreements, the consummation of the Merger and the other transactions contemplated hereby and thereby and the compliance by the Company with the provisions hereof and thereof do not and will not conflict with, or result in any violation or default (with or without notice or lapse of time or both) under, or give rise to a right of, or result in, termination, cancellation or acceleration of any obligation or to a loss of a material benefit under, or result in the creation of any lien, pledge, claim, charge, mortgage, encumbrance or other security interest of any kind, whether arising by Contract or by operation of Law (a "*Lien*"), in or upon any of the properties or assets of the Company under, or give rise to any increased, additional, accelerated or guaranteed rights or entitlements under, any provision of (i) the Constitutive Documents of the Company, (ii) any Material Contract or (iii) subject to the governmental filings and other matters referred to in Section 3.6(b)(i) and (ii), any constitution, act, statute, law (including common law), ordinance, treaty, rule or regulation of any Governmental Entity (a "*Law*") or any judgment, order or decree (a "*Judgment*"), in each case applicable to the Company or its properties or assets, except in the case of clauses (ii) and (iii) where such conflict, violation, default or other result is not likely to have a Material Adverse Effect on the Company.

(b) No consent, approval, license, permit, order or authorization of, registration, declaration or filing with, or notice to, any Governmental Entity is required by or with respect to the Company in connection with the execution and delivery by the Company of this Agreement, the other Transaction Agreements, the consummation by the Company of the Merger and the other transactions contemplated hereby or thereby or the compliance by the Company with the provisions hereof and thereof, except for (i) filings required under, and compliance with other applicable requirements of, the Hart Scott Rodino Antitrust Improvements Act of 1976 (the "*HSR Act*"), (ii) filings required under, and compliance with other applicable requirements of, non-U.S. Laws intended to prohibit, restrict or regulate actions or transactions having the purpose or effect of monopolization, restraint of trade, harm to competition or effectuating foreign investment (collectively, "*Foreign Antitrust Laws*"), (iii) filings pursuant to, and compliance with other applicable requirements of Section 5021 of the Omnibus Trade and Competitiveness Act of 1988 (the "*Exon-Florio Act*"), (iv) the filing of the Certificate of Merger with the Delaware Secretary of State and appropriate documents with the relevant authorities of other states in which the Company is qualified to do business and (v) such other consents, approvals, orders, authorizations, registrations, declarations, filings and notices, the failure of which to be obtained or made individually or in the aggregate would not cause a Material Adverse Effect.

Section 3.7. Compliance with Laws. Each of the Company and its Subsidiaries is, and for the last five years, has been, in material compliance with all applicable Judgments and all material applicable Laws. In the last five years, none of the Company or any of its Subsidiaries has received a notice or other communication alleging a violation by the Company or such Subsidiary of any material applicable Law or Judgment applicable to its businesses or operations.

Section 3.8. Permits. Each of the Company and its Subsidiaries validly holds and has in full force and effect all material federal, state or local, domestic or foreign, governmental consents, approvals, orders, authorizations, certificates, filings, notices, permits, concessions, registrations, franchises, licenses or rights (“*Permits*”) necessary for it to own, lease or operate its properties and assets and to carry on its businesses as now conducted, and there has occurred no material violation of, or default (with or without notice or lapse of time or both) under, or event giving to the issuer thereof the right to terminate, amend or cancel any such Permit. Each of the Company and its Subsidiaries has complied in all material respects with the terms and conditions of all Permits issued to or held by the Company or such Subsidiary, and such Permits will not be subject to suspension, modification, revocation or nonrenewal as a result of the consummation of the Merger, the execution and delivery of this Agreement or the other transactions contemplated hereby. No proceeding is pending or, to the Knowledge of the Company, threatened seeking the revocation or limitation of any Permit. No Permits are held in the name of any current or former director, officer, employee, independent contractor or consultant of the Company or its Subsidiaries (“*Company Personnel*”) or agent or otherwise on behalf of the Company or its Subsidiaries.

Section 3.9. Financial Statements.

(a) The Company has delivered (A) the unaudited consolidated balance sheet (the “*Most Recent Balance Sheet*”) of the Company and its Subsidiaries as of March 25, 2006 (the “*Most Recent Balance Sheet Date*”), and the unaudited consolidated statements of income and cash flows of the Company and its Subsidiaries for the year ended March 25, 2006, and (B) the audited consolidated balance sheets of the Company and its Subsidiaries as of March 26, 2005 and March 27, 2004, and the audited consolidated statements of income and cash flows of the Company and its Subsidiaries for the years ended March 31, 2005 and March 31, 2004, together with the notes to such financial statements (the financial statements described in clauses (A) and (B) above, together with the financial statements to be delivered pursuant to Section 5.8(a)(i) and 5.9 (after such financial statements are delivered), collectively, the “*Financial Statements*”). The Financial Statements (i) are consistent with the books and records of the Company, (ii) have been prepared in accordance with United States generally accepted accounting principles, consistently applied (“*GAAP*”), except that the Financial Statements listed in clause (A) and any delivered pursuant to Section 5.9 do not or will not contain notes and remain subject to year end adjustments, and (iii) present fairly the consolidated financial condition, results of operations, stockholders’ equity and cash flows of the Company as of the respective dates thereof and for the periods referred to therein.

(b) All accounts receivable of the Company and its Subsidiaries reflected on the Most Recent Balance Sheet are current and arose from valid transactions in the ordinary course of business in substantially the same manner as presently conducted and consistent with past practice (the “*Ordinary Course of Business*”) with unrelated third parties. Neither of the Company nor any of its Subsidiaries has received any notice or other indication that any of the Company’s or such Subsidiary’s accounts receivable will not be collectible in full, net of any reserves shown on the Most Recent Balance Sheet.

(c) The Company maintains a system of internal accounting controls sufficient to provide reasonable assurance that: (i) transactions are executed in accordance with management's general or specific authorizations; (ii) transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP; (iii) access to material assets is permitted only in accordance with management's general or specific authorization; and (iv) the recorded accountability for material assets is compared with the existing assets at reasonable intervals and appropriate actions are taken with respect to any differences.

Section 3.10. Absence of Changes or Events. Since the Most Recent Balance Sheet Date, (a) each of the Company and its Subsidiaries has conducted its businesses only in the Ordinary Course of Business, (b) there has occurred no Material Adverse Effect, and (c) neither the Company nor any of its Subsidiaries has taken any of the actions that, if taken after the date of this Agreement, would constitute a breach of any of the covenants set forth in Section 5.1.

Section 3.11. Undisclosed Liabilities. Neither the Company nor any of its Subsidiaries has any material liabilities or obligations of any nature (whether known, absolute, contingent, accrued or otherwise), except for such liabilities and obligations (a) to the extent shown on the Most Recent Balance Sheet, (b) that were incurred in the Ordinary Course of Business since the Most Recent Balance Sheet Date or (c) set forth in Contracts, other than obligations due to any material breaches or non-performance thereunder.

Section 3.12. Assets other than Real Property.

(a) Each of the Company and its Subsidiaries is the true and lawful owner or lessor and has good and valid title to, or a valid leasehold interest in, all assets (tangible or intangible) reflected on the Most Recent Balance Sheet or thereafter acquired, except those sold or otherwise disposed of in the Ordinary Course of Business since the Most Recent Balance Sheet Date and not in violation of this Agreement, in each case free and clear of all Liens (other than Permitted Liens).

(b) Each of the Company and its Subsidiaries owns or leases all tangible assets sufficient for the conduct of its businesses as presently conducted. The tangible assets of the Company and each Subsidiary are free from material defects, have been maintained in accordance with the past practice of the Company or such Subsidiary and generally accepted industry practice, are in good working order and are suitable for the purposes for which they are presently used. All material leased personal property of the Company or any of its Subsidiaries is in good working order, ordinary wear and tear excepted.

(c) This Section 3.12 does not relate to real property or interests in real property, such items being the subject of Section 3.13, or to Intellectual Property or interests in Intellectual Property, such items being the subject of Section 3.15.

Section 3.13. Real Property. Neither the Company nor any of its Subsidiaries owns any real property or interests in real property. Section 3.13 of the Disclosure Schedule lists all real property and interests in real property leased by the Company or its Subsidiaries (each, a "*Leased Property*"). The Company has made available to Parent complete and accurate copies of all such leases, and any operating agreements relating thereto. With respect to each Leased Property, the Company and each of its Subsidiaries have good and valid title to the leasehold estate relating thereto, free and clear of all Liens (other than Permitted Liens), leases, assignments and subleases and the Company and each of its Subsidiaries enjoy peaceful and undisturbed possession thereunder.

Section 3.14. Contracts.

(a) Section 3.14(a) of the Disclosure Schedule lists each of the following Contracts which the Company or any of its Subsidiaries are a party to or are bound by (each such Contract, whether or not set forth in such section of the Disclosure Schedule, a “*Material Contract*”):

- (i) employment or consulting Contract, or any employee collective bargaining agreement or other Contract with any labor union or any Company Personnel;
- (ii) Contract not to compete or otherwise restricting the Company or any of its Subsidiaries in the development, manufacture, marketing, distribution or sale of any of their respective products or services or otherwise in their respective operations and business;
- (iii) Contract containing any “non-solicitation” or “no-hire” provision that restricts the Company or such Subsidiary;
- (iv) lease, sublease or similar Contract with any Person under which the Company is a lessor or sublessor of, or makes available for use to any Person (other than the Company), (A) any Leased Property or (B) any portion of any premises otherwise occupied by the Company or its Subsidiaries;
- (v) lease or similar Contract with any Person under which (A) the Company or any of its Subsidiaries is lessee of, or holds or uses, any machinery, equipment, vehicle or other tangible personal property owned by any Person or (B) the Company or any of its Subsidiaries is a lessor or sublessor of, or makes available for use by any Person, any tangible personal property owned or leased by the Company or any of its Subsidiaries;
- (vi) Contract (or substantially related Contracts) for the purchase or sale of products or the furnishing or receipt of services (A) requiring or otherwise involving, or reasonably be expected to involve, payment by or to the Company or any of its Subsidiaries of more than an aggregate of \$100,000, (B) in which the Company has granted manufacturing rights, “most favored nation” pricing provisions or marketing or distribution rights relating to any products or territory, (C) in which the Company or any of its Subsidiaries has agreed to purchase a minimum quantity of goods or services which would exceed an aggregate of \$100,000 or has agreed to purchase goods or services exclusively from a certain party or (D) with any of the Customers or Suppliers (each as defined herein);
- (vii) Contract for the disposition of any significant portion of the assets or business of the Company or any of its Subsidiaries or any agreement for the acquisition, directly or indirectly, of a significant portion of the assets or business of any other Person;
- (viii) Contract for any joint venture or partnership;

(ix) Contract granting a third party, including but not limited to Affiliates of the Company, any license or other right to any Intellectual Property Right, or pursuant to which the Company or any of its Subsidiaries has been granted by a third party any right or license to any Intellectual Property (excluding non-exclusive licenses for commercial off-the-shelf Software), or pursuant to which the Company obtained any option to purchase or obtain a license to, the Intellectual Property of any other Person;

(x) Contract (other than trade debt incurred in the Ordinary Course of Business) under which the Company or any of its Subsidiaries has borrowed any money from, or issued any note, bond, debenture or other evidence of Indebtedness to, any Person;

(xi) Contract under which (A) any Person has directly or indirectly guaranteed Indebtedness, liabilities or obligations of the Company or any of its Subsidiaries or (B) the Company or any of its Subsidiaries has directly or indirectly guaranteed Indebtedness, liabilities or obligations of any Person (in each case other than endorsements for the purpose of collection in the Ordinary Course of Business);

(xii) Contract under which the Company or any of its Subsidiaries has, directly or indirectly, made any advance, loan, extension of credit or capital contribution to, or other investment in, any Person;

(xiii) Contract providing for any mortgage or other Lien;

(xiv) Contract providing for indemnification of any Person by the Company or any of its Subsidiaries (other than the Constitutive Documents of the Company or any of its Subsidiaries);

(xv) Contract providing that the Company, any of its Subsidiaries or any Company Personnel maintain the confidentiality of any information, or providing for any Person to maintain the confidentiality of any information material to the Company or any of its Subsidiaries;

(xvi) Contract involving a research or development collaboration or similar arrangement;

(xvii) Contract involving a confidentiality, standstill or similar obligation of the Company or any of its Subsidiaries to a third party or of a third party to the Company or any of its Subsidiaries; and

(xviii) Contract or other document involving the grant of a Warrant.

(b) Each Material Contract is in full force and effect, and is legal, valid, binding and enforceable in accordance with its terms except as limited by bankruptcy, insolvency or other similar laws affecting creditors' rights generally. True and complete copies of each Material Contract (and a written summary of the terms of any oral Material Contracts) have been made available to Parent. Except for matters that would not have a Material Adverse Effect, there is no violation, breach or default under any Material Contract by the Company or any of its Subsidiaries or, to the Knowledge of the Company, by any other party thereto, and no event has occurred or condition exists that with the lapse of time or the giving of notice or both would constitute a default thereunder by the Company or any of its Subsidiaries or, to the Knowledge of the Company, any other party thereto. No notice, waiver, consent or approval is required (or the lack of which would give rise to a right of termination, cancellation or acceleration of, or entitle any party to accelerate, whether after the giving of notice or lapse of time or both, any obligation under the Material Contracts) under or relating to any Material Contract in connection with the execution, delivery and performance of this Agreement or the consummation of the Merger or any of the other transactions contemplated hereby where such termination, cancellation or acceleration would have a Material Adverse Effect.

Section 3.15. Intellectual Property.

(a) With respect to Intellectual Property owned by the Company and its Subsidiaries, the Company or one of its Subsidiaries is the sole and exclusive owner of such Intellectual Property and has the right to use, sell and license, as the case may be, such Intellectual Property as currently used, sold and licensed by the Company or any of its Subsidiaries. With respect to Intellectual Property licensed to the Company, the Company has the right to use, sell and license such Intellectual Property as currently used, sold and licensed by the Company or any of its Subsidiaries. Such Intellectual Property owned by or licensed to the Company and its Subsidiaries is referred to herein as the “*Intellectual Property Rights.*”

(b) The products and operation of the business of the Company and each of its Subsidiaries and the use of the Intellectual Property Rights or the tangible embodiment thereof owned by the Company and each of its Subsidiaries in connection therewith, and its present business practices and methods, do not, to the Knowledge of the Company, infringe, constitute an unauthorized use of, or violate any Intellectual Property right of any third party. To the Knowledge of the Company, the Intellectual Property owned by or licensed to the Company or any of its Subsidiaries includes all of the Intellectual Property necessary to enable the Company or any of its Subsidiaries to conduct its business in the manner in which such business has been and is currently being conducted.

(c) Except with respect to licenses of commercial off-the-shelf Software, and except pursuant to the licenses listed in Section 3.15(c) of the Disclosure Schedule, neither the Company nor any of its Subsidiaries is obligated under any Contract to make any payments by way of royalties, fees or otherwise to any owner or licensor of, or other claimant to, any Intellectual Property, with respect to the Company’s or any of its Subsidiaries’ use thereof in connection with the conduct of its business.

(d) Section 3.15(d) of the Disclosure Schedule sets forth a complete and correct list of all Patents, registered Marks, pending applications for registration of any Marks, unregistered Marks currently being used by the Company, registered Copyrights, and pending applications for registration of Copyrights, in each case, owned by the Company and each of its Subsidiaries, including the jurisdictions in which such Patents, Marks and Copyrights have been issued or registered or in which such applications have been filed. The Company and each of its Subsidiaries have taken all action necessary in their reasonable discretion to maintain the registration, grant or issuance of the Intellectual Property listed in Section 3.15(d) of the Disclosure Schedule, other than any unregistered Marks currently being used by the Company as set forth on Section 3.15(d) of the Disclosure Schedule.

(e) Except as disclosed in Section 3.15(e) of the Disclosure Schedule, neither the Company nor any of its Subsidiaries has licensed any of its Intellectual Property to any Person on an exclusive basis, nor has the Company or any of its Subsidiaries entered into any Contract limiting its ability to exploit fully any of its Intellectual Property.

(f) No non-public, proprietary Intellectual Property Right material to the business of the Company as presently conducted has been authorized to be disclosed or, to the Knowledge of the Company, actually disclosed by the Company to any employee or third party other than pursuant to a non-disclosure agreement that protects the proprietary interests of the Company in and to such Intellectual Property Right.

(g) Except as disclosed in Section 3.15(g) of the Disclosure Schedule, neither the Company nor any of its Subsidiaries is the subject of any pending or, to the Knowledge of the Company, threatened action, suit, proceeding, claim, arbitration, mediation or investigation (a "*Legal Proceeding*") which involves a claim or notice of infringement of, unauthorized use of, or violation of any Intellectual Property of any third party or challenging the ownership, use, validity, priority, duration, scope or enforceability of any Intellectual Property Rights, and has not received written notice of any such threatened claim, and, to the Knowledge of the Company, there are no facts or circumstances which are likely to form the basis for any claim of infringement of, unauthorized use of, or violation of any Intellectual Property of any third party or challenging the ownership, use, validity, priority, duration, scope or enforceability of any Intellectual Property Rights. To the Knowledge of the Company, all material Intellectual Property Rights owned by the Company and each of its Subsidiaries are valid and enforceable.

