

RADCOM LTD  
Form 20-F  
June 27, 2007

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, 2006

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

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 \_\_\_\_\_

Commission file number 0-29452

**RADCOM Ltd.**

(Exact name of Registrant as specified in its charter)

**Israel**

(Jurisdiction of incorporation or organization)

**24 Raoul Wallenberg Street, Tel-Aviv 69719, Israel**

(Address of principal executive offices)

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

Title of each class  
**Ordinary Shares, NIS 0.05 par value per share**

Name of each exchange on which registered  
**NASDAQ Global Market**

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

**None.**

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

**None.**

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:

**16,232,277 Ordinary Shares, NIS 0.05 par value 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 o No x

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 o No x

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 x No o

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. (Check one):

Large accelerated filer o Accelerated filer o Non-accelerated filer x

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

Item 17 o Item 18 x

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 o No x

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## INTRODUCTION

RADCOM develops, manufactures, markets and supports innovative network test and service monitoring solutions for communications service providers and equipment vendors. We were incorporated in 1985 under the laws of the State of Israel and commenced operations in 1991.

Except for the historical information contained herein, the statements contained in this annual report are forward-looking statements, within the meaning of the Private Securities Litigation Reform Act of 1995, with respect to our business, financial condition and results of operations. Actual results could differ materially from those anticipated in these forward-looking statements as a result of various factors, including all the risks discussed in “Item 3—Key Information—Risk Factors” and elsewhere in this annual report.

We urge you to consider that statements that use the terms “believe,” “do not believe,” “expect,” “plan,” “intend,” “estimate,” “anticipate,” and similar expressions are intended to identify forward-looking statements. These statements reflect our current views regarding future events and are based on assumptions and are subject to risks and uncertainties. Except as required by applicable law, including the securities laws of the United States, we do not intend to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

As used in this annual report, the terms “we,” “us,” “our” “RADCOM” and the “Company” mean RADCOM Ltd. and its subsidiaries, unless otherwise indicated.

PrismLite™, Omni-Q™, MediaPro™, GearSet™ and Wirespeed™ are our trademarks. All other trademarks and trade names appearing in this annual report are owned by their respective holders.

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**PART I**

**ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISORS**

Not applicable.

**ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE**

Not applicable.

**ITEM 3. KEY INFORMATION**

**A. SELECTED FINANCIAL DATA**

We have derived the following selected consolidated financial data as of December 31, 2005 and 2006 and for each of the years ended December 31, 2004, 2005, and 2006 from our consolidated financial statements and notes included in this annual report. The selected consolidated financial data as of December 31, 2002, 2003 and 2004 and for the years ended December 31, 2002 and 2003 have been derived from audited consolidated financial statements not included in this annual report.

You should read the selected consolidated financial data together with “Item 5—Operating and Financial Review and Prospects” and our consolidated financial statements included elsewhere in this annual report. All references to “dollar,” “dollars” or “\$” in this annual report are to the “U.S. dollar” or “U.S. dollars.” All references to “NIS” are to the New Israeli Shekels.

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Year Ended December 31,  
(in thousands of U.S. dollars - except weighted average number of ordinary shares,  
and basic and diluted income (loss) per ordinary share)

2002                      2003                      2004                      2005                      2006

Statement of Operations Data:

Revenues

Products	\$	14,028	\$	10,228	\$	13,956	\$	20,514	\$	20,641
Services		563		975		2,099		1,826		2,900
		14,591		11,203		16,055		22,340		23,541

Cost of revenues

Products		5,019		4,854		5,045		7,290		7,213
Services		28		40		82		108		183
		5,047		4,894		5,127		7,398		7,396
Gross profit		9,544		6,309		10,928		14,942		16,145

Operating expenses:

Research and development		6,481		5,593		5,232		5,815		6,826
Less - royalty - bearing participation		2,328		1,997		1,722		1,735		1,904
Research and development, net		4,153		3,596		3,510		4,080		4,922

Sales and marketing		8,306		7,411		6,983		7,881		9,196
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General and administrative		2,018		1,620		2,191		1,689		2,553
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Total operating expenses		14,477		12,627		12,684		13,650		16,671
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Operating income (loss)		(4,933)		(6,318)		(1,756)		1,292		(526)
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Financing income, net		217		93		78		235		472
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Net income (loss) for the year		(4,716)		(6,225)		(1,678)		1,527		(54)
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Basic net income (loss) per ordinary share	\$	(0.45)	\$	(0.59)	\$	(0.12)	\$	0.10	\$	(0.00)
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Weighted average number of ordinary shares used to compute basic net income

(loss) per ordinary share		10,492,050		10,493,184		13,453,509		14,696,090		15,894,036
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Diluted net income (loss) per ordinary share

	\$	(0.45)	\$	(0.59)	\$	(0.12)	\$	0.10	\$	(0.00)
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Weighted average number of ordinary shares used to compute diluted net income

(loss) per ordinary share		10,492,050		10,493,184		13,453,509		15,561,585		15,894,036
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Balance Sheet Data:



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Working capital	\$	10,707	\$	5,702	\$	10,051	\$	12,987	\$	15,783
Total assets	\$	19,429	\$	14,403	\$	20,129	\$	23,790	\$	27,753
Shareholders' equity	\$	12,344	\$	6,246	\$	10,024	\$	12,485	\$	15,373

**B. CAPITALIZATION AND INDEBTEDNESS**

Not applicable.

**C. REASONS FOR THE OFFER AND USE OF PROCEEDS**

Not applicable.

## D. RISK FACTORS

*Our business, operating results and financial condition could be seriously harmed due to any of the following risks, among others. If we do not successfully address the risks to which we are subject, we could experience a material adverse effect on our business, results of operations and financial condition and our share price may decline. We cannot assure you that we will successfully address any of these risks.*

### ***Risks Related to Our Business and Our Industry***

#### **We may incur losses in the future.**

Although we had net income in the fiscal year ended December 31, 2005, in the fiscal years ended December 31, 2004, and 2006, we incurred losses, and we also incurred a loss in the first quarter of 2007 of \$2.8 million, mainly as a result of the combination of weakness in the 3G Cellular market, longer average sales cycles and internal execution problems. We may incur losses in the future, which could materially affect our cash and adversely affect the value and market price of our shares.

#### **We have a history of quarterly fluctuations and unpredictability in our results of operations and expect these fluctuations to continue. This may cause our stock price to decline.**

We have experienced and expect to experience in the future significant fluctuations in our quarterly results of operations. Factors that may contribute to fluctuations in our quarterly results of operations include:

- the variation in size and timing of individual purchases by our customers;
- absence of long-term customer purchase contracts;
- seasonal factors that may affect capital spending by customers, such as the varying fiscal year-ends of customers and the reduction in business during the summer months, particularly in Europe;
- the relatively long sale cycles for our products;
- competitive conditions in our markets;
- the timing of the introduction and market acceptance of new products or product enhancements by us and by our customers, competitors and suppliers;
- changes in the level of operating expenses relative to revenues;
- product quality problems;
- supply interruptions;
- changes in global or regional economic conditions or in the telecommunications industry;
- delays in purchasing decisions or customer orders due to customer consolidation;
- changes in the mix of products sold; and
- size and timing of approval of grants from the Government of Israel.

We believe, therefore, that period-to-period comparisons of our operating results should not be relied upon as a reliable indication of future performance.

- Our revenues in any period generally have been, and may continue to be, derived from a relatively small number of orders with relatively high average revenues per order. Therefore, the loss of any order or a delay in closing a transaction could have a more significant impact on our quarterly revenues and results of operations than on those of companies with relatively high volumes of sales or low revenues per order. Our products generally are shipped within 15 to 30 days after orders are received. As a result, we generally do not have a significant backlog of orders, and revenues in any quarter are substantially dependent on orders booked, shipped and installed in that quarter.

We may experience a delay in generating or recognizing revenues for a number of reasons. Unfulfilled orders at the beginning of each quarter are typically substantially less than our expected revenues for that quarter. Therefore, we depend on obtaining orders in a quarter for shipment in that quarter to achieve our revenue objectives. Moreover, demand for our products may fluctuate as a result of seasonality.

Our revenues for a particular period may also be difficult to predict and may be adversely affected if we experience a non-linear (back-end loaded) sales pattern during the period. We generally experience significantly higher levels of sales towards the end of a period as a result of customers submitting their orders late in the period or as a result of manufacturing issues or component shortages which may delay shipments. Such non-linearity in shipments can increase costs, as irregular shipment patterns result in periods of underutilized capacity and periods when overtime expenses may be incurred, and also lead to additional costs associated with inventory planning and management. Furthermore, orders received towards the end of the period may not ship within the period due to our manufacturing lead times.

- Except for our cost of revenues, most of our costs, including personnel and facilities costs, are relatively fixed at levels based on anticipated revenue. As a result, a decline in revenue from even a limited number of orders could result in our failure to achieve expected revenue in any quarter and unanticipated variations in the timing of realization of revenue could cause significant variations in our quarterly operating results and could result in losses.
- If our revenues in any quarter remain level or decline in comparison to any prior quarter, our financial results could be materially adversely affected. In addition, if we do not reduce our expenses in a timely manner in response to level or declining revenues, our financial results for that quarter could be materially adversely affected.
- Due to the factors described above, as well as other unanticipated factors, in future quarters our results of operations could fail to meet the expectations of public market analysts or investors. If this occurs, the price of our ordinary shares may fall.

**A slowdown in the telecommunications industry generally, or in the sectors of the industry that we target (currently primarily 3G Cellular and triple-play networks), could materially adversely affect our revenues and results of operations.**

Our future success is dependent upon the continued growth of the telecommunications industry. The global telecommunications industry is evolving rapidly, and it is difficult to predict its potential growth rate or future trends in technology development. The deregulation, privatization and economic globalization of the worldwide telecommunications market that have resulted in increased competition and escalating demand for new technologies and services may not continue in a manner favorable to us or our business strategies. In addition, the growth in demand for Internet services and the resulting need for high speed or enhanced telecommunications equipment may not continue at its current rate or at all.

Our future success depends upon the increased utilization of our test solutions by next-generation network operators and telecommunications equipment vendors. Industry-wide network equipment and infrastructure development driving the demand for our products and services may be delayed or prevented by a variety of factors, including cost, regulatory obstacles or the lack of, or reduction in, consumer demand for advanced telecommunications products and services. Telecommunications equipment vendors and network operators may not develop new technology or enhance current technology. Further, any such new technology or enhancements may not lead to greater demand for our products.

**Continued negative trends and factors affecting the telecommunications industry specifically and the economy in general may result in reduced demand and pricing pressure on our products.**

Negative trends and factors affecting the telecommunications industry specifically and the economy in general over the past several years have negatively affected our results of operations. As a result of the build-up of capacity by telecommunications companies in the late 1990s, the telecommunications sector has been facing significant challenges from excess capacity, new technologies and intense price competition. This excess network capacity, combined with the failure of many competitors in the telecommunications sector, has contributed to delayed adoption of next-generation cellular and wireline networks. As a result, we experienced a significant decline in demand for our products in 2001, 2002 and the first half of 2003, resulting in a significant decline in sales and revenues. In addition, weak economic conditions in the last recession resulted in reduced capital expenditures, reluctance to commit to long-term capital outlays and longer sales processes for network procurements by our customers. Although this trend has abated, we cannot predict the duration of the improvement or the impact it may have on our results of operations. Furthermore, during the first quarter of 2007, we were affected by a slowdown in the pace of new 3G Cellular deployments. Finally, an overall trend toward industry consolidation and rationalization among our customers, competitors and suppliers can affect our business, especially if any of the sectors we service or the countries or regions in which we do business are affected. Industry consolidation may slow down the implementation of new systems and technologies. Any future weakness in the economy or the telecommunications industry could affect us through reduced demand for our products, leading to a reduction in revenues and a material adverse effect on our business and results of operations.

**The market for our products is characterized by changing technology, requirements, standards and products, and we may be materially adversely affected if we do not respond promptly and effectively to such changes.**

The telecommunications market for our products is characterized by rapidly changing technology, changing customer requirements, evolving industry standards and frequent new product introductions, certain changes of which could reduce the market for our products or require us to develop new products. For example, the sharp reduction in demand for our ATM and frame relay products during 2003 resulted in significantly reduced revenues for that year.

New or enhanced telecommunications and data communications-related products developed by other companies could be incompatible with our products. Therefore, our timely access to information concerning, and our ability to anticipate, changes in technology and customer requirements and the emergence of new industry standards, as well as our ability to develop, manufacture and market new and enhanced products successfully and on a timely basis, will be significant factors in our ability to remain competitive. For example, many of our strategic initiatives and investments are aimed at meeting the requirements of application providers of 3G Cellular and triple-play networks. If networking evolves toward greater emphasis on application providers, we believe we have positioned ourselves well relative to our key competitors. If it does not, however, our initiatives and investments in this area may be of no or limited value. As a result we cannot quantify the impact of new product introductions on our future operations.

In addition, as a result of the need to develop new and enhanced products, we expect to continue making investments in research and development before or after product introductions. Some of our research and development activities relate to long-term projects, and these activities may fail to achieve their technical or business targets and may be terminated at any point, and revenues expected from these activities may not be received for a substantial time, if at all.

**Our inventory may become obsolete or unusable.**

We make advance purchases of various component parts in relatively large quantities to ensure that we have an adequate and readily available supply. Our failure to accurately project our needs for these components and the demand for our products that incorporate them, or changes in our business strategy or technology that reduce our need for these components, could result in these components becoming obsolete prior to their intended use or otherwise unusable in our business. This would result in a write-off of inventories for these components.

**Any reversal or slowdown in deregulation of telecommunications markets could materially harm the markets for our products.**

Future growth in the markets for our products will depend, in part, on the continued privatization, deregulation and the restructuring of telecommunications markets worldwide, as the demand for our products is generally higher when a competitive environment exists. Any reversal or slowdown in the pace of this privatization, deregulation or restructuring could materially harm the markets for our products. Moreover, the consequences of deregulation are subject to many uncertainties, including judicial and administrative proceedings that affect the pace at which the changes contemplated by deregulation occur, and other regulatory, economic and political factors. Furthermore, the uncertainties associated with deregulation have in the past, and could in the future, cause our customers to delay purchasing decisions pending the resolution of these uncertainties.

**Our business could be harmed if we were to lose the services of one or more members of our senior management team, or if we are unable to attract and retain qualified personnel.**

Our future growth and success depends to a significant extent upon the continuing services of our executive officers and other key employees. We do not have long-term employment agreements or non-competition agreements with any of our employees. Competition for qualified management and other high-level telecommunications industry personnel is intense, and we may not be successful in attracting and retaining qualified personnel. If we lose the services of any key employees, we may not be able to manage our business successfully or to achieve our business objectives.

Our success also depends on our ability to identify, attract and retain qualified technical, sales, finance and management personnel. We have experienced, and may continue to experience, difficulties in hiring and retaining candidates with appropriate qualifications. If we do not succeed in hiring and retaining candidates with appropriate qualifications, our revenues and product development efforts could be harmed.

**We may lose significant market share as a result of intense competition in the markets for our existing and future products.**

Many companies compete with us in the market for network testing and service monitoring solutions. We expect that competition will increase in the future, both with respect to products that we currently offer and products that we are developing. Moreover, manufacturers of data communications and telecommunications equipment, which are current and potential customers of ours, may in the future incorporate into their products capabilities similar to ours, which would reduce the demand for our products. In addition, affiliates of ours that currently provide services to us may, in the future, compete with us.

Many of our existing and potential competitors have substantially greater resources, including financial, technological, engineering, manufacturing and marketing and distribution capabilities, and several of them may enjoy greater market recognition than us. We may not be able to compete effectively with our competitors. A failure to do so could adversely affect our revenues and profitability.



**We are dependent upon the success of distributors who are under no obligation to distribute our products.**

We are highly dependent upon our distributors for their active marketing and sales efforts and for the distribution of our products. Many of our distributors outside of North America and China are the only entities engaged in the distribution of our products in their respective geographical areas. Typically, our arrangements with them do not prevent our distributors from distributing competing products, or require them to distribute our products in the future. Our distributors may not give a high priority to marketing and supporting our products. Our results of operations could be materially adversely affected by changes in the financial situation, business or marketing strategies of our distributors. Any such changes could occur suddenly and rapidly.

**We may lose customers and/or distributors on whom we currently depend and we may not succeed in developing new distribution channels.**

We have one customer in North America who accounted for more than 10% of our sales in each of 2005 and 2006. If we were to lose this customer or if this customer were to reduce, delay or cancel its orders, our operating results could be harmed.

Our seven largest distributors accounted for a total of approximately 47.2% of our sales in 2004, 36.1% of our sales in 2005 and 40.7% of our sales in 2006. Two of our largest distributors in Europe each accounted for more than 10% of our sales in 2004 and one of our largest distributors in Europe accounted for about 10% of our sales in 2005. None of our distributors accounted for more than 10% of our sales in 2006. If we terminate or lose any of our distributors or if they downsize significantly, we may not be successful in replacing them on a timely basis, or at all. Any changes in our distribution and sales channels, particularly the loss of a major distributor or our inability to establish effective distribution and sales channels for new products, will impact our ability to sell our products and result in a loss of revenues.

**We could be subject to warranty claims and product recalls, which could be very expensive and harm our financial condition.**

Products as complex as ours sometimes contain undetected errors. These errors can cause delays in product introductions or require design modifications. In addition, we are dependent on other suppliers for key components that are incorporated in our products. Defects in systems in which our products are deployed, whether resulting from faults in our products or products supplied by others, due to faulty installation or any other cause, may result in customer dissatisfaction, product return and, potentially, product liability claims being filed against us. Our warranties permit customers to return defective products for repair. The warranty period is for one year. Any failure of a system in which our products are deployed (whether or not our products are the cause), any product recall or product liability claims with any associated negative publicity, could result in the loss of, or delay in, market acceptance of our products and harm to our business.

**We depend on limited sources for key components and if we are unable to obtain these components when needed, we will experience delays in manufacturing our products.**

We currently obtain key components for our products from either a single supplier or a limited number of suppliers. We do not have long-term supply contracts with any of our existing suppliers. This presents the following risks:

- Delays in delivery or shortages in components could interrupt and delay manufacturing and result in cancellations of orders for our products.
- Suppliers could increase component prices significantly and with immediate effect.



We may not be able to locate alternative sources for product components.

- Suppliers could discontinue the manufacture or supply of components used in our products. This may require us to modify our products, which may cause delays in product shipments, increased manufacturing costs and increased product prices.
- We may be required to hold more inventory than would be immediately required in order to avoid problems from shortages or discontinuance.
- We have experienced delays and shortages in the supply of components on more than one occasion in the past. This resulted in delays in our delivering products to our customers.

