

RADVISION 2002 ANNUAL REPORT



High-value, robust infrastructure and development solutions for voice, video, and rich media collaborative communications



Dear Shareholder,

2002 was a successful year for RADVISION. Not only did we see the visual communications market grow and the technology development market hold steady, but we also achieved the following: (i) increased revenue by 28%; (ii) expanded our customer base worldwide; (iii) returned to operating profitability ahead of schedule; and (iv) more than doubled our earnings. Of equal importance, we delivered on our promise of completing three significant deals in 2002, while establishing our foothold in the enterprise and newly emerging personal video markets.

For 2002, revenue reached \$49.1 million, with gross profit of \$38 million or 78% of revenue. With a close eye on capital spending, we also reported positive cash flow of \$2.5 million for the full year. Net income for 2002 was \$2.8 million or \$0.15 per diluted share, a strong showing compared with \$1.4 million or \$0.07 per diluted share, excluding a one-time charge, in 2001. We reached operating profitability in Q3, increased it in Q4 and, for the full year of 2002, we reported an operating profit of nearly \$1 million.

Our balance sheet remains very strong, with practically no debt. We ended 2002 with cash and cash equivalents of approximately \$88.4 million, or \$4.85 per basic share. Combined with long-term deposits, this represents about 80% of our total assets.

In 2002 both business units announced a number of powerful technologies to better serve their core markets. In the Networking Business Unit (NBU), which offers videoconferencing infrastructure solutions, we announced new products for the growing enterprise videoconferencing market. The flagship product for 2002 was our very successful MCU version 2 (Multipoint Conferencing Unit) which provided our customers with best-in-breed media handling and advanced conference functionality. We also announced INVISION, the industry's first ever suite of videoconferencing network appliances which provides IT managers with plug-and-play devices that are easily ordered and deployed into any enterprise network for turn-key videoconferencing over IP and ISDN. Since its introduction in November 2002, INVISION has won product awards from Internet Telephony, Communications Convergence, and Videoconferencing Insight.

RADVISION's Technology Business Unit (TBU), which sells software development and testing solutions, also announced a number of powerful developer toolkits over the year. Noteworthy was the introduction of a new SIP Server Toolkit, which radically simplifies and accelerates the development of SIP servers, a necessary component in a voice over IP network. We also were proud to introduce the industry's first 3G-324M Toolkit. This toolkit enables the development of wireless multimedia applications and services such as videoconferencing and video streaming for 3G mobile phones over existing circuit-switched networks.

Looking forward, while we expect to see continued revenue growth in our V²OIP ENSEMBLE™ suite of software development and testing solutions for voice over IP and 3G equipment developers, we believe that the more significant growth potential for RADVISION is in the visual communications market.

In addition to increasing revenues in 2002 for enterprise and institutions (e.g., hospitals, education, and government), we have also seen major developments in the move of visual communications out of the corporate environment and into the personal communication space.

In the second half of 2002, we announced a deal with FastWeb, a leading broadband service provider in Italy. FastWeb is using our technology and infrastructure to offer visual communications to their hundreds of thousands of broadband residential customers and small business customers throughout the country. This is an exciting development, because for the first time ever, videoconferencing is going beyond the workplace and into consumers' homes.

In 2002 we also saw the beginning of video telephony in the wireless market. In late 2002 we worked on finalizing a deal in the mobile market with the leader in 3G and wireless services in Asia. The contract, with NTT/DoCoMo, was formally announced in early 2003. At the same time we also announced an agreement with Alcatel, a major European telecommunications equipment provider, which is selling our 3G video telephony gateway as part of their product suite for carrier markets.

The emergence of the 3G video telephony market, combined with our success with FastWeb in delivering videoconferencing to its residential and small business customers, means that real time videoconferencing is now truly available any place, any time, and over any device. These two markets also play to RADVISION's strengths, because our products have IP-centric architecture and because our technology expertise enables us to develop new products such as the 3G gateway for these markets.

We are also moving deeper into the enterprise market. In the last half of 2002, we began a trial program with a leading global investment bank that plans to move its traditional ISDN based conferencing system to an IP based system. This is a significant

live trial with RADVISION's systems on multiple continents, supporting thousands of employees, and providing an IP-based visual communications platform, while fully supporting the client's existing ISDN based systems. This deployment also demonstrates RADVISION's international strengths as we rolled out and supported this multi-continent deployment in a short period of time without any problems.

Additionally, in the second half of 2002 we announced that we are engaged in another pilot project with another high profile investment bank for a multi-country video conferencing solution, which will also be integrated into their existing IP and ISDN network. A significant factor in this application is that this company is interested in also moving their video conferencing from their meeting rooms to employee desktops through the world, which is an ideal converged application of RADVISION's IP centric platform. In turn this will create the need for thousands of endpoints being deployed, rather than just tens or hundreds. Investment banks are typically early adopters in new communication technologies and the strong interest we are seeing from these two banks indicate to us the real potential and future direction of the marketplace for integrating visual communications into the enterprise.

Looking to the future, there are a number of significant market trends that play directly to RADVISION's advantage over others in the visual communications infrastructure space, both in technology and system architecture, namely:

- ISDN is giving way to more cost-effective IP, which we believe will become the only standard for real-time visual communications, and we are the technology leader in video over IP;
- The intelligence that enables videoconferencing is centralizing in the network rather than the endpoint device, providing a robust market for the video telephony infrastructure devices RADVISION produces;
- Videoconferencing is evolving to also include personal videoconferencing and video telephony and is expanding from meeting room environments to the desktop, into the home and on the road over 3G video phones. Our technology and products are making this possible;
- Expensive endpoints are being complemented by inexpensive devices and soft endpoints, which should help ignite market growth;
- Our market is both evolving and becoming more firmly established. We believe that there is a worldwide acceptance for videoconferencing now as a viable solution and a viable alternative to any other means of communication; and
- As the only independent vendor of network videoconferencing technology and products in the world, RADVISION along with our partners will benefit and will continue to make that happen.

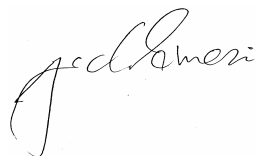
In this context, we believe that RADVISION is building a future for itself of substantial opportunity. The significant deals we completed over the past year have given us entry to every major market for videoconferencing and video telephony. 2003 is the year for us to more fully penetrate and capitalize on those markets by enlarging these specific deals and adding more customers in each of these categories.

We have also reaffirmed and significantly strengthened our partnership with Cisco. Cisco is our largest customer and channel and, in 2002, we expanded our partnership with them both on the technical and sales side. Cisco is demonstrating a heightened commitment to the video telephony market, which holds a strong position in their future vision. We expect to play an even greater role in this partnership in 2003. We also renewed our focus on our traditional reseller channels, resulting in a closer relationship with these key partners. Finally, we are continuing to work closely with our technology partners, such as Tandberg, Sony, and Latitude to closely integrate the RADVISION solution with their respective products and offerings.

We will continue to build upon our growing global presence in 2003. We have new offices in a number of rapidly growing existing markets, such as China, and have also expanded to other markets with new offices in Brazil, Japan, and India.

In conclusion, all of us on the RADVISION team are proud to have delivered on our promises to you in 2002 and are committed to continuing to do so in 2003. Specifically, we plan to solidify the new markets we entered in 2002, continue to grow our market share in our core markets, keep working closely with our technology and reseller partners, and continue to expand the reach of visual communications from the corporate meeting room onto the employee desktop, into the home, and out on the road. We are committed to ensuring our success as a leader in visual communications.

