

RADWARE LTD  
Form 20-F  
April 26, 2006

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**Washington, D.C. 20549**  
**FORM 20-F**

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

**OR**

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

For the fiscal year ended December 31, 2005

**OR**

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

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

**o 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 0-30324

**RADWARE LTD.**  
(Exact name of Registrant as specified in its charter)

**Israel**  
(Jurisdiction of incorporation or organization)

**22 Raoul Wallenberg Street, Tel Aviv 69710, Israel**  
(Address of principal executive offices)

Securities registered or to be registered pursuant to Section 12(b) of the Act:  
**Title of each class - Name of each exchange on which registered**

None    None

Securities registered or to be registered pursuant to Section 12(g) of the Act:  
**Ordinary Shares, NIS 0.1 par value per share**  
(Title of Class)

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

**None**  
**(Title of Class)**

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

**19,061,760 Ordinary Shares, NIS 0.1 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 ☒ No

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

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

☒ Yes ☐ No

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

Large Accelerated Filer ☐ Accelerated Filer ☒ Non-Accelerated Filer ☐

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

☐ Item 17 ☒ Item 18

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

## INTRODUCTION

As used in this annual report, the terms “we,” “us,” “our,” the “Company,” and “Radware” mean Radware Ltd. and its subsidiaries, unless otherwise indicated. The references to “Companies Law” or the “Israeli Companies Law” are to the Israeli Companies Law, 5759-1999 (as amended).

## CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

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 Report 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 “Risk Factors” and elsewhere in this annual report.

We urge you to consider that statements which 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 with respect to 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.

We have registered trademarks for “Web Server Director®,” “Cache Server Director®”, “FireProof®”, “LinkProof®”, “Triangulation®”, “Smart Nat®”, “Get Certain®”, “CertainT®”, “Peer Director®”, “Synapps Architecture®”, “DefensePro®”, “StringMatch Engine®” and “CID - Content Inspection Director®” and we have trademark applications pending for “UpLink™”, “Radware™”, “AppDirector™”, “AppXcel™” and “SecureFlow™”. All other trademarks and tradenames 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****Selected Financial Data**

The following tables present our consolidated statement of operations and balance sheet data for the periods and as of the dates indicated. We derived the statement of operations for the years ended December 31, 2003, 2004 and 2005 and the balance sheet data as at December 31, 2004 and 2005 from our audited consolidated financial statements included elsewhere in this annual report, which have been prepared in accordance with generally accepted accounting principles in the United States ("U.S. GAAP"). The selected consolidated statement of operations financial data for the years ended December 31, 2001 and 2002 and the balance sheet data for the years ended December 31, 2001, 2002 and 2003 are derived from our audited consolidated financial statements not included in this annual report, which have been prepared in accordance with U.S. GAAP. *You should read the following selected financial data together with the section of this annual report entitled "Operating and Financial Review and Prospects" and our consolidated financial statements together with the notes thereto included elsewhere in this annual report.* Please see notes 2R and 12B of the notes to our consolidated financial statements for an explanation regarding the computation of basic and diluted net earnings (loss) per ordinary share.

|                                             | Year ended<br>December<br>31,<br>2001 | Year ended<br>December<br>31,<br>2002 | Year ended<br>December<br>31,<br>2003 | Year ended<br>December<br>31,<br>2004 | Year ended<br>December<br>31,<br>2005 |
|---------------------------------------------|---------------------------------------|---------------------------------------|---------------------------------------|---------------------------------------|---------------------------------------|
| (US \$ in thousands, except per share data) |                                       |                                       |                                       |                                       |                                       |

**Statement of Operations Data:**

|                                                        |            |            |           |           |           |
|--------------------------------------------------------|------------|------------|-----------|-----------|-----------|
| Revenues                                               | \$ 43,327  | \$ 43,663  | \$ 54,780 | \$ 68,439 | \$ 77,584 |
| Cost of revenues                                       | 7,709      | 7,946      | 9,854     | 12,184    | 14,896    |
| Gross profit                                           | 35,618     | 35,717     | 44,926    | 56,255    | 62,688    |
| Operating expenses:                                    |            |            |           |           |           |
| Research and development, net                          | 8,293      | 7,809      | 8,398     | 10,342    | 13,017    |
| Sales and Marketing                                    | 29,986     | 30,019     | 29,753    | 31,898    | 40,002    |
| General and administrative                             | 4,543      | 4,219      | 4,120     | 4,493     | 5,244     |
| Total operating expenses                               | 42,822     | 42,047     | 42,271    | 46,733    | 58,263    |
| Operating profit (loss)                                | (7,204)    | (6,330)    | 2,655     | 9,522     | 4,425     |
| Financial income, net                                  | 6,312      | 4,240      | 3,740     | 4,565     | 5,159     |
| Income (loss) before income taxes                      | (892)      | (2,090)    | 6,395     | 14,087    | 9,584     |
| Income taxes                                           | (389)      | -          | -         | (341)     | (240)     |
| Loss in respect of an investment in an affiliate       | (6,333)    | -          | -         | -         | -         |
| Minority interest in losses (earnings) of a subsidiary | 37         | (23)       | (40)      | 34        | -         |
| Net income (loss)                                      | \$ (7,577) | \$ (2,113) | \$ 6,355  | \$ 13,780 | \$ 9,344  |
| Basic net earnings (losses) per share                  | \$ (0.46)  | \$ (0.13)  | \$ 0.37   | \$ 0.77   | \$ 0.50   |
| Diluted net earnings (losses) per share                | \$ (0.46)  | \$ (0.13)  | \$ 0.34   | \$ 0.70   | \$ 0.47   |

|                                                                                                    | Year ended<br>December<br>31,<br>2001 | Year ended<br>December<br>31,<br>2002 | Year ended<br>December<br>31,<br>2003 | Year ended<br>December<br>31,<br>2004 | Year ended<br>December<br>31,<br>2005 |
|----------------------------------------------------------------------------------------------------|---------------------------------------|---------------------------------------|---------------------------------------|---------------------------------------|---------------------------------------|
|                                                                                                    | (in thousands)                        |                                       |                                       |                                       |                                       |
| Weighted average number of ordinary shares used in computing basic net earnings (loss) per share   | 16,423                                | 16,655                                | 17,184                                | 17,995                                | 18,800                                |
| Weighted average number of ordinary shares used in computing diluted net earnings (loss) per share | 16,423                                | 16,655                                | 18,666                                | 19,805                                | 20,072                                |

|                                                                                                                                 | 2001       | 2002      | December 31,<br>2003<br>(US \$ in thousands) | 2004       | 2005       |
|---------------------------------------------------------------------------------------------------------------------------------|------------|-----------|----------------------------------------------|------------|------------|
| <b>Balance Sheet Data:</b>                                                                                                      |            |           |                                              |            |            |
| Cash and cash equivalents, short-term bank deposits and marketable securities and current maturities of long-term bank deposits | \$ 125,680 | \$ 52,274 | \$ 62,882                                    | \$ 109,020 | \$ 126,901 |
| Long-term bank deposits, structured note and marketable securities                                                              | -          | 73,027    | 76,139                                       | 48,021     | 37,592     |
| Working capital                                                                                                                 | 124,911    | 50,690    | 60,477                                       | 107,687    | 124,005    |
| Total assets                                                                                                                    | 144,461    | 142,998   | 158,114                                      | 183,241    | 204,347    |
| Shareholders' equity                                                                                                            | 128,938    | 127,357   | 140,246                                      | 160,917    | 177,426    |

## Risk Factors

*Our business, operating results and financial condition could be seriously harmed due to any of the following risks. The trading price of our ordinary shares could decline due to any of these risks.*

### Risks Related to Our Business and Our Industry

#### We have incurred losses in the past, and may incur losses in the future

While we were profitable in 2005, 2004 and 2003, we incurred losses in 2002 and 2001. We had net income of approximately \$9.3 million in 2005, \$13.8 million in 2004 and \$6.4 million in 2003. We incurred net losses of approximately \$2.1 million in 2002 and \$7.6 million in 2001. We will need to generate increased revenues as well as manage our costs to maintain and increase profitability. We cannot assure you that we will be able to maintain and/or increase profitability. Our gross margin is currently approximately 81%. As a result, any decrease in sales may have a significant effect on our profitability.

Our revenues may not grow or continue at their current level. For example, the growth rate in 2004 compared to 2003 was approximately 25%, whereas the growth rate in 2005 compared to 2004 was approximately 13%. In addition, our operating expenses may increase. Our decision to increase operating expenses and the scope of such increase will depend upon several factors, including the market situation and the results that our past expenditures produce. We may make additional expenditures in anticipation of generating higher revenues, which we may not realize, if at all, until some time in the future. If our revenues do not increase as anticipated, or if our expenses increase at a greater pace than revenues, we may not be profitable or, if we are profitable, we may not be able to sustain or increase profitability on a quarterly or annual basis.

Our net profit for 2005 derives also from financial income in an amount of approximately \$5.2 million. We cannot assure you that we will be able to generate financial income in the future or that such financial income will remain at the same level. For example, in December 2005 we acquired the business of V-Secure Technologies Inc., or V-Secure, for a total amount of \$15 million, of which \$9 million was paid in December 2005 and \$6 million may be paid during the first half of 2006, subject to meeting a certain milestone. The amount spent on the acquisition, as well as any additional investments we make in the future, will reduce our level of cash and consequently reduce the amount of financial income derived in the future.

**Volatility of the market for our products, including deterioration of the economy worldwide, slow-down in expenditures by service providers, e-commerce businesses and other trends in our industry could have a material adverse effect on our results of operations.**

Our business is dependent on current and anticipated market demand for our products. Beginning in late 2000, market demand was negatively impacted by the general deterioration of the global economy and the economic uncertainties in the telecommunications market. These conditions, and the uncertainties surrounding the growth rates of economies worldwide, resulted in a curtailment of capital investment by companies in our target markets and caused our revenue growth to increase at a significantly slower pace during 2001 and 2002 relative to prior years. According to our estimates, in 2003, the market remained substantially flat and in 2004 and 2005 there was slight improvement in the market. Due to the past volatility of the market it is difficult to predict the conditions of our market going forward. In addition, we believe that market conditions could cause our customers and potential customers to be more conservative in planning their spending. If the global conditions deteriorate, and companies in our target markets continue to reduce capital expenditures, we may experience a reduction in sales, as well as downward pressure on the price of our products. In addition, if the market will be flat and customers experience low visibility we may not be able to increase our sales. Each of the above scenarios would have a material adverse effect on our business, operating results and financial condition.

**We may experience significant fluctuations in our quarterly financial performance because of the factors discussed below and seasonal fluctuations in our sales.**

Our quarterly operating results have varied significantly in the past and may vary significantly in the future as a result of various factors, many of which are outside of our control. These factors include:

- Our limited order backlog;
- Our dependence upon our suppliers;
- Our need to develop and introduce new and enhanced products; and
- The long sales cycles of our products.

As a result of the foregoing our results in any quarter may also fall below projected results.

In addition, our quarterly operating results have been, and are likely to continue to be, influenced by seasonal fluctuations in our sales. Because our sales have grown significantly since inception, these fluctuations may not be apparent from our historical financial statements. However, we believe that our sales and sales growth have been, and will continue to be, affected by the seasonal purchasing patterns of some of our customers. For example, we believe that our sales may be reduced from the levels which we might otherwise have been able to attain during the third quarter of 2006 because of the slowdown in business activities during the summer months in Europe, and that our sales during the fourth quarter of 2006 may be increased because some of our customers tend to make greater capital expenditures towards the end of their own fiscal years. Because of these anticipated fluctuations, our sales and operating results in any quarter may not be indicative of future performance and it may be difficult for investors to

properly evaluate our prospects.

**If the market for Application Delivery solutions does not continue to develop, we will not be able to sell enough of our products to maintain profitability.**

The Application Delivery market in which we operate is rapidly evolving and we cannot assure you that it will continue to develop and grow or that our products and technology will keep pace with these changes. Market acceptance of Application Delivery solutions is not proven and may be inhibited by, among other factors, a lack of anticipated congestion and strain on existing network infrastructures and the availability of alternative solutions. If demand for Application Delivery solutions does not continue to grow, we may not be able to sell enough of our products to maintain and increase profitability.

**Competition in the market for Application Delivery solutions is intense. As a result, we may lose market share and we may be unable to maintain profitability.**

The Application Delivery market is highly competitive and we expect competition to intensify in the future. We may lose market share if we are unable to compete effectively with our competitors. Our principal competitors in the Application Delivery solutions market include: Cisco Systems, Inc., Nortel Networks Corp., F5 Networks, Inc., Citrix Systems, Inc. and Juniper Networks Inc. In addition, we face competitors in the Application Security space, with respect to our Intrusion Prevention Systems (IPS). Such competitors include Internet Security Systems, Inc., Juniper Networks, Inc., 3Com Systems, Inc. and McAfee, Inc. We expect to continue to face additional competition as new participants enter the market. Larger companies with substantial resources, brand recognition and sales channels may form alliances with or acquire competing Application Delivery solutions and emerge as significant competitors. For example, Juniper Networks Inc. became a competitor in the application delivery market by acquiring Peribit Networks Inc. and Redline Networks Inc., and Citrix Systems Inc. became a competitor in the Application Delivery market by acquiring Netscaler Inc. Competition may result in lower prices or reduced demand for our products and a corresponding reduction in our ability to recover our costs, which may impair our ability to maintain and increase profitability. Furthermore, the dynamic market environment, which is demonstrated by the above acquisitions, poses a challenge in predicting market trends and expected growth.

**Some of our competitors have greater resources than us, which may limit our ability to effectively compete with them.**

Some of our competitors have greater financial, personnel and other resources than us, which may limit our ability to effectively compete with them. These competitors may be able to:

- respond more quickly to new or emerging technologies or changes in customer requirements;
- benefit from greater economies of scale;
- offer more aggressive pricing;
- devote greater resources to the promotion of their products; and/or
- bundle their products or incorporate an Application Delivery component into existing products in a manner that renders our products partially or fully obsolete.

**We must develop new products and enhancements to existing products to remain competitive. If we fail to develop new products and product enhancements on a timely basis, we may lose market share.**

The market for Application Delivery solutions is characterized by rapid technological change, frequent new product introductions, changes in customer requirements and evolving industry standards. Accordingly, our future success will depend to a substantial extent on our ability to:

- invest significantly in research and development;
- develop, introduce and support new products and enhancements on a timely basis; and
- gain and consecutively increase market acceptance of our products.



We are currently developing new products and enhancements to our existing products. We may not be able to successfully complete the development and market introduction of new products or product enhancements. If we fail to develop and deploy new products and product enhancements on a timely basis, or if we fail to gain market acceptance of our new products, our revenues will decline and we may lose market share to our competitors. For example, at the end of 2005 we introduced our next generation APSolute application delivery product family. This product launch includes a high end application switch with enhanced system software called APSolute OS, and introducing three new products, AppDirector, AppXcel and SecureFlow. During 2005 we invested, and plan to continue to invest in 2006, in creating and increasing market acceptance of our APSolute product family. There is no assurance that we will be successful in marketing and selling our next generation application delivery solution and growing revenues to justify our investments.

**We have a very limited order backlog. If revenue levels for any quarter fall below our expectations, our earnings will decrease.**

We have a very limited order backlog, which makes revenues in any quarter dependent on orders received and delivered in that quarter. A delay in the recognition of revenue, even from one customer, may have a significant negative impact on our results of operations for a given period. We base our decisions regarding our operating expenses on anticipated revenue trends, and our expense levels are relatively fixed, or require some time for adjustment. Because only a small portion of our expenses varies with our revenues, if revenue levels fall below our expectations, our earnings will decrease.

**We depend upon independent distributors to sell our products to customers. If our distributors do not succeed in selling our products, our revenues will suffer.**

We sell our products primarily to independent distributors, including value added resellers, original equipment manufacturers and systems integrators. These distributors resell our products to the ultimate customers. We currently have over 200 active independent distributors and resellers that sell our products. We are highly dependent upon our distributors' active marketing and sales efforts. Our distribution agreements generally are non-exclusive, one-year agreements with no obligation on the part of our distributors to renew the agreements. Typically, our distribution agreements do not prevent our distributors from selling products of other companies, including products that may compete with our products, and do not contain minimum sales or marketing performance requirements. As a result, our distributors may give higher priority to products of other companies or to their own products, thus reducing or discontinuing their efforts to sell our products. We may not be able to maintain our existing distribution relationships. If our distributors terminate their relationships with us, we may not be successful in replacing them. In addition, we may need to develop new distribution channels for new products and we may not succeed in doing so. Any changes in our distribution channels, or our inability to establish distribution channels for new products, will impair our ability to sell our products and result in the loss of revenues.

**Our products generally have long sales cycles, which increases our costs in obtaining orders and reduces the predictability of our earnings.**

Our products are technologically complex and are typically intended for use in applications that may be critical to the business of our customers. As a result, our sales process is often subject to delays associated with lengthy approval processes that typically accompany the design and testing of new equipment. The sales cycles of our products to new customers can last as long as twelve months from initial presentation to sale. This delays the time in which we recognize revenue, and results in our having to invest significant resources in marketing and sales.

Long sales cycles also subject us to risks not usually encountered in a short sales cycle, including our customers' budgetary constraints, internal acceptance reviews and cancellation. In addition, orders expected in one quarter could shift to another because of the timing of our customers' procurement decisions. Furthermore, customers may defer orders in anticipation of new products or product enhancements introduced by us or by our competitors. These factors

complicate our planning processes and reduce the predictability of our earnings.

**We must manage our anticipated growth effectively in order to maintain profitability.**

We have actively expanded our operations in the past and may continue to expand them in the future in order to gain market share in the evolving market for Application Delivery solutions. This expansion has required, and may continue to require, managerial, operational and financial resources.

We cannot assure you that we will continue to expand, or that we will be able to offer and expand our operations successfully. If we are unable to manage our expanding operations effectively, our revenues may not increase, our cost of operations may rise and we may not be profitable.

As we grow we may need new or enhanced systems, procedures or controls. For example, we are in the process of purchasing and migrating to a new ERP system. The purchase, migration and implementation of such a system can take up to 24 months. The transition to such systems, procedures or controls, as well as any delay in transitioning to new or enhanced systems, procedures or controls, may seriously harm our ability to accurately forecast sales demand, manage our product inventory and record and report financial and management information on a timely and accurate basis.

**Our efforts to increase our presence in additional markets may not be profitable.**

We currently offer our products in over 40 countries in addition to North America. In fiscal years 2004 and 2005, our sales outside the Americas represented approximately 58% and 59%, respectively, of our total sales. Our ability to penetrate new markets is subject to risks inherent to these markets. The risks may impair our ability to generate profits from our increased sales efforts outside North America. In addition, any future political or economic instability in these or other foreign countries could significantly reduce demand for our products.

**Our success depends on our ability to attract, train and retain highly qualified sales, technical and customer support personnel.**

As we grow, we may need to increase our research and development, sales and marketing, and support staff. Our products require a sophisticated marketing and sales effort targeted at several levels within a prospective customer's organization. The integration of these solutions into existing networks and ongoing support can be complex. Accordingly, we need highly-trained sales, marketing and customer support personnel. Competition for qualified sales personnel, as well as technical and customer support personnel is intense, and we may not be able to hire sufficient personnel to support our research and development and sales and marketing efforts. Our success depends upon our ability to attract, train and retain highly qualified personnel.

**We are dependent on Roy Zisapel, our Chief Executive Officer and President, the loss of whom would negatively affect our business.**

Our future success depends in large part on the continued services of our senior management and key personnel. In particular, we are highly dependent on the services of Roy Zisapel, our Chief Executive Officer and President. Although we have employment contracts with our senior management and key personnel, we do not carry life insurance on our senior management or key personnel. Any loss of the services of Roy Zisapel, other members of senior management or other key personnel could negatively affect our business.

**Undetected hardware and software errors may increase our costs and impair the market acceptance of our products.**

Our products have occasionally contained, and may in the future contain, undetected errors, especially when first introduced or when new versions are released, either due to errors we fail to detect or errors in components supplied by third parties. These errors tend to be found from time to time in new or enhanced products after the commencement of commercial shipments. Our customers integrate our products into their networks with products from other vendors. As a result, when problems occur in a network, it may be difficult to identify the product that has caused the problem. Regardless of the source of these errors, we will need to divert the attention of our engineering personnel from our product development efforts to address the detection and correction of these errors. In the past, we have not incurred significant warranty or repair costs, nor have we been subject to liability claims for damages related to product errors or experienced any material lags or delays as a result of these errors. However, we cannot assure you that we will not

incur these costs or liabilities or experience these lags or delays in the future. Any insurance policies that we may have may not provide sufficient protection should a claim be asserted. Moreover, the occurrence of errors, whether caused by our products or the products of another vendor, may result in significant customer relations problems and injure our reputation, thus impairing the market acceptance of our products.

**We rely on third party manufacturing vendors to provide key components of our products. If USR Technologies and Electronics (2003) Ltd., or USR, is not able to provide us with adequate supplies of the principal component used in our products, we may not be able to deliver sufficient quantities of our products to satisfy demand, or may have a delay in fulfilling orders.**

We rely on USR to supply us with circuit boards. These circuit boards are a principal component, which we use in the manufacture of our products. If we are unable to acquire circuit boards from USR on acceptable terms, or should USR cease to supply us with circuit boards for any reason, we may not be able to identify and integrate an alternative source of supply in a timely fashion or at the same costs. Any transition to one or more alternate suppliers would likely result in delays, operational problems and increased costs, and may limit our ability to deliver our products to our customers on time for such transition period. There is no assurance, that we will be able to obtain an additional supplier or that we will be able to get components from an additional supplier in prices that are competitive to USR prices. We are currently negotiating an agreement with an additional supplier, however, for supply of a limited number of product platforms.

**A shortage of components or manufacturing capacity could cause a delay in our ability to fulfill orders or increase our manufacturing costs**

Our growth and ability to meet customer demands depend in part on our ability to obtain timely deliveries of parts from our suppliers and contract manufacturers. We may experience a shortage of certain component parts as a result of our own manufacturing issues, manufacturing issues at our suppliers or contract manufacturers, capacity problems experienced by our suppliers or contract manufacturers, or strong demand in the industry for those parts, especially if the economy grows. Growth in the economy is likely to create greater pressures on us and our suppliers to accurately project overall component demand and component demands within specific product categories and to establish optimal component levels. If shortages or delays persist, the price of these components may increase, or the components may not be available at all, and we may also encounter shortages if we do not accurately anticipate our needs. We may not be able to secure enough components at reasonable prices or of acceptable quality to build new products in a timely manner in the quantities or configurations needed. Accordingly, our revenues and gross margins could suffer until other sources can be developed. Our operating results would also be adversely affected if, anticipating greater demand than actually develops, we commit to the purchase of more components than we need. There can be no assurance that we will not encounter these problems in the future. Although in many cases we use standard parts and components for our products, certain components are presently available only from a single source or limited sources. We may not be able to diversify sources in a timely manner, which could harm our ability to deliver products to customers and seriously impact present and future sales..

**Our products may not meet the new European governmental regulations, including environmental standards, required for their sale, which may negatively affect our sales.**

Our activities in Europe require that we comply with European Union Directives with respect to product quality assurance standards and environmental standards. Directive 2002/95/EC on Restriction Of the Use of Certain Hazardous Substances in Electrical and Electronic Equipment (known as the “RoHs” Directive), requires products sold in Europe to meet certain design specifications, which exclude the use of hazardous substances, will take effect on July 1, 2006 and requires that certain of our products be modified to meet this regulation. Directive 2002/96/EC on Waste Electrical and Electronic Equipment (known as the “WEEE” Directive) requires producers of electrical and electronic equipment to register in different European countries and provide collection and recycling facilities for used products. If we fail to achieve compliance, we may be restricted from selling our products in the European Union and this could adversely affect our results of operations.

**Following the Implementation of SFAS No. 123R, we are required to record a compensation expense in connection with share based compensation, and, as a result, our profitability will be reduced significantly.**

On December 16, 2004, the Financial Accounting Standards Board (FASB) issued Statement No. 123 (revised 2004), Share-Based Payment ("SFAS No. 123(R) "), which is a revision of SFAS No. 123.

Generally, the approach in SFAS 123(R) is similar to the approach described in Statement 123. However, SFAS No. 123 permitted, but did not require, share-based payments to employees to be recognized based on their fair values while SFAS No. 123(R) requires, as of the first quarter of 2006, all share-based payments to employees to be recognized as a compensation expense based on their fair values. SFAS No. 123(R) also revises, clarifies and expands guidance in several areas, including measuring fair value, classifying an award as equity or as a liability and attributing compensation cost to reporting periods. The impact of the adoption of SFAS No. 123(R) cannot be predicted at this time because it will depend also on levels of share-based compensation granted in the future. Had we adopted this standard in prior period, however, we would have recorded a material amount as compensation expense, which would have a material adverse effect on our profitability. The adoption of this standard could materially adversely affect our profitability in the future. In addition, if as a result of SFAS No. 123(R) we would stop or limit the use of stock options as an incentive and retention tool, it could have a negative effect on our ability to recruit and retain employees.

### **Our profitability could suffer if third parties infringe upon our proprietary technology.**

Our profitability could suffer if third parties infringe upon our intellectual property rights or misappropriate our technologies and trademarks for their own businesses. Our success depends upon the protection of our proprietary software installed in our products, our trade secrets and our trademarks. To protect our rights to our intellectual property, we rely on a combination of trademark and patent law, trade secret protection, confidentiality agreements and other contractual arrangements with our employees, affiliates, distributors and others. In the United States, we have registered trademarks for “Web Server Director®,” “Cache Server Director®”, “FireProof®”, “LinkProof®”, “Triangulation®”, “Smart Nat®”, “Get Certain®”, “CertainT®”, “Peer Director®”, “Synapps Architecture®”, “DefencePro®”, “StringMatch Engine®” and “CID - Content Inspection Director®”. We also have trademark applications pending for “UpLink™”, “Radware™”, “AppDirector™”, “AppXCell™” and “SecureFlow™”. In addition, we have registered patents in the United States for our triangle redirection method used for the global load balancing, for our mechanism for efficient management and optimization of multiple links used in our LinkProof product, for our method for load balancing by global proximity used in our WSD product and for our method for controlling traffic on links between autonomous BGP systems. We also have pending patent applications and provisional patents in connection with several features used in our products. The protective steps we have taken may be inadequate to deter misappropriation of our proprietary information. We may be unable to detect the unauthorized use of our proprietary technology or take appropriate steps to enforce our intellectual property rights. Effective trademark, patent and trade secret protection may not be available in every country in which we offer, or intend to offer, our products. Failure to adequately protect our intellectual property could devalue our proprietary content and impair our ability to compete effectively. Furthermore, defending our intellectual property rights could result in the expenditure of significant financial and managerial resources. For example, on July 16, 2004 we filed a lawsuit in the District Court of New Jersey against F5 Networks, Inc. for infringement of our patent directed at a method for load balancing by global proximity. The lawsuit was settled on March 10, 2005. Although the lawsuit did not result in a significant expenditure we spent time and resources litigating and settling the claim.

### **Our products may infringe on the intellectual property rights of others.**

Third parties may 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. As a result we may incur costs defending ourselves or settling lawsuits even if we believe we do not infringe third parties rights. For example, on March 19, 2003, F5 Networks, Inc. filed a lawsuit against us for patent infringement in U.S. District Court for the Western District of Washington. We settled the claim in September 2004 and licensed the F5 patent in suit. Although the settlement and license did not have a material effect on our financial results, we spent time and resources on defending and settling the claim.

**Our non-competition agreements with our employees may not be enforceable in certain jurisdictions. If any of these employees leaves our company and joins a competitor, our competitor could benefit from the expertise our former employee gained while working for us.**

We currently have non-competition agreements with all of our employees. These agreements prohibit our employees, in the event they cease to work for us, from directly competing with us or working for our competitors for a limited period after termination of employment. The laws of the U.S., Israel and other countries in which we have employees, may limit or prohibit our ability to enforce these non-competition agreements, or may allow us to enforce them only to a limited extent. In the event that we are unable to enforce any of these agreements, competitors that employ our former employees could benefit from the expertise our former employees gained while working for us.

**Some of our deposits and other investments may be in excess of insured limits and are not insured in other jurisdictions.**

The majority of our cash and cash equivalents, and short-term and long-term bank deposits are invested in banks in the United States and in the U.K. Some of these deposits may be in excess of insured limits and are not otherwise insured. If one or more of these financial institutions were to become insolvent, the loss of these investments would have a material adverse effect on our financial condition.

### **Risks Related to the Market for Our Ordinary Shares**

**Two shareholders may exert significant influence in the election of our directors and over the outcome of matters requiring shareholder approval.**

As of April 24, 2006, Mr. Yehuda Zisapel, Chairman of our board of directors, beneficially owns an aggregate of 2,577,477 ordinary shares, representing approximately 13.27% of the ordinary shares outstanding as of April 24, 2006 and options to purchase 60,000 ordinary shares, of which 20,000 are vested. Roy Zisapel, Mr. Yehuda Zisapel's son, is our Chief Executive Officer, President and a director. Roy Zisapel owns 457,584 ordinary shares and options to purchase 800,000 ordinary shares, of which 700,000 are fully vested as of April 24, 2006. In addition, Mr. Yehuda Zisapel has the right to vote the ordinary shares issuable upon exercise of options while held by the trustee under our share option plan. As a result, these shareholders may exert significant influence in the outcome of various actions that require shareholder approval, such as the election of our directors, approve or reject a merger and similar corporate transactions.

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

Generally, if for any taxable year 75% or more of our gross income is passive income, or at least 50% of our assets are held for the production of, or produce, passive income, we would be characterized as a passive foreign investment company, or PFIC, for U.S. federal income tax purposes. This characterization could result in adverse U.S. tax consequences to our U.S. shareholders, including having gain realized on the sale of our ordinary shares treated as ordinary income, as opposed to capital gain income, and having potentially punitive interest charges apply to such sales proceeds. 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.

We believe we were not a PFIC for our 2005 tax year. It is possible that the Internal Revenue Service will attempt to treat us as a PFIC for 2005 or prior years. The tests for determining PFIC status are applied annually and it is difficult to make accurate predictions of future income and assets, which are relevant to this determination. Accordingly, there can be no assurance that we will not become a PFIC in 2006 or in subsequent years. For a discussion of the rules relating to passive foreign investment companies and related tax consequences, please see the section of this annual report entitled "Taxation — United States Federal Income Tax Considerations."





### **Risks Related to Operations in Israel**

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

We are incorporated under Israeli law and our principal offices and manufacturing and research and development facilities are located in Israel. Accordingly, our operations and financial results could be adversely affected if political, economic and military events curtailed or interrupted trade between Israel and its present trading partners or if major hostilities involving Israel should occur in the Middle East.

Since the establishment of the State of Israel in 1948, a number of armed conflicts have taken place between Israel and its Arab neighbors. A state of hostility, varying in degree and intensity, has led to security and economic problems for Israel. Since October 2000, there has been a high level of violence between the Palestinians and Israel, which has strained Israel's relationship with its Arab citizens, Arab countries and, to some extent, with other countries around the world. We do not believe that the political and security situation has had a material impact on our business to date, however, there is no assurance that this will always be the case in the future. We could be adversely affected by any major hostilities, including acts of terrorism or any other hostilities involving or threatening Israel, the interruption or curtailment of trade between Israel and its trading partners or a significant downturn in the economic or financial condition of Israel. Furthermore, several countries restrict business with Israel and Israeli companies, and additional countries or companies may restrict doing business with Israel and Israeli companies as the result of the aforementioned hostilities. No predictions can be made as to whether or when a final resolution of the area's problems will be achieved or the nature thereof and to what extent the situation will impact Israel's economic development or our operations.

#### **Some of our directors and officers as well as many of our Israeli employees are obligated to perform annual military reserve duty in Israel. We cannot assess the potential impact of these obligations on our business.**

Some of our directors, officers and employees are, unless exempt, obligated to perform annual military reserve duty, depending upon their age and prior position in the army. They may also be further subject to being called to active duty at any time under emergency circumstances. Directors, officers, and key employees falling within these requirements include Roy Zisapel, our Chief Executive Officer and President, Amir Peles, our Chief Technical Officer, and Assaf Ronen, our Vice President, Research and Development. Our operations could be disrupted by the absence, for a significant period, of one of more of these officers or other key employees due to military service, and any disruption in our operations would harm our business. The full impact on our workforce or business if some of our officers and employees will be called upon to perform military service, especially in times of national emergency, is difficult to predict.

#### **The rate of inflation in Israel and the change in the exchange rate between the New Israeli Shekel against the U.S. dollar and/or the U.S. dollar against the Euro is volatile, and may negatively impact our costs.**

Most of our revenues are denominated in U.S. dollars or are dollar-linked, but we incur a portion of our expenses, principally salaries and related personnel expenses, in other currencies mainly in Israel, in New Israeli Shekels ("NIS") and in Europe, in Euros. In 2005, we sold in Euros in most European countries. In this respect, we are exposed to the following risks: the rate of inflation in Israel may exceed the rate of devaluation of the NIS in relation to the dollar, the timing of this devaluation may lag behind inflation in Israel, or the NIS may increase in value relative to the dollar. In such events, the dollar cost of our operations in Israel will increase and our dollar-measured results of operations will be adversely affected. In addition, if the Euro increases in value relative to the dollar and sales in Euros do not exceed expenses incurred in Euros, the dollar cost of our operations in Europe will increase and our operating profit will be adversely affected. If the Euro decreases in value relative to the dollar and sales in Euros exceed expenses incurred in Euros, our operating profit will be negatively affected as a result of a decrease in the dollar value of our sales. In 2005,

the value of the dollar increased in relation to the NIS by 6.8%, the inflation rate in Israel was 2.4%, and the value of the dollar increased in relation to the Euro by 15.3%. As a result, during 2005, we had a decrease in expenses (as a result of the decrease in the Euro exchange rate), which was offset by the decrease we had in our sales due to the fact that our sales to the EU countries are also denominated in Euro. We cannot provide assurances that we will not be materially adversely affected by the rate of inflation in Israel or exchange rate fluctuations in the future.