(h) To the Knowledge of the Company, no third party is infringing, violating, misusing or misappropriating any material Intellectual Property Rights and no such claims have been made against a third party by the Company or any of its Subsidiaries.

(i) The Company and each of its Subsidiaries have taken reasonable measures to protect the secrecy and/or confidentiality of all non-public and proprietary Intellectual Property Rights, including requiring all Company and Subsidiary employees or consultants with access to such Intellectual Property Rights and all other Persons with access to such Intellectual Property Rights, as necessary, to execute a binding confidentiality agreement. The Company and each of its Subsidiaries have taken reasonable measures to protect the value of all Intellectual Property used in the conduct of the business of the Company or any of its Subsidiaries, including requiring all Company and Subsidiary employees to execute an agreement which includes provisions assigning to the Company or its Subsidiaries the ownership of any Intellectual Property created by such employees within the scope of his or her employment, or in the case of a Person other than an employee from the services such Person performs for the Company or any of its Subsidiaries. Copies or forms of the agreement or agreements referred to in this clause (i) have been made available to Parent and, to the Knowledge of the Company, there has not been a material breach of any such agreement or agreements.

Section 3.16. Litigation. There is no Legal Proceeding that is pending or, to the Knowledge of the Company, has been threatened against the Company or any of its Subsidiaries. There are no Judgments outstanding against the Company or any of its Subsidiaries. Since January 1, 2001, there has not been any Legal Proceeding in respect of the Company or any of its Subsidiaries that (a) resulted in a Judgment against or settlement by the Company or such Subsidiary (whether or not such Judgment or settlement was paid, in whole or in part, by an insurer of the Company or other third party) or (b) resulted in any equitable relief. There is no Legal Proceeding pending by the Company or any of its Subsidiaries, or which the Company or such Subsidiary intend to initiate, against any other Person.

Section 3.17. Taxes.

(a) All Tax Returns required to be filed by or on behalf of the Company and its Subsidiaries, have been timely filed and all Taxes shown as due on such Tax Returns have been timely paid.

(b) All Tax Returns filed by or on behalf of the Company and its Subsidiaries are true and complete in all material respects. The charges, accruals and reserves for Taxes with respect to the Company and its Subsidiaries reflected on the Most Recent Balance Sheet are adequate to cover all Tax liabilities payable or anticipated to be payable in respect of all periods or portions thereof ending on or before the Most Recent Balance Sheet Date. There are no Liens (other than Permitted Liens) for Taxes against the Company or any of its Subsidiaries or the Company's or any of its Subsidiary's assets.

(c) No property of the Company or any of its Subsidiaries is "tax exempt use property" within the meaning of Section 168(h) of the Code and neither the Company nor any of its Subsidiaries is a party to any lease made pursuant to Section 168(f)(8) of the Internal Revenue Code of 1954 (without regard to any amendments or modifications to the Internal Revenue Code of 1954 following its original enactment).

(d) Section 3.17(d) of the Disclosure Schedule (i) indicates those Tax Returns that have been audited; and (ii) indicates those Tax Returns that currently are the subject of an audit. The Company has delivered to Parent correct and complete copies of all income Tax Returns, examination reports, and statements of deficiency assessed against or agreed to by the Company or any of its Subsidiaries for taxable years in which the statute of limitations (including extensions thereof) has not expired, with respect to Taxes of any type. There are no actions, suits, proceedings, audits, investigations, proposed adjustments or claims pending, or to the Knowledge of the Company, proposed against the Company or any of its Subsidiaries concerning the Tax liability of the Company or any of its Subsidiaries. No issue has been raised in any examination by any Governmental Entity with respect to the Company or any of its Subsidiaries which, by application of similar principles, reasonably could be expected to result in a proposed deficiency or increase in Taxes for any other period not so examined.

(e) There are no outstanding agreements or waivers extending the statutory period of limitation applicable to any Tax assessment or deficiency with respect to the Company or any of its Subsidiaries, and neither the Company nor any of its Subsidiaries has requested any extension of time within which to file any Tax Return, which Tax Return has not yet been filed.

(f) Each of the Company and its Subsidiaries has withheld and paid all Taxes required by Law to have been withheld and paid and has complied in all material respects with all rules and regulations relating to the withholding or remittance of Taxes (including, without limitation, employee-related Taxes).

(g) Each of the Company and its Subsidiaries is not a party to any Contract that, individually or collectively, could give rise to any payment (whether in cash or property) that would be non-deductible pursuant to Sections 162(a)(1), 162(m), 162(n) or 280G of the Code or similar provision of state, local or foreign Law.

(h) Neither the Company nor any of its Subsidiaries will be required to include any item of income in, or exclude any item of deduction from, taxable income for any taxable period ending after the Closing Date as a result of any: (i) adjustment pursuant to Section 481 of the Code or similar provision of state, local or foreign Law associated with a change of accounting method that is effective on or before the date of this Agreement; (ii) closing agreement or other agreement with any Governmental Entity executed on or before the date of this Agreement; or (iii) installment sale or open transaction disposition made on or before the date of this Agreement.

(i) Since the Company's formation, neither the Company nor any of its Subsidiaries has constituted either a "distributing corporation" or a "controlled corporation" (within the meaning of Section 355(a)(1)(A) of the Code) in a distribution qualifying for tax-free treatment under Section 355(a) of the Code.

(j) The Company has not been a United States real property holding corporation within the meaning of Section 897(c)(2) of the Code during the 5-year period that will end on the Closing Date.

(k) No written claim has ever been received by the Company or any Subsidiary from a Governmental Entity in a jurisdiction where the Company or any Subsidiary does not file Tax Returns that the Company or any Subsidiary is or may be subject to Tax in that jurisdiction.

(l) Neither the Company nor any of its Subsidiaries is a party to any Tax allocation, indemnity or sharing Contract. Neither the Company nor any of its Subsidiaries has any liability for Taxes of any Person (i) under Treasury Regulation Section 1.1502-6 or similar provision of state, local or foreign Law, (ii) as transferee or successor, (iii) by Contract, or (iv) otherwise. Neither the Company nor any of its Subsidiaries has ever been a member of any affiliated, combined, consolidated or unitary group (other than a group the common parent of which was the Company) and has never filed Tax Returns as a member of such group.

(m) The Company is not a "personal holding company" as defined in Section 542 of the Code (or any similar provision of state, local or foreign law).

(n) The Company has disclosed on its federal income Tax Returns all positions taken therein that could give rise to a substantial understatement of federal income Tax within the meaning of Section 6662 of the Code and neither the Company nor any of its Subsidiaries has participated in any "reportable transaction" within the meaning of Treasury Regulations Section 1.6011-4.

(o) Neither the Company nor any of its Subsidiaries is the subject of any private letter ruling or similar ruling issued by any Governmental Entity relating to Taxes.

Section 3.18. Insurance. The insurance policies owned and maintained by the Company and each of its Subsidiaries and the coverage amounts thereunder are listed in Section 3.18 of the Disclosure Schedule. All such policies are in full force and effect, all premiums due and payable thereon have been paid, the Company and each of its Subsidiaries shall not be liable for retroactive premiums or similar payments related thereto, and the Company and each of its Subsidiaries are in compliance with the terms of such policies. There is no claim pending under any such policy as to which coverage has been questioned, denied or disputed by the underwriter of such policy. To the Knowledge of the Company, there has been no notice of cancellation or termination (or any other threatened termination) of, or premium increase with respect to, any such policy.

Section 3.19. Benefit Plans.

(a) Section 3.19(a) of the Disclosure Schedule contains a list of all Benefit Plans. The Company has delivered to Parent true and complete copies of (i) each Benefit Plan (including amendments since the most recent restatement) or, in the case of any unwritten Benefit Plans, written descriptions thereof, (ii) the annual report (Form 5500) filed with the IRS or the Department of Labor with respect to each Benefit Plan (if any such report was required) for each plan year since the Company's formation, (iii) the most recent determination letter issued to each "employee pension benefit plan," as defined in Section 3(2) of ERISA (a "Pension Plan"), that is intended to be qualified under Section 401(a) of the Code and any pending applications for a determination letter for such plans, (iv) the most recent summary plan description (and any summary of material modifications since the most recent summary plan description) for each Benefit Plan for which such a summary plan description is required and any material summaries or other communications distributed to participants for each Benefit Plan whether or not required to provide a summary plan description, (v) all personnel, payroll, and employment manuals and policies, (vi) each trust agreement, recordkeeping or other third-party agreement and group annuity Contract relating to any Benefit Plan, (vii) for any Pension Plan described in Section 401(a) of the Code, copies of confirmations that such Pension Plan satisfied applicable nondiscrimination tests in each plan year since the Company's formation, (viii) all notices in the Company's possession that were given by the Company or any Benefit Plan to the IRS, the Pension Benefit Guaranty Corporation, the Department of Labor, the Securities and Exchange Commission, the Equal Employment Opportunity Commission, or any other Governmental Entity relating to a Benefit Plan, and (ix) all notices that were given by the IRS, the Pension Benefit Guaranty Corporation, the Department of Labor, the Securities and Exchange Commission, the Equal Employment Opportunity Commission, or any other Governmental Entity to the Company relating to any Benefit Plan.

(b) Each Benefit Plan has been operated and administered in all material respects in accordance with its terms and applicable Law (including but not limited to Laws specifically mentioned in this Section 3.19). The Company and each of its Subsidiaries and all the Benefit Plans are in all material respects in compliance with the applicable provisions of the Employee Retirement Income Security Act of 1974 ("ERISA"), the Code, and other applicable Laws. All reports, returns and similar documents with respect to the Benefit Plans required to be filed with any Governmental Entity or distributed to any Benefit Plan participant, beneficiary, or alternate payee have been duly and timely filed or distributed. There are no lawsuits, actions, termination proceedings or other proceedings pending, or, to the Knowledge of the Company, threatened against or involving any Benefit Plan and there are no investigations by any Governmental Entity or other claims (except claims for benefits payable in the normal operation of the Benefit Plans) pending or, to the Knowledge of the Company, threatened against or involving any Benefit Plan or asserting any rights to benefits under any Benefit Plan. To the Knowledge of the Company, there are no unasserted claims that, if pending or threatened, would be of the type described in this Section 3.19(b). The Company and each of its Subsidiaries does not have any liability to the IRS with respect to any Benefit Plan, including any liability imposed under Chapter 43 of the Code.

(c) All contributions to, and payments from, the Benefit Plans that were or are required to be made in accordance with the terms of the Benefit Plans and applicable Laws, including, when applicable, Section 302 of ERISA or Section 412 of the Code, have been timely made. All such contributions to, and payments from, the Benefit Plans, except those payments to be made from a trust exempt under Section 501(a) of the Code, for any period ending before the Closing Date that are not yet, but will be, required to be made, will be properly accrued and reflected on the Most Recent Balance Sheet. There is no Lien on the assets of the Company or any of its Subsidiaries arising under Section 302(f) or 4068(a) of ERISA or Section 412(n) of the Code.

(d) All Pension Plans intended to be qualified and exempt from federal income Taxes under Sections 401(a) and 501(a) of the Code, respectively, have received determination letters from the IRS to the effect that such Pension Plans are so qualified and exempt from federal income Taxes, and no such determination letter has been revoked nor, to the Knowledge of the Company, has revocation of any such determination letter been threatened. No such Pension Plan has been amended since the date of its most recent determination letter or application therefor in any respect, nor has any other circumstance or event occurred, that would adversely affect its qualification or materially increase its cost. A determination letter covering "GUST" (as defined in footnote 1 of Rev. Proc. 2004-25) has been received for each Pension Plan intended to be qualified under Section 401(a) of the Code or an application for such a letter has been filed within the applicable remedial amendment period. Timely "good faith" amendments (within the meaning of Notice 2001-42) with respect to the Economic Growth and Tax Relief Reconciliation Act of 2001 have been made for each Pension Plan intended to be qualified under Section 401(a) of the Code. The Company and each of its Subsidiaries performed all material obligations required to be performed by them under, and are not in default under or in violation of, the material terms of any Benefit Plan.

(e) No transaction prohibited by Section 406 of ERISA and no "prohibited transaction" (as defined in Section 4975 of the Code) has occurred with respect to any Benefit Plan. None of the Pension Plans has been terminated nor have there been any "reportable events" (as defined in Section 4043 of ERISA) with respect thereto. No Company Personnel, nor any trustee, administrator or other fiduciary of any Benefit Plan nor any agent of any of the foregoing has engaged in any transaction or acted or failed to act in a manner that could subject the Company or any of its Subsidiaries to any material liability for breach of fiduciary duty under ERISA or any other applicable Law (whether such liability is directly against the Company or any of its Subsidiaries or the result of any existing indemnity agreements).

(f) No Benefit Plan is or has ever been (or has ever been the successor or transferee of) a "multiemployer plan" (as defined in Section 3(37) of ERISA) or a "defined benefit plan" (as defined in Section 3(35) of ERISA). Neither the Company nor any of its Subsidiaries has any actual or potential, secondary, or contingent liability to any Person under Title IV of ERISA and no Benefit Plan is subject to Title IV of ERISA. Neither the Company nor any of its Subsidiaries has contributed to, been required to contribute to, or withdrawn from any "multiemployer plan" (as defined in Section 3(37) of ERISA).

(g) Neither the Company nor any of its Subsidiaries has ever established, maintained or contributed to, or had an obligation to maintain or contribute to or has or had any liability with respect to, any “voluntary employees’ beneficiary association” (within the meaning of Section 501(c)(9) of the Code), any organization or trust described in Sections 501(c)(17) or 501(c)(20) of the Code or any “welfare benefits fund” described in Section 419(e) of the Code.

(h) Neither the Company nor any of its Subsidiaries has offered to provide health or life insurance coverage to any individual, or to the family members or beneficiaries of any individual, for any period extending beyond the termination of the individual’s employment by the Company, except to the extent required by the health care continuation (also known as “COBRA”) provisions of ERISA and the Code or similar state benefit continuation Laws. Each Benefit Plan that is a group health plan, as such term is defined in Section 5000(b)(1) of the Code, complies in all respects with Sections 601 et seq. and 701 et seq. of ERISA and Section 4980B and Subtitle K of the Code.

(i) Neither the Company nor any of its Subsidiaries has any current or projected liability or contingent obligation in respect of medical or other benefits for retired or former Company Personnel or any predecessor Person, except as required under COBRA or similar state benefit continuation Laws.

(j) Each Benefit Plan (including any such plan covering retirees or other former employees) may be discontinued or terminated without liability to the Company or any of its Subsidiaries (other than the administrative costs of termination) on or at any time after the Effective Time.

(k) Neither the execution and delivery of this Agreement, nor the consummation of the Merger or the other transactions contemplated thereby will result in the payment, vesting, or acceleration of any bonus, stock option or other equity-based award, retirement, severance, job security or similar benefit or any enhanced benefit to any Person.

(l) Except as set forth in Section 3.19(l) of the Disclosure Schedule, neither the Company nor any of its Subsidiaries has any Benefit Plan in which non-United States employees (or their beneficiaries) participate and is not required to maintain any such plan.

(m) Since the Company’s formation, no Person is or has been a Person which is (or at any relevant time was) a member of a “controlled group of corporations” with, under “common control” with, or a member of an “affiliated service group” with the Company as such terms are defined in Section 414(b), (c), (m) or (o) of the Code (an “ERISA Affiliate”).

(n) No event has occurred or circumstances exist that may result in (i) a material increase in premium costs of Benefit Plans that are insured, or (ii) a material increase in benefit or administrative costs of Benefit Plans that are self-insured.

(o) Neither the Company nor any of its Subsidiaries has taken any action that, by itself or in conjunction with any action of equal magnitude that may be taken after the Effective Time, will require any compliance with the Worker Adjustment and Retraining Notification Act of 1991 or any other similar or comparable applicable Law.

(p) Neither the Company nor any Affiliate thereof has a formal plan, commitment, or proposal, whether legally binding or not, or has made a commitment to any individual to create any additional Benefit Plan or modify or change any existing Benefit Plan that would affect any current employee, director or consultant, or former employee, of the Company or any of its Subsidiaries, or any beneficiary or alternate payee of such an individual. No events have occurred or are expected to occur with respect to any Benefit Plan that would cause a material change in the cost of providing the benefits under such plan or would cause a material change in the cost of providing for other liabilities of such plan.

(q) All assets of any Benefit Plan consist of cash, actively traded securities, or mutual funds registered under the Investment Company Act of 1940, as amended.

(r) Any Benefit Plan that is a “nonqualified deferred compensation plan” within the meaning of section 409A of the Code has been identified as such on Section 3.19(r) of the Disclosure Schedule. Each such Benefit Plan has been operated in accordance with a good faith interpretation of the requirements of section 409A (including any associated guidance).

(s) Neither the execution and delivery of this Agreement nor the consummation of the transactions contemplated hereby will (i) result in any material payment (including severance, unemployment compensation, golden parachute or otherwise) becoming due under any Benefit Plan, (ii) materially increase any benefits otherwise payable under any Benefit Plan or (iii) result in the acceleration of the time of payment or vesting of any such benefits to any material extent. No benefit that is or may become payable by any Benefit Plan as a result of, or arising under, this Agreement shall constitute an “excess parachute payment” (as defined in section 280G(b)(1) of the Code) that is subject to the imposition of an excise tax under section 4999 of the Code or that would not be deductible by reason of section 280G of the Code.