Sincerely,
Gadi Tamari
CEO, RADVISION





RADVISION LTD. AND ITS SUBSIDIARIES

CONSOLIDATED FINANCIAL STATEMENTS

AS OF DECEMBER 31, 2002

IN U.S. DOLLARS

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REPORT OF INDEPENDENT AUDITORS

To the Shareholders of
Radvision Ltd.:

We have audited the accompanying consolidated balance sheets of Radvision Ltd. (the "Company") and its subsidiaries as of December 31, 2002, and the related consolidated statements of operations, changes in shareholders' equity and cash flows for the year ended December 31, 2002. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company and its subsidiaries as of December 31, 2002, and the consolidated results of their operations and cash flows for the year ended December 31, 2002, in conformity with accounting principles generally accepted in the United States.

Tel-Aviv, Israel
January 29, 2003

KOST FORER & GABBAY
A Member of Ernst & Young Global

RADVISION LTD. AND ITS SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

U.S. dollars in thousands, except share data

	December 31,	
	2001	2002
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 6,717	\$ 13,825
Short-term bank deposits	27,701	14,879
Short-term marketable securities	25,084	14,712
Trade receivables (net of allowance for doubtful accounts of \$ 1,126 and \$ 1,593 at December 31, 2001 and 2002, respectively)	5,078	9,505
Other receivables and prepaid expenses	1,259	2,836
Inventories	1,884	996
Total current assets	67,723	56,753
LONG-TERM ASSETS:		
Long-term bank deposits	2,022	11,013
Long-term marketable securities	24,304	33,929
Severance pay fund	1,200	1,641
Total long-term assets	27,526	46,583
PROPERTY AND EQUIPMENT, NET	4,518	3,335
Total assets	\$ 99,767	\$ 106,671
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Current maturities of long-term bank loans	\$ 19	\$ -
Trade payables	765	3,347
Deferred revenues	3,491	2,863
Other payables and accrued expenses	10,071	12,385
Total current liabilities	14,346	18,595
ACCRUED SEVERANCE PAY	1,872	3,061
Total liabilities	16,218	21,656
COMMITMENTS AND CONTINGENCIES		
SHAREHOLDERS' EQUITY:		
Ordinary shares of NIS 0.1 par value: Authorized - 25,000,000 shares as of December 31, 2001 and 2002; Issued – 19,889,690 and 20,152,045 shares as of December 31, 2001 and 2002, respectively; Outstanding – 18,304,244 and 18,285,930 shares as of December 31, 2001 and 2002, respectively	182	187
Additional paid-in capital	104,209	104,586
Deferred stock compensation	(299)	(117)
Treasury stock, at cost (1,585,446 and 1,866,115 Ordinary shares of NIS 0.1 par value as of December 31, 2001 and 2002, respectively)	(9,903)	(11,757)
Accumulated deficit	(10,640)	(7,884)
Total shareholders' equity	83,549	85,015
Total liabilities and shareholders' equity	\$ 99,767	\$ 106,671

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

RADVISION LTD. AND ITS SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

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

	Year ended December 31,		
	2000	2001	2002
Revenues	\$ 45,911	\$ 46,227	\$ 49,095
Cost of revenues	<u>11,446</u>	<u>10,362</u>	<u>10,946</u>
Gross profit	<u>34,465</u>	<u>35,865</u>	<u>38,149</u>
Operating expenses:			
Research and development costs	14,263	17,933	15,338
Less - participation by the Chief Scientist of the Government of Israel	<u>353</u>	<u>-</u>	<u>-</u>
Research and development expenses, net	13,910	17,933	15,338
Marketing and selling expenses, net	17,358	16,735	18,624
General and administrative expenses	3,458	4,438	4,098
Restructuring costs	-	3,023	-
Repayment of future royalties	<u>3,666</u>	<u>-</u>	<u>-</u>
Total operating expenses	<u>38,392</u>	<u>42,129</u>	<u>38,060</u>
Operating income (loss)	(3,927)	(6,264)	89
Financial income, net	<u>4,176</u>	<u>4,652</u>	<u>2,667</u>
Net income (loss)	<u>\$ 249</u>	<u>\$ (1,612)</u>	<u>\$ 2,756</u>
Basic net earnings (loss) per Ordinary share	<u>\$ 0.014</u>	<u>\$ (0.09)</u>	<u>\$ 0.15</u>
Diluted net earnings (loss) per Ordinary share	<u>\$ 0.013</u>	<u>\$ (0.09)</u>	<u>\$ 0.15</u>

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

STATEMENTS OF SHAREHOLDERS' EQUITY

U.S. dollars in thousands, except share data

	Ordinary shares		Preferred shares		Additional paid-in capital	Deferred stock compensation	Treasury stock	Accumulated deficit	Total shareholder's equity
	Number	Amount	Number	Amount					
Balance as of January 1, 2000	10,686,306	\$ 17	2,957,165	\$ 4	\$ 13,789	\$ (1,052)	\$ -	\$ (9,277)	\$ 3,481
Ordinary shares issued	4,960,822	125	-	-	*) 89,094	-	-	-	89,219
Conversion of Preferred shares	2,957,165	4	(2,957,165)	(4)	-	-	-	-	-
Cancellation of Ordinary shares	(58,447)	-	-	-	-	-	-	-	-
Deferred compensation	-	-	-	-	218	(218)	-	-	-
Options exercised	599,138	19	-	-	780	-	-	-	799
Amortization of deferred compensation	-	-	-	-	(32)	629	-	-	597
Net income	-	-	-	-	-	-	-	249	249
Balance as of December 31, 2000	19,144,984	165	-	-	103,849	(641)	-	(9,028)	94,345
Purchase of treasury stock	(1,585,446)	-	-	-	-	-	(9,903)	-	(9,903)
Options exercised	744,706	17	-	-	924	-	-	-	941
Payment of issuance expenses	-	-	-	-	(550)	-	-	-	(550)
Amortization of deferred compensation	-	-	-	-	(14)	342	-	-	328
Net loss	-	-	-	-	-	-	-	(1,612)	(1,612)
Balance as of December 31, 2001	18,304,244	182	-	-	104,209	(299)	(9,903)	(10,640)	83,549
Purchase of treasury stock	(280,669)	-	-	-	-	-	(1,854)	-	(1,854)
Exercise of options by employees	262,355	5	-	-	377	-	-	-	382
Amortization of deferred stock compensation	-	-	-	-	-	182	-	-	182
Net income	-	-	-	-	-	-	-	2,756	2,756
Balance as of December 31, 2002	<u>18,285,930</u>	<u>\$ 187</u>	<u>-</u>	<u>\$ -</u>	<u>\$ 104,586</u>	<u>\$ (117)</u>	<u>\$ (11,757)</u>	<u>\$ (7,884)</u>	<u>\$ 85,015</u>

*) Net of issuance expenses of approximately \$ 8,400.

