

AUDIOCODES LTD  
Form 20-F  
March 24, 2015

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**WASHINGTON, D.C. 20549**

**FORM 20-F**

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

**OR**

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

**For the fiscal year ended December 31, 2014**

**OR**

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

**OR**

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

Date of event requiring this shell company report \_\_\_\_\_

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

Commission file number 0-30070

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

ISRAEL  
(Jurisdiction of incorporation or organization)

1 Hayarden Street, Airport City Lod 7019900, Israel  
(Address of principal executive offices)

Shabtai Adlersberg, CEO and President, Tel: 972-3-976-4105, Fax: 972-3-9764040, 1 Hayarden Street, Airport City, Lod 7019900 Israel

(Name, Telephone, E-mail and/or Facsimile number and Address of Company Contact Person)

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 |
|---------------------|---|
|---------------------|---|

|   |                             |
|---|-----------------------------|
| Ordinary Shares, nominal value NIS 0.01 per share | NASDAQ Global Select Market |
|---|-----------------------------|

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

None  
(Title of Class)

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

None  
(Title of Class)

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

As of December 31, 2014, the Registrant had outstanding 42,380,158 Ordinary Shares, nominal value NIS 0.01 per share.

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

Yes  No

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934:

Yes  No

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

Yes x No

Indicate by check mark whether registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files)

Yes x No

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

Large Accelerated filer    Accelerated filer    x Non-accelerated filer

Indicate by check mark which basis of accounting the registrant has used to prepare the financial statements included in this filing:

U.S. GAAP    x    International Financial Reporting Standards as issued by  
the International Accounting Standards Board    Other

If "Other" has been checked in response to the previous question, 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):



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## **PRELIMINARY NOTE**

This Annual Report contains “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1933, or the Securities Act, and Section 21E of the Securities Exchange Act, or the Exchange Act. These forward-looking statements can generally be identified as such because the context of the statement will include words such as may, “will,” “intends,” “plans,” “believes,” “anticipates,” “expects,” “estimates,” “predicts,” “potential,” “continue,” or the negative of these words or words of similar import. Similarly, statements that describe our business outlook or future economic performance, anticipated revenues, expenses or other financial items, introductions and advancements in development of products, and plans and objectives related thereto, and statements concerning assumptions made or expectations as to any future events, conditions, performance or other matters, are also forward-looking statements. Forward-looking statements are subject to risks, uncertainties and other factors that could cause actual results to differ materially from those stated in such statements. Factors that could cause or contribute to such differences include, but are not limited to, those set forth under Item 3.D, “Key Information - Risk Factors” of this Annual Report.

Our actual results of operations and execution of our business strategy could differ materially from those expressed in, or implied by, the forward-looking statements. In addition, past financial and/or operating performance is not necessarily a reliable indicator of future performance and you should not use our historical performance to anticipate results or future period trends. We can give no assurances that any of the events anticipated by the forward-looking statements will occur or, if any of them do, what impact they will have on our results of operations and financial condition. In evaluating our forward-looking statements, you should specifically consider the risks and uncertainties set forth under Item 3.D, “Key Information - Risk Factors” of this Annual Report.

## **PART I**

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

### **ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS**

Not applicable.

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

Not applicable.

### **ITEM 3. KEY INFORMATION**

#### *A. SELECTED FINANCIAL DATA*

The selected financial data, set forth in the table below, have been derived from our audited historical financial statements for each of the years from 2010 through 2014. The selected consolidated statement of operations data for the years ended December 31, 2012, 2013 and 2014, and the selected consolidated balance sheet data as of December 31, 2013 and 2014, have been derived from our audited consolidated financial statements set forth elsewhere in this Annual Report. The selected consolidated statement of operations data for the years ended December 31, 2010 and 2011, and the selected consolidated balance sheet data as of December 31, 2010, 2011 and 2012, have been derived from our previously published audited consolidated financial statements, which are not included in this Annual Report. The selected financial data should be read in conjunction with our consolidated financial statements, and are qualified entirely by reference to these consolidated financial statements.



Year Ended December 31,  
2010      2011      2012      2013      2014  
(In thousands, except per share data)

## Statement of Operations Data:

## Revenues:

|                |            |            |            |            |            |
|----------------|------------|------------|------------|------------|------------|
| Products       | \$ 132,662 | \$ 135,827 | \$ 103,651 | \$ 111,750 | \$ 118,561 |
| Services       | 17,378     | 20,025     | 23,839     | 25,482     | 33,018     |
| Total revenues | 150,040    | 155,827    | 127,490    | 137,232    | 151,579    |

## Cost of revenues:

|                        |        |        |        |        |        |
|------------------------|--------|--------|--------|--------|--------|
| Products               | 62,155 | 59,917 | 48,371 | 51,996 | 54,349 |
| Services               | 3,983  | 4,228  | 5,923  | 6,568  | 8,243  |
| Total cost of revenues | 66,138 | 64,145 | 54,294 | 58,564 | 62,592 |

|              |        |        |        |        |        |
|--------------|--------|--------|--------|--------|--------|
| Gross profit | 83,902 | 91,682 | 73,196 | 78,668 | 88,987 |
|--------------|--------|--------|--------|--------|--------|

## Operating expense:

|  |           |          |             |          |            |
|--|-----------|----------|-------------|----------|------------|
| Research and development, net  | 30,189    | 32,150   | 28,677      | 28,194   | 32,275     |
| Selling and marketing  | 35,024    | 43,248   | 40,040      | 39,279   | 45,534     |
| General and administrative   | 8,252     | 9,028    | 8,214       | 8,456    | 7,677      |
| Total operating expenses   | 73,465    | 84,426   | 76,931      | 75,929   | 85,486     |
| Operating income (loss)  | 10,437    | 7,256    | (3,735 )    | 2,739    | 3,501      |
| Financial expenses (income), net   | 94        | (423 )   | (453 )      | (96 )    | 196        |
| Income (loss) before taxes on income   | 10,343    | 7,679    | (3,282 )    | 2,835    | 3,305      |
| Income tax expense (benefit), net  | (1,885 )  | 238      | 541         | (1,404 ) | 3,391      |
| Equity in losses of affiliated companies   | 213       | 277      | 354         | 21       | -          |
| Net income (loss)  | \$ 12,015 | \$ 7,164 | \$ (4,177 ) | \$ 4,218 | \$ (86 )   |
| Net loss attributable to a non- controlling interest   | \$ 111    | \$ -     | \$ -        | \$ -     | \$ -       |
| Net income (loss) attributable to AudioCodes' shareholders                                     | \$ 12,126 | \$ 7,164 | \$ (4,177 ) | \$ 4,218 | \$ (86 )   |
| Basic earnings (loss) per share  | \$ 0.30   | \$ 0.17  | \$ (0.11 )  | \$ 0.11  | \$ (0.00 ) |
| Diluted earnings (loss) per share  | \$ 0.30   | \$ 0.17  | \$ (0.11 )  | \$ 0.11  | \$ (0.00 ) |
| Weighted average number of ordinary shares used in computing basic earnings (loss) per share   | 40,560    | 41,438   | 39,125      | 38,241   | 42,286     |
| Weighted average number of ordinary shares used in computing diluted earnings (loss) per share | 40,961    | 41,935   | 39,125      | 39,097   | 42,286     |

|   | December 31, |          |          |          |          |
|---|--------------|----------|----------|----------|----------|
|   | 2010         | 2011     | 2012     | 2013     | 2014     |
| Balance Sheet Data:   |              |          |          |          |          |
| Cash and cash equivalents   | \$50,311     | \$28,257 | \$15,219 | \$30,763 | \$14,797 |
| Short-term and restricted bank deposits, marketable securities and accrued interest | 13,825       | 14,353   | 18,296   | 24,807   | 8,173    |
| Working capital   | 66,537       | 55,083   | 46,598   | 64,859   | 37,538   |
| Long-term and restricted bank deposits and long-term marketable securities          | -            | 32,943   | 25,013   | 6,697    | 62,750   |
| Total assets  | 173,644      | 192,677  | 165,789  | 174,304  | 200,384  |
| Bank loans  | 15,750       | 33,155   | 22,913   | 14,477   | 9,791    |
| Long term senior convertible notes  | 353          | 353      | 353      | -        | -        |
| Shareholders' equity  | 99,180       | 106,019  | 98,297   | 104,809  | 133,721  |
| Non-controlling interest  | -            | -        | -        | -        | -        |
| Total equity  | 99,180       | 106,019  | 98,297   | 104,809  | 133,721  |
| Capital stock (*)   | 172,263      | 176,998  | 178,623  | 182,220  | 216,743  |

(\*) Capital stock represents share capital plus additional paid-in capital, less carrying amount of the equity component of the senior convertible notes.

### Currency and Exchange Rates

The following table sets forth the exchange rates for one United States dollar ("US\$") expressed in terms of one New Israeli Shekel ("NIS") in effect at the end of the following years, (based on the exchange rate on the last day of each year).

| December 31, |       |       |       |       |  |
|--------------|-------|-------|-------|-------|--|
| 2010         | 2011  | 2012  | 2013  | 2014  |  |
| 3.549        | 3.821 | 3.733 | 3.471 | 3.889 |  |

The high and low exchange rates for each month during the previous six months are as follows (NIS per United States \$1.00):

| Month          | High  | Low   |
|----------------|-------|-------|
| September 2014 | 3.695 | 3.578 |
| October 2014   | 3.793 | 3.644 |
| November 2014  | 3.889 | 3.782 |
| December 2014  | 3.994 | 3.889 |

|               |       |       |
|---------------|-------|-------|
| January 2015  | 3.998 | 3.889 |
| February 2015 | 3.966 | 3.844 |

The high, low, average (calculated by using the average of the exchange rates on the last day of each month during the period) and closing exchange rates for each of the Company's five previous fiscal years are as follows:

|            | Year Ended December 31, |       |       |       |       |
|------------|-------------------------|-------|-------|-------|-------|
|            | 2010                    | 2011  | 2012  | 2013  | 2014  |
| High       | 3.894                   | 3.821 | 4.084 | 3.791 | 3.994 |
| Low        | 3.549                   | 3.363 | 3.700 | 3.471 | 3.402 |
| Average    | 3.732                   | 3.579 | 3.858 | 3.609 | 3.577 |
| Period End | 3.549                   | 3.821 | 3.733 | 3.471 | 3.889 |

Unless otherwise indicated, in this Annual Report all references herein are to United States dollar.

The exchange rate on March 20, 2015, as reported by the Bank of Israel, for the conversion of United States dollars into New Israeli Shekel was U.S. \$1.00 equals NIS 4.053.

*B. CAPITALIZATION AND INDEBTEDNESS*

Not applicable.

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

Not applicable.

*D. RISK FACTORS*

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

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

**We reported losses in 2012 and 2014. We may report additional losses in the future.**

We reported a net loss in each of 2012 and 2014. We reported net income in each of 2010, 2011 and 2013. The majority of our expenses are directly and indirectly related to the number of people we employ. We may increase our expenses based on projections of revenue growth. If at any given time we do not meet our expectations for growth in revenues our expenses incurred in anticipation of projected revenues may cause us to incur a loss. We may not be able to anticipate the correct amount of expenses in relation to our revenue and adjust our variable costs accordingly. As a result, we may report additional losses in the future.

**Our gross profit percentage could be negatively impacted by amortization expenses in connection with acquisitions, increased manufacturing costs and other factors. This could adversely affect our results of operations.**

Our gross profit percentage has fluctuated in the past, including decreases in each of 2012 and 2013. Our gross profit percentage has been negatively affected in the past and could continue to be negatively affected by amortization expenses in connection with acquisitions, expenses related to equity based compensation, increases in manufacturing costs, a shift in our sales mix towards our less profitable products, increased customer demand for longer product warranties, fixed expenses that are applied to a lower revenue base and increased cost pressures as a result of increased competition. Acquisitions of new businesses could also negatively affect our gross profit percentage. A decrease in our gross profit percentage could cause an adverse effect on our results of operations.

**We have depended, and expect to continue to depend, on a small number of large customers. The loss of one or more of our large customers or the reduction in purchases by a significant customer or failure of such customer to pay for the products it purchases from us could have a material adverse effect on our revenues.**

Historically, a substantial portion of our revenues has been derived from large purchases by a small number of original equipment manufacturers, or OEMs, and network equipment providers, or NEPs, systems integrators and distributors. Our top three customers accounted for approximately 25.3% of our revenues in 2012, 27.8% of our revenues in 2013 and 27.7% of our revenues in 2014. Sales to ScanSource Communications Group, our largest customer, accounted for 14.9% of our revenues in 2014, compared to 17.8% of our revenues in 2013 and 13.7% of our revenues in 2012. In addition, sales to Westcon Group accounted for 10.5% of our revenues in 2014. We do not enter into sales agreements in which a customer is obligated to purchase a set quantity of our products. Based on our experience, we expect that our customer base may change from period to period. If we lose a large customer and fail to add new customers, or if purchases made by such customers are significantly reduced, there could be a material adverse effect on our results of operations.

**We have invested significant resources in developing products compatible with Microsoft Lync and related solutions of other partners of ours. If Microsoft or our other partners, such as Genesys Avaya or Broadsoft, abandon their solutions, decide to promote products of our competitors instead of our products, are unwilling to continue to recognize AudioCodes as its partner or fail to achieve the expected growth of its solution, our results of operations will be adversely affected.**

We have invested significant resources in complying with Microsoft's requirements for the purpose of becoming a Microsoft recognized partner for their unified communication solutions for the enterprise market, which are known as Microsoft Lync. We have adapted some of our gateway products, IP phones, session border controllers, survivable branch applications, value added applications and professional services to operate in the Microsoft Lync environment. We believe that recognition as a Microsoft partner enhances our access to and visibility in markets relevant to our products. We are dependent on the users of Microsoft Lync to recognize the utility of our compatible products and purchase them. If Microsoft were to abandon Lync, decide to promote the products of our competitors instead of our products, is unwilling to continue to recognize AudioCodes as a Lync partner or fails to achieve the expected growth of Lync, our results of operations will be adversely affected.

Similarly, we have invested in the development of products and capabilities and achieving certifications for the solutions of other partners of ours, such as Genesys and Avaya contact centers or Broadsoft broadworks. If those partners decide to promote products of our competitors instead of our products, are unwilling to continue to recognize AudioCodes as a partner or fail to achieve the expected growth, our results of operations may be adversely affected.

**Recent and future economic conditions may adversely affect our business.**

The uncertain economic and credit environment is having a negative impact on business around the world. In the past, the impact of these conditions on the technology industry and our major customers and potential customers has been significant. Conditions may continue to be uncertain or may be subject to deterioration which could lead to a reduction in consumer and customer spending overall, which could have an adverse impact on sales of our products. A disruption in the ability of our significant customers to access liquidity could cause serious disruptions or an overall deterioration of their businesses which could lead to a significant reduction in their orders of our products and the inability or failure on their part to meet their payment obligations to us, any of which could have a material adverse effect on our results of operations and liquidity. A significant adverse change in a customer's financial and/or credit position could also require us to assume greater credit risk relating to that customer's receivables or could limit our ability to collect receivables related to previous purchases by that customer. As a result, our allowance for doubtful accounts and write-offs of accounts receivable could increase.

**We may need additional financing to operate or grow our business. We may not be able to raise additional financing for our capital needs on favorable terms, or at all, which could limit our ability to grow and to continue our longer term expansion plans.**

We may need additional financing to operate our business or continue our longer term expansion plans. To the extent that we cannot fund our activities and acquisitions through our existing cash resources and any cash we generate from operations, we may need to raise equity or debt funds through additional public or private financings. We cannot be certain that we will be able to obtain additional financing on commercially reasonable terms, or at all. This could inhibit our growth, increase our financing costs or cause us severe financial difficulties.

**We could be forced to repay our bank debt if we are unable to satisfy the covenants in our loan agreements.**

In 2011, we borrowed \$23.8 million, of which \$19.9 million is repayable in 20 equal quarterly payments of approximately \$1.0 million from December 2011 through September 2017 and the remaining \$3.9 million is repayable in 10 equal semiannual payments of \$390,000 from June 2012 through December 2016. If we are unable to make

payments when required by these loan agreements or if we do not comply with covenants in our loan agreements with respect to maintaining shareholders' equity, cash balances, and liabilities to banks at specified levels or achieving certain levels of operating income, we could be required to repay all or a portion of these bank loans prior to their maturity.

**We may expand our business through acquisitions that could result in diversion of resources and extra expenses. This could disrupt our business and affect our results of operations.**

Part of our strategy is to pursue acquisitions of, or investments in, businesses and technologies or to establish joint ventures to expand our business. The negotiation of acquisitions, investments or joint ventures, as well as the integration of acquired or jointly developed businesses or technologies, could divert our management's time and resources. Acquired businesses, technologies or joint ventures may not be successfully integrated with our products and operations. The markets for the products produced by the companies we acquire may take longer than we anticipated to develop and to result in increased sales and profits for us. We may not realize the intended benefits of any acquisition, investment or joint venture and we may incur losses from any acquisition, investment or joint venture.

Acquisitions could result in:

- substantial cash expenditures;
- potentially dilutive issuances of equity securities;
- the incurrence of debt and contingent liabilities;
- a decrease in our profit margins;

- amortization of intangibles and potential impairment of goodwill and intangible assets;
- reduction of management attention to other parts of the business;
- failure to invest in different areas or alternative investments;
- failure to generate expected financial results or reach business goals; and
- increased expenditures on human resources and related costs.

If acquisitions disrupt our sales or marketing efforts or operations, our business may suffer.

**If new products we introduce or expect to introduce in the future fail to generate the level of demand we anticipated, we will realize a lower than expected return from our investment in research and development with respect to those products, and our results of operations may suffer.**

Our success is dependent, in part, on the willingness of our customers to transition or migrate to new products, such as our expanded offering of Mediant and IP media products, our residential gateways, our session border controller products, our multi service business routers (MSBRs), our software solutions and value added application products, our services or expected future products. We are involved in a continuous process of evaluating changing market demands and customer requirements in order to develop and introduce new products, features and applications to meet changing demands and requirements. We need to be able to interpret market trends and the advancement of technology in order to successfully develop and introduce new products, features and applications. If potential customers defer transition or migration to new products, our return on our investment in research and development with respect to products recently introduced or expected to be introduced in the near future will be lower than we originally anticipated and our results of operations may suffer.

**Because of the rapid technological development in the communications equipment market and the intense competition we face, our products can become outmoded or obsolete in a relatively short period of time, which requires us to provide frequent updates and/or replacements to existing products. If we do not successfully manage the transition process to the next generation of our products, our operating results may be harmed.**

The communications equipment market is characterized by rapid technological innovation and intense competition. Accordingly, our success depends in part on our ability to develop next generation products in a timely and cost-effective manner. The development of new products is expensive, complex and time consuming. If we do not



rapidly develop our next generation products ahead of our competitors, we may lose both existing and potential customers to our competitors. Further, if a competitor develops a new, less expensive product using a different technological approach to delivering informational services over existing networks, our products would no longer be competitive. Conversely, even if we are successful in rapidly developing new products ahead of our competitors and we do not cost-effectively manage our inventory levels of existing products when making the transition to the new products, our financial results could be negatively affected by high levels of obsolete inventory. If any of the foregoing were to occur, then our operating results would be harmed.

**Our industry is rapidly evolving and we may not be able to keep pace with technological changes, which could adversely affect our business.**

The transmission of multimedia over data networks is rapidly evolving. Short product life cycles place a premium on our ability to manage the transition from current products to new products. Our future success in generating revenues will depend on our ability to enhance our existing products and to develop and introduce new products and product features. These products and features must keep pace with technological developments and address the increasingly sophisticated needs of our customers. The development of new technologies and products is increasingly complex and uncertain. This increases the difficulty in coordinating the planning and production process and can result in delay in the introduction of new technologies and products.

**The increase in the number of IP networks may adversely affect the demand for media gateway products.**

Media gateway products are primarily intended to transcode voice from traditional telephony networks to IP networks and vice versa. Along with the growth in the number of IP networks, there has been an increase in the amount of information that is sent directly from one IP network to another IP network. This direct network communication potentially obviates the need to use a media gateway or transcoding. A reduction in the demand for media gateways may adversely affect the demand for our media gateway products and, in turn, adversely affect our results of operations.

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

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

**Our OEM customers or potential customers or partners may develop or prefer to develop their own technical solutions, or purchase third party technology, and as a result, would not buy our products.**

Our products are sold also as components or building blocks to large OEMs and NEPs. These customers incorporate our products into their product offerings, usually in conjunction with value-added services of their own or of third parties. OEM or NEP customers or potential customers may prefer to develop their own technology or purchase third party technology. They could also manufacture their own components or building blocks that are similar to the ones we offer. Large customers have already committed significant resources in developing integrated product offerings. Customers may decide that this gives them better profitability and/or greater control over supplies, specifications and performance. Customers may therefore not buy components or products from an external manufacturer such as us. This could have an adverse impact on our ability to sell our products and our revenues.

**We have a limited order backlog. If revenue levels for any quarter fall below our expectations, our results of operations will be adversely affected.**

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

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

**equipment by these end-users.**

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

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

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

Our principal competitors in the area of analog media gateways (2 to 24 ports) for access and enterprise are Grandstream, Natex, Iskratel, Zyxel, Adtran, Media5, Cisco, Sangoma, Innovaphone AG, Patton, Dialogic and Edgewater.

In the area of low and mid density digital gateways we face competition from companies such as Sonus Networks, Huawei, Cisco, Dialogic, Genband, Edgewater, Patton, Ferrari and Sangoma.

Our competitors in the area of multi service business routers are companies such as Cisco, Juniper, Adtran, One-Access, Patton, Huawei, HP/3COM and Alcatel-Lucent.

Specifically in the area of enterprise class session border controller technology we compete with ACME Packet (acquired by Oracle), Cisco, SIPera (acquired by Avaya), Sonus Networks, NET (acquired by Sonus Networks), Ingate and Edgewater.

Our competitors in the Microsoft Lync certified gateways, session border controller, , Survivable Branch Appliance and IP Phone markets include NET (acquired by Sonus Networks), Dialogic, Cisco, Ferrari, ACME Packet (acquired by Oracle) Polycom Snom, Yealink, Patton and HP.

Some of our competitors are also customers of our products and technologies.

Our principal competitors in the residential gateway market are Fritzbox, Technicolor, Cisco, ADB Global, Sagemcom, ZyXEL, Netgear, Bewan (Pace), Huawei and ZTE .

Our principal competitors in the sale of signal processing chips are Broadcom, Octasic and Mindspeed. Other indirect competition is arriving from the integration of VoIP functionality into processors (running VoIP signal processing on generic ARM/MIPS cores), thus decreasing the need for dedicated signal processing chips in the VoIP product. Examples of such manufacturers are Cavium and Texas Instruments. Our principal competitors in the communications board market are Dialogic, Sangoma and PIKA Technologies.

Our principal competitors in the area of IP Phones are comprised of “best-of-breed” IP phone vendors and end-to-end IP telephony vendors. “Best of breed” IP phone vendors sell standard-based SIP phones that can be integrated into any standards-based IP-PBX or hosted IP telephony system. These competitors include Polycom, HP, Grandstream, Yealink and SNOM. End-to-end IP telephony vendors sell IP phones that only work in their proprietary systems. These competitors include Cisco, Avaya, Alcatel-Lucent, Siemens, Aastra (acquired by Mitel) and NEC.

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

In the future, we may also develop and introduce other products with new or additional telecommunications capabilities or services. As a result, we may compete directly with VoIP companies and other telecommunications and solution infrastructure providers, some of which may be our customers. Additional competitors may include

companies that currently provide communication software products and services. The ability of some of our competitors to bundle other enhanced services or complete solutions with VoIP products could give these competitors an advantage over us.

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

Our product offerings range from media gateway building blocks, such as chips and boards, to media gateways, media servers and session border control products (systems). These products could compete with products offered by our customers. These customers could decide to decrease purchases from us because of this competition. This could result in a material adverse effect on our results of operations.

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

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

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

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

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

In addition, we have engaged several original design manufacturers, or ODMs, based in Asia to design and manufacture some of our products and may engage additional ODMs in the future. Any problems that occur and persist in connection with the delivery, quality, cost of the assembly or testing of our products, as well as the termination of our commercial relationship with an ODM or the discontinuance of the manufacturing of the respective products could have a material adverse effect on our business, financial condition and results of operations.

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

Texas Instruments Incorporated supplies all of the chips for our signal processor product line. Our signal processor line is used both as a product line in its own right and as a key component in our other product lines. Motorola and Cavium Networks manufacture all of the communications and network processors currently used on our embedded communications boards and network products.

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

An unexpected termination of the supply of the chips provided by Texas Instruments or the communications processors supplied by Motorola or Cavium Networks or disruption in their timely delivery would require us to make a large investment in capital and personnel to shift to using chips or signal processors manufactured by other companies and may cause a delay in introducing replacement products. Customers may not accept an alternative product design. Supporting old products or redesigning products may make it more difficult for us to support our products.