**We depend on a limited number of independent manufacturers, which reduces our ability to control our manufacturing process.**

We rely on a limited number of independent manufacturers, some of which are small, privately held companies, to provide certain assembly services to our specifications. We do not have any long-term supply agreements with any third-party manufacturer. If our assembly services are reduced or interrupted, our business, financial condition and results of operations could be adversely affected until we are able to establish sufficient assembly services supply from alternative sources. Alternative manufacturing sources may not be able to meet our future requirements, and existing or alternative sources may not continue to be available to us at favorable prices.

**If we do not effectively manage our planned growth, our business and operating results could be adversely affected.**

Our planned growth has placed, and is expected to continue to place, significant demands on our management and our administrative and operational resources. To manage our planned expansion effectively, we need to continue to develop and improve our operational and financial systems, sales and marketing capabilities and expand, train, retain, manage and motivate our employee base. Our systems, procedures or controls may not be adequate to support our operations and our management may not be able to successfully exploit future market opportunities or successfully manage our relationships with customers and other third parties. We may not continue to grow and, if we do, we may not effectively manage such planned growth. Any failure to manage planned growth could have an adverse effect on our business, financial condition and results of operations.

**Our proprietary technology is difficult to protect and unauthorized use of our proprietary technology by third parties may impair our ability to compete effectively.**

Our success and ability to compete depend in large part upon protecting our proprietary technology. We rely upon a combination of contractual rights, software licenses, trade secrets, copyrights, nondisclosure agreements and technical measures to establish and protect our intellectual property rights in our products and technologies. In addition, we sometimes enter into non-competition, non-disclosure and confidentiality agreements with our employees, distributors and manufacturers' representatives, and certain suppliers with access to sensitive information. However, we have no registered patents, and these measures may not be adequate to protect our technology from third-party infringement. Moreover, pursuant to current U.S. and Israeli laws, we may not be able to enforce certain existing non-competition agreements. Additionally, effective trademark, patent and trade secret protection may not be available in every country in which we offer, or intend to offer, our products.

**We may be subject to litigation, including without limitation, regarding infringement claims or claims that we have violated intellectual property rights, which could seriously harm our business.**

Third parties may from time to time assert against us infringement claims or claims that we have violated a patent or infringed a copyright, trademark or other proprietary right belonging to them. If such infringement were found to

exist, we might be required to modify our products or intellectual property or obtain a license or right to use such technology or intellectual property. Any infringement claim, even if not meritorious, could result in the expenditure of significant financial and managerial resources.

**Yehuda Zisapel and Zohar Zisapel, beneficially own approximately 33.3% of our ordinary shares and therefore have significant influence over the outcome of matters requiring shareholder approval, including the election of directors.**

As of June 15, 2007, Yehuda Zisapel and Zohar Zisapel (our Chairman of the Board of Directors), who are brothers, beneficially owned an aggregate of 5,475,662 ordinary shares, representing approximately 33.3% of the ordinary shares. As a result, Yehuda Zisapel and Zohar Zisapel have significant influence over the outcome of various actions that require shareholder approval, including the election of our directors. In addition, Yehuda Zisapel and Zohar Zisapel may be able to delay or prevent a transaction in which shareholders might receive a premium over the prevailing market price for their shares and prevent changes in control of management.

**We engage in transactions, and compete, with companies controlled by Yehuda Zisapel and Zohar Zisapel, which may result in potential conflicts.**

We are engaged in, and expect to continue to be engaged in, numerous transactions with companies controlled by Yehuda Zisapel and Zohar Zisapel. We believe that such transactions are beneficial to us and are generally conducted upon terms that are no less favorable to us than would be available from unaffiliated third parties. Nevertheless, these transactions may result in a conflict of interest between what is best for us and the interests of the other parties in such transactions. In addition, several products of such affiliated companies may be used in place of our products, and it is possible that direct competition between us and one or more of such affiliated companies may develop in the future. Moreover, opportunities to develop, manufacture, or sell new products (or otherwise enter new fields) may arise in the future and be pursued by one or more affiliated companies instead of or in competition with us. This could materially adversely affect our business and results of operations.

**We may encounter difficulties with our international operations and sales which could affect our results of operations.**

While we are headquartered in Israel, approximately 96.6% of our sales in 2005 and 98.5% of our sales in 2006 were generated outside of Israel, including in North America, Europe, Asia, South America and Australia. This subjects us to many risks inherent in international business activities, including:

- national standardization and certification requirements and changes in tax law and regulatory requirements;
- longer sales cycles, especially upon entry into a new geographic market;
- export license requirements;
- trade restrictions;
- changes in tariffs;
- currency fluctuations;
- economic or political instability;
- greater difficulty in safeguarding intellectual property; and
- difficulty in managing overseas subsidiaries, branches or international operations.

We may encounter significant difficulties in connection with the sale of our products in international markets as a result of one or more of these factors.

**Any inability to comply with Section 404 of the Sarbanes-Oxley Act of 2002 regarding internal control attestation may negatively impact the report on our financial statements to be provided by our independent auditors.**

We are subject to the reporting requirements of the United States Securities and Exchange Commission (the “SEC”). The SEC, as directed by Section 404 of the U.S. Sarbanes Oxley Act of 2002, adopted rules requiring public companies to include a report of management on the Company’s internal control over financial reporting in its annual report on Form 10-K or Form 20-F, as the case may be, that contains an assessment by management of the effectiveness of the Company’s internal control over financial reporting. In addition, the Company’s independent registered public accountants must attest to and report on management’s assessment of the effectiveness of the Company’s internal control over financial reporting. Our management may not conclude that our internal controls over financial reporting are effective. Moreover, even if our management does conclude that our internal controls over financial reporting are effective, if the independent accountants are not satisfied with our internal controls, the level at which our controls are documented, designed, operated or reviewed, or if the independent accountants interpret the requirements, rules or regulations differently from us, they may issue an adverse opinion on our internal control over financial reporting. Any of these possible outcomes could result in a loss of investor confidence in the reliability of our financial statements, which could negatively impact the market price of our shares.

In a release issued on December 15, 2006, the SEC extended the date by which a foreign private issuer that is a non-accelerated filer must comply with the disclosure requirements of Section 404 regarding management’s report on internal control over financial reporting to the annual report for fiscal years ending on or after December 15, 2007, and regarding the Section 404(b) requirement to provide an independent auditor’s attestation, to the annual reports for fiscal years ending on or after December 15, 2008.

If we determine that we are not in compliance with Section 404, we may be required to implement new internal control procedures and re-evaluate our financial reporting. We may experience higher than anticipated operating expenses as well as outside 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 conclusion that our internal controls over financial reporting are not effective.

**Our adoption of SFAS 123(R) will result in ongoing accounting charges that will significantly reduce our net income.**

In December 2004, the Financial Accounting Standards Board (the “FASB”) issued Statement of Financial Accounting Standards No. 123 (revised 2004) “Share-Based Payment” ( “SFAS 123(R)”), which requires all companies to measure compensation expense for all share-based payments (including employee stock options) at fair value, and which became effective for public companies for annual reporting periods of fiscal years beginning after June 15, 2005. Our adoption of SFAS 123(R) required us to record an expense of \$558,000 for stock-based compensation plans during 2006 and will continue to result in ongoing accounting charges that will significantly reduce our net income. See Note 6 of our Notes to the Consolidated Financial Statements for further information.

**If we are characterized as a passive foreign investment company, our U.S. shareholders may suffer adverse tax consequences.**

As more fully described below in “Item 10—Additional Information—Taxation—United States Federal Income Tax Considerations—Taxation of Ordinary Shares—Passive Foreign Investment Company Status,” if for any taxable year our passive income, or our assets that produce (or are held for the production of) passive income, exceed specified levels, we may be characterized as a passive foreign investment company for U.S. federal income tax purposes. This characterization could result in adverse U.S. tax consequences to our U.S. shareholders, including gain on the

disposition of our ordinary shares being treated as ordinary income and any resulting U.S. federal income tax being increased by an interest charge. Rules similar to those applicable to dispositions generally will apply to certain “excess distributions” in respect of our ordinary shares. U.S. shareholders should consult with their own U.S. tax advisors with respect to the U.S. tax consequences of investing in our ordinary shares.

**Volatility of the market price of our ordinary shares could adversely affect us and our shareholders.**

The market price of our ordinary shares has been and is likely to continue to be highly volatile and could be subject to wide fluctuations in response to numerous factors, including the following:

- market conditions or trends in our industry;
- political, economic and other developments in the State of Israel and worldwide;
- actual or anticipated variations in our quarterly operating results or those of our competitors;
- announcements by us or our competitors of technological innovations or new and enhanced products;
- changes in the market valuations of our competitors;
- announcements by us or our competitors of significant acquisitions;
- entry into strategic partnerships or joint ventures by us or our competitors; and
- additions or departures of key personnel.

In addition, the stock market in general, and the market for Israeli and technology companies in particular, has been highly volatile. Many of these factors are beyond our control and may materially adversely affect the market price of our ordinary shares, regardless of our performance. Shareholders may not be able to resell their ordinary shares following periods of volatility because of the market's adverse reaction to such volatility and we may not be able to raise capital through an offering of securities.

**From time to time we may need to raise financing. If adequate funds are not available on terms favorable to us or to our shareholders, our operations and growth strategy will be materially adversely affected.**

From time to time we may be required to raise financing in connection with our operations and growth strategy. We do not know whether additional financing will be available when needed, or whether it will be available on terms favorable to us. If adequate funds are not available on terms favorable to us or to our shareholders, our operations and growth strategy will be materially adversely affected.

**We might not satisfy all the requirements for continued listing on the NASDAQ Global Market, and our shares may be delisted.**

We are currently in compliance with all requirements for continued listing on the NASDAQ Global Market (the "NASDAQ"). We cannot assure you, however, that we will maintain such compliance over the long term or that we will be able to maintain compliance with all of the continued listing requirements for the NASDAQ Global Market. If we fail to comply with any of the continued listing requirements, we could be delisted from the NASDAQ Global Market. Our shares would then be quoted on the NASDAQ Capital Market (if we satisfy the continued listing requirements for that market) or the Over-The-Counter Bulletin Board. For example, from time to time during 2003, our share price decreased below the required minimum bid price, and we did not maintain the required minimum market value of publicly held shares. In addition, in 2003, we fell below the minimum \$10 million shareholders' equity requirement. In March 2004, we raised \$5.5 million in a private placement of 3,851,540 of our ordinary shares and warrants to purchase 962,887 of our ordinary shares. This equity financing enabled us, among other things, to sustain compliance with certain continued listing requirements of the NASDAQ Global Market. Depending upon our level of revenues in the future and the strategy we adopt, we may need to raise additional debt or equity capital to meet our working



capital needs in the future. Further, during 2007, the lowest closing price of our ordinary shares on the NASDAQ Global Market was \$1.33 per share. If our share price continues to decline we might be unable to satisfy the NASDAQ Global Market continued listing requirement of a minimum bid price of a \$1 per share.

***Risks Relating to Our Location in Israel***

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

We are incorporated under Israeli law and our principal offices and manufacturing and research and development facilities are located in the State of Israel. Political, economic and military conditions in Israel directly affect our operations. Since the establishment of the State of Israel in 1948, a number of armed conflicts have taken place between Israel and its Arab neighbors, and a state of hostility, varying in degree and intensity, has led to security and economic problems for Israel. We could be adversely affected by hostilities involving Israel, the interruption or curtailment of trade between Israel and its trading partners, a significant increase in inflation, or a significant downturn in the economic or financial condition of Israel. Since October 2000, there has been a marked increase in hostilities between Israel and the Palestinians, which has adversely affected the peace process and has negatively influenced Israel's relationship with several Arab countries. Also, the political and security situation in Israel may result in certain parties with whom we have contracts claiming that they are not obligated to perform their commitments pursuant to force majeure provisions of those contracts. 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. During the third quarter of 2006, Israel was engaged in war with the Hezbollah in Lebanon; however, the war did not materially affect the Company's results.

Since our manufacturing facilities are located exclusively in Israel, we could experience disruption of our manufacturing due to acts of terrorism or any other hostilities involving or threatening Israel. If an attack were to occur, any Israeli military response that results in the call to duty of the country's reservists (as further discussed below) could affect the performance of our Israeli facilities for the short term. Our business interruption insurance may not adequately compensate us for losses that may occur and any losses or damages incurred by us could have a material adverse effect on our business. We do not believe that the political and security situation has had any material impact on our business to date; however, we can give no assurance that it will have no such effect in the future.

Some neighboring countries, as well as certain companies and organizations, continue to participate in a boycott of Israeli firms and others doing business with Israel or with Israeli companies. We are also precluded from marketing our products to certain of these countries due to U.S. and Israeli regulatory restrictions. Because none of our revenue is currently derived from sales to these countries, we believe that the boycott has not had a material adverse effect on us. However, restrictive laws, policies or practices directed towards Israel or Israeli businesses could have an adverse impact on the expansion of our business.

All male adult citizens and permanent residents of Israel under the age of 51 are, unless exempt, obligated to perform military reserve duty annually. Additionally, these residents are subject to being called to active duty at any time under emergency circumstances. Many of our officers and employees are currently obligated to perform annual reserve duty. Given these requirements, we believe that we have operated relatively efficiently since beginning operations in 1991 and since increased hostilities with the Palestinians beginning in October 2000. In addition, our operations were not materially affected by the war with Lebanon that took place during the third quarter of 2006. However, we cannot assess what the full impact of these requirements on our workforce or business would be if the situation with the Palestinians changed, and we cannot predict the effect on our business operations of any expansion or reduction of these military reserve requirements.

**We may be adversely affected if the rate of inflation in Israel exceeds the rate of devaluation of the New Israeli Shekel against the dollar, and if the value of the New Israeli Shekel against the dollar increases.**

A portion of our expenses, primarily labor expenses, is incurred in NIS. As a result, we are exposed to the risk that the rate of inflation in Israel will exceed the rate of devaluation of the NIS in relation to the dollar or that the timing of this devaluation will lag behind inflation in Israel. Further, during certain periods of 2007 the dollar decreased in value relative to the NIS by about 5% compared to the level at the end of 2006. Although this trend started to shift back recently, if this trend towards devaluation continues, it, coupled with a high inflation rate in Israel, may result in higher dollar costs for our operations in Israel, adversely affecting our dollar-measured results of operations.

**We currently benefit from government programs and tax benefits that may be discontinued or reduced.**

We currently receive grants and potential tax benefits under Government of Israel programs. In order to maintain our eligibility for these programs and benefits, we must continue to meet specific conditions, including making specific investments in fixed assets and paying royalties with respect to grants received. In addition, some of these programs restrict our ability to manufacture particular products outside of Israel or to transfer particular technology. If we fail to comply with these conditions in the future, the benefits received could be canceled and we could be required to refund any payments previously received under these programs, or pay increased taxes. The Government of Israel has reduced the benefits available under these programs in recent years and these programs and tax benefits may be discontinued or curtailed in the future. If we do not receive these grants in the future, we will have to allocate funds to product development at the expense of other operational costs. The amount, if any, by which our taxes will increase depends upon the rate of any tax increase, the amount of any tax benefit reduction and the amount of any taxable income that we may earn in the future. If the Government of Israel ends these programs and tax benefits, our business, financial condition and results of operations could be materially adversely affected.

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

The Israeli Companies Law (the “Companies Law”) generally requires that a merger be approved by a company’s board of directors and by a majority of the shares voting on the proposed merger. Unless a court rules otherwise, the statutory merger will not be deemed approved if shares representing a majority of the voting power present at the shareholders meeting, and which are not held by the potential merger partner (or by any person who holds 25% or more of the shares of capital stock or the right to appoint 25% or more of the directors of the potential merger partner or its general manager), vote against the merger. Upon the request of any creditor of a party to the proposed merger, a court may delay or prevent the merger if it concludes that there is a reasonable concern that, as a result of the merger, the surviving company will be unable to satisfy its obligations. In addition, a merger may generally not be completed unless at least (i) 50 days have passed since the filing of the merger proposal with the Israeli Registrar of Companies by each of the merging companies, and (ii) 30 days have passed since the merger was approved by the shareholders of each of the parties to the merger.

Finally, Israeli tax law treats some acquisitions, such as stock-for-stock exchanges between an Israeli company and a foreign company less favorably than do U.S. tax laws. For example, Israeli tax law may, under certain circumstances, subject a shareholder who exchanges his ordinary shares for shares in another corporation to taxation prior to the sale of the shares received in such a stock-for-stock swap.

These provisions of Israeli corporate and tax law and the uncertainties surrounding such law may have the effect of delaying, preventing or making more difficult a merger with us or an acquisition of us. This result could prevent a change of control over us and depress our ordinary shares' market price which otherwise might rise as a result of such a change of control.

**It may be difficult to (i) effect service of process, (ii) assert U.S. securities laws claims and (iii) enforce U.S. judgments in Israel against directors, officers and auditors named in this annual report.**

We are incorporated in Israel. All of our executive officers and directors named in this annual report are non-residents of the United States, except for Avi Zamir who is a resident of the United States. A substantial portion of our assets and the assets of such 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 of those persons or to effect service of process upon those persons. It may also be difficult to enforce civil liabilities under U.S. federal securities laws in original actions instituted in Israel.

**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, and since February 20, 2006, on the Tel-Aviv Stock Exchange (the "TASE"). Trading in our ordinary shares are traded on these markets in different currencies (U.S. dollars on the NASDAQ and New Israeli Shekels on the 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 expected to be lower compared to the trading volume on the NASDAQ, and as such, could be subject to higher volatility. The trading prices of our ordinary shares on these two markets are expected to often differ, resulting from as a result of the factors described above, as well as in this paragraph, and because of 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.

#### **ITEM 4. INFORMATION ON THE COMPANY**

##### **A. HISTORY AND DEVELOPMENT OF THE COMPANY**

Both our legal and commercial name is RADCOM Ltd, and we are a corporation. RADCOM Ltd. was incorporated in 1985 under the laws of the State of Israel, and we commenced operations in 1991. The principal legislation under which we operate is the Israeli Company Laws 1999 (the "Israeli Companies Law"). Our principal executive offices are located at 24 Raoul Wallenberg Street, Tel Aviv 69719, Israel, and our telephone and fax numbers are 972-3-645-5055 and 972-3-647-4681, respectively. Our website is [www.radcom.com](http://www.radcom.com). Information on our website and other information that can be accessed through it are not part of, or incorporated by, reference into this annual report.