Section 3.20. Employee and Labor Matters.

(a) There is not, and since January 1, 2001 there has not been, any labor strike, dispute, work stoppage, slowdown or lockout pending, or, to the Knowledge of the Company, threatened, against the Company or any of its Subsidiaries. To the Knowledge of the Company, no union organizational campaign or petition for certification is in progress with respect to the Company Personnel. Neither the Company nor any of its Subsidiaries is a party to any collective bargaining or other similar labor Contracts with respect to any Company Personnel. There are no pending, or, to the Knowledge of the Company, threatened, charges against the Company, any of its Subsidiaries or any Company Personnel before the Equal Employment Opportunity Commission or any other Governmental Entity responsible for the prevention of unlawful employment practices in any jurisdiction. Since January 1, 2001, neither the Company nor any of its Subsidiaries has received notice of the intent of any Governmental Entity responsible for the enforcement of labor or employment Laws to conduct an investigation of the Company or any of its Subsidiaries relating to unlawful employment practices and, to the Knowledge of the Company, no such investigation is in progress.

(b) No officer or director of the Company or any of its Subsidiaries is, and, to the Knowledge of the Company, no other employee of the Company or any of its Subsidiaries is, a party to or bound by any Contract, license, covenant or Contract of any nature, or subject to any judgment, decree or order of any Governmental Entity, that may interfere with the use of such Person’s efforts to promote the interests of the Company or any of its Subsidiaries, conflict with the business of the Company, any of its Subsidiaries or the Merger and the other transactions contemplated by this Agreement, or that could reasonably be expected to result in a Material Adverse Effect. To the Knowledge of the Company, no activity of any employee of the Company or any of its Subsidiaries as or while an employee of the Company or any of its Subsidiaries has caused a violation of any employment Contract, confidentiality agreement, patent disclosure agreement, or other Contract.

(c) Section 3.20(c) of the Disclosure Schedule contains a true and complete list of the names, positions and rates of compensation of all officers, directors, employees and consultants of the Company and each of its Subsidiaries, as of the date hereof, showing each such person's name, positions and annualized remuneration, bonuses and non-standard fringe benefits for 2005 and 2006. Except as indicated in Section 3.20(c) of the Disclosure Schedule, (i) all employees are employed on an "at-will" basis and their employment can be terminated at any time for any legal reason without any amounts being owed to such individual other than payments required by applicable Laws, (ii) the Company's and each of its Subsidiaries' relationships with all individuals who act on their own as contractors or other service providers to the Company or such Subsidiary can be terminated at any time for any reason without any amounts being owed to such individual other than with respect to compensation or payments accrued before the termination, and (iii) no employee is on leave of absence. The Company and each of its Subsidiaries have complied, in all material respects, with all Laws governing the employment of personnel by U.S. companies and the employment of non-U.S. nationals in the United States, including the Immigration and Nationality Act 8 U.S.C. Sections 1101 et seq. and its implementing regulations. The Company and each of its Subsidiaries have not sponsored any employee for, or otherwise engaged any employee working pursuant to, a non-immigrant visa.

Section 3.21. Environmental Matters. Each of the Company and its Subsidiaries has complied at all times with all applicable Environmental Laws. No property (including soils, groundwater, surface water, buildings or other structures) currently owned or operated by the Company or any of its Subsidiaries has been contaminated with any Hazardous Material as a result of the operations of the Company or any of its Subsidiaries, or, to the Knowledge of the Company, has otherwise been contaminated with any Hazardous Material. To the Knowledge of the Company, no property (including soils, groundwater, surface water, buildings or other structures) formerly owned or operated by the Company or any of its Subsidiaries was contaminated with any Hazardous Material on or prior to such period of ownership or operation. Neither the Company nor any of its Subsidiaries is subject to any liability for Hazardous Material disposal or contamination on any third party property. Each of the Company and its Subsidiaries has complied at all times with all applicable Environmental Laws relating to the collection, recovery and recycling of waste from their marketed products and packaging. To the Knowledge of the Company, none of the properties of the Company or any of its Subsidiaries contains any underground storage tanks, asbestos-containing material, lead products, or polychlorinated biphenyls. There are no circumstances involving the Company or any of its Subsidiaries that could reasonably be expected to result in any material claims, liability, investigations, costs or restrictions on the ownership, use or transfer of any property in connection with any Environmental Law. Copies of all environmental reports, studies, assessments, sampling data and other environmental information in the possession of the Company or any of its Subsidiaries relating to the Company or such Subsidiary have been made available to Parent. Neither the Company nor any of its Subsidiaries has received any written notice, demand, letter, claim or request for information from any Governmental Entity or other Person indicating that it may be in violation of or subject to liability under any Environmental Law or regarding any actual, alleged, possible or potential liability arising from or relating to the presence, generation, manufacture, production, transportation, importation, use, treatment, refinement, processing, handling, storage, discharge, release, emission or disposal of any Hazardous Material used by the Company or any of its Subsidiaries. No Lien or "superlien" has been placed on any site owned or, to the Knowledge of the Company, operated by the Company or any of its Subsidiaries pursuant to the Federal Comprehensive, Environmental Response, Compensation, and Liability Act of 1980 or any similar Law. To the Knowledge of the Company, all of the products marketed by the Company and its Subsidiaries are in full compliance with the applicable Environmental Laws on chemical composition, environmental design and energy efficiency. Neither the Company nor any of its Subsidiaries is subject to any order, decree, injunction or other arrangement with any Governmental Entity relating to liability under any Environmental Law. Each of the Company and its Subsidiaries has taken appropriate steps to ensure that its marketed products will be in full and timely compliance with Directive 2002/95/EC on the restriction of the use of hazardous substances in electrical and electronic equipment. The Company has provided to Parent a written plan setting forth the procedures that the Company has put in place to comply with this Directive and the estimated costs of compliance. The representations and warranties contained in this Section 3.21 are the only representations and warranties being made by the Company with respect to any Environmental Liabilities or the compliance of the Company with Environmental Laws and Environmental Permits, and no other representation or warranty, express or implied, is being made by the Company with respect thereto.

Section 3.22. Transactions with Affiliates. Section 3.22 of the Disclosure Schedule describes any material transaction, since January 1, 2003, between the Company, on the one hand, and any Seller or Affiliate (other than the Company) of any Seller, on the other hand, other than any employment Contract, Contract not to compete with the Company, Contract to maintain the confidential information of the Company, or Contract assigning Intellectual Property Rights to the Company, in each case listed in Section 3.14(a) of the Disclosure Schedule. Except as set forth in Section 3.22 of the Disclosure Schedule, no Affiliate of the Company (i) owns or has any interest in any property (real or personal, tangible or intangible), Intellectual Property Rights or Contract used in or pertaining to the business of, the Company, (ii) has any claim or cause of action against the Company, (iii) owes any money to, or is owed any money by, the Company, (iv) has any other rights with respect to the Company other than rights as an equity holder similar to the rights of all other holders of the same equity, or (v) to the Knowledge of the Company, is a party to any agreement or understanding, oral or written, with any other Affiliate or any employee of the Company relating to the approval or performance of any provisions of the Merger Agreement, including without limitation with respect to any actions to be taken or to be refrained from being taken by such Affiliate or employee with respect to achieving the Earn Out Amount.

Section 3.23. Accounts; Officers and Directors. Section 3.23 of the Disclosure Schedule sets forth (i) a true and complete list of all bank and savings accounts of the Company and each of its Subsidiaries, identifying with respect to each any Person authorized to sign thereon and (ii) a true and complete list of all officers and directors of the Company and each of its Subsidiaries.

Section 3.24. Brokers. No broker, finder, financial advisor, investment banker or other Person is or will be entitled to any brokerage, finder's, financial advisor's or other similar fee or commission in connection with the Merger based upon arrangements made by or on behalf of any Seller, for which the Company could be liable, or by or on behalf of the Company.

Section 3.25. Certain Business Practices. Neither the Company, any of its Subsidiaries nor any of their respective directors, officers, agents or employees, has (i) used any funds for unlawful contributions, gifts, entertainment or other unlawful expenses related to political activity; (ii) made any unlawful payment to foreign or domestic government officials or employees or to foreign or domestic political parties or campaigns or violated any provision of the Foreign Corrupt Practices Act of 1977 or (iii) made any payment in the nature of criminal bribery.

Section 3.26. Corporate Books and Records. The Company has made available to Parent and its Representatives true and complete copies of the stock certificate and transfer books and the minute books of the Company and each of its Subsidiaries, and all such records are true and complete in all material respects.

Section 3.27. No Former Business. Neither the Company nor any of its Subsidiaries has, alone or with any other Person, owned or operated any business other than its current business.

Section 3.28. Customers. Section 3.28 of the Disclosure Schedule sets forth the name of the top twenty (20) customers of the Company and its Subsidiaries as a whole for last two fiscal years (the “*Customers*”). Since January 1, 2005, no Customer has cancelled or otherwise terminated its relationship with the Company or any Subsidiary. No Customer has provided any written notification to the Company or any of its Subsidiaries specifically indicating its intent to terminate, cancel or otherwise materially and adversely modify its relationship with the Company or any Subsidiary or to decrease materially or limit its usage, purchase or distribution of the products and services of the Company and its Subsidiaries.

Section 3.29. Suppliers. Section 3.29 of the Disclosure Schedule sets forth the name of the top fifteen (15) suppliers of the Company and its Subsidiaries as a whole for the last two fiscal years (the “*Suppliers*”). None of the Suppliers represents the sole source of available supply for the products or services it provides to the Company or any of its Subsidiaries. Since January 1, 2005, no Supplier has cancelled or otherwise terminated its relationship with the Company or any of its Subsidiaries. No Supplier has provided any written notification to the Company or any of its Subsidiaries specifically indicating its intent to terminate, cancel or otherwise materially and adversely modify its relationship with the Company or any of its Subsidiaries.

ARTICLE 4
REPRESENTATIONS AND WARRANTIES OF PARENT AND MERGER SUB

AudioCodes, Parent and Merger Sub make the representations and warranties set forth in Article 4 as of the date of this Agreement and as of the Closing:

Section 4.1. Organization and Standing. Each of AudioCodes, Parent and Merger Sub is a corporation duly organized, validly existing and, as applicable, in good standing under the Laws of its jurisdiction of incorporation. Each of AudioCodes and Parent has all requisite corporate power and authority to carry on its business as now being conducted.

Section 4.2. Power and Authority; Binding Agreement. Each of AudioCodes, Parent and Merger Sub has all requisite corporate power and authority to execute and deliver this Agreement, to consummate the Merger and the other transactions contemplated hereby and to perform its obligations hereunder. The execution and delivery by AudioCodes, Parent and Merger Sub of this Agreement and the consummation by AudioCodes, Parent and Merger Sub of the Merger and the other transactions contemplated hereby, have been duly authorized by all necessary corporate action on the part of AudioCodes, Parent and Merger Sub. This Agreement has been duly executed and delivered by AudioCodes, Parent and Merger Sub and, assuming the due execution and delivery of this Agreement by the Company constitutes a legal, valid and binding obligation of AudioCodes, Parent and Merger Sub, enforceable against AudioCodes, Parent and Merger Sub in accordance with its terms except as such enforceability may be limited by bankruptcy, insolvency or other similar laws affecting creditors' rights generally.

Section 4.3. Noncontravention.

(a) The execution and delivery by AudioCodes, Parent and Merger Sub of this Agreement, the other Transaction Agreements to which it is a party, the consummation of the Merger and the other transactions contemplated hereby and thereby and the compliance by AudioCodes, Parent and Merger Sub with the provisions hereof and thereof do not and will not conflict with, or result in any violation or default (with or without notice or lapse of time or both) under, or give rise to a right of, or result in, termination, cancellation or acceleration of any obligation or to a loss of a material benefit under, or result in the creation of any Lien in or upon any of the properties or assets of AudioCodes, Parent or Merger Sub under, or give rise to any increased, additional, accelerated or guaranteed rights or entitlements under, any provision of (i) the Constitutive Documents of AudioCodes, Parent or Merger Sub, (ii) any Contract to which AudioCodes, Parent or Merger Sub is a party or bound by or their respective properties or assets are bound by or subject to or otherwise under which AudioCodes, Parent or Merger Sub has rights or benefits or (iii) subject to the governmental filings and other matters referred to in Section 4.3(b), any Law or Judgment, in each case, applicable to AudioCodes, Parent or Merger Sub or their respective properties or assets, other than, in the case of clauses (ii) and (iii), any such conflicts, violations, breaches, defaults, rights, losses, Liens or entitlements that individually or in the aggregate are not likely to impair in any material respect the ability of each of AudioCodes, Parent and Merger Sub to perform its obligations under this Agreement, or prevent or materially impede or delay the consummation of the Merger or any of the other transactions contemplated hereby.

(b) No consent, approval, license, permit, order or authorization of, registration, declaration or filing with, or notice to, any Governmental Entity is required by or with respect to AudioCodes, Parent or Merger Sub in connection with the execution and delivery by AudioCodes, Parent and Merger Sub of this Agreement, the other Transaction Agreements, the consummation by AudioCodes, Parent and Merger Sub of the Merger and the other transactions contemplated hereby or thereby or the compliance by AudioCodes, Parent and Merger Sub with the provisions hereof or thereof, except for (i) filings required under, and compliance with other applicable requirements of, the HSR Act and filings required under, and compliance with other applicable requirements of, Foreign Antitrust Laws, (ii) filings pursuant to, and compliance with other applicable requirements of, the Exon-Florio Act, (iii) the filing of the Certificate of Merger with the Delaware Secretary of State and appropriate documents with the relevant authorities of other states in which the Company is qualified to do business and (iv) such other consents, approvals, orders, authorizations, registrations, declarations, filings and notices, the failure of which to be obtained or made individually or in the aggregate would not impair in any material respect the ability of each of AudioCodes, Parent and Merger Sub to perform its obligations under this Agreement, or prevent or materially impede or delay the consummation of the Merger or any of the other transactions contemplated hereby.

Section 4.4. Brokers. No broker, finder, financial advisor, investment banker or other Person is or will be entitled to any brokerage, finder's, financial advisor's or other similar fee or commission in connection with the Merger based upon arrangements made by or on behalf of AudioCodes, Parent or Merger Sub, for which the Company could be liable.

Section 4.5. Availability of Funds. AudioCodes and Parent have, and will have available to them at the Closing, collectively sufficient funds to consummate the transactions contemplated by this Agreement.

Section 4.6. Merger Sub. Merger Sub was formed solely for the purpose of engaging in the transactions contemplated by this Agreement, has engaged in no other business activities and has conducted its operations only as contemplated by this Agreement.

Section 4.7. Ownership. AudioCodes owns 100% of the issued and outstanding equity interests in Parent. Parent owns 100% of the issued and outstanding equity interests in Merger Sub.