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

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

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

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

Our customers expect us to maintain an inventory of products available for purchase off the shelf subsequent to the initial sales cycle for these products. This may require us to incur the costs of manufacturing inventory without having a purchase order for the products. The VoIP industry is subject to rapid technological change and volatile customer demands, which result in a short product commercial life before a product becomes obsolete. If we are unable to sell products that are produced to hold in inventory, we will need to write-off all or a part of the inventory value of these products. Write-offs could adversely affect our operating results and financial condition. We wrote off inventory in an aggregate amount of, \$2.3 million in 2012 \$1.7 million in 2013 and \$82,000 in 2014. We have incurred write-offs as a result of slow moving items, excess inventories, discontinued products and products with market prices lower than cost.

**The right of our customers to return products and their right to exchange products may affect our ability to recognize revenues which could adversely affect the results of our operations.**

Some of our customers expect us to permit them to return some or all of the products they purchase from us. If we contractually agree to allow a customer to return products, the customer may be entitled to a refund for the returned products or to receive a credit for the purchase of replacement products. If we agree to this type of contractual obligation, it could affect our ability to recognize revenues. In addition, if we are not able to resell any products that are returned, we would have to write off this inventory. This could adversely affect our results of operations.

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

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

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

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

Our success and ability to compete depend in part upon protecting our proprietary technology. We rely on a combination of patent, trade secret, copyright and trademark laws, nondisclosure and other contractual agreements and technical measures to protect our proprietary rights. These agreements and measures may not be sufficient to protect our technology from third-party infringement, or to protect us from the claims of others.



Enforcement of intellectual property rights may be expensive and may divert attention of management and of research and development personnel away from our business. Intellectual property litigation could also call into question the ownership or scope of rights owned by us. We believe that at least one of our patents may cover technology related to the ITU G.723.1 standard. Because of our involvement in the standard setting process, we may be required to license certain of our patents on a reasonable and non-discriminatory basis to a current or future competitor, to the extent required to carry out the G.723.1 standard. Additionally, our products may be manufactured, sold, or used in countries that provide less protection to intellectual property than that provided under U.S. or Israeli laws or where we do not hold relevant intellectual property rights.

We believe that the frequency of third-party intellectual claims is increasing, as patent holders, including entities that are not in our industry and that purchase patents as an investment or to monetize such rights by obtaining royalties, use infringement assertions as a competitive tactic and a source of additional revenue. Any intellectual property claims against us, even if without merit, could cost us a significant amount of money to defend and divert management's attention away from our business. We may not be able to secure a license for technology that is used in our products and we may face injunctive proceedings that prevent distribution and sale of our products even prior to any dispute being concluded. These proceedings may also have a deterrent effect on purchases by customers, who may be unsure about our ability to continue to supply their requirements. We may be forced to repurchase our products and compensate customers that have purchased such infringing products. We may be forced to redesign the product so that it becomes non-infringing, which may have an adverse impact on the results of our operations.

In addition, claims alleging that the development, use, or sale of our products infringes third parties' intellectual property rights may be directed either at us or at our direct or indirect customers. We may be required to indemnify such customers against claims made against them. We may be required to indemnify them even if we believe that the claim of infringement is without merit.

**Multiple patent holders in our industry may result in increased licensing costs.**

There are a number of companies besides us that hold patents for various aspects of the technology incorporated in our industry's standards and our products. We expect that patent enforcement will be given high priority by companies seeking to gain competitive advantages or additional revenues. We have been sued a number of times in recent years for alleged patent infringement. The holders of patents may take the position that we are required to obtain a license from them. We cannot be certain that we would be able to negotiate a license agreement at an acceptable price or at all. Our results of operations could be adversely affected by the payment of any additional licensing costs or if we are prevented from manufacturing or selling a product.

**Changes in governmental regulations in the United States or other countries could slow the growth of the VoIP telephony market and reduce the demand for our customers' products, which, in turn, could reduce the demand for our products.**

VoIP and other services are not currently subject to all of the same regulations that apply to traditional telephony. Nevertheless, it is possible that foreign or U.S. federal or state legislatures may seek to impose increased fees and administrative burdens on VoIP, data, and video providers. The FCC requires VoIP service providers to meet various emergency service requirements relating to delivery of 911 calls, known as E911, and to accommodate law enforcement interception or wiretapping requirements, such as the Communications Assistance for Law Enforcement Act, or CALEA. In addition, the FCC may seek to impose other traditional telephony requirements such as disability access requirements, consumer protection requirements, number assignment and portability requirements, and other obligations, including additional obligations regarding E911 and CALEA. The cost of complying with FCC regulations could increase the cost of providing Internet phone service which could result in slower growth and decreased profitability for this industry, which would adversely affect our business.

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

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

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

**We are subject to regulations that require us to use components based on environmentally friendly materials. We may be subject to various regulations relating to management and disposal of waste with respect to electronic equipment. Compliance with these regulations has increased our costs. Failure to comply with these regulations could materially adversely affect our results of operations.**

We are subject to an increasing number of telecommunications industry regulations requiring the use of environmentally-friendly materials in telecommunications equipment. For example, pursuant to a European Community directive, telecom equipment suppliers are required to stop using specified materials that are not environmentally friendly. In addition, telecom equipment suppliers that take advantage of an exemption with respect to the use of lead in solders are required by this directive to eliminate the lead in solders from their products by the time set forth by the European Community regulations. This exemption has been extended by the authorities. Some of our customers may also require products that meet higher standards than those required by the directive, such as complete removal of additional harmful substances from our products. We are dependent on our suppliers for components and sub-system modules, such as semiconductors and purchased assemblies and goods, to comply with these requirements. This may harm our ability to sell our products in regions or to customers that may adopt such directives.

Compliance with these directives, especially with respect to the requirement that products eliminate lead solders, has required us to undertake significant expenses with respect to the re-design of our products. In addition, we may be required to pay higher prices for components that comply with this directive. We may not be able to pass these higher component costs on to our customers. Compliance with these regulations have increased and could continue to increase our product design costs. New designs may also require qualification testing with both customers and government certification boards. We cannot be certain of the reliability of any new designs that utilize non-lead components. While we have not experienced any significant reliability issues as a result of using non-lead components, the incorporation of these new components could adversely affect equipment reliability and durability.

Some of our operations use substances regulated under various federal, state, local and international laws governing the environment, including laws governing the management and disposal of waste with respect to electronic equipment. We could incur substantial costs, including fines and civil or criminal sanctions, if we were to violate or become liable under environmental laws or if our products become non-compliant with environmental laws. We also face increasing complexity in our product design and procurement operations as we adjust to new and future requirements relating to the materials that compose our products. The EU has enacted the Waste Electrical and Electronic Equipment Directive, which makes producers of electrical goods financially responsible for specified collection, recycling, treatment and disposal of past and future covered products. Similar legislation has been or may be enacted in other jurisdictions, including the United States, Canada, Mexico, China and Japan.

Our inability or failure to comply with these regulations could have a material adverse effect on our results of operations. In addition, manufacturers of components that use lead solders may decide to stop manufacturing those components prior to the required compliance date. These actions by manufacturers of components could result in a shortage of components that could adversely affect our business and results of operations.

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

Revenues generated outside of the Americas and Israel represented approximately 42% of our revenues in 2012 42% of our revenues in 2013 and 44% of our revenues in 2014. Part of our strategy is to expand our penetration in existing foreign markets and to enter new foreign markets. Our ability to penetrate some international markets may be limited due to different technical standards, protocols or product requirements in different markets. Expansion of our international business will require significant management attention and financial resources. Our international sales and operations are subject to numerous risks inherent in international business activities, including:

- economic and political instability in foreign countries;

- compliance with foreign laws and regulations;
- different technical standards or product requirements;
- staffing and managing foreign operations;
- foreign currency fluctuations;
- export control issues;
- governmental controls;
- import or currency control restrictions;
- local taxation;
- increased risk of collection; and
- burdens that may be imposed by tariffs and other trade barriers.

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

**The prices of our products may become less competitive due to foreign exchange fluctuations.**

Although we have operations throughout the world, the majority of our revenues and our operating costs in 2014 were denominated in, or linked to, the U.S. dollar. Accordingly, we consider the U.S. dollar to be our functional currency. However, a significant portion of our operating costs in 2014 were incurred in New Israeli Shekels (NIS). During 2014, the NIS depreciated against the U.S. dollar, which resulted in a decrease in the U.S. dollar cost of our operations in Israel. As a result of this differential, from time to time we may experience increases in the costs of our operations outside the United States, as expressed in U.S. dollars. If there is a significant increase in our expenses, we may be required to increase the prices of our products and may be less competitive. Currently, our international sales are denominated primarily in U.S. dollars. Therefore, any devaluation in the local currencies of our customers relative to the U.S. dollar could cause customers to decrease or cancel orders or default on payment.

Our sales to European customers denominated in Euros are increasing. Sales denominated in Euros could make our revenues subject to fluctuation in the Euro/U.S. dollar exchange rate. If the U.S. dollar appreciates against the Euro, we may be required to increase the prices of our products that are denominated in Euros. In 2014, the U.S. dollar appreciated against the Euro, which resulted in an increase in the prices of our products that are denominated in Euros.

**We may be unable to attract sales representatives who will market our products effectively.**

A significant portion of our marketing and sales involves the aid of independent sales representatives that are not under our direct control. We cannot be certain that our current independent sales representatives will continue to distribute our products or that, even if they continue to distribute our products, they will do so successfully. These representatives are not subject to any minimum purchase requirements and can discontinue marketing our products at any time. In addition, these representatives often market products of our competitors. Accordingly, we must compete for the attention and sales efforts of our independent sales representatives.

**Our products could contain defects, which would reduce sales of those products or result in claims against us.**

We develop complex and evolving products. Despite testing by us and our customers, undetected errors or defects may be found in existing or new products. The introduction of products with reliability, quality or compatibility problems could result in reduced revenues, additional costs, increased product returns and difficulty or delays in collecting accounts receivable. The risk is higher with products still in the development stage, where full testing or certification is not yet completed. This could result in, among other things, a delay in recognition or loss of revenues, loss of market share or failure to achieve market acceptance. We could also be subject to material claims by customers that are not covered by our insurance.

**Obtaining certification of our products by national regulators may be time-consuming and expensive. We may be unable to sell our products in markets in which we are unable to obtain certification.**

Our customers may expect us to obtain certificates of compliance with safety and technical standards set by national regulators, especially standards set by U.S. or European regulators. There is no uniform set of standards, and each national regulator may impose and change its own standards. National regulators may also prohibit us from importing products that do not conform to their standards. If we make any change in the design of a product, we are usually required to obtain recertification of the product. The process of certification may be time-consuming and expensive and may affect the length of the sales cycle for a product. If we are unable to obtain certification of a product in a market, we may be unable to sell the product in that market.

**We depend on a limited number of key personnel who would be difficult to replace.**

Because our products are complex and our market is evolving, the success of our business depends in large part upon the continuing contributions of our management and key personnel. Specifically, we rely heavily on the services of Shabtai Adlersberg, our Chief Executive Officer and President, and Lior Aldema, our Chief Operating Officer and Head of Global Sales. If our Chief Executive Officer or our Chief Operating Officer are unable or unwilling to continue with us, our results of operations could be materially and adversely affected. We do not carry key person insurance for our key personnel.

The success of our business also depends upon our continuing ability to attract and retain other highly-qualified management, technical, sales and marketing personnel. We need highly-qualified technical personnel who are capable of developing technologies and products and providing the technical support required by our customers. We experience competitive pressure with respect to retaining and hiring employees in the high technology sector in Israel. If we fail to hire and retain skilled employees, our business may be adversely affected.

**If we do not manage our operations effectively, our results of operations could be adversely affected.**

We have actively expanded our operations in the past and may continue to expand them in the future. This expansion has required, and may continue to require, the application of managerial, operational and financial resources. We cannot be sure that we will continue to expand, or that we will be able to expand our operations successfully. In particular, our business requires us to focus on multiple markets, including the VoIP, wireline, cable, enterprise unified communications and wireless markets. In addition, we work simultaneously with a number of large OEMs and network equipment providers each of which may have different requirements for the products that we sell to them. We may not have sufficient personnel, or may be unable to devote this personnel when needed, to address the requirements of these markets and customers. If we are unable to manage our operations effectively, our revenues may not increase, our cost of operations may rise and our results of operations may be adversely affected.

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

**The growth in our product portfolio means that we have to service and support more products. This may result in an increase in our expenses and an adverse effect on our results of operations.**

The size of our product portfolio has increased and continues to increase. As a result, we are required to provide to our customers sales support. Customers have requested that we provide a contractual commitment to support a product for a specified period of time. This period of time may exceed the working life of the product or extend past the period of time that we may intend to manufacture or support a product. We are dependent on our suppliers for the components (hardware and software) needed to provide support and may be unable to secure the components necessary to satisfy our service commitments. We do not have long-term contracts with our suppliers, and they may not be obligated to provide us with products or services for any specified period of time. We may need to purchase an inventory of replacement components and parts in advance in order to try to provide for their availability when needed. This could result in an increased risk of write-offs with respect to our replacement component inventory to the extent that we cannot accurately predict our future requirements under our customer service contracts. If any of our component suppliers cease production, cease operations or refuse or fail to make timely delivery of orders, we may not be able to meet our contractual commitments for product support. We may be required to supply enhanced components or parts as substitutes if the original versions are no longer available. Product support may be costly and any extra service revenues may not cover the hardware and software costs associated with providing long-term support.

**Terrorist attacks, or the threat of such attacks, may negatively impact the global economy which may materially adversely affect our business, financial condition and results of operation and may cause our share price to decline.**



Financial, political, economic and other uncertainties following terrorist attacks throughout the world may negatively impact the global economy. As a result, many of our customers and potential customers have become much more cautious in setting their capital expenditure budgets, thereby restricting their telecommunications procurement. Uncertainties related to the threat of terrorism have had a negative effect on global economy, causing businesses to continue slowing spending on telecommunications products and services and further lengthen already long sales cycles. Any escalation of these threats or similar future events may disrupt our operations or those of our customers, distributors and suppliers, which could adversely affect our business, financial condition and results of operations.

**We are subject to taxation in several countries.**

Because we operate in several countries, we are subject to taxation in multiple jurisdictions. We are required to report to and are subject to local tax authorities in the countries in which we operate. In addition, our income that is derived from sales to customers in one country might also be subject to taxation in other countries. We cannot be sure of the amount of tax we may become obligated to pay in the countries in which we operate. The tax authorities in the countries in which we operate may not agree with our tax position. Our tax benefits from carry forward losses and other tax planning benefits such as Israeli approved enterprise programs, may prove to be insufficient due to Israeli tax limitations, or may prove to be insufficient to offset tax liabilities from foreign tax authorities. Foreign tax authorities may also use our gross profit or our revenues in each territory as the basis for determining our income tax, and our operating expenses might not be considered for related tax calculations, which could adversely affect our results of operations.

*Risks Related to Operations in Israel*

**Conditions in Israel affect our operations and may limit our ability to produce and sell our products and instability in the Middle East may adversely affect us.**

We are incorporated under the laws of the State of Israel, and our principal executive offices and principal research and development facilities are located in the State of Israel. Political, economic and military conditions in Israel directly affect our operations. There has been an increase in unrest and terrorist activity in Israel, which has continued with varying levels of severity for many years through the current period of time. This has led to ongoing hostilities between Israel, the Palestinian Authority, other groups in the West Bank and Gaza Strip, and the northern border of Lebanon, such as the hostilities along Israel's border with the Gaza Strip and the missiles fired from the Gaza Strip into Israel in 2012 and 2013, as well as during the latest hostilities in the summer of 2014. The future effect of this conflict on the Israeli economy and our operations is unclear. The Israeli-Palestinian conflict may also lead to political instability between Israel and its neighboring countries. Ongoing violence between Israel and the Palestinians, as well as tension between Israel and the neighboring countries, may have a material adverse effect on our business, financial conditions and results of operations.

Recent political events in various countries in the Middle East, such as Syria, Iraq, Iran and Egypt, have weakened the stability of those countries, and have allowed extreme terrorists organizations, such as ISIS, to operate in certain territories in the Middle East. This instability may lead to deterioration of the geo-political conditions in the Middle East. In addition, this instability may affect the global economy and marketplace through changes in oil and gas prices. Our headquarters and research and development facilities are located in the State of Israel. Any events that affect the State of Israel may impact us in unpredictable ways. We have contingent plans for alternative manufacturing and supply sources, but these plans may be insufficient. Should our operations be impacted in a significant way, this may adversely affect the results of our operations.

We cannot predict the effect on us of an increase in these hostilities or any future armed conflict, political instability or violence in the region. Additionally, some of our officers and employees in Israel are obligated to perform annual military reserve duty and are subject to being called for additional active duty under emergency circumstances. Some of our employees live within conflict area territories and may be forced to stay at home instead of reporting to work. We cannot predict the full impact of these conditions on us in the future, particularly if emergency circumstances or an escalation in the political situation occur. If many of our employees are called for active duty, or forced to stay at home, our operations in Israel and our business may be adversely affected.

A number of countries and organizations continue to restrict or ban business with Israel or Israeli companies or companies doing business with Israel or Israeli companies, which may limit our ability to make sales in those countries. In addition, there have been increased efforts by activists to cause companies and consumers to boycott

Israeli goods based on Israeli government policies. Such actions, particularly if they become more widespread, may adversely impact our ability to sell our products.

**We are adversely affected by the changes in the value of the U.S. dollar against the New Israeli Shekel and could be adversely affected by the rate of inflation in Israel.**

We generate most of our revenues in U.S. dollars and, in 2014, a significant portion of our expenses, primarily salaries, related personnel expenses and the leases of our buildings in Israel, were incurred in NIS. We anticipate that a significant portion of our expenses will continue to be denominated in NIS.

Our NIS related costs, as expressed in U.S. dollars, are influenced by the exchange rate between the U.S. dollar and the NIS. During 2012 and 2013, the NIS appreciated against the U.S. dollar, which resulted in a significant increase in the U.S. dollar cost of our operations in Israel. During 2014, the NIS depreciated against the U.S. dollar, which resulted in a decrease in the U.S. dollar cost of our operations in Israel. To the extent the U.S. dollar weakens against the NIS, we could experience an increase in the cost of our operations, which are measured in U.S. dollars in our financial statements, which could adversely affect our results of operations. In addition, in periods in which the U.S. dollar appreciates against the NIS, we bear the risk that the rate of inflation in Israel will exceed the rate of such devaluation of the NIS in relation to the U.S. dollar or that the timing of such devaluations were to lag considerably behind inflation, which will increase our costs as expressed in U.S. dollars.

A decrease in value of the U.S. dollar in relation to the NIS could have the effect of increasing the cost in U.S. dollars of these expenses. Our U.S. dollar-measured results of operations were adversely affected in 2012 and 2013 when the NIS appreciated against the U.S. dollar. This could happen again if the U.S. dollar were to decrease in value against the NIS.

In order to manage the risks imposed by foreign currency exchange rate fluctuations, from time to time, we enter into currency forward and put and call options contracts to hedge some of our foreign currency exposure. We can provide no assurance that our hedging arrangements will be effective. In addition, if we wish to maintain the U.S. dollar-denominated value of our products in non-U.S. markets, devaluation in the local currencies of our customers relative to the U.S. dollar may cause our customers to cancel or decrease orders or default on payment.

Because exchange rates between the NIS and the U.S. dollar fluctuate continuously, exchange rate fluctuations have an impact on our profitability and period-to-period comparisons of our results of operations. In 2014, the value of the U.S. dollar increased in relation to the NIS by 12.0% and the deflation rate in Israel was 0.1%. In 2013, the value of the U.S. dollar decreased in relation to the NIS by 7.0% and the inflation rate in Israel was 1.9%. In 2012, the value of the U.S. dollar decreased in relation to the NIS by 2.3% and the inflation rate in Israel was 1.4%. Our results of operations may be adversely affected in case of a decrease in the value of the U.S. dollar to the NIS.

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

Currently there are four programs under the Israeli Law for the Encouragement of Capital Investments, 1959, or the Investment Law, that entitle us to certain tax benefits. Our facilities in Israel have been granted Approved Enterprise status under the Israeli Law for the Encouragement of Capital Investments, 1959, or the Investment Law under four programs of Approved Enterprise. We have two programs that qualify as Beneficiary Enterprises pursuant to an amendment to the Investment Law that came into effect in April 2005. Among other things, the Investment Law, as amended in 2005, provides tax benefits to both local and foreign investors and simplifies the approval process. Such amendments do not apply to investment programs approved prior to December 31, 2004. Therefore, our Approved Enterprise program is not subject to the provisions of the amendment, but our four Beneficiary Enterprise programs are subject to the amendment.

In order to be eligible for tax benefits under the Investment Law, our Approved Enterprise and Privileged Enterprises must comply with various conditions set forth in the Investment Law and the criteria set forth in the applicable certificate of approval for the Approved Enterprise, as well as periodic reporting obligations. If we fail to meet these requirements, we would be subject to corporate tax in Israel at the regular statutory rate. Additionally, some of these programs and the related tax benefits are available to us for a limited number of years, and these benefits expire from time to time. We could also be required to refund tax benefits, with interest and adjustments for inflation based on the Israeli consumer price index. See Note 15 to our Consolidated Financial Statements for additional information with respect to tax benefits under the Investment Law.

If the Government of Israel discontinues or modifies these programs and potential tax benefits, our business, financial condition and results of operations could be materially and adversely affected.

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

In connection with research and development grants we received from the Office of the Chief Scientist of the Israeli Ministry of Economy, or the OCS, we must pay royalties to the OCS on the revenue derived from the sale of products, technologies and services developed with the grants from the OCS. The terms of the OCS grants and the law pursuant to which grants are made restrict our ability to manufacture products or transfer technologies outside of Israel if OCS grants funded the development of the products or technology, without special approvals from the OCS. Furthermore, the consideration available to our shareholders in a transaction involving the transfer outside of Israel of technology or know-how developed with OCS funding (such as a merger or similar transaction) may be reduced by any amounts that we are required to pay the OCS. These restrictions may limit our ability to enter into agreements for such transactions without OCS approval. We cannot be certain that any approval of the OCS will be obtained on terms that are acceptable to us, or at all.

In order to meet specified conditions in connection with the grants and programs of the OCS, we have made representations to the Government of Israel concerning our Israeli operations. If we fail to meet the conditions related to the grants, including the maintenance of a material presence in Israel, or if there is any material deviation from the representations made by us to the Israeli government, we could be required to refund the grants previously received (together with an adjustment based on the Israeli consumer price index and an interest factor) and would likely be ineligible to receive OCS grants in the future and, in certain cases, may be subject to criminal charges. In addition, manufacturing products outside the State of Israel (as we currently do) increases the rates of royalties to be paid to the OCS. Any inability to receive these grants would result in an increase in our research and development expenses.

In 2014, we recognized a royalty-bearing grant of \$3.9 million from the Government of Israel, through the OCS, for the financing of a portion of our research and development expenditures in Israel. The OCS budget has been subject to reductions, which may affect the availability of funds for these prospective grants and other grants in the future. As a result, we cannot be certain that we will continue to receive grants at the same rate, or at all. In addition, the terms of any future OCS grants may be less favorable than our past grant. As of December 31, 2014, we have a contingent obligation to pay royalties in the amount of approximately \$39.6 million.

**It may be difficult to enforce a U.S. judgment against us, our officers and directors, assert U.S. securities law claims in Israel or serve process on substantially all of our officers and directors.**

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

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

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

**The rights and responsibilities of our shareholders are governed by Israeli law which may differ in some respects from the rights and responsibilities of shareholders of U.S. corporations.**

Since we are incorporated under Israeli law, the rights and responsibilities of our shareholders are governed by our articles of association and Israeli law. These rights and responsibilities differ in some respects from the rights and responsibilities of shareholders in United States corporations. In particular, a shareholder of an Israeli company has a duty to act in good faith and in a customary manner in exercising its rights and performing its obligations towards the company and other shareholders and to refrain from abusing its power in the company, including, among other things, in voting at a general meeting of shareholders on certain matters, such as an amendment to a company's articles of association, an increase of a company's authorized share capital, a merger of a company and approval of related party

transactions that require shareholder approval. In addition, a controlling shareholder or a shareholder who knows that it possesses the power to determine the outcome of a shareholders' vote or to appoint or prevent the appointment of an office holder in a company or has another power with respect to a company, has a duty to act in fairness towards the company. However, Israeli law does not define the substance of this duty of fairness. Some of the parameters and implications of the provisions that govern shareholder behavior have not been clearly determined. These provisions may be interpreted to impose additional obligations and liabilities on our shareholders that are not typically imposed on shareholders of United States corporations.

***Risks Relating to the Ownership of our Ordinary Shares***

**The price of our ordinary shares may fluctuate significantly.**

The market price for our ordinary shares, as well as the prices of shares of other technology companies, has been volatile. Between January 1, 2010 and March 20, 2015, our share price has fluctuated from a low of \$1.20 to a high of \$9.12. The following factors may cause significant fluctuations in the market price of our ordinary shares:

- fluctuations in our quarterly revenues and earnings or those of our competitors;
- shortfalls in our operating results compared to levels forecast by securities analysts or by us;
- announcements concerning us, our competitors or telephone companies;
- announcements of technological innovations;

- the introduction of new products;
- changes in product price policies involving us or our competitors;
- market conditions in the industry;
- integration of acquired businesses, technologies or joint ventures with our products and operations;
- the conditions of the securities markets, particularly in the technology and Israeli sectors; and
- political, economic and other developments in the State of Israel and worldwide.