In 1993, we established a wholly-owned subsidiary in the United States, RADCOM Equipment, Inc. ("RADCOM Equipment, Inc."), a New Jersey corporation. RADCOM Equipment is located at 6 Forest Avenue, Paramus, New Jersey 07652, and its telephone number is (201) 518-0033. In 1996, we incorporated a wholly-owned subsidiary in Israel, RADCOM Investments (1996) Ltd. ("RADCOM Investments"), located at our office in Tel Aviv, Israel; its telephone number is the same as ours (972-3-645-5055). In 2001, we established a wholly-owned subsidiary in the United Kingdom, RADCOM (UK) Ltd., a United Kingdom corporation. RADCOM (UK) Ltd. is located at 2440 The Quadrant, Aztec West, Almondsbury, Bristol, BS32 4AQ England, and its telephone number is 44-1454-878827.

##### **B. BUSINESS OVERVIEW**

Below are the definitions of certain technical terms that are used throughout this 20-F and that are important for understanding our business.



## GLOSSARY

3G	A third-generation digital cellular telecommunication.
Asynchronous Transfer Mode (ATM)	A cell-based network technology protocol that supports simultaneous transmission of data, voice and video typically at T1/E1 or higher speeds.
Code Division Multiple Access (CDMA)	A digital wireless technology that uses a modulation technique in which many channels are independently coded for transmission over a single wideband channel.
CDMA2000 1X (EV-DO)	A third-generation digital high-speed wireless technology for packet-based transmission of text, digitized voice, video, and multimedia that is the successor to CDMA.
Time Division Synchronous Code Division Multiple Access (TD-SCDMA)	A 3G mobile telecommunications standard, being pursued in the People's Republic of China by the Chinese Academy of Telecommunications Technology (CATT).
Global System for Mobile Communications (GSM)	A digital wireless technology that is widely deployed in Europe and, increasingly, in other parts of the world.
General Packet Radio Service (GPRS)	A packet-based digital intermediate speed wireless technology based on GSM. (2.5 generation)
Universal Mobile Telecommunications Service (UMTS)	A third-generation digital high-speed wireless technology for packet-based transmission of text, digitized voice, video, and multimedia that is the successor to GSM.
Voice Over IP (VoIP)	A telephone service that uses the Internet as a global telephone network.
IP Multimedia Subsystem (IMS)	An internationally recognized standard defining a generic architecture for offering Voice over IP and multimedia services to multiple-access technologies.
Triple Play	A marketing term for the provisioning of the three services: high-speed Internet, television (Video on Demand or regular broadcasts) and telephone service over a single broadband connection.
Internet Protocol TV (IPTV)	Transmitting video in IP packets. Also called "TV over IP," IPTV uses streaming video techniques to deliver scheduled TV programs or video on demand (VOD).
Protocol	A specific set of rules, procedures or conventions governing the format, means and timing of transmissions between two devices.
Session	A lasting connection between a user (or user agent) and a peer, typically a server, usually involving the exchange of many packets between the user's computer and the server. A session is typically implemented as a layer in a network protocol.



## Overview

We develop, manufacture, market and support innovative network test and service monitoring solutions for communications service providers and equipment vendors. We specialize in next generation cellular as well as voice, data and video over IP networks. Our solutions are used in the development and installation of network equipment and in the maintenance of operational networks. Our products facilitate fault management, network service performance monitoring and analysis, troubleshooting and pre-mediation (the ability to collect network information for a third-party application). We currently offer the following solutions:

### *Network Monitoring*

Our award-winning Omni-Q is a unique, next-generation network testing, monitoring and performance management solution. The Omni-Q system consists of a powerful and user-friendly central management module and a broad range of intrusive and non-intrusive probes covering various networks and services, including VoIP, UMTS, CDMA, IPTV, IMS data and others. The Omni-Q's central management module is designed to exploit the unique capabilities and feature set of our probes. It consolidates captured information into a comprehensive, integrated network service view that facilitates performance monitoring, fault detection, and network and service troubleshooting.

### *Protocol Analyzers*

Our award-winning network protocol analyzers offer a powerful network analysis and test solutions available to the Cellular, VoIP and data communications industry. Our network analyzers support over 700 protocols with multiple interfaces, allowing users to troubleshoot and analyze the most complex and advanced networks, quickly and simply.

## Our Customers and the Market for Our Solutions

The key benefits of our solutions to markets and customers are described below;

*For Developers:* Reduced time to market, reduced development costs, automated testing and application versatility from research and development(" R&D") to QA (quality assurance) through final testing and field service.

*For Service Providers/Enterprises:*

- reduced quality degradation, reduced outages, improved network utilization and longer customer hold times;
- ability to employ fewer and less experienced maintenance staff due to the utilization of a single test system environment, controlled by a central console, ensuring ease of use and reduced learning curves; and
- decreased support costs through centralized management, portable high-end solutions for in-depth troubleshooting, ability to offer premium SLAs (service level agreements) and LOE (level of experience) parameters based on measurable parameters and all-inclusive, probe-based solution.

The market for our products consists of the following types of end-users:

*Telecommunications Service Providers (Cellular and Wireline)* are organizations responsible for providing telecommunications services. This group of companies uses of our product fall into four main categories:

- Fault detection - to detect when there is a problem.
-



Performance - to analyze the behavior of network components and customer network usage in order to understand trends, performance and optimization (to help identify faults before the customer complains).

· Troubleshooting - to drill down to resolve specific issues. and

· Pre-Mediation - to provide call detail records or CDR information to third-party operations support systems (OSS) or other solutions.

*Labs of Telecommunication Service Providers.* This group of customers includes companies that buy specific equipment and networks from manufacturers, and provide services to their customers. Our products may be used by these customers to evaluate the quality and performance of this equipment and networks and verify the conformance and interoperability between vendors.

*Data Communications and Telecommunications Equipment Developers and Manufacturers.* This group of customers includes companies that develop, manufacture and market data communications and telecommunications equipment.

## **Our Strategy**

Our objective is to become a market leader in network test and service monitoring solutions. To this end, we seek to deliver customer-oriented, technically advanced and cost-effective products and to support them according to world-class standards. Key elements of our strategy include:

- Capitalizing on the growth in the Cellular network and the move of wireline networks to IP technology markets and their associated monitoring needs;
- Leveraging and expanding our top-tier customer base and distribution channels to gain access to the service providers who are offering these new technologies;
- Broadening our penetration of major service providers and vendors;
- Extending our sales capabilities and distribution channels;
- Repeating sales to our existing customers;
- Leveraging our experience and knowledge in the area of converged networks and technology platforms to produce comprehensive testing and analysis solutions for triple-play networks;
- Maintaining technological leadership while addressing the needs of emerging technology markets;
- Partnering with companies that offer complementary solutions and applications; and
- Carrying out synergistic acquisitions of companies in tangent markets to broaden our solution portfolio and our sales and marketing reach.

Our sales network includes North America through our wholly-owned U.S. subsidiary, RADCOM Equipment, a sales office in China and, in the rest of the world, a network of more than 35 distributors selling in over 35 countries. RADCOM Equipment sells our products to end-users through a direct sales force and through 10 independent sales representatives. Our testing and monitoring equipment has been sold to a number of international companies and government agencies, including Hutchison, British Telecom, Telstra, Deutsche Telekom, Verizon Wireless, Vodafone, KPN, Nortel Networks, Lucent, Siemens, Cisco, NTT, NEC, Nokia, ZTE, Huawei, Detang, Alcatel and Ericsson.

## **Industry Background**

Service providers deploy unified, packet-based platforms with broadband and 3G technologies to enhance the value proposition of converged networks. These technologies allow service providers to offer new types of revenue-enhancing services, such as voice calls, video calls, video streaming, IPTV, music downloading and messaging solutions. Mainstream deployment of converged networks has begun and equipment vendors are under

pressure to develop and improve the required technologies. Both types of our main market players equipment vendors and service providers need sophisticated testing solutions. Equipment vendors need these solution to speed time-to-market while achieving the highest standard of products, and service providers need to evaluate vendors' products and to monitor customer experience and quality of service (QoS) on an ongoing basis. For these reasons, the demand for new testing and monitoring equipment is growing. For example, analysis from Frost & Sullivan, World VoIP Monitoring Solution Markets, reveals that the revenue in this industry totaled \$50.7 million in 2004 and projects to reach \$297.1 million in 2011.

## Products and Solutions

We categorize our products into two primary lines: (i) the Omni-Q network monitoring solution and (ii) the Performer Family.

### The Omni-Q Network Monitoring Solution

- The Omni-Q is a unique, comprehensive, next-generation network monitoring and services solution. The Omni-Q solution consists of a powerful and user-friendly central management server and a broad range of intrusive and non-intrusive probes covering various networks and services, including VoIP, UMTS, CDMA and data. These probes are based on the R70 probe and Performer family platforms, enabling the Omni-Q to deliver full visibility at the session and application level (and not only at the single packet or message level), with full 7-layer analysis. The R70 probe platform is an embedded Linux platform, based on our GearSet technology. The GearSet is a technology extension of our successful GEAR chip technology, allowing a full session tracing and analysis in a chip set and permitting wirespeed analysis of network services.
- In addition, the Omni-Q benefits global telecommunications carriers, by providing end-to-end voice quality monitoring and management. The Omni-Q is designed to enable service providers and vendors to successfully face tremendous challenges in the coming years, including:
  - deployment of next-generation networks such as UMTS, CDMA2000 and triple-play;
  - integration of new architectures such as high-speed downlink packet access (HSDPA), high-speed uplink packet access (HSUPA), long term evolution (LTE), IMS, UMTS Release 6 and CDMA Rev' A or evolution data voice (EVDV);
  - successful delivery of advanced services such as VoIP, IPTV and video conferencing; and
- proactive management of call quality on existing and next-generation service providers' production networks, along with maintenance of high-availability, high-quality voice services over packet telephony.
- Telecommunications Service Providers (Cellular and Wireline) use the Omni-Q in four main areas:
  - Fault detection - to detect when and where there is a problem.
  - Performance - to analyze the behavior of network components and customer network usage in order to understand trends, performance and optimization (i.e., to help identify faults before the customer complains).
  - Troubleshooting - to drill down to resolve specific issues.
  - Pre-Mediation - to provide call detail records or CDR information to third-party operations support systems (OSS) or other solutions.

The Omni-Q is comprised of the following components:

- The Omni-Q's central management module is designed to take advantage of the unique capabilities and feature set of our platform by consolidating the monitoring and analysis information into a comprehensive, integrated view that enables visibility, fault detection, performance and troubleshooting.
- The Omni-Q Wireline monitoring solution gives service providers, incumbent local exchange carriers (ILECs) and cable/multi-system operators(MSOs) complete visibility into the voice, video or TV service running over the network, enabling early-stage fault detection, pre-emptive maintenance and optimization, and drill-down troubleshooting that leads to quick and easy fault resolution.
- The Omni-Q UMTS/CDMA2000 Network Monitoring gives cellular service providers complete visibility into their networks, enabling long-term real-time traffic analysis, fault detection, troubleshooting and data collection. It monitors and analyzes the performance of Radio Access, Core Signaling and Core IP components. It provides extensive and flexible Key Performance Indicators (KPIs) and Key Quality Indicators (KQIs) analyses with real-time alarms that allow operators to detect faults before their customers experience problems.

### **The Performer Family**

The Performer family is an open platform that supports a wide range of test applications over a variety of technologies. With simplified control from a central console, the Performer hardware and software suite tests the quality and grade of service of a real-world network environment. The Performer family is a PC-based system, utilizing our generic analyzer processor, or GEAR-based, hardware. Our GEAR (GenEric AnalyzeR processor) chip is our main differentiating technology. It is a proprietary, one-chip analyzer processor designed to provide on all layers wirespeed testing performance, independent of protocols and technologies,. The GEAR processor positions us as the industry leader in the high-performance, communication test-equipment market. It allows one platform to carry out both network troubleshooting and analysis as well as packet and cell analysis in real time, at up to 2.5 gigabytes per second (Gbps), with no limitation on interface type or protocols. The GEAR technology also allows us to rapidly develop and roll out new interfaces by merely adding a new interface with the appropriate functionality. The Performer family is unique for its combination of strong hardware performance and flexible software use.

The Performer's architectural advantages include:

- Single Platform - Our single-platform technology enables all functions to be performed on one platform, as opposed to the multi-system architecture of its competitors;
- Scalable - Our systems are fully scalable, can migrate quickly to new applications, and can be easily integrated with third-party applications; and
- Distributed system - Our solution is based on a GPS synchronization technology, IP connectivity and management console/server architecture.

The Performer family response to customer needs is twofold:

- Post-deployment/quality management solutions and troubleshooting for convergence service providers, and
- Pre-deployment, predictive test systems for convergence vendors.

Our system solutions are critical for the successful rollout of next-generation 3G Cellular networks, Voice over IP and Video over IP technologies. Our solutions lead the market in their ability to troubleshoot connectivity problems and

analyze network performance, helping equipment vendors and service providers to ensure a trouble-free network environment and a high-quality user experience. We continuously extend our solutions in response to rapidly changing technology and customer requirements, evolving industry standards and frequent new product introductions. In addition, our ability to provide highly cost-effective solutions has been a critical asset in this competitive market.

### *Network Protocol Analyzer*

The Performer's innovative approach provides customers with real-time cell and packet analysis and troubleshooting capabilities at all seven telecommunications layers, including, basic physical and link layer testing, complex tracing of NAS layer voice, IP session signaling and data/voice quality of service validation. This analyzer supports Ethernet, WAN, ATM and POS interfaces, and can decode over 700 communication protocols. The Network Protocol Analyzer, a fully distributed system, is an ideal solution for vendor research and development, quality assurance and integration labs, as well as for use by operators during network setup and operation for protocol verification, cell/frame-level analysis, voice call and IP session analysis and streaming media and voice quality testing.

### *The Cellular Performer*

The Cellular Performer is an application that runs on our Performer platform launched in February 2003. The Cellular Performer is a multi-layer session-level analysis of applications and services that gives users a simple, intuitive and powerful troubleshooting tool. Used for drilling down to each of a cellular networks interfaces, our cellular protocol analysis tools enable users to trace a call over a whole network, and identify the source of network problems. This allows users to quickly pinpoint specific problems, and to smooth out the performance of highly complex networks. The product supports all major 2.5 and third-generation networks, including GPRS, UMTS, CDMA2000, Enhanced Data Rates for Global Revolution Standard (Edge) and Time Division Synchronous CDMA (TD-SCDMA).

The Network Consultant is an advanced cellular network analysis application that enables mobile operators to quickly verify subscriber connectivity and proactively monitor end-to-end network performance. The Network Consultant gathers and processes data from multiple server links from the Radio Access Network, Core signaling, and Core IP. It enables full drill-down analysis capabilities of the call session, voice calls and video calls. Using it, customers can zoom in and view the signaling and procedures on each interface separately - online and offline.

The RANalysis is a solution that enables fast and easy RAN analysis in UMTS networks. With the RANalysis, different types of RAN problems can be identified. And with the number of services, mobile devices, and customers expected to grow every year, radio-optimization engineers need a long-term solution that can provide a quick and easy view of problems in the cells. RANalysis offers engineers rich functionality, with an easy-to-use application and focused reports. RANalysis changes the way deep UMTS radio analysis is done. Based on a vast amount of detailed radio measurements, RANalysis supports the RAN optimization process, reduces the huge expenses involved in drive-testing and helps shorten radio troubleshooting turnaround time.

### *The Voice-over-IP Performer*

- The Voice-over-IP Performer is designed to support pre-deployment testing of current and emerging convergence technologies. The Voice-over-Data Performer is the first performance testing solution that we launched.

The following are some of the highlights of the Voice-over-IP Performer:

- SIPSim - The SIPSim is a SIP services load generator that focuses on high-stress load testing of any SIP application. The SIPSim provides high industry performance while retaining the flexibility needed to emulate all types of services. By emulating up to hundreds of thousands of users over the SIPSim's Triple Mcapability (multi-IP, multi-MAC and multi-VLAN), any service can be emulated over any type of network configuration. The SIPSim is capable of stress-testing different SIP services and network elements, including softswitch, SBC and IMS networks. Using the SipStudio, the user can build scripts to customize the SipSim to simulate almost any call flow. This is especially important in the IMS environment, where network topology is complex and each new service introduces a new flow;





- H.323Sim - a voice-over-IP generator that generates over 2000 calls simultaneously, at the rate of over 100,000 calls per hour, emulating the functionality of an H.323 terminal;
- MediaPro - A real-time hardware-based, multi-protocol, multi-technology VoIP and Video analyzer, capable of analyzing a wide variety of VoIP signaling protocols and media CODECs; and
- QPro - The QPro is a multi-technology call quality analyzer that enables users to test many call quality parameters over a variety of interfaces.

### **The Prism Series of Multitechnology Analyzers and Others**

- Part of our legacy product line is the PrismLite and PNNI simulation. The PrismLite addresses the needs of field service engineers and quality assurance and research and development labs, both of equipment developers and service providers who may need to test the operation of equipment using multiple technologies simultaneously. The PrismLite is convenient for transporting to on-site locations for the testing of internetworking problems. Starting in the first quarter of 2003, sales of the Prism series products for ATM and frame relay declined dramatically as our customers' transitioned to our new Performer product line. The PNNI simulation product, a software application used to test ATM switches running the Private Network to Network Interface (PNNI) protocol. This application enables the user to graphically design PNNI networks and simulate the existence of a multi-tiered network in its interaction with the ATM switch.

The following table shows the breakdown of our consolidated sales for the fiscal years 2004, 2005 and 2006 by product:

	2004	Year ended December 31,		2006
		2005		
		(in thousands of U.S. dollars)		
The Omni Q Family	\$ 200	\$ 3,940	\$ 15,765	
The Performer Family and others	\$ 15,855	\$ 18,400	\$ 7,776	
Total	\$ 16,055	\$ 22,340	\$ 23,541	

### **Sales and Marketing**

We sell our products in North America through our wholly-owned U.S. subsidiary, RADCOM Equipment, which sells our products to end-users primarily directly or through independent representatives. Most of these representatives have exclusive rights to the distribution of our products in their respective geographical areas throughout North America (with the exception of some accounts and the Omni-Q, our monitoring solution which we handle directly) and are compensated by us on a commission basis. The activities of our representatives and our other sales and marketing efforts in North America are coordinated by RADCOM Equipment's employees, who also provide product support to our North American customers. The independent representatives do not hold any of our inventory, and they do not buy products from us. Our representatives locate customers, provide a demo if needed (in which case they use our demo equipment), and in some cases they provide training to the end-users. The customers submit orders directly to our wholly owned subsidiary, RADCOM Equipment, which invoices the end-user customers and collects payment directly, and then pays commissions to the representative for the sales in their territory. The commission is between 7.5% and 15%, depending on the agreement RADCOM Equipment has with the individual representative.