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

RADVISION LTD. AND ITS SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

	Year ended December 31,		
	2000	2001	2002
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income (loss)	\$ 249	\$ (1,612)	\$ 2,756
Adjustments required to reconcile net income (loss) to net cash provided by operating activities:			
Depreciation	1,843	2,407	2,665
Gain on sale of property and equipment	-	-	(2)
Accrued interest and amortization of premium on held-to-maturity marketable securities	-	-	(263)
Accrued severance pay, net	107	279	748
Amortization of deferred stock compensation	597	328	182
Decrease (increase) in trade receivables, net	(3,810)	1,947	(4,427)
Decrease (increase) in other receivables and prepaid expenses	465	(208)	(1,577)
Decrease (increase) in inventories	(2,522)	3,072	888
Increase (decrease) in trade payables	1,158	(2,951)	2,582
Increase (decrease) in deferred revenues	7,367	(6,807)	(628)
Increase (decrease) in other payables and accrued expenses	3,076	3,592	2,314
Other	34	174	-
Net cash provided by operating activities	<u>8,564</u>	<u>221</u>	<u>5,238</u>
CASH FLOWS FROM INVESTING ACTIVITIES:			
Increase in short-term investments	(39,550)	(13,235)	-
Increase in long-term investments	(15,897)	(10,429)	-
Proceeds from redemption of held-to-maturity marketable securities	-	-	45,810
Purchase of held-to-maturity marketable securities	-	-	(44,800)
Proceeds from withdrawal of bank deposits	-	-	36,998
Purchase of bank deposits	-	-	(33,167)
Purchase of property and equipment	(4,175)	(2,045)	(1,705)
Proceeds from sale of property and equipment	118	146	225
Net cash provided by (used in) investing activities	<u>(59,504)</u>	<u>(25,563)</u>	<u>3,361</u>
CASH FLOWS FROM FINANCING ACTIVITIES:			
Issuance of share capital	90,018	941	-
Purchase of treasury stock	-	(9,903)	(1,854)
Exercise of options by employees	-	-	382
Payment of issuance expenses	-	(550)	-
Repayment of long-term bank loans	(66)	(46)	(19)
Net cash provided by (used in) financing activities	<u>89,952</u>	<u>(9,558)</u>	<u>(1,491)</u>
Increase (decrease) in cash and cash equivalents	39,012	(34,900)	7,108
Cash and cash equivalents at the beginning of the year	<u>2,605</u>	<u>41,617</u>	<u>6,717</u>
Cash and cash equivalents at the end of the year	<u>\$ 41,617</u>	<u>\$ 6,717</u>	<u>\$ 13,825</u>
Supplemental disclosure of cash flow activities:			
Cash paid during the year for:			
Interest	<u>\$ 8</u>	<u>\$ 4</u>	<u>\$ -</u>

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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 1:- GENERAL

Radvision Ltd. ("the Company"), an Israeli corporation, designs, develops and supplies products and technology that enable real-time voice, video and data communications over packet networks, including the Internet and other networks based on the Internet protocol.

The Company's products and technology are used by its customers to develop systems that enable enterprises and service providers to use packet networks for real-time IP ("Internet Protocol") communications.

Commencing in 2001, the Company operates under two reportable segments, based on its restructured internal organization, management of operations and performance evaluation. These segments are: 1) the "networking" business unit or NBU, which focuses on a networking product and is responsible for developing networking products for IP-centric voice, video and data conferencing services; and 2) the "technology" business unit or TBU, which focuses on creating developer toolkits for the underlying IP communication protocols and testing tools needed for real-time voice and video over IP.

The Company has four wholly-owned subsidiaries: Radvision Inc., in the United States, Radvision B.V., in the Netherlands, Radvision HK in Hong Kong, and Radvision U.K. in the United Kingdom. The subsidiaries are primarily engaged in the sale and marketing of the Company's products and technology.

Revenues derived from the Company's two largest customers in 2002 represented 25% and 11% of total sales (see Note 11c).

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements are prepared according to generally accepted accounting principles in the United States or U.S. GAAP. The significant accounting policies followed in the preparation of the financial statements, applied on a consistent basis, are as follows:

a. Use of estimates

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

b. Principles of consolidation:

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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**U.S. dollars in thousands****NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

- c. Financial statements in U.S. dollars:

The Company and its subsidiaries' revenues are generated in U.S. dollars ("dollar"). In addition, a portion of the Company and its subsidiaries' costs is incurred in dollars. The Company's management believes that the dollar is the primary currency of the economic environment in which the Company and its subsidiaries operate. Thus, the functional and reporting currency of the Company and its subsidiaries is the dollar.

Accordingly, the Company and its subsidiaries' transactions and balances, denominated in dollars, are presented at their original amounts. Non-dollar transactions and balances have been remeasured into U.S. dollars, in accordance with Statement of the Financial Accounting Standard No. 52 "Foreign Currency Translation" ("SFAS No.52"). All transaction gains and losses from remeasurement of monetary balance sheet items denominated in non-dollar currencies, are reflected in the statements of operations as financial income or expenses, as appropriate, and have not been material for all periods presented.

- d. Cash equivalents:

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

- e. Marketable securities:

The Company accounts for investments in debt securities in accordance with Statement of Financial Accounting Standard No. 115, "Accounting for Certain Investments in Debt and Equity Securities" ("SFAS No. 115"). Management determines the appropriate classification of its investments in debt and equity securities at the time of purchase and reevaluates such determinations at each balance sheet date. Debt securities are classified as held-to-maturity when the Company has the positive intent and ability to hold the securities to maturity and are stated at amortized cost. The amortized cost of held-to-maturity securities is adjusted for amortization of premiums and accretion of discounts to maturity. Such amortization any decline in value judged to be other than temporary and interest are included in financial income, net.

- f. Short-term bank deposits:

Short-term bank deposits are deposits with maturities of more than three months but less than one year. The deposits are in U.S. dollars and bear interest at an average rate of 2.95%. The short-term deposits are presented at their cost, including accrued interest.

- g. Long-term bank deposits:

Bank deposits with maturities of more than one year are included in long-term investments, and presented at their cost plus accrued interest. The deposits are in U.S. dollars and bear interest at an average rate of 3.76%.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**U.S. dollars in thousands****NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

h. Inventories:

Inventories are stated at the lower of cost or market value.

Inventory write-offs and write-down provisions are provided to cover risks arising from slow-moving items or technological obsolescence. The Company and its subsidiaries periodically evaluate the quantities on hand, relative to current and historical selling prices, and historical and projected sales volume and aging inventory. Based on this evaluation, provisions are made when required to write inventory down to its market prices. As a result of adjusted forecast of revenues for the years 2002 and 2003, and the decision to discontinue selling certain products, the Company and its subsidiaries wrote off excess inventories in order to adjust the inventory level to the new revenue expectations, in the amount of approximately \$ 864 in 2001 and \$ 396 and in 2002, which have been included in the cost of revenues.

Cost is determined as follows:

Raw materials - using the average cost method.

Work-in-progress - represents the cost of subcontractors.

Finished products - on the basis of subcontractors' costs, with the addition of raw materials.

i. Property and equipment:

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

	%
Computers and peripheral equipment	15-33
Office furniture and equipment	7-15
Motor vehicles	15
Leasehold improvements	Over the term of the lease

The Company and the subsidiaries' long-lived assets are reviewed for impairment in accordance with Statement of Financial Accounting Standard No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS No. 144") whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to the future undiscounted cash flows expected to be generated by the assets. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be disposed of by sale are reported at the lower of the carrying amount or fair value less selling costs. As of December 31, 2002, no impairment losses have been identified.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**U.S. dollars in thousands****NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

j. Severance pay:

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

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

Severance expenses for the years ended December 31, 2000, 2001 and 2002, amounted to approximately \$ 107, \$ 279 and \$ 748, respectively.

k. Revenue recognition:

The Company and its subsidiaries generate revenues mainly from: 1) licensing the rights to use its software products and sales of systems; 2) royalty income; and 3) maintenance, support and training. The Company and its subsidiaries sell their products to end-users principally through indirect channel by OEMs, system integrators and value added resellers, all of which are considered end-users.