**The tax benefits we may receive in connection with our approved enterprise program require us to satisfy prescribed conditions and may be terminated or reduced in the future. This would increase taxes and decrease our net profit**

The Investment Center has granted us an approval to establish an "Approved Enterprise" program at our Tel Aviv and Jerusalem facilities. An Approved Enterprise is eligible for tax benefits on taxable income derived from its Approved Enterprise programs. The benefits available to an Approved Enterprise are dependent upon the fulfillment of conditions stipulated in applicable law and in the certificate of approval. If we fail to comply with these conditions, in whole or in part, with respect to any Approved Enterprise program we establish, or if we voluntarily decide to cease the Approved Enterprise program, we may be required to pay additional taxes for the period in which we benefited from the tax exemption or reduced tax rates and we would likely be denied these benefits in the future. One criterion for establishing the level of tax benefits is the percentage of holdings by foreign (i.e. non-Israeli) investors in our shares. A decrease in the level of foreign investors' holdings may increase our tax rate.

A recent amendment to the Investment Law, which was published on April 1, 2005 (the "Amendment") has changed certain provisions of the Investment Law. As a result of the Amendment, the Company is no longer obliged to obtain an Approved Enterprise status in order to receive the tax benefits previously available under the Alternative Benefits provisions, and therefore there is no need to apply to the Investment Center for this purpose (Approved Enterprise status remains mandatory for companies seeking grants). Rather, the Company may claim the tax benefits offered by the Investment Law directly in its tax returns, provided that its facilities meet the criteria for tax benefits set out by the Amendment. The Company is also granted a right to approach the Israeli Tax Authority for a pre-ruling regarding their eligibility for benefits under the Amendment. Tax benefits are available under the Amendment to production facilities (or other eligible facilities), which are generally required to derive more than 25% of their business income from export (referred to as a "Benefited Enterprise" under the Amendment). In order to receive the tax benefits, the Amendment states that the Company must make an investment in the Benefited Enterprise exceeding a minimum amount specified in the Law. Such investment may be made over a period of no more than three years ending at the end of the year in which the Company requested to have the tax benefits apply to the Benefited Enterprise (the "Year of Election"). Where the Company requests to have the tax benefits apply to an expansion of existing facilities, then only the expansion will be considered a Benefited Enterprise and the Company's effective tax rate will be the result of a weighted combination of the applicable rates. In this case, the minimum investment required in order to qualify as a Benefited Enterprise is required to exceed a certain percentage of the Company's production assets before the expansion.

Our approved program and tax benefits thereunder may not continue in the future at their current levels or at any level. The termination or reduction of these tax benefits would likely increase our taxes. The amount, if any, by which our taxes would increase will depend 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.

**We may be required to pay stamp duty on agreements executed by us after June 1, 2003 and prior to January 1, 2006. This would increase our taxes.**

The Israeli Stamp Duty on Documents Law, 1961, or the Stamp Duty Law, provides that most documents signed by Israeli companies are subject to a stamp duty, generally at a rate of between 0.4% and 1% of the value of the subject matter of such document. De facto, it has been common practice in Israel not to pay such stamp duty unless a document is filed with a governmental authority or with the courts. As a result of an amendment to the Stamp Duty Law that came into effect on June 1, 2003, the Israeli tax authorities have approached many companies in Israel and requested the disclosure of all agreements signed by such companies after June 1, 2003 with the aim of collecting stamp duty on such agreements. Based on advice from counsel, we believe that we may only be required to pay stamp duty on documents signed on or after August 2004. However, we cannot assure you that the tax authorities or the courts will accept such view. Although at this stage it is not yet possible to evaluate the effect, if any, on us of the

amendment to the Stamp Duty Law, the same could materially adversely affect our results of operations.

Under an order published in December 2005, the requirement to pay stamp duty was terminated with respect to documents signed on or after January 1, 2006.

**Provisions of Israeli law could delay, prevent, or make difficult, a change of control, thereby depressing the price of our ordinary shares.**

The Israeli Companies Law generally provides that a merger be approved by both the board of directors of a company and a majority of the shares present and voting on the proposed merger. For purposes of the shareholder vote, unless a court rules otherwise, the 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 other party to the merger (or by any person who holds 25% or more of the voting power or the right to appoint 25% or more of the directors of the other party or its general manager) voted 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 the obligations of the surviving company. In addition, a merger generally may not be completed unless at least (i) 50 days have passed since the filing of the merger proposal signed by each of the merging companies with the Israeli Registrar of Companies and (ii) 30 days have passed since the merger was approved by the shareholders of each of the parties to the merger. Also, in certain circumstances an acquisition of shares in a public company must be made by means of a tender offer. Lastly, Israeli tax law treats some acquisitions, such as stock-for-stock exchanges between an Israeli company and a foreign company, less favorable than U.S. tax laws. These provisions of Israeli corporate and tax law may have the effect of delaying, preventing or make more difficult an acquisition of or merger with us, which could depress our share price.

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

Service of process upon us, our Israeli subsidiaries and affiliates, and our directors and officers named herein substantially all of whom reside outside the United States, may be difficult to obtain within the United States. Furthermore, because the majority of our assets and investments, and substantially all of our directors and officers are located outside the United States, any judgment obtained in the United States against us or any of them may not be collectible within the United States.

There is doubt as to the enforceability of civil liabilities under the Securities Act and the Securities Exchange Act in original actions instituted in Israel. However, subject to specified time limitations, Israeli courts may enforce a U.S. final executory judgment in a civil matter, provided that:

- Adequate service of process has been effected and the defendant has had a reasonable opportunity to be heard;
- The judgment and its enforcement are not contrary to the law, public policy, security or sovereignty of the State of Israel;
- The judgment was obtained after due process before a court of competent jurisdiction according to the rules of private international law prevailing in Israel;
- The judgment was not obtained by fraudulent means and does not conflict with any other valid judgment in the same matter between the same parties;
- An action between the same parties in the same matter is not pending in any Israeli court at the time the lawsuit is instituted in the U.S. court; and
- The U.S. court is not prohibited from enforcing the judgments of Israeli courts.



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

### **History and Development of the Company**

Radware Ltd. was organized in May 1996 as a corporation under the laws of the State of Israel, and commenced operations in April 1997. Our principal executive offices are located at 22 Raoul Wallenberg Street, Tel-Aviv 69710, Israel and our telephone number is 972-3-766-8666. Our website address is [www.radware.com](http://www.radware.com). *Information contained on our website does not constitute a part of this annual report.*

As of January 1, 1999, we established a wholly-owned subsidiary in the United States, Radware Inc., which conducts the sales and marketing of our products in the Americas and is our authorized representative and agent in the United States. The principal offices of Radware Inc. are located at 575 Corporate Dr., Lobby 2, Mahwah, NJ 07430 and its telephone number is 201-512-9771.

We also have several wholly owned subsidiaries world-wide handling local support and promotion activities.

For a discussion of our capital expenditures and divestitures, see “Item 5—Operating and Financial Review and Prospects - Liquidity and Capital Resources.”

### **Business Overview**

#### **General**

We develop, manufacture and market Application-smart networking solutions that provide end-to-end availability, performance and security of mission critical networked applications. Radware’s integrated Application Front-End, Application Security and Application Access solutions enable enterprises and carriers to deliver their mission critical applications successfully between data centers and remote locations, over all critical points in the network.

Our Application Delivery solutions enable customers to manage their network infrastructure, bypass systems failures, scale their application performance, and secure their Internet protocol (“IP”) traffic. Our products align network behavior with business process to improve productivity and extract the greatest value from investments in network infrastructures by intelligently distributing traffic within the network, optimizing the use of available network resources and protecting applications, networks and users at high speeds. Since our establishment, our products have won a number of awards for performance, including Network Computing Editor’s Choice, SC Magazine Recommended Buy Award, Network Computing Well-Connected, Internet World Best of Show, PC Magazine Editor’s Choice and Network Magazine Product of the Year. In addition, we have been recognized as industry leaders by independent, third party analysts such as Gartner, IDC and Yankee Group.

### **Solution Architecture, Management and Products**

All Radware APSolute products are built around our family of intelligent ASIC and Network Processor based application switches, and incorporate our innovative new APSolute OS software platform. APSolute products ship with the full set of integrated APSolute OS availability, performance and security capabilities and users have the flexibility to choose the integrated functionality they want activated across the product family for custom-fit application delivery solutions. APSolute OS aligns network operations and resources with application needs for end-to-end fault tolerance and maximum availability, performance and security. Deployed enterprise wide, from the data center to branch offices, APSolute OS meets application demands across application infrastructure server farms, and connectivity and security layers of the network.



APSolute OS is a modular operating system built around Radware's core software engines, the Application Classifier and Flow Manager, that are used to classify traffic based on an extensive and granular set of application intelligence. Users can define classes of traffic and policies for how network resources should handle that traffic based on any combination of network, application, content and user information. APSolute OS service modules (each as described below), which are available on our hardware products, include: Advanced Health Monitoring, Traffic Redirection and Load Balancing, Bandwidth Management, Content Acceleration, Compression, SSL Offloading, Intrusion Prevention and DoS Protection. With APSolute OS, enterprises and carriers can address existing and emergent application service requirements across server farms, security and connectivity layers.

**Advanced Health Monitoring** provides accurate detection of application failures, controls operational components, immediately bypasses failures for non-stop operation, provides failure alerts, and takes automatic corrective action to deliver redundancy at all levels. By tracking traffic flows across the datacenter and distributed sites, and implementing multi-step decisions at every critical point across the transaction path, health monitoring ensures reliable application delivery. Advanced Health Monitoring enables the comprehensive monitoring of resources such as servers, firewalls, VPN gateways, IDS, anti-virus gateways, ISP links, cache and routers. The Health Monitoring module extends predefined health checks including: HTTP (Hypertext Transfer Protocol), HTTPS (Hypertext Transfer Protocol over Secure Socket Layer), FTP (File Transfer Protocol), RADIUS, RTSP (Real-Time Streaming Protocol), while enabling the configuration of customized checks by device, transaction path and content.

**Traffic Redirection and Load Balancing** intelligently distributes traffic across network devices, optimizing the utilization of site-wide resources to accelerate application performance. By providing maximum utilization and flexible traffic distribution across server farms and distributed sites, enterprises gain virtually unlimited scaling of applications, server operations and handling of increased user traffic for economical growth. Traffic redirection optimizes existing resources (locally and remotely), by dynamically distributing traffic across the various servers and sites using an extensive array of traffic redirection algorithms to dispatch traffic - including cyclic distribution, least users, least packets and least bytes. Using patented load balancing technology, Radware distributed traffic according to client/site network proximity and site availability, thus providing a global load balancing solution based on real end user performance. Applications are delivered to the users quickly, no matter where they are located. APSolute traffic redirection extracts granular application intelligence, classifies different types of traffic based on any one, or combination of, application, content, user, and network parameters, and aligns network behavior with business processes, by adapting network behavior to accommodate different types of traffic.

**Bandwidth Management** provides control over bandwidth resource allocation, to prioritize all network traffic, and guarantee service levels for mission critical applications. This ensures that bandwidth required for mission critical applications is not being over-utilized by bandwidth intensive non-critical applications. Bandwidth management policies leverage the classification of traffic by users, applications, and content, for the configuration and prioritization of traffic to ensure that each class receives the level of service according to the defined policy. Based on business requirements, APSolute solutions utilize granular traffic shaping to ensure that critical business applications get higher priority than non-critical applications. With automatic application discovery for over 70 enterprise applications, administrators can limit/guarantee bandwidth on a per-user and per-session basis, and provide granular control to ensure quality of service.

**Content Acceleration** provides economical and transparent scaling of network and server resources with multi-layer acceleration methods, including content caching, TCP optimization, HTTP offloading, SSL offloading, and open-ended content and image compression. These acceleration capabilities reduce bandwidth overhead, congestion and network bottlenecks, and dramatically accelerate content delivery to end-users.

**End-to-end Compression** reduces network latency, and lowers bandwidth costs. Providing open-ended compression eliminates the need for client-side devices or proprietary software for compression over the LAN, and across the WAN. Compression optimizes under-utilized bandwidth and controls bandwidth utilization by compressing web content (reducing the average page size by 50%), and optimizing images (reducing a file size by a factor of 10).

**SSL (Secure Socket Layer) Offloading** of server intensive SSL operations and persistent functions frees server CPU's to handle a greater number of requests, thus reduces the need to buy additional hardware to support application processing requirements. Radware uses a dedicated high throughput, and specialized acceleration platform that enables 16,000 SSL transactions per second, and supports up to 150,000 concurrent connections. A FIPS (Federal Information Processing Standard) compliance card is used for storing security keys and certificates, greatly simplifying key and certificate management. Providing centralized management for all security keys and certificates eliminates the need to maintain keys and certificates on individual servers - saving costs and reducing complexity.



**Intrusion Prevention** automatically secures network resources from over 1,700 malicious attack signatures for Viruses, Worms, Trojans, Scanning software, Spyware, and Protocol anomalies.

By continuously monitoring all network traffic at Gigabit speeds, Intrusion Prevention detects and prevents attacks in real time, immediately blocks malicious traffic to safeguard enterprise operations from hacking. Suspect traffic is monitored and reported, enabling network administrators to take proactive measures against potential intruders. Radware's Security Update Service (SUS) provides the additional security of having immediate protection from any emerging application threat by issuing new attack signatures as they emerge. Unknown attacks are detected using protocol anomaly inspection. Looking for protocol anomalies enables the detection of abnormal packet fragmentation which, in most cases, indicates malicious activity.

**DoS Protection** identifies and blocks debilitating Denial of Service attacks, protecting the network from service failures and downtime. Coupling multi-gigabit throughput speeds with an advanced sampling algorithm, the DoS protection module detects abnormal service requests and stops DoS attacks before they undermine network operations for complete security and business continuity. Additionally, SYN Flood protection protects the network from both known and unknown SYN Flood attacks. This means that while attack mitigation is taking place, legitimate traffic flows normally and users are unaffected by the attack. APSolute also provides DHCP Flood protection to maintain uninterrupted network access.

At the end of 2005 we acquired the business of V-Secure, which included the acquisition of the technology, customers relationship, and goodwill. As a result of the acquisition, V-Secure's key research and development employees were hired by us. Following this acquisition we integrated the V-Secure self-learning expert system algorithms for proactive zero-day protection into our integrated IPS and DoS security solutions. The first version of the integrated product was launched in February 2006. V-Secure adaptive technology is designed to provide customers with immediate protection from new and unknown security threats using advanced behavioral based IPS technology that protects against worms propagation and DoS attacks by identifying anomalous traffic patterns without human intervention.

### ***APSolute Insite***

The common application management tool which runs across all Radware products is APSolute Insite. APSolute Insite is a unified management tool with an intuitive GUI that provides end-to-end network visibility, control and policy management of all application switching devices. APSolute Insite's unified administration allows users to control and monitor IP application performance across the enterprise. APSolute Insite is a service driven management tool that optimizes business performance and availability by providing a unified environment for the seamless management of all Radware devices. Features such as trend analysis and full views of statistics allow network administrators to proactively monitor, manage and tune network resources to optimize their mission critical enterprise services.

Based on an easy-to-use site map interface, APSolute Insite lets users draw their network, configure Radware Application-smart switching devices and set-up the APSolute OS Services (as described above) to address end-to-end IP application service requirements. APSolute Insite's statistics module provides real-time and historical views of actual application performance levels for monitoring site-wide operations and simple pinpointing of vulnerabilities and failures, affording complete visibility and control over the performance of Web and Application Servers, security tools, cache servers, anti-virus tools and Internet links.

APSolute Insite provides real-time and historical views of all Radware Application Switching devices and APSolute OS services for complete visibility of site-wide IP application performance, facilitating trend analysis while extending comprehensive control of enterprise operations. The collected statistics enable administrators to identify network vulnerabilities and take proactive steps to mitigate service failures before they affect the site. APSolute Insite offers a comprehensive set of user defined statistics that provide performance and bandwidth consumption data per device,

including bi-directional traffic, failures, bottlenecks, resource management and client information. Based on this information, network administrators can decide to add resource capacities, tune bandwidth policies or relocate devices to better manage actual traffic loads and IP application performance requirements.

## Application Switch Platforms

All Radware products are powered by our Application Switch platforms. Radware purpose-built Application Switching hardware offers scalable and flexible throughput performance to meet the broad range of enterprise and carrier end-to-end application delivery requirements.

Radware's Application Switch 1 combines ASIC-based switching, CPU processing power and APSolute OS Services to deliver the performance and service breadth to address all IP application requirements across network layers 4-7. Designed to guarantee application availability, security and performance, Application Switch 1 bridges the gap between IT infrastructure and IP Applications for comprehensive control of all critical operations across the enterprise.

Application Switch 2 is powered by a multi-layered switching architecture designed to address the widest set of protocols and service requirements across network layers 4-7 while boosting IP application performance to Gigabit Speeds. Delivering accelerated processing speeds with the ability to optimize routing decisions based on specific applications, web requests and content, Application Switch 2 provides reliability, performance and security across IP applications, for complete control over enterprise operations.

Application Switch 3 is a 3-tier processing architecture designed to meet the high capacity processing requirements for the most intensive layer 4-7 switching operations. Dual network processors in the second tier of the Application Switch 3 architecture, accelerate traffic redirection, load-balancing, quality of service control, real-time intrusion prevention and DoS mitigation for application security to multi-Gigabit speeds. The third-tier in the Application Switch 3 architecture is the powerful RISC processor that is responsible for managing and prioritizing all active application sessions.

In 2005, we introduced our new high-end Application Switch 4 which provides superior performance and port density with 20 ports of Gigabit Ethernet.

The APSolute™ product family consists of the following products, all of which are built around Radware application switch platforms and a common APSolute OS and APSolute Insite software architecture:

- *AppDirector™ and Web Server Director®* provides full availability, redundancy, security and optimized operation of servers - in order to achieve high performing IP applications.
- *The LinkProof® Family: LinkProof®* manages Internet traffic for networks, commonly referred to as multi-homed networks, which access the Internet through multiple connections via several ISPs, to provide fault tolerant and cost effective Internet connectivity. *LinkProof® Branch* manages the operation of multiple links across all remote office links, allowing large, multi-branched enterprises to control and reduce the costs of their connectivity and VPN between headquarters and branch offices. The LinkProof Family delivers an end-to-end multi-homing solution from central headquarters to remote branch offices.
- *DefensePro®* Intrusion Prevention and Denial of Service Switch protects against worms, viruses, malicious intrusions and Denial of Service attacks at up to 3 Gigabit speeds, preventing attacks in real-time for intrusion prevention and multi-layer application defense.
- *AppXcel™ and CertainT 100 ® Application Accelerator* performs web compression and HTTP multiplexing, and accelerates web applications for high performance content serving and Secure Sockets Layer (“SSL”) encryption and decryption, providing secure and effective SSL processing.



- *SecureFlow™ simplifies the management and optimizes performance of best of breed enterprise security tools to enable transparent, selective integration of content inspection, anti-virus, VPN, IDS and firewalls into a unified switched architecture to eliminate the security/performance tradeoff*
- *CID - Content Inspection Director® managed service delivery platform for carriers that enables centralized and optimized IP value added service deployment. With Content Inspection Director carriers can extend high-performance security and media services to customers, customizing delivery, guaranteeing SLAs and generating a new source of revenues.*

Our products are compatible with any system that uses the Internet protocol and can operate with various network structures, configurations and operating systems. Our products support a wide variety of IP-based applications, including web services, e-mail, voice, P2P, ERP, Customer Relationship Management tools, database and file transfers.

### **Security Update Service**

Radware's Security Update Service is an optional subscription service that delivers immediate and ongoing security updates, to protect customers against the latest security threats. The Security Update Service, available as a subscription service, is comprised of the following services: A Security Operations Center, Emergency Filters, Weekly Security Updates and Custom Filters, which are sent to the service subscribers.

### **Customers and End Users**

With the exception of our limited direct sales efforts to select customers, we sell our products through distributors or resellers who then sell our products to end users.

We have a globally diversified end-user base, consisting of corporate enterprises including banks, insurance companies, manufacturing and retail, government agencies, media companies and service providers, such as telecommunication carriers, Internet service providers and application service providers. Customers in these different vertical markets deploy Radware for availability, performance and security of their applications from headquarters to branch offices.

In 2005, approximately 41% of our sales were in the Americas (principally in the United States), 31% were in EMEA (Europe, Middle East and Africa) and 28% in Asia-Pacific. Other than the United States, no single country accounted for more than 10% of our sales for 2005.

For the years ended December 31, 2005, 2004 and 2003, one single customer (a distributor) accounted for 16%, 11% and 11% of our sales, respectively. As of December 31, 2005 one single customer (a distributor) represented 16% of the trade receivables balance. As of December 31, 2004, no single customer represented more than 10% of the trade receivables balance.

### **Sales and Marketing**

*Sales.* We market and sell our products primarily through an indirect sales channel that consists primarily of distributors located in North America, Europe and Asia. In addition, we generate direct sales to select customers. Our sales channels are supported by our sales managers who are also responsible for recruiting potential distributors and resellers and for initiating and managing marketing projects in their assigned regions. The sales managers are supported by our internal sales support staff who help generate and qualify leads for the sales managers. As of December 31, 2005, we employed a total of 51 sales managers and sales staff in the Americas with locations in various states. We also employed 62 sales managers and sales staff based in the rest of the world, who are responsible



for developing and maintaining distribution channels outside the Americas. We have subsidiaries and representative offices and branches in several countries, which promote and market our products and provide customer support in their respective regions.

*Marketing Strategy.* Our marketing strategy is to enhance brand recognition and maintain our reputation as a provider of technologically advanced, quality Application-smart solutions. We seek to build upon our marketing and branding efforts globally to achieve greater worldwide sales. Our sales force and

marketing efforts are principally directed at developing brand awareness and providing sales support to our distributors. We participate in major trade shows and offer support to our distributors who participate in regional trade shows and events. We also invest in web based and print advertising campaigns as well as a global media and public relations campaign. In addition to our independent marketing efforts, we invest in joint marketing efforts with our distributors, value added resellers and other companies that have formed strategic alliances with us. We have entered into co-marketing arrangements with companies in other complementary Internet segments, including:

- Aventail Corporation;
- Finjan Software;
- Oracle Corporation;
- BEA Systems, Inc.;
- BMC Software Inc.;
- Aladdin Knowledge Systems Ltd.;
- Secure Computing Corporation;
  - Microsoft Corporation;
- WatchGuard Technologies Inc.; and
- Hewlett Packard Company.

*Strategic Alliances and Original Equipment Manufacturer Agreements.* We have entered into strategic alliances and original equipment manufacturer agreements with other software and hardware vendors, including Comverse Technology, Inc. and NEC Corporation, as well as mutual channel information sharing arrangements. We believe that these companies have significant customer relationships and offer products which complement our products. Our agreements allow these companies to distribute our products on a world-wide non-exclusive basis with discounts based upon the volume of orders received. There usually is no requirement for a minimum sales quota. The products are branded with the names of these companies or co-branded with our name. These agreements are standard distributor agreements, purchase agreements, OEM (original equipment manufacturer) agreements or other specific agreements and are terminable by either party at will. We plan to further invest in the development of strategic alliances in order to provide greater access to our target markets and enhance our brand name.

## **Technical Management**

Our technical team, which consists of 106 employees worldwide as of December 31, 2005, supports our sales force during the sales process, assists our customers and distributors with the initial installation, set-up and ongoing support of our products, trains distributors and customers to use our products and provides software updates and product upgrades for our products. In addition, our technical team trains and certifies our distributors to provide limited technical support in each of the geographical areas in which our products are sold, and is directly responsible for remote support. Our Certainty Support Program provides offerings which allow customers to automatically get new software versions of their products and obtain optimized performance by purchasing any of the following five optional offerings: extended warranty, software updates, 24x7 help-desk (directly to our customers and through our distributors), on-site support and unit replacement.

## **Research and Development**

In order to maintain our share of the Application Switching market, we place considerable emphasis on research and development to expand the capabilities of our existing products, develop new products and improve our existing technologies and capabilities. We believe that our future success will depend upon our ability to maintain our technological expertise, enhance our existing products and introduce, on a timely basis, new commercially viable products that will continue to address the needs of our customers. Accordingly, we intend to continue devoting a significant portion of our personnel and financial resources to research and development. In order to identify market needs and to define appropriate product specifications, as part of the product development process we seek to maintain

close relationships with current and potential distributors, customers and vendors in related industry segments.

As of December 31, 2005, our research and development staff consisted of 122 employees. Research and development activities take place at our facilities in Israel. We employ established procedures for the requirement management, development and quality assurance of our new product developments. Our research and development organization is divided according to our existing products. Each product group is headed by a group leader and includes team leaders and engineers. In addition, we have a hardware and infrastructure group responsible for the development of the Radware hardware platforms and infrastructure which is the basis for all products, serving all product groups, which consists of a group leader, team leaders, and engineers and a generic software group responsible for the software which is common to all our products (such as the management tools), which consists of a group leader, team leaders and engineers. We furthermore have a quality assurance department, which assists all product groups, and includes a group leader and quality control engineers and technicians. We occasionally use third party subcontractors for the development of portions of research and development projects.

## **Manufacturing and Suppliers**

USR Technologies and Electronics (2003) Ltd. (“USR”) manufactures the circuit boards which are the principal hardware component used in our products. It supplies us with finished circuit boards for final assembly. The other components and subassemblies included in our products are supplied to USR from a limited group of suppliers and subcontractors. USR monitors each stage of the circuit board production process, including the selection of components and subassembly suppliers. USR is ISO 9002 certified, indicating that its manufacturing processes adhere to established quality standards.

We install our proprietary software onto the circuit boards we receive from USR. Quality assurance testing, final assembly and packaging and shipping operations are primarily performed at our facility in Jerusalem, Israel.

These circuit boards are the principal component which we use in the manufacture of our products. If we are unable to acquire circuit boards from USR on acceptable terms, or should USR cease to supply us with circuit boards for any reason, we may not be able to identify and integrate an alternative source of supply in a timely fashion or at the same costs. Any transition to one or more alternate suppliers would likely result in delays, operational problems and increased costs, and may limit our ability to deliver our products to our customers on time for such transition period. We are currently negotiating an agreement with an additional supplier for a limited number of product platforms.

Our activities in Europe require that we comply with European Union Directives with respect to product quality assurance standards and environmental standards. The “RoHS” Directive, will take effect on July 1, 2006 and requires that certain of our products be modified to meet this regulation. The “WEEE” Directive requires producers of electrical and electronic equipment to register in different European countries and provide collection and recycling facilities for used products. If we fail to achieve compliance, we may be restricted from selling our products in the European Union and this could adversely affect our results of operations.

## **Proprietary Rights**

We rely on patent, trademark and trade secret laws, as well as confidentiality agreements and other contractual arrangements with our employees, distributors and others to protect our technology. We have a policy that requires our employees to execute employment agreements, including confidentiality and non-compete provisions.

We have registered trademarks for “Web Server Director®,” “Cache Server Director®”, “FireProof®”, “LinkProof®”, “Triangulation®”, “Smart Nat®”, “Get Certain®”, “CertainT®”, “Peer Director®”, “Synapps Architecture®”, “DefensePro®”, “StringMatch Engine®” and “CID - Content Inspection Director®” and we have trademark applications pending for “UpLink™”, “Radware™”, “APScalPDirector™”, “AppXCel™” and “SecureFlow™”. We do not currently own any registered copyrights. We have registered patents in the United States for our triangle redirection method used for the global load balancing, for our mechanism for efficient management and optimization of multiple links used in our LinkProof

product, for our method for load balancing by global proximity used in our WSD product and for our method for controlling traffic on links between autonomous BGP systems, and pending patent applications and provisional patents in connection with several methods and features used in our products. These applications may not result in any patent being issued, and, if issued, the patents may not provide adequate protection against competitive technology and may not be held valid and enforceable if challenged. In addition, other parties may assert rights as inventors of the underlying technologies, which could limit our ability to fully exploit the rights conferred by any patent that we receive. Our competitors may be able to design around any patent we receive and other parties may obtain patents that we would need to license or circumvent in order to exploit our patents.

The protective steps we have taken may be inadequate to deter misappropriation of our technology and information. We may be unable to detect the unauthorized use of, or take appropriate steps to enforce, our intellectual property rights. Some of the countries in which we sell our products do not protect intellectual property to the same extent as the United States and Israel. In addition, our competitors may independently develop technologies that are substantially equivalent or superior to our technology. Any licenses for intellectual property that might be required for our services or products may not be available on reasonable terms.

For example, in March 2003, F5 Networks, Inc. filed a lawsuit against us for patent infringement in U.S. District Court for the Western District of Washington. We settled the claim in September 2004.

In July 2004, we filed a lawsuit in the District Court of New Jersey against F5 Networks, Inc. for infringement of our patent directed at a method for load balancing by global proximity. We settled the lawsuit in March 2005.

## **Competition**

Our industry is characterized by intense competition. Our principal competitors in the sale of Application Delivery solutions include Cisco Systems, Inc., Nortel Networks Corporation, Juniper Networks Inc, Citrix Networks Inc., and F5 Networks, Inc. We expect to face increasing competition as new competitors enter our market and multinational corporations purchase players in the market. In addition, we face competition in the Intrusion Prevention space. Such competitors include 3Com Systems, Inc., Internet Security Systems, Inc. Juniper Networks, Inc. and McAfee, Inc.

Some of our competitors have substantially greater financial, personnel and other resources, and may offer a broader range of products than we do. These competitors may be able to respond more quickly to new or emerging technologies or changes in customer requirements. They may also benefit from greater economies of scale, offer more aggressive pricing, devote greater resources to the promotion of their products, bundle their products or incorporate an existing Application Delivery solution into existing products. Furthermore, in the past year there have been several acquisitions of companies in our market creating larger competitors. For example, Juniper Networks Inc. became a competitor in the application delivery market by acquiring Peribit Networks Inc. and Redline Networks Inc., and Citrix Systems Inc. became a competitor in the application delivery market by acquiring Netscaler Inc. Examples of two additional acquisitions by competitors in the application delivery space were Cisco Systems Inc.'s purchase of FindGround Networks Inc. and F5 Networks Inc.'s acquisition of Swan Labs Corp. The dynamic market environment, which is demonstrated by the above acquisitions, poses a challenge in predicting market trends and expected growth.

We believe that our success will depend primarily on our ability to provide more technologically advanced and cost-effective Application Delivery solutions, and more responsive customer service and support, than our competitors. However, we cannot assure you that the products we offer will compete successfully with those of our competitors. Furthermore, should competition intensify, we may have to reduce the prices of our products which will negatively impact our business and financial condition.

## **Israeli Office of Chief Scientist**

From time to time, eligible participants may receive grants under programs of the Office of the Chief Scientist of the Israeli Ministry of Industry, Trade and Labor, or the Chief Scientist. Grants received are generally repaid through a mandatory royalty based on revenues from products (and ancillary services) incorporating know-how developed, in whole or in part, with the grants. This governmental support is conditioned upon the participant's ability to comply with certain applicable requirements and conditions specified in the Chief Scientist's program and with the provisions of the Law for the Encouragement of Research and Development in the Industry, 1984, and the regulations promulgated thereunder, or the Research and Development Law. In June 2005, an amendment to the Research and Development Law came into effect, among other things, relaxes restrictions on the transfer of manufacturing rights outside Israel and on the transfer of Chief Scientist-funded know-how outside of Israel, as described below.



Under the Research and Development Law, research and development programs that meet specified criteria and are approved by the research committee of the Chief Scientist are eligible for grants usually of up to 50% of certain approved expenditures of such programs, as determined by said 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 therefrom (including ancillary services in connection therewith), up to an aggregate of 100 - 150% of the dollar-linked value of the total grants received in respect of such program, plus interest.

The Israeli government is currently in the process of formulating a proposed amendment to the royalty regulations promulgated under the Research and Development 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 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 is expected to have retroactive effect from January 1, 2006, although there is no assurance as to whether and when it will be adopted. The Research and Development Law generally requires that the product developed under a program be manufactured in Israel. However, upon the approval of the Chief Scientist, some 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 up to 300% of the grant, depending on the portion of the total manufacturing volume that is performed outside of Israel. The June 2005 amendment to the Research and Development Law further permits the Chief Scientist, among other things, 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. Effective April 1, 2003, the Research and Development 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 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.

By December 31, 2001, we repaid by way of royalties the full amount we owed to the Chief Scientist. In 2004, we applied, together with another company, to obtain a grant from the Chief Scientist under the "joint R&D project" track. The Chief Scientist approved the maximum grant to the project of approximately \$0.2 million. In 2005, we applied to obtain an additional grant from the Chief Scientist, under the same project. The Chief Scientist approved an additional grant to the project in an additional maximum amount of approximately \$0.2 million. During 2005 we have received an aggregate amount of \$0.3 million for this project from the Chief Scientist. In the beginning of 2006 we applied to obtain an additional grant, under the same project, in an amount of approximately \$0.3 million. Under the "joint R&D project" track there is no royalty commitment but other limitations of the Research and Development Law are applicable.

The Research and Development Law also provides that know-how developed under an approved research and development program may not be transferred to third parties in Israel without the approval of the research committee. Such approval is not required for the export of any products resulting from such research or development. The Research and Development Law further provides that the know-how developed under an approved research and development program may not be transferred to any third parties outside Israel, except in certain circumstances and subject to the Chief Scientist's prior approval. The Chief Scientist may approve the transfer of Chief Scientist-funded know-how outside Israel, generally in the following cases: (a) the grant recipient pays to the Chief Scientist a portion of the sale price paid in consideration for such Chief Scientist-funded know-how (according to certain formulas), or (b) the grant recipient receives know-how from a third party in exchange for its Chief Scientist-funded know-how, or (c) such transfer of Chief Scientist-funded know-how arises in connection with certain types of cooperation in research and development activities.



The Research and Development 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 Office of the Chief Scientist to comply with the Research and Development Law. In addition, the rules of the Office 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 Research and Development Law.

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 what would be the amounts of future grants, if any, that we might receive.