Outside North America, we sell our products through a global network of distributors who market data communications-related hardware and software products. We currently have more than 35 independent distributors, some of whom have exclusive rights to sell our products in their respective geographical areas. We have opened regional sales support offices in China, Singapore, Korea and Spain. These offices support our distributors in these regions. We continue to search for new distributors to penetrate new geographical markets or to better serve our target markets.

Our distributors serve as an integral part of our marketing and service network around the world. They offer technical support in the end-user's native language, attend to customer needs during local business hours, organize user programs and seminars and, in some cases, translate our manuals and product and marketing literature into the local language. We have a standard contract with our distributors. Based on this agreement, sales to distributors are final, and distributors have no right of return or price protection. The distributors do not need to disclose to us their customers' names, prices or date of order. To the best of our knowledge, a distributor places an order with us after it receives an order from its end-user, and does not hold our inventory for sale. Usually, we are not a party to the agreements between distributors and their customers. Distributors may hold products for a demo or as repair parts in order to keep their service agreement with a customer. According to our agreement with the distributors, a distributor generally should buy at least one demo unit in order to present the equipment to their customers. This is a final sale, and there are no rights of return. The distributor cannot sell this equipment to the end-user; the license is only for the distributor. We do not consider this a benefit to the distributors since we sell only the demo systems with a special software discount.

We focus a significant amount of our sales and marketing resources on our distributors, providing them with ongoing communications and support, and our employees regularly visit distributors' sites. We organize annual distributors' meetings to further our relationships with our distributors and familiarize them with our products. In addition, in conjunction with our distributors, we participate in the exhibitions of our products worldwide, place advertisements in local publications, encourage exposure in the form of editorials in communications journals and prepare direct mailings of flyers and advertisements. The table below indicates the approximate breakdown of our revenue by territory:

	Year ended December 31, (in millions of U.S. dollars)			Year ended December 31, (in percentage)		
	2004	2005	2006	2004	2005	2006
North America	4.5	8.8	7.6	27.7%	39.5%	32.3%
Europe	8.5	8.6	9.4	53.1	38.5	40.0
Asia Pacific	2.3	3.3	2.6	14.3	14.8	11.1
South America	0.2	0.7	2.6	1.2	3.2	11.1
Others	0.6	0.9	1.3	3.7	4.0	5.5
Total revenues	16.1	22.3	23.5	100.0%	100.0%	100.0%

### Seasonality of Our Business

Generally, we are affected by the capital spending of the end-users of our products. These end-users tend to spend more towards the end of their fiscal year, which is typically the end of the calendar year, resulting in more orders during the second half of the year compared to the first half of the year. This has been the pattern over the last few years.

### Customer Service and Support

We believe that providing a high level of customer service and support to end-users is essential to the acceptance of our products. We offer a toll-free technical support help desk to our representatives in the United States and a

technical support help desk to our distributors worldwide. We also support our customers via fax, email and cellular phone service, and provide additional technical information on our Internet home page. We also offer an E-Learning system, which provides technical courses to our distributors, representatives and sales and technical support people at remote locations. These services are partially available to end-users. We regularly produce a newsletter which is sent to representatives and distributors, and we publish application notes and technical briefs for representatives, distributors and end-users to assist them in using our products more efficiently.

In addition to our direct service and support activities, our representatives in North America and our distributors worldwide provide to end-user customers sales, service and technical support functions for our products in their respective territories. We organize annual technical seminars in different areas of the world every year to increase the technical knowledge of distributors in the use of our products.

Our products are designed and manufactured to meet standards required by our customers. We provide a free one-year warranty, which includes bug-fixing solutions and a hardware warranty on our products. After the initial update period, our customers can purchase an extended warranty for one-, two- or three-year periods. The extended warranty includes bug fixing and full hardware repair of any faulty units. Generally the cost of the extended warranty is based on a percentage of the overall cost of the product as an annual maintenance fee. For the Prism products the cost is fixed.

### **Manufacturing and Suppliers**

Our manufacturing facilities, which are located in Tel Aviv, Israel, consist primarily of final assembly, testing and quality control. Electronic components and subassemblies are prepared by subcontractors according to our designs and specifications. Certain components used in our products are presently available from, or supplied by, only one source and others are only available from limited sources. In addition, some of the software packages that we include in our product line are being developed by unaffiliated subcontractors. The manufacturing processes and procedures are generally ISO 2000 and ISO 14000 certified.

### **Research and Development**

The industry in which we compete is subject to rapid technological developments, evolving industry standards, changes in customer requirements, and new product introductions and enhancements. As a result, our success, in part, depends upon our ability, on a cost-effective and timely basis, to continue to enhance our existing products and to develop and introduce new products that improve performance and reduce total cost of ownership. In order to achieve these objectives, we work closely with current and potential end-users, distributors and manufacturer's representatives and leaders in certain data communications and telecommunications industry segments to identify market needs and define appropriate product specifications. We intend to continue developing products that meet key industry standards and to support important protocol standards as they emerge. Still, there can be no assurances that we will be able to successfully develop products to address new customer requirements and technological changes, or that such products will achieve market acceptance.

Our gross research and development costs were approximately \$5.2 million in 2004, \$5.8 million in 2005 and \$6.8 million in 2006, representing 32.6%, 26.0% and 28.9% of our sales, respectively. Aggregate research and development expenses funded by the Office of the Chief Scientist were approximately \$1.7 million in 2004, \$1.7 million in 2005 and \$1.9 million in 2006. For more information on the Office of the Chief Scientist, see "Israeli Office of the Chief Scientist" below. We expect to continue to invest significant resources in research and development.

As of December 31, 2006, our research and development staff consisted of 71 employees. Research and development activities take place at our facilities in Tel Aviv. We occasionally use independent subcontractors for portions of our development projects.

### **Israeli Office of the Chief Scientist**

From time to time we file applications for grants under programs of the Office of the Chief Scientist of the Israeli Ministry of Industry, Trade and Labor, (the "Chief Scientist"). Grants received under such programs are repaid through a mandatory royalty based on revenues from products (and related services) incorporating know-how developed with the grants. This government support is contingent upon our ability to comply with certain applicable requirements and conditions specified in the Chief Scientist's programs and with the provisions of the Law for the Encouragement of Research and Development in Industry, 1984 and the regulations promulgated thereunder (the "R&D Law").

Under the R&D Law, research and development programs that meet the specified criteria and are approved by the Research Committee of the Chief Scientist (the "Research Committee") are usually eligible for grants of up to 50% of certain approved expenditures of such programs, as determined by this Research Committee.

In exchange, the recipient of such grants is required to pay the Chief Scientist royalties from the revenues derived from products incorporating know-how developed within the framework of each such program or derived from such program (including ancillary services in connection with such products), usually up to an aggregate of 100% of the dollar-linked value of the total grants received in respect of such program, plus interest. As of 2006, our royalty rate was 3.5%.

The Israeli government is currently in the process of formulating a proposed amendment to the royalty regulations promulgated under the R&D Law. The amendment is expected to include changes to the royalty rates, which would vary from company to company based on the amount of its revenues and the approval date of its program, up to a rate of 6%, and, as of 2006, to increase the rate of interest accruing on grants by 1% per year. The amendment was supposed to be effective retroactive to January 1, 2006, although there is no assurance as to whether and when it will be adopted.

The R&D Law generally requires that the product developed under a program be manufactured in Israel. However, upon notification to the Chief Scientist, up to 10% of the manufacturing volume may be performed outside of Israel; furthermore, with the approval of the Chief Scientist, a greater portion of the manufacturing volume may be performed outside of Israel, provided that the grant recipient pays royalties at an increased rate, which may be substantial, and the aggregate repayment amount is increased, which increase might be up to 300% of the grant, depending on the portion of the total manufacturing volume that is performed outside of Israel. The R&D Law further permits the Chief Scientist to approve the transfer of manufacturing rights outside Israel in exchange for an import of different manufacturing into Israel as a substitute, in lieu of the increased royalties. The R&D Law also allows for the approval of grants in cases in which the applicant declares that part of the manufacturing will be performed outside of Israel or by non-Israeli residents and the Research Committee is convinced that doing so is essential for the execution of the program. This declaration will be a significant factor in the determination of the Chief Scientist as to whether to approve a program and the amount and other terms of benefits to be granted. For example, the increased royalty rate and repayment amount will be required in such cases.

The R&D Law also provides that know-how developed under an approved research and development program may not be transferred to another person or entity in Israel without the approval of the Research Committee. Such approval is not required for the sale or export of any products resulting from such research or development. The R&D Law permits the transfer of Chief Scientist-funded know-how outside of Israel, under certain circumstances and subject to the Chief Scientist's prior approval, only in the following cases: (a) if the subject company pays to the Chief Scientist a portion of the sale price paid in consideration of such funded know-how; (b) if the subject company receives know-how from a third party in exchange for its funded know-how; or (c) if such transfer of funded know-how arises in connection with certain types of cooperation in research and development activities.



The R&D Law imposes reporting requirements with respect to certain changes in the ownership of a grant recipient. The law requires the grant recipient and its controlling shareholders and foreign interested parties to notify the Chief Scientist of any change in control of the recipient or a change in the holdings of the means of control of the recipient that results in a non-Israeli becoming an interested party directly in the recipient, and requires the new interested party to undertake to the Chief Scientist to comply with the R&D Law. In addition, the rules of the Chief Scientist may require additional information or representations in respect of certain of such events. For this purpose, “control” is defined as the ability to direct the activities of a company other than any ability arising solely from serving as an officer or director of the company. A person is presumed to have control if such person holds 50% or more of the means of control of a company. “Means of control” refers to voting rights or the right to appoint directors or the chief executive officer. An “interested party” of a company includes a holder of 5% or more of its outstanding share capital or voting rights, its chief executive officer and directors, someone who has the right to appoint its chief executive officer or at least one director, and a company with respect to which any of the foregoing interested parties owns 25% or more of the outstanding share capital or voting rights or has the right to appoint 25% or more of the directors. Accordingly, any non-Israeli who acquires 5% or more of our ordinary shares will be required to notify the Office of the Chief Scientist that it has become an interested party and to sign an undertaking to comply with the R&D Law.

The funds available for Chief Scientist grants made out of the annual budget of the State of Israel were reduced in 1998, and the Israeli authorities have indicated in the past that the government may further reduce or abolish the Chief Scientist grants in the future. Even if these grants are maintained, we cannot presently predict the amounts of future grants, if any, that we might receive. In each of the last ten fiscal years, we have received such royalty-bearing grants from the Chief Scientist. At December 31, 2006, our contingent liability to the Office of the Chief Scientist in respect of grants received was approximately \$20.9 million.

#### ***Binational Industrial Research and Development Foundation***

We received from the Binational Industrial Research and Development Foundation (the “BIRD Foundation”) funding for the research and development of products. At December 31, 2006, our contingent liability to the BIRD Foundation for funding received was approximately \$306,000. We have not received grants from the BIRD Foundation since 1995.

#### **Proprietary Rights**

To protect our rights to our intellectual property, we rely upon a combination of trademarks, contractual rights, trade secret law, copyrights, nondisclosure agreements and technical measures to establish and protect our proprietary rights in our products and technologies. We own registered trademarks for the names PrismLite, Omni-Q, MediaPro, GearSet and Wirespeed. In addition, we sometimes enter into non-disclosure and confidentiality agreements with our employees, distributors and manufacturer’s representatives and with certain suppliers with access to sensitive information. However, we have no registered patents or trademarks (except for those listed above) and these measures may not be adequate to protect our technology from third-party infringement, and our competitors may independently develop technologies that are substantially equivalent or superior to ours.

Given the rapid pace of technological development in the communications industry, there also can be no assurance that certain aspects of our internetworking test solutions do not or will not infringe on existing or future proprietary rights of others. Although we believe that our technology has been independently developed and that none of our technology or intellectual property infringes on the rights of others, from time to time third parties may assert infringement claims against us. If such infringement is found to exist, or if infringement is found to exist on existing or future proprietary rights of others, we may be required to modify our products or intellectual property or obtain the requisite licenses or rights to use such technology or intellectual property. However, there can be no assurance that such licenses or rights can be obtained or obtained on terms that would not have a material adverse effect on us.





## Competition

The markets for our products are very competitive and we expect that competition will increase in the future, both with respect to products that we are currently offering and products that we are developing. We believe that the principal competitive factors in the market for internetworking test and analysis equipment include:

- name recognition;
- product performance;
- product fit to customer workflow and procedures;
- support of the required interfaces and protocols;
- support of the right services;
- quality of the software and the hardware;
- technical features;
- multitechnology support;
- price;
- customer service and support;
- ease of use; and
- ability to integrate with other information systems.

Our principal competitors are Agilent , Tektronix, NetHawk, Anritsu (Nettest), SPIRENT Communications, Sunrise Telecom Inc., Empirix and Brix Networks. In addition to these competitors, we expect substantial competition from established and emerging computer, communications, network management and test equipment companies. Many of these competitors have substantially greater resources than we have, including financial, technological, engineering, manufacturing and market and distribution capabilities, and some of them may enjoy greater market recognition than we do.

## Employees

As of December 31, 2006, we had 129 permanent employees and 8 temporary employees located in Israel, 15 permanent employees of RADCOM Equipment located in the United States and 10 permanent employees in total located in Spain, Singapore, Korea and China, collectively. Of the 137 employees located in Israel, 71 were employed in research and development, 18 in operations (including manufacturing and production), 37 in sales and marketing and 11 in administration and management. Of the 15 employees located in the United States, 12 were employed in sales and marketing and 3 were employed in administration and management. All the 10 employees located in Spain, Singapore, Korea and China, were employed in sales and marketing. We consider our relations with our employees to be good and we have never experienced a labor dispute, strike or work stoppage. Most of our permanent employees have employment agreements and none of our employees are represented by labor unions. Our temporary employees are paid an hourly rate, have employment agreements and are not represented by a labor union.

Although we are not a party to a collective bargaining agreement, we are subject to certain provisions of general collective agreements between the Histadrut (General Federation of Labor in Israel) and the Coordinating Bureau of Economic Organizations (including the Industrialists' Association) that are applicable to our employees by virtue of expansion orders of the Israeli Ministry of Labor and Welfare. In addition, Israeli labor laws are applicable to all of our employees in Israel. These provisions and laws principally concern the length of the work day, minimum daily wages for workers, procedures for dismissing employees, determination of severance pay and other conditions of employment.

In Israel, a general practice we follow (although not legally required) is the contribution of funds on behalf of most of our permanent employees to an individual insurance policy known as “Managers’ Insurance.” This policy provides a combination of savings plan, insurance and severance pay benefits to the insured employee. It provides for payments to the employee upon retirement or death and accumulates funds on account of severance pay, if any, to which the employee may be legally entitled upon termination of employment. Each participating employee contributes an amount equal to 5% of such employee’s base salary, and we contribute between 13.3% and 14.7% of the employee’s base salary. Full-time employees who are not insured in this way are entitled to a savings account, to which each of the employee and the employer makes a monthly contribution of 5% of the employee’s base salary. We also provide our permanent employees with an Education Fund, to which each participating employee contributes an amount equal to 2.5% of such employee’s base salary and we contribute an amount equal to 7.5% of the employee’s base salary. In the United States we provide benefits, in the form of health, dental, vision and disability coverage, in an amount equal to 14.49% of the employee’s base salary. All Israeli employers, including us, are required to provide certain increases in wages as partial compensation for increases in the consumer price index. The specific formula for such increases varies according to the general collective agreements reached among the Manufacturers’ Association and the Histadrut. Israeli employees and employers also are required to pay pre-determined sums which include a contribution to national health insurance to the Israel National Insurance Institute, which provides a range of social security benefits.

### C. ORGANIZATIONAL STRUCTURE

In January 1993, we established our wholly-owned subsidiary in the United States, RADCOM Equipment which conducts the sale and marketing of our products in North America. In July 1996, we incorporated a wholly-owned subsidiary in Israel, Radcom Investments (1996) Ltd., for the purpose of making various investments, including the purchase of securities. As of June 15, 2007, Radcom Investments did not hold any of our outstanding shares. In August 2001, we established our wholly-owned subsidiary in the United Kingdom, RADCOM (UK) Ltd., which is currently not active, but in the past conducted the sales and marketing of our products in the United Kingdom. In 2002, we established our wholly-owned Representative Office in China, which conducts the sales and marketing for our products in China. Our subsidiaries include:

<u>Name of Subsidiary</u>	<u>Jurisdiction of Incorporation</u>
RADCOM Equipment, Inc.	United States
RADCOM Investments (1996) Ltd.	Israel
RADCOM (UK) Ltd.	United Kingdom

Yehuda Zisapel and Zohar Zisapel are co-founders and principal shareholders of our Company. Individually or together, they are also founders, directors and principal shareholders of several other privately and publicly held high technology and real estate companies which, together with us and the other subsidiaries and affiliates, are known as the “RAD-Bynet Group.” In addition to engaging in other businesses, members of the RAD-Bynet Group are actively engaged in designing, manufacturing, marketing and supporting data communications and telecommunications products. Our Company has limited competition with RADVision Ltd., which supplies as part of its technology package a protocol simulation that may serve some of the needs of our customers for test equipment. Some of the products of members of the RAD-Bynet Group are complementary to, and have been and are currently used in connection with, our products.

## **D. PROPERTY, PLANTS AND EQUIPMENT**

We do not own any real property. We currently lease an aggregate of approximately 2,462 square meters of office premises in Tel Aviv, which includes 2,196 square meters from affiliates of our principal shareholders. Our manufacturing facilities consist primarily of final assembly, testing and quality control of materials, wiring, subassemblies and systems. In 2006, aggregate annual lease and maintenance payments for the Tel Aviv premises were approximately \$519,000, of which approximately \$384,000 was paid to affiliates of our principal shareholders. We may, in the future, lease additional space from affiliated parties. We also lease premises in Paramus, New Jersey from an affiliate. In 2006, we leased approximately 6,131 square feet from an affiliate, 276 square feet of which we now sub-lease to a related party. In 2006, aggregate annual lease payments for the premises were approximately \$139,000 and we received \$5,000 from the related party for those sub-leases. We also lease approximately 142 square meters in Beijing. In 2006, our aggregate annual lease payments for those premises were approximately \$26,000. The rental agreements for the premises in Tel Aviv and New Jersey, United States, expire on December 31, 2008 and on January 15, 2011, respectively.