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

**Our quarterly results of operations have fluctuated in the past and we expect these fluctuations to continue. Fluctuations in our results of operations may disappoint investors and result in a decline in our share price.**

We have experienced and expect to continue to experience significant fluctuations in our quarterly results of operations. In some periods, our operating results may be below public expectations or below revenue levels and operating results reached in prior quarters or in the corresponding quarters of the previous year. If this occurs, the market price of our ordinary shares could decline.

The following factors have affected our quarterly results of operations in the past and are likely to affect our quarterly results of operations in the future:

- size, timing and pricing of orders, including order deferrals and delayed shipments;
- launching of new product generations;
- length of approval processes or market testing;



- technological changes in the telecommunications industry;
- competitive pricing pressures;
- the timing and approval of government research and development grants;
- accuracy of telecommunication company, distributor and original equipment manufacturer forecasts of their customers' demands;
- changes in our operating expenses;
- disruption in our sources of supply;
- temporary or permanent reduction in purchases by our significant customers; and
- general economic conditions.

Therefore, the results of any past periods may not be relied upon as an indication of our future performance.

**Our actual financial results might vary from our publicly disclosed financial forecasts.**

From time to time, we publicly disclose financial forecasts. Our forecasts reflect numerous assumptions concerning our expected performance, as well as other factors which are beyond our control and which might not turn out to be correct. As a result, variations from our forecasts could be material. Our financial results are subject to numerous risks and uncertainties, including those identified throughout this "Risk Factors" section and elsewhere in this Annual Report. If our actual financial results are worse than our financial forecasts, the price of our ordinary shares may decline.

**It is our policy that we will generally not provide quarterly forecasts of the results of our operations. This policy could affect the willingness of analysts to provide research with respect to our ordinary shares which could affect the trading market for our ordinary shares.**

It is our policy that we will generally not provide quarterly forecasts of the results of our operations. This could result in the reduction of research analysts who cover our ordinary shares. Any reduction in research coverage could affect the willingness of investors, particularly institutional investors, to invest in our shares which could affect the trading market for our ordinary shares and the price at which our ordinary shares are traded.

**As a foreign private issuer whose shares are listed on NASDAQ, we follow certain home country corporate governance practices instead of certain NASDAQ requirements.**

As a foreign private issuer whose shares are listed on NASDAQ, we are permitted to follow certain home country corporate governance practices instead of certain requirements contained in the NASDAQ listing rules. We do not comply with the NASDAQ requirement that we obtain shareholder approval for certain dilutive events, such as for the establishment or amendment of certain equity based compensation plans. Instead, we follow Israeli law and practice which permits the establishment or amendment of certain equity based compensation plans to be approved by our board of directors without the need for a shareholder vote, unless such arrangements are for the compensation of directors or the chief executive officer, in which case they also require compensation committee and shareholder approval.

As a foreign private issuer listed on the NASDAQ, we may also elect in the future to follow home country practice with regard to, among other things, director nomination, composition of the board of directors and quorum at shareholders' meetings, as well as not obtain shareholder approval for certain dilutive events.

Accordingly, our shareholders may not be afforded the same protection as provided under NASDAQ's corporate governance rules.

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

Our ordinary shares are listed for trading on NASDAQ and on the Tel Aviv Stock Exchange ("TASE"). Trading in our ordinary shares on these markets is made in different currencies (U.S. dollars on NASDAQ and New Israeli Shekels on TASE), and at different times (resulting from different time zones, different trading days and different public holidays in the United States and Israel). Actual trading volume on the TASE is generally lower than trading volume

on NASDAQ, and as such could be subject to higher volatility. The trading prices of our ordinary shares on these two markets often differ resulting from the factors described above, as well as differences in exchange rates. Any decrease in the trading price of our ordinary shares on one of these markets could cause a decrease in the trading price of our ordinary shares on the other market.

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

We have never declared or paid cash dividends on our ordinary shares and do not plan to pay any cash dividends in the near future.

**U.S. shareholders face certain income tax risks in connection with their acquisition, ownership and disposition of our ordinary shares. In any tax year, we could be deemed a passive foreign investment company, which could result in adverse U.S. federal income tax consequences for U.S. shareholders.**

Based on the composition of our gross income, the composition and value of our gross assets and the amounts of our liabilities for each taxable year from 2004 through 2014, we do not believe that we were a passive foreign investment company, or PFIC, for U.S. federal income tax purposes during any of such tax years. It is likely, however, that we were a PFIC in each of 2001, 2002 and 2003. There can be no assurance that we will not become a PFIC in any future tax year in which, for example, the value of our assets, as measured by the public market valuation of our ordinary shares, declines in relation to the value of our passive assets (generally, cash, cash equivalents and marketable securities). If we are a PFIC for any tax year, U.S. shareholders who own our ordinary shares during such year may be subject to increased U.S. federal income tax liabilities and reporting requirements for such year and succeeding years, even if we cease to be a PFIC in such succeeding years. A U.S. holder of our ordinary shares will be required to file an information return containing certain information required by the U.S. Internal Revenue Service for each year in which we are treated as a PFIC with respect to such holder.

We urge U.S. holders of our ordinary shares to carefully review Item 10E. – “Taxation - U.S. Federal Income Tax Considerations” in this Annual Report and to consult their own tax advisors with respect to the U.S. federal income tax risks related to owning and disposing of our ordinary shares and the consequences of PFIC status.

**We are subject to ongoing costs and risks associated with complying with extensive corporate governance and disclosure requirements.**

As a foreign private issuer subject to U.S. federal securities laws, we spend a significant amount of management time and resources to comply with laws, regulations and standards relating to corporate governance and public disclosure, including the Sarbanes-Oxley Act of 2002, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, United States Securities and Exchange Commission (“SEC”) regulations and NASDAQ rules. While we have developed and instituted corporate compliance programs and continue to update our programs in response to newly implemented or changing regulatory requirements, we cannot provide assurance that we are or will be in compliance with all potentially applicable corporate regulations. If we fail to comply with any of these regulations, we could be subject to a range of regulatory actions, fines or other sanctions or litigation. In connection with our compliance with the internal control provisions of Section 404 and the other applicable provisions of the Sarbanes-Oxley Act, our management and other personnel devote a substantial amount of time, and may need to hire additional accounting and financial staff, to assure that we comply with these requirements. The additional management attention and costs relating to compliance with the Sarbanes-Oxley Act, the Dodd-Frank Act and other corporate governance requirements could materially and adversely affect our financial results.

The internal control over financial reporting required by Section 404 of the Sarbanes-Oxley Act may not prevent or detect misstatements because of certain of its limitations, including the possibility of human error, the circumvention or overriding of controls, or fraud. As a result, even effective internal controls may not provide reasonable assurances with respect to the preparation and presentation of financial statements. We cannot provide assurance that, in the future, our management will not find a material weakness in connection with its annual review of our internal control over financial reporting pursuant to Section 404 of the Sarbanes-Oxley Act. We also cannot provide assurance that we could correct any such weakness to allow our management to assess the effectiveness of our internal control over financial reporting as of the end of our fiscal year in time to enable our independent registered public accounting firm to state that such assessment will have been fairly stated in our Annual Report on Form 20-F or state that we have maintained effective internal control over financial reporting as of the end of our fiscal year. Discovery and disclosure of a material weakness in our internal control over financial reporting could have a material impact on our financial statements and could cause our stock price to decline.

**The conflict minerals disclosure rules in the United States are complex and compliance with the rules could be difficult.**

We are subject to SEC disclosure obligations relating to our use of so-called “conflict minerals”—columbite-tantalite, cassiterite (tin), wolframite (tungsten) and gold. These minerals are present in a significant number of our products. The disclosure obligations are complex, and there is little formal guidance with respect to their application. Under the rules as adopted, our first report under these disclosure obligations was filed with the SEC in May 2014. Unless a legal challenge to the validity of these rules is upheld, this report is required to be filed on an annual basis by May of each year.

Although we expect to be able to file the required report on time if required to do so, the preparation of our report is dependent upon the implementation and operation of our systems and processes and information supplied by our suppliers of products that contain, or potentially contain, conflict minerals. To the extent that the information that we receive from our suppliers is inaccurate or inadequate or our processes in obtaining that information do not fulfill the SEC's requirements, we could face both reputational and SEC enforcement risks. In addition, our efforts to comply with the disclosure rules and to otherwise implement conflict-free sourcing policies could result in changes to our supply chain that could disrupt existing supply sources or cause more uncertainty with respect to our supply chain.

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

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

AudioCodes Ltd. was incorporated in 1992 under the laws of the State of Israel. Our principal executive offices are located at 1 Hayarden Street, Airport City, Lod, 7019900 Israel. Our telephone number is +972-3-976-4000. Our agent in the United States is AudioCodes Inc., 27 World's Fair Drive, Somerset, New Jersey 08873.

##### *Major Developments since January 1, 2014*

In March 2014, we sold in a public offering 4,025,000 of our ordinary shares, including 525,000 shares sold pursuant to the exercise in full of an over-allotment option granted to the underwriters, at a purchase price of \$8.00 per share. We realized from this offering net proceeds of approximately \$29.7 million, after deducting underwriting commissions and other offering expenses.

In April 2014, the Israeli Office of the Chief Scientist (OCS) approved a three-year program (2014-2016) for approximately NIS100 million (equal to approximately \$25.7 million based on the exchange rate in effect as of December 31, 2014) to enable us to establish an advanced innovative research and development center for cloud computing technologies and Unified Communications. In May 2014, the research and development center was established. The new research and development center is expected to increase its staff to 100 engineers by 2016. We expect that a significant portion of the cost of this project will be reimbursed to us through grants from the OCS pursuant to this program. The grants are subject to conditions relating to grants by the OCS. Funding for the whole term of the program is subject to the continued review and approval of the progress of the project by the OCS.

Since January 1, 2014, AudioCodes has invested in the following key product lines and solutions to address the following market segments:

*One Voice for Enterprise Mobility:* We keep expanding our One Voice offering with a cloud-based enterprise mobility solution suite for business customers. This solution includes mobile clients coupled with a delivery platform for secure connectivity, management and monitoring and enables service providers to offer their business customers mobile communications services over data networks while reducing the total cost of ownership. MobilityPlus Business Edition (BE) and VocaNOM is based on home-grown technologies, which include a proven Voice Engine and connectivity to social networks and over public cloud architecture. This application leverages the MobilityPlus Consumer Edition (CE) formerly known as VMAS. The MobilityPlus BE enables employees of a customer to communicate with their colleagues seamlessly from their smartphone devices by initiating VoIP calls over Wi-Fi and cellular data networks. Connecting with the enterprise's PBX or IP-PBX, the application allows enterprises to reduce their cellular communications charges and streamline mobile collaboration between their employees through features such as advanced dialing, smart contacts, enhanced presence, instant messaging and one-number reach. MobilityPlus BE supports high-definition voice quality and leverages AudioCodes session border controller products and core voice engine technologies to provide end-to-end HD VoIP. Deployed as an add-on to the existing IP-PBX or PBXs of a business customer, the solution reduces the need for costly replacement of equipment.

*VocaNOM Speech-driven Dialing for Enterprises:* During 2014, AudioCodes utilized cloud technology in order to expand service reach and customer scope, significantly reducing product cost and allowing an attractive offering to SMBs as well as large-scale enterprises. In parallel to the cloud migration efforts, AudioCodes started developing the VocaNOM mobile application as part of a business marketing strategy. Four languages in addition to Hebrew were developed for the VocaNOM service in order to enable speech recognition in English (U.S.), Spanish, Russian and German.

*Extended Connectivity, Survivability and Applications for Microsoft Lync Deployments:* During 2014, AudioCodes expanded its portfolio specifically designed for Microsoft Lync, Exchange online and Office 365. We launched One Box 365, One Box 365 Pro edition and the One Box 365 Enterprise edition product family that provide an all-in-one Lync appliance solution. OneBox 365 targets Office 365 customers who seek to add enterprise voice capabilities and PSTN connectivity. OneBox 365 significantly reduces the time it takes to install a full Lync solution and simplifies the day to day maintenance operations of Lync deployments. In addition, we qualified two new Lync phone models, HD430 and HD440, which broaden our Lync phone offering aimed at higher end users. AudioCodes'

Interactive Voice Response (IVR) application for Lync was certified by Microsoft. AudioCodes IVR provides large, multi-branch organizations with a localized per branch IVR implementation. Additionally, in 2014, AudioCodes released a version of our Session Experience Manager (SEM) for Lync, which integrates with Microsoft Lync to provide IT managers with a complete end to end enterprise voice quality monitoring system. Finally, a new cost effective Lync resiliency solution called “One Voice Resiliency” (OVR) was developed and released. OVR targets micro branches (up to 50 users) in need of high voice service availability. The OVR solution is based on AudioCodes Mediant SBCs and provides protection against WAN failures.

*Extended Connectivity and Survivability for Hosted Services:* In 2014, AudioCodes continued to evolve its demarcation device offerings for hosted services. The demarcation device is located at the enterprise premise and provides business continuity, smooth migration from on-premises PBX, and quality monitoring for hosted services. Zero touch configuration mechanisms were added to facilitate smooth deployment of the demarcation device. In addition to the demarcation device, we expanded our Access SBC offering for service provider networks. The main task of our Access SBC is to protect the service provider’s network. In addition, it monitors and enforces voice quality and normalizes SIP traffic. We launched the Mediant 9000 as our premier Access SBC and expanded its capacity up to 24,000 concurrent sessions. During 2014, our MSBR family, Mediant 9000 SBC and IP Phones obtained certifications from Broadsoft, assuring hosted service providers relying on the Broadsoft solution seamless interoperability with AudioCodes CPE and Access SBC portfolio.

*Software Enterprise Session Border Controller:* There has been a move to Network Function Virtualization (NFV) in the service provider space. Service providers seek to harmonize their infrastructure on common off the shelf servers, as opposed to proprietary hardware. In 2014, AudioCodes continued to invest in NFV by adding more capabilities to its software SBC product line. This includes kernel Based Virtual Machine, or KVM, hypervisor support and integration with orchestration frameworks. We enhanced the performance of our software SBCs. The capacity of our Server Edition SBC, which is a bare blade SBC running on Commercial off the shelf, or COTS, servers, increased from 16,000 to 24,000 sessions. The capacity of our Virtualized Edition SBC increased from 2,000 to 6,000 sessions.

*IP Phones for Microsoft Lync, Contact Centers, and hosted environment (BroadSoft):* During 2014, we added advanced capabilities to our 400HD Lync compatible IP phones, including capabilities for integration with Lync PC client and security enhancements. Our 400HD phones received BroadSoft certification. In addition, we added specific capabilities such as Shared Line Appearance, Network Conference and Resiliency. For contact center markets and webRTC environments, we added OPUS codec support for an end to end high definition voice quality experience. Our IP Phones were further enhanced for Genesys contact centers by adding capabilities such as business continuity and support for call distribution groups.

*Multi-Service-Business-Routers:* A new cost efficient single PRI MSBR was added to our portfolio, based on the Mediant 500. The Mediant 500 single PRI configuration joins the Mediant 800 two PRI device. We have also developed a new IPv6 routing functionality needed by most service providers. IPv6 routing allows interworking with IPv6-based MPLS backbones as a CPE router. In addition, we added support for TR-69 provisioning for service providers that use it for their residential customers and prefer to stay with the same protocol for their enterprise customers as well. Web configuration was also added to allow the service provider's end customer some basic provisioning capabilities.

*One Voice Operations Centre.* Our One Voice operations center ("OVOC") offers management applications for large scale cloud or premise-based unified communications deployments. It monitors, manages and operates AudioCodes' session border controllers (SBC), media gateways, Microsoft survivable branch appliances (SBA), multi-service business routers (MSBR) and IP phones. During 2014 we invested in the following modules and functionalities of OVOC:

*Session Experience Manager (SEM):* In 2014, we launched "SEM for Lync". This new SEM specifically targets Lync customers. It provides an in depth view of the entire enterprise network voice quality. SEM measures the quality across SIP trunks as well as on individual calls, including Lync to Lync calls. To do so, SEM for Lync integrates with Lync Monitoring server and Active Directory. By using SEM for Lync, an enterprise IT can be alerted to problems, root cause analyze these problems and identify network bottlenecks.

*Element Management System (EMS):* In 2014 we launched EMS for 400 HD IP Phones. The EMS IP Phones management system consists of a web based interface which is launched from the EMS generic client. EMS for IP Phones provide day one management operations, such as automatic provisioning and firmware download, user management, comprehensive configuration file templates and mass operations. The EMS for IP Phones day by day operation consists of real time dashboard showing for each end user the status of the IP Phone as well as showing and forwarding IP Phones alarms.



***Principal Capital Expenditures***

We have made and expect to continue to make capital expenditures in connection with expansion of our production capacity. The table below sets forth our principal capital expenditures incurred for the periods indicated (amounts in thousands):

|                                    | <b>Year Ended</b>  |         |         |
|------------------------------------|--------------------|---------|---------|
|                                    | <b>December 31</b> |         |         |
|                                    | 2012               | 2013    | 2014    |
| Computers and peripheral equipment | \$1,619            | \$1,478 | \$1,775 |
| Office furniture and equipment     | 353                | 101     | 108     |
| Leasehold improvements             | 34                 | 7       | 655     |
| Total                              | \$2,006            | \$1,586 | \$2,538 |

## *B. BUSINESS OVERVIEW*

### **Introduction**

We design, develop and sell products and services for voice and data over packet networks. In broad terms, voice over packet, or VoP, networks consist of key network elements such as software switches, application servers, IP phones, media gateways and session border controllers (SBC). Our products primarily provide the media gateway and SBC element in the network, as well as voice over Internet protocol, or VoIP, end-points such as IP Phones and VoIP mobile clients. Multi-service business routers integrate media gateway functionality with data routing and network access. The media gateways connect legacy and IP networks. They essentially receive the legacy format of communication and convert it to an IP communication and vice versa. Typically, media gateways utilize compression algorithms to compress the amount of information and reduce the amount of bandwidth required to convey the information (for example, a voice communication). With the industry migration to an end-to-end IP network, media gateways evolved into SBC, now also connect between different VoIP networks, providing security, interoperability, resiliency and voice quality functionality.

Voice over IP gateway and SBC equipment can be generally segmented into three classes: service providers' gateways and SBCs for use in central office facilities, enterprise gateways and SBCs for use by corporations and in small offices, and residential gateways for use in homes. In addition to the gateway element, which connects legacy voice equipment to an IP network, there is growth in native VoIP end user equipment, primarily including IP phones, soft phones and VoIP mobile clients, running on desktop PCs or portable devices such as cellular phones, smart phones, tablets, laptops, and other devices that have wireless IP connectivity running over WiFi or cellular data networks.

The need to re-route voice and fax traffic from the traditional circuit-switched networks onto packet networks has led to the development of interface equipment between the two networks, generally referred to as media gateways. The processing of voice and fax signals in gateway and access equipment is done according to industry-wide standards. These standards are needed to ensure that all traditional telephony traffic is seamlessly switched and routed over the packet network and vice versa. The industry migration into a network that is utilizing IP end-to-end has also created a need for a new functionality to mediate between different VoIP networks. This includes protocol translation as well as security services, business continuity and voice quality enforcement and is provided by stand-alone SBCs as well as Enterprise SBC (E-SBC) functionality integrated into the gateway.

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

Packet networks offer a number of advantages over circuit-switched networks. Rather than requiring a dedicated circuit for each individual call, packet networks commingle packets of voice, fax and data from several communications sources on a single physical link. This provides superior utilization of network resources, especially in dealing with information sources with bursts of information followed by periods of silence. This superior utilization means that more traffic can be carried over the same amount of network resources.

The integration of voice and data communications makes possible an enrichment of services and an entire range of new, value-added applications, such as unified communications and voice-enabled web sites. In addition, voice traffic over packet networks is usually compressed to provide a further reduction in the use of or demand for bandwidth. Another recent trend in the VoIP environment, referred to as High Definition VoIP, or HD VoIP, enables the improvement of voice quality. The adoption of both VoIP technology and broadband networks has enabled the development and deployment of high-quality voice coding algorithms that make communication more efficient, effective and natural. HD VoIP allows carriers to differentiate their services with an improved audio experience, with the goal of creating customer loyalty and affinity. It also enables enterprises to provide better, clearer voice services for their employees, which we believe makes them more productive and makes it easier to work across different cultures and accents.

As customers integrate more services into their IP network, they tend to use integrated products that provide all the services they need in one box. Multi-service business routers, or MSBRs, combine all the capabilities of media gateways and session border controllers with the support of native data switching and routing. The MSBR enables enterprise customers to connect their branch office networks into the corporate headquarters, and service providers to connect their customers into their network data and voice services. Some MSBRs also include an integrated server which can run off-the-shelf applications such as unified communications. This combination enables system integrators and service providers to provide a fully integrated solution for small/medium businesses and enterprise branches, or SMB/E, that includes the voice and data infrastructure and the application in one device.

Moving into the VoIP world, enterprise and service providers have started to use phone devices that inherently produce packets instead of legacy voice, called IP phones. The IP phone is an advanced telephone that connects into the network using VoIP over Ethernet instead of using analog TDM interfaces. Most enterprise telephony systems sold today use IP phones, as well as service providers managed services such as IP Centrex.

In addition to wireline IP telephony, mobile networks have started to use VoIP as well. Mobile VoIP clients, running on smart-phones enable cost effective mobile roaming and allow Internet telephony service providers, or ITSPs, to enter the mobile space. These include mobile VoIP clients for leading smartphones operating systems, such as iOS, Android, Symbian and Windows phones.

## **Industry Background**

### *Market Trends*

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

*New technologies.* The increase of speed and the proliferation of broadband access technologies alongside related technologies, such as new high definition voice compression algorithms, quality of service mechanisms and security and encryption algorithms and protocols, have enabled delivery of voice over packet to residential and enterprise customers with more reliability, higher quality and greater security. Examples of these broadband access technologies include: third generation cellular, WiMax, LTE, WiFi, data over cable, digital subscriber line technologies and fiber networks (FTTx). Packet technologies enable delivery of real time and non-real time services by different service providers that do not necessarily own the access network or the part of the network through which the subscriber accesses the network. This allows for the growth of alternative or virtual service providers that do not own an access network.

*Competition by alternative service providers with incumbent and traditional service providers.* Competition by alternative service providers is causing incumbents to deploy advanced broadband access technologies and increase their competitiveness by offering bundled services to their subscribers, such as voice, video and data, and online gaming. In addition, the emergence of wide band vocoders that use a higher sampling rate than used in legacy time domain multiplexing, or TDM, networks allows service providers to offer higher quality voice and music over their newly established IP network.

*Increasing need for peering between VoIP networks.* Service providers and enterprises are increasingly building out VoIP networks. As a result, there is an increasing need to connect between two VoIP networks. In order to

interconnect between two VoIP networks, service providers and enterprises need session border controllers to provide connectivity and security.

*Unified communications in the enterprise.* With the move to VoIP and the network integration between voice and data based on Ethernet and IP, enterprises can easily move into a unified communications network. Unified communications networks integrate all means of communications into a single experience, providing on line (voice, data, instant messaging) and off line (voice mail, email and fax) integration into the same device. The devices can be PCs, desktop phones or mobile smartphones and tablets.

*Mobility.* Mobile smartphones have become popular among business professionals as well as the general public. Smartphones, running advanced operating systems such as Symbian, Windows phone, Android and iOS, include high CPU power, large storage space, integrated WiFi and cellular data, as well as the ability to run high performance multimedia applications. Mobile VoIP is one of these applications, allowing cost-effective roaming for a service provider's customers and enterprise mobility services.

*WebRTC.* WebRTC is a free, open project that provides WEB browsers and mobile applications with Real-Time Communications (RTC) capabilities via simple Application Programming Interface, or APIs. The WebRTC components have been optimized to best serve this purpose. WebRTC enables rich, high quality RTC applications to be developed for the standard WEB browser, mobile platforms, and Internet of Things (IoT) devices, and allows them all to communicate via a common set of protocols. The WebRTC initiative is a project supported by Google, Mozilla and Opera, among others. Over 300 vendors are now active in the market. WebRTC support is available by default mainstream web browsers like Chrome, Opera and Firefox, and also in mobile, WebRTC is making a major impact in the RTC world as it does not require a user to download a specific application and also makes it easy for WEB developers to quickly develop RTC services without requiring specific RTC knowhow. To enable connecting SIP based communication services (e.g., unified communications or contact centers) with WebRTC, a WebRTC gateway is required to mediate between the incompatible media and signaling of the different systems. WebRTC gateway functionality may be standalone or incorporated into an SBC.