### Organizational Structure

As of January 1, 1999, we established a wholly-owned subsidiary in the United States, Radware Inc., which conducts the sales and marketing of our products in America. We also have subsidiaries in Australia, France, Germany, the United Kingdom, Italy, Japan, Singapore, Korea, Canada and Switzerland. We have also established representative offices in China, Taiwan and Russia, and a liaison office in India. All the above subsidiaries are wholly-owned. Our subsidiaries include:

| <b><u>Name of Subsidiary</u></b> | <b><u>Country of Incorporation</u></b> |
|----------------------------------|----------------------------------------|
| Radware Inc.                     | New Jersey, United States of America   |
| Radware UK Limited               | United Kingdom                         |
| Radware France                   | France                                 |
| Radware Srl                      | Italy                                  |
| Radware GmbH                     | Germany                                |
| Nihon Radware KK                 | Japan                                  |
| Radware Australia Pty. Ltd.      | Australia                              |
| Radware Singapore Pte. Ltd.      | Singapore                              |
| Radware Korea Ltd.               | Korea                                  |

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|                     |             |
|---------------------|-------------|
| Radware Canada Inc. | Canada      |
| Radware GmbH        | Switzerland |

Yehuda Zisapel is a co-founder and shareholder of Radware. Yehuda Zisapel is also the Chairman of the Board of Directors of Radware. Individually or together with his brother, Zohar Zisapel, he is also a founder, director and/or principal shareholder of several other companies which, together with Radware and our subsidiaries listed above are known as the RAD-Bynet Group. These corporations include:

|                                 |                                               |                       |
|---------------------------------|-----------------------------------------------|-----------------------|
| AB-NET Communications Ltd.      | Ceragon Networks Ltd.                         | WISAIR Inc.           |
| BYNET Data Communications Ltd.  | Commex Technologies Inc.                      | Sanrad Inc.           |
| BYNET Electronics Ltd.          | Infogate On Line Ltd.                         | RADLive Inc.          |
| BYNET SEMECH (outsourcing) Ltd. | Modules Inc.                                  | RAD-OP, Inc.          |
| Bynet Software Systems Ltd.     | Packetlight Networks Ltd.                     | RADView Software Ltd. |
| Bynet System Applications Ltd.  | RAD-Bynet Properties and Services (1981) Ltd. | RADVision Ltd.        |
|                                 | RADCOM Ltd.                                   | RADWIN Ltd.           |
|                                 | RAD Data                                      | RiT Technologies Ltd. |
|                                 |                                               | Silicom Ltd.          |

The group also includes several other holdings, real estate companies and pharmaceutical companies. The above list does not constitute a complete list of the investments of Messrs. Yehuda and Zohar Zisapel.

In addition to engaging in other businesses, members of the RAD-Bynet Group are actively engaged in designing, manufacturing, marketing and supporting data communications products, none of which currently compete with our products. Some of the products of members of the RAD-Bynet Group are complementary to, and may be used in connection with, our products. See also Item 7 - *Related Party Transactions*.

### Property, Plants and Equipment

Our headquarters and principal administrative, finance, research and development and marketing operations are located in approximately 31,500 square feet of leased office space in Tel Aviv, Israel. The lease expires in October 2007. The facilities are leased from affiliated companies owned by Messrs. Yehuda and Zohar Zisapel - see Item 7 - *Major Shareholders and Related Parties Transactions*."

We also sublease approximately 5,482 square feet of space in Jerusalem for our manufacturing facility from USR. The sublease with respect to 2,150 square feet expires in April 2009 and the sublease with respect to the remaining 3,332 square feet expires in December 2007. In the United States, we lease approximately 12,382 square feet in Mahwah, New Jersey from a related party, which lease will expire in April 2007. We also lease 4,916 square feet from an unaffiliated party in Costa Mesa, California, which lease expires in March 2007. We also lease 3,024 square feet in Dallas, Texas, which lease expires in February 2009. In addition, we lease facilities for the operation of our subsidiaries and representative offices in several locations in the United States, Europe and Asia Pacific. We may need additional space if we expand our business and believe that we will be able to obtain space as needed.

### ITEM 4A. UNRESOLVED STAFF COMMENTS

None.

## ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS

### 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 April 1997. 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 infrastructure.

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.

*Revenues.* Our revenues are derived primarily from sales of our products and, to a lesser extent, from sales of post-contract customer support through our Certainty Support program and sales of a security subscription service the “Security Update Service” (hereunder “SUS”). We generally recognize product revenue when persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed or determinable, no further obligation exists and collectability is probable. Post-contract customer support and the SUS service, which represents mainly software update subscriptions, help-desk support and unit replacements, is recognized ratably over the contract period, which is typically one year.

*Cost of Sales.* Our cost of sales consists primarily of the cost of circuit boards and other components required for the assembly of our products, salaries and related personnel expenses for those engaged in the final assembly and maintenance service of our products and other overhead costs.

*Research and Development Expenses.* Research and development expenses consist primarily of salaries and related personnel expenses, costs of subcontractors and prototype expenses related to the design, development, testing and enhancement of our products. All research and development costs are expensed as incurred. We believe that continued investment in research and development is critical to attaining our strategic product objectives.

*Marketing and Selling Expenses.* Marketing and selling expenses consist primarily of salaries, commissions and related personnel expenses for those engaged in the sales and marketing of our products as well as related trade shows, advertising, promotional, web site maintenance and public relations 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.

Operating expenses also included amortization of stock-based compensation, which is allocated among research and development expenses, marketing and selling expenses and general and administrative expenses, based on the division in which the recipient of the option grant is employed. Amortization of stock-based compensation results from the granting of stock options to employees with exercise prices per share determined to be below the deemed fair market value per share of our ordinary shares on the dates of grant or from modifications to specific stock option grants. The stock-based compensation is being amortized to operating expenses over the vesting period of the individual options.

On December 16, 2004, the Financial Accounting Standards Board (FASB) issued Statement No. 123 (revised 2004), Share-Based Payment ("SFAS No. 123(R)"), which is a revision of SFAS No. 123. Generally, the approach in SFAS 123(R) is similar to the approach described in Statement 123. However, SFAS No. 123 permitted, but did not require, share-based payments to employees to be recognized based on their fair values while SFAS No. 123(R) requires all share-based payments to employees to be recognized, as of the first quarter of 2006, based on their fair values. SFAS No. 123(R) also revises, clarifies and expands guidance in several areas, including measuring fair value, classifying an award as equity or as a liability and attributing compensation cost to reporting periods.

SFAS No. 123(R) permits public companies to adopt its requirements using one of two methods: (i) a "modified prospective" method in which compensation cost is recognized beginning with the effective date (a) based on the requirements of Statement SFAS No. 123(R) for all share-based payments granted after the effective date and (b) based on the requirements of SFAS No. 123 for all awards granted to employees prior to the effective date of SFAS No. 123(R) that remain unvested on the effective date. (ii) a "modified retrospective" method which includes the requirements of the modified prospective method described above, but also permits entities to restate based on the amounts previously recognized under SFAS No. 123 for purposes of pro forma disclosures either (a) all prior periods presented or (b) prior interim periods of the year of adoption.

We plan to adopt the new statement effective January 1, 2006, using the "modified prospective" method. We expect the adoption of SFAS No. 123R may have a significant effect on the Company's results of operations and net earnings per share. However, our assessment of the estimated compensation charges is affected by our stock price as well as assumptions regarding a number of complex and subjective variables and the related tax impact. These variables include, but are not limited to, the volatility of our stock price and employee stock option exercise patterns. Had we adopted SFAS No. 123(R) in prior periods, the impact of that standard would have approximated the impact of SFAS No. 123 as described in the disclosure of pro forma net income and earnings per share in Note 2 to our consolidated financial statements.

*Financial Income (Expenses), Net.* Financial income, net consists primarily of interest earned on short-term and long-term bank deposits, and of amortization of premiums, accretion of discounts and interest earned on investment in marketable securities of proceeds from the issuance of our shares to the public, from the exercise of options to purchase our shares, from cash generated from our operations and from income and expenses from the translation of monetary balance sheet items denominated in non-dollar currencies.

*Taxes.* Israeli companies are generally subject to corporate tax on their taxable income at the rate of 35% for the 2004 tax year, 34% for the 2005 tax year, 31% for the 2006 tax year 29% for the 2007 tax year, 27% for the 2008 tax year, 26% for the 2009 tax year and 25% for the 2010 tax year and thereafter, and are 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.

However, we have established an approved enterprise program (the "Program"), which is eligible for the tax benefits for operational profit, described below under the heading "Corporate Tax Rate." These benefits result in part of our income being tax exempt or taxed at a lower rate for some time after we begin to report taxable income. The tax rate depends upon the percentage of our income derived at that time from the Approved Enterprise program. The tax benefits depend on our meeting the requirements of the Program and there is no assurance we will be able to obtain such benefits. Our U.S. subsidiary has carry-forward tax losses to offset against future taxable profit. We have recorded a deferred tax asset in relation to these carry-forward tax losses and we anticipate that we will utilize part of these tax losses in 2006. Other subsidiaries of ours are taxed according to the laws in their countries of incorporation and tax expenses are recorded accordingly. We may incur, for accounting purposes, tax expenses in 2006 which we anticipate to be at a rate of approximately 10%. The tax expenses for accounting purposes might be higher than the actual tax payments to the tax authorities, due to exercise of non qualified options by our employees which gains from such exercises are considered a deductible expense for tax purposes. The tax benefit resulting from the exercise of such stock options will be credited to additional paid-in-capital, when probable, rather than a deduction from the tax expenses for accounting purposes.

*Market trends.* According to our estimations, the market in 2005 has continued the trend which started in 2004 and continued to grow slightly. This slight growth in the past two years has followed a few years in which there was a deterioration of the economy worldwide and economic uncertainty in the telecommunications market which resulted in a curtailment of capital investment by companies in our

target markets and caused our revenue growth to increase at a significantly slower pace during the last few years relative to prior years. Due to the past volatility of the market it is difficult to predict the conditions of our market going forward. In addition, we believe that market conditions cause our customers and potential customers to be more conservative in planning their spending. If the global conditions deteriorate, and companies in our target markets continue to reduce capital expenditures, we may experience a reduction in sales, as well as downward pressure on the price of our products. In addition, if the market continues to be flat and customers continue to experience low visibility we may not be able to increase our sales. Each of the above scenarios would have a material adverse effect on our business, operating results and financial condition. Furthermore, 2005 was marked by several acquisitions of companies in our space which resulted in continuous changes in the competitive landscape. For example, 3Com Systems, Inc. became a competitor in the Intrusion Prevention market by acquiring Tipping Point Technologies, Inc., Juniper Networks Inc. became a competitor in the application delivery market by acquiring Peribit Networks Inc. and Redline Networks Inc., and Citrix Systems Inc. became a competitor in the application delivery market by acquiring Netscaler Inc. The dynamic market environment, which is demonstrated by the above acquisitions, poses a challenge in predicting market trends and expected growth.

We intend to continue our investment in the marketing and branding of our APSolute application delivery product family which we released a few months ago, in order to broaden market acceptance of such products. Such investment includes recruitment of skilled personnel, participation in trade shows, testing and certification of our products by leading firms in the industry, investment in brand awareness and so forth. There is no assurance that we will be successful in such marketing and selling activities and that the increase in revenues, if any, will justify the investment.

*Business combination - acquisition of V-Secure.* In December 2005, we acquired the business of V-Secure which included the acquisition of intellectual property, technology, customers relationship and goodwill. The total consideration for the acquisition was \$9,168,000, out of which an amount of \$ 9,011,000 was paid in cash; and \$148,000 was paid by issuance of fully vested warrants to V-Secure to purchase 45,454 ordinary shares of the Company. The remaining balance is related to acquisition costs payable. Additional cash consideration of \$6,000,000 is payable contingent upon meeting a certain milestone by June 28, 2006. The purchase price was allocated to the identifiable intangible assets acquired (which have been valued by a third party valuation specialist) based upon their estimated fair values. The acquisition of V-Secure was accounted for under the purchase method of accounting. See also Note 1e to our Consolidated Financial Statements included in this annual report.

### **Critical Accounting Policies**

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

In many cases, the accounting treatment of a particular transaction is specifically dictated in the U.S. GAAP and does not require management's judgment in its application. There are also areas in which management's judgment in selecting among available alternatives would produce a materially different result. The Company's management has reviewed these critical accounting policies and related disclosures with the Company's Audit Committee. See Note 2 to our Consolidated Financial Statements, which contains additional information regarding our accounting policies and other disclosures required by U.S. GAAP.

Our management believes the significant accounting policies which affect its more significant judgments and estimates used in the preparation of its consolidated financial statements and which are the most critical to aid in fully understanding and evaluating our reported financial results include the following:





- Revenue recognition;
- Accounting for doubtful accounts;
- Inventory valuation;
- Income taxes; and
- Legal contingencies.

*Revenue recognition.* The Company and its subsidiaries generate revenues from selling their products and post-contract customer support primarily through distributors and resellers, all of which are considered as end-users.

Revenues from product sales are recognized when delivery has occurred, persuasive evidence of an agreement exists, the fee is fixed or determinable, no further obligation exists and collectability is probable.

Revenues in arrangements with multiple deliverables are recognized under the “residual method” when Vendor specific objective evidence ("VSOE") of fair value exists for all undelivered elements, no VSOE exists for the delivered elements, and all other revenue recognition criteria are satisfied. VSOE for post-contract customer support is determined based on the price when it is sold separately in similar arrangements. The price may vary in the territories and vertical markets in which the Company conducts business. Price is determined by using a consistent percentage of the product price.

Revenue derived from post-contract customer support, which represents mainly software subscription, SUS and unit replacement services, is recognized ratably over the contract period, which is typically one year.

Revenues from training and installation, which are considered as not essential to the functionality of the product, included in multiple elements arrangements are recognized at the time they are rendered.

The Company and its subsidiaries provide a provision for product returns and stock rotation based on their experience with historical sales returns, analysis of credit memo data and other known factors, in accordance with Statement of Financial Accounting Standard No. 48 "Revenue Recognition When Right of Return Exists" ("SFAS No. 48"). If the historical data used to calculate these estimates does not properly reflect future returns, additional provision for sales returns may be required, and revenues in that period could be adversely affected.

Deferred revenue includes unearned amounts received under post-contract customer support and SUS.

*Accounting for doubtful accounts.* Our accounts receivable are derived from our sales to our customers located all over the world. We perform periodic credit evaluations of our customers' financial condition. We maintain an allowance for doubtful accounts for estimated losses, which may result from the inability of our customers to make required payments. Management exercises judgment as to its ability to collect outstanding receivables. Allowances for doubtful accounts are made based upon a specific review of all significant outstanding invoices. For those invoices not specifically reviewed, allowances for doubtful accounts are made based upon the age of the receivable. In determining the allowance, we analyze our historical collection experience and current economic trends. If the historical data used to calculate the allowances for doubtful accounts do not reflect the future ability to collect outstanding receivables, additional allowances for doubtful accounts may be needed and the future results of operations could be materially affected.

*Inventory valuation.* At each balance sheet date, we evaluate our inventory balance for excess quantities and obsolescence. This evaluation includes an analysis of sales levels by product and projections of future demand. In

addition, we write off inventories that are considered obsolete. Remaining inventory balances are adjusted to the lower of cost or market value. If future demand for our old or new products, or market conditions are less favorable than our projections, additional inventory write-downs may be required and would be reflected in cost of sales for such period.

*Income taxes.* We 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. We provide a valuation allowance, if necessary, to reduce deferred tax assets to their estimated realizable value.

In evaluating our ability to recover our deferred tax assets, we consider all available positive and negative evidence including our past operating results, the existence of cumulative losses in the most recent fiscal years and our forecast of future taxable income on a jurisdiction by jurisdiction basis. In determining future taxable income, we are responsible for assumptions utilized, the reversal of temporary differences and the implementation of feasible and prudent tax planning strategies. These assumptions require significant judgment about the forecasts of future taxable income and are consistent with the plans and estimates we use to manage the underlying business.

*Legal contingencies.* As discussed in “Item 8 - Financial Information” under the caption “Legal Proceedings,” in December 2001, we were named as a defendant in a class action complaint alleging violations of the federal securities laws in the United States District Court, Southern District of New York, together with approximately 300 additional issuers. We have approved a settlement agreement and related agreements, which set forth the terms of a settlement between us, the plaintiff class and the vast majority of the other approximately 300 issuer defendants.

The settlement agreement provides a guaranteed recovery of \$1 billion to plaintiffs for the cases relating to all of the approximately 300 issuers. To the extent that the underwriter defendants settle all of the cases for at least \$1 billion, no payment will be required under the issuers’ settlement agreement. To the extent that the underwriter defendants settle for less than \$1 billion, the issuers are required to make up the difference. On April 20, 2006, JPMorgan Chase and the plaintiffs reached a preliminary agreement for a settlement for \$425 million. The JPMorgan Chase settlement has not yet been approved by the Court. However, if it is finally approved, then the maximum amount that the issuers or their insurers will be potentially liable for is \$575 million, of which our part is less than \$2 million.

It is anticipated that any potential financial obligation of ours to plaintiffs due pursuant to the terms of the settlement agreement and related agreements will be covered by existing insurance. Therefore, our management, based on the opinions of our legal advisors handling the claim, does not expect that the settlement will involve any payment by the Company. Accordingly, no provision for such contingency was provided in our financial statements.

The settlement agreement and related agreements are subject to a number of contingencies, including the approval of the settlement agreement by the Court. On February 15, 2005, the court granted preliminary approval of the settlement agreement, subject to certain modifications consistent with its opinion. Those modifications have been made. On March 20, 2006, the Underwriter Defendants submitted objections to the settlement to the Court. The Court held a hearing regarding these and other objections to the settlement at a fairness hearing on April 24, 2006, but has not yet issued a ruling. There is no assurance that the court will grant final approval to the settlement. If the settlement agreement is not approved and we are found liable, we are unable to estimate or predict the potential damages that might be awarded, whether such damages would be greater than our insurance coverage, and whether such damages would have a material impact on our results of operations, cash flows or financial condition in any future period.

**A. Operating Results**

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

|                                               | Year ended<br>December 31,<br>2002 | Year ended<br>December 31,<br>2003 | Year ended<br>December 31,<br>2004 | Year ended<br>December 31,<br>2005 |
|-----------------------------------------------|------------------------------------|------------------------------------|------------------------------------|------------------------------------|
| Revenues                                      | 100.0%                             | 100.0%                             | 100.0%                             | 100.0%                             |
| Cost of revenues                              | 18.2                               | 18.0                               | 17.8                               | 19.2                               |
| Gross profit                                  | 81.8                               | 82.0                               | 82.2                               | 80.8                               |
| Operating expenses:                           |                                    |                                    |                                    |                                    |
| Research and development, net                 | 17.9                               | 15.3                               | 15.1                               | 16.8                               |
| Sales and Marketing                           | 68.7                               | 54.3                               | 46.6                               | 51.5                               |
| General and administrative                    | 9.7                                | 7.6                                | 6.6                                | 6.8                                |
| Total operating expenses                      | 96.3                               | 77.2                               | 68.3                               | 75.1                               |
| Operating profit (loss)                       | (14.5)                             | 4.8                                | 13.9                               | 5.7                                |
| Financial income, net                         | 9.7                                | 6.9                                | 6.7                                | 6.6                                |
| Income (loss) before income taxes             | (4.8)                              | 11.7                               | 20.6                               | 12.3                               |
| Income taxes                                  | -                                  | -                                  | (0.5)                              | (0.3)                              |
| Minority interest in earnings of a subsidiary | -                                  | (0.1)                              | -                                  | -                                  |
| Net income (loss)                             | (4.8)%                             | 11.6%                              | 20.1%                              | 12.0%                              |

**Executive Summary - Year Ended December 31, 2005**

Sales in 2005 were approximately \$77.6 million, an increase of 13% compared with sales of \$68.4 million in 2004. In 2005 we have continued the trend of sequential increase in sales, year over year, since our first year of incorporation. The cost of sales as percentage of revenues slightly increased, compared to its level in 2003 and 2004. In order to continue to strengthen and broaden our product lines we have slightly increased our investments in research and development during 2005. In order to increase market acceptance of our new products and to strengthen our branding and market penetration in certain regions, we decided to continue and increase our sales and marketing expenses throughout the year. Our sales increased at a lower rate than the increase of our operating expenses. As a result, there was a decrease in our operating profit in 2005 to an amount of \$4.4 million, compared to an amount of \$9.5 million in 2004. The financial income increased due to the increase in our cash and due to the increase in interest rates. This increase was partially offset by loss from foreign currency translation differences. Such differences resulted mainly from the decrease in the value of the Euro relative to the Dollar during 2005.

In 2006 we intend to continue and increase investment in the development of new products and directions, as well as support continued growth in our sales and enhancement of market acceptance for our end to end product offerings. As a result our research and development and sales and marketing expenses are expected to increase compared to 2005. There is no assurance that our investment in new products and market penetration will increase our revenues and justify the additional expense.

**Year Ended December 31, 2005 Compared with Year Ended December 31, 2004**

*Sales.* Sales in 2005 were approximately \$77.6 million, an increase of approximately 13% compared with sales of approximately \$68.4 million in 2004. The growth in sales during 2005 is primarily attributable to the expansion of our sales and marketing activities, and a slight improvement in the market environment and corporate spending.

*Cost of Sales.* Cost of sales was approximately \$14.9 million in 2005, compared with cost of sales of approximately \$12.2 million in 2004. Cost of sales as a percentage of sales was 19.2% in 2005, a slight increase compared to the cost of sales level of 17.8% in 2004. This increase is primarily attributable to the introduction of new products as well as a different mix of products.

*Research and Development ("R&D") Expenses.* Research and development expenses were approximately \$13.0 million in 2005, an increase of 26% compared with research and development expenses of approximately \$10.3 million in 2004. The increase is primarily due to hiring of new R&D personnel. Additional R&D employees were hired during 2005 in order to support our Application Delivery capabilities and development of new platforms and products, including enhancement of our quality assurance department. A small part of the increase was offset due to the decrease in the Dollar cost of our salaries for our research and development staff caused by the decrease in value of the NIS against the dollar. All these salaries were paid in NIS. We expect the R&D expenses to increase in 2006 due to the recruitment of additional personnel and salary increases of existing personnel.

*Sales and Marketing Expenses.* Sales and marketing expenses were approximately \$40.0 million in 2005, an increase of 25% compared with sales and marketing expenses of approximately \$31.9 million in 2004. Percentage-wise, the share of sales and marketing expenses of total revenues increased from 46.6% in 2004 to 51.5% in 2005. The increase of our sales and marketing expenses in 2005 is related to the increase in sales as well as the continued investment in market acceptance of new products and our next generation APSolute application delivery product family, and investment in new geographical markets, mainly in Europe and the Far East. We anticipate increasing sales and marketing expenses for 2006 primarily for the purpose of (i) increasing brand awareness and market acceptance of our new products (by participation in trade shows and seminars, testing and certification of our products by leading firms in the industry); (ii) strengthening our international presence (by adding sales and marketing personnel, as well as technical support people).

*General and Administrative Expenses.* General and administrative expenses were approximately \$5.2 million in 2005, an increase of approximately 16.7% compared with general and administrative expenses of approximately \$4.5 million in 2004. This increase is primarily attributable to the actions we have taken in order to improve our information systems and to professional services received in order to prepare our company to comply with the Sarbanes Oxley Act.

*Financial Income, Net.* Financial income, net was approximately \$5.2 million in 2005, an increase of approximately 13% compared with financing income, net of approximately \$4.6 million in 2004. This increase is attributable to the total increase in cash and cash equivalents, bank deposits and marketable securities and increase in interest rates which was partially offset by a loss from foreign currency translation differences which are included in financial income, caused mainly by a decrease in the value of the Euro relative to the Dollar.

*Income Taxes.* Income taxes were approximately \$0.3 million in 2005 (in and outside Israel), the same as in 2004. This amount derives mainly from current taxes and change in deferred taxes.

#### **Year Ended December 31, 2004 Compared with Year Ended December 31, 2003**

*Sales.* Sales in 2004 were approximately \$68.4 million, an increase of approximately 25% compared with sales of approximately \$54.8 million in 2003. The growth in sales during 2004 is primarily attributable to the expansion of our sales and marketing activities, the introduction of new products, and a slight improvement in the market environment and corporate spending.

*Cost of Sales.* Cost of sales was approximately \$12.2 million in 2004, compared with cost of sales of approximately \$9.9 million in 2003. This increase is primarily attributable to the increase in sales. Cost of sales as a percentage of sales were 17.8% in 2004, similar to the cost of sales level of 18.0% in 2003.

*Research and Development ("R&D") Expenses.* Research and development expenses were approximately \$10.3 million in 2004, an increase of 23% compared with research and development expenses of approximately \$8.4 million in 2003. The increase is primarily due to hiring of new R&D personnel. Additional R&D employees were hired during 2004 in order to support our Application Security and IPS capabilities and development of new platforms and products, including enhancement of our Quality Assurance department. A small part of the increase can be attributed

to the increase in the dollar cost of our salaries for our research and development staff caused by the increase in value of the NIS against the dollar. All these salaries were paid in NIS.

*Sales and Marketing Expenses.* Sales and marketing expenses were approximately \$31.9 million in 2004, an increase of 7% compared with sales and marketing expenses of approximately \$29.8 million in 2003. Percentage-wise, however, the share of Sales and Marketing expenses of total revenues decreased from 54.3% in 2003 to 46.6% in 2004. The increase of our sales and marketing expenses in 2004 is related to the increase in sales as well as the investment in market acceptance of new products, and investment in new geographical markets, mainly in Europe and the Far East.

*General and Administrative Expenses.* General and administrative expenses were approximately \$4.5 million in 2004, an increase of approximately 9% compared with general and administrative expenses of approximately \$4.1 million in 2003. This increase is primarily attributable to the legal expenses resulting from a lawsuit for patent infringement which was filed against us and was settled in 2004. In addition we filed a lawsuit for patent infringement in July 2004 which was settled in March 2005, however, we did not incur material cost in connection with this lawsuit.

*Financial Income, Net.* Financial income, net was approximately \$4.6 million in 2004, an increase of approximately 22% compared with financing income, net of approximately \$3.7 million in 2003. This increase is attributable to the total increase in cash, bank deposits and marketable securities, increase in interest rates and an increase in the value of the Euro relative to the Dollar. As a result, there was an increase in foreign currency translation differences, which are included in the financial income.

*Income Taxes.* Income taxes were approximately \$0.3 million in 2004. This amount derives mainly from taxes in respect to prior years and current taxes, offset by deferred taxes.

## B. Liquidity and Capital Resources

Since our inception, we have financed our operations through a combination of issuing debt and/or equity securities, including two public offerings, research and development and/or marketing grants from the Government of Israel and cash generated by operations. We raised approximately \$12.9 million in two private placements, in November 1997 and June 1999. In October 1999, we raised net proceeds of approximately \$56.8 million in the initial public offering of our ordinary shares. In January 2000, we raised net proceeds to the Company of approximately \$59.8 million in a public offering of our ordinary shares.

Our principal commitments consist of outstanding operating leases for the Company's facilities. The lease agreements expire in the years 2006 to 2009 (some with renewal options). Our future minimum payments under non-cancelable operating lease agreements at December 31, 2005, are approximately as follows:

| Payments Due By Period (US\$ in thousands) |       |                  |           |           |                   |
|--------------------------------------------|-------|------------------|-----------|-----------|-------------------|
| Contractual Obligations                    | Total | Less than 1 year | 1-3 years | 3-5 years | More than 5 years |
| Operating leases                           | 3,154 | 1,674            | 1,357     | 123       | -                 |
| Total contractual cash obligations         | 3,154 | 1,674            | 1,357     | 123       | -                 |

We operate from leased premises mainly in Tel Aviv and Jerusalem in Israel and New Jersey and California in the United States. We also lease premises for our subsidiaries', representative offices' and branches' activities, in several locations in the United States, Europe and Asia Pacific. Our aggregate annual rent obligations under these leases are approximately \$1,674,000 for 2006. Our aggregate rent expenses paid under our lease obligations for 2005 were approximately \$1,768,000.

Capital expenditures for the years ended December 31, 2003, 2004 and 2005 were approximately \$1.3 million, \$2.4 million and \$3.6 million, respectively. These expenditures were mainly comprised of machinery and equipment, computers, lab equipment and testing tools. We are currently in the process of purchasing and migrating to a new ERP



system. Significant expenditures on such system are likely to take place in 2006 and 2007. We may have additional capital spending consistent with possible growth in our operations, infrastructure and personnel.

During 2005 we generated cash (which was further invested in bank deposits and marketable securities) in a net amount of approximately \$7.5 million. Cash generation derived mainly from our operating activities, from the exercise of options under our Employees Share Incentive Plan and from the purchase of shares under our Employee Stock Purchase Plans, offset by an amount of \$9 million paid in connection with the acquisition of the business V-Secure in December 2005.

Net cash provided by operating activities was approximately \$13.9 million for the year ended December 31, 2005, compared with \$ 15.2 million for the year ended December 31, 2004 and \$9.0 million for the year ended December 31, 2003. Net cash provided by operating activities for the years 2005, 2004 and 2003 changed primarily due to the changes in our operating profit in these years, as a result of our increasing sales and increase in operating expenses - which , for example, in 2005 exceeded in its pace the increase in sales. Net cash provided by operating activities for the year 2005 consisted primarily of net income plus an increase in deferred revenues and other payables and accrued expenses, offset by an increase in trade receivables and inventories. Net cash provided by operating activities for the year 2004 consisted primarily of net income plus an increase in deferred revenues, offset by an increase in trade receivables and inventories. Net cash provided by operating activities for the year 2003 consisted primarily of net income plus an increase in trade payables and in deferred revenues, offset by a decrease in other payables and accrued expenses.

Net cash provided by investing activities was approximately \$26.3 million for the year ended December 31, 2005, compared to net cash used in investing activities of approximately \$45.0 million for the year ended December 31, 2004, and to net cash provided by investing activities of approximately \$0.2 million for the year ended December 31, 2003. Cash was provided in 2005 mainly from redemption of long-term bank deposits which was partially offset by the purchase of marketable securities and by the acquisition of the business of V-Secure Technologies Inc. and other property and equipment. Cash was used in 2004 mainly to purchase long-term marketable securities and for capital expenditures. Cash was provided in 2003 mainly from the redemption of marketable securities, which was almost fully offset by investments in long-term bank deposits and purchase of property and equipment.

Net cash provided by financing activities was \$7.3, \$6.9 and \$6.6 million for the years ended December 31, 2005, 2004 and 2003, respectively, generated from options exercised by our employees under the Key Employee Share Option Plans and Employee Stock Purchase Plans (see Item 6 - *Key Employee Share Incentive Plan; 1999 Employee Stock Purchase Plan; 2001 Employee Stock Purchase Plan and 2002 Employee Stock Purchase Plan*).

As of December 31, 2005, we had cash and cash equivalents, including short-term and long-term bank deposits and marketable securities of approximately \$164.5 million, as compared to approximately \$157.0 million as of December 31, 2004. Our capital requirements depend on numerous factors, including market acceptance of our products and the resources we allocate to our research and development efforts and our marketing and sales activities. Since our inception, we have experienced substantial increases in our expenditures consistent with growth in our operations and personnel, and we may increase our expenditures in the foreseeable future in order to execute our strategy. We anticipate that operating activities as well as capital expenditures will demand the use of our cash resources. We believe that cash balances will provide sufficient cash resources to finance our operations and the projected expansion of our marketing and sales activities and research and development efforts for a period of no less than the next twelve months.

## Related Parties

We have entered into a number of agreements with certain companies, of which Yehuda and Zohar Zisapel are co-founders, directors and/or principal shareholders, collectively known as the RAD-Bynet Group. Of these agreements, the lease for our headquarters in Tel Aviv is material to our operations. We believe that the terms of the transactions in which we have entered with members of the RAD-Bynet Group are not different in any material respect from terms we could obtain from unaffiliated third parties. The pricing of the transactions was arrived at based on negotiations between the parties. Members of our management reviewed the pricing of the lease agreements and confirmed that they were not different than that which 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 in certain terms than might be available from unaffiliated third parties on similar issues. In the event that the transaction with members of the RAD-Bynet Group is terminated and we enter into similar transactions with unaffiliated third parties, that flexibility may not be available to us.

In addition, the Company purchases different services from third parties at special rates offered to the RAD-Bynet Group, such as car leases, maintenance, insurance and communication services. In the event that we cease to be a member of the RAD-Bynet Group, we may not be able to obtain the current rates for such services.

## Impact of Inflation and Currency Fluctuations

The U.S. dollar cost of our operations is influenced by the extent to which any increase in the rate of inflation in Israel is offset, or is offset on a lagging basis, by the devaluation of the NIS in relation to the dollar, if any, and the appreciation or depreciation of the Euro to the dollar. Most of our sales are denominated in dollars or are dollar-linked and we incur a portion of our expenses, principally salaries and related personnel expenses, in Israel - in NIS, and in Europe - in Euros. An appreciation of the NIS, or, unless offset by a devaluation of the NIS, inflation in Israel, will have a negative effect on our profitability. Conversely, devaluations of the NIS relative to the dollar at a rate in excess of the rate of inflation in Israel could have a positive effect on our profitability. In 2004 we began selling to the European Union countries in Euros instead of dollars in order to reduce the exposure to fluctuations in the Euro exchange rate. We are still exposed to the risk of an appreciation of the Euro in the event our expenses in Euros exceed our sales in Euros. In addition, if the Euro devaluates relative to the dollar and sales in Euros exceed expenses incurred in Euros, our operating profit may be negatively affected as a result of a decrease in the dollar value of our sales.

The following table presents information about the rate of inflation in Israel:

| <b>Year ended December 31,</b> | <b>Israeli inflation rate<br/>%</b> |
|--------------------------------|-------------------------------------|
| 2001                           | 1.4                                 |
| 2002                           | 6.5                                 |
| 2003                           | (1.9)                               |
| 2004                           | 1.2                                 |
| 2005                           | 2.4                                 |

We cannot assure you that we will not be materially and adversely affected in the future if inflation in Israel exceeds the devaluation of the NIS against the dollar or if the timing of the devaluation lags behind inflation in Israel, or if there will be a revaluation of the NIS or a revaluation or devaluation of the Euro against the Dollar. Because exchange rates between the NIS and the dollar and between the Euro and the dollar fluctuate continuously, exchange rate fluctuations and especially larger periodic devaluations or revaluations 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

consolidated financial statements in the statement of operations.

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**Market Risk**

We do not invest in, or otherwise hold, for trading or other purposes, any financial instruments subject to market risk, with the exception of the following: Approximately 6% of our investment portfolio is invested in a structured note with guaranteed principal and changing interest. An increase in short-term interest rates will negatively affect the income received from this note. Approximately 53% of our investment portfolio is invested in high-rated marketable securities, mainly U.S. government agency bonds, and corporate bonds. Since these investments carry fixed interest rates, interest income over the holding period is not sensitive to changes in interest rates. We have no debt.