### **ITEM 4A. UNRESOLVED STAFF COMMENTS**

Not applicable.

## **ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS**

The following discussion of our financial condition and results of operations should be read in conjunction with the consolidated financial statements and the related notes included elsewhere in this annual report.

This discussion contains forward-looking statements regarding future events and our future results that are subject to the safe harbors created under the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended (the “Exchange Act”). These statements are based on current expectations, estimates, forecasts and projections about the industries in which we operate and the beliefs and assumptions of our management. Words such as “expects,” “anticipates,” “targets,” “goals,” “projects,” “intends,” “plans,” “believes,” “seeks,” “estimates,” “continues,” “may,” variation and similar expressions are intended to identify such forward-looking statements. In addition, any statements that refer to projections of our future financial performance, our anticipated growth and trends in our businesses, and other characterizations of future events or circumstances are forward-looking statements. Readers are cautioned that these forward-looking statements - including those identified below, as well as certain factors - including, but not limited to, those set forth in “Item 3—Key Information—Risk Factors” - are only predictions and are subject to risks, uncertainties, and assumptions that are difficult to predict. Therefore, actual results may differ materially and adversely from those expressed in any forward-looking statements. We undertake no obligation to revise or update any forward-looking statements for any reason.

### **Overview**

We develop, manufacture, market and support innovative network test and service monitoring solutions for communications service providers and equipment vendors. We specialize in next generation cellular as well as voice, data and video over IP networks. Our solutions are used in the development and installation of network equipment and in the maintenance of operational networks. Our products facilitate fault management, network service performance monitoring and analysis, troubleshooting and pre-mediation, the latter of which refers to the ability to collect network information for a third-party application.

### *General*

Our discussion and analysis of our financial condition and results of operation are based upon our consolidated financial statements, which have been prepared in accordance with generally accepted accounting principles in the United States. Our operating and financial review and prospects should be read in conjunction with our financial statements, accompanying notes thereto and other financial information appearing elsewhere in this annual report.

We commenced operations in 1991. Since then, we have focused on developing and enhancing our products, building our worldwide direct and indirect distribution network and establishing and expanding our sales, marketing and customer support infrastructures.

Most of our revenues are generated in U.S. dollars or are dollar-linked and the majority of our expenses are incurred in dollars and, as such, we use the dollar as our functional currency. Our consolidated financial statements are prepared in dollars and in accordance with generally accepted accounting principles in the United States.

Our technology vision is based on an architectural evolution of networking from simple connectivity of products to application systems, or as we refer to it, the "Application Provider." As such, many of our strategic initiatives and investments are aimed at meeting the requirements of Application Providers of 3G Cellular and triple-play networks. If networking evolves toward greater emphasis on Application Providers, we believe we have positioned ourselves well relative to our key competitors. If it does not, however, our initiatives and investments in this area may be of no or limited value. As a result we cannot quantify the impact of new product introductions on our historical operations or anticipated impact on future operations.

As we evaluate our growth prospects and manage our operations for the future, we continue to believe that the leading indicator of our growth will be the deployment of 3G Cellular and triple-play networks. During fiscal year 2006, we continued to focus our resources on the 3G Cellular segment and triple-play networks. While this potentially increases our exposure to changes in telecommunications industry conditions, we feel that this is a growing area and that we have the technology to capitalize on this market growth.

After commencing sales of our Performer in the first quarter of 2003, our revenues began to increase. Through 2005, our Performer family was the main driver increasing our revenues. In 2006 our comprehensive monitoring solution started to evolve as our main product. As a result of these developments, we enjoyed increased sales across all converged network product lines and the average size of our deals began to rise.

Our net sales for 2006 were \$23.5 million, compared with \$22.3 million in fiscal year 2005. Net loss for 2006 was \$54,000, compared with net income of \$1.5 million in fiscal 2005. We recorded negative cash flow of \$8.5 million for 2006 compared with a positive cash flow of \$4.0 million for 2005.

In 2007, we will continue to focus on our two major growth areas of 3G Cellular and triple-play networks with the goal of continuing to expand our sales and profits. With analysts (Informa Telecoms & Media, WCIS and 3G America) projecting that the 3G market will eventually include 200-300 operators and an even larger number of next-generation wireline players, we believe there is a lot of room for additional growth. However, in the first quarter of 2007 we identified weakness in our sales and marketing capabilities in North America and the Far East that have temporarily hindered our ability to take advantage of the strong potential of these markets, and that have significantly impacted our sales. Among the key factors that will influence our 2007 performance are the continued evolution of the global telecommunications industry towards converged services and our customers' perspective regarding the prospects for improving conditions, together with our ability to rectify our execution issues.

*Revenues.* Our revenues are derived primarily from sales of our products and, to a lesser extent, from sales of warranty services. Product revenues consist of gross sales of products, less discounts, refunds and returns.

*Cost of sales.* Cost of sales consists primarily of our manufacturing costs, warranty expenses, allocation of overhead expenses and royalties to the Chief Scientist. As part of our plan to reduce product cost and improve manufacturing flexibility, we have shifted to a subcontracting model for the manufacturing of our products. Currently, the functions performed by us are the planning and integration of other companies' solutions into our products, while the subcontractors purchase the component parts, assemble the product and test it. These functions can be divided as follows:

RADCOM

Planning

Integration

Subcontractor

Purchase component parts

Assembly

Testing

We provide a non-binding rolling forecast every quarter for the coming year, and submit binding purchase orders quarterly for material needed in the next quarter. Purchase orders are generally filled within three months of placing the order. We are charged by the unit, which ensures that unnecessary charges for reimbursements are minimal. We are not required to reimburse subcontractors for losses that are incurred in providing services to us and there are no minimum purchase requirements in our subcontracting arrangements. If we change components in our products, however, and the subcontractor already bought components based on a purchase order, we would reimburse the subcontractor for any losses incurred relating to the subcontractor's disposal of such components. The subcontracting arrangements are generally governed by one-year contracts that are automatically renewable and that can be terminated by either party upon ninety days' written notice.

By reducing fixed manufacturing costs, we seek to ensure that our cost of goods sold fluctuates more directly in line with revenues.

Our gross profit is affected by several factors, including the introduction of new products, price erosion due to increasing competition, product mix and integration of other companies' solutions into our own. During the initial launch and manufacturing ramp-up of a new product, our gross profit is generally lower as a result of manufacturing inefficiencies during that period. As the difficulties in manufacturing new products are resolved and the volume of sales of such products increases, our gross profit generally improves. For example, in 2003, during the initial launch of the Performer, our gross profit was lower and subsequently improved.

Most of our products consist of a combination of hardware and software. Following an initial purchase of a product, a customer can add additional functions by purchasing software packages. These packages may add functions to the product such as providing additional testing data or adding the ability to test equipment based on different transmission technologies. Since there are no incremental hardware costs associated with the sale of the add-on software, the gross margins on these sales are higher. We also have higher gross profit on sales in North America, where we sell directly and through representatives, than on sales outside North America where we sell through distributors.

*Research and Development.* Research and development costs consist primarily of salaries and, to a lesser extent, payments to subcontractors, raw materials and overhead expenses. We use raw materials to build prototypes of our hardware and software products. These prototypes have no value since they cannot be sold or otherwise capitalized as inventory. The allocation of overhead expenses consists of a variety of costs, including rent, office expenses (including telecommunications expenses) and administrative costs, such as human resources activities. The methodology for allocating these expenses depends on the nature of the expense. Costs such as rent and associated costs are based on the square meters used by the R&D department. Administrative costs such as human resources activities are allocated based on the number of employees in the department. There has been no change in methodology from year to year. These expenses have been partially offset by royalty-bearing grants from the Chief Scientist.





*Sales and Marketing.* Sales and marketing expenses consist primarily of salaries, commissions to representatives, advertising, public relations, trade shows, promotional expenses, web site maintenance, public relations and overhead expenses.

*General and Administrative Expenses.* General and administrative expenses consist primarily of salaries and related personnel expenses for executive, accounting and administrative personnel, professional fees (which include legal, audit and additional consulting fees), bad debt expenses and other general corporate expenses.

*Financial Income, Net.* Financial income, net, consists primarily of interest earned on bank deposits, gains and losses from the exchange rate differences of monetary balance sheet items denominated in non-dollar currencies and interest expenses paid on bank short-term loans.

#### ***Additional Expense for Share-Based Compensation***

SFAS 123(R), Share-Based Payment, which requires all companies to measure compensation expense for all share-based payments (including employee stock options) at fair value, became effective for public companies for fiscal years beginning after June 15, 2005. As a result of SFAS 123(R) we have been required to record an expense for stock-based compensation plans which has resulted in ongoing accounting charges that have significantly reduced our net income. For further information, see the section entitled "Share-Based Compensation" in Note 6 of the Notes to our Consolidated Financial Statements.

#### **Summary of Our Financial Performance in Fiscal Year 2006**

During the year ended December 31, 2006 our revenues increased by 5.4% to \$23.5 million, while our loss for the year increased to approximately \$54,000.

During fiscal 2006, our cash, cash equivalents and short-term deposits decreased by \$0.5 million, of which \$2.6 million of our cash, cash equivalents and short-term deposits was used in operating activities. Of this amount, \$2.4 million was provided from the sale of shares under our share option plans and exercise of warrants. Capital expenditures in fiscal 2006 amounted to \$0.3 million.

*Revenues.* We experienced a rise in sales quarter over quarter during the first three quarters of 2006, reflecting an increase in deals from major operators throughout the world with growing strength in South America, an important focus region for us. However, in the first quarter of 2007, the combination of weakness in the 3G Cellular market, longer average sales cycles and internal execution problems, led to a significant decrease in our revenues compared to the first quarter of 2006.

*Research and development.* Since our future success will depend upon our ability to introduce new products that address the changing demands of the telecommunications industry on a timely basis, we try to achieve a balance between the short-term and long-term challenges regarding demand. In 2006 we launched our new R70 probe based on the Gearset technology. The R70 platform sets a new level for monitoring and analysis next generation networks and provides service providers with comprehensive and correlated view of their 3G and triple-play networks.

*Sales and marketing.* Our sales and marketing focus for the last two years has been on large prospects, a strategy that has afforded us several significant sales but has also reduced the overall depth and breadth of our sales pipeline. In 2007, we plan to accelerate the pace of our sales and marketing efforts and costs with the goal of expanding our sales pipeline and closing rate.

#### **Organization of Our Business**

Management receives sales information by product groups and by geographical regions. The cost of material and related gross profit for the Omni-Q and the Performer family is almost identical. Research and development, sales and marketing, and general and administrative expenses are reported on a combined basis only (i.e. they are not allocated to product groups or geographical regions). Because a measure of operating profit or loss by product groups or geographical regions is not presented to the Company's management, we have concluded that we operate in one reportable segment.

**A. OPERATING RESULTS**

The following table sets forth, for the periods indicated, certain financial data expressed as a percentage of sales:

	Year Ended December 31,		
	2004	2005	2006
Sales	100.0%	100.0%	100.0%
Cost of sales	31.9	33.1	31.4
Gross profit	68.1	66.9	68.6
Operating expenses:			
Research and development	32.6	26.0	29.0
Less royalty bearing participation	10.7	7.8	8.1
Research and development, net	21.9	18.2	20.9
Sales and marketing	43.5	35.3	39.1
General and administrative	13.6	7.6	10.8
Total operating expenses	79.0	61.1	70.8
Operating income (loss)	(10.9)	5.8	(2.2)
Financial income, net	0.5	1.0	2.0
Net income (loss)	(10.4)	6.8	(0.2)

**Financial Data for Year Ended December 31, 2006 Compared with Year Ended December 31, 2005 and Year Ended December 31, 2004**

*Revenues*

	Year Ended December 31, (in millions of U.S. dollars)			% Change 2005 vs. 2004	% Change 2006 vs. 2005
	2004	2005	2006		
The Omni Q Family	0.2	3.9	15.7	1,850	303
The Performer Family and others	15.9	18.4	7.8	16	(58)
Total revenues	16.1	22.3	23.5	39	5

*Revenues.* Our revenue increased 5.4% over 2005 due to the continuing improvement in market conditions discussed above and our success in penetrating service providers around the world. During the first half of the year, the main component of our sales was to 3G cellular operators. In the second half of the year we began to see an increase in triple-play network deployments. This reflects a new scale of triple-play network deployments in the marketplace, and is indicative of the significant challenge the triple-play network operators must overcome in order to maintain quality services. Due to the nature of the service provider orders which represents a potential for larger sales on average than equipment vendor orders, both the average size of our transactions and the length of the sales cycle have increased.

Our sales network includes RADCOM Equipment, our wholly-owned subsidiary in the United States, as well as ten independent representatives, and more than 35 independent distributors in over 35 other countries. The table below shows the sales breakdown by territory:

	Year Ended December 31, (in millions of U.S. dollars)			Year Ended December 31, (as percentage)		
	2004	2005	2006	2004	2005	2006
North America	4.5	8.8	7.6	27.7%	39.5%	32.3%
Europe	8.5	8.6	9.4	53.1	38.5	40.0
Asia Pacific	2.3	3.3	2.6	14.3	14.8	11.1
South America	0.2	0.7	2.6	1.2	3.2	11.1
Others	0.6	0.9	1.3	3.7	4.0	5.5
Total revenues	16.1	22.3	23.5	100.0%	100.0%	100.0%

During 2005 we announced that we signed a multi million dollar contract with a major 3G CDMA mobile operator in North America. This major mobile operator in North America accounted for more than 10% of our sales both in 2005 and 2006. One of our distributors in Europe accounted for more than 10% of our sales in 2005.

#### *Cost of sales and Gross profit*

	Year ended December 31, (in millions of U.S. dollars)		
	2004	2005	2006
Cost of sales	5.1	7.4	7.4
Gross profit	10.9	14.9	16.1

*Cost of sales.* Since 2001, we have increasingly shifted to a subcontracting model for the manufacture of our products. As a result, cost of sales consisted of fixed costs of approximately \$1.8 million for 2006, \$1.3 million for 2005 and \$1.4 million for 2004. We believe that the reduction of our fixed manufacturing costs will ensure that our cost of sales fluctuates more directly in line with revenues.

Most of our revenues come from products that we develop internally, but in order to able to deliver a broader range of products and services to our customers in target markets, we must integrate other companies' solutions, mainly servers and storage units, into our Omni-Q system. The gross margins on these integrated sales are lower than the products that we develop internally. With revenue levels similar to 2006 or greater for the year we do not expect gross margins to change dramatically.

Our cost of sales during 2006 included an expense of \$14,000 for share-based compensation: \$0 in 2005 and \$2,000 in 2004. The following table provides the approximate operating costs and expenses of the Company in the 2004, 2005 and 2006, as well as the percent change of such expenses in 2005 compared to 2004 and in 2006 compared to 2005:

#### *Operating Costs and Expenses*

	Year ended December 31, (in millions of U.S. dollars)			% Change 2005 vs. 2004	% Change 2006 vs. 2005
	2004	2005	2006		
Research and Development	5.2	5.8	6.8	11.5	17.2
Less Royalty-bearing Participation	1.7	1.7	1.9	-	11.8
Research and Development, net	3.5	4.1	4.9	17.1	19.5

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Sales and Marketing	7.0	7.9	9.2	12.9	16.5
General and Administrative	2.2	1.7	2.6	(22.7)	52.9
Total Operating Expenses	12.7	13.7	16.7	7.9	21.9

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*Research and Development.* The increase in gross research and development expenses from 2005 to 2006 reflects our policy to support our growing activity and our long-term development goals. This increase is indicative primarily of an increase in the average number of our research and development personnel. Research and development expenses, gross, increased from \$5.8 million in 2005 to \$6.8 million in 2006. As a percentage of total revenues, research and development expenses, gross, increased from 26.0% in 2005 to 28.9% in 2006. Our research and development costs during 2006 included an expense of \$113,000 for share-based compensation: \$0 in 2005 and \$43,000 in 2004.

*Sales and Marketing.* In North America, we mainly sell our products primarily to end-users directly, which has increased our salary and other expenses. This increase, however, has been partially offset by lower commissions paid to sales representatives. We have also expanded our sales and marketing activities in China with the goal of preparing ourselves to address the area's emerging 3G market. We are still waiting for this development to materialize. The increase in sales and marketing expenses from 2005 to 2006, which included primarily an increase in the average number of sales personnel and salary expenses together with the expenses associated with opening our new sales offices in Singapore and Korea, reflects these activities. Sales and marketing expenses increased from approximately \$7.9 million in 2005 to approximately \$9.2 million in 2006. As a percentage of total revenues, sales and marketing expenses increased from 35.3% in 2005 to 39.1% in 2006.

Our sales and marketing expenses during 2006 included an expense of \$193,000 for share based compensation: \$0 in 2005 and \$34,000 in 2004.

*General and Administrative.* General and administrative expenses for 2006 increased by 51.2% compared to 2005. General and administrative expenses included a provision for bad debts and other expenses totaling approximately \$557,000 for 2006, \$17,000 for 2005 and \$11,000 for 2004. The other main reason for the increase in general and administrative expenses during 2006 was an expense of \$238,000 for share-based compensation: \$12,000 in 2005 and \$15,000 in 2004.

*Financial Income, Net.* Financial income, net, was approximately \$472,000 in 2006 compared to \$235,000 in 2005. The increase in financial income, net, in 2006 compared to 2005 was due to higher prevailing rates of return.

#### **Year Ended December 31, 2005 Compared to the Year Ended December 31, 2004**

The following discussion of 2005 compared with 2004 should be read in conjunction with the section of this report entitled "Financial Data for Year Ended December 31, 2006 Compared with Year Ended December 31, 2005 and Year Ended December 31, 2004."

*Revenues.* The increase in net sales in 2005 was primarily due to a significant rise in sales in North America. Our total revenue increased 39.1% over 2004 due to the continuing improvement in market conditions discussed above and our successful penetration into a large CDMA service provider. In addition, with our award-winning Omni-Q solution, next-generation network testing, monitoring and performance management solution, we have successfully penetrated the service provider market. Due to the nature of the service provider orders which represents a potential for larger sales on average than do equipment vendors, the average size of our transactions began to increase.

*Cost of Sales.* Since 2001, we increasingly shifted to a subcontracting model for the manufacture of our products. As a result, cost of sales consisted of fixed costs of approximately \$1.3 million for 2005, \$1.4 for 2004 and \$1.4 million for 2003. We believe that the reduction of our fixed manufacturing costs will ensure that our cost of sales fluctuates more directly in line with revenues.