*Network Function Virtualization (NFV).* NFV is a Transition of network infrastructure services to run on virtualized computing platforms using cloud technology to provide network functionality. The significance of software only products for the telecommunications market is increasing as operators and enterprises are seeking to move away from dedicated hardware platforms to common generic computing platforms that are enabling data centers. NFV aims to leverage standard IT virtualization technology to consolidate potentially all network functions (including SBCs) onto industry standard high volume servers, switches and storage, which could be located in datacenters, network nodes and on end user premises. There are a number of challenges that NFV needs to address, including performance, scale, resilience, management and automation. These and other technical challenges are being addressed in a network operator-led Industry Specification Group (ISG) under the auspices of ETSI, an industry standards setting body.

*Hosted Business Services.* The growth of Hosted Business Services is widely affecting the communications world. Enterprises are adopting hosted and cloud services. Hosted unified communications and contact centers that are driven by Microsoft, BroadSoft, Interactive Intelligence, Genesys and others are gaining wide traction within the enterprise community and are growing fast as an alternative to on premise solutions.

*Cloud Computing.* The emergence of cloud computing services also affects the communications world. Leading unified communication vendors offer their hosted services on the cloud as an alternative to enterprise owned systems. This includes solutions such as Microsoft Office 365, IP Centrex services by telecom providers and quality of experience monitoring solutions such as Broadsoft PacketSmart.

### *The Challenges*

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

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

enterprise and contact centers. Such assessment typically requires high load simulations and advanced voice quality monitoring systems.

*Service Reliability.* In order for a packet network to be efficient for voice or fax transmission, the VoIP equipment that is installed in core networks and enterprises must be able to deliver a high level of performance and reliability to ensure continuous service. Since data networks are more susceptible to outages compared to traditional voice networks, businesses relying on centralized or hosted communication services need to ensure resiliency in their headquarters and remote branches in case of data network failure.

*Connectivity and Security.* In contrast with legacy circuit switched voice and video communications, IP-based communications are more susceptible to attacks, interceptions and fraud by unauthorized entities. In addition, the complexity and relative immaturity of IP networks and protocols pose significant quality of service and connectivity interoperability challenges when sessions cross between separate IP networks.

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

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

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

### **AudioCodes' Solution**

Using our voice compression algorithms, industry standards, advanced digital signal processing techniques, VoIP control protocol and security expertise, and voice communications system design expertise, our products address interoperability challenges, quality of service problems, security problems and reliability problems facing the VoIP industry. We enable our customers to build voice over packet networks that provide communication quality comparable to, and even better than, traditional telephone networks. Using HDVoIP, voice quality can even surpass the quality of traditional TDM networks. We work closely with our customers in order to tailor our products to meet their specific needs, assist them in integrating our products within their networks and help them bring their systems into operation on a timely basis. We also work with our customers in deploying their systems in various network environments.

Utilizing our investment in developing standards-based VoIP protocol support for our products, customers can integrate our products with a large number of industry leading IP-PBXs, unified communications, contact centers and carrier soft switches. Our interoperability teams test our products against a variety of other products for interoperability, primarily focusing on the leading VoIP protocols standards: Session Initiation Protocol/SIP.

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

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



*Digital signal processing design expertise.* Our extensive experience and expertise in designing advanced digital signal processing algorithms enables us to implement them efficiently in real time systems. Digital signal algorithms are computerized methods used to extract information out of signals. In designing our signal processors, we use minimal digital signal processing memory and processing power resources. This allows us to develop higher density solutions than our competitors. Our expertise is comprehensive and extends to all of the functions required to perform voice compression, fax and modem transmission over packet networks and telephone signaling processing.

*Compressed voice communications systems design expertise.* We have the expertise to design and develop the various building blocks and the products required for complete voice over packet systems. In building these systems, we develop hardware architectures, voice packetization software and signaling software, and integrate them with our signal processors to develop a complete, high performance compressed voice communications system. We assist our customers in integrating our signal processors into their hardware and software systems to ensure high voice quality, high completion rate of fax and data transmissions and telephone signaling processing accuracy. Further, we are able to customize our off-the-shelf products to meet our customers' specific needs, thereby providing them with a complete, integrated solution.

*Real time embedded software design and implementation expertise.* We have the expertise to design and develop voice and data network elements using embedded real time software to achieve more competitive pricing. The development and integration of VoIP signaling protocols, routing protocols, management and provisioning into a more cost-effective solution uses our expertise and investment in research and development resources. We believe that the benefits we can deliver are better price performance, smaller footprint, reduced power consumption and more attractive products.

*Media gateway and session border control protocols design expertise.* We have extensive experience in developing media gateway and session border control standard protocols and keep ourselves up to date with new requests for comments. As a result, we are able to adjust our features according to customer requirements. In addition, interoperability testing allows us to provide our customers with a single gateway or session border control platform that can interface with most of the leading PBX, IP-PBX and unified communications solution providers and provide seamless connectivity to SIP trunk services.

*Network Management and Monitoring tools.* We have deep understanding of how large scale enterprise networks operate, and as a result, have significant expertise in network management and monitoring tools. We combine our understanding of real-time media processing technology, with our experience in unified communications, contact center, and hosted services, to develop and deliver the needed network management and monitoring tools required to efficiently operate large scale, globally distributed organizations.

*IP Phone design expertise.* We have gained significant expertise around the development of IP Phones, which are used by enterprise employees in conjunction with IP Telephony, IP Centrex, Unified Communications, and Contact Center deployments. We leverage our deep understand of voice processing, along with our expertise in signaling, to develop advanced IP Phones.

*Close technology relationships with market leaders.* Our continuing efforts with respect to testing and certifying our systems for compatibility with other vendors' complimentary solutions, positions us as a provider of VoIP products that can interoperate with most of the world's leading VoIP products. It also helps to create for us an extensive feature list that can be used by different customers for their own networks and solutions.

*Deep understanding of VoIP security.* Based on long-standing market experience with deploying AudioCodes products at enterprise networks, we have developed a detailed understanding of the VoIP security requirements of enterprises including admission control, denial of service, throttling and traversal aspects. This understanding and knowledge helps us reach integration with our communications protocols implementation creating an effective VoIP security solution.

*VoIP professional services.* Based on our extensive expertise in VoIP network and technology we offer services intended to enhance customer's VoIP network capabilities, by offering network assessment services and other professional services.

We believe that our products possess the following advantages:

*Voice over Packet signal processors.* Our multi-channel signal processors enable our customers and us to create products that meet the reliability, capacity, size, power consumption and cost requirements needed for building high capacity VoIP products.

*Multiple and comprehensive product lines.* We address both the standards-based open telecommunications architecture market and the proprietary system market. We can do this because we enable our customers to use multiple applications in different market segments. For example, our VoIP communications boards target the open telecommunications architecture market, while our signal processors, modules and voice packetization software target the proprietary system market. Our analog and digital media gateways and multi-service business gateways target residential, hosted, access, trunking and enterprise applications and our session border controllers target

unified communication, SIP trunking, IP centrex and contact center networks. Our IP phones and VoIP mobile clients target the enterprise and service provider hosted solutions markets.

*Extensive feature set.* Our products incorporate an extensive set of signal processing functions and features (such as coders, fax processing and echo cancellation), functionalities (such as session initiation protocol, or SIP, H.248, or Megaco, and media gateway control protocol, or MGCP) and implement a complete system. We offer the ability to manage multiple channels of communications working independently of each other, with each channel capable of performing all of the functions required for voice compression, fax and modem transmission, telephone signaling processing and other functions. These functions include voice, fax or data detection, echo cancellation, telephone tone signal detection, generation and other telephony signaling processing. Our gateway products, media server and multi-service business gateways also offer wireless/mobile features to enable fixed mobile convergence.

*Cost-effective solutions.* We are able to address different market segments and applications with the same hardware platforms thus providing our customers with efficient and cost-effective solutions.

*Open architecture.* Our networking products utilize industry standard control protocols that enable them to interoperate with other vendors and easily integrate into enterprise IP telephony systems as well as carrier networks. Our voice over packet communications boards target the open architecture gateway market segment, which enables our customers to use hardware and software products widely available for standards-based open telecommunications platforms. We believe that this provides our customers the benefits of scalability, upgradeability and enhanced functionality without the need to replace their systems for evolving applications.

*Various entry level products.* Our wide product range (chips to media gateways, multi-service business gateway, IP phones and media servers) provides our customers with a range of entry level products. We believe that these building blocks enable our customers to significantly shorten their time to market by adding their value added solution.

*VoIPerfect architecture.* Our VoIPerfect architecture serves as the underlying technology platform common to all of our products since 1998. VoIPerfect™ is regularly updated and upgraded with features and functionalities required to comply with evolving standards and protocols. VoIPerfect™ architecture comprises VoIP digital signal processing, or DSP, software and media streaming embedded software, integrated public telephone switched network, or PTSN, signaling protocols and VoIP standard control protocols, VoIP security mechanisms, provisioning and management engines. Additional features enable carrier-grade quality and high availability. VoIPerfect™ architecture components are available in AudioCodes' products at various levels of integration, from the chip level, through blades, to high-availability and non-high-availability analog and digital gateway and session border controller platforms.

## **Business Strategy**

AudioCodes' vision is to become a leading strategic supplier of VoIP and converged VoIP and data solutions for service providers and enterprises worldwide. The following are key elements of our strategy:

*Maintain and extend technological leadership.* We intend to capitalize on our expertise in voice compression technology and voice signaling protocols and proficiency in designing voice communications systems. We continually upgrade our product lines with additional functionalities, interfaces and densities. We have invested heavily and are committed to continued investment in developing technologies that are key to providing high performance voice, data and fax transmission over packet networks and to be at the forefront of technological evolution in our industry.

*Strengthen and expand strategic relationships with key partners and customers.* We sell our products to leading enterprise channels, regional system integrators, global equipment manufacturers and value-added resellers, or VARs, in the telecommunications and networking industries and establish and maintain long-term working relationships with them. We work closely with our customers to engineer products and subsystems that meet each customer's particular needs. The long development cycles usually required to build equipment incorporating our products frequently results in close working relationships with our customers. By focusing on leading equipment manufacturers with large volume potential, we believe that we reach a substantial segment of our potential customer base while minimizing the cost and complexity of our marketing efforts.

*Expand and enhance the development of highly-integrated products.* We plan to continue designing, developing and introducing new product lines and product features that address the increasingly sophisticated needs of our customers. We believe that our knowledge of core technologies and system design expertise enable us to offer better solutions that are more complete and contain more features than competitive alternatives. We believe that the best opportunities for our growth and profitability will come from offering a broad range of highly-integrated network product lines and product features, the integration of data services into our VoIP products, and the expansion into the unified communications and contact center markets.

*Build upon existing technologies to penetrate new markets.* The technology we developed originally for the OEM market has served us in building products that now sell into the service provider and enterprise markets. The same products and technology can also be used to create application-specific products and solutions. Key segments that we focus on are unified communications, contact centers, SIP trunking and hosted services markets that have been adopting VoIP solutions.

*Work close to market and customers.* Our partners and customers are distributed around the world, and part of our ability to serve them is by being close by. For this reason, we are investing in building local operations in key countries and regions, including sales, marketing and support resources to closely serve our partners and customers.

*Develop a network of strategic partners.* We sell our products through or in cooperation with customers that can offer or certify our products as part of a full-service solution to their customers. We expect to further develop our strategic partner relationships with solution providers, system integrators and other service providers in order to increase our customer base. Our strategic partners include companies such as Microsoft, BroadSoft, Avaya, Genesys, Interactive Intelligence and Alcatel-Lucent.

*Acquire complementary businesses and technologies.* We may pursue the acquisition of complementary businesses and technologies or the establishment of joint ventures to broaden our product offerings, enhance the features and functionality of our systems, increase our penetration in targeted markets and expand our marketing and distribution capabilities.

*Engage enterprise customers in direct sales effort.* We are pursuing a strategy of engaging large enterprise customers on a global level, as part of the AudioCodes product fit within leading enterprise solutions, mainly with Microsoft and Genesys. Our ability to engage these enterprises directly enhances our ability to influence procurement decisions. This, in turn, is designed to increase demand, which is expected to allow our business partners to fulfill this demand based on their relationship with AudioCodes.

## Products

Our products facilitate the transmission of voice, data and fax over packet networks. We have incorporated our algorithms, technologies and systems design expertise in both our networking and technology product lines.

We typically categorize our revenues from products and services into two main business lines: network and technology. Network products consist of customer premises equipment, or CPE, gateways for the enterprise and service provider (or carrier) markets and of carrier-grade-oriented low- and mid-density media gateways for service providers and ESBCs. Complementing our media gateways and session border gateways as network products are our multi-service business routers (MSBR). IP phones, media servers, mobile VoIP solutions and value added application products. Sales of network products accounted for approximately 62% of our revenues in 2012, approximately 66% of our revenues in 2013 and approximately 62% of our revenues in 2014. Network services accounted for approximately 18% of our revenues in 2012, approximately 18% of our revenues in 2013 and approximately 24% of our revenues in 2014.

Technology products are enabling in nature and consist of our chips and boards business products. These are sold primarily to original equipment manufacturers, or OEMs, through distribution channels. Our chips and boards serve as building blocks that our customers incorporate in their products. In contrast, our networking products are used by our customers as part of a broader technological solution and are a box level product that interacts directly with other third party products. Sales of technology products accounted for approximately 19% of our revenues in 2012, approximately 15% of our revenues in 2013 and approximately 13% of our revenues in 2014. Technology services accounted for approximately 1% of our revenues in 2012 and 2013 and less than 1% of our revenues in 2014.

### *Networking products*

This line of products includes products that are network level products. Networking products are deployed in enterprise unified communications networks, service providers residential and access networks, trunking applications in carrier networks, and fixed-mobile convergence applications.

Our media gateways enable voice, data and fax to be transmitted over Internet and other protocols, and interface with third party equipment to facilitate enhanced voice and data services. We offer analog media gateways for toll bypass, residential gateways, hosted, access and enterprise applications; and digital media gateways with various capacities for wireless, wireline, cable, enterprise, fixed mobile convergence, and unified communications;

Our session border controller (E-SBC) for enterprises and service providers connecting to SIP trunk and hosted services and between unified communications and IP PBX systems. Our SBCs provide demarcation for security, interoperability, local survivability and quality assurance that are required for reliable IP to IP connectivity between enterprise branch offices and main office, between enterprise and SIP trunking or cloud-based applications service providers. E-SBCs also connect between IP-PBXs and unified communication systems from different vendors, and enable remote workers connectivity into the enterprise VoIP network. In the service and cloud provider segment, our SBCs function primarily as Access SBCs providing security, multi-tenancy and connectivity for the business customers of the hosted application server

Our multi-service business routers integrate multiple data, telephony and security services into a single device. Building on our media gateway CPE line, we have added the support of additional functions such as a LAN switching, data routing, firewall WiFi Access Point, WAN interface and a session border controller, providing service providers with an integrated demarcation point and the enterprise with an all-in-one solution for its communications needs.

Our IP phones include a family of phones designed for high definition Unified Communications and Contact Centers markets, as well as for IP-Centrex (or Hosted Unified Communications) service provider solutions.

We offer a variety of products that are tailored for Microsoft unified communication environments. These products include connectivity platforms that are based on our Mediant gateway and SBC devices, as well as survivable branch appliances (SBAs), enhanced gateways, E911 gateways and SBCs and One Box 365 (designed to allow Enterprise Voice capabilities and PSTN connectivity for Office 365 customers). Other products for the Microsoft Lync environment include IP phones and applications such as faxing solutions, call recording solutions (SmartTAP) and Speech Recognition Auto Attendant solutions.

Our media servers enable conferencing, multi-language announcement functionality, and other applications for voice over packet networks.

We offer a professional service module of VoIP network assessment for enterprises (VNA). The VNA is provided to enterprises seeking a smooth and high quality transition to deployment of unified communications (e.g., Microsoft Lync) and IP contact centers. The VNA provides the customer with an understanding of its current IP network capability and readiness to carry high quality VoIP traffic on top of data services.

We support our networking products with a range of professional services.

### *Technology Products*

This line of products serves as a building block for network level products. Our technology products are enabling products that are part of our own or our customers' products.

Our signal processor chips process and compress voice, data and fax and enable connectivity between traditional telephone networks and packet networks;

- VoIP communications boards;
- Media processing boards for enhanced services and functionalities; and
- Voice and data logging hardware integration board products.

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

### *Our Product Families - Networking Products*

*Analog Media Gateways for Toll Bypass, Service Provider Access and Enterprise Applications*



Our MediaPack™ family comprises our analog and basic rate interface, or BRI, media gateways for toll bypass, service provider access and enterprise applications. These products are designed to empower the next-generation network by providing cost-effective, cutting-edge technology solutions that deliver voice and fax services to the corporate market, small businesses and home offices. Our analog media gateways for access and enterprise applications provide media streaming functionality while being either controlled by a centralized call agent or used in box VoIP control protocols (SIP, H.323, and MGCP). Convergence of data, voice and fax is achieved by a combination of the media gateway with any IP access technology, eliminating the cost of multiple access circuits.

The MediaPack family includes the MP112, 114, 118 and 124 analog gateways supporting 2, 4, 8 or 124 analog lines respectively, as well as the MP-2xx family of residential and Small Office Home Office (SOHO) gateways (MP-252, MP-262 and MP264). The MediaPack 262 and 264 (MP-252) are feature-rich SOHO gateways for hosted business telephony. With VDSL2 and Gigabit access multiple antenna wireless LAN connectivity, DECT handsets supporting HD VoIP, bluetooth interface for connecting cellular phones and optional battery backup, it is an advanced, cost-effective all-in-one solution for hosted telephony and unified communications providers. The MP-252 supports ADSL2+ targeting the residential market.

*The Mediant Family of Products - Session Border Controllers (SBCs), Digital and Mixed (Digital and Analog) Media Gateways (MGWs),) and Multi-Service Business Routers (MSBRs) for Service Provider Access and Enterprise Applications (Mediant™ 500L, 500, 800, 1000, 2000, 3000 Media Gateways and SBC, Mediant4000, 9000 SBCs, Mediant SE and VE Software and virtualized SBCs and Mediant 500L, 500, 800 and 1000 MSBRs), as well as higher capacity Media and Transcoding Gateways for Wireless, Wireline and Cable Service Provider networks (Mediant, 5000 and 8000)*

The Mediant™ product family offers scalability and functionality, providing a full suite of standards compliant control protocols and public switched telephone network, or PSTN, signaling interfaces for a variety of applications in most unified communications, IP-PBX, SIP application and softswitch controlled environments. This product family is compatible with popular voice over IP voice coders and protocols, including code-division multiple access, or CDMA, global system for mobile communications, or GSM, CDMA2000, universal mobile telecommunications service, or UMTS, and Long Term Evolution (LTE), as well as popular narrowband and wideband voice coders used in enterprise and Over the Top networks, such as OPUS SILK, RTA, SPEEX, G.722 and more. It builds on our VoIPerfect® architecture, which is installed in millions of lines worldwide. It is also interoperable with most of the world's leading vendors.

The Mediant™ family provides customers with a comprehensive line of different sized gateways and SBCs. Small or medium-sized gateways enable cost-effective solutions for enterprise or small points of presence, as well as entry into fast growing new and emerging markets. The large gateways scale to central office capacities and are designed to meet carriers' operational requirements. The Mediant family of media gateways is capable of supporting unified communication, contact center and service provider VoIP applications which may be of increased interest to enterprises and service providers.

The Mediant family of products consists of a number of models that offer different capacity, that is the number of concurrent calls or sessions that the gateway or SBC can handle. The capacity of our Mediant products range from approximately 30 concurrent calls/sessions to 24,000 concurrent calls/sessions.

Our Mediant 1000, Mediant 800 Mediant 500 and Mediant500L have three different configurations. The first two are a modular VoIP media gateway and enterprise session border controllers. The other includes multi-service business routers, or MSBRs, which are networking devices that combine multiple multiservice functions such as a media gateway, session border controller, data router, firewall, LAN switch, WAN access and survivability. The MSBR concept is designed to address the needs of service providers that offer hosted Unified Communications and SIP trunking services . The range of interfaces supported on the Mediant 500L, Mediant500, Mediant 800 and Mediant 1000 MSBR include a variety of voice and data (WAN) interfaces.

Our product line specifically designed for the Microsoft unified communications environment, known as Lync, is constantly upgraded to support the latest Microsoft unified communications specifications. These products include Lync qualified IP Phones, enhanced gateways, enterprise session border controllers, survivable branch appliances and OneBox365 (integrated Lync, SBC and MGW for Office365 voice deployments) based on our Mediant family, as well as faxing solutions, auto attendant solutions and SmartTAP, a passive compliance recording solution. The marketing and sales of these products utilizes our growing network of Microsoft VSPs (voice specialized partners) with whom we work closely.

Our SBC technology integrates into all Mediant platforms , except the Mediant5000 and Mediant8000 gateways. It offers secure VoIP and multimedia traversal of firewall, or FW, and network address translation, or NAT, systems, as well as denial of service, or DoS, attack prevention at both the signaling and media layers. These products target the VoIP security, connectivity and Quality of Service (QoS) needs of enterprises and service providers of different sizes, migrating from traditional PSTN connectivity to IP. NAT and FW traversal as necessary to allow VoIP and multimedia sessions to pass from the service provider ("SP") network to the residential, enterprise or other SP network. Security and DoS attack prevention protects the enterprise or SP networks from fraud attacks that load an application server until it crashes. QoS assurance prioritizes voice sessions, manages a number of concurrent sessions and monitors the quality of voice to make sure voice communications is of high quality and warns if it degrades

The Mediant SBC also provides comprehensive protocol mediation capabilities, which is the translation between two variants of the same VoIP protocol to enable two VoIP systems to communicate with each other. Examples of protocol mediation include connecting an IP PBX with SIP trunk services or connecting between two unified communication systems of different vendors. In addition, ESBCs support remote workers connectivity, enabling unified communications over IP between the enterprise and its workers located outside the premises. The market for these products includes value-added resellers system integrators and service provider channels.

The Mediant 800 and 1000 products can also include an OSN (open solutions network) server module featuring a general purpose CPU and hard disk, allowing hosting of any third-party off-the-shelf application. This solution enables system integrators and software vendors to use these platforms for integrated unified communications solutions.

#### *IPmedia™ Servers for Enhanced Services and Functionalities*

IPmedia™ platforms are designed to answer the growing market demand for enhanced voice services over packet networks, particularly network-based applications like unified communications, call recording, and conferencing by carriers and application service providers. IPmedia™ enables our customers to develop and market applications such as unified communications, interactive voice response, call-centers, conferencing and voice-activated personal assistants.

#### *300HD and 400HD Series of High Definition IP Phones*

AudioCodes 300 and 400 Series of HD VoIP-enabled IP phones offer a new dimension of voice call quality and clarity for the enterprise and service provider markets. This product line enables us to provide an end-to-end solution which relies heavily on the technological infrastructure and proven track record in providing state-of-the art high quality VoIP products for enterprise, wireline, wireless and cable applications.

The 300 and 400 Series of IP phones meet the demand for high definition VoIP solutions in end-user phones and terminals, providing high voice fidelity, advanced security and features and enhanced user interface. Our IP phones are widely interoperable with numerous IP-PBXs, soft switches and IP-Centrex solutions.

### *One Voice Operation Center (OVOC)*

One Voice Operations Center is a management suite providing full coverage of the entire set of actions required to manage AudioCodes voice network products in a unified communication, contact center or service provider environment. The AudioCodes One Voice Operations Center provides a complete end-to-end voice network control, service assurance capabilities and comprehensive reporting tools.

The AudioCodes One Voice Operations Center uniformly manages, monitors and operates the entire AudioCodes portfolio, including SBCs and Media Gateways

Microsoft SBAs and IP phones.

The key components of One Voice Operation Center are the Element Management System and Session Experience Manager

### *Element Management System*

Our element management system, or EMS, is an advanced solution for centralized, standards-based management of our network products, covering all areas vital to the efficient operations, administration, configuration, provisioning and monitoring of our Mediant™ and MediaPack™ VoP gateways, session border controllers and 300/400 IP phones series.

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

The EMS for IP phones module provides day one management operations such as automatic provisioning and firmware download, user management, comprehensive configuration file templates and mass operations. The EMS for IP phones day by day operation consist of real time dashboard showing per end user the status of the IP phone, as well as showing and forwarding IP phone alarms.

*Session Experience Manager (SEM):*

Our Session Experience Manager, or SEM, is an integral part of the One Voice Operations Center suite. This software module is built to monitor, analyze, report and control the quality of voice over IP in real-time for enterprise and service providers' networks. SEM is designed as an intuitive, easy to use solution, which includes an array of advanced tools producing a continuous comprehensive view of voice quality of experience at the enterprise and service provider network and its connecting trunks. Among these tools are network views to map devices and their associated voice quality, graphic illustrations of VoIP call metrics, convenient drill down details of a given call, traffic trend analysis to identify current and future bottlenecks, active and historic alarm display, and flexible pre-defined reports. In addition to VoIP, SEM includes a tool for analyzing fax transmission quality. SEM complements our Element Management System (EMS) by providing comprehensive configuration, monitoring and performance solutions for IT managers and service providers deploying a network of AudioCodes network products.