**ITEM 6. DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES****Directors and Senior Management**

The following table lists our current directors and executive officers:

| <b>Name</b>                 | <b>Age</b> | <b>Position</b>                                 |
|-----------------------------|------------|-------------------------------------------------|
| Yehuda Zisapel(1)           | 63         | Chairman of the Board of Directors              |
| Roy Zisapel(2)              | 35         | Chief Executive Officer, President and Director |
| Meir Moshe                  | 52         | Chief Financial Officer                         |
| Larry Marino                | 48         | President, Radware Inc.                         |
| Vered Raviv-Schwarz         | 36         | General Counsel and Secretary                   |
| Michelle Blank              | 51         | Chief Marketing Officer                         |
| Alexandre Bertuzzi          | 35         | Vice President, Sales EMEA                      |
| Amir Peles                  | 34         | Vice President, Chief Technology Officer        |
| Asaf Ronen                  | 32         | Vice President, Research and Development        |
| Yiftach Atir(1)(3)(4)       | 56         | Director                                        |
| Avigdor Willenz(1)(3)(4)    | 49         | Director                                        |
| Christopher McCleary (4)(5) | 53         | Director                                        |
| Liora Katzenstein (2)(4)    | 50         | Director                                        |
| Kenneth E. Sichau (4) (5)   | 51         | Director                                        |
| Hagen Hultsch (5)           | 65         | Director                                        |

(1) Term as director expires at the annual meeting of shareholders to be held in 2006.

(2) Term as director expires at the annual meeting of shareholders to be held in 2007.

(3) External Director, as defined in the Israeli Companies Law.

(4) Qualified as an Independent Director, as determined under the Nasdaq rules, and serves on the Audit Committee of the Board of Directors.

(5) Term as director expires at the annual meeting of shareholders to be held in 2008.

**Yehuda Zisapel**, co-founder of our company, has served as our Chairman of the Board of Directors since our inception. Mr. Zisapel also serves as a director of Radware Inc. Mr. Zisapel is also a founder and a director of RAD Data Communications Ltd., a worldwide data communications company headquartered in Israel, and BYNET Data Communications Ltd., a distributor of data communications products in Israel, Chairman of the Board of Directors of RIT Technologies Ltd., and a director of other companies in the RAD-Bynet Group, including SILICOM Ltd., and several private companies. Mr. Zisapel has a B.Sc. and an M.Sc. degree in electrical engineering as well as an Award of Honorary Doctorate (DHC-Doctor Honoris Causa) from the Technion, Israel Institute of Technology and an

M.B.A. degree from Tel Aviv University. Yehuda Zisapel is the father of Roy Zisapel.

**Roy Zisapel**, co-founder of our company, has served as our President and Chief Executive Officer and a director since our inception. Mr. Zisapel also serves as a director of Radware Inc. and other subsidiaries. From February 1996 to March 1997, Mr. Zisapel was a team leader of research and development projects for RND Networks Ltd. From July 1994 to February 1996, Mr. Zisapel was employed as a software engineer for unaffiliated companies in Israel. Mr. Zisapel serves as a director in Infogate On Line Ltd. Mr. Zisapel has a B.Sc. degree in mathematics and computer science from Tel-Aviv University. Roy Zisapel is the son of Yehuda Zisapel.

**Meir Moshe** has served as our Chief Financial Officer since June 1999. From June 1997 to June 1999, Mr. Moshe was Chief Financial Officer, Secretary and Treasurer of ForSoft Ltd. Mr. Moshe holds a B.Sc. in economics and accounting from Tel Aviv University and is a certified public accountant.

**Larry Marino** joined us in January 2006 as President of Radware, Inc. Previously, Mr. Marino held various executive positions at AT&T with over 25 years of experience in the telecommunications industry. Mr. Marino holds a BS in Electrical Engineering from Worcester Polytechnic Institute and an MBA from the University of Pennsylvania, Wharton School.

**Vered Raviv-Schwarz** has served as our General Counsel since July 2000. From May 1995 to June 2000, Mrs. Raviv-Schwarz was an Associate at the law firm M. Seligman & Co. Mrs. Raviv-Schwarz has LL.B. and LL.M degrees from Tel Aviv University.

**Michelle Blank** was appointed Chief Marketing Officer in August 2005. Dr. Blank has 25 years of experience building businesses around commercializing innovative new technologies. From 1997 to 2001 Dr. Blank was at RADVISION where she held the positions of Senior VP of Global Marketing and President of RADVISION, Inc. From 2002 through 2005 she was engaged in private consulting work. She began her career in 1981 at Bell Laboratories. She left in 1984 to pursue her entrepreneurial interest working with early stage companies. Dr. Blank holds a BA in Communication Arts & Sciences/Psychology from Queens College of the City University of New York and a Ph.D in Cognitive Science from the University of Texas.

**Alexandre Bertuzzi** has served as our Vice President EMEA since January 2002. From January 2000 to December 2002, Mr. Bertuzzi served as our Regional Director for France and Benelux. Prior to joining us, Mr. Bertuzzi had various sales and management positions within networking companies such as Cabletron Systems and Fore Systems (known as "Marconi" since 1999). Mr. Bertuzzi has a degree in computer science from EPITA (Ecole Pour L'Informatique et le Techniques Avancees)..

**Amir Peles** has served as our Vice President, Chief Technology Officer since April 2000. Prior to that, Mr. Peles was our Vice President of Research and Development since July 1997. From July 1996 to July 1997, Mr. Peles was a senior team leader at Amdocs Corporation. Mr. Peles has a B.Sc. degree in computer science, statistics and operations research from Tel Aviv University.

**Assaf Ronen** has served as our Vice President of Research and Development since April 2000. From February 1997 to April 2000, Mr. Ronen served as a senior program manager at Comverse Network Systems. Prior to February 1997, Mr. Ronen served in various positions in the Israel Defense Forces Computers Unit. Mr. Ronen has a B.Sc. degree in computer science from the Israeli Open University and an M.B.A. from Manchester University.

**Yiftach Atir** has served as a director since November 1997. Since January 2003, Mr. Atir has been a private consultant in the field of investments and investment banking. From August 2000 until January 2003, Mr. Atir served as the managing director of Koor Corporation Venture Capital. Until July 2000, Mr. Atir served as a managing director in Evergreen Venture Capital Funds, a management company for a group of technology focused venture capital funds, where he had been employed since November 1994. Prior to joining Evergreen, Mr. Atir served as a Brigadier General in the Intelligence Corps of the Israel Defense Forces. Mr. Atir also serves as a director in Aran Industries Ltd. Mr. Atir has a B.A. in political science from Haifa University and an M.B.A. from Tel Aviv University.

**Avigdor Willenz** has served as a director since October 1999. From November 1992 until January 2001, Mr. Willenz served as Chief Executive Officer and Chairman of the Board of Directors of Galileo Technology Ltd. During the years 2001-2002, Mr. Willenz served as a director in Marvell® Technology Group Ltd. Mr. Willenz currently serves as a director in both UCLT Ltd. and Wintegra Inc. Mr. Willenz holds a B.S.E.E. from the Technion, Israel Institute of Technology.

**Christopher McCleary** has served as a director since February 2000. Mr. McCleary is currently a Venture Partner at Blue Chip Venture Company. He was previously the founder, Chairman and CEO of Evergreen Assurance, Incorporated. Mr. McCleary was previously non-executive Chairman of USinternetworking Inc. and served as the



Chairman and Chief Executive Officer of USi from January 1998 until June 2000. Prior to founding USi, he was the Chairman and Chief Executive Officer of DIGEX, Inc. from January 1996 to December 1997. From October 1990 to January 1996, Mr. McCleary served as Vice President and General Manager for Satellite Telephone Service at American Mobile Satellite Corporation, a satellite communications company. Mr. McCleary serves as a director in JackBe, Inc. and in Digital 5, Inc.. Mr. McCleary has a BGS from the University of Kentucky.

**Liora Katzenstein** has served as a director since January 2001. In 1996 Prof. Katzenstein founded and has since served as President of ISEMI - Israel School of Entrepreneurial Management and Innovation (Part of Swinburne University of Technology's (Australia) Graduate School of Entrepreneurship). Prof. Katzenstein also lectured in Business Administration at the Harvard Business School, Tel Aviv University, Nanyang Technological University (Singapore), the Technion, Israel Institute of Technology and in the Israeli Management Center. From 1995 to 1996 Prof. Katzenstein was an associate Dean at TISOM - Tel Aviv International School of Business, and from 1992 to 1995 she was a Senior Lecturer at the Tel Aviv University Recanati Graduate School of Business Administration. Prof. Katzenstein also serves as a director in Radvision Ltd., RiT Technologies Ltd. and OTI Ltd. Prof. Katzenstein has a 'License' and a Ph.D. in International Economics from the Graduate Institute of International Studies, University of Geneva, and an MALD in Law and Diplomacy from the Fletcher School of Law and Diplomacy, Tufts University.

**Kenneth E. Sichau** has served as a director since October 2004. Mr. Sichau is a seventeen year veteran of the telecommunications industry, having held senior leadership positions in sales, marketing, product management and operations. Most recently he was President, AT&T Business Sales for AT&T where he was an EVP and a member of AT&T's Executive Committee. He retired from AT&T in 2003. Prior to AT&T, he was a Vice President of Business Development at Marriott Corporation. Currently Mr. Sichau serves as a management advisor to small and mid- size companies. Mr. Sichau is a veteran of the U.S. Navy, where he served as a Naval Aviator. He holds a BS from the US Naval Academy and a MBA from Harvard Business School.

**Hagen Hultzs** has served as a director since January, 2005. Dr. Hultzs served on the Board of Management of Deutsche Telekom AG from 1993 until 2001. Since 2001, Dr. Hultzs has served on the Boards or Advisory Boards of several companies and academic institutions. As of March 2005, he serves as a Board Member in the following companies: InSynCo AG, VoiceObjects Inc., VoiceObjects GmbH, T-Systems Solutions for Research, ICANN Inc., TranSwitch Corporation Inc., SCM-Microsystems Inc., RIT Ltd., Aspect Corporate Advisors, EUTEX AG, SUP Consultants, Convergys Inc., Communardo Software GmbH, TVM GmbH, XTraMind Technologies GmbH, Narus Corporation Inc., Actelis Networks Inc., Axerra Networks, Ceragon Networks, International Club La Redoute Bonn. Dr. Hultzs holds a PhD. from Mainz University.

Except as described above, there are no family relationships between any of the directors or members of senior management named above.

Under Nasdaq National Market requirements, commencing July 31, 2005, a majority of the members of our board of directors are required to be "independent," as defined thereunder. We currently satisfy this requirement as Mr. Chris McCleary, Mr. Yiftach Atir, Mr. Avigdor Willenz, Prof. Liora Katzenstein, Mr. Kenneth Sichau and Dr. Hagen Hultzs, i.e., six out of our eight directors, qualify as independent directors under such Nasdaq rules.

## Compensation

Under our articles of association, no director may be paid any remuneration by the company for his services as director except as may be approved pursuant to the provisions of the Companies Law, which generally require the approval of the Audit Committee, the Board of Directors and then the approval of the shareholders of the company, in that order. An external director is entitled to consideration and reimbursement of expenses only as provided in regulations promulgated under the Israeli Companies Law and is otherwise prohibited from receiving any other compensation, directly or indirectly, in connection with his service as an external director.

The following table sets forth all compensation we paid with respect to all of our directors and officers as a group for the year ended December 31, 2005. The table does not include any amounts we paid to reimburse any of our affiliates for costs incurred in providing us with services during such period.

|                                                                 | <b>Salaries, fees,<br/>commissions and<br/>bonuses</b> | <b>Pension,<br/>retirement<br/>and other<br/>similar benefits</b> |
|-----------------------------------------------------------------|--------------------------------------------------------|-------------------------------------------------------------------|
| All directors and officers as a group, consisting of 15 persons | \$ 1,510,000                                           | \$ 128,000                                                        |

As of April 24, 2006, our directors and officers as a group, consisting of 13 persons, held options to purchase an aggregate of 1,610,000 ordinary shares. Other than reimbursement for expenses and grant of options to purchase shares of the Company, during fiscal year 2005, we did not compensate our directors for serving on our board of directors.

Each of our independent directors, including our external directors, is granted options to purchase 10,000 ordinary shares for each year of service. This grant was approved by our shareholders.

During 2005, we granted to our directors and officers options to purchase 125,000 ordinary shares, in the aggregate, at a weighted average exercise price of \$17.08. The options expire sixty-two months after grant.

## Board Practices

### Introduction

According to the Israeli Companies Law and our articles of association, the oversight of the management of our business is vested in our board of directors. The board of directors may exercise all powers and may take all actions that are not specifically granted to our shareholders. As part of its powers, our board of directors may cause us to borrow or secure payment of any sum or sums of money for our purposes, at times and upon terms and conditions as it determines, including the grant of security interests in all or any part of our property.

Our articles of association provide for a board of directors of not less than five and not more than nine directors. Currently, our board consists of eight directors, including the external directors (as described below). In accordance with current Nasdaq National Market requirements, nominees for election as directors are approved and recommended to the board by a decision of a majority of our independent directors. Under an amendment to the Israeli Companies Law, our board of directors is required to determine, by April 19, 2006, the minimum number of directors who must have “accounting and financial expertise” (as such term is defined in regulations promulgated under the Companies Law).

Since our ordinary shares are listed for quotation on the Nasdaq National Market, we are subject to the rules of the Nasdaq National Market applicable to listed companies. In addition, since we are incorporated as an Israeli company, we are subject to the provisions of the Israeli Companies Law and the regulations adopted thereunder.

### Staggered Board

In accordance with the terms of our articles of association, our board of directors (other than our external directors) is divided into three classes with each class serving until the third annual meeting following their election as follows:

| <b>Class*</b> | <b>Term<br/>expiring at<br/>the annual<br/>meeting<br/>for the year</b> | <b>Directors</b> |
|---------------|-------------------------------------------------------------------------|------------------|
| Class I       | 2006                                                                    | Yehuda Zisapel   |

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|           |      |                                                  |
|-----------|------|--------------------------------------------------|
| Class II  | 2007 | Roy Zisapel and Prof. Liora Katzenstein          |
| Class III | 2008 | Christopher McCleary, Ken Sichau, Hagen Hultzsch |

At each annual meeting of shareholders after the initial classification, the successors to directors whose terms will then expire will be elected to serve from the time of election and qualification until the third annual meeting following the election. Directors, other than external directors, are elected by a simple majority of the votes cast, whereas their removal from office requires the vote of a majority of at least seventy-five percent of the voting power represented at the general meeting. Any additional directorships resulting from an increase in the number of directors will be distributed among the three classes so that, as nearly as possible, each class will consist of one-third of the directors. This classification of our board of directors may have the effect of delaying or preventing changes in control or management of our company.

The above classification does not apply to Messrs. Avigdor Vilenz and Yiftach Atir, who were appointed as external directors whose term of appointment ends in 2006.

## **External Directors**

### *Qualifications of External Directors*

Under the Companies Law, companies incorporated under the laws of Israel whose shares are listed for trading on a stock exchange or 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 such person's relative, partner, employer or any entity under the person's control has, as of the person's appointment to serve as an 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 this 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, excluding service as a director that was appointed to serve as an external director of a company that is about to make its initial public offering.

The Companies Law defines the term "office holder" of a company to include a director, the chief executive officer, the chief financial officer, a vice president and any officer of the company that reports directly to the chief executive officer.

No person can 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 may otherwise interfere with the person's ability to serve as an external director. Until the lapse of two years from termination of office 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.

### *Election of External Directors*

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

- At least one third of the shares of non-controlling shareholders voted at the meeting 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 voting rights in the company.

The initial term of an external director is three years and may be extended for one additional three year term. External directors may be removed from office only by the vote of the same percentage of shareholders as is required for their election, or by a court only if they cease to meet the statutory qualifications for appointment or if they violate their duty of loyalty to the company. Each committee of a company's board of directors is required to include at least one external director, except for the audit committee which is required to include all the external directors.

Currently, Messrs. Yiftach Atir and Avigdor Vilenz qualify as external directors under the Companies Law and were elected by the general shareholders meeting held in June 2000, to serve as our external directors, and were re-elected to an additional three-year term in June of 2003.

Pursuant to an amendment to the Companies Law, effective as of January 19, 2006, (1) an external director must have either "accounting and financial expertise" or "professional qualifications" (as such terms are defined in regulations promulgated under the Companies Law) and (2) at least one of the external directors must have "accounting and financial expertise." These requirements will apply to us upon the election of one or more external directors.

#### **Our Committees**

The board of directors appoints committees to help carry out its duties. Each committee reviews the results of its meetings with the full board of directors. The board of directors established its Audit and Share Incentive Committees in 1999, and its Compensation Committee (which replaced the Share Incentive Committee) in 2004. Only non-employee directors serve on our Audit Committee and Compensation Committee.

#### **Audit Committee**

##### *Nasdaq Requirements*

Our ordinary shares are listed for quotation on the Nasdaq National Market and we are subject to the rules of the Nasdaq National Market applicable to listed companies. Under the Nasdaq rules, we are 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. The members of the Audit Committee, Mr. Chris McCleary, Mr. Yiftach Atir, Mr. Avigdor Willenz, Prof. Liora Katzenstein, and Mr. Kenneth Sichau qualify as independent directors under the current Nasdaq National Market requirements. In accordance with Nasdaq rules, the Audit Committee has adopted a charter.

The Audit Committee assists the 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 sole authority and responsibility to select, evaluate and, where appropriate, recommend to replace the independent auditors (or to nominate the independent auditors subject to shareholder approval) and to pre-approve audit engagement fees and all permitted non-audit services and fees.

The Audit Committee met five times during fiscal year 2005. Mr. Yiftach Atir, Mr. Kenneth Sichau, Mr. Christopher McCleary and Mr. Avigdor Willenz attended all of the Audit Committee meetings and Prof. Liora Katzenstein attended four of the meetings.

##### *Israeli Companies Law Requirements*

Under the Companies Law, our board of directors is required to appoint an audit committee, comprised of at least three directors including all of the external directors, but excluding:

- the chairman of the board of directors; and
- a controlling shareholder or a relative of a controlling shareholder and any director employed by the company or who provides services to the company on a regular basis.

In accordance with the Companies Law, the duty of our audit committee is, in addition to the requirements imposed by Nasdaq rules (1) to identify irregularities in the business management of the company, including in consultation with the internal auditor and/or the company's independent accountants, and to recommend remedial measures to the board, and (2) to review, and, where appropriate, approve certain interested party transactions specified under the Companies Law, as more fully described below. Our Audit Committee consists of our external directors, and three additional directors, Mr. Christopher McCleary, Prof. Liora Katzenstein and Mr. Kenneth Sichau.



### *Approval of Interested Party Transactions*

The approval of the audit committee is required under the Israeli Companies Law to effect specified actions and transactions with office holders, controlling shareholders and entities in which they have a personal interest. An audit committee may not approve an action or a transaction with interested parties or with an office holder unless at the time of approval the two external directors are serving as members of the audit committee and at least one of whom was present at the meeting in which an approval was granted. The Companies Law defines the term “interested party” to include a person who holds 5% or more of the company’s outstanding share capital or voting rights, a person who has the right to appoint one or more directors or the general manager, or any person who serves as a director or as the general manager.

### **Compensation Committee**

Our compensation committee consists of our independent directors, Messrs. Kenneth Sichau, Chris McCleary and Avigdor Willenz. On March 8, 2005, our compensation committee adopted a charter, which sets forth the committee’s responsibilities. Pursuant to the charter, the compensation committee is authorized to make decisions regarding executive compensation and terms and conditions of employment, to follow market trends and provide recommendations to the board of directors in connection with the Company’s general compensation philosophy and policies, as well as to recommend that the board of directors issue options under our stock option plans.

### **Internal Auditor**

Under the Companies Law, the board of directors of a public company must appoint an internal auditor proposed by the audit committee. The role of the internal auditor is to examine, among other things, whether the company’s conduct complies with applicable law and orderly business procedure. The internal auditor may participate in all audit committee meetings and has the right to demand that the chairman of the audit committee convene a meeting. Under the Companies Law, the internal auditor may be an employee of the company but may not be an interested party, an office holder or a relative of any of the foregoing, nor may the internal auditor be the company’s independent accountant or its representative. Mr. Gideon Duvshani, CPA, was our internal auditor until the end of 2005, and in December 2005, we have appointed Mrs. Sharon Vitkovski-Tabib, CPA, of BDO Ziv Haft, CPAs, as our internal auditor.

### **Approval of Specified Related Party Transactions Under Israeli Law**

#### *Fiduciary Duties of Office Holders*

The Companies Law imposes a duty of care and a duty of loyalty on all office holders of a company.

The duty of care requires an office holder to act with the level of care with which a reasonable office holder in the same position would have acted under the same circumstances. The duty of care includes a duty to use reasonable means to obtain:

- Information regarding the advisability of a given action submitted for his approval or performed by him by virtue of his position; and
- All other important information pertaining to these actions.

The duty of loyalty of an office holder includes a duty to:

- Refrain from any conflict of interest between the performance of his duties in the company and the performance of his other duties or his personal affairs;
- Refrain from any activity that is competitive with the company;

- Refrain from exploiting any business opportunity of the company to receive a personal gain for himself or others; and
- Disclose to the company any information or documents relating to a company's affairs which the office holder has received due to his position as an office holder.

*Disclosure of Personal Interest of an Office Holder*

The Companies Law requires that an office holder of a company disclose to the company any personal interest that he may have and all related material information known to him, in connection with any existing or proposed transaction by the company. The disclosure is required to be made promptly and in any event no later than the board of directors meeting in which the transaction is first discussed. If the transaction is an extraordinary transaction, the office holder's duty to disclose also applies to a personal interest of a relative of the office holder.

Under the Companies law, an extraordinary transaction is a transaction:

- Other than in the ordinary course of business;
- Not on market terms; or
- That is likely to have a material impact on the company's profitability, assets or liabilities.

Once an office holder complies with the above disclosure requirement, the board of directors may approve a transaction between the company and an office holder, or a third party in which an office holder has a personal interest unless the articles of association provide otherwise. Nevertheless, a transaction that is adverse to the company's interest may not be approved.

If the transaction is an extraordinary transaction, approval is required of both the audit committee and the board of directors, in that order. Under specific circumstances, shareholder approval may also be required. A director who has a personal interest in a matter which is considered at a meeting of the board of directors or the audit committee may not be present at this meeting or vote on this matter, unless a majority of the members of the board of directors or the audit committee, as the case may be, has a personal interest in the matter. If a majority of members of the board of directors have a personal interest therein, shareholder approval is also required.

Under the Companies Law, all arrangements as to compensation of directors in public companies such as ours generally require the approvals of the audit committee, the board of directors and the shareholders, in that order.

*Disclosure of Personal Interests of a Controlling Shareholder*

Under the Companies Law, the disclosure requirements which apply to an office holder also apply to a controlling shareholder of a public company. A controlling shareholder is a shareholder who has the ability to direct the activities of a company, including a shareholder that owns 25% or more of the voting power in the company, if no other shareholder owns more than 50% of the voting power in the company, but excluding a shareholder whose power derives solely from his or her position on the board of directors or any other position with the company. Extraordinary transactions of a public company with a controlling shareholder or in which a controlling shareholder or with a third party has a personal interest, and the terms of engagement of a controlling shareholder as an office holder or employee, require the approval of the audit committee, the board of directors and the shareholders of the company in that order. The shareholder approval must be by a majority of the shares voted on the matter, provided that either:

- At least one-third of the shares of shareholders who have no personal interest in the transaction, and who are present and voting (in person, by proxy or by written ballot) vote in favor thereof; or
- The shareholders who have no personal interest in the transaction who vote against the transaction do not represent more than one percent of the voting power in the company.

Shareholders generally have the right to examine any document in the company's possession pertaining to any matter that requires shareholder approval.

### *General Duties of Shareholders*

Under the Companies Law, each shareholder has a duty to act in good faith in exercising his rights and fulfilling his obligations toward the company and other shareholders and to refrain from abusing his power in the company, such as shareholder votes. Furthermore, specified shareholders have a duty of fairness toward the company. These shareholders include any controlling shareholder, any shareholder who knows that he/it possesses the power to determine the outcome of a shareholder vote, and any shareholder who, pursuant to the provisions of the articles of association, has the power to appoint or to prevent the appointment of an office holder or any other power toward the company. However, the Companies Law does not define the substance of this duty of fairness.

### **Founders' Agreement**

On April 1, 1997, we entered into an agreement with our founders, Messrs. Zohar, Yehuda and Roy Zisapel, pursuant to which Roy Zisapel agreed to serve as our chief executive officer for a period of no less than five years. In consideration for his services:

- We agreed to pay Roy Zisapel an annual salary of approximately \$44,000, plus benefits, including contributions to a managers' insurance policy (his salary was increased in 2000 and 2001 and is now approximately \$120,000, plus benefits); and
- We granted Roy Zisapel options under our share option plan equal to 9.9% of the total amount of our issued and outstanding share capital as of April 1997.

In addition, the agreement provides that Roy Zisapel may not compete with us or disclose to third parties information pertaining to our business for a period ranging from twelve to thirty months from the date of termination of his employment, depending on the length of his term of employment with us.

### **Employees**

At the time of commencement of employment, our employees in North America generally sign offer letters specifying basic terms and conditions of employment, and our employees in Israel generally, including our executive officers, sign standard written employment agreements, which include confidentiality and non-compete provisions. The employees in our subsidiaries sign employment agreements which differ according to the country in which they are located.

As of December 31, 2005, we had 432 employees worldwide, of whom 191 were based in Israel, 118 were based in the United States and 123 were based in our other subsidiaries and offices. Of these 432 employees, 122 were employed in research and development, 243 were employed in sales, technical support and marketing, and 67 were employed in management, operations and administration.

We are subject to Israeli labor laws and regulations with respect to our Israeli employees. These laws principally concern matters such as paid annual vacation, paid sick days, length of the workday and work week, minimum wages, pay for overtime, insurance for work-related accidents, severance pay and other conditions of employment.

Furthermore, we and our Israeli employees are subject to provisions of the collective bargaining agreements between the Histadrut, the 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. These provisions principally concern cost of living increases, recreation pay and other conditions of employment. We provide our employees with benefits and working conditions above the required minimums. Our employees are not represented by a labor union. To date, we have not experienced any work stoppages.

The employees of our subsidiaries are subject to local labor laws, regulations and/or collective bargaining agreements that vary from country to country.

## Share Ownership

The following table sets forth certain information regarding the beneficial ownership of our ordinary shares by our directors and officers as of April 24, 2006. The percentage of outstanding ordinary shares is based on 19,429,319 ordinary shares outstanding as of April 24, 2006.

| Name                                                                         | Number of<br>ordinary<br>shares | Percentage of<br>outstanding<br>ordinary<br>shares |
|------------------------------------------------------------------------------|---------------------------------|----------------------------------------------------|
| Yehuda Zisapel                                                               | 2,597,477(1)                    | 13.35%                                             |
| Roy Zisapel                                                                  | 1,157,584 (2)                   | 5.75%                                              |
| Meir Moshe                                                                   | 286,165(3)                      | 1.45%                                              |
| All directors and<br>executive officers<br>as a group (13<br>persons) (4)(5) | 4,337,005                       | 18.25%                                             |

Consists of 2,577,477 shares and 20,000

- (1) options which are fully vested at the date of this Annual Report.
- (2) Consists of 457,584 shares and 700,000 options which are fully vested or will be vested in the 60 days following the date of this Annual Report.
- (3) Consists of 36,165 shares and 250,000 options which are fully vested or which will be fully vested within the next 60 days.
- (4) Consists of 3,079,505 shares and 1,257,500 options which are fully vested or which will be fully vested within the next 60 days.
- (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 the date of this Annual Report) and have therefore not been separately disclosed.

## Key Employee Share Incentive Plan

In June 1997, we adopted our Key Employee Share Incentive Plan (1997). Options granted pursuant to our share option plan are for a term of sixty-two months from the date of the grant of the option. As of December 31, 2005, 7,474,484 ordinary shares have been reserved for option grants under the plan, of which we have granted options to purchase 6,964,185 ordinary shares, at a weighted average exercise price of \$10.93 per ordinary share. The amount of reserved shares includes an increase of the number of shares reserved under the plan in an amount of 3% of our issued and outstanding stock, plus 60,000 additional shares, approved by the annual shareholders meeting held on December 11, 2005. We intend to grant further options under our share option plan to our executive officers and employees. In light of the new accounting standard SFAS No. 123(R), however, we may amend our option plan, reduce the number of options granted to the employees or suggest alternative compensation schemes. In 2006 we intend to reduce the

number of options granted to each employee.

Our share option plan is administered by the compensation committee of our board of directors. Pursuant to the plan, the committee has the authority to determine (subject to applicable law), or advise the board of directors, in its discretion:

- The persons to whom options are granted;
- The number of shares underlying each options award;
- The time or times at which the award shall be made;
- The exercise price, vesting schedule and conditions pursuant to which the options are exercisable; and
- Any other matter necessary or desirable for the administration of the plan.



Pursuant to our share option plan, all options, or shares issued upon exercise of options, are held in trust and registered in the name of a trustee which was selected by the share incentive committee. The trustee will not release the options or ordinary shares to the option holder before the options are vested (unless pre-approved by us) or before the lapse of a longer period if so required under local tax laws and regulations. Our board of directors may terminate or amend our share option plan, provided that any action by our board of directors which will alter or impair the rights of an option holder requires the prior consent of that option holder.

In order to comply with the provisions of Section 102 of the Israeli Income Tax Ordinance [New Version], 1961 (the "Ordinance"), which was amended in January 2003, on March 5, 2003, our board of directors adopted an addendum to our share option plan with respect to options granted on or after January 1, 2003 to grantees who are residents of Israel (the "Addendum"). The Addendum does not add to nor modify our share option plan in respect to grantees that are not residents of Israel.

### **Directors and Consultants Option Plan**

On February 18, 2000 we adopted a Directors and Consultants Option Plan. Options granted pursuant to our share option plan are for a term of sixty-two months from the date of the grant of the option. The terms of the Directors and Consultants Option Plan are similar to the terms of the Key Employee Share Incentive Plan. The shares reserved for the Key Employee Share Incentive Plan provide for the Directors and Consultants Option Plan as well, and the same Compensation Committee administers the two plans. The Compensation Committee may not grant options to members of the Committee or to a shareholder of over 10% of our issued and outstanding shares. The shares reserved for the 1997 Key Employee Share Incentive Plan, are also used for option grants under the Directors and Consultants Option Plan.

### **Employee Stock Purchase Plans**

The Company's Board of Directors adopted three Employee Share Purchase Plans (the "ESPP"), during the years 2000, 2001 and 2002, which provided for the issuance of a maximum of 750,000, 200,000 and 300,000 ordinary shares, respectively. Pursuant to the ESPPs, eligible employees could have up to 10% of their net income withheld, up to certain maximums, to be used to purchase our ordinary shares. The ESPPs were implemented with purchases once in every six-month period. The price of each ordinary share purchased under the ESPP was equal to 85% of the lower of the fair market value of the ordinary share at the commencement date of each offering period or on the semi-annual purchase date pursuant to the plans. During 2005, 69,639 shares were issued under the ESPPs for an aggregate consideration of \$ 1,161,000. As of November 2005, all three ESPPs were terminated by our Board.

**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 April 24, 2006, 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 Securities and Exchange Commission. The voting rights of all major shareholders are the same as for all other shareholders.

| <b>Name</b>                             | <b>Number of<br/>ordinary<br/>shares</b> | <b>Percentage of<br/>outstanding<br/>ordinary<br/>shares</b> |
|-----------------------------------------|------------------------------------------|--------------------------------------------------------------|
| Yehuda Zisapel (1)                      | 2,597,477                                | 13.35%                                                       |
| Roy Zisapel (2)                         | 1,157,584                                | 5.75%                                                        |
| Artizan Partners Limited<br>Partnership | 1,398,900                                | 7.2%                                                         |
| Artizan Investment Corporation          |                                          |                                                              |
| Andrew A. Ziegler                       |                                          |                                                              |
| Carlene Murphy Ziegler (3)              |                                          |                                                              |
| FMR Corp. (4)                           | 975,100                                  | 5.02%                                                        |

(1) Includes 295,000 ordinary shares owned of record by Carm-AD Ltd., an Israeli company, which is controlled by Yehuda Zisapel, and 20,000 options which are fully vested at the date of this Annual Report.

(2) Includes 457,584 shares and 700,000 options which are fully vested or will be vested in the 60 days following the date of this Annual Report.

(3) Artizan Partners Limited Partnership ("Artizan Partners") is an investment adviser registered under section 203 of the Investment Advisers Act of 1940; Artizan Investment Corporation is the General Partner of Artizan Partners; Mr. Ziegler and Ms. Ziegler are the principle stockholders of Artizan Investment Corporation. This information is based on FMR's Form 13-G filing on January 27, 2006.

(4) Includes 681,300 shares beneficially owned by Fidelity Management & Research Company, a wholly owned subsidiary of FMR Corp., as a result of acting as an investment advisor to various investment companies registered under Section 8 of the Investment Company Act of 1940. 45,100 shares are beneficially owned by Fidelity Management Trust Company, a wholly owned subsidiary of FMR Corp., and a bank as defined in Section 3(a)(6) of the Securities Exchange Act of 1934, as a result of its serving as an investment manager of institutional accounts. The remaining 248,700 shares are held by Fidelity International Limited, an investment advisor to various investment companies, and various foreign-based subsidiaries. This information is based on FMR's Form 13-G filing on February 14, 2006.

**B. Related Party Transactions**

We have entered into a number of agreements with certain companies, of which Yehuda and Zohar Zisapel are co-founders, directors and/or principal stockholders, collectively known as the RAD-Bynet Group. Of these agreements, the lease for our headquarters in Tel Aviv is material to our operations. We believe that the terms of the transactions in which we have entered with members of the RAD-Bynet Group are not different in any material respect from terms we could obtain from unaffiliated third parties. The pricing of the transactions were arrived at based on negotiations between the parties. Members of our management reviewed the pricing of the lease agreement,

and confirmed that they were not different than that which could have been obtained from unaffiliated third parties. In addition, the Company purchases different services from third parties at special rates offered to the RAD-Bynet Group, such as car leases, maintenance, insurance and communication services. In the event that we cease to be a member of the RAD-Bynet Group, we may not be able to obtain the current rates for such services. We believe, however, that due to the affiliation between us and the RAD-Bynet Group, we have greater flexibility in certain terms than might be available from unaffiliated third parties on similar issues. In the event that the transaction with members of the RAD-Bynet Group is terminated and we enter into similar transactions with unaffiliated third parties, that flexibility may not be available to us.