Software licensing, royalties and other revenues:

The Company accounts for software sales in accordance with Statement of Position 97-2, "Software Revenue Recognition," ("SOP 97-2") as amended by Statement of Position 98-9, "Modification of SOP 97-2, Software Revenue Recognition with Respect to Certain Transactions", ("SOP 98-9"). SOP 98-9 requires that revenue be recognized under the "residual method" when vendor specific objective evidence (VSOE) of fair value exists for all undelivered elements and VSOE does not exist for all of the delivered elements and all other SOP 97-2 revenue recognition criteria are met. Under the residual method any discount in the arrangement is allocated to the delivered element.

Revenue from license fees is recognized when persuasive evidence of an agreement exists, delivery of the product has occurred, no significant obligations with regard to implementation remain, the fee is fixed or determinable, and collectibility is probable.

Revenues from short-term time-based licenses are recognized ratably over the terms of software agreement.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Certain royalty agreements provide for per unit royalties to be paid to the Company based on the shipments by customers of units containing the Company's products. Revenues under such agreements are recognized at the time of shipments by the customers as they are paid to the Company by these customers. Non-refundable payments on account of future royalties from similar agreements are recognized upon payment, provided that no future obligation exists.

Maintenance and support revenue included in multiple element arrangements is deferred and recognized on a straight-line basis over the term of the maintenance and support agreement. The VSOE of fair value of the undelivered elements (maintenance and support fees) is determined based on the price charged for the undelivered elements when sold separately.

In agreements for which the customer requires a 30-day acceptance provision, the Company and its subsidiaries defer revenues until the receipt of the acceptance confirmation.

Deferred revenue includes unearned amounts received under maintenance and support contracts, and amounts received from customers but not recognized as revenues.

Sales of systems:

Revenues from systems sales are recognized in accordance with Staff Accounting Bulletin No.101, "Revenue Recognition in Financial Statements" ("SAB No.101"), when delivery has occurred, persuasive evidence of an agreement exists, the vendor's fee is fixed or determinable, no further obligation exists and collectability is probable.

The Company and its subsidiaries generally do not grant a right of return to its customers. When returns are expected and estimated, the Company defers revenue until the probability for such returns expires, at which time revenue is recognized provided that all other revenue recognition criteria are met. The Company maintains provision for product returns; based on its experience in accordance with Statement of Financial Accounting Standard No. 48, "Revenue Recognition When Right of Return Exists". The provision has been immaterial for the years ended December 31, 2000, 2001 and 2002.

1. **Research and development costs:**

Research and development costs, net of grants received, are charged to the statement of operations, as incurred. Statement of Financial Accounting Standard No. 86 "Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed", requires capitalization of certain software development costs subsequent to the establishment of technological feasibility.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Based on the Company's product development process, technological feasibility is established upon completion of a working model. Costs incurred by the Company between completion of the working models and the point at which the products are ready for general release have been insignificant. Therefore, all research and development costs have been expensed.

The Company received grants from the Israel U.S Binational Industrial Research and Development Foundation (see Note 8b) and the Chief Scientist Office. These grants are recognized at the time the Company is entitled to such grants on the basis of the costs incurred and included as a deduction of research and development expenses.

m. Income taxes:

The Company and its subsidiaries account for income taxes in accordance with Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes" ("SFAS No. 109"). This Statement prescribes the use of the liability method whereby deferred tax assets and liability account balances are determined based on differences between financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. The Company and its subsidiaries provide a valuation allowance, if necessary, to reduce deferred tax assets to their estimated realizable value.

n. Fair value of financial instruments:

The Company and its subsidiaries, in estimating the fair value of its financial instruments used the following methods and assumptions for disclosures of financial instruments:

The carrying amount reported in the balance sheet for cash and cash equivalents, short-term bank deposits, trade receivables, trade payables and current maturities of long-term bank loans approximate their fair values due to the short-term maturities of such instruments.

The fair value for held to maturity marketable securities is based on amortized cost, which does not differ significantly from the quoted market value (see Note 3).

o. Accounting for stock-based compensation:

The Company has elected to follow Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB No. 25") and FASB No. Interpretation No. 44, "Accounting for Certain Transactions Involving Stock Compensation" ("FIN No. 44") in accounting for its employee stock option plans. Under APB No. 25, when the exercise price of the Company's stock options is less than the market price of the underlying shares on the date of grant, compensation expense is recognized.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Under Statement of Financial Accounting Standard No. 123 "Accounting for Stock-Based Compensation ("SFAS No. 123"), pro forma information regarding net income and net earnings per share is required, and has been determined as if the Company had accounted for its employee stock options under the fair value method of SFAS No. 123. The fair value for these options is amortized over their vesting period and estimated at the date of grant using a Black - Scholes Option Valuation Model with the following weighted-average assumptions for 2000, 2001 and 2002: risk-free interest rates of 5.0% for 2000, 2.5% for 2001 and 3.0% for 2002; dividend yields of 0% for 2000, 2001 and 2002; volatility factors of the expected market price of the Company's Ordinary shares of 0.8 for 2000, 0.98 for 2001 and 0.48 for 2002; and an expected life of the option of 2.5 years after the option is vested for 2000, 2.63 years for 2001 and 4 years for 2002.

Pro forma information under SFAS No. 123:

	Year ended December 31,		
	2000	2001	2002
Net income (loss) as reported	\$ 249	\$ (1,612)	\$ 2,756
Add: stock based compensation expense determined under APB 25	\$ 596	\$ 328	\$ 193
Deduct: stock-based compensation expense determined under fair value method for all awards	\$ (4,042)	\$ (6,687)	\$ (5,440)
Pro forma net loss	\$ (3,197)	\$ (7,971)	\$ (2,491)
Basic and diluted earnings (loss) per share, as reported	\$ 0.013	\$ (0.09)	\$ 0.15
Pro forma basic and diluted net loss per share	\$ (0.19)	\$ (0.42)	\$ (0.14)

p. Concentration of credit risk:

Financial instruments that potentially subject the Company and its subsidiaries to concentrations of credit risk consist principally of cash and cash equivalents, marketable securities, short-term bank deposits, trade payables, trade receivables and long-term bank deposits.

The majority of the Company's cash and cash equivalents and short-term and long-term bank deposits are invested in dollar investments with major banks in Israel and the U.S. Such cash and cash equivalents, short-term and long-term bank deposits in the United States may be in excess of insured limits and are not insured in other jurisdictions. However, management believes that the financial investments that hold the Company's investments are financially sound and accordingly, minimal credit risk exists with respect to these investments.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

The Company and its subsidiaries' marketable securities include investments in debentures of U.S. corporations, and state and political subdivisions. Management believes that the portfolio is well diversified, and accordingly, minimal credit risk exists with respect to these marketable securities.

The Company and its subsidiaries' trade receivables related to NBU business are derived from sales to large and solid organizations located mainly in North America, Europe, the Far East and Israel. The Company and its subsidiaries perform ongoing credit evaluations of its customers and to date have not experienced any material losses. An allowance for doubtful accounts is determined with respect to those amounts that the Company and its subsidiaries have determined to be doubtful of collection and by a general reserve. In certain circumstances, the Company and its subsidiaries may require letters of credit, other collateral or additional guarantees.

The Company and its subsidiaries' trade receivables related to TBU business are derived from sales to emerging companies located mainly in North America, Europe, the Far East and Israel. The Company and its subsidiaries perform ongoing credit evaluations of its customers and when uncertainty of collectability exists, the Company defers revenues until such uncertainty expires.

As of December 31, 2002, current balances of two customers accounted for 41.6% and 9.1% of the Company's trade receivables, or a total of approximately \$ 4,819.