Session Experience Manager for Lync expansion is an intelligent analysis tool to quickly isolate and remediate real time problems over a VoIP eco system that is comprised of Microsoft Lync and Audiocodes One Voice integrated solution. The SEM for Lync has visibility on all voice calls within the Lync environment, including Lync to Lync, Lync to federated, Lync to remote workers, Lync to Gateway/SBC and Lync to mediation server.

*Our Product Families - Technology Products*

*Voice Over Packet Processors*

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

*TrunkPack™ VoIP Communication Boards*

Our communications boards are designed to operate in gateways connecting the circuit-switched telephone network to packet networks based on Internet protocols. Our boards comply with VoIP industry standards and allow for interoperability with other gateways. Our boards support standards-based open telecommunications architecture systems and combine our signal processor chips with communications software, signaling software and proprietary hardware architecture to provide a cost efficient interoperable solution for high capacity gateways. We believe that using open architecture permits our customers to bring their systems to market quickly and to integrate our products more easily within their systems.

*IPmedia™ Boards for Enhanced Services and Functionalities*

The IPmedia™ product family is designed to allow OEMs and application partners to provide sophisticated content and services that create revenue streams and customer loyalty through the ability to provide additional services. The IPmedia™ boards provides voice and fax processing capabilities to enable, together with our partners, an architecture for development and deployment of enhanced services.

*Voice and Data Logging Hardware Integration Board Products*

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

**Services**

To support today's complex multi-service networks, AudioCodes has developed a comprehensive professional services program intended to provide responsive, preventive, and consultative support of AudioCodes networking products. AudioCodes professional services support networking devices, applications and infrastructures, allowing large organizations and service providers to realize the potential of a high-performance multi-service network. The foundation for AudioCodes professional services is a network life-cycle model based on the four basic phases of planning, design, implementation and operations. The result is a specially designed portfolio of complementary and synergistic service components. Services accounted for approximately 19% of our revenues in 2012 and 2013 and approximately 22% of our revenues in 2014.

## Core Technologies

We believe that one of our key competitive advantages is our broad base of core technologies ranging from advanced voice compression algorithms to complex architecture system design. We have developed and continue to build on a number of key technology areas. We have named our cross platform core technology VoIPerfect. It essentially allows us to leverage the same feature set and interoperability with other products across our product lines.

### *Narrowband and Wideband (HDVoIP) Voice Compression Algorithms*

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

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

We also provide wideband compression techniques that provide high definition VoIP quality, which expands the sampled frequency range from the traditional narrowband frequency range of 3.3Khz to over 7Khz, providing better voice quality and intelligibility, and a better user expertise. This technology is expanding and is expected to become a de-facto standard for future VoIP communications.

#### *Advanced Digital Signal Processing Algorithms*

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

Our algorithms include:

*Echo cancellation.* Low bit rate voice compression techniques introduce considerable delay, necessitating the use of echo cancellation algorithms. The key performance criterion of an echo canceller is its ability to deal with large echo reflections, long echo delays, fast changing echo characteristics, diverse telecommunications equipment and network effects. Our technology achieves low residual echo and fast response time to render echo effects virtually unnoticeable.

*Fax transmission.* There are two widely used techniques for real time transmission of fax over networks based on Internet protocols: fax relay and fax spoofing. Fax relay takes place when a fax is sent from a fax machine through a gateway over networks based on Internet protocols in real time to a fax machine at the other end of the network. At the gateway, the analog fax signals are demodulated back into digital data, converted into packets, routed over the packet network and reassembled at the receiving end. Fax relay is used when the round trip network delay is small (typically below one second). When the round trip network delay increases, one of the fax machines may time out while waiting for a response from the other fax machine to arrive.

*Data modem technology.* We have developed data modem technologies that facilitate data relay over packet networks. Our data modem relay software algorithms support all existing data modem standards up to a bit rate of 14.4 kbps.

*Telephony signaling processing.* Various telephony signaling standards and protocols are employed to route calls over the traditional telephone network, some of which use “in-band” methods, which means that the signaling tones are sent



over the telephone line just like the voice signal. As a result, in-band signaling tones may have to undergo the compression process just like the voice signal. Most low bit-rate voice coders, however, are optimized for speech signals and exhibit poor tone transfer performance. To overcome this, our processors are equipped with tone detection and tone generation algorithms. To provide seamless transparency between the traditional telephone network and packet networks for signaling, we employ various digital signal processing techniques for efficient tone processing.

#### *Voice Communications Software*

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

#### *Media Processing*

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

Our media processing technology is integrated into our enabling technology platforms like Voice over Packet processors and VoIP blades, as well as into our network platforms like the Mediant media gateways and the IPMedia media servers. The same technology is also integrated into our multi-service business gateways, enabling the use of these platforms to run third party VoIP software, offloading media processing from the host CPU.

#### *Addressing Multiple Networks and Standards Concurrently*

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

Our voice over packet products provide a cost-effective solution for these convergence needs, complying with the requirements of broadband Wireline operators using xDSL technologies, Cable operators, mobile operators, FTTx operators, Internet telephony service providers, or ITSPs, and virtual network Operators (VNOs). This includes support for relevant vocoders (wireline and wireless concurrently), interfaces and protocols.

Our products are also positioned to support the requirement of all types of enterprise customers. From SOHO, SMB all the way up to large enterprises, our products can provide integrated VoIP services and service provider access to enterprises in multiple vertical markets.

#### *Hardware Architectures for Dense Multi-Trunk Voice over Packet Systems*

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

#### *Carrier Grade System Expertise*

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

#### **Customers**

Our customers consist of service providers and enterprises, primarily via channels (such as distributors), OEMs, network equipment providers and systems integrators. Historically, we have derived the majority of our revenues from sales to a small number of customers. The identities of our principal customers have changed and we expect that they will continue to change, from year to year. Historically, a substantial portion of our revenue has been derived from large purchases by a small number of original equipment manufacturers, or OEMs, and network equipment providers, or NEPs, systems integrators and distributors. ScanSource Communications Group, our largest customer, accounted for 13.7% of our revenues in 2012, 17.8% of our revenues in 2013 and 14.9% of our revenues in 2014. In addition, sales to Westcon Group accounted for 10.5% of our revenues in 2014. Our top three customers accounted for approximately 25.3% of our revenues in 2012, 27.8% of our revenues in 2013 and 27.7% of our revenues in 2014.

## **Sales and Marketing**

Our sales and marketing strategy is to secure the leading channels and system integrators in each region, partner with leading application companies and achieve design wins with network equipment providers in our targeted markets. We select our partners based on their ability to provide effective field sales, marketing communications and technical support to our customers. In addition, we engage in direct sales and marketing with significant operators and enterprises. Prospective customers and channels generally must make a significant commitment of resources to test and evaluate our products and to integrate them into larger systems, networks and applications. As a result, our sales process is often subject to delays associated with lengthy approval processes that typically accompany the design and testing of new communications equipment. For these reasons, the sales cycles of our products to new customers are often lengthy, averaging approximately six to twelve months after achieving a design win. This time may be further extended because of internal testing, field trials and requests for the addition or customization of features.

We market our products in the United States, Europe, Asia, Latin America and Israel primarily through a direct sales force. We have invested significant resources in setting up local sales forces giving us a presence in relevant markets. We have given particular emphasis to emerging markets such as Latin America, Asia and Eastern Europe in addition to continuing to sell our products in developed countries.

We have generally entered into a combination of exclusive and non-exclusive sales representation agreements with these customers in each of the major countries in which we do business. These agreements are typically for renewable 12-month terms, are terminable at will by us upon 90 days' notice, and do not commit the customer to any minimum sales of our products to third parties. Some of our customers have the ability to return some of the products they have previously purchased and purchase more up to date models.

In 2014, we continued to enhance our field marketing efforts with direct touch enterprise engagements, along with channel recruitments and generic marketing activities including tradeshows, webinars, seminars, on-line and social marketing. The AudioCodes One Voice positioning is strongly emphasized in our marketing efforts.

In January 2013, we introduced the One Voice marketing message which positions AudioCodes as a one-stop-vendor for the voice connectivity needs of various enterprise applications. The marketing campaign started with the positioning of One Voice for Lync, which presented the AudioCodes value proposition as a vendor of comprehensive voice networking for Microsoft Lync unified communications. Additionally, One Voice for Lync positions AudioCodes as a vendor that can deliver end-to-end support and that offers value-added professional services including design, implementation, and network readiness assessment, among others. We later also introduced One Voice for Hosted Services which similarly positions AudioCodes as a one-stop vendor for Operators hosted services, mainly in collaboration with Broadsoft. AudioCodes believes it can deliver a full suite of voice and networking equipment that is required to connect business customers to an operator's network.

## **Manufacturing**

Some of our components are obtained from single suppliers. For example, Texas Instruments Incorporated supplies all of our DSP components, while Motorola and Cavium Networks provide embedded CPU and network processors. Other components are generic in nature and we believe they can be obtained from multiple suppliers.

We have not entered into any long-term supply agreements. However, we have worked for years in several countries with established global manufacturing leaders such as Flextronics and have a good experience with their level of commitment and ability to deliver. To date, we have been able to obtain sufficient amounts of these components to meet our needs and do not foresee any supply difficulty in obtaining timely delivery of any parts or components. However, an interruption in supply from any of these sources, especially with regard to DSP components from Texas Instruments Incorporated and CPU and network processors from both Cavium Networks and Motorola, or an unexpected termination of the manufacture of certain electronic components, could disrupt production, thereby adversely affecting our results. We generally maintain an inventory of critical components used in the manufacture and assembly of our products although our inventory of signal processor chips would likely not be sufficient in the event that we had to engage an alternate supplier for these components.

We utilize contract manufacturing for substantially all of our manufacturing processes. Most of our manufacturing is carried out by third-party subcontractors in Israel and China. Our internal manufacturing activities consist primarily of the production of prototypes, test engineering, materials purchasing and inspection, final product configuration and quality control and assurance.

In addition, we have engaged several original design manufacturers, or ODM, based in Asia to design and manufacture some of our products. We may engage additional ODMs in the future. Termination of our commercial relationship with an ODM or the discontinuance of manufacturing of products by an ODM would negatively affect our business operations.

We are obligated under certain agreements with our suppliers to purchase goods and to purchase excess inventory. Aggregate non-cancellable obligations under these agreements as of December 31, 2014 were approximately \$13.4 million.

### **Industry Standards and Government Regulations**

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

We are subject to telecommunication industry regulations and requirements set by telecommunication carriers that address a wide range of areas including quality, final testing, safety, packaging and use of environmentally friendly components. We comply with the European Union's Restriction of Hazardous Substances Directive (under certain exemptions) that requires telecommunication equipment suppliers to not use some materials that are not environmentally friendly. These materials include cadmium, hexavalent chromium, lead, mercury, polybrominated biphenyls and polybrominated diphenyl ethers. Under the directive, an extension for compliance was granted with respect to the usage of lead in solders in network infrastructure equipment. We expect that other countries, including countries we operate in, will adopt similar directives or other additional regulations.

## Competition

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

Our principal competitors in the area of analog media gateways (2 to 24 ports) for access and enterprise are Media5, Grandstream, Innovaphone AG, Sonus Networks, Tainet Communication System Corp., Patton, Sangoma, Dialogic and Edgewater.

Our principal competitors in the residential gateway market are Pirelli Broadband (ADB), Technicolor, Sagemcom, Netgear and Huawei

In the area of low and mid density digital gateways we face competition from companies such as Huawei, Cisco, Dialogic, Genband, Sonus Networks, Patton, Ferrari and Sangoma.

Our competitors in the area of multi-service business gateways are companies such as Cisco, Juniper, Adtran, One Access, Patton, Huawei and Edgewater Networks.

Our competitors with respect to enterprise class session border controller technology include Oracle, Cisco, Avaya, Sonus Networks, Ingate and Edgewater Networks.

Our competitors in the Microsoft Lync certified gateway and session border controller markets include Sonus Networks, Dialogic, Cisco, Ferrari, Sangoma, Media5, HP, Paton, Ingate and Oracle.

Some of our competitors are also customers of our products and technologies.

Our principal competitors in the sale of signal processing chips are Broadcom, Octasic and Mindspeed. Other indirect competition is arriving from the integration of VoIP functionality into processors (running the VoIP signal processing on generic ARM/MIPS cores), thus decreasing the need for dedicated signal processing chips in a VoIP product. Examples to such manufacturers are Cavium, Texas Instruments and more. Our principal competitors in the communications board market are Dialgic, Sangoma and PIKA Technologies.

Our principal competitors in the area of IP phones are comprised of “best-of-breed” IP phone vendors and end-to-end IP telephony vendors. “Best-of-breed” IP phone vendors sell standard-based SIP phones that can be integrated into any standards-based IP-PBX or hosted IP telephony systems. These competitors include Polycom, HP, Yaelink and SNOM. End-to-end IP telephony vendors sell IP phones that only work in their proprietary systems. These competitors include Cisco, Avaya, Alcatel-Lucent, Siemens, Aastra and NEC.

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

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

### **Intellectual Property and Proprietary Rights**

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

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

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

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

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

Each of the parties to the agreement is free to develop and sell products embodying the intellectual property incorporated into the G.723.1 standard without payment of royalties to other parties, so long as the G.723.1 standard is implemented as is, without modification. The agreement expires upon the last expiration date of any of the AudioCodes, DSP Group, Inc., France Telecom or Université de Sherbrooke patents incorporated in the G.723.1



standard. The parties to the agreement are not the only claimants to technology underlying the G.723.1 standard.

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

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

We have entered into technology licensing fee agreements with third parties. Under these agreements, we agreed to pay the third parties royalties, based on sales of relevant products.

## **Legal Proceedings**

In May 2014, one of our former senior executives filed a claim with the Israeli labor court claiming an amount of NIS 2,500,000 (approximately \$625,000) relating to the termination of his employment. We denied his allegations and believe that we have valid defenses to this claim. A preliminary hearing was held in January 2015 during which the parties have mutually agreed to refer the dispute to a mediator. In the event that mediation is unsuccessful, the parties will continue with the claim in Israeli labor court.

In November 2013, AudioCodes Brasil Equipamentos Voz Sobre IP Ltda., our Brazilian subsidiary, was served with proceedings in the Labor Court of Sao Paulo, Brazil by a former employee alleging that he is entitled to approximately \$600,000 as a result of the termination of his employment by our subsidiary. We have denied allegations and believe that we have valid defenses to this claim.

## *C. ORGANIZATIONAL STRUCTURE*

### **List of Significant Subsidiaries**

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

AudioCodes Development Ltd., our wholly-owned subsidiary in Beer Sheva, Israel.

## *D. PROPERTY, PLANTS AND EQUIPMENT*

We lease our main facilities, located in Airport City, Lod, Israel, which occupy approximately 200,000 square feet for annual lease payments of approximately \$5.4 million (including management fees). In September 2013, this lease was extended by an additional 10 years, and is scheduled to expire on January 31, 2024.

Our U.S. subsidiary, AudioCodes Inc., leases approximately 28,000 square foot facility in Somerset, New Jersey which was extended for five years until December 31 2018. AudioCodes Inc. also leases offices in Plano, Texas, San Jose, California, Raleigh, North Carolina, Boston, Massachusetts and Mexico. The annual lease payments in 2014 (including management fees) for all our offices in the United States were approximately \$600,000.

We lease additional offices in Israel as well as for our international offices. We do not believe the lease agreements for these offices to be material.

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

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

None.

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

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

Our consolidated financial statements are prepared in accordance with U.S. generally accepted accounting principles, or 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.

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

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

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

- Revenue recognition and allowance for sales returns;

- Allowance for doubtful accounts;

- Inventories;

- Intangible assets;

- Goodwill;

- Income taxes and valuation allowance;

- Stock-based compensation; and

- Contingent liabilities.

#### *Revenue Recognition and Allowance for Sales Returns*

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

Revenues from products are recognized in accordance with Accounting Standards Codification ("ASC") 605, "Revenue Recognition", when the following criteria are met: (i) persuasive evidence of an arrangement exists, (ii) delivery of the product has occurred, (iii) the fee is fixed or determinable and (iv) collectability is probable. We have no obligation to customers after the date on which products are delivered, other than pursuant to warranty obligations and any applicable right of return. We grant to some of our customers the right of return or the ability to exchange a specific percentage of the total price paid for products they have purchased over a limited period for other products.

We maintain a provision for product returns and exchanges and other incentives. This provision is based on historical sales returns, analysis of credit memo data and other known factors. This provision amounted to \$1.2 million in 2012, \$1.3 million in 2013 and \$1.3 million in 2014.

Revenues from the sale of products which were not yet determined to be final sales due to market acceptance or technological compatibility were deferred and included in deferred revenues. In cases where collectability is not probable, revenues are deferred and recognized upon collection. Revenues from services are recognized ratably over the time of the service agreement, usually one year.

Under Accounting Standards Update ("ASU") No. 2009-13, Topic 605, "Multiple-Deliverable Revenue Arrangements" ("ASU 2009-13"), the selling price for a deliverable is based on its vendor-specific objective evidence ("VSOE") if available, third-party evidence ("TPE") if VSOE is not available, or estimated selling price ("ESP") if neither VSOE nor TPE is available. We then recognize revenue on each deliverable in accordance with our policies for product and service revenue recognition. VSOE of selling price is based on the price charged when the element is sold separately. In determining VSOE, we require that a substantial majority of the selling prices fall within a narrow range based on standalone rates. TPE of selling price is established by evaluating largely interchangeable competitor products or services in stand-alone sales to similarly situated customers. However, as our products contain a significant element of proprietary technology and our solutions offer substantially different features and functionality, the comparable pricing of products with similar functionality typically cannot be obtained. Additionally, as we are unable to reliably determine the selling prices of competitors products on a stand-alone basis, we are not typically able to determine TPE. The ESP is established considering multiple factors including, but not limited to, pricing practices in different geographical areas and through different sales channels, gross margin objectives, internal costs, the pricing strategies of our competitors, and industry technology lifecycles. The selling price of the products and professional services was based on ESP. Maintenance selling price was based on VSOE.

We limit the amount of revenue recognition for delivered elements to the amount that is not contingent on the future delivery of products or services or subject to customer-specific return or refund privileges. We evaluate each deliverable in an arrangement to determine whether it represents a separate unit of accounting.

#### *Allowance for Doubtful Accounts*

Our trade receivables are derived from sales to customers located primarily in the Americas, the Far East, Israel and Europe. We perform ongoing credit evaluations of our customers and to date have not experienced any material losses from uncollected receivables. An allowance for doubtful accounts is determined with respect to those amounts that we have recognized as revenue and determined to be doubtful of collection. We usually do not require collateral on trade receivables because most of our sales are to large and well-established companies. On occasion we may purchase credit insurance to cover credit exposure for a portion of our sales and this may mitigate the amount we need to write off as a result of doubtful collections.

#### *Inventories*

Inventories are stated at the lower of cost or market value. Cost is determined using the “weighted average cost” method for raw materials and on the basis of direct manufacturing costs for finished products. We periodically evaluate the quantities on hand relative to current and historical selling prices and historical and projected sales volume and technological obsolescence. Based on these evaluations, inventory write-offs are provided to cover risks arising from slow moving items, technological obsolescence, excess inventories, discontinued products and for market prices lower than cost. We wrote-off inventory in a total amount of \$2.3 million in 2012, \$1.7 million in 2013 and \$82,000 in 2014.

#### *Intangible assets*

As a result of our acquisitions, our balance sheet included acquired intangible assets, in the aggregate amount of approximately \$2.9 million as of December 31, 2012, \$4.3 million as of December 31, 2013 and \$3.0 million in December 2014.

We allocated the purchase price of the companies we have acquired to the tangible and intangible assets acquired and liabilities assumed, based on their estimated fair values. These valuations require management to make significant estimations and assumptions, especially with respect to intangible assets. Critical estimates in valuing intangible assets include future expected cash flows from technology acquired, trade names, backlog and customer relationships. In addition, other factors considered are the brand awareness and market position of the products sold by the acquired

companies and assumptions about the period of time the brand will continue to be used in the combined company's product portfolio. Management's estimates of fair value are based on assumptions believed to be reasonable, but which are inherently uncertain and unpredictable.

If we did not appropriately allocate these components or we incorrectly estimate the useful lives of these components, our computation of amortization expense may not appropriately reflect the actual impact of these costs over future periods, which will affect our net income.

Intangible assets are comprised of acquired technology, customer relations and licenses.

Intangible assets that are not considered to have an indefinite useful life are amortized using the straight-line basis over their estimated useful lives, which range from four and a half to ten years. Recoverability of these assets is measured by a comparison of the carrying amount of the asset to the undiscounted future cash flows expected to be generated by the assets. If the assets are considered to be impaired, the amount of any impairment is measured as the difference between the carrying value and the fair value of the impaired assets.

During 2012, 2013 and 2014 no impairment charges were identified.

### *Goodwill*

As a result of our acquisitions, our balance sheet included acquired goodwill in the aggregate amount of approximately \$32.1 million as of December 31, 2012 and \$33.7 million as of December 31, 2013 and 2014. Goodwill represents the excess of the purchase price and related costs over the value assigned to net tangible and identifiable intangible assets of businesses acquired and accounted for under the purchase method. In accordance with ASC 350, "Intangible, Goodwill and Other," goodwill is not amortized and is tested for impairment at least annually. Our annual impairment test is performed at the end of the fourth quarter each year. If events or indicators of impairment occur between the annual impairment tests, we perform an impairment test of goodwill at that date.

ASC 350 prescribes a two-phase process for impairment testing of goodwill. The first phase screens for impairment, while the second phase (if necessary) measures impairment. Goodwill impairment is deemed to exist if the net book value of a reporting unit exceeds its estimated fair value. In such case, the second phase is then performed, and we measure impairment by comparing the carrying amount of the reporting unit's goodwill to the implied fair value of that goodwill. An impairment loss is recognized in an amount equal to the excess. We have an option to perform a qualitative assessment to determine whether it is more-likely-than-not that the fair value of a reporting unit is less than its carrying amount prior to performing the two-step goodwill impairment test. If this is the case, the two-step goodwill impairment test is required. If it is more-likely-than-not that the fair value of a reporting unit is greater than its carrying amount, the two-step goodwill impairment test is not required.

During 2012, 2013 and 2014, no impairment losses were identified.

#### *Income Taxes and Valuation Allowance*

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

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

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

#### *Stock-based compensation*

We account for stock-based compensation in accordance with ASC 718, "Compensation-Stock Compensation." We utilize the Black-Scholes option pricing model to estimate the fair value of stock-based compensation at the date of



grant. The Black-Scholes model requires subjective assumptions regarding dividend yields, expected volatility, expected life of options and risk-free interest rates. These assumptions reflect management's best estimates. Changes in these inputs and assumptions can materially affect the estimate of fair value and the amount of our stock-based compensation expenses. We recognized stock-based compensation expense of \$1.5 million in 2012, \$1.7 million in 2013 and \$2.5 million in 2014. As of December 31, 2014, there was approximately \$3.7 million of total unrecognized stock-based compensation expense related to non-vested stock-based compensation arrangements granted by us. As of December 31, 2014, that expense is expected to be recognized over a weighted-average period of 1.1 years.

### *Contingent liabilities*

We are, from time to time, involved in claims, lawsuits, government investigations, and other proceedings arising from the ordinary course of our business. We record a provision for a liability when we believe that it is both probable that a liability has been incurred, and the amount can be reasonably estimated. Significant judgment is required to determine both probability and the estimated amount. Such legal proceedings are inherently unpredictable and subject to significant uncertainties, some of which are beyond our control. Should any of these estimates and assumptions change or prove to have been incorrect, it could have a material impact on our results of operations, financial position and cash flows. See Item 4B - "Information on the Company-Business Overview-Legal Proceedings" for a discussion of certain claims against us.

### *A. OPERATING RESULTS*

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

### **Overview**

We design, develop and sell advanced voice over IP, or VoIP, and converged VoIP and data networking products and applications to service providers and enterprises. We are a VoIP technology leader focused on VoIP communications, applications and networking elements, and its products are deployed globally in broadband, mobile, cable, and enterprise networks. We provide a range of innovative, cost-effective products including media gateways, multi-service business gateways, residential gateways, IP phones, media servers, session border controllers, and value-added applications. Our underlying technology, VoIPerfectHD, relies primarily on our leadership in digital signal processing, or DSP, voice coding and voice processing technologies. Our high definition ("HD") VoIP technologies and products provide enhanced intelligibility, and a better end user communication experience in emerging voice networks.

Our products enable our customers to build high-quality packet networking equipment and network solutions and provide the building blocks to connect traditional telephone networks to VoIP networks, as well as connecting and securing multimedia communication between different packet-based networks. Our products are sold primarily to leading original equipment manufacturers, or OEMs, system integrators and network equipment providers in the telecommunications and networking industries. We have continued to broaden our offerings, both from internal and external development and through acquisitions, as we have expanded in the last few years from selling chips to boards, subsystems, media gateway systems, media servers, session border controllers and messaging platforms. We have also increased our product portfolio to enhance our position in the market and serve our channels better as a one stop shop for voice over IP hardware.