All transactions and arrangements with affiliated parties, including other members of the RAD-Bynet Group, require approval by the audit committee and our board of directors and may, in certain circumstances, require approval by our shareholders.

### **Services Furnished by members of the RAD-Bynet Group**

Some companies which are also members of the RAD-Bynet Group provide us with marketing, administrative and network management services, and we reimburse each for its costs in providing such services. The aggregate amount of the reimbursements to such companies amounted to approximately \$393,000 in 2005.

### **Lease of Property**

We lease the office space for our headquarters and principal R&D, administrative, finance and marketing and sales operations from two private companies owned by Messrs. Zohar Zisapel and Yehuda Zisapel. The facilities are located in a five-story building in Tel Aviv, Israel, and consist of approximately 31,500 square feet, plus storage and parking space. The monthly rent amounts to approximately \$34,000. The lease expires in October 2007. We also lease additional 3,800 square feet in the building under the same lease agreement and sublease this area to an unaffiliated company, back-to-back. We entered into an agreement with RAD Data Communications, Inc., pursuant to which we will lease approximately 12,382() square feet in Mahwah, New Jersey, consisting of 8,121 square feet of office space and 4,261 square feet of warehouse space, in consideration for annual rent of approximately \$18,000 (including taxes and management fees). The lease expires on April 20, 2007.

### **Distribution Agreement**

Bynet Data Communications Ltd., a member of the RAD-Bynet Group distributes our products in Israel on a non-exclusive basis. We have a written distributor agreement with Bynet according to which we provide them with discounts similar to the discounts provided to third-party distributors in the region in the ordinary course of business. The total sales to Bynet Data Communications amounted to \$3,111,000 during 2005.

### **Founders' Agreement**

See discussion in Item 6 - "Directors and Senior Management."

### **C. Interests of Experts and Counsel**

Not applicable

## ITEM 8. FINANCIAL INFORMATION

### A. Consolidated Statements and other Financial Information

See financial statements under Item 18.

#### A.7. Legal Proceedings

In December 2001, the Company, its Chairman Yehuda Zisapel, its President, Chief Executive Officer and Director Roy Zisapel and its Chief Financial Officer Meir Moshe (the "Individual Defendants") and several underwriters in the syndicates for our September 30, 1999 initial public offering and January 24, 2000 secondary offering, were named as defendants in a class action complaint alleging violations of the federal securities laws in the United States District Court, Southern District of New York. The complaint seeks unspecified damages as a result of alleged violations of Section 11 of the Securities Act of 1933 against all the defendants and Section 15 of the Securities Act of 1933 against the Individual Defendants arising from activities purportedly engaged in by the underwriters in connection with our initial public offering and secondary offering. Plaintiffs allege that the underwriter defendants agreed to allocate stock in the Company's initial public offering and secondary offering to certain investors in exchange for excessive and undisclosed commissions and agreements by those investors to make additional purchases of stock in the aftermarket at pre-determined prices.

An amended complaint filed on April 19, 2002, which is now the operative complaint, added a claim under Section 10(b) of the Securities Exchange Act of 1934 against the Company and a claim under Section 20(a) of the Securities Exchange Act of 1934 against the Individual Defendants. Plaintiffs allege that the Prospectuses for the Company's initial public offering and secondary offering were false and misleading because they did not disclose these arrangements.

The action is being coordinated with approximately three hundred other nearly identical actions filed against other companies before one judge in the U.S. District Court for the Southern District of New York. A motion to dismiss addressing issues common to the companies and individuals who have been sued in these actions was filed on July 15, 2002. On October 9, 2002, the court dismissed the Individual Defendants from the case without prejudice based upon Stipulations of Dismissal filed by the plaintiffs and the Individual Defendants. This dismissal disposed of the Section 15 and 20(a) control person claims without prejudice, since these claims were asserted only against the Individual Defendants. On February 19, 2003, the Court denied the motion to dismiss with respect to the Company. On October 13, 2004, the Court certified a class in six of the approximately 300 other nearly identical actions and noted that the decision is intended to provide strong guidance to all parties regarding class certification in the remaining cases. Plaintiffs have not yet moved to certify a class in the Radware case.

We approved a settlement agreement and related agreements which set forth the terms of a settlement between the Company, the Individual Defendants, the plaintiff class and the vast majority of the other approximately 300 issuer defendants. Among other provisions, the settlement provides for a release of the Company and the Individual Defendants for the conduct alleged in the action to be wrongful. We would agree to undertake certain responsibilities, including agreeing to assign away, not assert, or release certain potential claims we may have against our underwriters. The settlement agreement also provides a guaranteed recovery of \$1 billion to plaintiffs for the cases relating to all of the approximately 300 issuers. To the extent that the underwriter defendants settle all of the cases for at least \$1 billion, no payment will be required under the issuers' settlement agreement. To the extent that the underwriter defendants settle for less than \$1 billion, the issuers are required to make up the difference. On April 20, 2006, JPMorgan Chase and the plaintiffs reached a preliminary agreement for a settlement for \$425 million. The JPMorgan Chase settlement has not yet been approved by the Court. However, if it is finally approved, then the maximum amount that the issuers or their insurers will be potentially liable for is \$575 million.

It is anticipated that any potential financial obligation of ours to plaintiffs pursuant to the terms of the settlement agreement and related agreements will be covered by existing insurance. We are currently not aware of any material limitations on the expected recovery of any potential financial obligation to plaintiffs from its insurance carriers. The carriers are solvent, and we are not aware of any uncertainties as to the

legal sufficiency of an insurance claim with respect to any recovery by plaintiffs. Therefore, we do not expect that the settlement will involve any payment by the Company. If material limitations on the expected recovery of any potential financial obligation to the plaintiffs from our insurance carriers should arise, our maximum financial obligation to plaintiffs pursuant to the settlement agreement would be less than \$3.4 million. However, if the JPMorgan Chase settlement is finally approved, our maximum financial obligation to the plaintiffs pursuant to the settlement agreement would be less than \$2 million.

On February 15, 2005, the court granted preliminary approval of the settlement agreement, subject to certain modifications consistent with its opinion. Those modifications have been made. On March 20, 2006, the Underwriter Defendants submitted objections to the settlement to the Court. The Court held a hearing regarding these and other objections to the settlement at a fairness hearing on April 24, 2006, but has not yet issued a ruling. There is no assurance that the court will grant final approval to the settlement. If the settlement agreement is not approved and we are found liable, we are unable to estimate or predict the potential damages that might be awarded, whether such damages would be greater than our insurance coverage, and whether such damages would have a material impact on our results of operations, cash flows or financial condition in any future period.

From time to time, we are involved in routine trade litigation. We are not subject to any additional material legal proceedings.

## **B. Significant Changes**

Except as otherwise disclosed in this annual report, we are not aware of any significant changes since the date of the audited consolidated financial statements included in this annual report.

**ITEM 9. The Listing****A. Listing Details**

Our ordinary shares have been listed for quotation on the Nasdaq National Market as of September 30, 1999, and, since May 12, 2004 on the Tel Aviv Stock Exchange, or TASE, both under the symbol “RDWR”.

The following table sets forth the high and low closing price for our ordinary shares as reported by the Nasdaq National Market and TASE for the periods indicated:

| Annual High and Low           | Nasdaq National Market |          | Tel Aviv Stock Exchange |           |
|-------------------------------|------------------------|----------|-------------------------|-----------|
|                               | High                   | Low      | High                    | Low       |
| <b>2001</b>                   | \$ 21.94               | \$ 7.63  | --                      | --        |
| <b>2002</b>                   | \$ 12.95               | \$ 6.5   | --                      | --        |
| <b>2003</b>                   | \$ 28.54               | \$ 7.97  | --                      | --        |
| <b>Quarterly High and Low</b> |                        |          |                         |           |
| <b>2004</b>                   |                        |          |                         |           |
| First Quarter                 | \$ 32.42               | \$ 22.83 | --                      | -         |
| Second Quarter                | \$ 28.22               | \$ 14.94 | NIS 82.62               | NIS 69.60 |
| Third Quarter                 | \$ 22.00               | \$ 16.45 | NIS 98.76               | NIS 74.43 |
| Fourth Quarter                | \$ 27.19               | \$ 21.92 | NIS 118.00              | NIS 97.20 |
| <b>2005</b>                   |                        |          |                         |           |
| First Quarter                 | \$ 26.56               | \$ 22.24 | NIS 115.00              | NIS 98.07 |
| Second Quarter                | \$ 24.65               | \$ 18.08 | NIS 108.90              | NIS 82.97 |
| Third Quarter                 | \$ 19.49               | \$ 15.19 | NIS 90.27               | NIS 67.93 |
| Fourth Quarter                | \$ 19.43               | \$ 17.03 | NIS 89.41               | NIS 79.29 |



**Most recent six months**

|             |    |       |    |       |                      |
|-------------|----|-------|----|-------|----------------------|
| <b>2006</b> |    |       |    |       |                      |
| April*      | \$ | 16.60 | \$ | 15.22 | NIS 82.22 NIS 70.33  |
| March       | \$ | 21.49 | \$ | 17.63 | NIS 101.10 NIS 94.42 |
| February    | \$ | 19.93 | \$ | 17.90 | NIS 91.96 NIS 85.23  |
| January     | \$ | 20.20 | \$ | 18.75 | NIS 95.19 NIS 84.49  |
| <b>2005</b> |    |       |    |       |                      |
| December    | \$ | 19.06 | \$ | 18.16 | NIS 88.90 NIS 84.80  |
| November    | \$ | 18.89 | \$ | 17.19 | NIS 89.41 NIS 81.15  |
| October     | \$ | 19.43 | \$ | 17.03 | NIS 87.21 NIS 79.29  |

\*Through April 25, 2006.

**B. Plan of Distribution**

Not applicable

**C. Markets**

Our ordinary shares are listed for quotation on the Nasdaq National Market under the symbol “RDWR”.

**D. Selling Shareholders**

Not applicable

**E. Dilution**

Not applicable

**F. Expenses of the Issue**

Not applicable

## **ITEM 10. ADDITIONAL INFORMATION**

### **A. Share Capital**

Not applicable

### **B. Memorandum and Articles of Association**

*Set out below is a description of certain provisions of our Memorandum of Association and Articles of Association, and of the Israeli Companies Law related to such provisions. This description is only a summary and does not purport to be complete and is qualified by reference to the full text of the Memorandum and Articles which are incorporated by reference to exhibits to this Annual Report and by Israeli law.*

We were first registered under Israeli law on May 16, 1996 as a private company, and on November 18, 1999 became a public company. Our registration number with the Israeli registrar of companies is 52-004437-1.

### **Objects and Purposes**

Pursuant to our articles of association, our object is to engage, directly or indirectly, in any lawful undertaking or business whatsoever, including, without limitation, as stipulated in our Memorandum of Association, which was filed with the Israeli registrar of companies.

### **Shares; Transfer of Shares**

Our registered capital is divided into 30,000,000 ordinary shares of nominal (par) value NIS 0.10 each. There are no other classes of shares. All of our outstanding shares are fully paid and non-assessable. The shares do not entitle their holders to preemptive rights and fully paid ordinary shares may be freely transferred pursuant to our articles of association unless such transfer is restricted or prohibited by another instrument.

### **Dividend and Liquidation Rights**

Dividends on our ordinary shares may be paid only out of profits and other surplus, as defined in the Companies Law, as of the end of the most recent financial statements or as accrued over a period of two years, whichever is higher. Our board of directors is authorized to declare dividends, provided that there is no reasonable concern that payment of the dividend will prevent us from satisfying our existing and foreseeable obligations as they become due, and provided further that our shareholders approved the final dividend declared by the board, in an amount not to exceed the board's recommendation. In the event of our liquidation, after satisfaction of liabilities to creditors, our assets will be distributed to the holders of ordinary shares in proportion to their respective holdings. This liquidation right may be affected by the grant of preferential dividends or distribution rights to the holders of a class of shares with preferential rights that may be authorized in the future.

### **Voting, Shareholders' Meetings and Resolutions**

We have two types of general shareholder meetings: the annual general meeting and the extraordinary general meeting. An annual general meeting must be held once in every calendar year, but not more than 15 months after the last annual general meeting. The Board of Directors may convene an extraordinary general meeting whenever it thinks fit, and is obliged to do so upon the request of any of: two directors or one fourth of the serving directors; one or more shareholders who have at least 5% of the issued share capital and at least 1% of the voting rights; or one or more shareholders who have at least 5% of the voting rights.

Under the Companies Law, shareholder meetings generally require prior notice of not less than 21 days. The Companies Law also provides that the record date for the participation of shareholders of a company whose shares are traded or registered outside of Israel such as us may generally be no more than 40 but no less than 28 days prior to the meeting, provided that notice for said meeting is given prior to the record date. A shareholder may vote in person or by proxy, or, if the shareholder is a corporate body, by its representative.

Holders of ordinary shares have one vote for each ordinary share held on all matters submitted to a vote of shareholders. A shareholder may only vote the shares for which all calls have been paid, except in separate general meetings of a particular class.

These voting rights may be affected by the grant of any special voting rights to the holders of a class of shares with preferential rights that may be authorized in the future. The quorum required for an ordinary meeting of shareholders consists of at least two shareholders present in person or by proxy who hold or represent between them at least 35% of the outstanding voting shares unless otherwise required by applicable rules. A meeting adjourned for lack of a quorum generally is adjourned to the same day in the following week at the same time and place or any time and place as the Chairman may designate with the consent of a majority of the voting power represented at the meeting and voting on the matter adjourned. At such reconvened meeting the required quorum consists of any two members present in person or by proxy.

Under the Companies Law, unless otherwise provided in the articles of association or applicable law, all resolutions of the shareholders require a simple majority of the shares present, in person or by proxy, and voting on the matter. However, our articles of association require approval of at least 75% of the shares present and voting to increase our share capital or to change its structure, grant any special rights to the holders of a class of shares with preferential rights or change such rights previously granted or remove directors from office.

Subject to the Companies Law, a resolution in writing signed by the holders of all of our ordinary shares entitled to vote at a meeting of shareholders or to which all such shareholders have given their written consent will be sufficient to adopt the resolution in lieu of a meeting.

### **General Duties of Shareholders**

Under the Companies Law, each and every shareholder has a duty to act in good faith in exercising his rights and fulfilling his obligations towards the company and other shareholders and refrain from abusing his power in the company, such as in voting in the general meeting of shareholders on the following matters:

- Any amendment to the articles of association;
- An increase of the company's authorized share capital;
- A merger; or
- Approval of certain related party transactions and actions which require shareholder approval pursuant to the Companies Law.

In addition, each and every shareholder has the general duty to refrain from depriving rights of other shareholders.

Furthermore, any controlling shareholder, any shareholder who knows that it possesses the power to determine the outcome of a shareholder vote and any shareholder that, pursuant to the provisions of the articles of association, has the power to appoint or to prevent the appointment of an office holder in the company or any other power toward the company is under a duty to act in fairness towards the company. The Companies Law does not describe the substance of this duty of fairness. These various shareholder duties may restrict the ability of a shareholder to act in what the shareholder perceives to be its own best interests.

### **Restrictions on Non-Israeli Residents**

The ownership or voting of our ordinary shares by non-residents of Israel, except with respect to citizens of countries which are in a state of war with Israel, is not restricted in any way by our Memorandum of Association or Articles of

Association or by the laws of the State of Israel.

**Mergers and Acquisitions under Israeli Law**

There are no specific provisions of our memorandum or articles of association that would have an effect of delaying, deferring or preventing a change in control of us or that would operate only with respect to a merger, acquisition or corporate restructuring involving us (or any of our subsidiaries). However, certain provisions of the Companies Law may have such effect.

The Israeli Companies Law includes provisions that allow a merger transaction and requires that each company that is party to a merger approve the transaction by its board of directors and a vote of the majority of its shares, voting on the proposed merger at a shareholders' meeting. For purposes of the shareholder vote, unless a court rules otherwise, the 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 other party to the merger (or by any person who holds 25% or more of the voting power of the right to appoint 25% or more of the directors of the other party), vote against the merger. Upon the request of a creditor of either party of the proposed merger, the court may delay or prevent the merger if it concludes that there exists a reasonable concern that as a result of the merger, the surviving company will be unable to satisfy the obligations of any of the parties to the merger. In addition, a merger may not be completed unless at least (i) 50 days have passed from the time that a proposal of the merger has been filed with the Israeli Registrar of Companies by each merging company and (ii) 30 days have passed since the merger was approved by the shareholders of each merging company.

In addition, provisions of the Companies Law that deal with "arrangements" between a company and its shareholders may be used to effect squeeze-out transactions in which the target company becomes a wholly-owned subsidiary of the acquiror. These provisions generally require that the merger be approved by a majority of the participating shareholders holding at least 75% of the shares voted on the matter. In addition to shareholder approval, court approval of the transaction is required, which entails further delay. The Companies Law also provides for a merger between Israeli companies, after completion of the above procedure for an "arrangement" transaction and court approval of the merger.

The Companies Law also provides that an acquisition of shares of a public company must be made by means of tender offer if as a result of the acquisition the purchaser would become a 25% or greater shareholder of the company and there is no 25% or greater shareholder in the company. Similarly, the Companies Law provides that an acquisition of shares in a public company must be made by means of a tender offer if as a result of the acquisition the purchaser would become a 45% or greater shareholder of the company, unless there is already a 45% or greater shareholder of the company. These requirements do not apply if, in general, the acquisition (1) was made in a private placement that received shareholder approval, (2) was from a 25% or greater shareholder of the company which resulted in the acquirer becoming a 25% or greater shareholder of the company, or (3) was from a 45% or greater shareholder of the company which resulted in the acquirer becoming a 45% or greater shareholder of the company. The tender offer must be extended to all shareholders, but the offeror is not required to purchase more than 5% of the company's outstanding shares, regardless of how many shares are tendered by shareholders. The tender offer may be consummated only if (i) at least 5% of the company's outstanding shares will be acquired by the offeror and (ii) the number of shares tendered in the offer exceeds the number of shares whose holders objected to the offer.

If, as a result of an acquisition of shares, the acquirer will hold more than 90% of a company's outstanding shares, the acquisition must be made by means of a tender offer for all of the outstanding shares. If less than 5% of the outstanding shares are not tendered in the tender offer, all the shares that the acquirer offered to purchase will be transferred to it. The Companies Law provides for appraisal rights if any shareholder files a request in court within three months following the consummation of a full tender offer. If more than 5% of the outstanding shares are not tendered in the tender offer, then the acquiror may not acquire shares in the tender offer that will cause his shareholding to exceed 90% of the outstanding shares.

Finally, Israeli tax law treats stock-for-stock acquisitions between an Israeli company and a foreign company less favorably than does U.S. tax law. For example, Israeli tax law subjects a shareholder who exchanges his ordinary shares for shares in another corporation to taxation on half the shareholder's shares two years following the exchange and on the balance four years thereafter even if the shareholder has not yet sold the new shares.

## **Modification of Class Rights**

Our articles of association provide that the rights attached to any class (unless otherwise provided by the terms of such class), such as voting, rights to dividends and the like, may be varied by written consent of holders of seventy-five percent of the issued shares of that class, or by adoption by the holders of seventy-five percent of the shares of that class at a separate class meeting. Subject thereto, the conditions imposed by our articles of association governing changes in the rights of any class of shares, are no more stringent than is required by Israeli law.

## **Board of Directors**

According to the Companies Law and our articles of association, the management of our business is vested in our board of directors. Our articles of association provide that the board of directors shall consist of not less than five and not more than nine directors. In accordance with our articles of association, our board of directors (other than our external directors) is divided into three classes with each class serving until the third annual meeting following their election, as more fully described in Item 6C under “Staggered Board”. There is no requirement under our articles or Israeli law for directors to retire on attaining a specific age. Our articles do not require directors to hold our ordinary shares to qualify for election.

The board of directors may exercise all such powers and may take all such actions that are not specifically granted to our shareholders. As part of its powers, our board of directors may cause the company to borrow or secure payment of any sum or sums of money for the purposes of the Company, at such times and upon such terms and conditions as it thinks fit, including the grants of security interests on all or any part of the property of the company. In addition, the Companies Law requires that transactions between a company and its office holders (which term includes directors) or that benefit its office holders, including arrangements as to the compensation of office holders, be approved as provided for in the Companies Law and the company's articles of association, as more fully described in Item 6C under “Approval of Specified Related Party Transactions Under Israeli Law”.

A resolution proposed at any meeting of the board of directors shall be deemed adopted if approved by a majority of the directors present and voting on the matter.

## **Exculpation, Insurance and Indemnification**

### *Exculpation of Office Holders*

Under the Companies Law, an Israeli company may not exempt an office holder from liability for a breach of his duty of loyalty, but may exempt in advance an office holder from his liability to the company, in whole or in part, for a breach of his duty of care (except in connection with distributions), provided that the articles of association of the company allow it to do so. Our articles of association allow us to exempt our office holders to the maximum extent permitted by law.

### *Insurance of Office Holders*

Our articles of association provide that, subject to the provisions of the Companies Law, we may enter into a contract for the insurance of the liability of any of our office holders, with respect to an act performed in the capacity of an office holder for:

- A breach of his duty of care to us or to another person;
- A breach of his duty of loyalty to us, provided that the office holder acted in good faith and had reasonable cause to assume that his act would not prejudice our interests; or



- A financial liability imposed upon him in favor of another person.

*Exculpation and Indemnification of Office Holders*

Under the Companies Law, we may indemnify any of our office holders against the following obligations and expenses imposed on the office holder with respect to an act performed in the capacity of an office holder:

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- A financial liability imposed on him in favor of another person by a court judgment, including a settlement or an arbitration award approved by the court. Such indemnification may be approved (i) after the liability has been incurred or (ii) in advance, provided that our undertaking to indemnify is limited to events that our board of directors believes are foreseeable in light of our actual operations at the time of providing the undertaking and to a sum or criterion that our board of directors determines to be reasonable under the circumstances;
- Reasonable litigation expenses, including attorney's fees, expended by the office holder as a result of an investigation or proceeding instituted against him by a competent authority, provided that such investigation or proceeding concluded without the filing of an indictment against him or the imposition of any financial liability in lieu of criminal proceedings other than with respect to a criminal offense that does not require proof of criminal intent; and
- Reasonable litigation expenses, including attorneys' fees, expended by the office holder or charged to him by a court in connection with proceedings we institute against him or instituted on our behalf or by another person, a criminal indictment from which he was acquitted, or a criminal indictment in which he was convicted for a criminal offense that does not require proof of criminal intent.

#### *Limitations on Insurance and Indemnification*

The Companies Law provides that a company may not indemnify an office holder, or enter into an insurance contract which would provide coverage for any monetary liability incurred as a result of any of the following:

- A breach by the office holder of his duty of loyalty unless, with respect to indemnification or insurance coverage, the office holder acted in good faith and had a reasonable basis to believe that the act would not prejudice the company;
- A breach by the office holder of his duty of care if the breach was done intentionally or recklessly unless the breach was done negligently;
  - Any act or omission done with the intent to derive an illegal personal benefit; or
  - Any fine levied against the office holder.

In addition, under the Companies Law, indemnification of, and procurement of insurance coverage for, our office holders must be approved by our audit committee and our board of directors and, if the beneficiary is a director, by our shareholders.

We currently hold directors and officers liability insurance for the benefit of our office holders. In general, we submit the renewal of our policy to the approvals of our audit committee, board of directors and shareholders, in that order, every year. In addition, we provide our directors and officers indemnification pursuant to the terms of a Letter of Indemnification, be substantially in the form approved by our shareholders [(See Exhibit 4.4 in Item 19 for the form of such letter).

#### **C. Material Contracts**

For a summary of our material contracts, see Item 7 - "*Related Party Transactions*", and see Item 5 - "*Business Combination - acquisition of V-Secure*".

## **Exchange Controls**

There are currently no Israeli currency control restrictions on payments of dividends or other distributions with respect to our ordinary shares or the proceeds from the sale of the shares, except for the obligation of Israeli residents to file reports with the Bank of Israel regarding certain transactions. However, legislation remains in effect pursuant to which currency controls can be imposed by administrative action at any time.

## **Taxation**

**Holders of our ordinary shares should consult their own tax advisors as to the United States, Israeli or other tax consequences of the purchase, ownership and disposition of ordinary shares, including, in particular, the effect of any foreign, state or local taxes.**

## **Israeli Tax Considerations**

The following is a summary of the current tax structure applicable to companies incorporated in Israel, with special reference to its effect on us. The following also contains a discussion of the material Israeli and United States tax consequences to purchasers of our ordinary shares and Israeli government programs benefiting us. To the extent that the discussion is based on new tax legislation which has not been subject to judicial or administrative interpretation, we cannot assure you that the views expressed in the discussion will be accepted by the Israel tax authorities or courts. The discussion is not intended, and should not be construed, as legal or professional tax advice and is not exhaustive of all possible tax considerations.

### *General Corporate Tax Structure*

Generally, Israeli companies are subject to "Corporate Tax" on their taxable income. On July 25, 2005, the Knesset (Israeli Parliament) approved the Law of the Amendment of the Income Tax Ordinance (No. 147), 2005, which prescribes, among others, a gradual decrease in the corporate tax rate in Israel to the following tax rates: in 2006 - 31%, in 2007 - 29%, in 2008 - 27%, in 2009 - 26% and in 2010 and thereafter - 25%. However, the effective tax rate payable by a company which derives income from an approved enterprise (as further discussed below) may be considerably less.

### *Stamp Duty*

The Israeli Stamp Duty on Documents Law, 1961, or the Stamp Duty Law, provides that any document (or part thereof) that is signed in Israel or that is signed outside of Israel and refers to an asset or other thing in Israel or to an action that is executed or will be executed in Israel, is subject to a stamp duty, generally at a rate of between 0.4% and 1% of the value of the subject matter of such document. De facto, it has been common practice in Israel not to pay such stamp duty unless a document is filed with a governmental authority. An amendment to the Stamp Duty Law that came into effect on June 1, 2003, determines, among other things, that stamp duty on most agreements shall be paid by the parties that signed such agreement, jointly or severally, or by the party that undertook under such agreement to pay the stamp duty. As a result of the aforementioned amendment to the Stamp Duty Law, the Israeli tax authorities have approached many companies in Israel and requested disclosure of all agreements signed by such companies after June 1, 2003, with the aim of collecting stamp duty on such agreements. The legitimacy of the aforementioned amendment to the Stamp Duty Law and of said actions by the Israeli tax authorities are currently under review by the Israeli High Court of Justice.

Based on advice from counsel, we believe that we may only be required to pay stamp duty on documents signed on or after August 2004. However, we cannot assure you that the tax authorities or the courts will accept such view.

Under an order published in December 2005, the requirement to pay the stamp duty was terminated with respect to agreements signed after January 1, 2006.

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

*The law before the amendment of 2005*

The Law for the Encouragement of Capital Investments, 1959, as amended (effective as of April 1, 2005) (the “Investments Law”), provides that a proposed capital investment in eligible facilities may, upon application to the Investment Center of the Ministry of Industry and Commerce of the State of Israel, be designated as an approved enterprise. The Investment Center bases its decision as to whether or not to approve an application, among other things, on the criteria set forth in the Investments Law and regulations, the then prevailing policy of the Investment Center, and the specific objectives and financial criteria of the applicant. Each certificate of approval for an approved enterprise relates to a specific investment program delineated both by its financial scope, including its capital sources, and by its physical characteristics, e.g., the equipment to be purchased and utilized pursuant to the program.

The Investments Law provides that an approved enterprise is eligible for tax benefits on taxable income derived from its approved enterprise programs. The tax benefits under the Investments Law also apply to income generated by a company from the grant of a usage right with respect to know-how developed by the approved enterprise, income generated from royalties, and income derived from a service which is auxiliary to such usage right or royalties, provided that such income is generated within the approved enterprise’s ordinary course of business. If a company has more than one approval or only a portion of its capital investments are approved, its effective tax rate is the result of a weighted average of the applicable rates. The tax benefits under the Investments Law are not, generally, available with respect to income derived from products manufactured outside of Israel. In addition, the tax benefits available to an approved enterprise are contingent upon the fulfillment of conditions stipulated in the Investments Law and regulations and the criteria set forth in the specific certificate of approval, as described above. In the event that a company does not meet these conditions, it would be required to refund the amount of tax benefits, plus a consumer price index linkage adjustment and interest.

The Investments Law also provides that an approved enterprise is entitled to accelerated depreciation on its property and equipment that are included in an approved enterprise program.

Taxable income of a company derived from an approved enterprise is subject to corporate tax at the maximum rate of 25%, rather than the regular corporate tax rate, for the benefit period. This period is ordinarily seven years commencing with the year in which the approved enterprise first generates taxable income, and is limited to twelve years from commencement of production or 14 years from the date of approval, whichever is earlier.

A company may elect to receive an alternative package of benefits. Under the alternative package of benefits, a company’s undistributed income derived from the approved enterprise will be exempt from corporate tax for a period of between two and ten years from the first year the company derives taxable income under the program, depending on the geographic location of the approved enterprise within Israel, and such company will be eligible for a reduced tax rate for the remainder of the benefits period. A company that has elected the alternative package of benefits, such as us, that subsequently pays a dividend out of income derived from the approved enterprise during the tax exemption period will be subject to corporate tax in respect of the amount distributed, including any taxes thereon, at the rate which would have been applicable had it not elected the alternative package of benefits, generally 10%-25%, depending on the percentage of the company’s ordinary shares held by foreign shareholders. The dividend recipient is subject to withholding tax at the rate of 15% applicable to dividends from approved enterprises, if the dividend is distributed during the tax exemption period or within twelve years thereafter. The company must withhold this tax at source.

A company that has an approved enterprise program is eligible for further tax benefits if it qualifies as a foreign investors’ company. A foreign investors’ company is a company which more than 25% of its share capital and combined share and loan capital is owned by non-Israeli residents. A company that qualifies as a foreign investors’ company and has an approved enterprise program is eligible for tax benefits for a ten-year benefit period. As specified above, depending on the geographic location of the approved enterprise within Israel, income derived from the

approved enterprise program may be exempt from tax on its undistributed income for a period of between two to ten years, and will be subject to a reduced tax rate for the remainder of the benefits period. The tax rate for the remainder of the benefits period will be 25%, unless the level of foreign investment exceeds 49%, in which case the tax rate will be 20% if the foreign investment is more than 49% and less than 74%; 15% if more than 74% and less than 90%; and 10% if 90% or more.

Subject to applicable provisions concerning income under the alternative package of benefits, dividends paid by a company are considered to be attributable to income received from the entire company and the company's effective tax rate is the result of a weighted average of the various applicable tax rates, excluding any tax-exempt income. Under the Investments Law, a company that has elected the alternative package of benefits is not obliged to distribute retained profits, and may generally decide from which year's profits to declare dividends. We currently intend to reinvest any income derived from our approved enterprise program and not to distribute such income as a dividend.

The Investment Center has granted us an approval to establish an approved enterprise program under the Investments Law, at our facilities in Tel Aviv and Jerusalem.

The current benefits for an approved enterprise program in Jerusalem provide that income derived from the approved enterprise program allocated to the approved enterprise in Jerusalem is tax exempt for ten years commencing with the year in which the approved enterprise first generates taxable income and will be taxed at a reduced company tax rate of up to 25% (rather than the regular corporate tax rate).

The current benefits for an approved enterprise program in Tel Aviv provide that income derived from the approved enterprise program and allocated to our Tel Aviv facility will be tax exempt for a period of two years and will be subject to a reduced tax rate, depending on the level of foreign investment, for an additional period of five to eight years.

As mentioned above, the Investment Center's approval is for establishing an approved enterprise program in both Tel Aviv and Jerusalem. The approval provides for the allocation of tax benefits between our facilities in Tel Aviv and Jerusalem such that the income derived from the approved enterprise program shall be allocated pro-rata between the aforementioned facilities based on the expenses borne by each facility. However, since all our manufacturing and part of our research and development facilities are located in Jerusalem, the Investment Center determined the method of allocation of tax benefits between our facilities in Jerusalem and Tel Aviv as follows: The method of allocation of the tax benefits between our facilities in Tel Aviv and Jerusalem will be based on the number of research and development employees in each of the facilities, provided, however that the average salary for such employees in our Jerusalem facility will not be less than 85% of the average salary of such employees in our Tel Aviv facility. In the years that such condition is not fulfilled, the method of allocation will be as follows: (i) 50% of our income will be allocated between our Jerusalem facility and our Tel Aviv facility, pro-rata according to the number of employees engaged in research and development or manufacturing activities in each facility; and (ii) 50% of our income will be allocated between our Jerusalem facility and our Tel Aviv facility, pro-rata according to the salaries paid to the employees engaged in research and development or manufacturing activities in each facility. The Israeli government may reduce or eliminate tax benefits available to approved enterprise programs in the future. We cannot assure you that our approved program and the benefits thereunder shall continue in the future at its current level or at any level - see Item 3 (Risks relating to Location in Israel).

In 2004, the Company began to utilize the above mentioned tax benefits, and they are scheduled to gradually expire through 2013. As of December 31, 2005, retained earnings included approximately \$19,925,000 in tax-exempt income earned by the Company's "Approved Enterprise". The Company has decided not to declare dividends out of such tax-exempt income. Accordingly, no deferred income taxes have been provided on income attributable to the Company's "Approved Enterprise".

If the retained tax-exempt income is distributed, it would be taxed at the corporate tax rate applicable to such profits as if the Company had not elected the alternative tax benefits (currently between 10% - 25%) and an income tax liability of approximately between \$2,000,000 to \$5,850,000 would be incurred.

Income from sources other than the "Approved Enterprise" will be subject to the tax at the regular rate.

During 2004, the Company's production facilities in Israel (Tel-Aviv and Jerusalem) have been granted an expansion program to its Approved Enterprise status by the Investment Center. The Company applied for an amendment to this expansion program, according to which it requested an enlargement to this expansion program, neutralization of certain assets and an approval that the benefits period from such expansion program will commence in 2006. The Investment Center has not yet approved this application. If the Investment Center will not approve the above application, the company will apply for a new program under the 2005 amendment to the Investment Law, as described below.