The Company has no significant off-balance-sheet concentration of credit risk, such as foreign exchange contracts, options contracts or other foreign hedging arrangements.

q. Basic net earnings (loss) per share:

Basic net earnings (loss) per share is computed based on the weighted average number of shares of Common Stock outstanding during the year. For the same periods, diluted net earnings (loss) per share further includes the effect of dilutive stock options outstanding during the year, all in accordance with SFAS No. 128, "Earnings per Share".

r. Recently issued accounting pronouncements:

FASB recently also issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities" ("SFAS 136"). SFAS 146 addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies Emerging Issues Task Force (EITF) Issue No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)". SFAS 146 improves financial reporting by requiring that a liability for a cost associated with an exit or disposal activity be recognized and measured initially at fair value only when the liability is incurred. The provisions of SFAS 146 are effective for exit or disposal activities that are initiated after December 31, 2002. Adoption of SFAS 146 is not expected to have a material effect on the Company and its subsidiaries' financial position or operating results.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 3:- MARKETABLE SECURITIES

The following is a summary of held-to-maturity securities at December 31, 2002:

	<u>Amortized cost</u>	<u>Unrealized gains (losses)</u>	<u>Estimated fair value</u>
Obligations of state and political subdivisions	\$ 21,501	\$ 821	\$ 22,322
Corporate obligations	27,140	(876)	26,264
	<u>\$ 48,641</u>	<u>\$ (55)</u>	<u>\$ 48,586</u>

At December 31, 2001, the carrying amount of securities approximated the fair value and the amount of unrealized gain or loss was not significant. Gross realized gains or losses for 2002, 2001, and 2000 were not significant.

The amortized cost of held-to-maturity debt and securities at December 31, 2002, by contractual maturities, are shown below:

	<u>Amortized cost</u>	<u>Estimated fair value</u>
Due in one year or less	\$ 14,712	\$ 15,526
Due after one year through five years	33,929	31,060
	<u>\$ 48,641</u>	<u>\$ 48,586</u>

NOTE 4:- INVENTORIES

Inventories are composed of the following:

	<u>December 31,</u>	
	<u>2001</u>	<u>2002</u>
Raw materials	\$ 991	\$ 194
Work-in-progress	391	720
Finished products	502	82
	<u>\$ 1,884</u>	<u>\$ 996</u>

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 5:- PROPERTY AND EQUIPMENT

Composition of assets, grouped by major classifications, is as follows:

	December 31,	
	2001	2002
Computers and peripheral equipment	\$ 3,651	\$ 5,780
Office furniture and equipment	3,781	3,272
Motor vehicles	1,001	591
Leasehold improvements	1,487	1,536
	9,920	11,179
Less - accumulated depreciation	5,402	7,844
Depreciated cost	\$ 4,518	\$ 3,335

Depreciation expense amounted to \$ 1,843, \$ 2,407 and \$ 2,665, for the years ended December 31, 2000, 2001 and 2002, respectively.

NOTE 6:- OTHER PAYABLES AND ACCRUED EXPENSES

	December 31,	
	2001	2002
Employees and employee accruals	\$ 2,369	\$ 1,617
Tax withholding payable	284	-
Accrued expenses	7,418	10,768
	\$ 10,071	\$ 12,385

NOTE 7:- LONG-TERM BANK LOANS

	December 31,	
	2001	2002
Loans linked to the U.S. dollar	\$ 19	\$ -
Less - current maturities	19	-
	\$ -	\$ -

The loans bore an annual interest rate of LIBOR plus 1%.

As of December 31, 2002, the Company had an unused line of credit in the amount of \$ 2,500.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 8:- COMMITMENTS AND CONTINGENCIES

- a. In connection with its marketing activities, the Company received in prior years participation payments from the Government of Israel - Fund for the Encouragement of Marketing Activities in the total amount of approximately \$ 686. In return for the participation payments, the Company is committed to pay royalties at a rate of 3% of the Company's total increase in export sales, from the end of the second year of implementation of the marketing plan until the date at which the participation has been fully repaid. The Company's total commitment for royalties payable with respect to future sales, based on Government of Israel participations received or accrued, net of royalties paid or accrued, totaled approximately \$ 0 as of December 31, 2002.

- b. In connection with its research and development, the Company received and accrued participation payments from the Israel U.S. Binational Industrial Research and Development Foundation (BIRD-F), in the total amount of approximately \$ 188. In return for the participation, the Company is committed to pay royalties at a rate of 2.5% of proceeds from the first year's sales and 5% of the proceeds from the succeeding years' sales, up to the amount of the grant. Once the amount of the grant has been repaid, royalties will be payable at the rate of 2.5% of proceeds, until additional royalties equal to one half of the grant amount have been repaid. The Company's total commitment for royalties payable with respect to future sales, based on BIRD-F participations received or accrued, net of royalties paid or accrued, totaled approximately \$ 276 as of December 31, 2002. Royalties paid or accrued to the BIRD-F amounted to \$ 0.

- c. The Company and its subsidiaries operate from leased premises in Israel, United States, China, United Kingdom and Hong Kong. Lease agreements expire till June 2005 (some with renewal options). The Company rents vehicles under operating lease agreements that expire on various dates, the latest of which is in 2006.

Annual minimum future rental payments due under the above agreements, at the exchange rate in effect on December 31, 2002, are approximately as follows:

2003	\$	2,162	
2004		1,841	
2005		788	
2006		33	
		33	
		\$ 4,824	

For the years ended December 31, 2000, 2001 and 2002, rental expense was \$ 1,015, \$ 1,424 and \$ 1,556, respectively.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**U.S. dollars in thousands, except share and per share data****NOTE 8:-COMMITMENTS AND CONTINGENCIES (Cont.)**

- d. The Company is committed to pay royalties to two third parties for the integration of these third parties' technologies into the Company's products. Royalties are payable based on the sales volume of these products, as long as the Company uses these technologies.

The rates of royalties to one of the third parties are based on a fixed amount per product sold by the Company ranging from \$ 1.00 to \$ 5.00 per unit sold.

The rates of royalties to the other third party are comprised of (in U.S. dollars):

- (i) Royalties based on a fixed amount per certain product sold by the Company ranging from \$ 20 to \$ 48 per unit sold, and;
- (ii) a minimum aggregate royalty payment in the amount of \$ 85 to be paid until the earlier of May, 2005, or the completion of an aggregate sales volume of 600 units of another product.

The agreements pursuant to which the royalties are payable have no expiration date. Annual minimum future royalty payments are approximately as follows as of December 31, 2002:

2003	\$	25
2004		<u>25</u>
	\$	<u><u>50</u></u>

The Company paid royalties in the amount of \$ 25 in 2002.

- e. In 1998, a third party sent correspondence to the Company's affiliate alleging that some products manufactured by the Company infringe upon patents held by the third party and offered to license these patents to the Company. In subsequent correspondence, the Company's affiliate requested that the third party specifically substantiate each allegation of infringement before the Company's affiliate would be prepared to enter into any licensing arrangements. The Company does not believe that these allegations will have a material adverse effect upon its business, financial position, results of operations or liquidity. The Company's affiliate has received further correspondence from the third party, in which the third party has, among other things, reiterated its claims. The Company's affiliate does not believe the third party has substantiated its claims and has communicated this belief to the third party. The Company's affiliate has advised the Company that the alleged infringement claims are unresolved. The Company's management is unable to determine with any certainty the ultimate outcome of the allegations, and its effect on the Company's business, results of operations and financial condition.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 8:-COMMITMENTS AND CONTINGENCIES (Cont.)