We have invested significant development resources in complying with Microsoft's requirements for the purpose of becoming a Microsoft recognized partner for their unified communication solutions for the enterprise market, which are known as Microsoft Lync. We have adapted some of our gateway products, IP phones, session border controllers, survivable branch applications, value added applications and professional services to operate in the Microsoft Lync environment. Our products to the Lync Unified Communications market are sold primarily to our channel partners that distribute and integrate the Lync solution to enterprises.

In April 2014, the Israeli Office of the Chief Scientist (OCS) approved a three-year program (2014-2016) for approximately NIS100 million (equal to approximately \$25.7 million based on the exchange rate in effect as of December 31, 2014) to enable us to establish an advanced innovative research and development center for cloud computing technologies and Unified Communications. In May 2014, the research and development center was established. The new research and development center is expected to increase its staff to 100 engineers by 2016. We expect that a significant portion of the cost of this project will be reimbursed to us through grants from the OCS pursuant to this program. The grants are subject to conditions relating to grants by the OCS. Funding for the whole term of the program is subject to the continued review and approval of the progress of the project by the OCS.

AudioCodes offers a comprehensive professional services program intended to provide responsive, preventive, and consultative support of AudioCodes networking products. AudioCodes professional services support networking devices, applications and infrastructures, allowing large organizations and service providers to realize the potential of a high-performance multi-service network.

Our headquarters and research and development facilities are located in Israel with research and development extensions in the U.S. and U.K. We have other offices located in Europe, the Far East, and Latin America.

The identities of our principal customers have changed and we expect that they will continue to change, from year to year. Historically, a substantial portion of our revenue has been derived from large purchases by a limited number of original equipment manufacturers, or OEMs, and network equipment providers, or NEPs, systems integrators and distributors. ScanSource Communications Group, our largest customer, accounted for 13.7% of our revenues in 2012,

17.8% of our revenues in 2013 and 14.9% of our revenues in 2014. In addition, Westcon Group accounted for 10.5% of our revenues in 2014. Our top five customers accounted for 31.4% of our revenues in 2012, 34.2% of our revenues in 2013 and 32.0% of our revenues in 2014. If we lose a large customer and fail to add new customers to replace lost revenue, our operating results may be materially adversely affected.

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

|          | Year Ended December 31, |         |         |
|----------|-------------------------|---------|---------|
|          | 2012                    | 2013    | 2014    |
| Americas | 52.1 %                  | 52.1 %  | 50.4 %  |
| Far East | 13.7                    | 15.0    | 15.3    |
| Europe   | 28.1                    | 27.2    | 29.0    |
| Israel   | 6.1                     | 5.7     | 5.3     |
| Total    | 100.0 %                 | 100.0 % | 100.0 % |

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

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

The demand for Voice over IP, or VoIP, technology has increased during recent years. In recent years, the shift from traditional circuit-switched networks to next generation packet-switched networks continued to gain momentum. As data traffic becomes the dominant factor in communications, service providers are building and maintaining converged networks for integrated voice and data services. In developed countries, traditional and alternative service providers adopt bundled triple play (voice, video and data) and quadruple play (voice, video, data and mobile) offerings. This trend, enabled by voice and multimedia over IP, has fueled competition among cable, wireline, ISP and mobile operators, increasing the pressure for adopting and deploying VoIP networks. In addition, underdeveloped markets without basic wire line service in countries such as China and India and certain countries in Eastern Europe are adopting the use of VoIP technology to deliver voice and data services that were previously unavailable.

The general economic uncertainty, including disruptions in the world credit and equity markets, has had and continues to have a negative impact on business around the world. This economic environment has had an adverse impact on the technology industry and our major customers. Conditions may continue to be uncertain or may be subject to deterioration which could lead to a reduction in consumer and customer spending overall, which could have an adverse impact on sales of our products. A disruption in the ability of our significant customers to access liquidity could cause serious disruptions or an overall deterioration of their businesses which could lead to a significant reduction in their orders of our products and the inability or failure on their part to meet their payment obligations to us, any of which could have a material adverse effect on our results of operations and liquidity. In addition, any disruption in the ability of customers to access liquidity could lead customers to request longer payment terms from us or long-term financing of their purchases from us. Granting extended payment terms or a significant adverse change in a customer's financial and/or credit position could also require us to assume greater credit risk relating to that customer's receivables or could limit our ability to collect receivables related to purchases by that customer. As a result, our allowance for doubtful accounts and write-offs of accounts receivable could increase.

## **Results of Operations**

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

| Statement of Operations Data:               | Year Ended December 31, |         |         |
|---|-------------------------|---------|---------|
|   | 2012                    | 2013    | 2014    |
| <b>Revenues:</b>                            |                         |         |         |
| Products                                    | 81.3 %                  | 81.4 %  | 78.2 %  |
| Services                                    | 18.7 %                  | 18.6 %  | 21.8 %  |
| Total revenues                              | 100.0 %                 | 100.0 % | 100.0 % |
| <b>Cost of revenues:</b>                    |                         |         |         |
| Products                                    | 38.0                    | 37.9    | 35.9    |
| Services                                    | 4.6                     | 4.8     | 5.4     |
| Total cost of revenues                      | 42.6                    | 42.7    | 41.3    |
| Gross profit                                | 57.4                    | 57.3    | 58.7    |
| <b>Operating expenses:</b>                  |                         |         |         |
| Research and development, net               | 22.5                    | 20.5    | 21.3    |
| Selling and marketing                       | 31.4                    | 28.6    | 30.0    |
| General and administrative                  | 6.4                     | 6.2     | 5.1     |
| Total operating expenses                    | 60.3                    | 55.3    | 56.4    |
| Operating income (loss)                     | (2.9 )                  | 2.0     | 2.3     |
| Financial income (expenses), net            | 0.4                     | 0.1     | (0.1 )  |
| Income (loss) before taxes on income        | (2.5 )                  | 2.1     | 2.2     |
| Income tax benefit (expense), net           | (0.4 )                  | 1.0     | (2.2 )  |
| Equity in losses of affiliated company, net | (0.3 )                  | (0.0 )  | -       |
| Net income (loss)                           | (3.2 )%                 | 3.1 %   | (0.1 )% |

### **Year Ended December 31, 2014 Compared to Year Ended December 31, 2013**

*Revenues.* Revenues increase 10.5% to \$151.6 million in 2014 from \$137.2 million in 2013. The increase in revenues was due to an increase in revenues from our networking product line, as well as an increase in support services related to our networking products.

Our revenues from products in 2014 increased by 6.1% to \$118.6 million, or approximately 78% of total revenues, from \$111.8 million, or 81% of total revenues, in 2013. The increase in revenues from products was primarily attributable to the increase in our networking product line, particularly with respect to our Session Boarder Controller product line, as well as due to the growing demand for our networking product line in the Unified Communications market, Contact Centers and Hosted Services markets.

Our revenues from services in 2014 increased by 29.6% to \$33.0 million, or approximately 22% of total revenues, from \$25.5 million, or 19% of total revenues, in 2013. The increase in revenues from services was driven by the growth in support services related to the increase in revenues from networking products and by the growth in professional services.

*Cost of Revenues and Gross Profit.* Cost of revenues includes the cost of hardware, quality assurance, overhead related to manufacturing activity, technology licensing and royalty fees payable to third parties and royalties payables to the Office of the OCS. Gross profit increased to \$89.0 million in 2014 from \$78.7 million in 2013. Gross profit as a percentage of revenues was 58.7% in 2014, compared to 57.3% in 2013.

Cost of revenues from products increased by 4.5% to \$54.3 million in 2014 from \$52.0 million in 2013. This increase is primarily attributable to an increase in the procurement of materials, in line with the increase in revenues from products. Gross margin percentage for sales of products increased to 54% from 53% in 2013.

Cost of revenues from services increased by 25.5% to \$8.2 million from \$6.6 million in 2013. This increase is primarily attributable to higher support personnel expenses associated with providing services and implementation of our products with service providers as well as enterprise customers. In 2014, the gross margin for sales of services increased to 75% from 74% in 2013. In 2014, expenses included in cost of revenues related to stock-based compensation were \$89,000 compared to \$62,000 in 2013.

*Research and Development Expenses, net.* Research and development expenses, net, consist primarily of salaries and related costs of employees engaged in ongoing research and development activities, development-related raw materials and the cost of subcontractors, less grants from the OCS. Research and development expenses were \$32.3 million in 2014 and \$28.2 million in 2013. As a percentage of total revenues, these expenses were 21.3% in 2014 and 20.5% in 2013. Research and development expenses increased primarily as a result of adding personnel in connection with our continued development of new products and as a result of the NIS appreciation against the U.S. dollar. In 2014, expenses included in research and development expenses related to stock-based compensation were \$585,000, compared to \$408,000 in 2013. Grants recognized from the OCS were \$3.9 million in 2014, compared to \$2.8 million in 2013.

*Selling and Marketing Expenses.* Selling and marketing expenses consist primarily of salaries and related costs of selling and marketing personnel, as well as exhibition, travel and related expenses. Selling and marketing expenses increased 15.9% in 2014 to \$45.5 million from \$39.3 million in 2013 and increased as a percentage of total revenues to 30.0% in 2014 from 28.6% in 2013.

These expenses increased on an absolute basis as a result of an increase in our sales force and marketing activities. In 2014, expenses included in selling and marketing expenses related to stock-based compensation were \$1,105,000 compared to \$625,000 in 2013.

*General and Administrative Expenses.* General and administrative expenses consist primarily of salaries and related costs of finance, human resources and general management personnel, rent, network and allowance for doubtful accounts, as well as insurance and consultant services expenses. General and administrative expenses decreased 9.2% to \$7.7 million in 2014 from \$8.5 million in 2013. As a percentage of revenues, general and administrative expenses decreased to 5.1% in 2014 from 6.2% in 2013. In 2014, expenses included in general and administrative expenses related to stock-based compensation were \$767,000, compared to \$606,000 in 2013.

*Financial Income (Expenses), Net.* Financial income, net consists primarily of interest earned on cash and cash equivalents, marketable securities and bank deposits, net of interest accrued on our bank loans as well as on our remaining senior convertible notes outstanding, and bank charges. Financial expenses, net, in 2014 were \$196,000, compared to financial income, net of \$96,000 in 2013. The increase in financial expenses, net in 2014 was due to lower interest income recorded with respect to our bank deposits, due to fluctuations in the NIS/U.S. dollar exchange rate which were partially offset by lower expenses recorded with respect to interest on our bank loans and financial income with respect to our marketable securities.

*Income Tax Benefit (Expense), Net.* We had a net income tax expenses of \$3.4 million in 2014 compared to net income tax benefit of \$1.4 million in 2013. The net income tax benefit in 2013 is a result of a tax benefit of \$1.8 million relating to the available net carry forward tax losses based on expectations of generating taxable income in the foreseeable future and an increase of tax rates. The increase in the net income tax expenses is primarily a result of utilization of deferred tax assets.

*Equity in Losses of Affiliated Company, Net.* Equity in losses of affiliated company, net was \$21,000 in 2013. In May 2013, we acquired certain assets of our affiliated company, Mailvision. After the closing of this acquisition, Mailvision ceased operations and, as a result, there were no losses recorded with respect to this company.

### **Year Ended December 31, 2013, Compared to Year Ended December 31, 2012**

*Revenues.* Revenues increase 7.6% to \$137.2 million in 2013 from \$127.5 million in 2012. The increase in revenues was due to an increase in revenues from our networking product line as described below.

Our revenues from products in 2013 increased by 7.8% to \$111.8 million, or approximately 81% of total revenues, from \$103.7 million, or 81% of total revenues, in 2012. The increase in revenues from products was primarily attributable to the increase in our networking product line, particularly with respect to our Session Boarder Controller product line, as well as due to the growing demand for our networking product line in the Unified Communications market.

Our revenues from services in 2013 increased by 6.9% to \$25.5 million, or approximately 19% of total revenues, from \$23.8 million, or 19% of total revenues, in 2012. The increase in revenues from services was driven by the growth in support services related to the increase in revenues from products.

*Cost of Revenues and Gross Profit.* Cost of revenues includes the cost of hardware, quality assurance, overhead related to manufacturing activity, technology licensing and royalty fees payable to third parties and royalties payables to the Office of the OCS. Gross profit increased to \$78.7 million in 2013 from \$73.2 million in 2012. Gross profit as a percentage of revenues was 57.3% in 2013, compared to 57.4% in 2012.

Cost of revenues from products increased by 7.5% to \$52.0 million in 2013 from \$48.4 million in 2012. This increase is primarily attributable to an increase in the procurement of materials, in line with the increase in revenues from products. Gross margin percentage for sales of products was approximately 53% in both 2013 and 2012.



Cost of revenues from services increased by 10.9% to \$6.6 million from \$5.9 million in 2012. This increase is primarily attributable to higher support personnel expenses associated with providing services and implementation of our products with service providers as well as enterprise customers. In 2013, the gross margin for sales of services decreased to 74% from 75% in 2012. In 2013, expenses included in cost of revenues related to stock-based compensation were \$62,000 compared to \$61,000 in 2012

*Research and Development Expenses, net.* Research and development expenses, net, consist primarily of salaries and related costs of employees engaged in ongoing research and development activities, development-related raw materials and the cost of subcontractors, less grants from the OCS. Research and development expenses were \$28.2 million in 2013 and \$28.7 million in 2012. As a percentage of total revenues, these expenses were 20.5% in 2013 and 22.5% in 2012. Research and development expenses decreased primarily as a result of our cost reduction plan which was implemented during 2012 and reduced the number of our research and development personnel. We expect that research and development expenses will increase on an absolute dollar basis in 2014, as a result of adding personnel in connection with our continued development of new products. In 2013, expenses included in research and development expenses related to stock-based compensation were \$408,000, compared to \$430,000 in 2012. Grants recognized from the OCS were \$2.8 million in 2013, compared to \$2.7 million in 2012.

*Selling and Marketing Expenses.* Selling and marketing expenses consist primarily of salaries and related costs of selling and marketing personnel, as well as exhibition, travel and related expenses. Selling and marketing expenses decreased 1.9% in 2013 to \$39.3 million from \$40.0 million in 2012 and decreased as a percentage of total revenues to 28.6% in 2013 from 31.4% in 2012. These expenses decreased on an absolute basis primarily as a result of our cost reduction plan which was implemented during 2012. We expect that selling and marketing expenses will increase on an absolute dollar basis in 2014, as a result of an expected increase in our sales force and marketing activities. In 2013, expenses included in selling and marketing expenses related to stock-based compensation were \$625,000 compared to \$427,000 in 2012.

*General and Administrative Expenses.* General and administrative expenses consist primarily of salaries and related costs of finance, human resources and general management personnel, rent, network and allowance for doubtful accounts, as well as insurance and consultant services expenses. General and administrative expenses increased 2.9% to \$8.5 million in 2013 from \$8.2 million in 2012. As a percentage of revenues, general and administrative expenses decreased to 6.2% in 2013 from 6.4% in 2012. In 2013, expenses included in general and administrative expenses related to stock-based compensation were \$606,000, compared to \$601,000 in 2012.

*Financial Income, Net.* Financial income, net consists primarily of interest earned on cash and cash equivalents, marketable securities and bank deposits, net of interest accrued on our bank loans as well as on our remaining senior convertible notes outstanding, and bank charges. Financial income, net, in 2013 was \$96,000, compared to \$453,000 in 2012. The decrease in financial income, net in 2013 was primarily due to lower interest income recorded with respect to our bank deposits, as a result of a decrease in market interest rates.

*Income Tax Benefit (Expense), Net.* We had a net income tax benefit of \$1.4 million in 2013 compared to net income tax expenses of \$541,000 in 2012. The net income tax benefit in 2013 is a result of a tax benefit of \$1.8 million relating to the available net carry forward tax losses based on expectations of generating taxable income in the foreseeable future and an increase of tax rates.

*Equity in Losses of Affiliated Company, Net.* Equity in losses of affiliated company, net was \$21,000 in 2013, compared to \$354,000 in 2012. In May 2013, we acquired certain assets of our affiliated company, Mailvision. After the closing of this acquisition, Mailvision ceased operations and, as a result, our losses in this company decreased.

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

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

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

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

| Year Ended<br>December 31, | Israeli<br>inflation<br>Rate<br>% | NIS<br>devaluation<br>rate<br>% | Israeli inflation<br>adjusted for<br>Devaluation<br>% |
|----------------------------|-----------------------------------|---------------------------------|---|
| 2012                       | 1.4                               | (2.3 )                          | 3.7   |
| 2013                       | 1.9                               | (7.0 )                          | (8.9 )  |
| 2014                       | (0.1 )                            | 12.0                            | 12.1  |

### Recent Accounting Pronouncements

In April 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update No. 2014-08 (ASU 2014-08) "Presentation of Financial Statements (Topic 205) and Property, Plant, and Equipment (Topic 360): Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity." ASU 2014-08 raises the threshold for a disposal to qualify as a discontinued operation and requires new disclosures of both discontinued operations and certain other disposals that do not meet the definition of a discontinued operation. The guidance is effective for annual periods beginning on or after December 15, 2014. Early adoption is permitted but only for disposals that have not been reported in financial statements previously issued. We do not expect the impact of the adoption of ASU 2014-08 to be material to the consolidated financial statements.

In May 2014, the FASB issued Accounting Standards Update No. 2014-09 (ASU 2014-09) "Revenue from Contracts with Customers." ASU 2014-09 supersedes the revenue recognition requirements in "Revenue Recognition (Topic 605)", and requires entities to recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled to in exchange for those goods or services. ASU 2014-09 is effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. Early adoption is not permitted. We are currently in the process of evaluating the impact of the adoption of ASU 2014-09 on our consolidated financial statements.

### *B. LIQUIDITY AND CAPITAL RESOURCES*

We have financed our operations for the last three years primarily from our cash and cash equivalents, bank deposits, bank borrowings and cash from operations. In addition, in March 2014 we realized net proceeds of approximately \$29.7 million as a result of the sale by us of 4,025,000 of our ordinary shares in a public offering.

As of December 31, 2014, we had \$85.7 million in cash and cash equivalents, marketable securities and bank deposits, an increase of \$23.5 million from \$62.2 million at December 31, 2013. As of December 31, 2014, we were restricted with respect to using approximately \$11.1 million of our cash as a result of provisions in our loan agreements, a lease agreement and foreign exchange derivatives transactions.

### *Public Offering*

In March 2014, we sold in a public offering 4,025,000 of our ordinary shares, including 525,000 shares sold pursuant to the exercise in full of an over-allotment option granted to the underwriters, at a purchase price of \$8.00 per share. Our net proceeds from this offering were approximately \$29.7 million, after deducting underwriting commissions and other offering expenses.

### *Share Repurchase Program*

In August 2014, our Board of Directors approved a program to repurchase up to \$3.0 million of our ordinary shares. In November 2014, we received court approval in Israel to repurchase up to an additional \$15.0 million of our ordinary shares. Share purchases will take place in open market transactions or in privately negotiated transactions and may be made from time to time depending on market conditions, share price, trading volume or other factors. The repurchase program does not require us to purchase a specific number of shares and may be suspended from time to time or discontinued. During 2014, we acquired an aggregate of 1,048,891 of our ordinary shares for an aggregate consideration of approximately \$5.3 million.

### *Senior Convertible Notes*

In November 2004, we issued \$125.0 million aggregate principal amount of our 2.00% Senior Convertible Notes due 2024. The Notes were convertible at a rate of \$18.71 per share, subject to adjustment in certain circumstances, such as changes in our capital structure or upon the issuance by us of share dividends or certain cash distributions. As of December 31, 2013, there was a total of \$353,000 in principal amount of the Notes outstanding as we repurchased all of the other Notes during 2008 and 2009. During 2014, we repurchased the full remaining principal amount of the Notes.

### *Bank Loans*

In April and July 2008, we entered into loan agreements with two Israeli banks that provided for borrowings of an aggregate of \$30 million. The loans bear interest at an annual rate equal to LIBOR plus 1.3%-1.5% with respect to \$23 million of borrowings and LIBOR plus 0.5%-0.65% with respect to \$7.0 million of borrowings. The principal amount borrowed was repayable in 20 equal quarterly payments from August 2008 through July 2013. As of December 31, 2013, this loan had been paid in full.

In September and December 2011, we entered into another loan agreements with two Israeli banks that provided for borrowings of an aggregate of \$23.8 million. Certain amounts of these loans were required to be maintained as a compensating bank deposits that decrease as the loans are repaid. The loans bear interest at an annual rate equal to LIBOR plus 2.1%-4.35% with respect to \$19.9 million of these loans. The remaining \$3.9 million principal amount of these loans bears interest at 0.5% above interest paid with respect to the bank deposit. Of these borrowings, \$19.9 million of the principal amount borrowed is repayable in 20 equal quarterly payments and the remaining \$3.9 million of principal amount is repayable in 10 equal semiannual payments through September 2017. As of December 31, 2014, there was \$9.8 million principal amount of these loans outstanding.

As of December 31, 2014, we were required to maintain an aggregate of \$4.9 million of compensating bank deposits with respect to our bank loans. The amount of the compensating balances we are required to keep decreases over time as we repay these loans.

The loan agreements require us, among other things, to meet certain financial covenants such as maintaining shareholders' equity, cash balances, and liabilities to banks at specified levels, as well as achieving certain levels of operating income.

*Cash from Operating Activities*

Our operating activities provided cash in the amount of \$6.0 million in 2014, primarily due to a decrease of \$2.9 million in deferred tax assets and an increase of \$2.9 million in trade payables and \$3.7 million in deferred revenues, as well as non-cash charges of \$3.2 million for depreciation and amortization and \$2.5 million for stock-based compensation expenses, offset in part by an increase of \$4.7 million in trade receivables and \$2.2 million in other receivables and prepaid expenses, as well as a decrease of \$2.2 million in other payables and accrued expenses and other liabilities. The deferred tax assets decreased as a result of utilization of these assets. Our deferred revenues increased due to the increase in the revenues from services and our trade receivables increased primarily because of our higher sales volume in 2014, compared to 2013.

Our operating activities provided cash in the amount of \$14.1 million in 2013, primarily due to our net income of \$4.2 million, a decrease of \$3.0 million in inventories and an increase of \$2.6 million in other payables and accrued expenses, and \$3.1 million in deferred revenues, as well as non-cash charges of \$3.2 million for depreciation and amortization and \$1.7 million for stock-based compensation expenses, offset in part by an increase of \$2.3 million in trade receivables and \$1.9 million in deferred tax assets. The deferred tax assets increased as a result of an increase in our net income tax benefit in 2013, relating to the available net carry forward tax losses based on expectations of generating taxable income in the foreseeable future. Our deferred revenues increased due to the increase in the revenues from services and our trade receivables increased primarily because of our higher sales volume in 2013, compared to 2012.

Our operating activities provided cash in the amount of \$3.0 million in 2012, primarily due to a decrease of \$6.5 million in trade receivables and \$3.6 million in inventories, as well as non-cash charges of \$2.9 million for depreciation and amortization and \$1.5 million for stock-based compensation expenses, offset in part by our net loss of \$4.2 million and decreases of \$5.5 million in trade payables and \$3.1 million in other payables and accrued expenses. Our trade receivables and our inventories decreased primarily because of our lower sales volume in 2012, compared to 2011.

*Cash from Investing Activities*

In 2014, we used \$43.4 million of cash in investing activities, primarily due to purchase of marketable securities of \$60.3 and capital expenditures of \$2.5 million, offset in part, by proceeds from redemption of marketable securities of \$15.4 million and of long-term bank deposits of \$2.7 million, as well as a decrease in bank deposits, net of \$1.5 million.

In 2013, our investing activities provided cash in the amount of \$8.6 million, primarily due to the proceeds from marketable securities of \$7.6 million and from long-term bank deposits of \$2.6 million, as well as from a decrease in short-term deposits, net of \$1.2 million, offset in part by capital expenditures of \$1.6 million and an investment in an affiliated company of \$1.2 million.



In 2012, our investing activities provided cash in the amount of \$1.4 million, primarily due to the net proceeds of \$3.7 million from short-term bank deposits, offset in part by \$2.0 million in purchases of property and equipment.

#### *Cash from Financing Activities*

In 2014, our financing activities provided cash in the amount of \$21.5 million, primarily due to the \$29.7 million of proceeds from the sale of our ordinary shares in a public offering and \$2.2 million of proceeds from the issuance of shares upon exercise of stock options, offset, in part, by \$4.7 million used for repayment of loans and \$5.3 million used to repurchase our shares.

In 2013, we used \$7.2 million of cash in financing activities primarily as a result of \$8.4 million used for repayment of bank loans offset, in part, by \$1.8 million in proceeds from issuance of shares upon exercise of stock options and purchases of shares under our employee stock purchase plan.

In 2012, we used \$17.4 million of cash in financing activities as a result of \$10.2 million used for repayment of bank loans and \$6.9 million used to repurchase our shares.

#### *Financing Needs*

We anticipate that our operating expenses will be a material use of our cash resources for the foreseeable future. We believe that our current working capital is sufficient to meet our operating cash requirements for at least the next twelve months, including payments required under our existing bank loans. Part of our strategy is to pursue acquisition opportunities. If we do not have available sufficient cash to finance our operations and the completion of additional acquisitions, we may be required to obtain additional debt or equity financing. We cannot be certain that we will be able to obtain, if required, additional financing on acceptable terms or at all.