ARTICLE 5 CERTAIN COVENANTS

Section 5.1. Conduct of Business. Except with the prior written consent of Parent (which will not be unreasonably withheld) or as expressly permitted by the terms of this Agreement, from the date hereof to the Effective Time, the Company shall, and shall cause each of its Subsidiaries to, (i) conduct its businesses in the Ordinary Course of Business and in accordance with all applicable Laws and (ii) use commercially reasonable efforts to preserve intact its current business organization, keep its physical assets in good working condition, preserve, maintain the value of, renew, extend and keep in full force and effect all Intellectual Property Rights, keep available the services of its current officers and employees and preserve its relationships with customers, suppliers, licensors, licensees, distributors and others having business dealings with it. Without limiting the generality of the foregoing, except as expressly permitted by the terms of this Agreement, the Company shall not and shall not cause any of its Subsidiaries to, without the prior written consent of Parent (which will not be unreasonably withheld):

- (a) amend its Constitutive Documents;
- (b) (i) declare, set aside or pay any dividend on, or make any other distribution (whether in cash, stock or property) in respect of, any of its Capital Stock; (ii) split, combine or reclassify any of its Capital Stock, or issue or authorize the issuance of any other securities in respect of, in lieu of or in substitution for shares of its Capital Stock; or (iii) purchase, redeem or otherwise acquire any shares of its Capital Stock, or any option, warrant, call or right relating to such shares, interests or other securities (including any Options);

(c) issue, deliver, sell or grant (i) any shares of its Capital Stock, (ii) any Voting Company Debt or other voting securities, (iii) any securities convertible into or exchangeable for, or any options, warrants or rights to acquire, any such shares, Voting Company Debt, voting securities or convertible or exchangeable securities or (iv) any “phantom” stock, “phantom” stock rights, stock appreciation rights or stock-based performance units, other than the issuance of shares of Company Common Stock upon the exercise of Options or the conversion of Preferred Stock, in each case outstanding on the date of this Agreement and in accordance with the terms of such Options or Preferred Stock on the date of this Agreement;

(d) repurchase, prepay, create, incur, assume or modify any terms of any Indebtedness of the Company or any of its Subsidiaries, issue or sell any warrants or other rights to acquire any Indebtedness of the Company or any of its Subsidiaries, make any loans, advances or capital contributions to, or investments in, any Person, enter into any Contract to maintain any financial statement condition of another Person or enter into any Contract having the economic effect of any of the foregoing;

(e) sell, lease (as lessor), license or otherwise dispose of or subject to any Lien any properties or assets that are material, individually or in the aggregate, to the Company or any of its Subsidiaries, except sales of inventory in the Ordinary Course of Business;

(f) enter into any lease or sublease of real property (whether as a lessor, sublessor, lessee or sublessee) or modify, amend, terminate or fail to exercise any right to renew any lease or sublease of real property;

(g) acquire or agree to acquire (i) by merging or consolidating with, or by purchasing a substantial portion of the assets of, or by any other manner, any equity interest in or business of any Person or (ii) any assets that are material, individually or in the aggregate, to the Company or any of its Subsidiaries, except purchases of inventory in the Ordinary Course of Business;

(h) change its fiscal year, revalue any of its material assets or make any changes in financial accounting methods, principles, practices or policies, except as required by GAAP or applicable Law;

(i) make or change any Tax election; change any Tax accounting period or method; file any amended Tax Return; enter into any closing agreement with respect to Taxes; settle any Tax claim or assessment; surrender any right to claim a refund of Taxes; consent to any extension or waiver of the limitations period for the assessment of any Tax; take any action outside the Ordinary Course of Business whose effect would be to increase the Company's or any of its Subsidiaries' present or future Tax liability or to decrease the Company's or any of its Subsidiaries' present or future Tax assets;

(j) (i) grant any awards under any Benefit Plan (including the grant of stock options, stock appreciation rights, stock based or stock related awards, performance units or restricted stock or the removal of existing restrictions in any Contract, Benefit Plan or Benefit Agreement or awards made thereunder), (ii) pay or provide to any Company Personnel any bonus, other amount or other benefit, or make any advance or loan to any Company Personnel, not provided for under any Contract, Benefit Plan or Benefit Agreement in effect on the date of this Agreement other than the payment of bonus amounts which, in the aggregate, do not constitute Excess Bonus Costs, or the payment of base compensation or advances for business expenses in the Ordinary Course of Business, (iii) grant to any Company Personnel any increase in compensation (including any increase in severance or termination pay) except to the extent required under existing employment agreements, (iv) enter into any employment, consulting, indemnification, severance or termination agreement with any Company Personnel (v) establish, adopt, enter into or amend in any material respect any collective bargaining agreement, other Benefit Agreement or Benefit Plan or (vi) take any action to accelerate the vesting or payment of any compensation or benefit under any Contract, Benefit Plan or Benefit Agreement or to fund or in any other way secure the payment of compensation or benefits under any Contract, Benefit Plan or Benefit Agreement or make any material determinations not in the Ordinary Course of Business under any Benefit Agreement or Benefit Plan;

(k) incur or commit to incur any capital expenditure (or any obligation or liability in connection therewith), in an amount greater than \$100,000 individually or \$500,000 in the aggregate;

(l) enter into any Contract (or any substantially related Contracts, taken together) (i) that would constitute a Material Contract, other than Contracts with customers, suppliers and vendors that are entered into in the Ordinary Course of Business, (ii) that, if consummation of the Merger or any of the other transactions contemplated hereby or compliance by the Company with the provisions of this Agreement will conflict with, or result in any violation or breach of, or default (with or without notice or lapse of time or both) under, or give rise to a right of, or result in, termination, cancellation or acceleration of any obligation or to a loss of a benefit under, or result in the creation of any Lien in or upon any of the properties or assets of the Company or Parent or any of Parent's Subsidiaries under, or give rise to any increased, additional, accelerated or guaranteed rights or entitlements under, any provision of such Contract, or (iii) containing any restriction on the ability of the Company or any of its Subsidiaries to assign all or any portion of its rights, interests or obligations thereunder, unless such restriction expressly permits any assignment to Parent and Parent's Subsidiaries in connection with or following the consummation of the Merger and the other transactions contemplated hereby;

(m) pay, discharge, settle or satisfy any material Lien or material claims (including claims of stockholders and any stockholder litigation relating to the Merger or any other transaction contemplated hereby), liabilities or obligations (whether absolute, accrued, asserted or unasserted, contingent or otherwise), other than the payment, discharge or satisfaction, in the Ordinary Course of Business or in accordance with their terms, of liabilities reflected or reserved against in the Most Recent Balance Sheet or incurred since the Most Recent Balance Sheet Date in the Ordinary Course of Business (and all such liabilities incurred in the Ordinary Course of Business shall be paid or otherwise satisfied in the manner and time period consistent with past practice in the normal course of business); waive, release or assign any material rights or material claims under, fail to take a required action under, permit the lapse of or default under, or modify, amend or terminate any Material Contract; or cancel any material Indebtedness of another Person;

(n) collect its accounts receivable in any manner or over any time period that is inconsistent with past practices of the Company and its Subsidiaries in the normal course of business;

(o) create or dissolve any Subsidiary of the Company; or

(p) authorize any of, or commit, resolve or agree, to take any of the foregoing actions.

Section 5.2. Access. The Company shall, during normal business hours or such other times reasonably requested by Parent or AudioCodes (i) make available for inspection by Parent, AudioCodes and their Representatives all of the Company's and each of its Subsidiaries' properties, assets, books, records (including the work papers of the Company's external accountants to the extent such materials are in the Company's possession or can be obtained by the Company or its Subsidiaries under their respective rights granted pursuant to applicable contracts or agreements with such accountants) and Contracts and any other materials reasonably requested by any of them relating to the Company or any of its Subsidiaries at such times as Parent or AudioCodes may reasonably request; (ii) make available to Parent, AudioCodes and their Representatives the officers, other senior management and Representatives of the Company and its Subsidiaries for interviews, at such times as Parent, AudioCodes and their Representatives may reasonably request, to discuss the information furnished to Parent, AudioCodes and their Representatives and otherwise discuss the Company's and each of its Subsidiaries' existing and prospective businesses and assets and liabilities; (iii) use its commercially reasonable efforts to assist in gaining reasonable access for Parent, at such times as the Parties mutually agree, to the Company's and each of its Subsidiaries' lenders, creditors, lessors, lessees, licensors, licensees, officers, employees, developers, contractors, distributors, vendors, clients, customers, suppliers, Affiliates or other Persons having a material business relationship with the Company or any of its Subsidiaries; and (iv) make available to Parent, AudioCodes and their Representatives such information and materials relating to the Company and its Subsidiaries as are necessary or appropriate in order to prepare and file reports and registration statements with the Securities and Exchange Commission under the Securities Act of 1933, as amended (the "*Securities Act*") and under the Securities Exchange Act of 1934, as amended (the "*Exchange Act*"), including using commercially reasonable efforts to assist Parent and AudioCodes in obtaining any consents required from the Company's independent public accountants in order to file such reports and registration statements. Any and all such investigations shall be conducted in a manner that does not unreasonably interfere with the conduct of the business of the Company or any of its Subsidiaries and minimizes any disruption to the conduct of such business. Any information that is provided by the Company to Parent, AudioCodes or their Representatives in connection with the transactions contemplated by this Agreement shall constitute "Confidential Information" as such term is defined, and subject to the exceptions set forth, in the Confidentiality Agreement dated as of August 18, 2005, between Parent and the Company (the "*Confidentiality Agreement*").

Section 5.3. Tax Matters.

(a) The Company shall timely prepare and file any Tax Return required to be filed by the Company on or before the Closing Date (a “*Pre-Closing Tax Return*”), and timely pay any Tax reflected thereon. In addition, the Company shall submit any Pre-Closing Tax Returns that are to be filed after the date hereof to Parent for approval prior to filing, such approval shall not be unreasonably delayed or withheld. Except as may be required by applicable Law, the Company will not take any position on such Tax Returns that is materially inconsistent with past custom and practice.

(b) All stamp, transfer, documentary, sales, use, registration and other such Taxes (including all applicable real estate transfer or gains Taxes) and related fees (including any penalties, interest and additions to Tax) incurred in connection with the Merger and the other transactions contemplated hereby shall be paid one-half by the Sellers, on the one hand, and one-half by Parent and AudioCodes, on the other hand, and the Sellers’ Representative and Parent shall cooperate in timely filing all Tax Returns as may be required to comply with the provisions of such Tax Laws. Parent, AudioCodes and the Sellers’ Representative will reasonably cooperate with each other to lawfully minimize any such Taxes. Promptly upon Parent’s request, the Sellers’ Representative shall provide Parent with any information that is required with respect to any statement to be furnished to the Company’s stockholders or reporting requirements under Sections 6043 and 6043A of the Code, the regulations promulgated thereunder or forms prescribed by the United States Secretary of the Treasury.

(c) The Company shall cause the provisions of any Tax allocation, indemnity or sharing Contract between the Sellers, or any of their respective Affiliates (other than the Company) or any third party, on the one hand, and the Company, on the other hand, to be terminated on or before the Closing Date.

(d) From the date hereof through the Closing Date, the Company shall not effect any extraordinary transactions (other than any such transactions expressly required by applicable Law or by this Agreement) that could result in Tax liability to the Company in excess of Tax liability associated with the conduct of its business in the ordinary course.

Section 5.4. Notice of Certain Events.

(a) The Company shall promptly notify Parent of, and furnish Parent with any information it may reasonably request with respect to, the occurrence of any event or condition or the existence of any fact that causes or is reasonably likely to cause any of the Company’s representations and warranties in Article 3 hereof to no longer be true or correct or results in a failure of any of the conditions to the obligation of Parent to consummate the Merger set forth in Section 7.2. If any such event, condition or fact that is required to be disclosed pursuant to the preceding sentence requires any change in the Disclosure Schedule, or if any such event, condition, fact or circumstance would require such a change assuming the Disclosure Schedule were dated as of the date of the occurrence, existence or discovery of such event, condition or fact, then the Company shall promptly deliver to Parent an update to the Disclosure Schedule specifying such change. Such an update shall be deemed to supplement and amend the Disclosure Schedule (i) for the purposes of determining the accuracy of any of the representations and warranties made by the Company in this Agreement for the purposes of indemnification under Section 8 hereof, but (ii) not for purposes of determining whether any of the conditions set forth in Section 7.2 have been satisfied.

(b) AudioCodes or Parent shall notify the Company within five (5) Business Days of the receipt of any update of the Disclosure Schedule if it considers such updated information to impact, in any material respect, the value of the Company and its Subsidiaries, taken as a whole. If AudioCodes or Parent provides such a notice, the parties agree to negotiate in good faith, for a period of five (5) Business Days, to determine whether any adjustment to the Purchase Price or other amendment of this Agreement is appropriate. If the parties agree to adjust the Purchase Price or amend any other terms or conditions, the parties will promptly execute any amendment to this Agreement or such other documents necessary to effect such adjustment or amendment. Nothing in this Section 5.4(b) shall affect AudioCodes' or Parent's rights under Section 7.2 of this Agreement.

(c) Parent and AudioCodes shall promptly notify the Company of, and furnish the Company with any information it may reasonably request with respect to, the occurrence of any event or condition or the existence of any fact that causes any of Parent's or AudioCodes' representations and warranties in Section 4 hereof to no longer be true or correct or results in a failure of any of the conditions to the obligation of the Company to consummate the Merger set forth in Section 7.3.

Section 5.5. Insurance. The Company shall use its commercially reasonable efforts to keep all insurance policies set forth in Section 3.18 of the Disclosure Schedule, or comparable replacements therefor, in full force and effect through the Effective Time.

Section 5.6. Exclusivity.

(a) From the date of this Agreement through the Closing, the Company shall not, directly or indirectly through any of its officers, directors, stockholders, Affiliates of stockholders, Representatives, or any Representative of any of the foregoing, encourage, solicit, initiate, participate or otherwise facilitate any inquiry, proposal, offer, discussion or negotiation with, or provide any information or assistance to, any Person or group (other than Parent and its Representatives in their capacities as Representatives of Parent) concerning any (i) merger, reorganization, share exchange, consolidation, business combination, joint venture, strategic alliance, recapitalization, liquidation, dissolution, sale of any securities or sale of material assets involving the Company, (ii) license or grant of rights to any third party for any of the Intellectual Property Rights or (iii) similar transaction involving the Company.

(b) The Company shall notify AudioCodes of any inquiry, proposal or offer of the nature described in Section 5.6(a) within one Business Day of its officers and directors receiving such inquiry, proposal or offer or within one Business Day of it obtaining Knowledge that any of its stockholders, Affiliates of stockholders, Representatives or any Representatives of any of the foregoing received such inquiry, proposal or offer. In such notice to AudioCodes, the Company shall inform AudioCodes of the name of the Person making such inquiry, proposal or offer and the material terms, conditions and other aspects of such inquiry, proposal or offer.

Section 5.7. Stockholder Approval; Notices to Stockholders.

(a) The Company shall set the date hereof as the record date for action to be taken by written consent by the holders of Capital Stock of the Company to adopt this Agreement. As soon as practicable but in any case prior to the Closing, the Company shall deliver to the holders of Capital Stock of the Company a notice and disclosure statement (the “*Disclosure Statement*”) pursuant to Sections 228 and 262(d) of the DGCL, which shall comply with applicable Law and shall include (i) a summary of this Agreement and the transactions contemplated hereby and such other matters as are appropriate for such a disclosure document, (ii) a statement that appraisal rights are available for the shares of Capital Stock of the Company pursuant to the Appraisal Statute and a copy of the Appraisal Statute and (iii) except in the case of the Disclosure Statement given to stockholders executing a Written Consent, notice that the Stockholder Approval has been obtained following execution and delivery of this Agreement. The Company, acting through its Board of Directors, shall solicit the written consent of each such holder in favor of adopting the Merger Agreement and shall include in the Disclosure Statement the recommendation of its Board of Directors that the holders of the Company’s Capital Stock vote in favor of the adoption of the Merger Agreement. The Company agrees not to distribute the Disclosure Statement until Parent has had a reasonable opportunity to review and comment on the Disclosure Statement. The Company shall reflect all reasonable comments in the Disclosure Statement. The Company shall ensure that all holders of Capital Stock who approve the Merger Agreement by written consent under Section 228 of the DGCL shall have done so by executing and delivering a Written Consent.

(b) The Company will insure that the information in the Disclosure Statement will not, at the time the Disclosure Statement is provided to the holders of the Company’s Capital Stock, contain any statement that is false or misleading with respect to any material fact, or omit to state any material fact necessary in order to make the statements made therein, in light of the circumstances under which they are made, not false or misleading. If at any time prior to the Effective Time any event or information should be discovered by the Company that should be set forth in an amendment to the Disclosure Statement, the Company shall promptly inform Parent and shall communicate such information to the holders of the Company’s Capital Stock as necessary and in an appropriate manner. The Company shall use its commercially reasonable efforts to cause each Selling Stockholder to vote in favor of the Merger and shall comply with all applicable Laws in connection therewith.

Section 5.8. Additional Deliveries Prior to Closing.

(a) The Company shall deliver the following to Parent no later than ten (10) Business Days prior to the proposed Closing Date, determined in accordance with Section 1.2:

(i) the audited consolidated balance sheets of the Company and its Subsidiaries as of March 25, 2006 and the related audited consolidated statements of income and cash flows of the Company and its Subsidiaries for the fiscal year ended March 25, 2006, together with the notes to such financial statements, with the report thereon by Peterson & Co., LLP for the fiscal year ended March 25, 2006, which shall comply as to form and substance with the requirements of the Securities Act and the Exchange Act and the rules and regulations thereunder.

(ii) a statement (the “*Pre-Closing Statement*”) prepared by the chief financial officer of the Company setting forth the following calculations, together with a summary of the basis therefor: (i) the Banking Fees to be incurred and paid by the Company; (ii) the estimated amount of cash and cash equivalents of the Company and its Subsidiaries as of the Closing Date; (iii) the amount of any Indebtedness expected to be outstanding at the Closing; and (iv) the calculation of the Purchase Price, in accordance with this Agreement, indicating the extent to which the Purchase Price is to be adjusted based on the foregoing calculations.

(b) Parent shall notify the Company, at least two (2) Business Days prior to the Closing, as to whether it agrees with the calculations set forth in the Pre-Closing Statement and, if Parent does not agree with all such calculations, setting forth in reasonable detail Parent's objections to the Pre-Closing Statement and its determination of any such adjustments to the Purchase Price. If the parties are not able to reach agreement as to the amount of any adjustment to the Purchase Price, the Closing shall be postponed for a period of up to ten (10) Business Days while Parent and the Company use commercially reasonable efforts to resolve the dispute as to any such adjustments. If Parent and the Company are unable to reach agreement during such additional period, then the items in dispute shall be submitted immediately to the Accounting Firm, which shall be required to render a determination of the applicable dispute within fifteen (15) Business Days after referral of the matter to the Accounting Firm. The determination by the Accounting Firm must be in writing and must set forth, in reasonable detail, the basis therefor. Such determination shall be conclusive and binding upon the Company and Parent.

(c) Within five (5) Business Days after the date of this Agreement, the Company shall propose to AudioCodes for its approval an amount of retention bonus compensation payable to each of the employees of the Company listed on Schedule 5.8(c), up to the maximum aggregate amount of bonus compensation for all such employees as is set forth on Schedule 5.8(c). Following the approval by AudioCodes of the allocation of retention bonus compensation among such employees, the Company shall promptly execute and deliver to each such employee, and shall use its commercially reasonable efforts to cause each such employee to execute and deliver to the Company, a retention bonus agreement in substantially the form attached hereto as *Exhibit D*.