## The 2005 Amendment to the Investments Law

A recent amendment to the Law, which has been published on April 1, 2005 (the "Amendment") has changed certain provisions of the Law. As a result of the Amendment, a company is no longer obliged to acquire Approved Enterprise status in order to receive the tax benefits previously available under the Alternative Benefits provisions, and therefore generally there is no need to apply to the Investment Center for this purpose (Approved Enterprise status remains mandatory for companies seeking grants). Rather, the Company may claim the tax benefits offered by the Investment Law directly in its tax returns, provided that its facilities meet the criteria for tax benefits set out by the Amendment. A company is also granted a right to approach the Israeli Tax Authority for a pre-ruling regarding their eligibility for benefits under the Amendment.

Tax benefits are available under the Amendment to production facilities (or other eligible facilities), which are generally required to derive more than 25% of their business income from export (referred to as a "Benefited Enterprise"). In order to receive the tax benefits, the Amendment states that the company must make an investment in the Benefited Enterprise exceeding a certain percentage or a minimum amount specified in the Law. Such investment may be made over a period of no more than three years ending at the end of the year in which the company requested to have the tax benefits apply to the Benefited Enterprise (the "Year of Election"). Where the company requests to have the tax benefits apply to an expansion of existing facilities, then only the expansion will be considered a Benefited Enterprise and the company's effective tax rate will be the result of a weighted combination of the applicable rates. In this case, the minimum investment required in order to qualify as a Benefited Enterprise is required to exceed a certain percentage or a minimum amount of the company's production assets before the expansion.

The duration of tax benefits is subject to a limitation of the earlier of 7 to 10 years from the Commencement Year, or 12 years from the first day of the Year of Election. The tax benefits granted to a Benefited Enterprise are determined, as applicable to its geographic location within Israel, according to one of the following new tax routes, which may be applicable to us:

- Similar to the currently available alternative route, exemption from corporate tax on undistributed income for a period of two to ten years, depending on the geographic location of the Benefited Enterprise within Israel, and a reduced corporate tax rate of 10% to 25% for the remainder of the benefits period, depending on the level of foreign investment in each year. Benefits may be granted for a term of seven to ten years, depending on the level of foreign investment in the company. If the company pays a dividend out of income derived from the Benefited Enterprise during the tax exemption period, such income will be subject to corporate tax at the applicable rate (10%-25%). The company is required to withhold tax at the source at a rate of 15% from any dividends distributed from income derived from the Benefited Enterprise; and
- A special tax route, which enables companies owning facilities in certain geographical locations in Israel to pay corporate tax at the rate of 11.5% on income of the Benefited Enterprise. The benefits period is ten years. Upon payment of dividends, the company is required to withhold tax at source at a rate of 15% for Israeli residents and at a rate of 4% for foreign residents.

Generally, a company that is Abundant in Foreign Investment (as defined in the Investments Law) is entitled to an extension of the benefits period by an additional five years, depending on the rate of its income that is derived in foreign currency.

The Amendment changes the definition of “foreign investment” in the Investments Law so that the definition now requires a minimal investment of NIS 5 million by foreign investors. Furthermore, such definition now also includes the purchase of shares of a company from another shareholder, provided that the company’s outstanding and paid-up share capital exceeds NIS 5 million. Such changes to the aforementioned definition will take effect retroactively from 2003.

The Amendment will apply to approved enterprise programs in which the year of election under the Investments Law is 2004 or later, unless such programs received approval from the Investment Center on or prior to December 31, 2004, in which case the Amendment provides that terms and benefits included in any certificate of approval already granted will remain subject to the provisions of the law as they were on the date of such approval.

Should we elect to utilize tax benefits under the Amendment to the law, any such tax exempt profits might be subject to future taxation on the corporate level upon distribution to shareholders by a way of dividend or liquidation. Accordingly, we may be required to recognize deferred tax liability with respect to such tax exempt profits.

A substantial portion of our taxable operating income is derived from our approved enterprise program and we expect that a substantial portion of any taxable operating income that we may realize in the future will be also derived from such program. There is no assurance that our Jerusalem facility and Tel Aviv facility will continue to enjoy such status in the future.

#### *Tax Benefits for Research and Development*

Israeli tax law allows, under specified conditions, a tax deduction for expenditures, including capital expenditures, in the year incurred relating to scientific research and development projects, if the expenditures are approved by the relevant Israeli Government ministry, determined by the field of research, and the research and development is for the promotion of the company and is carried out by or on behalf of the company seeking such deduction. However, the amount of such deductible expenses shall be reduced by the sum of any funds received through government grants for the finance of such scientific research and development projects. Expenditures not so approved are deductible over a three-year period.

#### *Tax Benefits Under the Law for the Encouragement of Industry (Taxes), 1969*

Under the Law for the Encouragement of Industry (Taxes), 1969 (the “Industry Encouragement Law”), Industrial Companies are entitled to the following preferred corporate tax benefits, among others:

- Deduction of purchases of know-how and patents over an eight-year period for tax purposes;
- Right to elect, under specified conditions, to file a consolidated tax return with additional related Israeli Industrial Companies;
- Accelerated depreciation rates on equipment and buildings; and
- Deductions over a three-year period of expenses involved with the issuance and listing of shares on the Tel Aviv Stock Exchange or, on or after January 1, 2003, on a recognized stock market outside of Israel.

Eligibility for benefits under the Industry Encouragement Law is not subject to receipt of prior approval from any governmental authority. Under the Industry Encouragement Law, an “Industrial Company” is defined as a company resident in Israel, at least 90% of the income of which, in any tax year, determined in Israeli currency, exclusive of income from government loans, capital gains, interest and dividends, is derived from an “Industrial Enterprise” owned by it. An “Industrial Enterprise” is defined as an enterprise owned by an Industrial Company, whose major activity in a given tax year is industrial production activity.

We believe that we currently qualify as an Industrial Company within the definition of the Industry Encouragement Law. No assurance can be given that we will continue to qualify as an Industrial Company or that the benefits described above will be available in the future.

*Special Provisions Relating to Taxation Under Inflationary Conditions*

Under the Income Tax (Inflationary Adjustments) Law, 1985, or the Adjustments Law, results for tax purposes are measured in real terms, in accordance with the changes in the Israeli Consumer Price Index ("Israeli CPI"). Accordingly, until 2002, results for tax purposes were measured in terms of earnings in NIS after certain adjustments for increases in the Israeli CPI. Commencing in taxable year 2003, the Company has elected to measure its taxable income and file its tax return under the Israeli Income Tax Regulations (Principles Regarding the Management of Books of Account of Foreign Invested Companies and Certain Partnerships and the Determination of Their Taxable Income), 1986. Such an elective obligates the Company for three years. Accordingly, commencing taxable year 2003, results for tax purposes are measured in terms of earnings in dollar. We have submitted a request to the Israeli tax authorities to extend the effect of the above regulations on our company for 2006.

*Capital Gains Tax on Sales of Our Ordinary Shares*

Israeli law generally imposes a capital gains tax on the sale of any capital assets by residents of Israel, as defined for Israeli tax purposes, and on the sale of assets located in Israel, including shares in Israeli companies, by both residents and non-residents of Israel, unless a specific exemption is available or unless a tax treaty between Israel and the shareholder's country of residence provides otherwise. The law distinguishes between real gain and inflationary surplus. The inflationary surplus is a portion of the total capital gain which is equivalent to the increase of the relevant asset's purchase price which is attributable to the increase in the Israeli consumer price index or, in certain circumstances, a foreign currency exchange rate, between the date of purchase and the date of sale. The real gain is the excess of the total capital gain over the inflationary surplus.

Generally, until the 2006 tax year, capital gains tax was imposed on Israeli resident individuals at a rate of 15% on real gains derived on or after January 1, 2003, from the sale of shares in, among others, Israeli companies publicly traded on Nasdaq or on a recognized stock exchange or regulated market in a country that has a treaty for the prevention of double taxation with Israel (such as Radware). This tax rate was contingent upon the shareholder not claiming a deduction for financing expenses in connection with such shares (in which case the gain was generally be taxed at a rate of 25%), and did not apply to: (i) the sale of shares to a relative (as defined in the Israeli Income Tax Ordinance); (ii) the sale of shares by dealers in securities; (iii) the sale of shares by shareholders that report in accordance with the Inflationary Adjustments Law (that were taxed at corporate tax rates for corporations and at marginal tax rates for individuals); or (iv) the sale of shares by shareholders who acquired their shares prior to an initial public offering (that may be subject to a different tax arrangement).

As of January 1, 2006, the tax rate applicable to capital gains derived from the sale of shares, whether listed on a stock market or not, is 20% for Israeli individuals, unless such shareholder claims a deduction for financing expenses in connection with such shares, in which case the gain will generally be taxed at a rate of 25%. Additionally, if such shareholder is considered a "material shareholder" at any time during the 12-month period preceding such sale, i.e., such shareholder holds directly or indirectly, including with others, at least 10% of any means of control in the company, the tax rate shall be 25%. Israeli companies are subject to the Corporate Tax rate on capital gains derived from the sale of shares, unless such companies were not subject to the Adjustments Law (or certain regulations) at the time of publication of the aforementioned amendment to the Tax Ordinance that came into effect on January 1, 2006, in which case the applicable tax rate is 25%. However, the foregoing tax rates do not apply to: (i) dealers in securities; and (ii) shareholders who acquired their shares prior to an initial public offering (that may be subject to a different tax arrangement).

The tax basis of shares acquired prior to January 1, 2003 will be determined in accordance with the average closing share price in the three trading days preceding January 1, 2003. However, a request may be made to the tax authorities to consider the actual adjusted cost of the shares as the tax basis if it is higher than such average price.

Non-Israeli residents are exempt from Israeli capital gains tax on any gains derived from the sale of shares of Israeli companies publicly traded on a recognized stock exchange or regulated market outside of

Israel, provided however that such capital gains are not derived from a permanent establishment in Israel, such shareholders are not subject to the Adjustments Law, and such shareholders did not acquire their shares prior to an initial public offering. However, non-Israeli corporations will not be entitled to such exemption if an Israeli resident (i) has a controlling interest of 25% or more in such non-Israeli corporation, or (ii) is the beneficiary or is entitled to 25% or more of the revenues or profits of such non-Israeli corporation, whether directly or indirectly.

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

Pursuant to the Convention Between the government of the United States of America and the government of Israel with Respect to Taxes on Income, as amended (the “U.S.-Israel Tax Treaty”), the sale, exchange or disposition of ordinary shares by a person who (i) holds the ordinary shares as a capital asset, (ii) qualifies as a resident of the United States within the meaning of the U.S.-Israel Tax Treaty and (iii) is entitled to claim the benefits afforded to such person by the U.S.-Israel Tax Treaty, generally, will not be subject to the Israeli capital gains tax. Such exemption will not apply if (i) such Treaty U.S. Resident holds, directly or indirectly, shares representing 10% or more of our voting power during any part of the 12-month period preceding such sale, exchange or disposition, subject to certain conditions, or (ii) the capital gains from such sale, exchange or disposition can be allocated to a permanent establishment in Israel. In such case, the sale, exchange or disposition of ordinary shares would be subject to Israeli tax, to the extent applicable; however, under the U.S.-Israel Tax Treaty, such Treaty U.S. Resident would be permitted to claim a credit for such taxes against the U.S. federal income tax imposed with respect to such sale, exchange or disposition, subject to the limitations in U.S. laws applicable to foreign tax credits. The U.S.-Israel Tax Treaty does not relate to U.S. state or local taxes.

#### *Taxation of Non-Resident Holders of Shares*

Non-residents of Israel are subject to income tax on income accrued or derived from sources in Israel. Such sources of income include passive income such as dividends, royalties and interest, as well as non-passive income from services rendered in Israel. On distributions of dividends other than bonus shares, or stock dividends, income tax is withheld at the source at the following rates: (i) for dividends distributed prior to January 1, 2006 - 25%; (ii) for dividends distributed on or after January 1, 2006 - 20%, or 25% for a shareholder that is considered a “material shareholder” at any time during the 12-month period preceding such distribution, unless a different rate is provided in a treaty between Israel and the shareholder’s country of residence. Under the U.S.-Israel Tax Treaty, the maximum tax on dividends paid to a holder of ordinary shares who is a Treaty U.S. Resident is 25%. However, under the Investments Law, dividends generated by an Approved Enterprise (or Benefited Enterprise) are taxed at the rate of 15%. Furthermore, dividends not generated by an Approved Enterprise (or Benefited Enterprise) paid to a U.S. corporation holding at least 10% of our issued voting power during the part of the tax year which precedes the date of payment of the dividend and during the whole of its prior tax year, are generally taxed at a rate of 12.5%.

For information with respect to the applicability of Israeli capital gains taxes on the sale of ordinary shares by United States residents, see above “— Capital Gains Tax on Sales of Our Ordinary Shares.”

#### **United States Federal Income Tax Considerations**

Subject to the limitations described herein, the following discussion summarizes the material United States federal income tax consequences to a U.S. Holder of our ordinary shares. A “U.S. Holder” means a holder of our ordinary shares who is:

- A citizen or resident of the United States for U.S. tax purposes;
- A corporation or partnership (or other entity taxable as a corporation or partnership for U.S. federal income tax purposes) created or organized in the United States or under the laws of the United States or any political

subdivision thereof;

- An estate, the income of which is subject to United States federal income tax regardless of its source; or

- A trust (i) if, in general a court within the United States is able to exercise primary supervision over its administration and one or more U.S. persons have the authority to control all of its substantial decisions, or (ii) that has in effect a valid election under applicable U.S. Treasury regulations to be treated as a U.S. person.

This discussion considers only U.S. Holders that will own their ordinary shares as capital assets and does not purport to be a comprehensive description of all of the tax considerations that may be relevant to each person's decision to purchase our ordinary shares. Material aspects of U.S. federal income tax relevant to a holder of our ordinary shares that is not a U.S. Holder (a "Non-U.S. Holder") are also discussed below.

This discussion is based on current provisions of the Internal Revenue Code of 1986, as amended (the "Code"), current and proposed Treasury regulations promulgated thereunder, and administrative and judicial decisions as of the date hereof, all of which are subject to change, possibly on a retroactive basis. This discussion does not address all aspects of United States federal income taxation that may be relevant to any particular U.S. Holder in light of such holder's individual circumstances. In particular, this discussion does not address the potential application of the alternative minimum tax or United States federal income tax consequences to shareholders that are subject to special treatment, including holders that:

- Are broker-dealers or insurance companies;
- Have elected mark-to-market accounting;
- Are tax-exempt organizations or retirement plans;
- Are financial institutions or "financial services entities";
- Hold their shares as part of a straddle, "hedge" or "conversion transaction" with other investments;
- Acquired their shares upon the exercise of employee stock options or otherwise as compensation;
  - Are, or hold their shares through, partnerships or other pass-through entities;
  - Own directly, indirectly or by attribution at least 10% of our voting power; or
- Have a functional currency that is not the U.S. dollar.

In addition, this discussion does not address any aspect of state, local or non-United States tax laws or the possible application of United States federal gift or estate tax.

**Each holder of our ordinary shares is advised to consult such person's own tax advisor with respect to the specific tax consequences to such person of purchasing, holding or disposing of our ordinary shares, including the applicability and effect of federal, state, local and foreign income tax and other tax laws in such person's particular circumstances.**

#### *Taxation of Ordinary Shares*

*Taxation of Dividends Paid On Ordinary Shares.* Subject to the discussion below under "Passive Foreign Investment Company Status", a U.S. Holder will be required to include in gross income as dividend income the amount of any distribution paid on our ordinary shares, including any Israeli taxes withheld from the amount paid, on the date the distribution is received to the extent the distribution is paid out of our current or accumulated earnings and profits as determined for United States federal income tax purposes. Distributions in excess of such earnings and profits will be



applied against and will reduce the U.S. Holder's basis in our ordinary shares and, to the extent in excess of such basis, will be treated as gain from the sale or exchange of our ordinary shares. The dividend portion of such distributions generally will not qualify for the dividends received deduction available to corporations.

Dividends that are received by U.S. Holders that are individuals, estates or trusts will be taxed at the rate applicable to long-term capital gains (a maximum rate of 15%), provided that such dividends meet the requirements of "qualified dividend income." Dividends that fail to meet such requirements, and dividends received by corporate U.S. Holders, are taxed at ordinary income rates. No dividend received by a U.S. Holder will be a qualified dividend (1) if the U.S. Holder held the ordinary share with respect to which the dividend was paid for less than 61 days during the 121-day period beginning on the date that is 60 days before the ex-dividend date with respect to such dividend, excluding for this purpose, under the rules of Code section 246(c), any period during which the U.S. Holder has an option to sell, is under a contractual obligation to sell, has made and not closed a short sale of, is the grantor of a deep-in-the-money or otherwise nonqualified option to buy, or has otherwise diminished its risk of loss by holding other positions with respect to, such ordinary share (or substantially identical securities); or (2) to the extent that the U.S. Holder is under an obligation (pursuant to a short sale or otherwise) to make related payments with respect to positions in property substantially similar or related to the ordinary share with respect to which the dividend is paid. If we were to be a "passive foreign investment company" (as such term is defined in the Code) for any year, dividends paid on our ordinary shares in such year or in the following year would not be qualified dividends. In addition, a non-corporate U.S. Holder will be able to take a qualified dividend into account in determining its deductible investment interest (which is generally limited to its net investment income) only if it elects to do so; in such case the dividend will be taxed at ordinary income rates.

Distributions of current or accumulated earnings and profits paid in foreign currency to a U.S. Holder (including any Israeli taxes withheld therefrom) will be includible in the income of a U.S. Holder in a U.S. dollar amount calculated by reference to the exchange rate on the day the distribution is received. A U.S. Holder that receives a foreign currency distribution and converts the foreign currency into U.S. dollars subsequent to receipt will have foreign exchange gain or loss based on any appreciation or depreciation in the value of the foreign currency against the U.S. dollar, which will generally be U.S. source ordinary income or loss.

U.S. Holders will have the option of claiming the amount of any Israeli income taxes withheld at source either as a deduction from gross income or as a dollar-for-dollar credit against their United States federal income tax liability. Individuals who do not claim itemized deductions, but instead utilize the standard deduction, may not claim a deduction for the amount of the Israeli income taxes withheld, but such amount may be claimed as a credit against the individual's United States federal income tax liability. The amount of foreign income taxes which may be claimed as a credit in any year is subject to complex limitations and restrictions, which must be determined on an individual basis by each shareholder. These limitations include, among others, rules which limit foreign tax credits allowable with respect to specific classes of income to the United States federal income taxes otherwise payable with respect to each such class of income. The total amount of allowable foreign tax credits in any year cannot exceed regular U.S. tax liability for the year attributable to foreign source taxable income. A U.S. Holder will be denied a foreign tax credit with respect to Israeli income tax withheld from a dividend received on the ordinary shares if such U.S. Holder has not held the ordinary shares for at least 16 days of the 30-day period beginning on the date which is 15 days before the ex-dividend date with respect to such dividend, or to the extent such U.S. Holder is under an obligation to make related payments with respect to substantially similar or related property. Any days during which a U.S. Holder has substantially diminished its risk of loss on the ordinary shares are not counted toward meeting the required 16 day holding period. Distributions of current or accumulated earnings and profits will be foreign source passive income for United States foreign tax credit purposes.

*Taxation of the Disposition of Ordinary Shares.* Subject to the discussion below under "Passive Foreign Investment Company Status," upon the sale, exchange or other disposition of our ordinary shares, a U.S. Holder will recognize capital gain or loss in an amount equal to the difference between such U.S. Holder's basis in such ordinary shares, which is usually the cost of such shares, and the amount realized on the disposition. A U.S. Holder that uses the cash method of accounting calculates the U.S. dollar value of the proceeds received on the sale as of the date that the sale settles, while a U.S. Holder that uses the accrual method of accounting is required to calculate the value of the proceeds of the sale as of the "trade date," unless such U.S. Holder has elected to use the settlement date to determine its proceeds of sale. Capital gain from the sale, exchange or other disposition of our ordinary shares held more than one year is long-term capital gain, and is eligible for a reduced rate of taxation for individuals. Gains recognized by a U.S. Holder on a sale, exchange or other disposition of our ordinary shares will be treated as United States source income for United States foreign tax credit purposes. A loss recognized by a U.S. Holder on the sale, exchange or other disposition of our ordinary shares is allocated to U.S. source income. The deductibility of a capital loss recognized on the sale, exchange or other disposition of our ordinary shares is subject to limitations. A U.S. Holder that receives foreign currency upon disposition of our ordinary shares and converts the foreign currency into U.S. dollars subsequent to the settlement date or trade date (whichever date the taxpayer was required to use to calculate the value of the proceeds of sale) will have foreign exchange gain or loss based on any appreciation or depreciation in the value of the foreign currency against the U.S. dollar, which will generally be U.S. source ordinary income or loss.

*Passive Foreign Investment Company Status.* We will be a passive foreign investment company (a “PFIC”) if (taking into account certain “look-through” rules with respect to the income and assets of our subsidiaries) either 75 percent or more of our gross income in a taxable year is passive income or the average percentage (by value) of our passive assets during the taxable year is at least 50 percent. If we were a PFIC, each U.S. Holder would (unless it made one of the elections discussed below on a timely basis) be taxable on gain recognized from the disposition of our ordinary shares (including gain deemed recognized if the ordinary shares are used as security for a loan) and upon receipt of certain distributions with respect to our ordinary shares as if such income had been recognized ratably over the U.S. Holder’s holding period for the ordinary shares. The U.S. Holder’s income for the current taxable year would include (as ordinary income) amounts allocated to the current year and to any period prior to the first day of the first taxable year for which we were a PFIC. Tax would also be computed at the highest ordinary income tax rate in effect for each other period to which income is allocated, and an interest charge on the tax as so computed would also apply. Additionally, if we were a PFIC, U.S. Holders who acquire our ordinary shares from decedents (other than nonresident aliens) dying before 2010 would be denied the normally-available step-up in basis for such shares to fair market value at the date of death and, instead, would have a tax basis in such shares equal to the decedent’s basis, if lower.

As an alternative to the tax treatment described above, a U.S. Holder could elect to treat us as a “qualified electing fund” (a “QEF”), in which case the U.S. Holder would be taxed currently on its pro rata share of our ordinary earnings and net capital gain (subject to a separate election to defer payment of taxes, which deferral is subject to an interest charge). Special rules apply if a U.S. Holder makes a QEF election after the first year in its holding period in which we are a PFIC. We have agreed to supply U.S. Holders with the information needed to report income and gain under a QEF election if we were a PFIC. As another alternative to the tax treatment described above, a U.S. Holder could elect to mark our ordinary shares to market annually, recognizing as ordinary income or loss each year an amount equal to the difference as of the close of the taxable year between the fair market value of our shares and the shareholder’s adjusted basis in the shares. Losses would be allowed only to the extent of net mark-to-market gain previously included in income by the U.S. Holder.

As indicated above, we will be a PFIC for any tax year if the average percentage (by value) of our assets held for the production of, or that produce, passive income is at least 50 percent. We reasonably believe that we were not a PFIC for our tax year ended December 31, 2005.

It is possible that the Internal Revenue Service will attempt to treat us as a PFIC for 2005 or prior years. The tests for determining PFIC status are applied annually and it is difficult to make accurate predictions of future income and assets, which are relevant to this determination. Accordingly, there can be no assurance that we will not become a PFIC in 2006 or in subsequent years.

U.S. Holders who hold our ordinary shares during a period when we are a PFIC will be subject to the foregoing rules, even if we cease to be a PFIC, subject to certain exceptions for U.S. Holders who made a QEF election or the mark-to-market election.

Although a U.S. Holder normally is not permitted to make a retroactive QEF election for a foreign corporation, a retroactive election may be made for a taxable year of the U.S. Holder (the “retroactive election year”) if the U.S. Holder (i) reasonably believed that, as of the date the QEF election was due, the foreign corporation was not a PFIC for its taxable year that ended during the retroactive election year and (ii) filed a protective statement with respect to the foreign corporation, applicable to the retroactive election year, in which the U.S. Holder described the basis for its reasonable belief and extended the period of limitation on the assessment of taxes determined under Sections 1291 through 1298 of the Code with respect to the foreign corporation (PFIC related taxes) for all taxable years of the shareholder to which the protective statement applies.

**U.S. Holders are urged to consult their tax advisors about the PFIC rules, including eligibility for and the manner and advisability of making, the QEF election (or a “protective” QEF election) or the mark-to market election.**

*Tax Consequences for Non-U.S. Holders of Ordinary Shares*

Except as described in “Information Reporting and Back-up Withholding” below, a Non-U.S. Holder of ordinary shares will not be subject to U.S. federal income or withholding tax on the payment of dividends on, and the proceeds from the disposition of, ordinary shares, unless:

- Such item is effectively connected with the conduct by the Non-U.S. Holder of a trade or business in the United States and, in the case of a resident of a country which has a treaty with the United States, such item is attributable to a permanent establishment or, in the case of an individual, a fixed place of business, in the United States;
- The Non-U.S. Holder is an individual who holds the ordinary shares as a capital asset and is present in the United States for 183 days or more in the taxable year of the disposition and does not qualify for an exemption; or
- The Non-U.S. Holder is subject to tax pursuant to the provisions of United States tax law applicable to U.S. expatriates.

*Information Reporting and Back-up Withholding*

U.S. Holders generally are subject to information reporting requirements with respect to dividends paid in the United States on ordinary shares and proceeds paid from the sale, exchange, redemption or other disposition of ordinary shares. Under the Code, a U.S. Holder may be subject, under certain circumstances, to backup withholding currently at a rate of up to 28% with respect to dividends paid on our ordinary shares and proceeds paid from the sale, exchange, redemption or other disposition of ordinary shares unless the holder provides proof of an applicable exemption or correct taxpayer identification number and otherwise complies with applicable requirements of the backup withholding rules.

A holder of ordinary shares who does not provide a correct taxpayer identification number may be subject to penalties imposed by the IRS. Amounts withheld under the backup withholding rules are not an additional tax and may be refunded or credited against the holder’s federal income tax liability, provided the required information is furnished to the IRS.

Non-U.S. Holders generally are not subject to information reporting or back-up withholding with respect to dividends paid on, or the proceeds from the disposition of, ordinary shares, provided that such Non-U.S. Holder provides a taxpayer identification number, certifies to its foreign status, or otherwise establishes an exemption.

**F. Dividends and Paying Agents**

Not applicable.

**G. Statement by Experts**

Not applicable.

**H. Documents on Display**

We are subject to the informational requirements of the Securities Exchange Act of 1934, as amended, applicable to foreign private issuers and fulfill the obligations with respect to such requirements by filing reports with the Securities and Exchange Commission. You may read and copy any document we file with the Securities and Exchange Commission without charge at the Securities and Exchange Commission's public reference room at 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of such material may be obtained by mail from the Public Reference Branch of the Securities and Exchange Commission at such address, at prescribed rates. Please call the Securities and Exchange Commission at 1-800-SEC-0330 for further information on the public reference room. Such materials are also available free of charge at the website of the Securities and Exchange Commission at [www.sec.gov](http://www.sec.gov).

As a foreign private issuer, we are exempt from the rules under the Exchange Act prescribing the furnishing and content of proxy statements, and our officers, directors and principal shareholders are exempt from the reporting and “short-swing” profit recovery provisions contained in Section 16 of the Exchange Act. In addition, we are not required under the Exchange Act to file periodic reports and financial statements with the Securities and Exchange Commission as frequently or as promptly as United States companies whose securities are registered under the Exchange Act.

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

**I. Subsidiary Information**

Not applicable.

## **ITEM 11. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

We are exposed to market risk, including movements in interest rates and foreign currency exchange rates. Our primary market risk exposure occurs because we generate most of our revenues in U.S. dollars and incur a portion of our expenses in NIS and in Euro. In 2004 we began selling to some European countries in Euro.

We do not presently engage in any hedging or other transactions intended to manage risks relating to foreign currency exchange rate or interest rate fluctuations. As of December 31, 2005, we did not own any market risk sensitive instruments, except for the following: Approximately 6% of our investment portfolio is invested in a structured note with guaranteed principal and changing interest. An increase in short-term interest rates will negatively affect the income received from this note. We may in the future undertake hedging or other similar transactions or invest in market risk sensitive instruments if our management determines that it is necessary to offset these risks.

Approximately 40% of our investment portfolio is invested in high-rated marketable securities, mainly U.S. government agency bonds and corporate bonds. Since these investments carry fixed interest rates, interest income over the holding period is not sensitive to changes in interest rates.

## **ITEM 12. DESCRIPTION OF SECURITIES OTHER THAN EQUITY SECURITIES**

Not applicable.

## PART II

### ITEM 13. DEFAULTS, DIVIDEND AVERAGES AND DELINQUENCIES

Not applicable.

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

The effective date of the registration statement (No. 333-10752) for our initial public offering of our ordinary shares, NIS 0.1 par value, was September 29, 1999. The offering commenced on October 5, 1999, and terminated after the sale of all the securities registered. The managing underwriter of the offering was Salomon Smith Barney. We registered 4,025,000 ordinary shares in the offering, including shares issued pursuant to the exercise of the underwriters' over-allotment option. Of such shares, we sold 3,500,000 ordinary shares at an aggregate offering price of \$63.0 million (\$18.00 per share) and certain selling shareholders sold an aggregate of 525,000 ordinary shares at an aggregate offering price of \$9.45 million (\$18.00 per share). Under the terms of the offering, we incurred underwriting discounts of \$4.41 million. We also incurred estimated expenses of \$1.82 million in connection with the offering. None of the expenses consisted of amounts paid directly or indirectly to any of our directors, officers, general partners or their associates, any persons owning ten percent or more of any class of our equity securities, or any of our affiliates. The net proceeds that we received as a result of the offering were approximately \$56.8 million. None of the use of proceeds consisted of amounts paid directly or indirectly to any of our directors, officers, general partners or their associates, any persons owning ten percent or more of any class of our equity securities, or any of our affiliates.

In January 2000, we raised net proceeds of approximately \$60.0 million in a public offering of our ordinary shares.

The net proceeds of the two offerings are kept in short-term and long-term bank deposits and in marketable securities.

### ITEM 15. CONTROLS AND PROCEDURES

#### (a) Disclosure Controls and Procedures.

Our Chief Executive Officer, or CEO, and Chief Financial Officer, or CFO, are responsible for establishing and maintaining our disclosure controls and procedures. These controls and procedures were designed to ensure that information relating to the Company and its subsidiaries required to be disclosed in the reports that we file under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the SEC. We evaluated these disclosure controls and procedures under the supervision of our CEO and CFO as of December 31, 2005. Based on this evaluation, our CEO and CFO concluded that our disclosure controls and procedures are effective in timely alerting them to information required to be disclosed in the reports to the SEC.

#### (b) Internal Control Over Financial Reporting.

There were no changes in the Company's internal control over financial reporting that occurred during the year ended December 31, 2005 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

### ITEM 16. RESERVED





**ITEM 16A. Audit Committee Financial Expert**

Our board of directors has determined that Messrs. Chris McCleary and Yiftach Atir, members of our Audit Committee, are financial experts as defined in the applicable regulations, and has determined that such members are “independent” as this term is defined in the NASDAQ Listing Standards.

**ITEM 16B. Code of Ethics**

On February 2, 2004 our board of directors adopted our Code of Ethics, a code that applies to all directors, officers and employees of the Company, including our Chief Executive Officer and President, Chief Financial Officer, Director of Finance and Corporate Controller. On January 30, 2005, our board modified the Code of Conduct and Ethics. Our Code of Conduct and Ethics (as amended) has been posted on our Internet website, <http://www.radware.com/content/company/investorrelations>.

**ITEM 16C. Principal Accountant Fees and Services**

In the annual meeting held on December 11, 2005 our shareholders re-appointed Kost, Forer, Gabbay & Kasierer, a member of Ernst & Young Global (“Ernst & Young”), to serve as our independent auditors until the next annual meeting.

Ernst & Young billed the following fees to us for professional services in each of the last two fiscal years:

|                    | Year Ended December 31, |      |
|--------------------|-------------------------|------|
|                    | 2005                    | 2004 |
|                    | (\$ in thousands)       |      |
| Audit Fees         | 108                     | 60   |
| Audit-Related Fees | 23                      | 5    |
| Tax Fees           | 23                      | 55   |
| All Other Fees     | -                       | -    |
| Total              | 154                     | 120  |

"Audit Fees" are the aggregate fees billed for the audit of our annual financial statements, statutory audits and services that are normally provided in connection with statutory and regulatory filings or engagements.

"Audit-Related Fees" are the aggregate fees billed for assurance and related services that are reasonably related to the performance of the audit or review of our financial statements and are not reported under Audit Fees.

"Tax Fees" are the aggregate fees billed for professional services rendered for tax compliance, tax advice on actual or contemplated transactions and tax planning such as assistance with tax audits and tax advice.

"All Other Fees" are the aggregate fees billed for products and services provided by Ernst & Young other than as described above.

*Audit Committee's pre-approval policies and procedures*

Our Audit Committee oversees our independent auditors. See also the description under the heading "Board Practices" in Item 6. "*Directors, Senior Management and Employees*". In 2003 our Audit Committee also adopted a policy requiring management to obtain the Committee's approval before engaging our independent auditors to provide any other audit or permitted non-audit services to us or our subsidiaries. Pursuant to this policy, which is designed to assure that such engagements do not impair the independence of our auditors, and which is discussed and approved at the end of each calendar year, the Audit Committee pre-approves annually a catalog of specific audit and non-audit services in the categories Audit Service, Audit-Related Service and Tax Consulting Services that may be performed by our auditors. In addition, the Audit Committee limited the aggregate amount in fees our auditors may receive during the 2006 fiscal year for non-audit services in certain categories, unless pre- approved. Our Director of Legal

Affairs and Director of Finance review all individual management requests to engage our independent auditors as a service provider in accordance with this catalog and, if the requested services are permitted pursuant to the catalog, approve the request accordingly. We inform the Audit Committee about these approvals on a quarterly basis. Services that are not included in the catalog require pre-approval by the Audit Committee on a case-by-case basis. Our Audit Committee is not permitted to approve any engagement of our auditors if the services to be performed either fall into a category of services that are not permitted by applicable law or the services would be inconsistent with maintaining the auditors' independence.

**ITEM 16D. Exemptions From The Listing Standards For Audit Committees**

Not applicable.