*Research and Development.* The increase in gross research and development expenses from 2004 to 2005 reflects our policy to support our growing activity and our long-term development goals. This increase reflected primarily an increase in the average number of research and development personnel. Research and development expenses, gross, increased from \$5.2 million in 2004 to \$5.8 million in 2005. As a percentage of total revenues, research and development expenses, gross, decreased from 32.6% in 2004 to 26.0% in 2005.

*Sales and Marketing.* In some regions of North America, we started to sell our products to end-users directly, which has increased our salary and other expenses but this was partially offset by lower commissions paid to sales representatives. We have also expanded our sales and marketing activities in China with the goal of preparing ourselves to address the area's emerging 3G market. The increase in sales and marketing expenses from 2004 to 2005, including primarily an increase in the average number of sales personnel and salary expenses, reflects these activities. Sales and marketing expenses increased from approximately \$7.0 million in 2004 to approximately \$7.9 million in 2005. As a percentage of total revenues, sales and marketing expenses decreased from 43.5% in 2004 to 35.3% in 2005.

*General and Administrative.* There was a decrease in general and administrative expenses compared to 2004. As in 2004, we recorded approximately \$697,000 for litigation expenses and the settlement reached with Acterna LLC. This was partially offset by an increase in investor relation activities expenses. General and administrative expenses included a provision for bad debts and others totaling approximately \$17,000 for 2005, \$11,000 for 2004 and \$8,000 for 2003.

*Financial Income, Net.* Financial income, net, was approximately \$235,000 in 2005 compared to \$78,000 in 2004. The increase in financial income, net, in 2005 compared to 2004 was due to higher prevailing rates of return, higher cash and cash equivalents, and the exchange translation gain that resulted from revaluation of the NIS against the US dollar. (See the section entitled "Impact of Inflation and Currency Fluctuations" below.)

## **B. LIQUIDITY AND CAPITAL RESOURCES**

We have financed our operations through cash generated from operations, from the proceeds of our 1997 initial public offering and from our 2004 private placement transaction. Cash and cash equivalents, marketable securities and short-term deposits at December 31, 2004, 2005 and 2006 were approximately \$8.6 million, \$10.5 million and \$10.1 million, respectively. We believe that our existing capital will be sufficient for the Company's requirements for at least the next twelve months.

*Net Cash Generated by/Used in Operating Activities.* Net cash used in operating activities was approximately \$2.2 million in 2004 and \$2.6 million in 2006 while net cash generated from operations in 2005 was approximately \$1.4 million. The negative net cash flow in 2006 was primarily due to net increase of approximately \$2.7 million in trade receivables, an increase of approximately \$1.2 million in inventory and an increase of \$445,000 in other current assets. This was partially offset by loss of approximately \$54,000, employees' share-option compensation of \$558,000, increase of approximately \$380,000 in trade payables, increase of approximately \$276,000 in other payables and accruals and approximately \$603,000 of depreciation.

The trade receivables and days sales outstanding (DSO) are primarily impacted by payment terms, shipment linearity in the quarter and collections performance. Trade receivables increased during 2006 by \$2.7 million due primarily to the increase in our total revenue, payment terms extended to our customers and a higher concentration of shipments toward the end of the fourth quarter of 2006, which resulted in a shorter amount of time to collect the related accounts receivable before year-end and increased DSO. During 2007 we expect this trend to continue, resulting in higher DSOs than in previous years.

The overall increase in inventory in 2006 was due to the impact of increased sales, which resulted in increased production rates. All inventories are accounted for at the lower of cost or market.



The increase in other current assets in 2006 was primarily a result of an increase in prepaid expenses and Value Added Tax. The increase in trade payables is primarily due to the increase in purchases of inventory to meet our increased orders. The increase in payables and accruals in 2006 was primarily a result of an increase in employee-related expenses; this increase was offset by a decrease in accrued costs.

*Net Cash Provided by/Used in Investing Activities.* Our investing activities generally consist of two components: purchase and sale of short-term deposits and purchase of equipment. We invest cash that is surplus to our operating requirements in our short-term deposit portfolio in order to maximize our interest rates. In 2004 and 2006, we invested surplus cash in the amount of \$2.0 million and \$8.0 million, respectively. In 2005, we sold marketable securities which provided us cash in the amount of \$2.0 million. Net cash provided by (used in) investing activities in 2004, 2005 and 2006 was approximately \$2.3 million, \$1.7 million and \$(8.3) million, respectively.

*Purchase of Equipment.* Purchases of equipment in 2004, 2005 and 2006 were approximately \$292,000, \$336,000 and \$327,000, respectively. These expenditures were principally for computers and equipment purchases.

*Net Cash Provided by Financing Activities.* In 2004, net cash provided by financing activities totaled approximately \$5.4 million, approximately \$64,000 from the exercise of share options and approximately \$5.3 million from the private placement, which is described below under “Private Placement.” In 2005, net cash provided by financing activities totaled approximately \$909,000, of which \$184,000 came from the exercise of shares options and approximately \$725,000 from the exercise of warrants from the private placement as described below (see “Private Placement”). In 2006, net cash provided by financing activities totaled approximately \$2.4 million, \$974,000 from the exercise of share options and approximately \$1.4 million from the exercise of warrants from the private placement as described below (see “Private Placement”).

*Private Placement.* In March 2004, we raised \$5.5 million in a private placement, or PIPE, of ordinary shares and warrants. This equity financing enabled us, among other things, to sustain compliance with certain continued listing requirements of the NASDAQ Global Market. Under the PIPE transaction, we issued 3,851,540 of our ordinary shares at an aggregate purchase price of \$5.5 million, or \$1.428 per ordinary share. The investors in the PIPE included Star Ventures, B.C.S. Group, Yehuda Zisapel, Zohar Zisapel, and others. We also issued to the investors warrants to purchase up to 962,887 ordinary shares at an exercise price of \$2.253 per share. The warrants were exercisable for two years from the closing of the PIPE. As part of the private placement, we filed with the SEC a resale registration statement covering the shares purchased in the private placement (including the shares underlying the warrants); our F-3 was filed with the SEC on May 13, 2004, while our amended F-3/As were filed on October 15, 2004 and November 26, 2004. The registration was declared effective by the SEC on December 10, 2004. We incurred expenses of approximately \$89,000 in connection with the offering. Our net proceeds from the offering were approximately \$5.3 million. In 2005 and 2006 the investors exercised warrants to purchase 328,256 ordinary shares and 625,877 ordinary shares, respectively. Our net proceeds from these exercises were approximately \$725,000 and \$1.4 million, respectively.

### **Impact of Related Party Transactions**

We have entered into a number of agreements with certain companies, of which Yehuda Zisapel and Zohar Zisapel are co-founders, directors and/or principal shareholders, collectively known as the RAD-Bynet Group. Of these agreements, the office space leases and the distribution agreement with Bynet Electronics Ltd. (described in the section entitled “Related Party Transactions” below) in Israel are material to our operations. The pricing of the transactions was determined based on negotiations between the parties. Members of our management reviewed the pricing of the lease and distribution agreements and confirmed that these agreements were not different from terms that could have been obtained from unaffiliated third parties. We believe, however, that due to the affiliation between us and the RAD-Bynet Group, we have greater flexibility on certain issues than what may be available from unaffiliated third parties. In the event that the transactions with members of the RAD-Bynet Group are terminated and

we enter into similar transactions with unaffiliated third parties, that flexibility may no longer be available to us.

## **Impact of Inflation and Currency Fluctuations**

Substantially all of our sales and most of our expenses are denominated in U.S. dollars or are dollar-linked. The currency of the primary economic environment in which our operations are conducted is, therefore, the dollar, which is our functional currency.

Since we pay the salaries of our Israeli employees in NIS, the dollar cost of our operations is influenced by the exchange rates between the NIS and the dollar. While we incur some expenses in NIS, inflation in Israel will have a negative affect on our profits for contracts under which we are to receive payment in dollars or dollar-linked NIS, unless such inflation is offset on a timely basis by a devaluation of the NIS in relation to the dollar.

Inflation in Israel has occasionally exceeded the devaluation of the NIS against the dollar or we have faced the strengthening of the value of the NIS against the U.S. dollar. In the fourth quarter of 2004, for example, the value of the NIS expressed in dollar terms increased significantly, raising our Israeli-based costs as expressed in dollars. Under these conditions, we experienced higher dollar costs for our operations in Israel, adversely affecting our dollar-measured results of operations.

Because exchange rates between the NIS and the dollar fluctuate continuously exchange rate fluctuations will have an impact on our profitability and period-to-period comparisons of our results. The effects of foreign currency re-measurements are reported in our financial statements as financial income or expense.

## **Effective Corporate Tax Rate**

Israeli companies were generally subject to corporate tax on their taxable income at the rate of 31% for the 2006 tax year. Following an amendment to the Israeli Income Tax Ordinance [New Version], 1961 (the “Tax Ordinance”), which came into effect on January 1, 2006, the corporate tax rate decreased to 29% for the 2007 tax year and is scheduled to continue to decrease as follows: 27% for the 2008 tax year, 26% for the 2009 tax year and 25% for the 2010 tax year and thereafter. Israeli companies are generally subject to capital gains tax at a rate of 25% for capital gains (other than gains deriving from the sale of listed securities) derived after January 1, 2003.

Our manufacturing facilities have been granted “Approved Enterprise” status under the “Investments Law” - the Law for the Encouragement of Capital Investments, 1959, as amended - and consequently are eligible, subject to compliance with specific requirements, for tax benefits beginning when such facilities first generate taxable income. (For additional information on Approved Enterprise status, see “Item 10—Additional Information—Taxation—Israeli Tax Considerations—Law for the Encouragement of Capital Investments, 1959.”) The tax benefits under the Investment Law are not available with respect to income derived from products manufactured outside of Israel. We have derived, and expect to continue to derive, a substantial portion of our income from our Approved Enterprise facilities. We are entitled to a tax exemption for a period of two to four years (in respect of income derived from our Tel Aviv facility), commencing in the first year in which such income is earned, subject to certain time restrictions. These time periods have not yet commenced because we have incurred net operating losses for Israeli tax purposes. At December 31, 2006, we had net operating loss carry-forwards (unlimited in time) of approximately \$18.9 million.

Our effective corporate tax rate may substantially exceed the Israeli tax rate. Our U.S. subsidiary will generally be subject to applicable U.S. federal, state, local and foreign taxation, and we may also be subject to taxation in the other foreign jurisdictions in which we own assets, have employees or conduct activities. Our U.S. subsidiary had net operating loss carry-forwards of approximately \$11.2 million available at December 31, 2006 for U.S. federal and state income tax purposes. These carry-forwards may offset future taxable income and expire from 2008 through 2026 for U.S. federal income tax purposes. Because of the complexity of these local tax provisions, we are unable to anticipate the actual combined effective corporate tax rate that will apply to us. Our U.K. subsidiary had net loss carry-forwards available at December 31, 2006 of approximately \$401,000 for U.K. tax purposes.



We recorded a valuation allowance at December 31, 2006 for all of our deferred tax assets. Based on the weight of available evidence, it is more likely than not that all of our deferred tax assets will not be realized.

### **Government Grants and Related Royalties**

The Government of Israel, through the Office of the Chief Scientist, encourages research and development projects pursuant to the R&D Law and the regulations promulgated thereunder. We may receive from the Office of the Chief Scientist up to 50% of certain approved research and development expenditures for particular projects. We recorded grants from the Office of the Chief Scientist totaling approximately \$1.7 million in 2004, \$1.7 million in 2005 and \$1.9 million in 2006. Pursuant to the terms of these grants, we are obligated to pay royalties of 3.5% of revenues derived from sales of products (and related services) funded with these grants. In the event that a project funded by the Office of the Chief Scientist does not result in the development of a product which generates revenues, we would not be obligated to repay the grants we received for the product's development. Royalties' expenses relating to the Office of the Chief Scientist grants included in the cost of sales for years ended December 31, 2004, 2005 and 2006 were \$561,000, \$769,000 and \$807,000, respectively. The total research and development grants that we have received from the Office of the Chief Scientist as of December 31, 2006, were \$24.9 million. For projects authorized since January 1, 1999, the repayment interest rate is LIBOR. The accumulated interest as of December 31, 2006, was \$2.7 million. As of December 31, 2006, the accumulated royalties paid to the Office of the Chief Scientist were \$6.7 million. At December 31, 2006, our contingent liability to the Office of the Chief Scientist in respect of grants received was approximately \$20.9 million. For additional information, see "Item 4—Information on the Company—Business Overview—Israeli Office of Chief Scientist."

We are also obligated to pay royalties to the BIRD Foundation, with respect to sales of products based on technology resulting from research and development funded by the BIRD Foundation. Royalties to the BIRD Foundation are payable at the rate of 5% based on the sales revenues of such products, up to 150% of the grant received, linked to the United States Consumer Price Index. As of December 31, 2006, we had a contingent obligation to pay the BIRD Foundation aggregate royalties in the amount of approximately \$306,000. Since 1995 we have not received grants from the BIRD Foundation.

### **Critical Accounting Policies and Estimates**

Our significant accounting policies are more fully described in Note 2 to our Notes to the Consolidated Financial Statements. However, certain of our accounting policies are particularly important to the portrayal of our financial position and results of operations. In applying these critical accounting policies, our management uses its judgment to determine the appropriate assumptions to be used in making certain estimates. Those estimates are based on our historical experience, the terms of existing contracts, our observance of trends in the industry, information provided by our customers and information available from other outside sources, as appropriate. These estimates are subject to an inherent degree of uncertainty. With respect to our policies on revenue recognition, warranty costs and inventories, our historical experience is based principally on our operations since we commenced sales. Our critical accounting policies include the following:

*Revenue recognition.* Revenue from product sales is recognized in accordance with Statement of Position ("SOP") 97-2, "Software Revenue Recognition," when the following criteria are met: (1) persuasive evidence of an arrangement exists, (2) delivery has occurred, (3) the vendor's fee is fixed or determinable and (4) collectibility is probable. Amounts received from customers prior to product shipments are classified as advances from customers. With our products, we provide a one-year warranty, which includes bug fixing and a hardware warranty (the "Warranty"). We record an appropriate provision for Warranty in accordance with SFAS No. 5, "Accounting for Contingencies."

After the Warranty period initially provided with our products, we may sell extended warranty contracts, which includes bug fixing and a hardware warranty. In such cases, revenues attributable to the extended warranty are deferred at the time of the initial sale and recognized ratably over the extended contract warranty period.

Most of our revenues are generated from sales to independent distributors. We have a standard contract with our distributors. Based on this agreement, sales to distributors are final and distributors have no rights of return or price protection. We are not a party to the agreements between distributors and their customers.

We also generate sales through independent representatives. These representatives do not hold any of our inventories, and they do not buy products from us. We invoice the end-user customers directly, collect payment directly and then pay commissions to the representative for the sales in its territory. We report sales through independent representatives on a gross basis, based on the indicators of EITF 99-19, "Reporting Revenue Gross as a Principal versus Net as an Agent."

*Allowance for product warranty.* Our products sold are generally covered by a warranty for a period of one year. In respect of contracts where the warranty was recognized upon delivery, we recorded an appropriate provision.

*Trade receivables.* Trade receivables are recorded less the related allowance for doubtful accounts receivable. We consider accounts receivable to be doubtful when we think it is probable that we will be unable to collect all amounts, after taking into account current information regarding the customer's ability to repay its obligations. The balance sheet allowance for doubtful accounts for all of the reported periods through December 31, 2006, is determined as a specific amount for those accounts the collection of which is uncertain. If our customers' ability to repay their obligations diminishes in the future, the actual allowance for doubtful accounts may not be adequate.

*Inventories.* Inventories are stated at the lower of cost or market, cost being determined on the basis of the average cost method for raw materials and on the basis of actual manufacturing costs for work-in-progress and sub-contractors. Inventory write-off and write-down provisions are provided to cover risks arising from slow-moving items or technological obsolescence. Spare parts and raw materials that are no longer used in producing our product are written down to their fair market value. If changes in the market conditions or changes in the Company's products occur in the future, it is possible that additional write-off will be made at such time. In addition, we add to the cost of finished products and work in process held in inventory the overhead from our manufacturing process. If these estimates change in the future, the amount of overhead allocated to cost of revenues would change.

*Share option plans.* On January 1, 2006, we adopted SFAS No. 123, which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors based on estimated fair values. SFAS 123(R) supersedes our previous accounting under Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25") for periods beginning in fiscal 2006. In March 2005, the SEC issued Staff Accounting Bulletin No. 107 ("SAB 107") relating to SFAS 123(R). We have applied the provisions of SAB 107 in its adoption of SFAS 123(R). We adopted SFAS 123(R) using the modified prospective transition method, which requires the application of the accounting standard as of January 1, 2006. Our consolidated financial statements as of and for the year ended December 31, 2006, reflect the impact of SFAS 123(R). In accordance with the modified prospective transition method, our consolidated financial statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123(R). Share-based compensation expense recognized under SFAS 123(R) for fiscal 2006 was 558,000.

SFAS 123(R) requires companies to estimate the fair value of share-based payment awards on the grant date using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in our consolidated statements of operations. Prior to the adoption of SFAS 123(R), we accounted for share-based awards to employees and directors using the intrinsic value method in accordance with APB 25 as allowed under SFAS 123, "Accounting for Stock-Based Compensation" ("SFAS 123"). Share-based compensation expense recognized during the current period is based on the value of the portion of share-based payment awards that is ultimately expected to vest.

SFAS 123(R) requires forfeitures to be estimated at the time of grant in order to estimate the amount of share-based awards that will ultimately vest. The estimate is based on our historical rates of forfeiture. Share-based compensation expense recognized in our consolidated statement of operations for fiscal 2006 includes (i) compensation expense for share-based payment awards granted prior to, but not yet vested as of December 31, 2005, based on the grant-date fair value estimated in accordance with the pro forma provisions of SFAS 123 and (ii) compensation expense for the share-based payment awards granted subsequent to December 31, 2005, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123(R).

As share-based compensation expense recognized in the consolidated statements of operations for fiscal 2006 is based on awards ultimately expected to vest, it has been reduced by estimated forfeitures. Upon adoption of SFAS 123(R), we did not change our method of valuation for share-based awards which is the Black-Scholes option pricing model. See also Notes 2P and 6C of the Notes to our Consolidated Financial Statements, for further information.