Section 5.9. Delivery of Interim Financial Statements. As promptly as possible following the last day of each month after the date of this Agreement and until the Closing Date, and in any event within thirty (30) days after the end of each such month, the Company shall deliver to Parent the consolidated balance sheet of the Company and its Subsidiaries and the related consolidated statements of income and cash flows for the one-month period then ended and for the period from the beginning of the fiscal year through the end of such month. Such interim financial statements will be prepared in accordance with GAAP, provided that such interim financial statements will not have notes and will be subject to normal year-end adjustments, on a basis consistent with the Financial Statements and fairly present the financial condition and results of operations of the Company and its Subsidiaries as of the date thereof and for the period covered thereby (collectively, the "*Interim Financial Statements*").

Section 5.10. Satisfaction of Conditions Including Consents. The Company will use commercially reasonable efforts to obtain the satisfaction of the conditions set forth in Section 7.2 of this Agreement, including without limitation, obtaining all consents required as specified in Section 3.6(a)(ii) of the Disclosure Schedule.

Section 5.11. Benefits for Continuing Employees. Parent will, at its election, (A) continue existing employee welfare benefit plans, programs or policies currently offered by the Company or any of its Subsidiaries to continuing employees, and, as applicable, their eligible dependents or (B) permit continuing employees, and, as applicable, their eligible dependents, to participate in employee welfare benefit plans, programs or policies (including, without limitation, any vacation, sick, or personal time off plans or programs) of Parent and any plan of Parent intended to qualify within the meaning of Section 401(a) of the Code on terms no less favorable than those provided to similarly situated employees of Parent or its Subsidiaries; provided however, that (i) each such continuing employee will receive credit for purposes of eligibility to participate under such for years of service with the Company or any of its Subsidiaries prior to the Closing, and (ii) Parent will cause any and all pre-existing condition limitations, eligibility waiting periods and evidence of insurability requirements under any group health plans of Parent in which such employees and their eligible dependents will participate to be waived, to the extent permitted by the applicable plan documents or required by applicable Law.

Section 5.12. Indemnification.

(a) For a period of six years after the Effective Time, Parent and AudioCodes will cause the Surviving Corporation to fulfill and honor all rights to indemnification pursuant to agreements listed on Section 5.12 of the Disclosure Schedule in favor of each Person who is now, or has been at any time prior to the date of this Agreement or who becomes prior to the Effective Time, an officer or director of the Company or any of its Subsidiaries (the “*Company Indemnified Parties*”). For six (6) years after the Effective Time, Parent and AudioCodes will cause the Certificate of Incorporation and Bylaws of the Surviving Corporation to contain provisions with respect to exculpation and indemnification that are at least as favorable to the Company Indemnified Parties as those contained in the Constitutive Documents of the Company as in effect on the date hereof, and Parent and AudioCodes will cause such provisions to not be amended, repealed or otherwise modified in any manner that would adversely affect the rights thereunder of the Company Indemnified Parties, unless such modification is required by applicable Law.

(b) For six (6) years after the Effective Time, Parent and AudioCodes will, or will cause the Surviving Corporation to, maintain directors’ and officers’ liability insurance covering those Persons who are covered by the Company’s directors’ and officers’ liability insurance policy as of the date hereof in an amount and on terms no less favorable than those applicable to the current directors and officers of the Company.

(c) The provisions of this Section 5.12 are intended to be for the benefit of, and shall be enforceable by the Company Indemnified Parties and their heirs and personal representatives and shall be binding on Parent, AudioCodes and/or the Surviving Corporation, and their respective successors and assigns. In the event Parent, AudioCodes or the Surviving Corporation or any successor or assign (A) consolidates with or merges into any other Person and shall not be the continuing or surviving corporation or entity in such consolidation or merger or (B) transfers all or substantially all of its properties and assets to any Person, then in each such case proper provision shall be made so that the successor or assign of Parent or the Surviving Corporation, as the case may be, honors the obligations set forth with respect to Parent and/or the Surviving Corporation, as the case may be, in this Section 5.12.

ARTICLE 6
MUTUAL COVENANTS

Section 6.1. Commercially Reasonable Efforts. From the date of this Agreement to the Closing and upon the terms and subject to the conditions set forth in this Agreement, each of the Parties shall use all commercially reasonable efforts to take, or cause to be taken, all actions, and to do, or cause to be done, and to assist and cooperate with the other Parties in doing, all things necessary, proper or advisable to consummate and make effective, in the most expeditious manner practicable, the Merger and the other transactions contemplated hereby, including (i) the obtaining of all necessary actions or nonactions, waivers, consents and approvals from Governmental Entities and the making of all necessary registrations and filings and the taking of all reasonable steps as may be necessary to obtain an approval or waiver from, or to avoid an action or proceeding by, any Governmental Entity, (ii) the obtaining of all necessary consents, approvals, estoppels or waivers from third parties, (iii) the defending of any lawsuits or other legal proceedings, whether judicial or administrative, challenging this Agreement or the consummation of the Merger, including seeking to have any stay or temporary restraining order entered by any court or other Governmental Entity vacated or reversed, (iv) the execution and delivery of any additional instruments necessary to consummate the Merger and the other transactions contemplated hereby and to fully carry out the purposes of the Transaction Agreements and (v) ensuring that its representations and warranties remain true and correct in all material respects through the Closing Date and that the conditions to the obligations of the other Parties to consummate the Merger are satisfied.

Section 6.2. Publicity. No party to this Agreement (a “Party”) shall issue a press release or public announcement or otherwise make any public disclosure concerning the subject matter of this Agreement without the prior written approval of the other Parties; *provided, however*, that the Parties shall be permitted to issue a press release in agreed form on the date hereof; *provided further* that any Party may make any public disclosure it believes in good faith is required by applicable Law, court process or by Nasdaq or national securities exchange rule (a “Required Disclosure”). Any Party making a Required Disclosure will give the other Parties sufficient prior notice of the Required Disclosure before such disclosure is made to allow the other Parties to review and comment on the Required Disclosure.

Section 6.3. Antitrust Notification.

(a) Each of the Parties shall, as promptly as practicable (but in no event later than ten Business Days) following the date hereof, (i) file with the Federal Trade Commission (the “FTC”) and the United States Department of Justice (the “DOJ”) all materials initially required to be filed under the HSR Act in connection with the Merger and (ii) make all other filings necessary or appropriate under any Foreign Antitrust Laws in connection with the Merger and the other transactions contemplated hereby. To the extent permitted by applicable Law, the Parties shall work together and shall furnish to one another such necessary information and reasonable assistance as the other may require in connection with its preparation of any filing or submission under the HSR Act or Foreign Antitrust Law. The Parties shall keep one another apprised of the status of any communications with, and any inquiries or requests for additional information from, the FTC, the DOJ or any other applicable Governmental Entity, and shall comply promptly with any such reasonable inquiry or request.

(b) The Parties shall use commercially reasonable efforts to obtain any clearance required under the HSR Act or Foreign Antitrust Law for the Merger and the other transactions contemplated hereby. For purposes of this Section 6.3(b) and of Section 6.1, the “commercially reasonable efforts” of AudioCodes, Parent and Merger Sub shall not require AudioCodes, Parent or Merger Sub to agree to any prohibition, limitation or other requirement of the type set forth in clauses (ii) through (iv) of Section 7.2(c).

Section 6.4. Expenses. Whether or not the Merger and the other transactions contemplated hereby are consummated, each of the Parties shall bear its own fees and expenses incurred or owed in connection with the Merger, this Agreement and the other transactions contemplated hereby except (a) as otherwise set forth in Article 8 and the Escrow Agreement; (b) as otherwise set forth in the Expenses Escrow Agreement; and (c) any filing fee under the HSR Act shall be paid by AudioCodes or Parent, *provided* that the Purchase Price will be reduced by an amount equal to one-half of the initial filing fee as set forth in the definition of Purchase Price herein.

ARTICLE 7
CONDITIONS PRECEDENT

Section 7.1. Conditions to Each Party's Obligation. The respective obligation of each Party to effect the Merger is subject to the satisfaction (or express written waiver by Parent and the Company) on or prior to the Closing Date of the following conditions:

- (a) Stockholder Approval and Related Notices. The Stockholder Approval shall have been duly obtained and (i) the holders of the Preferred Stock and the Warrants shall have been given any requisite notice of the Merger (and related matters) to which they are entitled under the Company's Constitutive Documents and Contracts or other document under which the Warrants were granted, as the case may be, or (ii) each of such holders shall have waived such notice (and copies of such waivers shall have been provided to Parent).
- (b) Regulatory. All waiting periods (and extensions thereof) applicable to the Merger or other transactions contemplated hereby under the HSR Act and all review periods under the Exon-Florio Act applicable to the Merger or other transaction contemplated hereby shall have been terminated or shall have expired; and the applicable filings, approvals or expiration or termination of any and all applicable waiting periods under Foreign Antitrust Laws shall have expired or shall have been terminated.
- (c) No Injunction or Restraint. No temporary restraining order, preliminary or permanent injunction or other order or decree issued by any court of competent jurisdiction or other legal restraint or prohibition preventing the consummation of the Merger shall be in effect; provided, however, that prior to asserting this condition, subject to Section 6.1, each of the Parties shall have used all commercially reasonable efforts to prevent the entry of any such injunction or other order and to appeal as promptly as possible any such injunction or other order that may be entered.

Section 7.2. Conditions to AudioCodes' and Parent's Obligations. The obligations of AudioCodes, Parent and Merger Sub to effect the Merger are further subject to the satisfaction (or express written waiver by Parent) on or prior to the Closing Date of the following conditions:

- (a) Representations, Warranties and Covenants of the Company. The representations and warranties of the Company set forth in this Agreement that are qualified as to materiality (including in the definition of Material Adverse Effect) shall be true and correct, and all other representations and warranties of the Company set forth in this Agreement that are not so qualified shall be true and correct in all material respects as of the Closing Date with the same effect as though made as of the Closing Date, except that the accuracy of representations and warranties that by their terms speak as of a specified date will be determined as of such date. The Company shall have performed or complied with in all material respects all covenants, agreements and obligations required by this Agreement to be performed or complied with by the Company on or before the Closing Date, including without limitation the expiration of any notice or dispute resolution period provided for in Section 5.4 and 5.8 of this Agreement. The Company shall have delivered to Parent a certificate, dated the Closing Date and signed by the chief executive officer and chief financial officer of the Company, confirming the foregoing.

(b) No Material Adverse Effect. Since March 25, 2006, there shall not have been a Material Adverse Effect.

(c) No Injunction. There shall not be pending or threatened by any Governmental Entity any Legal Proceeding (or by any other Person any Legal Proceeding which has a reasonable likelihood of success), (i) challenging or seeking to restrain or prohibit the Merger or any of the other transactions contemplated by this Agreement or seeking to obtain from Parent or any of its Subsidiaries in connection with the Merger any damages that are material in relation to the Company, (ii) seeking to prohibit or limit the ownership or operation by Parent, its Subsidiaries or the Company of any material portion of the business or assets of Parent, its Subsidiaries or the Company and its Subsidiaries, or to compel Parent, its Subsidiaries or the Company to dispose of, hold separate or license any material portion of the business or assets of Parent, its Subsidiaries or the Company and its Subsidiaries, as a result of the Merger or any of the other transactions contemplated by this Agreement, (iii) seeking to impose limitations on the ability of Parent or any of its Subsidiaries to acquire or hold, or exercise full rights of ownership of, any shares of Capital Stock of the Company, including the right to vote such shares on all matters properly presented to the stockholders of the Company or (iv) seeking to prohibit Parent or any of its Subsidiaries from effectively controlling in any material respect the business or operations of the Company.

(d) Consents and Approvals. Parent shall have received evidence, in form and substance reasonably satisfactory to it, that all consents and approvals of third parties set forth in Section 3.6(a)(ii) of the Disclosure Schedule in connection with the Merger, this Agreement and the other transactions contemplated hereby, have been obtained and are in full force and effect.

(e) Appraisal Shares. The time during which a holder of Capital Stock is permitted to demand appraisal rights under the DGCL shall have expired and holders of not more than five percent of the shares of the Company's Common Stock issued and outstanding immediately prior to the Effective Time, shall have asserted or be seeking to assert their appraisal rights under Section 262 of the DGCL and the Company shall have delivered to Parent a certificate, signed on behalf of the Company by the Chief Executive Officer of the Company, certifying the foregoing and the date on which the Disclosure Statement was first mailed to the holders of the Capital Stock of the Company; *provided, however* that if no such holders of the shares of the Company Common Stock have asserted or are seeking to assert their appraisal rights under Section 262 of the DGCL, such certificate shall indicate such.

(f) Agreements with Sellers. At or prior to the Closing, the agreements listed in Section 3.22 of the Disclosure Schedule and any other Contract between any Seller or Affiliate thereof, on one hand, and the Company, on the other hand (other than (i) any confidentiality, noncompetition and nonsolicitation provisions, or provisions assigning or to assign inventions or other Intellectual Property or waiving to or waive any appraisal rights, contained therein inuring to the Company's benefit, (ii) the Contracts listed in Section 7.2(f) of the Disclosure Schedule and (iii) any other agreements contemplated by this Agreement to be entered into in connection with this Agreement (including the agreements required by this Agreement to terminate other agreements)), shall have been terminated pursuant to written agreements in form and substance reasonably satisfactory to Parent, and there shall be no obligations or liabilities of the Company with respect thereto.

(g) Audited Financial Statements. The audited financial statements delivered in accordance with Section 5.8(a) shall not differ in any material respects from the Financial Statements initially delivered pursuant to Section 3.9(a).

(h) Agreement with Company Auditors. Peterson & Co., LLP shall have provided (i) assurances, reasonably satisfactory to Parent, that it will execute and deliver, at such time or times as Parent shall request, its consent to the inclusion or incorporation by reference of its report as independent auditor, with respect to any Financial Statements for which it served as the independent auditor, in any report, registration statement or other filing to be made by AudioCodes within one year of the Closing Date with the Securities and Exchange Commission pursuant to the Securities Act or the Exchange Act in which such Financial Statements and report thereon are required to be included; and (ii) evidence reasonably satisfactory to AudioCodes, of its independence under the Securities Act and the Exchange Act and the rules and regulations thereunder.

(i) Other Documentation. Parent shall have received:

(i) from DLA Piper Rudnick Gray Cary US LLP, counsel to the Company, an opinion letter containing specific opinions in substantially the form of *Exhibit E* (subject to customary qualifications and assumptions), addressed to AudioCodes and Parent and dated as of the Closing Date;

(ii) a certificate, issued by the Company pursuant to Treasury Regulation Section 1.897-2(h) (as described in Treasury Regulation Section 1.1445-2(c)(3)), that the Company is not, and within the five year period ending on the Closing Date has not been, a U.S. real property holding corporation, as defined in Section 897 of the Code;

(iii) written resignations, effective as of the Closing, of each director of the Company;

(iv) counterparts of the Escrow Agreement and the Expenses Escrow Agreement executed and delivered by the Sellers' Representative and the Escrow Agent;

(v) a certificate (the "*Consideration Certificate*") of the Company, dated the Closing Date and signed by the chief financial officer of the Company, setting forth, with back-up calculations in reasonable detail, the amount of the Closing Merger Consideration to be paid to each holder of Company Common Stock and Preferred Stock, the Option Consideration to be paid to each holder of an Option pursuant to Section 2.2(a) and the Warrant Consideration to be paid to each holder of a Warrant pursuant to Section 2.2(a);

(vi) copies of the resolutions adopted by the board of directors of the Company authorizing the execution, delivery and performance of this Agreement and the other transactions contemplated hereby and copies of the Constitutive Documents of the Company, in each case certified by the secretary of the Company as being in effect as of the Closing Date;

(vii) a certificate of the Company, dated the Closing Date and signed by the secretary of the Company, certifying as to the incumbency and signatures of the officers executing this Agreement and the other documents delivered by the Company under this Agreement; and

(viii) copies of (A) the Constitutive Documents of the Company and each of its Subsidiaries, certified as of a recent date by the Secretary of State of the State of Delaware or such other applicable Governmental Authority where such Subsidiary is organized, (B) good standing certificates or equivalent certificates, dated as of a recent date, of the Company and each of its Subsidiaries from the Secretary of State of the State of Delaware or such other applicable Governmental Authority where such Subsidiary is organized and (C) certificates, dated as of a recent date, of the Company and each of its Subsidiaries from the Secretary of State or other applicable Governmental Entity in the United States, stating that, with respect to each of the Company and its Subsidiaries that is required to be qualified as a foreign corporation or entity in such jurisdiction, each such Person is duly qualified and in good standing as a foreign corporation or entity in such jurisdiction.

Section 7.3. Conditions to the Company's Obligation. The obligation of the Company to effect the Merger is subject to the satisfaction (or express written waiver by the Company) on or prior to the Closing Date of the following conditions:

(a) Representations and Warranties. The representations and warranties of AudioCodes, Parent and Merger Sub set forth in this Agreement that are qualified as to materiality (including in the definition of Material Adverse Effect) shall be true and correct, and all other representations and warranties of AudioCodes, Parent and Merger Sub set forth in this Agreement that are not so qualified shall be true and correct in all material respects, in each case as of the date of this Agreement and as of the Closing Date with the same effect as though made as of the Closing Date, except that the accuracy of representations and warranties that by their terms speak as of a specified date will be determined as of such date. The Company shall have received a certificate, dated the Closing Date and signed on behalf of Parent by an authorized signatory of Parent, confirming the foregoing.