**ITEM 16E. Purchases Of Equity Securities By The Issuer And Affiliated Purchasers**

Not applicable.

## PART III

### ITEM 17. FINANCIAL STATEMENTS

We have responded to Item 18 in lieu of this item.

### ITEM 18. FINANCIAL STATEMENTS

The Financial Statements required by this item are found at the end of this Annual Report, beginning on page F-1.

### ITEM 19. EXHIBITS

The exhibits filed with or incorporated into this annual report are listed on the index of exhibits below.

#### Exhibit No.

|      |                                                                                                                                       |
|------|---------------------------------------------------------------------------------------------------------------------------------------|
| 1.1  | Memorandum of Association*                                                                                                            |
| 1.2  | Articles of Association**                                                                                                             |
| 4.1  | Lease Agreement for the Company's Headquarters**                                                                                      |
| 4.2  | Lease Agreement for the Company's Mahwah office***                                                                                    |
| 4.3  | Distributor Agreement with Bynet Data Communications Ltd.***                                                                          |
| 4.4  | Form of Directors and Officers Indemnity Deed                                                                                         |
| 4.5  | Asset Purchase Agreement with V-Secure Technologies Inc.                                                                              |
| 10   | Consent of Independent Auditors                                                                                                       |
| 12.1 | Certification of the Chief Executive Officer pursuant to 17 CFR 240.13a-14(a), as adopted pursuant to § 302 of the Sarbanes-Oxley Act |
| 12.2 |                                                                                                                                       |

Certification of the Chief Financial Officer pursuant to 17 CFR 240.13a-14(a), as adopted pursuant to § 302 of the Sarbanes-Oxley Act

13. Certification of the Chief Executive Officer pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act.

13.2 Certification of the Chief Financial Officer pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act.

\* Incorporated by reference to the Registration Statement on Form F-1 (File No. 333-10752).

\*\* Incorporated by reference to the Annual Report on Form 20-F for the year ended December 31, 2000. An amendment to the Articles of Association is attached.

\*\*\* Incorporated by reference to the Annual Report on Form 20-F for the year ended December 31, 2001.

SIGNATURE

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

RADWARE LTD.

By: /s/Yehuda  
Zisapel  
Chairman of the Board of  
Directors

Date: April 26, 2006

**RADWARE LTD. AND ITS SUBSIDIARIES**

**CONSOLIDATED FINANCIAL STATEMENTS**

**AS OF DECEMBER 31, 2005**

**U.S. DOLLARS IN THOUSANDS**

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

**To the Shareholders of**

**RADWARE LTD.**

We have audited the accompanying consolidated balance sheets of Radware Ltd. ("the Company") and its subsidiaries as of December 31, 2004 and 2005, and the related consolidated statements of income, statements of changes in shareholders' equity and the consolidated statements of cash flows for each of the three years in the period ended December 31, 2005. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

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

Tel-Aviv, Israel  
January 29, 2006

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

**RADWARE LTD. AND ITS SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS****U.S. dollars in thousands**

|                                                                                                                      | <b>December 31,</b> |                   |
|----------------------------------------------------------------------------------------------------------------------|---------------------|-------------------|
|                                                                                                                      | <b>2004</b>         | <b>2005</b>       |
| <b>ASSETS</b>                                                                                                        |                     |                   |
| <b>CURRENT ASSETS:</b>                                                                                               |                     |                   |
| Cash and cash equivalents                                                                                            | \$ 8,792            | \$ 56,263         |
| Current maturity of long-term bank deposit                                                                           | 64,892              | -                 |
| Bank deposit                                                                                                         | -                   | 10,195            |
| Available-for-sale marketable securities                                                                             | 30,170              | 14,717            |
| Held-to-maturity marketable securities                                                                               | 5,166               | 45,726            |
| Trade receivables (net of allowance for doubtful accounts of \$ 1,060 and \$ 1,006 in 2004 and 2005, respectively *) | 13,166              | 14,661            |
| Other receivables and prepaid expenses                                                                               | 1,332               | 1,451             |
| Inventories                                                                                                          | 4,094               | 5,254             |
| <b>Total</b> current assets                                                                                          | <b>127,612</b>      | <b>148,267</b>    |
| <b>LONG-TERM INVESTMENTS:</b>                                                                                        |                     |                   |
| Structured note                                                                                                      | 9,224               | 9,458             |
| Available-for-sale marketable securities                                                                             | 12,477              | 11,399            |
| Held-to-maturity marketable securities                                                                               | 26,320              | 16,735            |
| Severance pay fund                                                                                                   | 1,921               | 2,178             |
| <b>Total</b> long-term investments                                                                                   | <b>49,942</b>       | <b>39,770</b>     |
| <b>PROPERTY AND EQUIPMENT, NET</b>                                                                                   | <b>4,452</b>        | <b>5,968</b>      |
| <b>LONG-TERM DEFERRED TAXES AND OTHER LONG-TERM ASSETS</b>                                                           |                     |                   |
|                                                                                                                      | 671                 | 1,075             |
| <b>INTANGIBLE ASSETS, NET</b>                                                                                        | <b>564</b>          | <b>2,813</b>      |
| <b>GOODWILL</b>                                                                                                      | <b>-</b>            | <b>6,454</b>      |
| <b>Total</b> assets                                                                                                  | <b>\$ 183,241</b>   | <b>\$ 204,347</b> |

\*) Includes balances in the amount of \$ 1,004 and \$ 1,447 with related parties as of December 31, 2004 and 2005, respectively (see also Note 13a).

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



**RADWARE LTD. AND ITS SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS**

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

|                                                                  | December 31, |            |
|------------------------------------------------------------------|--------------|------------|
|                                                                  | 2004         | 2005       |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>                      |              |            |
| <b>CURRENT LIABILITIES:</b>                                      |              |            |
| Trade payables *)                                                | \$ 5,075     | \$ 5,329   |
| Deferred revenues                                                | 9,888        | 12,424     |
| Other payables and accrued expenses                              | 4,962        | 6,509      |
| <u>Total</u> current liabilities                                 | 19,925       | 24,262     |
| <b>ACCRUED SEVERANCE PAY</b>                                     | 2,399        | 2,659      |
| <b>COMMITMENTS AND CONTINGENT LIABILITIES</b>                    |              |            |
| <b>SHAREHOLDERS' EQUITY:</b>                                     |              |            |
| Share capital:                                                   |              |            |
| Ordinary shares of NIS 0.1 par value:                            |              |            |
| Authorized - 30,000,000 shares as of December 31, 2004 and 2005; |              |            |
| Issued and outstanding - 18,488,530 and 19,061,760 shares as of  |              |            |
| December 31, 2004 and 2005, respectively                         | 457          | 470        |
| Additional paid-in capital                                       | 145,439      | 153,010    |
| Deferred stock based compensation                                | -            | (67)       |
| Accumulated other comprehensive loss                             | (52)         | (404)      |
| Retained earnings                                                | 15,073       | 24,417     |
| <u>Total</u> shareholders' equity                                | 160,917      | 177,426    |
| <u>Total</u> liabilities and shareholders' equity                | \$ 183,241   | \$ 204,347 |

\*) See Note 13a for balances with related parties.

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

**RADWARE LTD. AND ITS SUBSIDIARIES****CONSOLIDATED STATEMENTS OF INCOME**

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

|                                                                      | Year ended December 31, |           |           |
|----------------------------------------------------------------------|-------------------------|-----------|-----------|
|                                                                      | 2003                    | 2004      | 2005      |
| Revenues *)                                                          | \$ 54,780               | \$ 68,439 | \$ 77,584 |
| Cost of revenues *)                                                  | 9,854                   | 12,184    | 14,896    |
| Gross profit                                                         | 44,926                  | 56,255    | 62,688    |
| Operating expenses: *)                                               |                         |           |           |
| Research and development, net                                        | 8,398                   | 10,342    | 13,017    |
| Sales and marketing                                                  | 29,753                  | 31,898    | 40,002    |
| General and administrative                                           | 4,120                   | 4,493     | 5,244     |
| <u>Total</u> operating expenses                                      | 42,271                  | 46,733    | 58,263    |
| Operating income                                                     | 2,655                   | 9,522     | 4,425     |
| Financial income, net                                                | 3,740                   | 4,565     | 5,159     |
| Income before income taxes                                           | 6,395                   | 14,087    | 9,584     |
| Income taxes                                                         | -                       | 341       | 240       |
| Income before minority interest in losses (earnings) of a subsidiary | 6,395                   | 13,746    | 9,344     |
| Minority interest in losses (earnings) of a subsidiary               | (40)                    | 34        | -         |
| Net income                                                           | \$ 6,355                | \$ 13,780 | \$ 9,344  |
| Basic net earnings per share                                         | \$ 0.37                 | \$ 0.77   | \$ 0.50   |
| Diluted net earnings per share                                       | \$ 0.34                 | \$ 0.70   | \$ 0.47   |

\*) See Note 13b for transactions with related parties.

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

**RADWARE LTD. AND ITS SUBSIDIARIES****STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY**

U.S. dollars in thousands, except share data

|                                                                                          | Number of<br>outstanding<br>Ordinary<br>shares | Share<br>capital | Additional<br>paid-in<br>capital | Deferred<br>stock<br>based<br>compensation | Treasury<br>shares,<br>at cost | Accumulated<br>other<br>comprehensive<br>income<br>(loss) | Retained<br>earnings<br>(accumulated<br>deficit) | Total<br>comprehensive<br>income<br>(loss) | Total      |
|------------------------------------------------------------------------------------------|------------------------------------------------|------------------|----------------------------------|--------------------------------------------|--------------------------------|-----------------------------------------------------------|--------------------------------------------------|--------------------------------------------|------------|
| Balance as of January 1, 2003                                                            | 17,014,114                                     | \$ 424           | \$ 132,005                       | \$ (98)                                    | \$ (254)                       | \$ 89                                                     | \$ (4,809)                                       |                                            | \$ 127,357 |
| Retirement of 32,700 Ordinary shares of treasury stock                                   | -                                              | (1)              | -                                | -                                          | 254                            | -                                                         | (253)                                            |                                            | -          |
| Issuance of shares upon exercise of stock options and upon purchase of shares under ESPP | 690,069                                        | 16               | 6,547                            | -                                          | -                              | -                                                         | -                                                |                                            | 6,563      |
| Amortization of deferred stock based compensation                                        | -                                              | -                | -                                | 98                                         | -                              | -                                                         | -                                                |                                            | 98         |
| Comprehensive income:                                                                    |                                                |                  |                                  |                                            |                                |                                                           |                                                  |                                            |            |
| Unrealized losses from available-for-sale securities, net                                | -                                              | -                | -                                | -                                          | -                              | (127)                                                     | -                                                | \$ (127)                                   | (127)      |
| Net income                                                                               | -                                              | -                | -                                | -                                          | -                              | -                                                         | 6,355                                            | 6,355                                      | 6,355      |
| Total comprehensive income                                                               |                                                |                  |                                  |                                            |                                |                                                           | \$ 6,228                                         |                                            |            |
| Balance as of December 31, 2003                                                          | 17,704,183                                     | 439              | 138,552                          | -                                          | -                              | (38)                                                      | 1,293                                            |                                            | 140,246    |
| Issuance of shares upon exercise of stock options and upon purchase of shares under ESPP | 784,347                                        | 18               | 6,887                            | -                                          | -                              | -                                                         | -                                                |                                            | 6,905      |
| Comprehensive income:                                                                    |                                                |                  |                                  |                                            |                                |                                                           |                                                  |                                            |            |
| Unrealized losses from available-for-sale securities, net                                | -                                              | -                | -                                | -                                          | -                              | (14)                                                      | -                                                | \$ (14)                                    | (14)       |
| Net income                                                                               | -                                              | -                | -                                | -                                          | -                              | -                                                         | 13,780                                           | 13,780                                     | 13,780     |

|                                                                                          |            |        |            |         |      |          |           |           |            |
|------------------------------------------------------------------------------------------|------------|--------|------------|---------|------|----------|-----------|-----------|------------|
| Total comprehensive income                                                               |            |        |            |         |      |          |           | \$ 13,766 |            |
| Balance as of December 31, 2004                                                          | 18,488,530 | 457    | 145,439    | -       | -    | (52)     | 15,073    |           | 160,917    |
| Issuance of shares upon exercise of stock options and upon purchase of shares under ESPP | 573,230    | 13     | 7,298      | -       | -    | -        | -         |           | 7,311      |
| Deferred stock based compensation                                                        | -          | -      | 125        | (125)   | -    | -        | -         |           | -          |
| Amortization of deferred stock based compensation                                        | -          | -      | -          | 58      | -    | -        | -         |           | 58         |
| Warrants issued in respect of business combination                                       | -          | -      | 148        | -       | -    | -        | -         |           | 148        |
| Comprehensive income:                                                                    |            |        |            |         |      |          |           |           |            |
| Unrealized losses from available-for-sale securities, net                                | -          | -      | -          | -       | -    | (352)    | -         | \$ (352)  | (352)      |
| Net income                                                                               | -          | -      | -          | -       | -    | -        | 9,344     | 9,344     | 9,344      |
| Total comprehensive income                                                               |            |        |            |         |      |          |           | \$ 8,992  |            |
| Balance as of December 31, 2005                                                          | 19,061,760 | \$ 470 | \$ 153,010 | \$ (67) | \$ - | \$ (404) | \$ 24,417 |           | \$ 177,426 |

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

## RADWARE LTD. AND ITS SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

|                                                                                                                                             | Year ended December 31, |           |          |
|---------------------------------------------------------------------------------------------------------------------------------------------|-------------------------|-----------|----------|
|                                                                                                                                             | 2003                    | 2004      | 2005     |
| <u>Cash flows from operating activities:</u>                                                                                                |                         |           |          |
| Net income                                                                                                                                  | \$ 6,355                | \$ 13,780 | \$ 9,344 |
| Adjustments to reconcile net income to net cash provided by operating activities:                                                           |                         |           |          |
| Depreciation and amortization                                                                                                               | 1,509                   | 1,429     | 1,921    |
| Amortization of deferred stock based compensation                                                                                           | 98                      | -         | 58       |
| Minority interest in earnings (losses) of a subsidiary                                                                                      | 40                      | (34)      | -        |
| Amortization of premiums, accretion of discounts and accrued interest on available-for-sale and held-to-maturity marketable securities, net | 214                     | 318       | (475)    |
| Accrued interest on bank deposits and structured note                                                                                       | (184)                   | 791       | 1,468    |
| Accrued severance pay, net                                                                                                                  | 106                     | 288       | 3        |
| Decrease (increase) in long-term deferred taxes                                                                                             | -                       | (350)     | 20       |
| Increase in trade receivables, net                                                                                                          | (995)                   | (3,476)   | (1,495)  |
| Decrease (increase) in other receivables and prepaid expenses                                                                               | 63                      | (243)     | (119)    |
| Increase in inventories                                                                                                                     | (10)                    | (1,096)   | (1,160)  |
| Increase in trade payables                                                                                                                  | 1,673                   | 790       | 245      |
| Increase in deferred revenues                                                                                                               | 1,768                   | 2,830     | 2,536    |
| Increase (decrease) in other payables and accrued expenses                                                                                  | (1,678)                 | 123       | 1,547    |
| Other                                                                                                                                       | 1                       | 1         | (43)     |
| Net cash provided by operating activities                                                                                                   | 8,960                   | 15,151    | 13,850   |
| <u>Cash flows from investing activities:</u>                                                                                                |                         |           |          |
| Purchase of property and equipment *)                                                                                                       | (1,311)                 | (2,369)   | (3,626)  |
| Proceeds from sale of property and equipment                                                                                                | -                       | 16        | 297      |
| Investment in other long-term assets                                                                                                        | 15                      | (225)     | (24)     |
| Purchase of available-for-sale marketable securities                                                                                        | (5,586)                 | (21,281)  | (86)     |
| Purchase of held-to-maturity marketable securities                                                                                          | -                       | (31,320)  | (31,962) |
| Proceeds from sale and redemption of available-for-sale marketable debt securities                                                          | 20,137                  | 13,369    | 16,265   |
| Proceeds from redemption of held-to-maturity marketable debt securities                                                                     | -                       | -         | 1,462    |
| Investment in long-term bank deposits                                                                                                       | (12,754)                | (2,890)   | -        |
| Proceeds from maturity of long-term bank deposit                                                                                            | -                       | -         | 62,995   |
| Investment in bank deposit                                                                                                                  | -                       | -         | (10,000) |
| Increase in holdings in a subsidiary                                                                                                        | (350)                   | (335)     | -        |
| Payment for the acquisition of V-Secure (1)                                                                                                 | -                       | -         | (9,011)  |
| Net cash provided by (used in) investing activities                                                                                         | 151                     | (45,035)  | 26,310   |
| <u>Cash flows from financing activities:</u>                                                                                                |                         |           |          |
|                                                                                                                                             | 6,563                   | 6,905     | 7,311    |



Proceeds from exercise of stock options and from  
purchase of shares under ESPP

|                                                        |           |          |           |
|--------------------------------------------------------|-----------|----------|-----------|
| Net cash provided by financing activities              | 6,563     | 6,905    | 7,311     |
| Increase (decrease) in cash and cash equivalents       | 15,674    | (22,979) | 47,471    |
| Cash and cash equivalents at the beginning of the year | 16,097    | 31,771   | 8,792     |
| Cash and cash equivalents at the end of the year       | \$ 31,771 | \$ 8,792 | \$ 56,263 |

(1) Payment for the acquisition of V-Secure:

Estimated fair value of assets acquired at the date of  
acquisition:

|                            |      |      |          |
|----------------------------|------|------|----------|
| Acquired technology        | \$ - | \$ - | \$ 1,772 |
| Customers relationship     | -    | -    | 542      |
| Deferred compensation cost | -    | -    | 400      |
| Goodwill                   | -    | -    | 6,297    |
| \$ -                       | \$ - | \$ - | 9,011    |

Supplemental disclosure of cash flow activities:

Cash paid during the year for:

|       |      |          |      |
|-------|------|----------|------|
| Taxes | \$ - | \$ 1,494 | \$ - |
|-------|------|----------|------|

\*) See Note 13b for transactions with related parties.

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

**RADWARE LTD. AND ITS SUBSIDIARIES**

**NOTE 1:-**

**GENERAL**

a. Radware Ltd. ("the Company"), an Israeli corporation, and its subsidiaries, commenced operations in April 1997. The Company is engaged in the development, manufacture and sale of Application-smart networking solutions that provide end-to-end availability, performance and security of mission critical networked applications. The Company's products are marketed worldwide.

b. The Company established wholly-owned subsidiaries in the United States, France, Germany, Singapore, the United Kingdom, Japan, Korea, Canada, Switzerland and Italy. In addition, the Company established branches and representative offices in China, India and Taiwan. In Australia, the Company held approximately 83% of its Australian subsidiary as of January 1, 2004; the additional 17% was purchased by the Company during 2004 for a total amount of \$ 335.

The Company's subsidiaries are engaged primarily in sales, marketing and support activities.

c. The Company depends on a single supplier to supply certain components for the production of its products. If this supplier fails to deliver or delays the delivery of the necessary components, the Company will be required to seek alternative sources of supply. A change in suppliers could result in manufacturing delays, which could cause a possible loss of sales and, consequently, could adversely affect the Company's results of operations and financial position.

d. The Company relies upon independent distributors (which are considered to be end-users) to market and sell its products to customers. A loss of a major distributor, or any event negatively affecting such distributor's financial condition, could cause a material adverse effect on the Company's results of operations and financial position (see also Note 11b).

As of December 31, 2005 one single customer (a distributor) represented 16% of the trade receivables balance. As of December 31, 2004, no single customer represented more than 10% of the trade receivables balance.

e. Business combination - acquisition of V-Secure Technologies (US) Inc. ("V-Secure"):

In December 2005, the Company acquired the business of V-Secure which included the acquisition of its technology, customer relationship and goodwill. The total consideration for the acquisition was \$ 9,168, out of which an amount of \$ 9,011 was paid in cash; amount valued as \$ 148 was paid by issuance of fully vested warrants to V-Secure to purchase 45,454 Ordinary shares of the Company, at an exercise price of \$ 22 per share. The remaining balance is related to acquisition costs payable.

Additional cash consideration of \$ 6,000 (earn-out) is payable contingent upon meeting a certain technological milestone in regards to the integrated product of the Company and V-Secure by June 28, 2006. Resolution of the contingent with payment of the consideration will result in recording additional goodwill.

The Company plans to integrate V-Secure and the Company's technology in order to provide advanced technology solutions to its customers.

**RADWARE LTD. AND ITS SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands****NOTE 1:-****GENERAL (Cont.)**

The purchase price was allocated to the identifiable intangible assets acquired (which have been valued by management using a third party valuation specialist) based upon their estimated fair values as follows:

|                                |           |              |
|--------------------------------|-----------|--------------|
| Acquired technology            | \$        | 1,772        |
| Customers relationship         |           | 542          |
| Goodwill                       |           | 6,454        |
| <b>Total intangible assets</b> |           | <b>8,768</b> |
| Deferred compensation cost     |           | 400          |
| <b>Total consideration</b>     | <b>\$</b> | <b>9,168</b> |

The deferred compensation cost was carved-out of the goodwill and represents incentive to former employees of V-Secure that will remain with the Company for periods of no less than 12 to 24 months. Such deferred compensation cost will be amortized over the employment period, and will be recorded as compensation costs. Any amount not used for bonuses will be returned to V-Secure, and will increase the goodwill.

The acquisition of V-Secure was accounted for under the purchase method of accounting.

In accordance with Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets" ("SFAS No. 142"), goodwill arising from the acquisition will not be amortized. In lieu of amortization, the Company is required to perform an annual impairment review. If the Company determines, through the impairment review process, that goodwill has been impaired, it will record the impairment charge in its statement of income. The Company will also assess the impairment of goodwill whenever events or changes in circumstances indicate that the carrying value may not be recoverable.

**Unaudited pro-forma results:**

The following represents the unaudited pro-forma results of operations of V-Secure and the Company's consolidated statements of income for the years ended December 31, 2004 and 2005, assuming that V-Secure's acquisition occurred on January 1, of each year:

|                               | <b>Year ended<br/>December 31,</b>      |             |
|-------------------------------|-----------------------------------------|-------------|
|                               | <b>2004</b>                             | <b>2005</b> |
|                               | <b>Unaudited<br/>Total consolidated</b> |             |
| Revenues                      | \$ 69,069                               | \$ 78,145   |
| Net income                    | \$ 9,747                                | \$ 5,033    |
| Diluted net earning per share | \$ 0.49                                 | \$ 0.25     |

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**RADWARE LTD. AND ITS SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 2:-**

**SIGNIFICANT ACCOUNTING POLICIES**

The consolidated financial statements are prepared according to accounting principles generally accepted in the United States ("U.S. GAAP").

a. Use of estimates:

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

b. Financial statements in U.S. dollars:

A majority of the revenues of the Company and its subsidiaries are generated in U.S. dollars ("dollar"). In addition, a substantial portion of the Company's 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, monetary accounts maintained in currencies other than the dollar are remeasured into U.S. dollars in accordance with Statement of the Financial Accounting Standard Board No. 52 "Foreign Currency Translation" ("SFAS No. 52"). All transactions gains and losses from the remeasurement of monetary balance sheet items are reflected in the consolidated statements of operations as financial income or expenses, as appropriate.

c. Principles of consolidation:

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

d. Cash equivalents:

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

e. Marketable securities:

The Company accounts for investments in marketable 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.

**RADWARE LTD. AND ITS SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands****NOTE 2:-****SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

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 and decline in value judged to be other than temporary and interest are included in financial income, net. As of December 31, 2005, no impairment has been identified.

Debt securities that are designated as available-for-sale are stated at fair value, with unrealized gains and losses reported in accumulated other comprehensive income (loss), a separate component of shareholders' equity. Realized gains and losses on sales of investments, as determined on a specific identification basis, are included in financial income, net. The Company has the positive ability to hold the securities to maturity. As of December 31, 2005, no impairment has been identified.

f.

Inventories:

Inventories are stated at the lower of cost or market value. Inventory write-offs are provided to cover risks arising from slow-moving items, technological obsolescence, excess inventories, discontinued products and market prices lower than cost. As of December 31, 2004 and 2005, the provision for inventory write-offs amounted to \$ 430 and \$ 846, respectively.

Cost is determined as follows:

Raw materials and components - using the "first-in, first-out" method.

Work-in-progress and finished products:

Raw materials and components - using the "first-in, first-out" method.

Subcontracting costs - on the basis of direct subcontractors costs with the addition of allocable costs.

g.

Current maturity of long-term bank deposit:

Current maturity of long-term bank deposit consisted of a three-year bank deposit in U.S. dollars that bore interest at the rate of 4.8% and matured during 2005. The deposit was presented at cost, including accrued interest.

h.

Bank deposit:

Bank deposit is a deposit with a maturity of more than three months but less than one year. The deposit is in U.S. dollars and bears interest at a rate of 3.6%. The bank deposit is presented at its cost, including accrued interest.

i.

Structured note:

Structured note as of December 31, 2005, consists of a callable structured note ("Structured Note") with a maturity of eight years. The Structured Note bears interest of 8% in its first year, and starting from its second year, it bears interest that varies inversely with changes of the three-month USD LIBOR-rate.



**RADWARE LTD. AND ITS SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands****NOTE 2:-****SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

As of December 31, 2005, the Structured Note amounted to \$ 9,458. Interest income resulting from investment in the Structured Note is accounted for based on the guidelines provided in EITF No. 96-12, "Recognition of Interest Income and Balance Sheet Classification of Structured Notes". Under EITF No. 96-12, the retrospective interest method is used for recognizing interest income.

j. Property and equipment, net:

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

|                                             | %                                                                  |
|---------------------------------------------|--------------------------------------------------------------------|
| Computer, software and peripheral equipment | 15-33                                                              |
| Office furniture and equipment              | 7-15                                                               |
| Motor vehicles                              | 15                                                                 |
| Leasehold improvements                      | Over the shorter of the term of the lease or the life of the asset |

k. Impairment of long-lived assets:

The Company's and its subsidiaries' long-lived assets and certain identifiable intangibles are reviewed for impairment in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to the 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. As of December 31, 2005, no impairment losses have been identified.

l. Goodwill:

Goodwill represents excess of the costs over the fair value of net assets of businesses acquired. Under SFAS No. 142, goodwill is not amortized. SFAS No. 142 requires goodwill to be tested for impairment on adoption and at least annually thereafter or between annual tests in certain circumstances, and written down when impaired, rather than being amortized as previous accounting standards required. Goodwill is tested for impairment by comparing the fair value with its carrying value. Fair value is determined using discounted cash flows and market multiples. Goodwill purchased in the acquisition of V-Secure was recorded in December 2005; therefore no annual impairment test was performed in 2005.

m. Intangible assets:



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

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**RADWARE LTD. AND ITS SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**U.S. dollars in thousands**

**NOTE 2:-**

**SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

n.

Revenue recognition:

The Company and its subsidiaries generate revenues mainly from selling their products and from post-contract customer support primarily through distributors and resellers, all of which are considered end-users.

Revenues from product sales are recognized when delivery has occurred, persuasive evidence of an agreement exists, the fee is fixed or determinable, no further obligation exists and collectability is probable.

Revenues in arrangements with multiple deliverables are recognized under the "residual method" when Vendor Specific Objective Evidence ("VSOE") of fair value exists for all undelivered elements, no VSOE exists for the delivered elements, and all other revenue recognition criteria are satisfied. VSOE for post-contract customer support is determined based on the price when it is sold separately in similar arrangements. The price may vary in the territories and vertical markets in which the Company conducts business. Price is determined by using a consistent percentage of the Company's product price lists.

Revenue derived from post-contract customer support, which represents mainly software subscription, unit replacement and security update service, is recognized ratably over the contract period, which is typically one year.

Revenues from training and installation, which are considered as not essential to the functionality of the product, included in multiple elements arrangements are recognized at the time they are rendered.

The Company and its subsidiaries provide a provision for product returns and stock rotation based on their experience with historical sales returns, analysis of credit memo data and other known factors, in accordance with Statement of Financial Accounting Standard No. 48, "Revenue Recognition When Right of Return Exists" ("SFAS No. 48").

Deferred revenue includes unearned amounts received under post-contract customer support.

o.

Warranty costs:

The Company generally offers a one year warranty for all of its products. A provision for warranty costs is provided at the time revenues are recognized, for estimated material costs during the warranty period based on the Company's experience.

**RADWARE LTD. AND ITS SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**U.S. dollars in thousands**

**NOTE 2:-**

**SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

p. 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 Interpretation No. 44, "Accounting for Certain Transactions Involving Stock Compensation" ("FIN No. 44") in accounting for its employee stock option plans and its non-compensatory Employee Share Purchase Plans ("ESPP"). Under APB No. 25, when the exercise price of an employee stock option is equivalent to, or is above the market price of the underlying stock on the date of grant, no compensation expense is recognized.

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

Pro forma information regarding net income and net earnings per share is required by SFAS No. 123, and has been determined as if the Company had accounted for its employee stock options under the fair value method of that statement. The fair value for these options was estimated at the grant date using a Black-Scholes formula for option pricing model with the following weighted-average assumptions for each of the three years ended December 31, 2003, 2004 and 2005: risk-free interest rates of 2.5%, 2.5% and 4.5%, respectively; dividend yields of 0% for each year; a volatility factor of the expected market price of the Company's Ordinary shares of 149%, 75% and 41%, respectively; and a weighted-average expected life of the option of 2.5, 2.5 and 3.5 years, respectively.

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

For purposes of pro forma disclosures, the estimated fair values of the options are amortized to expense over each option's vesting period.

**RADWARE LTD. AND ITS SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands****NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

Pro forma information under SFAS No. 123:

|                                                                                         | <b>Year ended December 31,</b> |             |             |
|-----------------------------------------------------------------------------------------|--------------------------------|-------------|-------------|
|                                                                                         | <b>2003</b>                    | <b>2004</b> | <b>2005</b> |
| Net income as reported                                                                  | \$ 6,355                       | \$ 13,780   | \$ 9,344    |
| Add - stock-based compensation expenses included in reported net income-intrinsic value | 98                             | -           | 58          |
| Deduct - stock-based compensation expense determined under fair value method            | (7,626)                        | (7,520)     | (6,082)     |
| Pro forma net income (loss)                                                             | \$ (1,173)                     | \$ 6,260    | \$ 3,320    |
| Basic net earnings per share as reported                                                | \$ 0.37                        | \$ 0.77     | \$ 0.50     |
| Diluted net earnings per share as reported                                              | \$ 0.34                        | \$ 0.70     | \$ 0.47     |
| Pro forma basic net earnings (loss) per share                                           | \$ (0.07)                      | \$ 0.35     | \$ 0.18     |
| Pro forma diluted net earnings (loss) per share                                         | \$ (0.07)                      | \$ 0.32     | \$ 0.17     |

On December 16, 2004, the Financial Accounting Standards Board (FASB) issued Statement No. 123 (revised 2004), "Share-Based Payment" ("SFAS No. 123(R)"), which is a revision of SFAS No. 123. Generally, the approach in SFAS 123(R) is similar to the approach described in Statement 123. However, SFAS No. 123 permitted, but did not require, share-based payments to employees to be recognized based on their fair values while SFAS No. 123(R) requires all share-based payments to employees to be recognized based on their fair values. SFAS No. 123(R) also revises, clarifies and expands guidance in several areas, including measuring fair value, classifying an award as equity or as a liability and attributing compensation cost to reporting periods. SFAS No. 123(R) will be effective for periods commencing January 1, 2006. SFAS No. 123(R) permits public companies to adopt its requirements using one of two methods:

- (i) a "modified prospective" method in which compensation cost is recognized beginning with the effective date (a) based on the requirements of Statement SFAS No. 123(R) for all share-based payments granted after the effective date and (b) based on the requirements of SFAS No. 123 for all awards granted to employees prior to the effective date of SFAS No. 123(R) that remain unvested on the effective date.
- (ii) a "modified retrospective" method which includes the requirements of the modified prospective method described above, but also permits entities to restate prior periods based on the amounts previously recognized under SFAS No. 123 for purposes of pro forma disclosures.

The Company plans to adopt SFAS No. 123(R) using the "modified prospective" method.

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**RADWARE LTD. AND ITS SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands, except per share data****NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

In March 2005, the SEC released SEC Staff Accounting Bulletin No. 107, "Share-Based Payment" ("SAB 107"). SAB 107 provides the SEC staff's position regarding the application of SFAS 123(R) and contains interpretive guidance related to the interaction between SFAS 123(R) and certain SEC rules and regulations, and also provides the SEC staff's views regarding the valuation of share-based payment arrangements for public companies. SAB 107 highlights the importance of disclosures made relating to the accounting for share-based payment transactions. The Company is currently reviewing the effect of SAB 107 and SFAS No. 123(R) on its financial position, results of operations and cash flows. Had the Company adopted SFAS No. 123(R) and SAB 107 in prior periods, management estimates the impact of those standards would have approximated the impact of SFAS No. 123 as described above. The Company expects that the adoption of SFAS No. 123(R) and SAB 107 will have a material effect on its financial position and results of operations.

q. Research and development costs:

Research and development costs are charged to the statement of income, as incurred.

r. Basic and diluted net earnings per share:

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

The weighted average number of shares related to outstanding anti dilutive options excluded from the calculation of diluted earnings per share was 213,492 and 709,972 for the years ended December 31, 2004 and 2005, respectively.

s. 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.

t. Concentrations of credit risks:

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

The majority of the Company's and its subsidiaries' cash and cash equivalents, and bank deposits are invested in major banks in the United States and in the United Kingdom in U.S. dollars. Management believes that the financial institutions that hold the Company's investments are financially sound and accordingly, minimal credit risk exists with

respect to these investments. Such deposits in the United States may be in excess of insured limits and are not insured in other jurisdictions.

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

## SIGNIFICANT ACCOUNTING POLICIES (Cont.)

The trade receivables of the Company and its subsidiaries are mainly derived from sales to customers located primarily in the United States, Europe, the Middle East, Africa and Asia Pacific. The Company performs ongoing credit evaluations of its customers. An allowance for doubtful accounts is determined with respect to those amounts that the Company has determined to be doubtful of collection. In certain circumstances, the Company may require from the customers letters of credit, other collateral or additional guarantees.