*Deferred Income Tax.* We account for income taxes in accordance with SFAS No. 109, "Accounting for Income Taxes." Deferred tax asset and liability account balances are recognized for the future tax consequences attributable to differences between the financial statements' carrying amounts of existing assets and liabilities and their respective tax bases, and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in the consolidated statement of operations in the period that includes the enactment date. We provide a valuation allowance to reduce deferred tax assets to the extent we believe it is more likely than not that such benefits will not be realized.

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

See "Item 4—Business Overview—Research and Development" and "Business Overview—Proprietary Rights."

## **D. TREND INFORMATION**

In 2005, there was increased spending in the industry by service providers, compared to 2004, as they began to expand and upgrade their networks, including next-generation wireless technologies and Voice over Internet Protocol, or IP, solutions. This increase in industry spending was strongest with the build-up of new technologies in both established and emerging markets. Our traditional large competitors remain strong and focused on certain key factors, such as customer relationships, repeat sales to their customer base, innovative and reliable products, services and price.

In 2006, these trends continued but at a slower rate of increase in the cellular market, while in the second half of the year we began to see an increase in triple-play network deployments.

Data service adoption over the new 3G cellular networks is increasing but at a slower rate than expected. There are an increasing number of 3G networks but most of them are used mainly for voice. We continue to believe the data service adoption will occur and will introduce an increased demand for our solutions.

Fixed mobile Convergence (FMC) has become a significant challenge for most service providers. As result we see service providers consolidation. An example is the KPN and KPN mobile and Cingular and AT&T mergers. These mergers influence decision making processes, resulting in a temporary slowdown in procurement and deployment of new telecommunications equipment. From the technology side, IMS is being accepted as the technology of choice to implement and deliver converged network services. Different service providers, mainly those that own both cellular and wireline operations, are currently at the trial level and anticipate moving into operation during 2007 - 2009. This movement could increase the need for service a monitoring solution, as it is a new service platform and it introduces new challenges for service providers regarding how to monitor their networks.

Another area which has potential growth in the future is IPTV. Wireline service providers, mainly the incumbent carriers, are starting to spend money on TV over IP solution. In 2006 spending was limited mainly for trial networks, and this trend is expected to continue in 2007. We expect spending to increase in the years 2008 - 2010. This trend is part of a triple-play strategy aimed at competing with the cable operators offering digital TV.

#### **E. OFF-BALANCE SHEET ARRANGEMENTS**

None.

#### **F. TABULAR DISCLOSURE OF CONTRACTUAL OBLIGATIONS**

The following table of our material contractual obligations as of December 31, 2006, summarizes the aggregate effect that these obligations are expected to have on our cash flows in the periods indicated:

Contractual Obligations	Total	Payments due by period			
		Less than	2-3	4-5	More than
		1 year	years	years	5 years
(in thousands of U.S. dollars)					
Property Leases	\$ 1,603	\$ 693	\$ 810	\$ 100	--
Open purchase orders	1,350	1,350	--	--	--
Operating Leases	1,227	564	598	65	--
Total	\$ 4,180	\$ 2,607	\$ 1,995	\$ 277	--

*Open purchase orders.* We purchase components from a variety of suppliers and use several contract manufacturers to provide manufacturing services for our products. During the normal course of business, in order to manage manufacturing lead times and help assure adequate component supply, we enter into agreements with contract manufacturers and suppliers that allow them to procure inventory based upon criteria as defined by our requirements. In certain instances, we provide a non-binding forecast every 12 months, and we submit binding purchase orders quarterly for material needed in the next quarter. These agreements allow us the option to cancel, reschedule, and adjust our requirements based on our business needs prior to firm orders being placed. There are no penalties incurred for not taking delivery; however, if we alter the components in our products, when the manufacturer has bought components based on a purchase order, we reimburse the manufacturer for any losses incurred relating to the manufacturer's disposal of such components. Consequently, only a portion of our reported purchase commitments arising from these agreements are firm, non-cancelable, and unconditional commitments and included in the table



above.

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In addition, we are required to pay royalties as percentages of the revenues derived from products incorporating know-how developed from research and development grants from the Office of the Chief Scientist. Royalty rates were 3%-3.5% in 2003 and 3.5% in 2004 and subsequent years. As of December 31, 2006, our contingent liability to the Office of the Chief Scientist in respect of grants received was approximately \$20.9 million and our contingent liability to the BIRD Foundation in respect of funding received was approximately \$306,000. If we do not generate revenues from products incorporating know-how developed within the framework of these programs, we will not be obligated to pay royalties.

Further, we provided a performance guarantee in favor of a customer from Bank Hapoalim in Israel amounting to \$189,000 as of December 31, 2006.

## ITEM 6. DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES

### A. DIRECTORS AND SENIOR MANAGEMENT

The following table lists our current directors and executive officers:

Name	Age	Position
Zohar Zisapel	58	Chairman of the Board of Directors
David Ripstein	40	President, Chief Executive Officer
Jonathan Burgin	46	Chief Financial Officer
Shahaf Kieselstein	35	Vice President Research and Development
Hanan Klainer	46	Vice President Sales and Marketing
Doron Milchtaich	40	Chief Technology Officer
Miki Shilinger	52	Vice President Operations
Uzi Yahav	52	Vice President Business Development
Avi Zamir	50	President of RADCOM Equipment
Rony Ross (1)	57	Director
(2)(3)(4)		
Zohar Gilon (2)(4)	59	Director
Dan Barnea (1) (2)(4)	62	Director

(1) External Director

(2) Independent Director

(3) Chairwoman of Audit Committee

(4) Audit Committee Member

Mr. Zohar Zisapel, a co-founder of our Company, has served as our Chairman of the Board since our inception. Mr. Zisapel is also a founder and a director of RAD Data Communications Ltd., a worldwide data communications company headquartered in Israel, for which he currently serves as Chairman of the Board and served as President from 1982 to 1997. Mr. Zisapel is the Chairman of two other public companies RADVision Ltd., and Ceragon Ltd. as well as a director or Chairman of several private companies. Mr. Zisapel has a B.Sc. and an M.Sc. degree in Electrical Engineering from the Technion and an M.B.A. degree from Tel-Aviv University.

Mr. David Ripstein, our President and Chief Executive Officer since April 1, 2007, joined RADCOM in 2000 as General Manager of the Quality Management Unit, a position under which he formed and executed RADCOM's service quality management strategy and spearheaded the development of its differentiating R70 technology platform. In 2002, Mr. Ripstein was nominated to head the Company's R&D and marketing activities. In May 2006, Mr. Ripstein was appointed as RADCOM's Chief Operating Officer. Prior to joining RADCOM, Mr. Ripstein served for 11 years as an officer of an elite R&D unit within the Israel Defense Forces (IDF) Intelligence Division, and then co-founded two startups: Firebit, a provider of ISP security service solutions, and Speedbit, a developer of Internet download acceleration tools. Mr. Ripstein earned B.Sc. and M.Sc. degrees in Electronic Engineering from Israel's Technion Institute of Technology.

Mr. Jonathan Burgin, our Chief Financial Officer, joined us in July 2006. Prior to joining us, Mr. Burgin was Chief Financial Officer of XTL Biopharmaceuticals (NASDAQ XTLB; LSE: XTL; TASE:XTL) beginning in 1999, where he took an active part in the process of listing its shares on the NASDAQ, London, and Tel-Aviv Stock Exchanges and raising \$110 million in four financing rounds. Previously, Mr. Burgin served as Chief Financial Officer of YLR Capital Markets, a publicly-traded Israeli investment bank, and as Senior Manager at Kesselman & Kesselman, the Israeli member of PricewaterhouseCoopers International Ltd. Mr. Burgin earned an M.B.A. and a B.A. in Accounting and Economics from Tel-Aviv University and is certified in Israel as a CPA.

Mr. Shahaf Kieselstein, our VP of Research and Development, joined us in September 2006. Prior to joining RADCOM, he was with Intel's LAN Division for eight years, beginning as a Software Team Manager and moving on to the position of Project Manager of large-scale networking software at Intel's Oregon plant. In 2002, he returned to Israel to take on the position of Software Manager of Intel's Israel LAN Division. Prior to his tenure at Intel, Mr. Kieselstein spent several years as a software engineer at Digital Semiconductor. Mr. Kieselstein holds B.Sc. and M.Sc. degrees in Computer Science, as well as a B.A. in Accounting from Hebrew University.

Mr. Hanan Klainer, our Vice President of Sales, joined us in 1998 as Regional Marketing Manager and was then promoted to the position of Vice President of Sales. Prior to joining us, he worked with Scopus Video Networks where he was Marketing Manager. Before that, he worked at Orbotech as Technical Marketing Manager for the Japanese Market. Mr. Klainer has a B.Sc. degree in electronic engineering from Tel-Aviv University and an Executive M.B.A. from the Hebrew University in Jerusalem.

Mr. Doron Milchtaich joined RADCOM in 2001, for several years serving as Product Manager of Cellular Solutions, and later as Director, Cellular Products. Before joining the company, Mr. Milchtaich was a Product Manager in Comverse's SMS division. In 1998, he co-founded Targetix, a startup that developed a targeted Internet advertising solution. He was also a Director of real-time testing at Tescom, and prior to that spent several years as head of an R&D section in the IDF. Mr. Milchtaich holds an M.B.A. and B.Sc. in Mathematics, both from Tel Aviv University.

Mr. Avi Zamir, President of our wholly-owned U.S. subsidiary, RADCOM Equipment, rejoined us in May 2004. Mr. Zamir also serves as a director of RADCOM Equipment. From 1999 to 2004, Mr. Zamir was co-founder of Business Layers Inc., a company that focuses on eProvisioning solutions, which allow organizations to transform business rules and changes into a set of corresponding IT activities. Prior to that, from 1993 to 1999 Mr. Zamir was the President of RADCOM Equipment. Mr. Zamir has a practical engineering qualification from Ort Yad-Singalovski, Tel-Aviv.

Mr. Miki Shilinger, our Vice President of Operations, joined us in June 1999. From May 1997 to May 1999 he was Director of Purchasing and Logistics for Tadiran - Telematics Ltd., an Israeli company involved in the marketing, development and production of systems for the location of vehicles, cargo and people. Prior to that Mr. Shilinger was a Director of Logistics at Galtronics Ltd., one of the leading companies in the manufacture of portable antennas for cellular systems. Prior to that Mr. Shilinger was the owner of a Management Information Systems Consulting firm implementing ERP Systems. Mr. Shilinger has a B.Sc. degree in Industry and Management from Ben-Gurion University.

Mr. Uzi Yahav, our Vice President of Business Development, joined us in November 2005. From 2002 to October 2005, he was the Vice President of Marketing and Business Development at Optibase Ltd. a developer of IPTV solutions for major operators and carriers worldwide. From 1999 to 2002, Mr. Yahav was the Vice President of Marketing at Be Connected Ltd. a subsidiary of Telrad Networks Ltd., a developer of integrated telecommunication solution for carriers. Prior to that, he was the Product Manager for advanced wireless solutions at Teledata Networks Ltd. Mr. Yahav has a B.Sc. degree in Electrical Engineering from Ben Gurion University, and an M.B.A. degree from Haifa University.



Ms. Rony Ross has served as a Director since December 2000. She is the Executive Chairperson and founder of Panorama Software Ltd., a developer and marketer of Business Intelligence and on-line analytical processing (OLAP) systems and has been its Chief Executive Officer from 1993 until 2002. Ms. Ross has over 25 years experience in the software and hi-tech industry. Ms. Ross holds a B.Sc. degree in Mathematics and Statistics from Tel Aviv University, an M.B.A. degree from the Recanati Management School of Tel-Aviv University and an M.Sc. degree in Computer Science from the Weizmann Institute of Science.

Mr. Zohar Gilon has served as a Director since June 1995. He serves as a General Partner and Managing Director of Tamar Technologies Ventures, a venture capital fund investing in Israel and the U.S. From 1993 until August 1995, he served as President of W.S.P. Capital Holdings Ltd., which provides investment banking and underwriting services in Israel and invests in real estate and high-technology investments in Israel and abroad. Mr. Gilon serves as a director of another public company Radware Ltd., and of several private companies. Mr. Gilon is also a private investor in numerous high-technology companies, including affiliates of ours in Israel. He holds a B.Sc. degree in Electrical Engineering from the Technion and an M.B.A. degree from Tel-Aviv University.

Mr. Dan Barnea has served as a Director since September 1999. Mr. Barnea is Senior Vice President for Strategy and Corporate Development of BMC Software Inc., one of the world's largest software publishers. Prior to that he served as President and Chief Executive Officer of New Dimension Software, an Israeli-based mission critical software developer, from 1995 until its acquisition by BMC. From 1991 to 1995, Mr. Barnea was the General Manager and, later, President and Chief Executive Officer of Laser Industries Ltd., a world leader in the development of laser systems for medical applications. From 1987 to 1991, Mr. Barnea was the General Manager of Indigo Ltd., an innovator and leader in digital offset color printing. From 1981 to 1987, Mr. Barnea held senior positions at Elscint Ltd., then a developer of medical imaging equipment. Mr. Barnea holds a B.Sc. degree in Electronics and a M.Sc. in computer science from the Technion.

## **B. COMPENSATION**

The aggregate direct remuneration paid to all of our directors and officers as a group (16 persons) for the year ended December 31, 2006 was approximately \$1.6 million. This amount includes approximately \$215,000, which was set aside or accrued to provide pension, retirement or similar benefits, but does not include any amounts we paid to reimburse our affiliates for costs incurred in providing services to us during such period. These amounts include payments - \$0.6 million and \$85,000, respectively - to 4 persons who are no longer officers of the Company.

As of December 31, 2006, our directors and officers as a group held options to purchase an aggregate of 1,300,500 ordinary shares. Other than the options granted to our directors under the Directors Share Incentive Plan (1997), the 2001 Share Option Plan, the International Employee Stock Option Plan and the 2003 Share Option Plan and reimbursement for expenses, we do not compensate our directors for serving on our Board of Directors.

### **Share Option Plans**

We have the following eight share option plans for the granting of options to our employees, officers, directors and consultants: (i) the Directors Share Incentive Plan (1997); (ii) the 1998 Employee Bonus Plan; (iii) the 1998 Share Option Plan; (iv) the International Employee Stock Option Plan; (v) the 2000 Share Option Plan; (vi) the 2001 Share Option Plan; and (vii) the 2003 Share Option Plan. Options granted under our option plans generally vest over a period of between two and four years, and generally expire seven to ten years from the date of grant. The stock options plans are administered either by the Board of Directors or, subject to applicable law, by the Share Incentive Committee, which has the discretion to make all decisions relating to the interpretation and operation of the options plans, including determining who will receive an option award and the terms and conditions of the option awards.



In December 2004, the FASB issued SFAS 123(R), which requires all companies to measure compensation expense for all share-based payments (including employee stock options) at fair value, and became effective for public companies for annual reporting periods of fiscal years beginning after June 15, 2005. Our adoption of SFAS 123(R) required us to record an expense of \$558,000 for share-based compensation plans during 2006 and will result in ongoing accounting charges that will significantly reduce our net income. See Notes 2P and 6C of the Notes to the Consolidated Financial Statements for further information.

As of December 31, 2006, we have granted options to purchase 4,299,124 ordinary shares, of which options to purchase 1,629,363 ordinary shares have been exercised and options to purchase 2,669,761 ordinary shares remain outstanding.

In August 2006 we elected, pursuant to Rule 4350(a) of the Nasdaq Marketplace Rules, to follow our home country practice in lieu of the Nasdaq Marketplace Rules with respect to the approvals required for the establishment and for material amendments to our share option plans. Consequently, the establishment of share option plans and material amendments thereto is now subject to the approval of our Board of Directors and is no longer subject to our shareholders' approval.

## **C. BOARD PRACTICES**

### **Terms of Office**

Our directors are elected by the shareholders at the annual general meeting of the shareholders, except in certain cases where directors are appointed by the Board of Directors and their appointment is later ratified at the first meeting of the shareholders thereafter. Except for external directors (as discussed below), directors serve until the next annual general meeting. The current Board of Directors is comprised of Zohar Zisapel, Zohar Gilon, Dan Barnea and Rony Ross. None of our directors have service contracts with the Company relating to their serving as a director, and none of the directors will receive benefits upon termination of their position as a director.

### **External Directors**

We are subject to the provisions of the new Israeli Companies Law, 5759-1999, which became effective on February 1, 2000, superseding most of the provisions of the Israeli Companies Ordinance (New Version), 5743-1983.

Under the Companies Law, companies incorporated under the laws of Israel whose shares have been offered to the public in or outside of Israel are required to appoint at least two external directors. The Companies Law provides that a person may not be appointed as an external director if the person or the person's spouse, siblings, parents, grandparents, descendants, spouses' descendants of the spouse of any of the foregoing (collectively, a "relative"), partner, employer or any entity under the person's control, has, as of the date of the person's appointment to serve as external director, or had during the two years preceding that date, any affiliation with the company, any entity controlling the company or any entity controlled by the company or by such controlling entity. The term affiliation includes:

· an employment relationship;

· a business or professional relationship maintained on a regular basis;

· control; and

· service as an office holder (defined in the Israeli Companies Law as a (i) director, (ii) general manager, (iii) chief business manager, (iv) deputy general manager, (v) vice general manager, (vi) executive vice president, (vii) vice president, (viii) another manager directly subordinate to the general manager and (ix) any other person assuming the



responsibilities of any of the forgoing positions without regard to such person's title), excluding service as a director who was appointed to serve as an office holder during the three-month period in which the company first offers its shares to the public.

No person may serve as an external director if the person's position or other business creates, or may create, a conflict of interest with the person's responsibilities as an external director or if his or her position or business may interfere with his or her ability to serve as a director. Until the lapse of two years from termination of service as an external director, a company may not engage an external director to serve as an office holder and cannot employ or receive services from that person, either directly or indirectly, including through a corporation controlled by that person.

External directors are to be elected by a majority vote at a shareholders meeting, provided that either:

- a majority of the shares voted at the meeting, including at least one third of the shares of non-controlling shareholders, vote in favor of the election; or
- the total number of shares voted against the election of the external director does not exceed one percent of the aggregate number of voting shares of the company.

The initial term of an external director is three years and may be extended for an additional three years. In certain special situations, the term may be extended beyond these periods. Each committee of a company's board of directors is required to include at least one external director. Both Rony Ross and Dan Barnea qualify as external directors under the Companies Law. At least one of the external directors has been appointed to each of the committees.