(b) Covenants and Agreements. Parent and Merger Sub shall have performed or complied with in all material respects all covenants, agreements and obligations required by this Agreement to be performed or complied with by them on or before the Closing Date. The Company shall have received a certificate, dated the Closing Date and signed on behalf of Parent by an authorized signatory of Parent, confirming the foregoing.

(c) No Injunction. There shall not be pending or threatened by any Governmental Entity any Legal Proceeding (or by any other Person any Legal Proceeding which has a reasonable likelihood of success), challenging or seeking to restrain or prohibit the Merger or any of the other transactions contemplated by this Agreement.

(d) Governmental Consents and Approvals. The Company shall have received evidence, in form and substance reasonably satisfactory to it, that all consents of Governmental Entities required in connection with the Merger, this Agreement and the other transactions contemplated hereby, have been obtained and are in full force and effect.

(e) Escrow Agreements. The Company and the Seller's Representative shall have received counterparts of the Escrow Agreement executed and delivered by Parent and the Escrow Agent and the Expenses Escrow Agreement executed and delivered by the Escrow Agent.

ARTICLE 8 INDEMNIFICATION

Section 8.1. Indemnification of Parent. From and after the Closing, each of AudioCodes, Parent and their Affiliates (including, from and after the Closing, the Surviving Corporation) (each, a "*Parent Indemnified Party*") shall be entitled to be indemnified and held harmless from the Escrow Fund (as defined in the Escrow Agreement, the "*Escrow Fund*") against any and all Losses suffered or incurred by such Parent Indemnified Party, arising from, relating to or otherwise in connection with:

- (a) any breach, as of the date of this Agreement or as of the Closing Date, of any representation or warranty of the Company contained in this Agreement or in any of the certificates furnished by the Company pursuant to this Agreement;
- (b) any breach or failure to perform any covenant or agreement of the Company contained in this Agreement;
- (c) any failure of any Selling Stockholder to have good, valid and marketable title, free and clear of all Liens, to the Capital Stock of the Company issued in the name of such Selling Stockholder and issued and outstanding immediately prior to the Effective Time;
- (d) any claim by a stockholder or former stockholder of the Company, or by any other Person, seeking to assert, or based upon: (i) ownership or rights to ownership of any shares of stock of the Company; (ii) any right of a stockholder of the Company (other than the right to receive the Closing Merger Consideration), including any option, preemptive right or right to notice or to vote; (iii) any right under the Certificate of Incorporation or By-laws of the Company; or (iv) any claim that its shares were wrongfully repurchased by the Company;
- (e) the following payments: (i) the excess of the sum of (A) the Banking Fees and Excess Employee Severance Costs over (B) \$1,400,000; and (ii) the amount of any Excess Bonus Costs; provided, that no indemnification shall be available to the extent such excess or amount, or any portion thereof, has previously resulted in a reduction of the Purchase Price;
- (f) any Losses incurred by the Company or any of its Subsidiaries, other than the Subsidiary referenced in Section 3.16(iv) of the Disclosure Schedule, in excess of \$200,000, resulting from or relating to the legal proceedings described in Section 3.16(iv) of the Disclosure Schedule;

(g) any Losses incurred by the Company or any of its Subsidiaries, in excess of \$200,000, resulting from or relating to the matter referenced in Section 3.16(iii) of the Disclosure Schedule;

(h) any Losses incurred by the Company or any of its Subsidiaries resulting from or relating to the matter referenced in Section 3.16(i) of the Disclosure Schedule;

(i) any Losses incurred by the Company or any of its Subsidiaries resulting from or relating to the claims referenced in Section 3.16(ii) of the Disclosure Schedule; and

(j) any Losses incurred by the Company or any of its Subsidiaries resulting from or relating to the matter referenced in Section 3.16(vi) of the Disclosure Schedule;

provided, however, that no Parent Indemnified Party shall be entitled to be indemnified pursuant to clauses (a), (c) and (d) above unless the aggregate of all Losses for which Parent Indemnified Parties would, but for this proviso, be liable exceeds on a cumulative basis \$450,000 (the “*Seller Indemnity Threshold*”), at which point each Parent Indemnified Party shall be entitled to be indemnified for the aggregate Losses and not just amounts in excess of the Seller Indemnity Threshold (except that the foregoing proviso shall not apply to any breach of the representations and warranties set forth in Sections 3.17 and 3.24, the Consideration Certificate or to any act of fraud). Other than the involvement of the Sellers’ Representative pursuant to the Escrow Agreement, the consent of any particular Seller shall not be required in order for Parent to be indemnified under this Article 8.

Section 8.2. Indemnification of Seller Indemnified Parties. From and after the Closing, AudioCodes and Parent shall indemnify the Sellers and their Affiliates (each a “*Seller Indemnified Party*”) against and hold each Seller Indemnified Party harmless from any and all Losses suffered or incurred by any such Seller Indemnified Party arising from, relating to or otherwise in connection with:

(a) any breach, as of the date of this Agreement or as of the Closing Date, of any representation or warranty of AudioCodes, Parent or Merger Sub contained in this Agreement or in the certificate furnished by Parent pursuant to this Agreement; or

(b) any failure to perform any covenant or agreement of AudioCodes, Parent or Merger Sub contained in this Agreement;

provided, however, that AudioCodes and Parent’s collective liability under this Section 8.2 shall be limited to an amount equal to the initial Escrow Amount, *provided, further*, that the affirmative payment obligations of AudioCodes and Parent specifically set forth in this Agreement shall not be subject to, or counted against, the foregoing limitation of liability.

Section 8.3. Indemnification Claims.

(a) In order for an Indemnified Party to be entitled to any indemnification provided for under Section 8.1 or 8.2 in respect of, arising out of or involving a Third Party Claim, such Indemnified Party must notify the Indemnifying Party in writing of the Third Party Claim (including in such notice a brief description of the applicable claim(s), including damages sought or estimated, to the extent actually known by Parent) within 20 Business Days after receipt by such Indemnified Party of notice of the Third Party Claim; *provided, however*, that failure to give such notification shall not affect the indemnification provided under Section 8.1 or 8.2 except to the extent the Indemnifying Party has been actually prejudiced as a result of such failure. Thereafter, the Indemnified Party shall deliver to the Indemnifying Party, within ten Business Days after the Indemnified Party's receipt thereof, copies of all notices and documents received by the Indemnified Party relating to the Third Party Claim. The Indemnifying Party shall conduct and control the defense of such Third Party Claim and the Indemnified Party shall be entitled to participate in the defense or settlement of such matter at its expense (including any fees for separate counsel); *provided* that the Indemnified Party shall not be entitled to be indemnified or held harmless under Section 8.1 or 8.2 for such Third Party Claim if it shall settle such Third Party Claim without the prior written consent of the Indemnifying Party, unless the Indemnified Party has sought such consent and such consent has been unreasonably withheld or delayed, it being agreed that the Indemnifying Party shall not unreasonably withhold or delay such consent. If the Indemnifying Party fails to assume the defense of any such Third Party Claim within ten (10) Business Days of notice to the Indemnifying Party of such Third Party Claim, the Indemnified Party may defend against such Third Party Claim in any manner it reasonably may deem appropriate. The Indemnifying Party shall not consent to the entry of any judgment or settle any such Third Party Claim (i) without the written consent of the Indemnified Party (which consent shall not be unreasonably withheld or delayed) if any relief, other than the payment of money damages, would be granted by such settlement or if the Indemnified Party would be liable to the third party for the amount of such settlement, and (ii) unless the Indemnified Party is granted a full release of claims.

(b) In order for an Indemnified Party to be entitled to any indemnification provided for under this Agreement other than in respect of, arising out of or involving a Third Party Claim, such Indemnified Party shall deliver notice of such claim with reasonable promptness to the Indemnifying Party (including in such notice a brief description of the applicable claim(s), including damages sought or estimated, to the extent actually known by Parent); *provided, however*, that failure to give such notification shall not affect the indemnification provided under Section 8.1 or 8.2 except to the extent the Indemnifying Party has been actually prejudiced as a result of such failure. If the Indemnifying Party does not notify the Indemnified Party within 20 Business Days following its receipt of such notice that the Indemnifying Party disputes the indemnity claimed by the Indemnified Party under Section 8.1 or 8.2, such indemnity claim specified by the Indemnified Party in such notice shall be conclusively deemed a liability to be indemnified under Section 8.1 or 8.2 and the Indemnified Party shall be indemnified for the amount of the Losses stated in such notice to the Indemnified Party on demand or, in the case of any notice in which the Losses (or any portion thereof) are estimated, on such later date when the amount of such Losses (or such portion thereof) becomes finally determined.

(c) Except with respect to fraud, from and after the Closing, the Escrow Agreement shall be the sole and exclusive means by which AudioCodes and Parent may collect any Losses for which it is entitled to indemnification under this Agreement. Notwithstanding the foregoing, nothing in this Article 8 shall limit Parent's or AudioCodes's recourse against any Seller pursuant to the terms of any document to which such Seller is a party, such as a Letter of Transmittal.

(d) With respect to any claim for indemnification pursuant to Section 8.1, references in this Agreement to the “Indemnifying Party” with respect to any right to give or receive notice or consent shall be deemed to refer to the Sellers’ Representative. Should the Sellers’ Representative resign or be unable to serve, a new Sellers’ Representative will be selected jointly by a vote of Sellers who, at Closing, held at least a majority of the Common Stock (on an as-converted basis), whose appointment shall be effective upon execution by such successor of a joinder agreement providing for such successor to become a party to the Escrow Agreement as the Sellers’ Representative, in which case such successor shall for all purposes of this Agreement and the Escrow Agreement be the Sellers’ Representative (and the prior acts taken by the succeeded Sellers’ Representative shall remain valid for purposes of this Agreement and the Escrow Agreement).

Section 8.4. Termination of Indemnification. All representations, warranties and covenants that are covered by the indemnification agreements in this Article 8 shall survive the Closing solely for purposes of this Article 8 and shall expire, and the right to be indemnified and held harmless shall terminate, on the date one year following the Closing Date (the “*Expiration Date*”); *provided, however*, that in accordance with the terms of the Escrow Agreement, such obligations to indemnify and hold harmless shall not terminate with respect to any Losses as to which the Indemnified Party shall have, on or prior to such date, previously made a claim by delivering a notice of such claim to the Indemnifying Party. The Expenses Escrow Fund shall terminate upon the Expiration Date; *provided, however*, that a portion of the Expenses Escrow Fund (the “*Required Portion*”) that, in the reasonable judgment of the Sellers’ Representative is necessary to remain available in order to fulfill the purposes of the Expenses Escrow Fund shall remain in the Expenses Escrow Fund. If there is any cash in the Expenses Escrow Fund in excess of the Required Portion on the Expiration Date, the Escrow Agent shall promptly release from escrow to the holders of Company Capital Stock their pro rata share of the Expenses Escrow Fund less the Required Portion, if any. Any funds remaining from the Required Portion at such time as the Sellers’ Representative determines that such funds are no longer necessary shall be released to the holders of Company Capital Stock according to their pro rata share of such funds promptly after such determination.

Section 8.5. No Right of Contribution. No Seller shall have any right of contribution against the Company or the Surviving Corporation with respect to any breach by the Company of any of its representations, warranties, covenants or agreements.

ARTICLE 9 TERMINATION

Section 9.1. Termination. This Agreement may be terminated, and the Merger contemplated hereby may be abandoned, at any time prior to the Effective Time whether before or after receipt of the Stockholder Approval:

- (a) by mutual written consent of AudioCodes, Parent, Merger Sub and the Company;
- (b) by either Parent or the Company;
- (i) if the Merger is not consummated on or before October 31, 2006 (the “*Outside Date*”), unless the failure to consummate the Merger is the result of a material breach of this Agreement by the Party seeking to terminate this Agreement;

(ii) if any Governmental Entity issues an order, decree or ruling or taken any other action permanently enjoining, restraining or otherwise prohibiting the Merger and such order, decree, ruling or other action shall have become final and nonappealable; or

(iii) if any condition to the obligation of such Party to consummate the Merger set forth in Section 7.2 (in the case of Parent) or 7.3 (in the case of the Company) becomes incapable of satisfaction prior to the Outside Date;

(c) by Parent, if the Company breaches or fails to perform in any material respect any of its representations, warranties or covenants contained in this Agreement, which breach or failure to perform (i) would give rise to the failure of a condition set forth in Section 7.2(a) and (ii) cannot be or has not been cured within ten (10) Business Days after the giving of written notice to the Company of such breach;

(d) by the Company, if AudioCodes or Parent breaches or fails to perform in any material respect of any of their respective representations, warranties or covenants contained in this Agreement, which breach or failure to perform (i) would give rise to the failure of a condition set forth in Section 7.3(a) or 7.3(b) and (ii) cannot be or has not been cured within ten (10) Business Days after the giving of written notice to Parent or AudioCodes of such breach; or

(e) by Parent if, within one hour after of the execution and delivery of this Agreement, the holders of Capital Stock of the Company set forth in Section 9.1(e) of the Disclosure Schedule shall not have executed and delivered the written consent of stockholders and notice to the Company attached as *Exhibit F* hereto (the "*Written Consent*"), duly adopting the resolutions contained therein, or the Stockholder Approval shall not have been duly obtained.

Section 9.2. Effect of Termination. If this Agreement is terminated and the Merger and the other transactions contemplated hereby are abandoned as described in this Article 9, this Agreement shall forthwith become void and of no further force or effect, except for the provisions of Sections 6.2, 6.4 and this Section 9.2; *provided* that nothing in this Section 9.2 shall be deemed to release any Party from any liability for any breach by such Party of the terms and provisions of this Agreement.

ARTICLE 10 GENERAL PROVISIONS

Section 10.1. Notices. All notices, requests, claims, demands, waivers and other communications under this Agreement shall be in writing and shall be by email, in the case of AudioCodes, and, in addition, shall be by facsimile, courier services or personal delivery to all parties, including AudioCodes, to the following addresses, or to such other addresses as shall be designated from time to time by a Party in accordance with this Section 10.1:

(a) if to AudioCodes

AudioCodes Ltd.
1 Hayarden Street, Airport City Lod, 70151
P.O. Box 255, Ben Gurion Airport , Israel 70100
Attention: Itamar Rosen
Facsimile No.: 972-3-976-4040
e-mail: notices@audiocodes.com

with a copy to:
Covington & Burling
1330 Avenue of the Americas
New York, New York 10019
Attention: Ellen Corenswet
Facsimile No.: (212) 841-1010

(b) if to Parent or Merger Sub:

AudioCodes Ltd.
1 Hayarden Street, Airport City Lod, 70151
P.O. Box 255, Ben Gurion Airport , Israel 70100
Attention: Itamar Rosen
Facsimile No.: 972-3-976-4040

and

AudioCodes, Inc.
2099 Gateway Place, Suite 500
San Jose, California 95110
Attention: Chief Financial Officer
Facsimile No: (408) 451-9520

with a copy to:
Covington & Burling
1330 Avenue of the Americas
New York, New York 10019
Attention: Ellen Corenswet
Facsimile No.: (212) 841-1010

(c) if to the Company:

Nuera Communications, Inc.
10445 Pacific Center Court
San Diego, CA 92121-1761
Attention: President and Chief Executive Officer
Facsimile No.: (858) 624-2422

with a copy prior to the Closing to:
DLA Piper Rudnick Gray Cary US LLP
4365 Executive Drive, Suite 1100
San Diego, California 92121
Attention: Jim Cartoni
Facsimile No.: (858) 677-1401

and with copies after the Closing to:

AudioCodes Ltd.
1 Hayarden Street, Airport City Lod, 70151
P.O. Box 255, Ben Gurion Airport, Israel 70100
Attention: Itamar Rosen
Facsimile No.: 972-3-976-4040

AudioCodes, Inc.
2099 Gateway Place, Suite 500
San Jose, California 95110
Attention: Chief Financial Officer
Facsimile No: (408) 451-9520

and

Covington & Burling
1330 Avenue of the Americas
New York, New York 10019
Attention: Ellen Corenswet
Facsimile No.: (212) 841-1010

(d) if to the Sellers' Representative to:

Robert Wadsworth
c/o HarbourVest Partners LLC
1 Financial Center
Boston, MA 02111
Facsimile No.: (617) 348-3715

with a copy to:
Debevoise & Plimpton
919 Third Avenue
New York, NY 10022
Attention: David J. Schwartz
Facsimile No.: (212) 909-6836

All notices and communications under this Agreement shall be deemed to have been duly given (w) when delivered by hand, if personally delivered, (x) one Business Day after when delivered to a courier, if delivered by commercial one-day overnight courier service, (y) when sent, if sent by facsimile, with an acknowledgment of sending being produced by the sending facsimile machine or (z) upon confirmation by telephone or an email response from the recipient, in the case of email.

Section 10.2. Definitions. The following capitalized terms have the following meanings:

“*Affiliate*” means, with respect to any Person, a Person who is an “affiliate” of such first Person within the meaning of Rule 405 under the Securities Act of 1933.

“*Banking Fees*” means, the fees and expenses of Goldman Sachs & Co., financial advisor to the Company, incurred in connection with the negotiation, entering into and consummation of this Agreement, the other Transaction Agreements, the Merger and the other transactions contemplated hereby and thereby.