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

##### *Research and Development*



In order to accommodate the rapidly changing needs of our markets, we place considerable emphasis on research and development projects designed to improve our existing products and to develop new ones. We are developing analog and digital media gateways for carrier and enterprise applications, multi service business routers and session border controllers, IP phones, management and productivity applications, as well as specialized appliances for Microsoft Lync such as SBA and OneBox365. Our platforms are expected to feature increased session capacity, new functionalities, enhanced signaling software and compliance with new control protocols, as well as new management and productivity applications. As of December 31, 2014, 266 of our employees were engaged primarily in research and development on a full-time basis.

Our research and development expenses were \$32.3 million in 2014, compared to \$28.2 million in 2013. From time to time we have received royalty-bearing grants from the OCS. As a recipient of grants from the OCS, we are obligated to perform all manufacturing activities for projects subject to the grants in Israel unless we receive an exemption. Know-how from the research and development which is used to produce products may not be transferred to third parties without the approval of the OCS and may further require significant payments. The OCS approval is not required for the export of any products resulting from such research or development. Through December 31, 2014, we had obtained grants from the OCS aggregating \$32.7 million for certain of our research and development projects. We are obligated to pay royalties to the OCS, amounting to 1.3%-6% of the sales of the products and other related revenues generated from such projects, up to 100% of the grants received, if no additional payments are required, linked to the U.S. dollar and bearing interest at the rate of LIBOR at the time of grant. The obligation to pay these royalties is contingent on actual sales of the products and in the absence of such sales no payment is required. As of December 31, 2014, we have contingent obligation to pay royalties in the amount of approximately \$39.6 million.

In April 2014, the OCS approved our application to participate in a special three year OCS program to enable us to establish an advanced innovative research and development center for cloud computing technologies and Unified Communications. As a result, the amount of the grants that we receive each year from the OCS is expected to increase.

*D. TREND INFORMATION*

The accelerated demand for VoIP technology has impacted our business during the last few years. Over the past few years, the shift from traditional circuit-switched networks to next generation packet-switched networks has continued to gain momentum. As data traffic becomes the dominant factor in communications, service providers are building and maintaining converged networks for integrated voice and data services. In addition, underdeveloped markets without basic wire line service in countries such as China and India and certain countries in Eastern Europe are beginning to use VoIP technology to deliver voice and data services that were previously unavailable. In addition, the growth in broadband access and related technologies has driven the emergence of alternative service providers. This in turn stimulates competition with incumbent providers, encouraging them to adopt voice over packet technologies.

While the growth in demand for VoIP services helped create demand for our products and services, there is an ongoing transition in network architectures that could adversely affect the demand for our products. The growth of services over Internet Protocol (IP) and data usage services over legacy voice using TDM is driving the transition in network architecture. The demand for our media gateway products is based on the need to interconnect VoIP networks with traditional non-packet based networks. The demand for our Enterprise Session Border Control (ESBC) products is based on the need to interconnect LAN and WAN voice over packet networks with each other. The migration from traditional TDM networks to pure IP networks is gradually increasing. This could positively affect the demand for our ESBC products, but negatively affect the demand for our media gateway products.

In addition, as businesses migrate towards pure IP networks, this could drive demand for our IP Phones and network management products.

We are experiencing decreasing demand for our technology products from customers who previously manufactured network equipment products based on our enabling technology. These customers are migrating from AudioCodes' enabling technology products to diverse integrated comprehensive solutions and, as a result, the demand for our technology products is being adversely affected.

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

*E. OFF-BALANCE SHEET ARRANGEMENTS*

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

*F. TABULAR DISCLOSURE OF CONTRACTUAL OBLIGATIONS*

As of December 31, 2014, our contractual obligations were as follows (dollars in thousands):

|                                     | PAYMENTS DUE BY PERIOD |            |              |                      | TOTAL   |
|-------------------------------------|------------------------|------------|--------------|----------------------|---------|
|                                     | LESS THAN-<br>1 YEAR   | 3<br>YEARS | 3-5<br>YEARS | MORE THAN<br>5 YEARS |         |
| Bank loans                          | \$ 4,686               | \$ 5,105   | \$ -         | \$ -                 | \$9,791 |
| Rent and lease commitments, net (1) | 6,463                  | 12,652     | 11,145       | 21,948               | 52,208  |
| Accrued severance pay, net (2)      | -                      | -          | -            | -                    | 73      |
| Uncertain tax positions (3)         | 370                    | -          | -            | -                    | 370     |
| Payment to MailVision               | 228                    | 215        | -            | -                    | 443     |
| Office of the Chief Scientist       | -                      | -          | -            | 39,559               | 39,559  |
| Other commitments                   | 13,395                 | -          | -            | -                    | 13,395  |

(1) Our obligation for rent and lease commitments as of December 31, 2014 was approximately \$53.0 million. We have rent and lease income in the amount of approximately \$835,000, leaving a net obligation of approximately \$52.2 million.

(2) Our obligation for accrued severance pay under Israel's Severance Pay Law as of December 31, 2014 was \$17.9 million. This obligation is payable only upon termination, retirement or death of the respective employee. We have funded \$17.8 million through deposits into severance pay funds, leaving a net obligation of approximately \$73,000.

(3) Uncertain income tax position under ASC 740 (formerly FASB Interpretation No 48), "Income Taxes," are due upon settlement and we are unable to reasonably estimate the ultimate amount of timing of settlement. See also Note 15f in our Consolidated Financial Statements for further information regarding our liability under ASC 740.

**ITEM 6.DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES***A. DIRECTORS AND SENIOR MANAGEMENT*

The following table sets forth certain information with respect to our directors, senior executive officers and key employees at March 20, 2015:

| <b>Name</b>                 | <b>Age</b> | <b>Position</b>                                       |
|-----------------------------|------------|---|
| Stanley B. Stern            | 58         | Chairman of the Board of Directors                    |
| Shabtai Adlersberg          | 62         | President, Chief Executive Officer and Director       |
| Ofer Segev                  | 56         | Vice President of Finance and Chief Financial Officer |
| Lior Aldema                 | 49         | Chief Operating Officer and Head of Global Sales      |
| Yair Hevdeli                | 50         | Vice President, Research and Development              |
| Jeffrey Kahn                | 57         | Chief Strategy Officer                                |
| Eyal Frishberg              | 56         | Vice President, Operations                            |
| Yehuda Herscovici           | 48         | Vice President, Products                              |
| Nimrod Borovsky             | 43         | Vice President, Marketing                             |
| Tal Dor                     | 45         | Vice President, Human Resources                       |
| Ofer Nimitsovich            | 46         | Vice President, Global Services                       |
| Shaul Weissman              | 49         | Vice President Business Development                   |
| Joseph Tenne(1)(2)(3)       | 59         | Director  |
| Dr. Eyal Kishon(1)(2)(3)(4) | 55         | Director  |
| Doron Nevo(1)(2)(3)(4)      | 59         | Director  |
| Zehava Simon                | 56         | Director  |

(1) Member of Audit Committee

(2) Member of Nominating Committee

(3) Member of Compensation Committee

(4) Outside Director under Israeli Law

*Stanley Stern* became a director and our Chairman of the Board in December 2012. From 2004 until 2013 Mr. Stern served in various positions at Openheimer & Co., including as a Managing Director and Head of Investment Banking, Technology, Israeli Banking and FIG. Since 2013, Mr. Stern has served as the president of Alnitak Capital, a private merchant bank and strategic advisory firm. From 2002 until 2004, he was a Managing Director and the Head of Investment Banking at C.E. Unterberg, Towbin where he focused on technology and defense related sectors. From January 2000 until January 2002, Mr. Stern was the President of STI Ventures Advisory USA Inc., a venture capital firm focusing on technology investments. Prior to his term at STI Ventures, he spent over 20 years at CIBC Openheimer in the investment banking department and started the technology banking group in 1990. From 2002

until 2012, Mr. Stern served as the Chairman of the Board of Directors of Tucows, Inc., an internet service provider that is public traded company on AMEX, and, from 2012 until 2013, he served as a Director of Tucows. From 2012 until February 2014, he served as a director of Given Imaging Ltd., a manufacturer of medical devices, until Given Imaging was acquired by another company. From 2004 until 2009, he served as a director of Odimo Inc. (DBA Diamond.com), an online jewelry vendor. From 2005 until its sale in 2011, he served as a director and Chairman of the Audit Committee of Fundtech Ltd. Mr. Stern received his MBA from Harvard Business School and a BS from Queens College.

*Shabtai Adlersberg* co-founded AudioCodes in 1993, and has served as our President, Chief Executive Officer and a director since inception. Until December 2012, Mr. Adlersberg also served as the Chairman of our Board of Directors. Mr. Adlersberg co-founded DSP Group, a semiconductor company, in 1987. From 1987 to 1990, Mr. Adlersberg served as the Vice President of Engineering of DSP Group, and from 1990 to 1992, he served as Vice President of Advanced Technology. As Vice President of Engineering, Mr. Adlersberg established a research and development team for digital cellular communication which was spun-off in 1992 as DSP Communications. Mr. Adlersberg also serves as Chairman of the Board of Directors of Natural Speech Communication Ltd. and as a director of CTI Squared Ltd. Mr. Adlersberg holds an M.Sc. in Electronics and Computer Engineering from Tel Aviv University and a B.Sc. in Electrical Engineering from the Technion-Israel Institute of Technology, or the Technion.

*Ofer Segev* has served as our Vice President of Finance and Chief Financial Officer since November 2014. Previously, Mr. Segev served as President and Chief Executive Officer of Ness Technologies from April 2012 to December 2013 and as a Board member from October 2011 to December 2013. He also served as Executive Vice President and Chief Financial Officer of Ness from April 2007 to April 2012, after joining Ness in March 2007 as an Executive Vice President. From June 2003 to March 2007, he served as Chief Financial Officer of Attunity, a provider of service-oriented software and solutions in the workplace applications market. From May 2001 to June 2003, Mr. Segev was the Chief Financial Officer of TeleKnowledge Group Ltd., a content commerce platform vendor. He also served as its Chief Executive Officer from January 2002 to June 2003. From May 2000 to May 2001, he served as Chief Financial Officer of Tundo, a developer of an IP-based voice and media services platform. From 1985 through May 2000, Mr. Segev served at Kost Forer Gabbay & Kasierer, a member of Ernst & Young Global, where from 1991 he was a partner and led the high-tech industry practice group, and from 1997 to 2000, was a member of the technology steering committee of Ernst & Young International. Mr. Segev holds a B.A. in Economics and Accounting from Bar-Ilan University in Israel, and has studied at the Kellogg School of Management at Northwestern University.

*Lior Aldema* has served as Chief Operating Officer (“COO”) since January 2010, and as our COO and Head of Global Sales since April 2012. Previously, he served as our Vice President, Product Management from 2002 until 2009, as well as our Vice President Marketing from February 2003 until 2009. He has been employed by us since 1998, when he was team leader and later headed our System Software Group in our research and development department. Prior to 1998, Mr. Aldema served as an officer in the Technical Unit of the Intelligence Corps of the Israeli Defense Forces (Major), heading both operational units and large development groups related to various technologies. Mr. Aldema holds an M.B.A. from Tel Aviv University and a B.Sc. from the Technion.

*Yair Hevdeli* joined AudioCodes in July 2013 as Vice President, Research and Development. From 2003 until 2013, Mr. Hevdeli served in various executive positions at Veraz/Dialogic, including Global Vice President, Research and Development and, most recently, as Senior Vice President, Research and Development and General Manager, Bandwidth Optimization BU. From 1998 until 2003, Mr. Hevdeli worked for ECI Ltd, where he held various technical and management positions. Mr. Hevdeli has over 20 years of experience leading large multidisciplinary global research and development teams in the telecom industry. Mr. Hevdeli graduated in 1995 with an M.B.A. in Business Management from Bar Ilan University, Israel and in 1992 received his B.A. in Computer Science and Economics, from Bar Ilan University.

*Jeffrey Kahn* has served as our Chief Strategy Officer since January 2010. Prior to joining us, Mr. Kahn served as Founder and Managing Director of Strategy3i, a global consultancy that he established in 2007 to provide counseling to leading global companies, including Pfizer, Unicredit and Renova, among others. From 2005 to 2007, Mr. Kahn served as a director of investment banking at Maxim Group LLC, and from 1995 to 2005 he served as the Chief Strategic Officer of Ruder Finn International, one of the world’s largest and oldest independent global communications firms. Mr. Kahn holds a B.A. in International Relations and Psychology from Brooklyn College and has done graduate studies in International Relations and Psychology at Tel Aviv University.

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

*Yehuda Herscovici* has served as our Vice President, Products, overlooking Product Management and Product Marketing since 2010. From 2003 till 2010, Mr. Herscovici served as our Vice President, Systems Group since 2003. From 2001 to 2003, Mr. Herscovici served as our Vice President, Advanced Products. From 2000 to 2001, Mr. Herscovici served as our Director of Advanced Technologies. From 1994 to 1998 and during 1999, Mr. Herscovici held a variety of research and development positions at Advanced Recognition Technologies, Ltd., a voice and handwriting recognition company, heading its research and development from 1999 to 2000 as Vice President, Research and Development. From 1998 to 1999, Mr. Herscovici was engaged in developing various wireless communication algorithms at Comsys, a telecommunications company. Mr. Herscovici holds an M.Sc. and a B.Sc.,

from the Technion both in the area of Telecommunications.

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

*Nimrod Borovsky* has served as our Vice President, Marketing since October 2013 and heads the strategic global marketing and business development efforts with AudioCodes partners and channels. From January 2013 until October 2013, Mr. Borovsky served as our Vice President of Unified Communications. Mr. Borovsky has been with AudioCodes since 2005 and has served in numerous product, marketing and business development positions with us. He has worked in telecom and VoIP markets for approximately 20 years. Prior to joining AudioCodes, Mr. Borovsky spent eight years at VocalTec Communications where he served in several positions in research and development, product management and marketing. Mr. Borovsky holds a B.Sc. degree in Electrical Engineering from the New Jersey Institute of Technology, and a M.Sc. degree in Biomedical Engineering from Tel Aviv University.

*Ofer Nimtsovich* joined AudioCodes in March 2013 as Vice President, Global Services. From 2000 until February 2013, Mr. Nimtsovich served in various executive positions at Retalix, including Chief Information Officer, Executive Vice President of Global Services and, most recently as the head of the Software as a Service division of Retalix. From 1994 till 2000, Mr. Nimtsovich worked for Scitex Corporation Ltd., where he held various technical and management positions, including as the Global Microsoft Infrastructure manager for Scitex. Mr. Nimtsovich graduated from the Business Administration College in Israel in 1997 with a B.A. in Business Administration and Marketing, and also holds an MBA degree from the University of Texas.

*Shaul Weissman* has served as our Vice President, Business Development since January 2014. Mr. Weissman has been with AudioCodes since 1994, serving in various positions. From 2007 until 2014, Mr. Weissman served as our Residential Business Line Manager. In addition Mr. Weissman has served as our Vice President and Manager of our chip business line since 2006. From 2001 until 2005, Mr. Weissman served as our Support and Professional Services Manager for our chip business line; and from 1994 until 2000 he served as a digital signal processing engineer. Prior to joining AudioCodes, Mr. Weissman served as Captain in the Israeli Air Force. Mr. Weissman holds an M.Sc. and a B.Sc., from the Technion, both in the area of Telecommunications.

*Joseph Tenne* has served as one of our directors since June 2003. Mr. Tenne serves as the Vice President Finance of Itamar Medical Ltd., an Israeli company listed on the Tel Aviv Stock Exchange. Mr. Tenne serves as a director of Enzymotec Ltd., an Israeli company listed on NASDAQ, Orbetech Ltd., an Israeli company listed on NASDAQ, MIND CTI Ltd., an Israeli company listed on NASDAQ, and Ratio Oil Explorations (Finance) Ltd., an Israeli company listed on the Tel Aviv Stock Exchange. From March 2014 to July 2014, Mr. Tenne served as the Chief Financial Officer of Orgenesis Inc., a U.S. company traded on the Over-The-Counter QB market. From March 2005 until April 2013, Mr. Tenne served as the Chief Financial Officer of Ormat Technologies, Inc., a company listed on the New York Stock Exchange. From January 2006 until April 2013, Mr. Tenne also served as the Chief Financial Officer of Ormat Industries Ltd., an Israeli holding company listed on the Tel-Aviv Stock Exchange and the parent company of Ormat Technologies, Inc. From 2003 to 2005, Mr. Tenne was the Chief Financial Officer of Treofan Germany GmbH & Co. KG, a German company, which is engaged in the development, production and marketing of oriented polypropylene films. From 1997 until 2003, Mr. Tenne was a partner in Kesselman & Kesselman, Certified Public Accountants in Israel and a member of PricewaterhouseCoopers International Limited. Mr. Tenne holds a B.A. in Accounting and Economics and an M.B.A. from Tel Aviv University. Mr. Tenne is also a Certified Public Accountant in Israel.

*Dr. Eyal Kishon* has served as one of our directors since 1997. Since 1996, Dr. Kishon has been Managing Partner of Genesis Partners, an Israel-based venture capital fund. From 1993 to 1996, Dr. Kishon served as Associate Director of Dovrat-Shrem/Yozma-Polaris Fund Limited Partnership. Prior to that, Dr. Kishon served as Chief Technology Officer at Yozma Venture Capital from 1992 to 1993. From 1991 to 1992, Dr. Kishon was a Research Fellow in the Multimedia Department of IBM Science & Technology. From 1989 to 1991, Dr. Kishon worked in the Robotics Research Department of AT&T Bell Laboratories. Dr. Kishon holds a B.A. in Computer Science from the Technion - Israel Institute of Technology and an M.Sc. and a Ph.D. in Computer Science from New York University.

*Doron Nevo* has served as one of our directors since 2000. Mr. Nevo is President and CEO of KiloLambda Technologies Ltd., an optical nano-technology company, which he co-founded in 2001. From 1999 to 2001, Mr. Nevo was involved in fund raising activities for Israeli-based startup companies. From 1996 to 1999, Mr. Nevo served as President and CEO of NKO, Inc. Mr. Nevo established NKO in early 1995 as a startup subsidiary of Clalcom, Ltd. NKO designed and developed a full scale, carrier grade, IP telephony system platform and established its own IP network. From 1992 to 1996, Mr. Nevo was President and CEO of Clalcom Ltd. Mr. Nevo established Clalcom in 1992 as a telecom service provider in Israel. He also serves as a director of Etgar - Portfolio Management Trust Co. and of a number of private companies. Mr. Nevo holds a B.Sc. in Electrical Engineering from the Technion - Israel Institute of Technology and an M.Sc. in Telecommunications Management from Brooklyn Polytechnic.



*Zehava Simon* was appointed a director in February 2014. Ms. Simon served as a Vice President of BMC Software Inc. from 2000 until September 2013, most recently as Vice President, Corporate Development. From 2002 to 2011, Ms. Simon served as Vice President and General Manager of BMC Software in Israel. Prior to joining BMC Software, Ms. Simon held a number of executive positions at Intel Corporation. In her last position at Intel, she led Finance and Operations and Business Development for Intel in Israel. Ms. Simon has served as a board member of various companies, including Tower Semiconductor from 1999-2004, M-Systems from 2005-2006 and InSightec from 2005-2012. Ms. Simon holds a bachelor's degree in Social Sciences from the Hebrew University, a law degree (LL.B.) from the Interdisciplinary Center in Herzlia and a master's degree in Business and Management from Boston University.

#### *B. COMPENSATION*

The aggregate direct remuneration paid during the year ended December 31, 2014 to the 16 persons who served in the capacity of director, senior executive officer or key employee during 2014 was approximately \$3.9 million, including approximately \$458,000 which was set aside for pension and retirement benefits. The compensation amounts do not include amounts expended by us for automobiles made available to our officers, expenses (including business, travel, professional and business association dues and expenses) reimbursed to officers and other fringe benefits commonly reimbursed or paid by companies in Israel.

We currently pay each of our non-employee directors an annual fee of \$38,000 and a fee of \$1,100 for each board meeting or committee meeting attended. In the event that a director attends a meeting by phone or a resolution is adopted by written consent, then the fee is reduced to 60% and 50% of the regular meeting fee, respectively. Such fees are in accordance with the rates prescribed by the Israeli Companies Law Regulation for fees of outside directors. Only directors who are not officers receive compensation for serving as directors. Our director, Mr. Adlersberg, who also serves as our President and Chief Executive Officer, does not receive board meeting fees. Instead, he receives compensation in accordance with the terms of his employment agreement, a copy of which is filed as an exhibit to this Annual Report.

Upon election or reelection to the board of directors for a term of three years, each non-employee director is granted options to purchase 22,500 ordinary shares, of which 7,500 vest on each of the first, second and third anniversary of the grant date. Each grant is subject to the approval of the compensation committee, board of directors and shareholders. All options to directors are granted at an exercise price equal to 100% of the closing price of the ordinary shares on the NASDAQ Global Select Market on the date of grant.

Options to purchase our ordinary shares granted under our 2008 Equity Incentive Plan to persons who served in the capacity of director or executive officer are generally exercisable at the fair market value at the date of grant and expire seven years from the date of grant. The options generally vest in four equal annual installments, commencing one year from the date of grant.

A summary of our stock option and restricted share units (“RSUs”) activity and related information for the years ended December 31, , 2012 2013 and 2014 for the persons who served in the capacity of director, senior executive or key employee officer during those years is as follows:

|  | 2012        |          | 2013          |          | 2014          |          |
|--|-------------|----------|---------------|----------|---------------|----------|
|  | Number      | Weighted | Number        | Weighted | Number        | Weighted |
|  | of          | Average  | of            | Average  | of            | Average  |
|  | Options and | Exercise | Options and   | Exercise | Options and   | Exercise |
|  | RSUs        | Price    | RSUs          | Price    | RSUs          | Price    |
| Outstanding at the beginning of the year | 1,314,449   | \$ 3.94  | (*) 1,548,496 | \$ 3.66  | (*) 1,772,913 | \$ 3.72  |
| Granted                                  | 396,835     | \$ 2.20  | 624,702       | \$ 4.13  | 512,939       | \$ 4.44  |
| Cancelled                                | (150,000 )  |          | (160,000 )    |          | (113,750 )    |          |
| Exercised                                | (56,788 )   | \$ 0.56  | (280,285 )    | \$ 1.95  | (211,427 )    | \$ 2.19  |
| Outstanding at the end of the year       | 1,504,496   | \$ 3.60  | 1,732,913     | \$ 3.71  | 1,960,675     | \$ 3.96  |

(\*) Including outstanding options granted to new executive officer in previous years, prior to joining management.

As of December 31, 2014, options to purchase 790,894 ordinary shares were exercisable by the 16 persons who served as an officer or director during 2014 at an average exercise price of \$3.98 per share. As of December 31, 2014, the 16 persons who served as an officer, director or key employee during 2014 held an aggregate of 157,024 RSUs.

### *C. BOARD PRACTICES*

#### **Corporate Governance Practices**

We are incorporated in Israel and therefore are subject to various corporate governance practices under the Israeli Companies Law, 1999, or the Companies Law, relating to such matters as outside directors, the audit committee, compensation committee, the internal auditor and approvals of interested party transactions and of compensation of officers and directors. These matters are in addition to the ongoing listing conditions of the NASDAQ Global Select Market and other relevant provisions of U.S. securities laws. Under the NASDAQ rules, a foreign private issuer may generally follow its home country rules of corporate governance in lieu of the comparable NASDAQ requirements, except for certain matters such as composition and responsibilities of the audit committee and the independence of its members. For further information, see Item 16G – “Corporate Governance.”

## Independent Directors

Under the Companies Law, Israeli companies that have offered securities to the public in or outside of Israel are required to appoint at least two “outside” directors. Doron Nevo and Dr. Eyal Kishon currently serve as our outside directors. Under the requirements for listing on the NASDAQ Global Select Market, a majority of our directors are required to be independent as defined by NASDAQ rules. Doron Nevo, Dr. Eyal Kishon, Zehava Simon, Stanley Stern and Joseph Tenne qualify as independent directors under the applicable Securities and Exchange Commission and NASDAQ rules, as well as under the Companies Law.

Under the Companies Law, a person may not serve as an outside director if at the date of the person’s election or within the prior two years the person is a relative of the company’s controlling shareholder, or the person or his or her relatives, partners, employers, supervisors or entities under the person’s control, have or had any affiliation with us or with a controlling shareholder or relatives of a controlling shareholder, and, in the case of a company without a controlling shareholder or a shareholder holding at least 25% of the voting rights, any affiliation, at the time of election, to the chairman of the board of directors, the chief executive officer, an interested party or the company’s most senior finance officer. Under the Companies Law, “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 in a private company prior to the first offering of its shares to the public if such director was appointed or elected as a director of the private company in order to serve as an outside director following the initial public offering.

In addition, a person may not serve as an outside director:

- if the person or his or her relatives, partners, employers, supervisors or entities under the person’s control, maintains a business or professional relationship with the company, even if such relationship is not on a regular basis, other than a negligible business or professional relationship, or

- if the person received compensation as an outside director in excess of the amounts permitted by the Companies Law and regulations there under.