- f. In January 2001, the Company entered into an agreement with related parties, to lease approximately 24,000 square feet of office space in Paramus, New Jersey for a period of 5 years, which space the Company subsequently surrendered. The parties have a dispute in respect to damages caused by this action, if any. The Company cannot predict the final outcome of this dispute. The Company's management is unable to determine with any certainty the ultimate outcome of the dispute, however it had accrued what it believes to be sufficient funds.

NOTE 9:- SHAREHOLDERS' EQUITY

The Ordinary shares of the Company are traded on the Nasdaq National Market.

Since October 20, 2002, the Ordinary shares of the Company have also traded on the Tel Aviv Stock Exchange.

The Ordinary shares confer upon their holders the right to receive notice to participate and vote in general meetings of the Company, and the right to receive dividends, if declared.

- a. In January 2000, the Company increased its authorized Ordinary share capital to 24,984,470 Ordinary shares and 15,530 deferred shares of NIS 0.1 par value per share and all outstanding Preferred shares were converted into an identical number of Ordinary shares. In January 2000, the Company effected a 211 to 1 share split in the form of a share dividend. All references to per share amounts and the number of shares in these financial statements have been restated to reflect the abovementioned changes.
- b. The Company had an authorized share capital of 15,530 deferred shares of par value NIS 0.1 each. The deferred shares conferred no rights or privileges on their holders, except for the right to receive, upon dissolution or liquidation, the par value of the deferred shares. In October 2002, special shareholders meeting approved a conversion of the deferred shares to Ordinary shares.
- c. In March 2000, the Company issued 590,822 Ordinary shares in a private placement to Siemens Aktiengesellschaft, Samsung Electro-Mechanics Co. Ltd. and Samsung Venture Investment Corporation for an aggregate consideration of approximately \$10 million.
- d. In March 2000, the Company issued 4,370,000 Ordinary shares in an initial public offering for \$ 87,000, or \$ 20 per share.
- e. In February 2001, the Company announced that its Board of Directors authorized the purchase of up to 10% of its outstanding Ordinary shares in the open market, from time to time, at prevailing market prices. No time limit was given with respect to the duration of the share purchase program.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 9:- SHAREHOLDERS' EQUITY (Cont.)

As of December 31, 2002, the Company had purchased 1,866,115 Ordinary shares at a cost of \$ 11,757.

On August 28, 2002, the Board of Directors authorized an additional purchase of up to \$ 10,000 or 2,000,000 of the Company's outstanding Ordinary shares in the open market.

- f. The Company adopted a key employee share incentive plan which provides for the grant by the Company of option awards to purchase up to an aggregate of 6,485,075 Ordinary shares to officers, employees, directors and consultants of the Company and its subsidiaries and affiliates. The options vest ratably over vesting periods ranging from three to five years. The options expire 5 to 10 years from the date of issuance. The incentive plan provides for the grant of options equal in the amount of up to 4% of the Company's share capital on a diluted basis.

As of December 31, 2002, 467,940 shares qualify for future grant. Options that are cancelled or forfeited before expiration become available for future grant.

Transactions related to the share incentive plan during the years ended December 31, 2000, 2001 and 2002, and the weighted average exercise prices per share at the date of grant, are summarized as follows:

	Year ended December 31,					
	2000		2001		2002	
	Amount	Weighted average exercise price	Amount	Weighted average exercise price	Amount	Weighted average exercise price
	\$	\$	\$	\$	\$	
Options outstanding at the beginning of the year	2,667,251	1.23	3,228,656	7.48	3,885,872	7.29
Granted	1,390,795	16.68	2,284,095	5.65	1,167,000	5.19
Exercised	(599,138)	1.46	(744,706)	1.31	(262,355)	1.61
Forfeited	(230,252)	7.30	(882,173)	8.74	(379,581)	7.88
Options outstanding at the end of the year	<u>3,228,656</u>	<u>7.48</u>	<u>3,885,872</u>	<u>7.29</u>	<u>4,410,936</u>	<u>6.99</u>
Options exercisable at the end of the year	<u>749,225</u>	<u>1.69</u>	<u>698,842</u>	<u>8.01</u>	<u>1,485,885</u>	<u>7.53</u>

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 9:- SHAREHOLDERS' EQUITY (Cont.)

A summary of the options outstanding and exercisable at December 31, 2002, is as follows:

Exercise price \$	Options outstanding			Options exercisable	
	Outstanding at December 31, 2002	Weighted - average remaining contractual life	Weighted - average exercise prices	Outstanding at December 31, 2002	Weighted - average exercise prices
		Years	\$		\$
0.68-1.02	186,046	6.58	0.95	98,480	0.95
1.02-1.53	247,913	6.58	1.18	178,283	1.18
1.53-2.3	188,441	7.50	1.58	112,486	1.58
3.45-5.18	1,278,892	8.96	4.86	295,229	4.94
5.18-7.77	1,675,425	8.93	5.62	365,412	6.06
7.77-11.66	110,564	7.33	10.20	82,922	10.20
11.66-17.49	553,155	7.50	14.64	276,573	14.65
26.24-28	170,500	7.75	28.00	76,500	28.00
	<u>4,410,936</u>		<u>6.99</u>	<u>1,485,885</u>	<u>7.53</u>

A summary of the options granted whose exercise prices differ from the market price of the date of the stock on the date of grant as follows:

	Year ended December 31,					
	2000		2001		2002	
	Options	Weighted average exercise price \$	Options	Weighted average exercise price \$	Options	Weighted average exercise price \$
Weighted average exercise prices less than fair value at date of grant	<u>121,114</u>	<u>10.20</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>
Weighted average exercise prices equal to fair value at date of grant	<u>1,269,681</u>	<u>17.52</u>	<u>2,284,095</u>	<u>5.65</u>	<u>1,167,000</u>	<u>5.19</u>

The amounts of deferred compensation recognized arising from the difference between the exercise price and the fair market value on the date of the grant of \$ 218, \$ 0 and \$ 0 for options granted in the years ended December 31, 2000, 2001 and 2002, are included in shareholders' equity and are amortized over the vesting periods of the options according to APB No. 25. Under APB No. 25, the amortization of deferred compensation expense for the years ended December 31, 2000, 2001 and 2002 amounted to \$ 597, \$ 328 and \$ 182, respectively. The weighted average fair values, on the grant date, for the years ended December 31, 2000, 2001 and 2002, amounted to \$ 7.72, \$ 3.29 and \$ 2.03, respectively.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 9:- SHAREHOLDERS' EQUITY (Cont.)

In the event that cash dividends are declared in the future, such dividends will be paid in NIS or in foreign currency subject to any statutory limitations. The Company does not intend to pay cash dividends in the foreseeable future. The Company has decided not to declare dividends out of tax exempt earnings.

NOTE 10:- NET EARNINGS (LOSS) PER SHARE

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

	Year ended December 31,		
	2000	2001	2002
Numerator:			
Net income (loss)	\$ 249	\$ (1,612)	\$ 2,756
Denominator:			
Weighted average number of Ordinary shares outstanding during the year used to compute basic net earnings (loss) per share	17,174,453	18,943,014	18,353,052
Incremental shares attributable to exercise of outstanding options (assuming proceeds would be used to purchase treasury stock)	2,698,769	*) -	630,278
Weighted average number of Ordinary shares used to compute diluted net earnings (loss) per share	19,873,222	18,943,014	18,983,330
Basic net earnings (loss) per share	\$ 0.01	\$ (0.09)	\$ 0.15
Diluted net earnings (loss) per share	\$ 0.01	\$ (0.09)	\$ 0.15

*) Anti-dilutive.