#### Audit Committee

##### *Nasdaq Requirements*

Our ordinary shares are listed for quotation on the NASDAQ Global Market and we are subject to the rules of the Nasdaq Marketplace Rules applicable to listed companies. Under the current Nasdaq rules, a listed company is required to have an audit committee consisting of at least three independent directors, all of whom are financially literate and one of whom has accounting or related financial management expertise. Rony Ross, Dan Barnea and Zohar Gilon qualify as independent directors under the current Nasdaq requirements, and all are members of the Audit Committee. Zohar Gilon is our "audit committee financial expert." In addition, we have adopted an Audit Committee charter.

As stated in our Audit Committee charter, the Audit Committee assists our board 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 engagement fees and all permitted non-audit services and fees.

##### *Companies Law Requirements*

Under the Companies Law, the board of directors of a public company is required to appoint an audit committee, which must be comprised of at least three directors and include all of the external directors, but may not include:

- the chairman of the board of directors;
- any controlling shareholder or any relative of a controlling shareholder; and

any director employed by the company or providing services to the company on a regular basis.

The duty of the audit committee is to identify irregularities in the management of the company's business, including in consultation with the internal auditor and the company's independent accountants, and to recommend remedial action relating to such irregularities. In addition, the approval of the audit committee is required under the Companies Law to effect certain related-party transactions.

An audit committee of a public company may not approve a related-party transaction under the Companies Law unless at the time of such approval the external directors are serving as members of the audit committee and at least one of them is present at the meeting at which such approval is granted.

Under the Companies Law, the board of directors of a public company must also appoint an internal auditor proposed by the audit committee. The duty of the internal auditor is to examine, among other things, whether the company's conduct complies with applicable law and orderly business procedure. Under the Companies Law, the internal auditor may not be an interested party, an office holder, or an affiliate, or a relative of an interested party, an office holder or affiliate, nor may the internal auditor be the company's independent accountant or its representative. An interested party is defined in the Companies Law as a 5% or greater shareholder, any person or entity who has the right to designate at least one director or the general manager of the company and any person who serves as a director or as a general manager.

Mr. Yossi Ginosar a partner of Fahn Kanne & Co., a member of Grant Thornton, serves as our internal auditor.

#### **Exculpation, Indemnification and Insurance of Directors and Officers**

We have agreed to exculpate and indemnify our office holders to the fullest extent permitted under the Companies Law. We have also purchased a directors and officers liability insurance policy. For information regarding exculpation, indemnification and insurance of directors and officers under applicable law and our articles of association, see "Item 10—Additional Information—Memorandum and Articles of Association."

#### **Management Employment Agreements**

We maintain written employment agreements with substantially all of our key employees. These agreements provide, among other matters, for monthly salaries, our contributions to Managers' Insurance and an Education Fund and severance benefits. Most of our agreements with our key employees are subject to termination by either party upon the delivery of notice of termination as provided therein.

#### **Nominating Committee**

The nominees to our Board are selected or recommended to the Board by our Audit Committee which performs the function of a Nominating Committee, and is comprised solely of independent directors provided that no such recommendation is required in cases, if any, where the right to nominate a director legally belongs to a third party. The written procedures addressing the nominating process, were approved by our Board. As members of our Audit Committee, Rony Ross, Dan Barnea and Zohar Gilon also constitute our Nominating Committee.

#### **Compensation Committee**

The compensation payable to executive officers must be approved either by a majority of the independent directors on our board or by a Compensation Committee comprised solely of independent directors. Our Audit Committee which is comprised solely of independent directors also serves as a Compensation Committee. As such, Rony Ross, Dan Barnea and Zohar Gilon, members of our Audit Committee, also comprise our Compensation Committee.

#### **D. EMPLOYEES**

As of December 31, 2006, we had 162 permanent and temporary employees worldwide, of which 81 were employed in research and development, 48 in sales and marketing, 15 in management and administration and 18 in operations. As of December 31, 2006, 137 of our employees were based in Israel, 15 were based in the United States and 10 were based in Spain, Singapore, Korea and China. All of our employees have executed employment agreements, including confidentiality and non-compete provisions, with us. We are subject to labor laws and regulations in Israel and the United States. We and our Israeli employees are also subject to certain provisions of the general collective agreements between the Histadrut (General Federation of Labor in Israel) and the Coordination Bureau of Economic Organizations (including the Industrialists Association) by order of the Israeli Ministry of Labor and Welfare. None of our employees are represented by a labor union and we have not experienced any work stoppages.

**E. SHARE OWNERSHIP**

The following table sets forth certain information regarding the beneficial ownership of our ordinary shares by our directors and officers as of June 15, 2007. The percentage of outstanding ordinary shares is based on 16,355,238<sup>(3)</sup> ordinary shares outstanding as of June 15, 2007.

Name	Number of Ordinary Shares Beneficially Owned <sup>(1)</sup>	Percentage of Outstanding Ordinary Shares Beneficially Owned <sup>(2) (3)</sup>
Zohar Zisapel <sup>(4)</sup>	3,626,342	22.1%
All directors and executive officers as a group (12 persons) <sup>(1) (2) (5)</sup>	4,229,042	24.9%

- (1) Pursuant to applicable community property laws, each person named in the table has sole voting and investment power with respect to all ordinary shares listed as owned by such person. Shares beneficially owned include shares that may be acquired pursuant to options to purchase ordinary shares that are exercisable within 60 days of June 15, 2007.
- (2) For determining the percentage owned by each person or group, ordinary shares for each person or group include ordinary shares that may be acquired by such person or group pursuant to options to purchase ordinary shares that are exercisable within 60 days of June 15, 2007.
- (3) The number of outstanding ordinary shares does not include shares that were repurchased by us.
- (4) Includes beneficial ownership of ordinary shares held by RAD Data Communications Ltd and Klil and Michael Ltd, Israeli companies and 80,000 ordinary shares issuable upon exercise of options exercisable within 60 days of June 15, 2007.
- (5) Each of the directors and executive officers not separately identified in the above table beneficially own less than 1% of our outstanding ordinary shares (including options held by each such party, and which are vested or shall become vested within 60 days of June 15, 2007) and have therefore not been separately disclosed. The amount of shares includes 621,500 ordinary shares issuable upon exercise of options exercisable within 60 days of June 15, 2007.

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

The following table sets forth certain information regarding the beneficial ownership of our ordinary shares as of June 15, 2007, by each person or entity known to own beneficially more than 5% of our outstanding ordinary shares based on information provided to us by the holders or disclosed in public filings with the SEC. The voting rights of our major shareholders do not differ from the voting rights of other holders of our ordinary shares. As of June 25, 2007, our ordinary shares had a total of 55 holders of record, of which 32 were registered with addresses in the United

States. We believe that the number of beneficial owners of our shares is substantially greater than the number of record holders, because a large portion of our ordinary shares is held of record in broker “street name.” As of June 25, 2007, U.S. holders of record held approximately 71% of our outstanding ordinary shares.

Name	Number of Ordinary Shares Beneficially Owned <sup>(1)</sup>	Percentage of Outstanding Ordinary Shares <sup>(2)</sup>
Zohar Zisapel <sup>(3) (4)(7)</sup>	3,626,342	22.1%
Yehuda Zisapel <sup>(3) (5)</sup>	2,027,161	12.4%
RAD Data Communications Ltd <sup>(6)</sup> .	177,841	1.1%

- (1) Except as otherwise noted and pursuant to applicable community property laws, each person named in the table has sole voting and investment power with respect to all ordinary shares listed as owned by such person. Shares beneficially owned include shares that may be acquired pursuant to options that are exercisable within 60 days of June 15, 2007.
- (2) The percentage of outstanding ordinary shares is based on 16,355,238 ordinary shares outstanding as of June 15, 2007. For determining the percentage owned by each person, ordinary shares for each person includes ordinary shares that may be acquired by such person pursuant to options to purchase ordinary shares that are exercisable within 60 days of June 15, 2007.  
The number of outstanding ordinary shares does not include shares that were repurchased by us.
- (3) Includes beneficial ownership of Messrs. Zohar Zisapel and Yehuda Zisapel of ordinary shares held by RAD Data Communications Ltd., an Israeli company.
- (4) Includes 177,841 ordinary shares owned of record by RAD Data Communications, 54,500 ordinary shares owned of record by Klil and Michael Ltd., an Israeli company and 80,000 ordinary shares issuable upon exercise of options exercisable within 60 days of June 15, 2007. Zohar Zisapel is a principal shareholder and director of each of RAD Data Communications Ltd. and Klil and Michael Ltd. and, as such, Mr. Zisapel may be deemed to have voting and dispositive power over the ordinary shares held by RAD Data Communications and Klil and Michael Ltd. Mr. Zisapel disclaims beneficial ownership of these ordinary shares except to the extent of his pecuniary interest therein.
- (5) Includes 177,841 ordinary shares owned of record by RAD Data Communications and 910,360 ordinary shares owned of record by Retem Local Networks Ltd., an Israeli company. Yehuda Zisapel is a principal shareholder and director of each of RAD Data Communications and Retem Local Networks and, as such, Mr. Zisapel may be deemed to have voting and dispositive power over the ordinary shares held by RAD Data Communications and Retem Local Networks. Mr. Zisapel disclaims beneficial ownership of these ordinary shares except to the extent of his pecuniary interest therein.
- (6) Messrs. Zohar and Yehudah Zisapel have shared voting and dispositive power with respect to the shares held by Rad Data Communications Ltd. The shares held by Rad Data Communications Ltd. are reflected under Zohar Zisapel's and Yehuda Zisapel's names in the table.

- (7) Includes 263,000 shares purchased by Mr. Zohar Zisapel in market transactions during May 2007.

## **B. RELATED PARTY TRANSACTIONS**

### **The RAD-BYNET Group**

Messrs. Yehuda and Zohar Zisapel are the founders and principal shareholders of our Company. Zohar Zisapel is our Chairman of the Board of Directors. One or both of Messrs. Yehuda Zisapel and Zohar Zisapel are also founders, directors and principal shareholders of several other companies which, together with us and their respective subsidiaries and affiliates, are known as the RAD-BYNET Group. Such other corporations include, without limitation: RAD Data Communications Ltd.; RADVision Ltd.; BYNET Data Communications Ltd.; BYNET SAMECH LTD.; BYNET SYSTEMS APPLICATIONS LTD.; BYNET ELECTRONICS LTD. (a non-exclusive distributor in Israel for us); and AB-NET Communication Ltd.



Members of the RAD-BYNET Group, each of which is a separate legal entity, are actively engaged in designing, manufacturing, marketing and supporting data communications and telecommunications products, none of which is currently the same as any product of ours. One or both of Messrs. Yehuda Zisapel and Zohar Zisapel are also founders, directors and principal shareholders of several other real estate, services, holdings and pharmaceutical companies. The above list does not constitute a complete list of the investments of Messrs. Yehuda and Zohar Zisapel.

We and other members of the RAD-BYNET Group also market certain of our products through the same distribution channels. Certain products of members of the RAD-BYNET Group are complementary to, and may be used in connection with, products of ours, and others of such products may be used in place of (and thus may be deemed to be competitive with) our products. We incorporate into our product line a software package for voice-over-IP simulation (H.323, SIP), which we purchased from a member of the RAD-BYNET Group. The aggregate amounts of such purchases were approximately \$30,000, \$30,000 and \$4,000 in 2004, 2005 and 2006, respectively.

We purchase certain products and services from members of the RAD-BYNET group, on terms that are either beneficial to us or are no less favorable than terms that might be available to us from unrelated third parties, based on quotes we received from unrelated third parties. In some cases, the RAD-BYNET Group obtains volume discounts for services from unrelated parties, and we pay our pro rata cost of such services. Based on our experience, the volume discounts provide better terms than we would be able to obtain on our own. The aggregate amounts of such purchases were approximately \$65,000, \$63,000 and \$38,000 in 2004, 2005 and 2006, respectively.

Each of RAD and BYNET provides legal, tax, personnel and administrative services to us and leases space to us, and each is reimbursed by us for its costs in providing such services. The aggregate amounts of such reimbursements were approximately \$83,000, \$45,000 and \$43,000 in 2004, 2005 and 2006, respectively.

We currently lease office premises in Tel Aviv and Paramus, New Jersey, from an affiliate. When these agreements were signed, the lease payments were at fair market prices based on quotes we received from third parties for similar space. Historically, we have had some additional flexibility to change the leased space, which we might not have had with unrelated third parties. The aggregate amount of lease payments were approximately \$621,000, \$526,000 and \$502,000 in 2004, 2005 and 2006, respectively. We also sub-lease 276 square feet of the New Jersey premises to a related party, and in 2006 received aggregate rental payments of approximately \$5,000.

We are party to a non-exclusive distribution agreement with BYNET ELECTRONICS LTD., a related party. We sell our products and services to BYNET on the same terms and conditions as it sells to unrelated Israeli distributors with whom it has distribution agreements. The aggregate amounts of such sales were approximately \$345,000, \$773,000 and \$335,000 in 2004, 2005 and 2006, respectively.

We believe that the terms of the transactions in which we have entered and are currently engaged with other members of the RAD-BYNET Group are beneficial to us and no less favorable to us than terms that might be available to us from unaffiliated third parties. All future transactions and arrangements (or modifications of existing ones) with members of the RAD-BYNET Group in which our office holders have a personal interest or which raise issues of such office holders' fiduciary duties will require approval by our Audit Committee and, in certain circumstances, approval of our shareholders under the Companies Law.

## **Registration Rights**

We have entered into agreements with certain of our directors and principal shareholders entitling them to certain registration rights. Pursuant to such agreements, certain directors will each have the right to demand one registration of their shares and the principal shareholders (as a group) will have the right to demand one registration of their shares. In addition, each of such parties has the right to have its shares included in certain registration statements of ours.

## **C. INTERESTS OF EXPERTS AND COUNSEL**

Not applicable.

## **ITEM 8. FINANCIAL INFORMATION**

### **A. CONSOLIDATED STATEMENTS AND OTHER FINANCIAL INFORMATION**

Our consolidated financial statements and other financial information are incorporated herein by reference to “Item 18—Financial Statements” below. Our financial statements can be found at the end of this Annual Report, beginning on page F-1.

### **Export Sales**

In 2006, the amount of our export sales was approximately \$23.2 million, which represented 98.5% of our total sales.

### **Legal Proceedings**

In June 2005, we received letters from legal counsel of another company claiming that the technology we currently use in the assembly of one of our products infringes upon certain patents owned by the other company. After correspondence between the parties over several months we met in person in December 2005, and tried to demonstrate that we do not infringe the company’s patent. We cannot predict whether a lawsuit will ensue, and if so, what its impact or chances of success will be. We and our legal counsel are of the opinion that the claim is without merit and that our product does not infringe upon any patent. In the event of a lawsuit we plan to defend ourselves vigorously. In addition, even if the claims are found to have merit, we believe we can continue to assemble our product using alternative technologies. We are still corresponding in an effort to solve this matter amicably.

In November 2005, we were served with a claim in the amount of approximately \$623,000 by Qualitest Ltd. an Israeli company which used to be a nonexclusive distributor of our products in Israel. Qualitest claims that we breached an exclusive distribution agreement. In December 2005, we filed a statement of defense against the claim asserting that an exclusive distribution agreement was never signed between the parties, and included a counterclaim in the amount of approximately \$131,000 for unpaid invoices. The case has been brought before an arbitrator, the Honorable Judge (Retired) Amnon Strashnov. In June 2006, Qualitest paid us \$69,000 in accordance with a partial verdict of the arbitrator. In June 2007, Qualitest paid the Company \$18,000 and by that and the partial verdict, settled the Company’s counterclaim. The file now continues only regarding Qualitest’s claim against the Company. The summations were already filed by both parties. It is not possible to estimate the amount of the lawsuit or the chances of success for this lawsuit.

*Dividend Policy*

We have never declared or paid any cash dividends on our ordinary shares. We currently intend to retain any future earnings to finance operations and to expand our business and, therefore, do not expect to pay any cash dividends in the foreseeable future.

**B. SIGNIFICANT CHANGES**

Except as otherwise disclosed in this annual report on Form 20-F, there has been no material change in our financial position since December 31, 2006.

**ITEM 9. THE OFFER AND LISTING****A. OFFER AND LISTING DETAILS****NASDAQ Global Market**

The following table sets forth the high and low bid prices of our ordinary shares as reported by the NASDAQ Global Market for the calendar periods indicated:

		High	Low
2002	\$	2.67	\$ 0.35
2003	\$	2.19	\$ 0.64
2004	\$	2.78	\$ 1.00
2005	\$	3.59	\$ 1.35
2006	\$	5.05	\$ 1.74

2005

First Quarter	\$	3.30	\$ 2.22
Second Quarter	\$	2.66	\$ 1.45
Third Quarter	\$	2.78	\$ 1.35
Fourth Quarter	\$	3.59	\$ 1.76

2006

First Quarter	\$	5.05	\$ 3.16
Second Quarter	\$	2.99	\$ 2.00
Third Quarter	\$	3.18	\$ 1.74
Fourth Quarter	\$	3.26	\$ 2.36

2007

First Quarter	\$	3.18	\$ 2.60
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Most recent six months

December 2006	\$	2.70	\$ 2.52
January 2007	\$	3.02	\$ 2.60
February 2007	\$	3.18	\$ 2.90
March 2007	\$	2.95	\$ 2.65
April 2007	\$	2.82	\$ 1.44
May 2007	\$	1.47	\$ 1.33

June 2007 (through June 25)	\$	1.50	\$	1.38
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*Dual Listing*

In addition to trading on the NASDAQ Global Market, on February 20, 2006, our ordinary shares began trading on the Tel Aviv Stock Exchange. According to a publication of the Israeli Tax Authorities, sales of securities of an industrial company, such as us, by individuals and companies to whom Chapter B of the Inflationary Law does not apply will continue to enjoy benefits of a lower Israeli capital gains tax after a dual listing.

**Tel-Aviv Stock Exchange**

The following table sets forth the high and low bid prices of our ordinary shares as reported by the Tel-Aviv Stock Exchange for the calendar periods indicated:

<u>2006</u>	High	Low
2006	NIS 24.04	NIS 7.87
First Quarter (February 20, 2006 through March 31, 2006)	NIS 24.04	NIS 19.08
Second Quarter	NIS 20.33	NIS 9.48
Third Quarter	NIS 13.01	NIS 7.87
Fourth Quarter	NIS 13.75	NIS 10.50
2007		
First Quarter	NIS 13.36	NIS 10.62

<u>Most recent six months</u>		
December 2006	NIS 12.09	NIS 10.50
January 2007	NIS 12.78	NIS 10.62