Severance pay:

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 the Israeli Severance Pay Law or labor agreements. The value of the deposited funds is based on the cash surrendered value of these policies, and includes immaterial profits.

Severance expenses for the years ended December 31, 2003, 2004, and 2005, amounted to approximately \$ 434, \$ 774 and \$ 405, respectively.

Fair value of financial instruments:

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

The carrying amount reported in the balance sheet of cash and cash equivalents, trade receivables, other receivables and prepaid expenses, bank deposits, trade payables and other payables and accrued expenses approximates their fair values due to the short-term maturities of such instruments.

The fair values for marketable securities are based on quoted market prices and do not significantly differ from carrying amounts (see also Note 3).





**RADWARE LTD. AND ITS SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands****NOTE 2:-****SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

The carrying amount of the Company's structured note is estimated by discounting the future cash flows using the future prospected interest rates for deposits of similar terms and maturities. The carrying amount of the structured note does not significantly differ from its fair value.

w.

Advertising expenses:

Advertising expenses are charged to the statements of income as incurred.

x.

Impact of recently issued Accounting Standards:

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

In May 2005, the FASB issued Statement of Financial Accounting Standard No. 154 ("SFAS 154"), "Accounting Changes and Error Corrections", a replacement of APB No. 20, "Accounting Changes" and SFAS No. 3, "Reporting Accounting Changes in Interim Financial Statements". SFAS 154 provides guidance on the accounting for and reporting of accounting changes and error corrections. APB No. 20 previously required that most voluntary changes in accounting principles be recognized by including in net income for the period of the change the cumulative effect of changing to the new accounting principle. SFAS 154 requires retroactive application to prior periods' financial statements of a voluntary change in accounting principles unless it is impracticable. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005.

On December 16, 2004, the Financial Accounting Standards Board (FASB) issued Statement No. 123 (revised 2004), "Share-Based Payment" ("SFAS No. 123(R)"), which is a revision of SFAS No. 123. SFAS No. 123(R) will be effective for periods commencing January 1, 2006 (see also p above).

y.

Reclassification:

Certain amounts from prior years have been reclassified to conform to the current year's presentation. The reclassification had no effect on previously reported net income, shareholders' equity or cash flows.

**RADWARE LTD. AND ITS SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands****NOTE 3:- MARKETABLE SECURITIES**

The Company invests in marketable debt securities, which are classified as available-for-sale and held-to-maturity investments. The following is a summary of marketable debt securities:

|                                                             | December 31,      |                              |                 |                   |                              |                 |
|-------------------------------------------------------------|-------------------|------------------------------|-----------------|-------------------|------------------------------|-----------------|
|                                                             | Amortized<br>cost | 2004<br>Unrealized<br>losses | Market<br>value | Amortized<br>cost | 2005<br>Unrealized<br>losses | Market<br>value |
| <u>Available-for-sale:</u>                                  |                   |                              |                 |                   |                              |                 |
| U.S. Government<br>debentures                               | \$ 9,004          | \$ (20)                      | \$ 8,984        | \$ 6,035          | \$ (114)                     | \$ 5,921        |
| Foreign banks and<br>government<br>debentures               | 2,988             | (4)                          | 2,984           | 8,376             | (196)                        | 8,180           |
| Corporate debentures                                        | 9,426             | (28)                         | 9,398           | 3,859             | (94)                         | 3,765           |
| Auction rate<br>securities                                  | 21,281            | -                            | 21,281          | 8,250             | -                            | 8,250           |
| <u>Total</u><br>available-for-sale<br>marketable securities | \$ 42,699         | \$ (52)                      | \$ 42,647       | \$ 26,520         | \$ (404)                     | \$ 26,116       |
| <u>Held-to-maturity:</u>                                    |                   |                              |                 |                   |                              |                 |
| U.S. Government<br>debentures                               | \$ 31,486         | \$ (345)                     | \$ 31,141       | \$ 62,461         | \$ (1,304)                   | \$ 61,157       |

The unrealized losses on available-for-sale debt securities included in other comprehensive income, as a separate component of shareholders' equity, totaled to \$ 52 and \$ 404 as of December 31, 2004 and 2005, respectively.

The unrealized losses on the Company's investments in held-to-maturity securities and in available-for-sale securities are a result of interest rate increases. Since the Company has the ability and intent to hold these investments until a recovery of fair value, which may be until maturity, the Company does not consider these investments to be other-than-temporarily impaired as of December 31, 2005.

The amortized cost and estimated fair value of available-for-sale and held-to-maturity investments as of December 31, 2004 and 2005, by contractual maturity, are as follows:

|  | December 31,              |              |                           |              |
|--|---------------------------|--------------|---------------------------|--------------|
|  | 2004<br>Amortized<br>cost | Market value | 2005<br>Amortized<br>cost | Market value |

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Available-for-sale:

|                                |    |        |    |        |    |        |    |        |
|--------------------------------|----|--------|----|--------|----|--------|----|--------|
| Matures in one year            | \$ | 30,192 | \$ | 30,170 | \$ | 14,832 | \$ | 14,717 |
| Matures in one to three years  |    | 10,331 |    | 10,251 |    | 8,966  |    | 8,692  |
|                                |    | 40,523 |    | 40,421 |    | 23,798 |    | 23,409 |
| Matures in three to five years |    | 2,176  |    | 2,226  |    | 2,722  |    | 2,707  |
|                                | \$ | 42,699 | \$ | 42,647 | \$ | 26,520 | \$ | 26,116 |

Held-to-maturity:

|                               |    |        |    |        |    |        |    |        |
|-------------------------------|----|--------|----|--------|----|--------|----|--------|
| Matures in one year           | \$ | 5,166  | \$ | 5,158  | \$ | 45,726 | \$ | 44,784 |
| Matures in one to three years |    | 26,320 |    | 25,983 |    | 16,735 |    | 16,373 |
|                               | \$ | 31,486 | \$ | 31,141 | \$ | 62,461 | \$ | 61,157 |

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**RADWARE LTD. AND ITS SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

U.S. dollars in thousands

**NOTE 4:- INVENTORIES**

|                              | <b>December 31,</b> |             |
|------------------------------|---------------------|-------------|
|                              | <b>2004</b>         | <b>2005</b> |
| Raw materials and components | \$ 414              | \$ 515      |
| Work-in-progress             | 1,878               | 2,457       |
| Finished products            | 1,802               | 2,282       |
|                              | \$ 4,094            | \$ 5,254    |

**NOTE 5:- PROPERTY AND EQUIPMENT**

Cost:

|                                             |          |           |
|---------------------------------------------|----------|-----------|
| Computer, software and peripheral equipment | \$ 8,933 | \$ 12,001 |
| Office furniture and equipment              | 998      | 1,152     |
| Motor vehicles                              | 341      | 166       |
| Leasehold improvements                      | 636      | 689       |
|                                             | 10,908   | 14,008    |
| Accumulated depreciation:                   |          |           |
| Computer, software and peripheral equipment | 5,398    | 7,020     |
| Office furniture and equipment              | 484      | 514       |
| Motor vehicles                              | 302      | 144       |
| Leasehold improvements                      | 272      | 362       |
|                                             | 6,456    | 8,040     |
| Depreciated cost                            | \$ 4,452 | \$ 5,968  |

Depreciation expenses for the years ended December 31, 2003, 2004 and 2005 were \$ 1,475, \$ 1,381 and \$ 1,856, respectively.

**NOTE 6:-****INTANGIBLE ASSETS**

a.

Intangible assets:

|                        | <b>December 31,</b> |             |
|------------------------|---------------------|-------------|
|                        | <b>2004</b>         | <b>2005</b> |
| Cost:                  |                     |             |
| Acquired technology    | \$ -                | \$ 1,772    |
| Customers relationship | 647                 | 1,189       |
|                        | 647                 | 2,961       |

Accumulated amortization:

|                        |        |          |
|------------------------|--------|----------|
| Acquired technology    | -      | -        |
| Customers relationship | 83     | 148      |
|                        | 83     | 148      |
| Amortized cost         | \$ 564 | \$ 2,813 |

Amortization expenses for the years ended December 31, 2003, 2004 and 2005, were \$ 34, \$ 49 and \$ 65, respectively.

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**RADWARE LTD. AND ITS SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

U.S. dollars in thousands

**NOTE 6:-****INTANGIBLE ASSETS (Cont.)**

b. Estimated amortization expenses for the years ended:

|       | <b>December 31,</b> |
|-------|---------------------|
|       |                     |
| 2006  | \$ 450              |
| 2007  | 450                 |
| 2008  | 451                 |
| 2009  | 451                 |
| 2010  | 450                 |
|       |                     |
| Total | \$ 2,252            |

**NOTE 7:-****OTHER PAYABLES AND ACCRUED EXPENSES**

|                                | <b>December 31,</b> |             |
|--------------------------------|---------------------|-------------|
|                                | <b>2004</b>         | <b>2005</b> |
| Employees and payroll accruals | \$ 2,565            | \$ 3,257    |
| Accrued expenses               | 1,781               | 2,941       |
| Provision for warranty costs   | 196                 | 190         |
| Other                          | 420                 | 121         |
|                                |                     |             |
|                                | \$ 4,962            | \$ 6,509    |

**NOTE 8:-****COMMITMENTS AND CONTINGENT LIABILITIES**

a. Operating leases:

The Company and its subsidiaries rent their facilities under various operating lease agreements, which expire on various dates, the latest of which is in 2009. Aggregate minimum rental payments under non-cancelable operating leases as of December 31, 2005, are as follows:

|      |          |
|------|----------|
| 2006 | \$ 1,674 |
| 2007 | 1,093    |
| 2008 | 264      |
| 2009 | 123      |
|      |          |
|      | \$ 3,154 |

Total rent expenses for the years ended December 31, 2003, 2004 and 2005, were approximately \$ 1,552, \$ 1,554 and \$ 1,768, respectively (see also Note 13b).

b. Litigation:

In December 2001, the Company, its Chairman, its President and Chief Executive Officer, and its Chief Financial Officer were named as defendants in a class action lawsuit alleging violations of the federal securities laws, in the United States District Court, Southern District of New York.

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**RADWARE LTD. AND ITS SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**U.S. dollars in thousands**

**NOTE 8:- COMMITMENTS AND CONTINGENT LIABILITIES (Cont.)**

The essence of the lawsuit is that the defendants issued and sold the Company's Ordinary shares pursuant to the Registration Statement for the September 30, 1999, Initial Public Offering ("IPO") without disclosing to investors that certain underwriters in the offering had solicited and received excessive and undisclosed commissions from certain investors.

The lawsuit also alleges that the Registration Statement for the IPO failed to disclose that the underwriters allocated Company shares in the IPO to customers in exchange for the customers' promises to purchase additional shares in the aftermarket at predetermined prices above the IPO price, thereby maintaining, distorting and/or inflating the market price for the shares in the aftermarket. The action seeks damages in an unspecified amount.

On October 9, 2002, the Court dismissed the individual defendants from the case without prejudice, based upon Stipulations of Dismissal filed by the plaintiffs and the individual defendants.

On February 19, 2003, the Court denied the motion to dismiss with respect to the Company. On October 13, 2004, the Court certified a class in six of the approximately 300 other nearly identical actions and noted that the decision is intended to provide strong guidance to all parties regarding class certification in the remaining cases. Plaintiffs have not yet moved to certify a class in the Company's case. The Company approved a settlement agreement and related agreements which set forth the terms of a settlement between the Company, the individual defendants, the plaintiff class and the vast majority of the other approximately 300 issuer defendants (the "Issuers").

Among other provisions, the settlement provides for a release of the Company and the individual defendants for the conduct alleged in the action to be wrongful. The Company would agree to undertake certain responsibilities, including agreeing to assign away, not assert, or release certain potential claims the Company may have against its underwriters. The settlement agreement also provides a guaranteed recovery of \$ 1 billion to plaintiffs for the cases relating to all of the approximately 300 issuers. To the extent that the underwriter defendants settle all of the cases for at least \$ 1 billion, no payment will be required under the Issuers' settlement agreement. To the extent that the underwriter defendants settle for less than \$ 1 billion, the issuers are required to make up the difference. The Company's management, based upon the opinions of the Company's legal advisors handling the claim, anticipates that any potential financial obligation of the Company to plaintiffs pursuant to the terms of the settlement agreement and related agreements will be covered by existing insurance. On February 15, 2005, the court granted preliminary approval of the settlement agreement, subject to certain modifications consistent with its opinion. Those modifications have been made. On March 20, 2006, the Underwriter Defendants submitted objections to the settlement to the Court. The Court held a hearing regarding these and other objections to the settlement at a fairness hearing on April 24, 2006, but has not yet issued a ruling. There is no assurance that the court will grant final approval to the settlement. If the settlement agreement is not approved and the Company is found liable, the Company's management is unable to estimate or predict the potential damages that might be awarded, whether such damages would be greater than the Company's insurance coverage, and whether such damages would have a material impact on the Company's results of operations, cash flows or financial condition in any future period.

**RADWARE LTD. AND ITS SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands****NOTE 8:- COMMITMENTS AND CONTINGENT LIABILITIES (Cont.)**

From time to time, the Company becomes involved in legal proceedings and claims which, arise in the ordinary course of business. The Company considers that the ultimate liability with respect to any known actions will not materially affect the business, financial position, results of operations or cash flows of the Company.

**NOTE 9:- SHAREHOLDERS' EQUITY**

The Company's shares are listed for trade on the NASDAQ National Market and since April 2004 on the Tel-Aviv Stock Exchange, both under the symbol "RDWR".

a. Treasury stock:

In November 2002, the Company's Board of Directors authorized the repurchase of up to 1,500,000 shares of the Company's Ordinary shares or \$ 10,000 in the open market, subject to normal trading restrictions. On December 19, 2002, the Company received court approval, which is required under Israeli law under certain conditions, as specified in the law. During 2002, the Company purchased 32,700 of its own Ordinary shares for total consideration of \$ 254. During 2003, according to a resolution of the Company's Board of Directors, all the shares held as treasury stock were retired.

b. Stock Option Plans:

Under the Company's Key Employee Share Incentive Plan (1997) and the Directors and Consultants Option Plan ("the Plans"), options may be granted to officers, directors, employees and consultants of the Company or its subsidiaries. The options expire sixty two months from the grant date. The options vest primarily over four years. Any options, which are forfeited or not exercised before expiration, become available for future grants.

Pursuant to the Plans, the Company reserved for issuance 7,474,484 Ordinary shares. The Company approved in December 2005 an increase of 571,669 Ordinary shares reserved for option grants under the Plans. In addition, the Company approved an additional increase of 60,000 Ordinary shares reserved for the purpose of option grants to directors. As of December 31, 2005, an aggregate of 510,299 Ordinary shares of the Company are still available for future grants.

A summary of the Company's options activity and related information is as follows:

|                                      | Year ended December 31, |                                          |                         |                                          |                         |                                          |
|--------------------------------------|-------------------------|------------------------------------------|-------------------------|------------------------------------------|-------------------------|------------------------------------------|
|                                      | 2003                    |                                          | 2004                    |                                          | 2005                    |                                          |
|                                      | Number<br>of<br>options | Weighted<br>average<br>exercise<br>price | Number<br>of<br>options | Weighted<br>average<br>exercise<br>price | Number<br>of<br>options | Weighted<br>average<br>exercise<br>price |
| Outstanding at the beginning of year | 3,664,062               | \$ 10.03                                 | 3,951,840               | \$ 11.12                                 | 3,902,433               | \$ 13.21                                 |

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|                                   |           |    |       |           |    |       |           |    |       |
|-----------------------------------|-----------|----|-------|-----------|----|-------|-----------|----|-------|
| Granted                           | 1,099,420 | \$ | 14.05 | 1,112,933 | \$ | 19.10 | 1,007,250 | \$ | 18.80 |
| Exercised                         | (593,467) | \$ | 9.95  | (669,865) | \$ | 8.93  | (503,591) | \$ | 12.15 |
| Forfeited                         | (218,175) | \$ | 10.80 | (492,475) | \$ | 15.62 | (351,712) | \$ | 18.06 |
|                                   |           |    |       |           |    |       |           |    |       |
| Outstanding at<br>the end of year | 3,951,840 | \$ | 11.12 | 3,902,433 | \$ | 13.21 | 4,054,380 | \$ | 14.31 |
| Exercisable at<br>the end of year | 1,137,657 | \$ | 10.93 | 1,251,679 | \$ | 10.24 | 1,428,575 | \$ | 9.52  |

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**RADWARE LTD. AND ITS SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands, except share data****NOTE 9:- SHAREHOLDERS' EQUITY (Cont.)**

The following table summarizes information about options outstanding and exercisable as of December 31, 2005:

| <b>Range of exercise price</b> | <b>Options outstanding as of December 31, 2005</b> | <b>Weighted average remaining contractual life (months)</b> | <b>Weighted average exercise price</b> | <b>Options exercisable as of December 31, 2005</b> | <b>Weighted average exercise price of options exercisable</b> |
|--------------------------------|----------------------------------------------------|-------------------------------------------------------------|----------------------------------------|----------------------------------------------------|---------------------------------------------------------------|
| \$ 0.03                        | 5,000                                              | 2                                                           | \$ 0.03                                | 5,000                                              | \$ 0.03                                                       |
| \$ 8 - 11                      | 1,743,172                                          | 14.33                                                       | \$ 9.24                                | 1,341,449                                          | \$ 8.99                                                       |
| \$ 15 - 18.68                  | 1,809,074                                          | 46.5                                                        | \$ 16.82                               | 43,125                                             | \$ 16.00                                                      |
| \$ 20 - 25.30                  | 497,134                                            | 48.94                                                       | \$ 23.04                               | 39,001                                             | \$ 21.63                                                      |
|                                | 4,054,380                                          |                                                             | \$ 14.31                               | 1,428,575                                          | \$ 9.52                                                       |

The weighted average fair values of the options granted during 2003, 2004 and 2005 were \$ 10.5, \$ 8.6 and \$ 7.1 respectively.

The Company has recorded deferred stock compensation for options issued with an exercise price below the fair market value of the Ordinary shares; the deferred stock compensation has been amortized and recorded as compensation expense ratably over the vesting period of the options. Compensation expense of approximately \$ 98, \$ 0 and \$ 58 were recognized for the years ended December 31, 2003, 2004 and 2005, respectively.

c. **Employee Share Purchase Plans:**

The Company's Board of Directors adopted three Employee Share Purchase Plans ("the Purchase Plans" or "ESPP"), which provide for the issuance of a maximum of 750,000, 200,000 and 300,000 Ordinary shares, respectively. Eligible employees can have up to 10% of their salaries withheld, up to certain maximums, to be used to purchase the Company's Ordinary shares. The Purchase Plans are implemented with purchases every six months. The price of an Ordinary share purchased under the Purchase Plans is equal to 85% of the lower of the fair market value of the Ordinary share at the commencement date of each offering period or on the semi-annual purchase date pursuant to the Plans. During 2005, 69,639 shares were issued under the Purchase Plans for aggregate consideration of \$ 1,161. As of December 31, 2005, the Company decided to terminate the ESPP.

d. **Dividends:**

Dividends, if any, will be paid in NIS. Dividends paid to shareholders outside Israel may be converted to U.S. dollars on the basis of the exchange rate prevailing at the date of the conversion. The Company does not intend to pay cash dividends in the foreseeable future.

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**RADWARE LTD. AND ITS SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands, except share data****NOTE 10:-****TAXES ON INCOME**

a. Israeli income taxes:

1. Measurement of taxable income:

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

2. Tax rates:

On July 25, 2005, the Knesset (Israeli Parliament) approved the Law of the Amendment of the Income Tax Ordinance (No. 147), 2005, which prescribes, among others, a gradual decrease in the corporate tax rate in Israel to the following tax rates: in 2006 - 31%, in 2007 - 29%, in 2008 - 27%, in 2009 - 26% and in 2010 and thereafter - 25%.

The amendment is not expected to have a material effect on the Company's financial position and results of operations.

3. Tax benefits under the Law for the Encouragement of Capital Investments, 1959:

The Company's production facilities in Israel (Tel-Aviv and Jerusalem) have been granted an "Approved Enterprise" status under the above law. According to the provisions of such Israeli law, the Company has been granted the "Alternative Benefit Plan", under which the main benefits are tax exemption and reduced tax rate. Therefore, the Company's income derived from Approved Enterprise and allocated to the Tel Aviv facility will be entitled to a tax exemption for a period of two years and to an additional period of five to eight years with reduced tax rates of 10%-25% (based on percentage of foreign ownership). Income allocated to the Jerusalem facility will be exempt from tax for a period of up to 10 years, provided that the Company meets certain criteria. The duration of tax benefits is subject to a limitation of the earlier of 12 years from commencement of production, or 14 years from the approval date. The Company began to utilize such tax benefits in 2004 and these tax benefits are scheduled to gradually expire through 2013.

As mentioned above, the approval, which the Investment Center granted the Company, is for establishing an Approved Enterprise program in Tel-Aviv and Jerusalem, Israel. The income derived from the "Approved Enterprise" program shall be allocated between the facilities in Tel-Aviv and Jerusalem based on a mechanism as determined by the Investment Center.

**RADWARE LTD. AND ITS SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**U.S. dollars in thousands**

**NOTE 10:-**

**TAXES ON INCOME (Cont.)**

The entitlement to the above benefits is conditional upon the Company's fulfilling the conditions stipulated by the above law, regulations published hereunder and the letters of approval for the specific investments in "Approved Enterprises". In the event of failure to comply with these conditions, the benefits may be partially or fully canceled and the Company may be required to refund the amount of the benefits, in whole or in part, including interest.

As of December 31, 2005, retained earnings included approximately \$ 23,400 in tax-exempt income earned by the Company's "Approved Enterprise". The Company has decided not to declare dividends out of such tax-exempt income. Accordingly, no deferred income taxes have been provided on income attributable to the Company's "Approved Enterprise".

If the retained tax-exempt income is distributed, it would be taxed at the corporate tax rate applicable to such profits as if the Company had not elected the alternative tax benefits (currently between 10% - 25%) and an income tax liability of approximately up to \$ 5,850 would be incurred by the Company.

Income from sources other than the "Approved Enterprise" will be subject to the tax at the regular rate.

During 2004, the Company's production facilities in Israel (Tel-Aviv and Jerusalem) have been granted an expansion program to its Approved Enterprise status by the Investment Center. The Company applied for an amendment to this expansion program, according to which it requested an enlargement to this expansion program, neutralization of certain assets and an approval that the benefits period from such expansion program will commence in 2006. The Investment Center has not yet approved this application. If the Investment Center will not approve the above application, the company will apply for a new program under the 2005 amendment to the Investment Law, as described below.

A recent amendment to the law, which has been officially published effective as of April 1, 2005 ("the Amendment") has changed certain provisions of the law. As a result of the Amendment, a company is no longer obliged to implement an Approved Enterprise status in order to receive the tax benefits previously available under the Alternative Benefits provisions, and therefore there is no need to apply to the Investment Center for this purpose (Approved Enterprise status remains mandatory for companies seeking grants). Rather, a company may claim the tax benefits offered by the Investment Law directly in its tax returns, provided that its facilities meet the criteria for tax benefits set out by the Amendment. A company is also granted a right to approach the Israeli Tax Authorities for a pre-ruling regarding their eligibility for benefits under the Amendment.

**RADWARE LTD. AND ITS SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands****NOTE 10:-****TAXES ON INCOME (Cont.)**

Tax benefits are available under the Amendment to production facilities (or other eligible facilities), which are generally required to derive more than 25% of the company's business income from export. In order to receive the tax benefits, the Amendment states that a company must make an investment in the Benefited Enterprise exceeding a minimum amount specified in the law. Such investment may be made over a period of no more than three years ending at the end of the year in which the company requested to have the tax benefits apply to the Benefited Enterprise ("the Year of Election"). Where a company requests to have the tax benefits apply to an expansion of existing facilities, then only the expansion will be considered a Benefited Enterprise and the company's effective tax rate will be the result of a weighted combination of the applicable rates. In this case, the minimum investment required in order to qualify as a Benefited Enterprise is required to exceed a certain percentage of the company's production assets before the expansion. The duration of tax benefits is subject to a limitation of the earlier of 7 years from the Commencement Year, or 12 years from the first day of the Year of Election.

Should the Company elect to utilize tax benefits under the Amendment to the law, than any such tax exempt profits might be subject to future taxation on the corporate level upon distribution to shareholders by a way of dividend or liquidation. Accordingly the Company may be required to recognize deferred tax liability with respect to such tax exempt profits.

4. Tax assessments:

In 2004, the Company received final tax assessments from the Israeli Tax Authorities for the tax years 1999 through 2002.

5. Stamp duty:

An amendment of the Stamp Duty on Documents Law, 1961, or the Stamp Duty Law, came into effect on June 1, 2003 determining, among other things, that the Stamp Duty on most agreements shall be paid by the parties that signed such agreement, jointly or severally, or by the party that undertook under such agreement to pay the Stamp Duty. The Stamp Duty Law determined that a document (or part thereof) that is signed in Israel or relates to an asset or obligation in Israel would be subject to a tax rate between 0.4% and 1% of the value of the subject matter of such document. Based on advice from the Company's legal counsel, the Company's management believes that adequate provision has been provided to cover such an exposure.

Under an order published in December 2005, the said requirement to pay stamp duty was cancelled with respect to documents signed on or after January 1, 2006.



**RADWARE LTD. AND ITS SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands****NOTE 10:-****TAXES ON INCOME (Cont.)**

b. Taxes on income are comprised as follows:

|                                 | <b>Year ended December 31,</b> |             |             |
|---------------------------------|--------------------------------|-------------|-------------|
|                                 | <b>2003</b>                    | <b>2004</b> | <b>2005</b> |
| Current taxes                   | \$ -                           | \$ 428      | \$ 304      |
| Taxes in respect of prior years | -                              | 803         | -           |
| Increase in deferred taxes      | -                              | (890)       | (64)        |
| \$ -                            |                                | \$ 341      | \$ 240      |
| Domestic                        | \$ -                           | \$ 1,576    | \$ 203      |
| Foreign                         | -                              | (1,235)     | 37          |
| \$ -                            |                                | \$ 341      | \$ 240      |

c. Deferred income taxes:

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

|                                                        | <b>December 31,</b> |             |
|--------------------------------------------------------|---------------------|-------------|
|                                                        | <b>2004</b>         | <b>2005</b> |
| Deferred tax assets:                                   |                     |             |
| Net operating loss carryforwards of subsidiaries       | \$ 1,500            | \$ 954      |
| Tax benefit related to employee stock option exercises | 2,156               | 2,538       |
| Net deferred tax asset before valuation allowance      | 3,656               | 3,492       |
| Valuation allowance                                    | (2,766)             | (2,538)     |
| Net deferred tax asset                                 | \$ 890              | \$ 954      |

d. Foreign:

The Company's U.S. subsidiary has estimated total available carryforward tax losses of approximately \$ 2,400 to offset against future taxable profit between 2011 and 2024. As of December 31, 2005, the Company recorded a deferred tax asset of \$ 954 relating to the available net carryforward tax losses.

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 limitation may

result in the expiration of net operating losses before utilization.

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

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**RADWARE LTD. AND ITS SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands****NOTE 10:-****TAXES ON INCOME (Cont.)**

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

|                                                                                | <b>Year ended December 31,</b> |             |             |
|--------------------------------------------------------------------------------|--------------------------------|-------------|-------------|
|                                                                                | <b>2003</b>                    | <b>2004</b> | <b>2005</b> |
| Income before taxes, as reported in the consolidated statements of income      | \$ 6,395                       | \$ 14,087   | \$ 9,584    |
| Statutory tax rate                                                             | 36%                            | 35%         | 34%         |
| Theoretical tax expenses on the above amount at the Israeli statutory tax rate | \$ 2,302                       | \$ 4,930    | \$ 3,259    |
| Decrease in taxes resulting from "Approved Enterprise" benefits (1)            | -                              | (4,762)     | (2,746)     |
| Tax adjustment in respect of different tax rate of foreign subsidiary          | 13                             | 52          | (22)        |
| Non-deductible expenses                                                        | 632                            | 893         | 528         |
| Deferred taxes on losses for which valuation allowance was provided            | (2,733)                        | (1,470)     | (632)       |
| Income taxes in respect of prior years                                         | -                              | 803         | -           |
| Other                                                                          | (214)                          | (105)       | (147)       |
| Actual tax expense                                                             | \$ -                           | \$ 341      | \$ 240      |
| (1) Per share amounts (basic) of the tax benefit resulting from the exemption  | \$ -                           | \$ 0.26     | \$ 0.15     |
| Per share amounts (diluted) of the tax benefit resulting from the exemption    | \$ -                           | \$ 0.24     | \$ 0.14     |

f.

Income before income taxes is comprised as follows:

|                            | <b>Year ended December 31,</b> |             |             |
|----------------------------|--------------------------------|-------------|-------------|
|                            | <b>2003</b>                    | <b>2004</b> | <b>2005</b> |
| Domestic                   | \$ 5,155                       | \$ 12,461   | \$ 7,601    |
| Foreign                    | 1,240                          | 1,626       | 1,983       |
| Income before income taxes | \$ 6,395                       | \$ 14,087   | \$ 9,584    |

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**RADWARE LTD. AND ITS SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands, except per share data****NOTE 11:- GEOGRAPHIC INFORMATION AND SELECTED STATEMENTS OF INCOME DATA**

a. Summary information about geographic areas:

The Company operates in one reportable segment (see Note 1 for a brief description of the Company's business). The total revenues are attributed to geographic areas based on the location of the end-users.

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

|                                              | <b>Year ended December 31,</b> |             |             |
|----------------------------------------------|--------------------------------|-------------|-------------|
|                                              | <b>2003</b>                    | <b>2004</b> | <b>2005</b> |
| Revenues from sales to customers located at: |                                |             |             |
| America (principally the United States)      | \$ 26,218                      | \$ 28,984   | \$ 31,900   |
| EMEA *)                                      | 14,038                         | 20,450      | 24,074      |
| Asia Pacific                                 | 14,524                         | 19,005      | 21,610      |
|                                              | \$ 54,780                      | \$ 68,439   | \$ 77,584   |

\*) Europe, the Middle East and Africa.

|                                          | <b>December 31,</b> |             |
|------------------------------------------|---------------------|-------------|
|                                          | <b>2004</b>         | <b>2005</b> |
| Long-lived assets, by geographic region: |                     |             |
| America                                  | \$ 1,246            | \$ 1,609    |
| EMEA                                     | 3,464               | 6,755       |
| Asia Pacific                             | 306                 | 417         |
|                                          | \$ 5,016            | \$ 8,781    |

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

|            | <b>Year ended December 31,</b> |             |             |
|------------|--------------------------------|-------------|-------------|
|            | <b>2003</b>                    | <b>2004</b> | <b>2005</b> |
| Customer A | 11%                            | 11%         | 16%         |

**RADWARE LTD. AND ITS SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands****NOTE 12:-****SELECTED STATEMENTS OF INCOME DATA**

a. Financial income (expenses):

|                                                                                                  | Year ended December 31, |          |          |
|--------------------------------------------------------------------------------------------------|-------------------------|----------|----------|
|                                                                                                  | 2003                    | 2004     | 2005     |
| Financial income:                                                                                |                         |          |          |
| Interest on bank deposits                                                                        | \$ 3,193                | \$ 3,045 | \$ 3,426 |
| Foreign currency translation differences, net                                                    | 352                     | 784      | -        |
| Amortization of premiums, accretion of discounts and interest on marketable debt securities, net | 645                     | 852      | 2,856    |
|                                                                                                  | 4,190                   | 4,681    | 6,282    |
| Financial expenses:                                                                              |                         |          |          |
| Interest and other bank charges                                                                  | (450)                   | (116)    | (70)     |
| Foreign currency translation differences, net                                                    | -                       | -        | (1,053)  |
|                                                                                                  | \$ 3,740                | \$ 4,565 | \$ 5,159 |

b. Net earnings per share:

The following table sets forth the calculation of basic and diluted net earnings per share:

|                                                                                                      | Year ended December 31, |            |            |
|------------------------------------------------------------------------------------------------------|-------------------------|------------|------------|
|                                                                                                      | 2003                    | 2004       | 2005       |
| <u>Numerator:</u>                                                                                    |                         |            |            |
| Net income available to shareholders of Ordinary shares                                              | \$ 6,355                | \$ 13,780  | \$ 9,344   |
| <u>Denominator:</u>                                                                                  |                         |            |            |
| Denominator for basic earnings per share - weighted average number of shares, net of treasury stock  | 17,184,141              | 17,995,207 | 18,800,474 |
| Effect of dilutive securities:                                                                       |                         |            |            |
| Employee stock options and ESPP                                                                      | 1,481,999               | 1,809,689  | 1,271,718  |
| Denominator for diluted net earnings per share - adjusted weighted average number of Ordinary shares | 18,666,140              | 19,804,896 | 20,072,192 |



**RADWARE LTD. AND ITS SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands, except share data****NOTE 13:- BALANCES AND TRANSACTIONS WITH RELATED PARTIES**

Represents transactions and balances with other entities in which certain of the Company's shareholders have interest:

- a. The following related party balances are included in the balance sheets:

|                   | <b>December 31,</b> |             |
|-------------------|---------------------|-------------|
|                   | <b>2004</b>         | <b>2005</b> |
| Trade receivables | \$ 1,004            | \$ 1,447    |
| Trade payables    | \$ 134              | \$ -        |

- b. The following related party transactions are included in the statements of income:

|                                                                                    | <b>Year ended December 31,</b> |             |             |
|------------------------------------------------------------------------------------|--------------------------------|-------------|-------------|
|                                                                                    | <b>2003</b>                    | <b>2004</b> | <b>2005</b> |
| Revenues                                                                           | \$ 1,011                       | \$ 2,400    | \$ 3,111    |
| Cost of revenues - components (1)                                                  | \$ 349                         | \$ -        | \$ -        |
| Operating expenses, net - primarily rental, sub-contractors and communications (2) | \$ 1,186                       | \$ 1,151    | \$ 1,309    |
| Purchase of property and equipment                                                 | \$ 47                          | \$ 466      | \$ 377      |

(1) Represents purchases of certain components for the Company's products, mainly circuit boards from a related party. On February 2, 2003, the purchase agreement with a related party was assigned to a third party.

(2) The Company leases office space and purchases other miscellaneous services from certain companies, which are considered to be related parties. In addition, the Company subleases part of the office space to related parties and provides certain services to related parties.