The total weighted average number of shares related to the outstanding options excluded from the calculation of diluted net earnings (loss) per shares, since they had an anti-dilutive effect, were 2,226,906 for the year ended December 31, 2002.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 11:- SEGMENT REPORTING AND GEOGRAPHICAL INFORMATION

- a. Beginning in the year 2001, the Company operates under two reportable segments based on its revised internal organization structure, management of operations and performance evaluation. These segments are: the technology business unit and the networking business unit. Discrete segment financial information was not available or reviewed by senior management during the year 2000. Therefore corresponding information for this year is not available.

The technology business unit is responsible for the development of enabling technologies for real-time voice and video over IP. The networking business unit is responsible for developing networking products for IP-centric voice, video and data conferencing services. There are no significant transactions between the two segments.

The Company evaluates segment performance based on revenues and operating income (loss) of each segment. As such, there are no separately identifiable segment assets, nor are there any separately identifiable statements of operations data below operating loss.

Business segment revenues are as follows:

	Year ended December 31,	
	2001	2002
Technology business unit	\$ 16,545	\$ 12,759
Networking business unit	29,682	36,336
Total revenues	<u>\$ 46,227</u>	<u>\$ 49,095</u>

Business segment operating income (loss) is as follows:

Technology business unit	\$ (3,122)	\$ 552
Networking business unit	(3,142)	(463)
Total operating income (loss)	<u>\$ (6,264)</u>	<u>\$ 89</u>

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 11:- SEGMENT REPORTING AND GEOGRAPHICAL INFORMATION (Cont.)

- b. The Company's sales by geographic area of end-customers are as follows:

	Year ended December 31,		
	2000	2001	2002
North America, principally the United States	\$ 28,830	\$ 29,245	\$ 24,599
Europe	7,328	8,096	12,029
Far East	5,287	6,940	10,200
Israel	4,466	1,946	2,267
	<u>\$ 45,911</u>	<u>\$ 46,227</u>	<u>\$ 49,095</u>
Long-lived assets by geographical region:			
Israel	\$ 4,852	\$ 3,916	\$ 2,576
United States	281	445	591
Other	67	157	168
	<u>\$ 5,200</u>	<u>\$ 4,518</u>	<u>\$ 3,335</u>

- c. For the years ended December 31, 2000, 2001 and 2002, one customer accounted for approximately 22%, 35% and 25%, respectively, of sales for that period. For the year ended December 31, 2002, another customer accounted for approximately 11% of sales for that period.

NOTE 12:- MARKETING AND SELLING EXPENSES, NET

	Year ended December 31,		
	2000	2001	2002
Marketing and selling expenses	\$ 17,492	\$ 16,735	\$ 18,624
Participation by the Government of Israel	134	-	-
Marketing and selling expenses, net	<u>\$ 17,358</u>	<u>\$ 16,735</u>	<u>\$ 18,624</u>
Marketing and selling expenses include:			
Royalties to the Government of Israel	<u>\$ 750</u>	<u>\$ 80</u>	<u>\$ -</u>

NOTE 13:- RESTRUCTURING COSTS

In the second quarter of 2001, the Company recorded a charge of approximately \$ 3,000, primarily relating to severance costs associated with a 13% workforce reduction and onerous lease commitments arising from a reduction in the facility as part of its plan to reduce operating expenses. As of December 31, 2002, the remaining reserve balance of approximately \$ 1,600 is included in other payables and accrued expenses in the balance sheet.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 14:- RELATED PARTY BALANCES AND TRANSACTIONS

- a. Balances with related parties:

	December 31,	
	2001	2002
Receivables	\$ 2	\$ 4
Trade payables	\$ 148	\$ 200

- b. Transactions with related parties:

	Year ended December 31,		
	2000	2001	2002
Revenues (1)	\$ 251	\$ 108	\$ 199
Cost of revenues (3)	\$ 842	\$ 188	\$ 244
Research and development expenses (2)	\$ 622	\$ 184	\$ 44
Marketing, selling, general and administrative expenses (2)	\$ 1,210	\$ 116	\$ 157
Purchase of property and equipment (4)	\$ 722	\$ 263	\$ 576

- (1) Includes revenues from the Company's products and maintenance sold to affiliated companies.
- (2) Includes administrative services provided to the Company by affiliated companies that the Company reimburses for the costs incurred in providing these services.
- (3) Includes the purchase of components from affiliated companies.
- (4) Includes property and equipment that were purchased from affiliated companies.

- c. As for the dispute with related parties, see Note 8f.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**U.S. dollars in thousands**

- d. The Company's Chairman and its former director and Chairman, are principal shareholders of the Company. Individually or together, they are also directors and principal shareholders of several other companies, which, together with the Company and other subsidiaries and affiliates, are known as the RAD-BYNET group and which are related parties to the Company. These corporations include:

AB-NET Ltd.
 BYNET Data
 Communications Ltd.
 BYNET Electronics Ltd.
 BYNET Properties Ltd.
 BYNET SEMECH Outsourcing Ltd.
 BYNET Systems Applications Ltd.
 BYNET Personal Computers Ltd.
 Ceragon Networks Ltd. Modules INC.
 Axerra Networks Inc.
 RADCOM Ltd.
 RAD Data Communications Ltd.
 RADLAN Computer
 Communications Ltd.
 RADView Software Ltd.
 RADWARE Ltd.
 RADWIN Ltd.
 RIT Technologies Ltd.
 RND Operation Services Ltd.
 Sanrad Inc.
 SILICOM Ltd.
 WISAIR Inc.

NOTE 15:- TAXES ON INCOME

- a. Tax benefits under the Law for the Encouragement of Capital Investment, 1959 ("the Law"):

The Company's investment program totaling \$ 122 has been granted Approved Enterprise status under the Law for Encouragement of Capital Investments, 1959. In addition, the Company was granted Approved Enterprise status for an expansion of a previous program totaling \$ 459. The Company is entitled to a tax benefit period of seven years, on income derived from these programs, as follows: a full income tax exemption for the first two years and a reduced income tax rate of 25% (instead of the regular rate of 36%) for the remaining five year period. If foreign shareholdings in the Company exceed 25%, the period for which the Company is entitled to a reduced income tax is extended to eight years, and subject to corporate taxes at the reduced rate of 10%-25% (depending on the level of non-Israeli investments in the Company).

The period of tax benefits detailed above is subject to limits of 12 years from the year of commencement of production, or 14 years from the date of granting the approval, whichever is earlier. Given the aforementioned conditions, under the first expansion program, the period of benefits for the production facilities, which has not yet commenced, will terminate in the year 2010, and under the second expansion program the period of benefits for the production, which has yet commenced, will terminate in the year 2012.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 15:- TAXES ON INCOME (Cont.)

As the Company currently has no taxable income, the benefits have not yet commenced for all programs since inception.

In addition, the Company filed a request for an "Approved Enterprise" status for a second expansion of the previous program totaling \$ 160. The request is not yet approved.

The tax-exempt income attributable to the "Approved Enterprise" can be distributed to shareholders without subjecting the Company to taxes only upon the complete liquidation of the Company. If these retained tax-exempt profits are distributed in a manner other than in the complete liquidation of the Company they would be taxed at the corporate tax rate applicable to such profits as if the Company had not elected the alternative system of benefits, currently between 25% for an "Approved Enterprise". As of December 31, 2002, the accumulated deficit of the Company does not include tax-exempt profits earned by the Company's "Approved Enterprise".