“*Benefit Agreement*” means any employment, deferred compensation, severance, termination, retention, change in control, employee benefit, loan, indemnification, stock repurchase, consulting or similar agreement between the Company or any of its Subsidiaries and any Company Personnel, or any agreement between the Company or any of its Subsidiaries and any Company Personnel, the benefits of which are contingent, or the terms of which are materially altered, upon the occurrence of a transaction involving the Company or any of its Subsidiaries of the nature contemplated by this Agreement.

“*Benefit Plan*” means any Pension Plan or any bonus, profit sharing, deferred compensation, incentive compensation, stock ownership, stock purchase, stock appreciation, restricted stock, stock repurchase rights, stock option (including the Company Stock Plans), phantom stock, performance, retirement, vacation, severance or termination, disability, death benefit, employment, supplemental unemployment benefit, consulting, independent contractor, director, retention, hospitalization, fringe benefit, medical, dental, vision, accident or other plan, program, policy, arrangement or Contract (whether or not subject to the Laws of the United States or of another jurisdiction) established, maintained, contributed to or required to be established, maintained or contributed to by the Company or any ERISA Affiliate, in each case, providing benefits to any Company Personnel (or to any other person for the benefit of any Company Personnel, such as a beneficiary, alternate payee, or a dependent thereof), and in each case whether written or oral, informal or formal, subject to ERISA or not. The term “Benefit Plan” shall also include any plan, program, policy, arrangement or Contract with respect to which the Company or any ERISA Affiliate may have liability (including potential, secondary or contingent liability) under Title IV of ERISA or otherwise to any Person being and including any liability by reason of any Person’s being or having been an ERISA Affiliate.

“*Business Day*” means any day other than (i) a Saturday or Sunday or (ii) a day on which banking institutions located in New York City or Tel Aviv, Israel are permitted or required by Law, executive order or decree of a Governmental Entity to remain closed.

“*Capital Stock*” means any capital stock or share capital of, other voting securities of, other equity interest in, or right to receive profits, losses or distributions of, any Person.

“*Closing Common Merger Consideration*” means, with respect to each share of Company Common Stock, an amount equal the Common Merger Consideration *multiplied* by the Closing Percentage.

“*Closing Percentage*” means one *minus* a fraction equal to (i) \$8,500,000 over (ii) the Purchase Price (excluding any amounts that increase the Purchase Price pursuant to clause (ii) of such definition).

“Closing Preferred Merger Consideration” means, with respect to each share of Company Preferred Stock, an amount equal to the Preferred Merger Consideration multiplied by the Closing Percentage.

“Common Merger Consideration” means the quotient of:

(i) (A) the Purchase Price minus (B) the aggregate of the Preference Amounts for all shares of Preferred Stock outstanding immediately prior to the Effective Time and all shares of Preferred Stock subject to Warrants cancelled pursuant to Section 2.2(a),

divided by

(ii) the sum of (A) the number of shares of Company Common Stock outstanding immediately prior to the Effective Time plus (B) the number of shares of Company Common Stock subject to Options and Warrants cancelled pursuant to Section 2.2(a) (including, for Warrants exercisable for shares of Preferred Stock, the number of shares of Common Stock into which such shares are convertible immediately prior to the Effective Time) plus (C) the number of shares of Company Common Stock into which the issued and outstanding shares of Preferred Stock are convertible immediately prior to the Effective Time.

“Company Knowledge Persons” means William Ingram, Michael Rinehart, Stephen Morley, Harprit Chhatwal and Mike Creamer.

“Constitutive Documents” means (i) with respect to a Person that is a corporation, such Person’s certificate or articles of incorporation and by-laws, (ii) with respect to a Person that is a limited liability company, such Person’s certificate of formation and operating or limited liability company agreement, (iii) with respect to a Person that is a partnership, such Person’s partnership agreement, (iv) with respect to a Person that is a trust, such Person’s trust instrument or agreement, and (v) with respect to a Person that is a legal entity (including one of the type described in clauses (i) through (iv)), any constitutive document of such entity or other document or Contract analogous to those described in clauses (i) through this clause (v).

“Contract” means any loan or credit agreement, bond, debenture, note, mortgage, indenture, guarantee, lease or other contract, commitment, agreement, instrument, obligation, undertaking, license, permit, concession, franchise or legally binding arrangement or understanding, whether written or oral.

“Disclosure Schedule” means a schedule of exceptions to the representations and warranties of the Company set forth in Article 3 and other items as set forth herein, delivered contemporaneously with this Agreement.

“Earn Out Period” means the one-year period commencing on first day of the first calendar month following the Closing Date.

“Earn Out Per Share Amount” means the amount determined by dividing (i) the Earn Out Amount; by (ii) the aggregate number of Earn Out Shares.

“*Earn Out Shares*” means (A) the shares of Company Common Stock outstanding immediately prior to the Effective Time, (B) the shares of Company Common Stock into which an issued and outstanding share of Preferred Stock is convertible immediately prior to the Effective Time, (C) the shares of Company Common Stock subject to Options cancelled pursuant to Section 2.2(a), and (D) the shares of Company Common Stock or Company Preferred Stock (on an as-converted basis), as applicable, subject to Warrants cancelled pursuant to Section 2.2(a).

“*Environmental Law*” means any applicable Law (including but not limited to principles of common law) and binding administrative or judicial interpretations thereof relating to (i) the protection of the environment (including indoor and outdoor air, water vapor, surface water, groundwater, wetlands, drinking water supply, surface or subsurface land), natural resources and human health and safety as it relates to exposure to Hazardous Materials; (ii) the exposure to, or the use, storage, recycling, treatment, generation, transportation, processing, handling, labeling, presence, or the release or threatened release of, Hazardous Materials; (iii) the collection, recovery and recycling of waste resulting from marketed products and their packaging; and (iv) the environmental design, energy efficiency requirements or chemical composition of marketed products and their packaging.

“*Environmental Liability*” means any and all Losses relating to the Company or any its Subsidiaries, their respective businesses, operations, assets, facilities, property (including, without limitation, owned property and Leased Property) or marketed products, arising from or relating to: (i) failure to comply with any requirement of an Environmental Law; (ii) failure to obtain, maintain in effect or comply with any required Environmental Permit; (iii) actual or alleged obligation to undertake environmental investigation, risk assessment, monitoring, remediation or restoration; or (iv) harm or injury, actual or alleged, to any real property, to any Person, to public health, or to any natural resource as relating to Hazardous Materials.

“*Environmental Permits*” means all permits, licenses, certificates, approvals or authorizations held by the Company or any of its businesses or operations pursuant to an Environmental Law.

“*Excess Bonus Costs*” means the excess of (i) the aggregate amount of any bonuses, other than the retention bonuses referred to in Section 5.8(c), paid or committed to be paid to any employees of the Company on or before the Closing Date over (ii) \$40,000.

“*Excess Employee Severance Costs*” means the excess of (i) with respect to all Terminated Employees other than persons at the level of Vice President or above, (A) the aggregate amount of cash paid or payable, and the value of any benefits provided, to such Terminated Employees (excluding base salary, bonuses, commissions and other amounts payable with respect to their employment through and including their last day of actual employment), over (B) the aggregate amount of the cash that would be paid to such Terminated Employees if such Terminated Employees received two weeks of base salary for every year of service to the Company, up to a maximum of eight weeks of base salary, and received no other benefits (including without limitation COBRA payments), and (ii) with respect to all Terminated Employees who are, at the time of termination, at the level of Vice President or above, (A) the aggregate amount of cash paid or payable, and the value of any benefits provided, to such Terminated Employees (excluding base salary, bonuses, commissions and other amounts payable with respect to their employment through and including their last day of actual employment), over (B) the cash that would be paid to such Terminated Employees if such Terminated Employees received 12 weeks of base salary and received no benefits other than COBRA payments for such 12-week period.

“*Governmental Entity*” means any nation, state, province, county, city or political subdivision and any official, agency, arbitrator, authority, court, department, commission, board, bureau, instrumentality or other governmental or regulatory authority of any thereof, whether domestic or foreign.

“*Hazardous Materials*” means any and all materials (including without limitation substances, chemicals, compounds, mixtures, products or byproducts, biologic agents, living or genetically modified materials, wastes, pollutants and contaminants) that are (i) listed, characterized or regulated pursuant to applicable Environmental Law; (ii) identified or classified as “hazardous,” “toxic,” “dangerous,” “pollutant,” “contaminant,” “explosive,” “corrosive,” “flammable,” “radioactive,” “reactive” or “special waste”; (iii) capable of causing harm or injury to human health, natural resources or the environment; or (iv) oils, petroleum, petroleum products, wastes or byproducts, asbestos or asbestos containing materials, lead-based paint, polychlorinated biphenyls, urea formaldehyde, explosives, bacteria or fungi.

“*Indebtedness*” of any Person means, without duplication, (i) all indebtedness of such Person for borrowed money, with respect to deposits or advances of any kind or for the deferred purchase price of property or services (other than current trade liabilities incurred in the Ordinary Course of Business and payable in accordance with customary practices and not more than 90 days past due), (ii) all obligations of such Person evidenced by bonds, debentures, notes or similar instruments, (iii) all obligations of such Person upon which interest charges are customarily paid, (iv) all obligations of such Person under conditional sale or other title retention agreements relating to property or assets purchased by such Person, (v) all Indebtedness of others secured by (or for which the holder of such Indebtedness has an existing right, contingent or otherwise, to be secured by) any Lien on property owned or acquired by such Person, whether or not the obligations secured thereby have been assumed, (vi) all guarantees by such Person of Indebtedness of others, (vii) all capital lease obligations of such Person, (viii) all obligations of such Person in respect of interest rate protection agreements, foreign currency exchange agreements, caps or collar agreements or other interest or exchange rate hedging arrangements either generally or under specific contingencies, (ix) all obligations of such Person as an account party in respect of letters of credit and banker’s acceptances, (x) all obligations of such Person consisting of overdrafts (e.g., cash float reflected as a negative on the cash line) and (xi) all obligations of such Person pursuant to any deferred compensation agreements.

“*Indemnified Party*” means either a Parent Indemnified Party or a Seller Indemnified Party.

“*Indemnifying Party*” means (i) with respect to a claim for indemnification pursuant to Section 8.1, Sellers, in accordance with the Escrow Agreement, and (ii) with respect to a claim for indemnification pursuant to Section 8.2, Parent.

“*Intellectual Property*” of any Person means all intellectual property rights or any kind, including intellectual property rights arising from or in respect of the following, whether protected, created or arising under any Law, including: (i) all patents and applications therefor, including continuations, divisionals, continuations-in-part, or reissues of patent applications and patents issuing thereon (collectively, “*Patents*”); (ii) all trademarks, service marks, trade names, service names, brand names, trade dress rights, logos, Internet domain names and corporate names, together with the goodwill associated with any of the foregoing, and all applications, registrations and renewals thereof, (collectively, “*Marks*”); (iii) copyrights and registrations and applications therefor, works of authorship and mask work rights (collectively, “*Copyrights*”); (iv) discoveries, trade secrets, concepts, ideas, research and development, know-how, formulae, algorithms, inventions, compositions, manufacturing and production processes and techniques, technical data, procedures, methods, programs, subroutines, tools, materials, processes, inventions (whether patentable or unpatentable and whether or not reduce to practice), apparatus, creations, improvements, works of authorship and other similar materials, all recordings, graphs, designs, drawings, reports, analyses, and other writings, specifications, databases and other proprietary and confidential information, including customer lists, supplier lists, pricing and cost information, and business and marketing plans and proposals and other tangible embodiments of the foregoing, in any form whether or not specifically listed herein, and all related technology; and (v) all Software.

“*Knowledge*” and “*knowledge*”, with respect to the Company, means the Company will have knowledge of a particular fact or other matter if any of the Company Knowledge Persons are actually aware of a particular fact or matter or if exercising reasonable care such persons would be expected to discover or become aware of that fact or matter in the course of carrying out their employment duties and responsibilities at the Company.

“*Losses*” means any debts, obligations and other liabilities (whether known or unknown, absolute or contingent, liquidated or unliquidated, due or to become due, accrued or not accrued, asserted or unasserted or otherwise), losses, claims, damages, Taxes, diminutions in value, interest obligations, deficiencies, Judgments, assessments, fines, fees, penalties and expenses (including amounts paid in settlement, interest, court costs, fees and expenses of attorneys, accountants, financial advisors, consultants, investigators and other experts and other expenses of litigation).

“*Material Adverse Effect*” means any change, circumstance, development, state of facts, event or effect (i) that has had or could reasonably be expected to have a material adverse change or effect (taken alone or in the aggregate with any other adverse change or effect) in or with respect to the business, assets, condition (financial or otherwise) or results of operations of the Company and its Subsidiaries, taken as a whole or (ii) that could reasonably be expected to prevent or materially impede, interfere with, hinder or delay the consummation by the Company of the Merger or the other transactions contemplated by this Agreement; *provided* that a Material Adverse Effect shall not include any effect attributable to general economic conditions or general changes in the industry in which the Company is engaged so long as the Company and its Subsidiaries as a whole are not disproportionately affected.

“*Merger Consideration*” means (i) with respect to the Company Common Stock, the Common Merger Consideration and (ii) with respect to the Preferred Stock, the Preferred Merger Consideration.

“*Net Product Sales*” shall be defined as the net amounts actually received by the Company and its Subsidiaries from sales, made during the Earn Out Period, of the specified products set forth on Schedule 2.3 (together with certain maintenance and service fees related thereto as specified on Schedule 2.3) to the specified customers set forth on Schedule 2.3 and such other customers as Parent may determine in its sole and absolute discretion, after products are shipped and unreserved payment is received by the Company for the product price, less payments for shipping charges, letter of credit and banking charges, insurance, sales and withholding or other similar taxes (but not income taxes), payment of third party commissions, product returns, refunds or credits; *provided*, that, only amounts received from such sales on or before sixty (60) days after the end of the Earn Out Period shall constitute Net Product Sales; and *provided, further*, that no amounts received shall constitute Net Product Sales if a claim against the Company or a Subsidiary is outstanding concerning such sale. Notwithstanding the foregoing, if net amounts would constitute Net Product Sales but for the fact that such amounts are not received during the 60 days following the end of the Earn Out Period, then, solely for purposes of calculating the Earn Out Amount following the end of the Earn Out Period (and not at any earlier date specified in Section 2.3(b) of this Agreement), any such net amounts that are payable to the Company under one or more purchase orders from the customers designated as “Special Customers” on Schedule 2.3 only when and if the products subject to such purchase orders are “accepted” by such customers (such amounts to be referred to as “*Retained Amounts*”) shall also constitute Net Product Sales; *provided*, that, no portion of a Retained Amount that exceeds 10% of the net amount payable for the product for which the Retained Amount has been withheld shall be included in Net Product Sales. Revenue recognition of product sales by the Company and its Subsidiaries, for purposes of determining Net Product Sales, shall be in accordance with the Parent’s revenue recognition policy, GAAP and the applicable rules of the Securities and Exchange Commission.

“*Option*” means an option to purchase or acquire shares of Common Stock of the Company held by an employee, director or consultant of the Company under a Company Stock Plan.

“*Permitted Liens*” means the following, to the extent not securing Indebtedness: (i) statutory Liens for Taxes not yet due or payable; (ii) Liens for assessments and other governmental charges or Liens of landlords, carriers, warehousemen, mechanics and repairmen incurred in the Ordinary Course of Business, in each case for sums not yet due and payable or due but not delinquent or being contested in good faith by appropriate proceedings; and (iii) Liens incurred in the Ordinary Course of Business in connection with workers’ compensation, unemployment insurance and other types of social security.

“*Person*” means an individual, corporation, partnership, limited liability company, joint venture, association, trust, unincorporated organization or other entity or any Governmental Entity.

“*Preference Amount*” means, for each share of Series A Preferred, the “Series A Preference Liquidation Amount” for such share as defined in Section V.2(a) of the Company’s Tenth Amended and Restated Certificate of Incorporation as filed with the Delaware Secretary of State on April 9, 2003.

“*Preferred Merger Consideration*” means, (i) for each share of Preferred Stock, the sum of the Preference Amount for such share of Preferred Stock and the Common Merger Consideration for the Company Common Stock into which such share of Preferred Stock is convertible at the Closing and (ii) for each share of Preferred Stock into which the Warrants cancelled pursuant to Section 2.2(a) are convertible, the sum of the Preference Amount for such share and the Common Merger Consideration into which such share is convertible at the Closing.

“*Purchase Price*” means an amount equal to (i) \$85,000,000, plus (ii) the aggregate exercise prices of the Options and Warrants outstanding immediately prior to the Effective Time which are cancelled pursuant to Section 2.2(a), minus (iii) the amount by which the sum of the Banking Fees and Excess Severance Costs as of the Closing Date exceeds \$1,400,000, minus (iv) any outstanding Indebtedness, minus (v) an amount equal to 50% of the initial fee paid by Parent in accordance with Section 6.4(c), minus (vi) any Excess Bonus Costs; provided, that in no event shall clause (ii) of this definition be deemed to imply that the aggregate Merger Consideration, aggregate Option Consideration and aggregate Warrant Consideration may exceed \$85,000,000 plus the Earn Out Amount, if any, and in no event shall such clause (ii) be deemed to imply that the holders of Options or Warrants shall be required to exercise their Options or Warrants for cash prior to the Effective Time, it being understood that such clause is included in this definition only for purposes of calculating the applicable consideration due to holders of Capital Stock, Options and Warrants.