The benefits from the Company's approved enterprise programs are dependent upon the Company fulfilling the conditions stipulated by the Law for Encouragement of Capital Investments, 1959 and the regulations published under this law, as well as the criteria in the approval for the specific investment in the Company's "Approved Enterprise" programs. If the Company does not comply with these conditions, the tax benefits may be canceled, and the Company may be required to refund the amount of the canceled benefits, with the addition of linkage differences and interest. As of the date of these financial statements, the Company's management believes that it has complied with these conditions.

By virtue of this law, the Company is entitled to claim accelerated depreciation on equipment used by the "Approved Enterprise" during five tax years.

Income from sources other than the "Approved Enterprise" during the benefit period will be subject to tax at the regular corporate tax rate of 36%.

b. Tax reform:

On July 24, 2002, Amendment 132 to the Israeli Income Tax Ordinance ("the Amendment") was approved by the Israeli parliament and came into effect on January 1, 2003. The principal objectives of the Amendment were to broaden the categories of taxable income and to reduce the tax rates imposed on employees income.

The material consequences of the Amendment applicable to the Company include, among other things, imposing a tax upon all income of Israeli residents, individuals and corporations, regardless of the territorial source of income and certain modifications in the qualified taxation tracks of employee stock options.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 15:- TAXES ON INCOME (Cont.)

- c. Measurement of taxable income under the Income Tax (Inflationary Adjustments) Law, 1985:

Results for tax purposes are measured and reflected in real terms in accordance with the change in the Israeli Consumer Price Index ("CPI"). As explained in Note 2c the consolidated financial statements are presented in U.S. dollars. The differences between the change in the Israeli CPI and in the NIS/U.S. dollar exchange rate causes a difference between taxable income or loss and the income or loss before taxes reflected in the consolidated financial statements. In accordance with paragraph 9(f) of SFAS No. 109, the Company has not provided deferred income taxes on this difference between the reporting currency and the tax bases of assets and liabilities.

- d. Tax benefits under Israel's Law for the Encouragement of Industry (Taxation), 1969:

The Company is an "industrial company", as defined by the law for the Encouragement of Industry (Taxes), 1969, and as such, is entitled to claim public issuance expenses, and accelerated depreciation on equipment used by the "Approved Enterprise", during the five tax years.

- e. As of December 31, 2002, the Company's net operating loss carryforwards for tax purposes amounted to approximately \$ 18,000. These net operating losses may be carried forward indefinitely and offset against future taxable income.
- f. The U.S. subsidiary's carryforward tax losses through December 31, 2002 amounted to approximately \$ 8,500. These losses are available to offset any future U.S. taxable income of the U.S. subsidiary and will expire in the years 2010-2015. In light of the subsidiary's recent history of operating losses, the Company has recorded a valuation allowance for all its deferred tax assets.

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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 15:- TAXES ON INCOME (Cont.)

g. Deferred income taxes:

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

	December 31, 2002
Operating loss carryforward	\$ 9,540
Valuation allowance	(9,540)
	<u>\$ -</u>

The Company and its subsidiaries provided valuation allowances in respect of deferred tax assets resulting from tax loss carryforward. Deferred taxes in respect of other temporary differences are immaterial. Management currently believes that it is more likely than not that the deferred tax regarding the loss carryforwards and other temporary differences will not be realized. The change in the valuation allowance as of December 31, 2002 was \$519.

h. The Company's total income (loss) before provision for income taxes is as follows:

	Year ended December 31,		
	2000	2001	2002
Domestic (Israel)	\$ 72	\$ (965)	\$ 7,880
Foreign	177	(647)	(5,124)
	<u>\$ 249</u>	<u>\$ (1,612)</u>	<u>\$ 2,756</u>

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

	Year ended December 31,		
	2000	2001	2002
Income (loss) before taxes on income	\$ 249	\$ (1,612)	\$ 2,756
Theoretical tax expense (benefit) computed at the statutory rate (36%)	90	(580)	992
Loss and other items for which deferred taxes were not provided, net	(182)	418	(1,235)
Non-deductible expenses	92	162	243
	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 16:- QUARTERLY INFORMATION (UNAUDITED)

The Company's quarterly consolidated financial position and statements of operations as of and for each of the quarterly periods in the years ended December 31, 2001, and 2002 are as follows:

	Three months ended,							
	Mar. 31, 2001	June 30, 2001	Sept. 30, 2001	Dec. 31, 2001	Mar. 31, 2002	June 30, 2002	Sept. 30, 2002	Dec. 31, 2002
Revenues	\$ 14,895	\$ 10,430	\$ 10,208	\$ 10,694	\$ 11,557	\$ 11,707	\$ 12,158	\$ 13,673
Cost of revenues	3,725	2,240	2,099	2,298	2,558	2,571	2,615	3,202
Gross profit	11,170	8,190	8,109	8,396	8,999	9,136	9,543	10,471
Operating expenses								
Research and development expenses	4,757	4,563	4,319	4,294	4,041	3,870	3,815	3,612
Marketing and selling expenses, net	4,840	4,365	3,690	3,840	4,469	4,587	4,642	4,926
General and administrative expenses	1,169	1,308	1,057	904	969	1,073	1,071	985
Restructuring costs	-	3,023	-	-	-	-	-	-
Total operating expenses	10,766	13,259	9,066	9,038	9,479	9,530	9,528	9,523
Operating income (loss)	404	(5,069)	(957)	(642)	(480)	(394)	15	948
Financial income, net	1,404	1,264	1,118	866	752	686	634	595
Net income (loss)	1,808	(3,805)	161	224	272	292	649	1,543
Basic earnings (loss) per Ordinary share	\$ 0.09	\$ (0.2)	\$ 0.01	0.01	\$ 0.01	\$ 0.02	\$ 0.04	\$ 0.08
Weighted average number of Ordinary shares outstanding	19,196,316	19,199,771	18,995,041	18,431,559	18,168,617	18,063,334	18,137,900	18,218,850
Diluted earnings (loss) per Ordinary share	\$ 0.09	\$ (0.20)	\$ 0.01	\$ 0.01	\$ 0.01	\$ 0.02	\$ 0.03	\$ 0.08
Weighted average number of shares	20,750,146	19,199,771	20,226,819	19,601,742	19,400,949	18,864,264	18,792,868	18,875,238

Corporate Information

Management

Gadi Tamari	<i>Chief Executive Officer</i>
Eli Doron	<i>Chief Technical Officer and Executive Vice President</i>
David Seligman	<i>Chief Financial Officer</i>
Avinoam Barak	<i>General Manager, Networking Business Unit (NBU)</i>
Boaz Raviv	<i>General Manager, Technology Business Unit (TBU)</i>
Ofer Shapiro	<i>Senior Vice President, Business Development</i>
Adit Tevel	<i>Senior Vice President, NBU International Sales</i>
Irit Machtey	<i>Senior Vice President Organization and Human Resources</i>
Arnie Taragin	<i>Vice President and Legal Counsel</i>
Arik Even-Tov	<i>Vice President NBU Customer Support</i>

Board of Directors

Zohar Zisapel	<i>Chairman of the Board of Directors</i>
Gadi Tamari	<i>Chief Executive Officer, President and Director</i>
Dan Goldstein	<i>Director</i>
Liora Katzenstein	<i>Director</i>
Andreas Mattes	<i>Director</i>
Efraim Wachtel	<i>Director</i>

Stock Listing

NASDAQ
National Market Systems
Symbol: RVSN
Common Stock

TASE

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Common Stock

Transfer Agent

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