“*Representatives*” means, with respect to a Person, such Person’s legal, financial, internal and independent accounting and other advisors and representatives.

“*Restricted Stock*” means any Capital Stock of the Company that is subject to a right of repurchase or redemption by the Company, subject to forfeiture back to the Company or subject to transfer or lock-up restrictions.

“*Sellers*” means the holders of Capital Stock of the Company and the holders of Options and Warrants, in each case as of immediately prior to the Effective Time, other than the Company itself in any case.

“*Selling Stockholders*” means the holders of the Capital Stock of the Company.

“*Software*” means any and all (i) computer programs, including any and all software implementations of algorithms, models and methodologies, whether in source code or object code, (ii) databases and compilations, including any and all data and collections of data, whether machine readable or otherwise, (iii) descriptions, flow-charts and other work product used to design, plan, organize and develop any of the foregoing, screens, user interfaces, report formats, firmware, development tools, templates, menus, buttons and icons, and (iv) documentation including user manuals and other training documentation related to any of the foregoing.

“*Subsidiary*” means, with respect to any Person, another Person (i) an amount of the voting securities, other voting ownership or voting partnership interests, of which is sufficient to elect at least a majority of its Board of Directors or other governing body (or, if there are no such voting interests, 50% or more of the equity interests of which) is owned directly or indirectly by such first Person or (ii) of which such first Person is a general partner.

“*Tax*” means: (i) any United States federal, state, local and foreign income, profits, franchise, license, capital, transfer, *ad valorem*, wage, severance, occupation, import, custom, gross receipts, payroll, sales, employment, use, stamp, alternative or add-on minimum, environmental, withholding and any other tax, duty, assessment or governmental tax charge of any kind whatsoever, imposed or required to be withheld by any taxing authority; (ii) any interest, additions to tax, or penalties applicable or related thereto; and (iii) any amount described in clause (i) or (ii) for which a Person is liable as a successor or transferee, or by Contract, indemnity or otherwise.

“*Tax Return*” means any return, declaration, report, claim for refund, or information return or statement or other form relating to Taxes filed or required to be filed with a Governmental Entity, including any schedule or attachment thereto, and including any amendment thereof.

“*Terminated Employees*” means the individuals whose employment is terminated by the Company or any Subsidiary during the sixty (60) day period following the Closing Date.

“*Third Party Claim*” means any Legal Proceeding, claim or demand by a Person other than a Person from which indemnification may be sought under Article 8.

“*Transaction Agreements*” means, collectively, this Agreement, the Escrow Agreement and the Expenses Escrow Agreement.

“*Warrant*” means a warrant, option or other right to purchase or acquire Capital Stock of the Company other than the Options.

Section 10.3. Descriptive Headings; Certain Interpretations. The table of contents and headings contained in this Agreement are for reference purposes only and shall not control or affect the meaning or construction of this Agreement. Except where expressly stated otherwise in this Agreement, the following rules of interpretation apply to this Agreement: (i) “or” is not exclusive and “include”, “includes” and “including” are not limiting; (ii) “hereof”, “hereto”, “hereby”, “herein” and “hereunder” and words of similar import when used in this Agreement refer to this Agreement as a whole and not to any particular provision of this Agreement; (iii) “date hereof” refers to the date of this Agreement; (iv) “extent” in the phrase “to the extent” means the degree to which a subject or other thing extends, and such phrase does not mean simply “if”; (v) definitions contained in this Agreement are applicable to the singular as well as the plural forms of such terms; (vi) references to an agreement or instrument mean such agreement or instrument as from time to time amended, modified or supplemented; (vii) references to a Person are also to its permitted successors and assigns; (viii) references to an “Article”, “Section”, “Subsection”, “Exhibit” or “Schedule” refer to an Article of, a Section or Subsection of, or an Exhibit or Schedule to, this Agreement; (ix) words importing the masculine gender include the feminine or neuter and, in each case, vice versa; and (x) references to a Law include any amendment or modification to such Law and any rules or regulations issued thereunder, whether such amendment or modification is made, or issuance of such rules or regulations occurs, before or after the date of this Agreement.

Section 10.4. Sellers' Representative.

(a) The Company designates Robert Wadsworth as the representative of Sellers and any other person who is or becomes, through the Effective Time, a holder of Capital Stock of the Company or a holder of Options (such person, the "*Sellers' Representative*"). The Seller's Representative hereby accepts its appointment as of the date hereof. From and after the date hereof, the Sellers' Representative shall serve as the sole representative of such Persons with respect to this Agreement, the Escrow Agreement and the transactions contemplated hereby and thereby.

(b) The Sellers' Representative shall not be liable for any act done or omitted hereunder as Sellers' Representative while acting in good faith and in the exercise of reasonable judgment and any act done or omitted pursuant to the advice of counsel shall be conclusive evidence of such good faith. The Selling Stockholders shall severally indemnify and hold the Sellers' Representative harmless against any loss, liability or expense incurred without gross negligence or bad faith on the part of the Sellers' Representative and arising out of or in connection with the acceptance or administration of his duties hereunder.

(c) The Sellers' Representative shall serve in such capacity without compensation except that the Sellers' Representative will be entitled to reimbursement for certain expenses as set forth in the Expenses Escrow Agreement. Notwithstanding anything to the contrary contained in this Agreement, Sellers' Representative shall have no duties or responsibilities except those expressly set forth herein, and no implied covenants, functions, responsibilities, duties, obligations or liabilities on behalf of any Seller shall otherwise exist against Sellers' Representative. Following Parent's payment to the Sellers' Representative of any amount pursuant to this Agreement or the Escrow Agreement, Parent shall have no liability to any Seller for any such amount, including for the Sellers' Representative's failure to distribute such amount to Sellers in accordance with their individual arrangements with the Sellers' Representative, and each Seller's sole remedy shall be against the Sellers' Representative and not against AudioCodes or Parent. The Sellers' Representative shall have reasonable access to information about the Company and the Surviving Corporation and the reasonable assistance of the Company's and Surviving Corporation's officers and employees for purposes of performing his duties and exercising his rights hereunder, provided that the Sellers' Representative shall treat confidentially and not disclose any nonpublic information from or about the Company or the Surviving Corporation to anyone (except on a need to know basis to individuals who agree to treat such information confidentially).

Section 10.5. Assignment. Neither this Agreement nor any of the rights, interests or obligations hereunder shall be assigned, in whole or in part, by operation of Law or otherwise by any of the Parties without the prior written consent of the other Parties, except that Merger Sub may assign, in its sole discretion, any of or all its rights, interests and obligations under this Agreement to AudioCodes or to any Subsidiary of AudioCodes, but no such assignment shall relieve Merger Sub of any of its obligations hereunder. Any purported assignment without such consent shall be void. Subject to the preceding sentence, this Agreement shall be binding upon, inure to the benefit of and be enforceable by, the parties hereto and their respective successors and assigns.

Section 10.6. Specific Enforcement. The Parties agree that irreparable damage would occur in the event that any of the provisions of this Agreement were not performed in accordance with their specific terms or were otherwise breached. It is accordingly agreed that the Parties shall be entitled to an injunction or injunctions to prevent breaches of this Agreement and to enforce specifically the terms and provisions of this Agreement, this being in addition to any other remedy to which they are entitled at Law, in equity or otherwise.

Section 10.7. Waiver and Amendment.

(a) At any time prior to the Effective Time, the Parties may (a) extend the time for the performance of any of the obligations or other acts of the other Parties, (b) waive any inaccuracies in the representations and warranties contained in this Agreement or in any document delivered pursuant to this Agreement or (c) subject to the proviso of Section 10.7(b), waive compliance with any of the agreements or conditions contained in this Agreement. No failure or delay on the part of any Party in exercising any right, power or remedy hereunder shall operate as a waiver thereof, nor shall any single or partial exercise of any such right, power or remedy preclude any other or further exercise thereof or the exercise of any other right, power or remedy. The remedies provided for herein are cumulative and are not exclusive of any remedies that may be available to any Party at Law, in equity or otherwise.

(b) Except as otherwise specifically set forth in this Agreement, this Agreement may be amended by the Parties at any time; *provided, however*, that there shall be made no amendment that by Law requires further approval by stockholders of either Party, without the further approval of such stockholders. This Agreement may not be amended except by an instrument in writing signed on behalf of each of the Parties.

(c) Except as otherwise specifically set forth in this Agreement, any amendment, supplement or modification of or to any provision of this Agreement and any waiver of any provision of this Agreement shall be effective (i) only if it is made or given in writing and signed by Parent and the Company or, in the case of a waiver, by the party granting the waiver and (ii) only in the specific instance and for the specific purpose for which made or given.

Section 10.8. Entire Agreement. The Transaction Agreements and the Confidentiality Agreement contain the entire agreement and understanding between the Parties with respect to the subject matter hereof and thereof and supersede all prior agreements and understandings, both written and oral, with respect to the transactions contemplated thereby. The Confidentiality Agreement shall survive any termination of this Agreement.

Section 10.9. No Third-Party Beneficiaries. Except for the Persons receiving the benefit of indemnification and additional insurance coverage under Section 5.12, this Agreement is for the sole benefit of the Parties and their permitted successors and assigns and nothing herein express or implied shall give or be construed to give to any Person, other than the Parties and such successors and assigns, any legal or equitable rights or remedies.

Section 10.10. Counterparts. This Agreement may be executed in one or more counterparts, all of which shall be considered one and the same agreement and shall become effective when one or more counterparts have been signed by each of the Parties and delivered to the other Parties.

Section 10.11. Governing Law; Jurisdiction; Venue; Service Of Process; Waiver of Jury Trial. This Agreement shall be governed by, and construed in accordance with, the laws of the State of New York, regardless of the laws that might otherwise govern under applicable principles of conflicts of laws thereof, except matters mandatorily governed by the DGCL shall be so governed. Each Party irrevocably submits to the exclusive jurisdiction of (a) the Supreme Court of the State of New York, New York County and (b) the United States District Court for the Southern District of New York for the purposes of any suit, action or other proceeding arising out of this Agreement, any of the other Transaction Agreements or any transaction contemplated hereby and thereby. Each Party agrees to commence any action, suit or proceeding relating hereto in the United States District Court for the Southern District of New York or if such suit, action or other proceeding may not be brought in such court for jurisdictional reasons, in the Supreme Court of the State of New York, New York County. Each Party further agrees that service of any process, summons, notice or document by registered mail to such Party's respective address set forth above shall be effective service of process for any action, suit or proceeding in New York with respect to any matters to which it has submitted to jurisdiction in this Section 10.11. Each Party irrevocably and unconditionally waives any objection to the laying of venue of any action, suit or proceeding arising out of this Agreement, the other Transaction Agreements and the transactions contemplated hereby or thereby in (i) the Supreme Court of the State of New York, New York County or (ii) the United States District Court for the Southern District of New York, and hereby further irrevocably and unconditionally waives, and shall not assert by way of motion, defense, or otherwise, in any such Legal Proceeding, any claim that it is not subject personally to the jurisdiction of the above-named courts, that its property is exempt or immune from attachment or execution, that the Legal Proceeding is brought in an inconvenient forum, that the venue of the Legal Proceeding is improper, or that this Agreement or any other Transaction Agreement or the Merger may not be enforced in or by any of the above-named courts. Each Party irrevocably and unconditionally waives any right to trial by jury with respect to any Legal Proceeding relating to or arising out of this Agreement or any other Transaction Agreement or any of the transactions contemplated hereby or thereby.

Section 10.12. Severability. If any term or other provision of this Agreement is invalid, illegal or incapable of being enforced by any rule or Law, or public policy, all other conditions and provisions of this Agreement shall nevertheless remain in full force and effect so long as the economic or legal substance of the transactions contemplated hereby is not affected in any manner materially adverse to any Party. Upon such determination that any term or other provision is invalid, illegal or incapable of being enforced, the Parties shall negotiate in good faith to modify this Agreement so as to effect the original intent of the Parties as closely as possible in an acceptable manner to the end that transactions contemplated hereby are fulfilled to the extent possible.

Section 10.13. Currency. All references to "dollars" or "\$" shall refer to the lawful currency of the United States and all calculations of amounts herein shall be determined in dollars unless otherwise provided herein.

Section 10.14. Transaction Costs. Each party shall pay all costs and expenses that it incurs with respect to the negotiation, execution, delivery and performance of this Agreement and the transactions contemplated hereby.

IN WITNESS WHEREOF, the Parties have duly executed this Agreement as of the date first written above.

AUDIOCODES LTD.

By: /s/ Shabtai Adlersberg

Shabtai Adlersberg
Chairman of the Board, President
and CEO

AUDIOCODES, INC.

By: /s/ Shabtai Adlersberg

Shabtai Adlersberg
Director

GREEN ACQUISITION CORP.

By: /s/ Shabtai Adlersberg

Shabtai Adlersberg
Director

By: /s/ William Ingram

William Ingram
President and Chief Executive Officer

SELLERS' REPRESENTATIVE*

By: /s/ Robert Wadsworth

Robert Wadsworth
M.D. HarbourVest Partners

* For purposes of Section 10.4 of this Agreement only.

Subsidiaries of AudioCodes, Ltd.

AudioCodes Inc

AudioCodes National Inc.

AudioCodes USA Inc

AudioCodes Europe Limited

AudioCodes Brasil Equipamentos de Voz sobre IP Ltda

AudioCodes Korea Co. Ltd.

AudioCodes Germany GmbH

AudioCodes Argentina SA

AudioCodes India Private Limited

AudioCodes Russ Ltd

AudioCodes France SAS

**CERTIFICATION PURSUANT TO
SECTION 302(a) OF THE SARBANES-OXLEY ACT OF 2002**

I, Shabtai Adlersberg, certify that:

1. I have reviewed this annual report on Form 20-F of AudioCodes Ltd.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the company as of, and for, the periods presented in this report;
4. The company's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the company and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the company, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;
 - (b) evaluated the effectiveness of the company's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (c) Disclosed in this report any change in the company's internal control over financial reporting that occurred during the period covered by the annual report that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting; and
5. The company's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the company's auditors and the audit committee of company's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the company's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the company's internal controls.

Date: June 29, 2006

/s/ SHABTAI ADLERSBERG

Shabtai Adlersberg
Chief Executive Officer

**CERTIFICATION PURSUANT TO
SECTION 302(a) OF THE SARBANES-OXLEY ACT OF 2002**

I, Nachum Falek, certify that:

1. I have reviewed this annual report on Form 20-F of AudioCodes Ltd.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the company as of, and for, the periods presented in this report;
4. The company's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the company and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the company, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;
 - (b) evaluated the effectiveness of the company's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (c) Disclosed in this report any change in the company's internal control over financial reporting that occurred during the period covered by the annual report that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting; and
5. The company's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the company's auditors and the audit committee of company's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the company's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the company's internal controls.

Date: June 29, 2006

/s/ NACHUM FALEK

Nachum Falek
Vice President Finance and
Chief Financial Officer

**CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Annual Report of AudioCodes Ltd. (the "Company") on Form 20-F for the period ending December 31, 2005 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Shabtai Adlersberg, Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to my knowledge:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

Date: June 29, 2006

/s/ SHABTAI ADLERSBERG

Shabtai Adlersberg
Chief Executive Officer

**CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Annual Report of AudioCodes Ltd. (the "Company") on Form 20-F for the period ending December 31, 2005 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Nachum Falek, Vice President and Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to my knowledge:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

Date: June 29, 2006

/s/ Nachum Falek

Nachum Falek
Vice President and
Chief Financial Officer

CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

We consent to the incorporation by reference in the following Registration Statements:

1. Registration Statement on Form F-3 (File No. 333-117703),
2. Registration Statement on Form F-3 (File No. 333-123859),
3. Registration Statement on Form S-8 (File No. 333-11894) pertaining to the AudioCodes Ltd. 1999 Key Employee Option Plan (F) and the AudioCodes Ltd. 1999 Key Employee Option Plan, Qualified Stock Option Plan-US Employees (F),
4. Registration Statement on Form S-8 (File No. 333-13268) pertaining to the AudioCodes Ltd. 1999 Key Employee Option Plan (F), as amended, and the AudioCodes Ltd. 1999 Key Employee Option Plan, Qualified Stock Option Plan-US Employees (F),
5. Registration Statement on Form S-8 (File No. 333-105473) pertaining to the AudioCodes Ltd. 1999 Key Employee Option Plan (F) and the AudioCodes Ltd. 1999 Key Employee Option Plan, Qualified Stock Option Plan-US Employees (F) , and
6. Registration Statement on Form S-8 (File No. 333-13378) pertaining to the AudioCodes Ltd. 2001 Employee Stock Purchase Plan Global Non-U.S. and the AudioCodes Ltd. 2001 U.S. Employee Stock Purchase Plan.

of our report dated February 1, 2006 with respect to the consolidated financial statements of AudioCodes Ltd. included in this Annual Report (Form 20-F) of AudioCodes Ltd.

/s/ KOST FORER GABBAY & KASIERER

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

Tel-Aviv, Israel
June 28, 2006