In addition, no individual may serve as an outside director if the individual's position or other activities create or may create a conflict of interest with his or her role as an outside director or are likely to interfere with his or her ability to serve as a director. Until the lapse of two years from the termination of office, the company, a controlling shareholder and entities under the company's control may not grant the outside director or any of his or her relatives, directly or indirectly, any benefit, or engage the outside director or his or her relatives as an office holder of the company, of a controlling shareholders or of an entity under the company's control, and may not employ or receive services from the outside director or any of his or her relatives, either directly or indirectly, including through a corporation controlled by that person. The restriction on a relative that is not the spouse or child of the outside director is limited to one year from the termination of office instead of two years. Pursuant to the Companies Law, at least one of the outside directors appointed by a publicly-traded company must have "financial and accounting expertise." The other outside directors are required to possess "financial and accounting expertise" or "professional expertise," as these terms are defined in regulations promulgated under the Companies Law. Joseph Tenne is designated as the "audit committee financial expert" as that term is defined in Securities and Exchange Commission rules.

Outside directors are elected by a majority vote at a shareholders' meeting. In addition to the majority vote, the shareholder approval of the election of an outside director must satisfy either of two additional tests:

the majority includes at least a majority of the shares voted by shareholders other than our controlling shareholders or shareholders who have a personal interest in the election of the outside directors (excluding a personal interest that is not related to a relationship with the controlling shareholders); or

the total number of shares held by non-controlling shareholders and disinterested shareholders that voted against the election of the outside director does not exceed 2% of the aggregate voting rights of our company.

The term of an outside director is three years and may be extended for additional three-year terms. An outside director can be removed from office only under very limited circumstances. All of the outside directors must serve on a company's statutory audit committee and compensation committee (including one outside director serving as the chair of the audit committee and one outside director serving as the chair of the compensation committee) and each other committee of a company's board of directors is required to include at least one outside director. If, at the time an outside director is elected, all current members of the board of directors that are not controlling shareholders or their respective relatives are of the same gender, then the elected outside director must be of the other gender.

Pursuant to the Companies Law, an Israeli company whose shares are publicly traded may elect to adopt a provision in its articles of association pursuant to which a majority of its board of directors (or a third of its board of directors in case the company has a controlling shareholder) will constitute individuals complying with certain independence criteria prescribed by the Companies Law. Pursuant to the regulations, directors who comply with the independence requirements of the NASDAQ and Securities and Exchange Commission regulations are deemed to comply with the independence requirements of the Companies Law. We have not included such a provision in our articles of association since our board of directors complies with the independence requirements of the NASDAQ and Securities and Exchange Commission regulations described above. In any event, as described above, a majority of our board of directors and all members of our audit committee are directors who comply with the independence criteria prescribed by the Companies Law.

### **Audit Committee**

Under the Companies Law and the requirements for listing on the NASDAQ Global Select Market, our board of directors is required to appoint an audit committee. Our audit committee must be comprised of at least three directors, including all of the outside directors (one of whom must serve as the chair of the audit committee), and a majority of the committee members must comply with the director independence requirements prescribed by the Companies Law. The audit committee consists of: Dr. Eyal Kishon, Doron Nevo and Joseph Tenne, with Doron Nevo serving as the chairman of the audit committee. Our board of directors has determined that Joseph Tenne is an "audit committee financial expert" as defined in Securities and Exchange Commission rules and that all members of the audit committee are independent under the applicable Securities and Exchange Commission rules, NASDAQ rules and provisions of the Companies Law.

The audit committee may not include the chairman of the board, or any director employed by us, by a controlling shareholder or by any entity controlled by a controlling shareholder, or any director providing services to us, to a controlling shareholder or to any entity controlled by a controlling shareholder on a regular basis, or any director whose income is primarily dependent on a controlling shareholder, and may not include a controlling shareholder or any relatives of a controlling shareholder. Individuals who are not permitted to be audit committee members may not participate in the committee's meetings other than to present a particular issue. However, an employee who is not a controlling shareholder or relative may participate in the committee's discussions but not in any vote, and the company's legal counsel and corporate secretary may participate in the committee's discussions and votes if requested by the committee.

Under the Companies Law, a meeting of the audit committee is properly convened if a majority of the committee members attend the meeting, and in addition a majority of the attending committee members are independent directors within the meaning of the Companies Law and include at least one outside director.

We have adopted an audit committee charter as required by NASDAQ rules. The audit committee's duties include providing assistance to the board of directors in fulfilling its legal and fiduciary obligations in matters involving our accounting, auditing, financial reporting, internal control and legal compliance functions by approving the fees of, and services performed by, our independent accountants and reviewing their reports regarding our accounting practices and systems of internal accounting controls. The audit committee also oversees the audit efforts of our independent accountants and takes those actions as it deems necessary to satisfy itself that the accountants are independent of management. Under the Companies Law, the audit committee also is required to monitor deficiencies in the administration of our company, including by consulting with the internal auditor and independent accountants, to review, classify and approve related party transactions and extraordinary transactions, to review the internal auditor's audit plan and to establish and monitor whistleblower procedures.

### **Nominating Committee**

NASDAQ rules require that director nominees be selected or recommended for the board's selection either by a committee composed solely of independent directors or by a majority of independent directors. Our Nominating Committee assists the board of directors in its selection of individuals as nominees for election to the board of directors and/or to fill any vacancies or newly created directorships on the board of directors. The Nominating Committee consists of Dr. Eyal Kishon, Doron Nevo and Joseph Tenne, with Doron Nevo serving as the chairman of the Nominating Committee. All members of the Nominating Committee are independent under the applicable NASDAQ rules and provisions of the Companies Law.

## **Compensation Committee**

Under the Companies Law, the board of directors of any public company must establish a compensation committee. The compensation committee must consist of at least three directors, include all of the outside directors (including one outside director serving as the chair of the compensation committee), and a majority of the committee members must comply with the director independence requirements prescribed by the Companies Law. Similar to the rules that apply to the audit committee, the compensation committee may not include the chairman of the board, or any director employed by us, by a controlling shareholder or by any entity controlled by a controlling shareholder, or any director providing services to us, to a controlling shareholder or to any entity controlled by a controlling shareholder on a regular basis, or any director whose primary income is dependent on a controlling shareholder, and may not include a controlling shareholder or any of its relatives. Individuals who are not permitted to be compensation committee members may not participate in the committee's meetings other than to present a particular issue; *However*, an employee who is not a controlling shareholder or relative may participate in the committee's discussions, but not in any vote, and the company's legal counsel and corporate secretary may participate in the committee's discussions and votes if requested by the committee.

The compensation committee's duties include recommending to the board of directors a compensation policy for executives and monitor its implementation, approve compensation terms of executive officers, directors and employees affiliated with controlling shareholders, make recommendations to the board of directors regarding the issuance of equity incentive awards under our equity incentive plan and exempt certain compensation arrangements from the requirement to obtain shareholder approval under the Companies Law. The compensation committee meets at least twice a year, with further meetings to occur, or actions to be taken by unanimous written consent, when deemed necessary or desirable by the committee or its chairperson.

The compensation committee consists of: Dr. Eyal Kishon, Doron Nevo and Joseph Tenne, with Doron Nevo serving as the chairman of the compensation committee. All members of the compensation committee are independent under the applicable Securities and Exchange Commission rules, NASDAQ rules and provisions of the Companies Law.

## **Internal Auditor**

Under the Companies Law, our board of directors is also required to appoint an internal auditor proposed by the audit committee. The internal auditor may be our employee, but may not be an interested party or office holder, or a relative of any interested party or office holder, and may not be a member of our independent accounting firm. The role of the internal auditor is to examine, among other things, whether our activities comply with the law and orderly business procedure. Brightman, Almagor Zohar & Co. (a member firm of Deloitte & Touche in Israel) has been our internal auditor since November 2008.



## **Board Classes**

Pursuant to our articles of association, our directors, other than our outside directors, are classified into three classes (classes I, II and III). The members of each class of directors and the expiration of his or her current term of office are as follows:

Zehava Simon      Class I    2016

Joseph Tenne      Class II   2017

Shabtai Adlersberg   Class III   2015

Stanley B. Stern    Class III   2015

Our outside directors under the Companies Law, Doron Nevo and Dr. Eyal Kishon, are not members of any class and serve in accordance with the provisions of the Companies Law. Mr. Nevo's term ends in 2015 and Dr. Kishon's term ends in 2017.

## **Chairman of the Board**

Under the Companies Law, the chief executive officer of a company (or a relative of the chief executive officer) may not serve as the chairman of the board of directors, and the chairman of the board of directors (or a relative of the chairman of the board of directors) may not serve as the chief executive officer, unless approved by the shareholders by a special majority vote prescribed by the Companies Law. The shareholder vote cannot authorize the appointment for a period of longer than three years, which period may be extended from time to time by the shareholders with a similar special majority vote. The chairman of the board of directors shall not hold any other position with the company (except as chief executive officer if approved in accordance with the above procedure) or in any entity controlled by the company, other than as chairman of the board of directors of a controlled entity, and the company shall not delegate to the chairman duties that, directly or indirectly, make him or her subordinate to the chief executive officer.

*D. EMPLOYEES*

We had the following number of employees as of December 31, 2012, 2013 and 2014 in the areas set forth in the table below:

|  | As of December 31, |      |      |
|--|--------------------|------|------|
|  | 2012               | 2013 | 2014 |
| Research and development                           | 225                | 248  | 266  |
| Sales and marketing, technical service and support | 231                | 248  | 272  |
| Operations   | 83                 | 84   | 86   |
| Management and administration                      | 40                 | 37   | 37   |
|  | 579                | 617  | 661  |

Our employees were located in the following areas as of December 31, 2012, 2013 and 2014.

|               | As of December 31, |      |      |
|---------------|--------------------|------|------|
|               | 2012               | 2013 | 2014 |
| Israel        | 352                | 382  | 413  |
| United States | 118                | 121  | 125  |
| Europe        | 28                 | 31   | 34   |
| Far East      | 69                 | 69   | 74   |
| Latin America | 12                 | 14   | 15   |
|               | 579                | 617  | 661  |

The increase in the number of employees in 2014 was primarily attributable to our continued development of new products and to the increase in our sales force. The increase in the number of employees in 2013 was primarily attributable to the acquisition of certain assets of MailVision, pursuant to which we added 22 employees during 2013.

Israeli labor laws and regulations are applicable to our employees in Israel. These laws principally concern matters such as paid annual vacation, paid sick days, length of the workday, pay for overtime, insurance for work-related accidents, severance pay and other conditions of employment. Israeli law generally requires severance pay, which may be funded by Manager's Insurance, described below, upon the retirement or death of an employee or termination of employment without cause (as defined under Israeli law). Furthermore, Israeli employees and employers are required to pay predetermined sums to the National Insurance Institute, which include payments for national health insurance. The payments to the National Insurance Institute currently range from approximately 6.75% to 18.75% of wages up to specified wage levels, of which the employee contributes approximately 55% and the employer contributes approximately 45%.

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

Pursuant to an order issued by the Israeli Minister of Industry, Trade and Labor, provisions relating to pension arrangements in the collective bargaining agreements between the Histadrut and the Coordination Bureau of Economic Organizations apply to all employees in Israel, including our employees in Israel. We regularly contribute to a “Manager’s Insurance Fund” or to a privately managed pension fund on behalf of our employees located in Israel. These funds provide employees with a lump sum payment upon retirement (or a pension, in case of a pension fund) and severance pay, if legally entitled thereto, upon termination of employment. We provide for payments to a Manager’s Insurance Fund and pension fund contributions in the amount of 13.3% of an employee’s salary on account of severance pay and provident payment or pension, with the employee contributing 5.0% of his salary. We also pay an additional amount of up to 2.5% of certain of our employees’ salaries in connection with disability payments. In addition, we administer an Education Fund for our Israeli employees and pay 7.5% of these employees’ salaries thereto, with the employees contributing 2.5% of their salary.

#### *E. SHARE OWNERSHIP*

The following table sets forth the share ownership and outstanding number of options of our directors and officers as of March 20, 2015.

| Name               | Total Shares<br>Beneficially<br>Owned | Percentage of<br>Ordinary Shares | Number of<br>Options |
|--------------------|---------------------------------------|----------------------------------|----------------------|
| Shabtai Adlersberg | 4,658,085                             | 11.2                             | % 451,850            |
| Stanley B. Stern   | *                                     |                                  | *                    |
| Ofer Segev         | *                                     |                                  | *                    |
| Lior Aldema        | *                                     |                                  | *                    |
| Yair Hevdeli       |                                       |                                  |                      |
| Jeffrey Kahn       | *                                     |                                  | *                    |
| Eyal Frishberg     | *                                     |                                  | *                    |
| Yehuda Herscovici  | *                                     |                                  | *                    |
| Nimrod Borovsky    | *                                     |                                  | *                    |
| Tal Dor            | *                                     |                                  | *                    |
| Ofer Nimitsovich   | *                                     |                                  | *                    |
| Shaul Weissman     |                                       |                                  |                      |
| Joseph Tenne       | *                                     |                                  | *                    |
| Dr. Eyal Kishon    | *                                     |                                  | *                    |
| Doron Nevo         | *                                     |                                  | *                    |
| Zehava Simon       | *                                     |                                  | *                    |

\* Less than one percent.

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

The following table sets forth information with respect to the options to purchase our ordinary shares held by Mr. Adlersberg as of March 20, 2015.

| Number of<br>Options | Grant Date        | Exercise<br>Price | Exercised | Cancelled | Vesting | Expiration Date   |
|----------------------|-------------------|-------------------|-----------|-----------|---------|-------------------|
| 120,808              | December 14, 2009 | \$ 2.57           | -         | -         | 4 years | December 14, 2016 |
| 123,456              | December 14, 2010 | \$ 5.83           | -         | -         | 4 years | December 14, 2017 |
| 122,201              | December 14, 2011 | \$ 3.66           | -         | -         | 4 years | December 14, 2018 |
| 113,876              | December 14, 2012 | \$ 3.02           | -         | -         | 4 years | December 14, 2019 |
| 116,031              | December 14, 2013 | \$ 6.69           | -         | -         | 4 years | December 14, 2020 |
| 127,829              | December 14, 2014 | \$ 4.60           | -         | -         | 4 years | December 14, 2021 |

The following table sets forth information with respect to the RSUs granted to Mr. Adlersberg as of March 20, 2015. These RSUs vest quarterly over a four-year period from the date of grant, subject to his continuing service to us.

| <b>Number of<br/>RSUs</b> | <b>Grant Date</b> | <b>Issued</b> |
|---------------------------|-------------------|---------------|
| 40,269                    | December 14, 2009 | 40,269        |
| 41,152                    | December 14, 2010 | 41,152        |
| 40,734                    | December 14, 2011 | 33,096        |
| 37,959                    | December 14, 2012 | 21,355        |
| 38,671                    | December 14, 2013 | 12,084        |
| 42,610                    | December 14, 2014 | 2,663         |

### **Employee Share Plans**

We have Employee Share Purchase Plans for the sale of shares to our employees and an Equity Incentive Plan for the granting of options, RSUs and restricted shares to our employees, officers, directors and consultants. Our 2008 Equity Incentive Plan is pursuant to the Israeli Income Tax Ordinance, entitling the beneficiaries who are our employees to tax benefits under Israeli law. There are various conditions that must be met in order to qualify for these benefits, including registration of the options in the name of a trustee for each of the beneficiaries who is granted options. For tax benefits each option, and any ordinary shares acquired upon the exercise of the option, must be held by the trustee at least for a period commencing on the date of grant and ending no later than 24 months after the date of grant, in accordance with the period of time specified by Section 102 of Israel's Income Tax Ordinance, and deposited in trust with the trustee.

*Employee Share Option Plans*

**2008 Equity Incentive Plan.** We adopted an equity incentive plan under Section 102 of the Israeli Income Tax Ordinance, or Section 102, which provides certain tax benefits in connection with stock-based compensation to employees, officers and directors. This plan, our 2008 Equity Incentive Plan, was approved by the Israeli Tax Authority.

Under our equity incentive plan, we may grant our directors, officers and employees restricted shares, restricted share units and options to purchase our ordinary shares under Section 102. We may also grant other persons awards under our equity incentive plan. However, such other persons (controlling shareholders and consultants) will not enjoy the tax benefits provided by Section 102. The total number of ordinary shares that is available for grant under the 2008 Plan is 6,009,122. This number is reduced by one share for each equity grant we make under the 2008 Plan. During 2014, options to purchase 823,329 ordinary shares and 79,715 restricted share units were granted under the 2008 Plan. As of December 31, 2014, 814,813 ordinary shares remained available for grant under the 2008 Plan. As of December 31, 2014 there are 3,257,859 options to purchase ordinary shares and 221,004 restricted share units outstanding under the plan.

The Israeli Tax Authority approved the 2008 Plan under the capital gains tax track of Section 102. Based on Israeli law currently in effect and the election of the capital gains tax track, and provided that options, restricted shares and restricted shares units granted or, upon their exercise or vesting, the underlying shares, issued under the plan are held by a trustee for the two years following the date in which such awards are granted, our employees, officers and directors will be (i) entitled to defer any taxable event with respect to the awards until the underlying ordinary shares are sold, and (ii) subject to capital gains tax of 25% on the sale of the shares. However, if we grant awards at a value below the underlying shares' market value at the date of grant, the 25% capital gains tax rate will apply only with respect to capital gains in excess of the underlying shares' market value at the date of grant and the remaining capital gains will be taxed at the grantee's regular tax rate. We may not recognize a tax benefit pertaining to the employees' restricted shares, restricted share units and options for tax purposes except in the events described above under which the gain is taxed at the grantee's regular tax rate.

Restricted shares, restricted share units and options granted under the 2008 Plan will generally vest over four years from the grant date. If the employment of an employee is terminated for any reason, the employee (or in the case of death, the designated beneficiary) may exercise his or her vested options within ninety days of the date of termination (or within twelve months of the date of termination in the case of death or disability) and shall be entitled to any rights upon vested restricted shares and vested restricted share units to be delivered to the employee to the extent that they were vested prior to the date his or her employment terminates. Directors are generally eligible to exercise his or her vested options within twelve months from the date the director ceases to serve on the board of directors.

The holders of options under all of the plans are responsible for all personal tax consequences relating to the options. The exercise prices of the options are based on the fair value of the ordinary shares at the time of grant as determined by our board of directors. The current practice of our board of directors is to grant options with exercise prices that equal 100% of the closing price of our ordinary shares on the applicable date of grant.

## ITEM 7. MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS

### A. MAJOR SHAREHOLDERS

To our knowledge, (A) we are not directly or indirectly owned or controlled (i) by another corporation or (ii) by any foreign government and (B) there are no arrangements, the operation of which may at a subsequent date result in a change in control of AudioCodes. The following table sets forth, as of March 20, 2015 the number of our ordinary shares, which constitute our only outstanding voting securities, beneficially owned by (i) all shareholders known to us to own more than 5% of our outstanding ordinary shares, and (ii) all of our directors and senior executive officers as a group.

| Identity of Person or Group  | Amount Owned | Percent of Class |   |
|--|--------------|------------------|---|
| Shabtai Adlersberg <sup>(1)</sup>  | 5,109,935    | 12.3             | % |
| Leon Bialik <sup>(2)</sup>   | 3,924,002    | 9.4              | % |
| Rima Senvest Management, LLC <sup>(3)</sup>  | 2,187,102    | 5.3              | % |
| All directors and senior executive officers as a group (16 persons) <sup>(4)</sup> | 5,477,230    | 13.2             | % |

(1) Includes options to purchase 451,850 shares, exercisable within 60 days of March 20, 2015.

(2) The information is derived from a statement on Schedule 13G/A, dated February 9, 2015 of Leon Bialik filed with the Securities and Exchange Commission.

The information is derived from a statement on Schedule 13G/A, dated February 19, 2015, of Rima Senvest Management, LLC (“RIMA”) and Richard Mashaal (“Mashaal”) filed with the Securities and Exchange Commission. Such Schedule 13G/A indicated that, as of February 19, 2015, (i) sole voting and dispositive power as to none of such Ordinary Shares, and shared voting and dispositive power as to 2,187,102 Ordinary Shares, by Mashaal and (3)(ii) sole voting and dispositive power as to none of such Ordinary Shares, and shared voting and dispositive power as to 1,570,435 Ordinary Shares, by RIMA. Mashaal, in his capacity as the Managing Member of RIMA, has voting or dispositive power as to all Ordinary Shares owned by RIMA and other related investment vehicles. In addition, such Schedule 13G/A indicates that as of December 31, 2014, Mashaal was the beneficial owner of 1,967,350 Ordinary Shares and that RIMA was the beneficial owner of 1,390,821 Ordinary Shares.

Includes 815,395 ordinary shares which may be purchased pursuant to options exercisable within sixty days (4) following March 20, 2015 and 3,750 ordinary shares issuable pursuant to restricted share units that vest within 60 days of March 20, 2015.

Mr. Adlersberg held 12.0% of our ordinary shares as of December 31, 2014 as compared to 13.4% of our ordinary shares as of December 31, 2013 and 14.4% of our ordinary shares as of December 31, 2012.

Mr. Bialik held 9.3% of our ordinary shares as of December 31, 2014 as compared to 10.1% of our ordinary shares as of December 31, 2013 and 10.7% of our ordinary shares as of December 31, 2012.

Rima Management, LLC held 4.6% of our ordinary shares as of December 31, 2014 as compared to 6.4% of our ordinary shares as of December 31, 2013 and 10.5% of our ordinary shares as of December 31, 2012.

As of March 20, 2015, there were approximately 18 holders of record of our ordinary shares in the United States, although we believe that the number of beneficial owners of the ordinary shares is significantly greater. The number of record holders in the United States is not representative of the number of beneficial holders nor is it representative of where such beneficial holders are resident since many of these ordinary shares were held of record by brokers or other nominees.

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

#### *B. RELATED PARTY TRANSACTIONS*

Not applicable.



*C. INTERESTS OF EXPERTS AND COUNSEL*

Not applicable.

**ITEM 8. FINANCIAL INFORMATION**

*A. Consolidated Statements and Other Financial Information*

See Item 18.

*Legal Proceedings*

For a discussion of our legal proceedings, please see Item 4B-“Information on the Company-Business Overview-Legal Proceedings.”

*Dividend Policy*

For a discussion of our dividend policy, please see Item 10B-“Additional Information-Memorandum and Articles of Association-Dividends.”

*B. Significant Changes*

No significant change has occurred since December 31, 2013, except as otherwise disclosed in this Annual Report.

**ITEM 9. THE OFFER AND LISTING***A. OFFER AND LISTING DETAILS UPDATE ALL TABLES AND DISCLOSURE IN THIS SECTION*

Our ordinary shares are listed on the NASDAQ Global Select Market and the TASE under the symbol “AUDC.”

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

| Calendar Year | Price Per Share |         |
|---------------|-----------------|---------|
|               | High            | Low     |
| 2014          | \$ 9.12         | \$ 4.11 |
| 2013          | \$ 7.62         | \$ 3.02 |
| 2012          | \$ 4.25         | \$ 1.20 |
| 2011          | \$ 8.07         | \$ 2.28 |
| 2010          | \$ 6.51         | \$ 2.31 |

| Calendar Period                        | Price Per Share |         |
|--|-----------------|---------|
|  | High            | Low     |
| 2015                                   |                 |         |
| First quarter (through March 20, 2015) | \$ 5.58         | \$ 4.47 |
| 2014                                   |                 |         |
| Fourth Quarter                         | \$ 5.04         | \$ 4.11 |
| Third Quarter                          | \$ 7.35         | \$ 4.77 |
| Second Quarter                         | \$ 7.49         | \$ 5.29 |
| First quarter                          | \$ 9.12         | \$ 6.60 |
| 2013                                   |                 |         |
| Fourth quarter                         | \$ 7.62         | \$ 5.46 |
| Third quarter                          | \$ 7.34         | \$ 4.29 |
| Second quarter                         | \$ 4.60         | \$ 3.02 |
| First quarter                          | \$ 4.75         | \$ 3.20 |

| Calendar Month | Price Per Share |         |
|----------------|-----------------|---------|
|                | High            | Low     |
| 2015           |                 |         |
| February       | \$ 5.58         | \$ 5.04 |

|           |         |         |
|-----------|---------|---------|
| January   | \$ 5.37 | \$ 4.47 |
| 2014      |         |         |
| December  | \$ 4.97 | \$ 4.27 |
| November  | \$ 5.04 | \$ 4.41 |
| October   | \$ 4.95 | \$ 4.11 |
| September | \$ 5.85 | \$ 4.77 |

The following table sets forth, for the periods indicated, the high and low sales prices of our ordinary shares as reported by The Tel Aviv Stock Exchange. All share prices shown in the following table are in NIS. As of December 31, 2014, the exchange rate was equal to approximately NIS 3.889 per U.S. \$1.00.

| Calendar Year | Price Per Share |           |
|---------------|-----------------|-----------|
|               | High            | Low       |
| 2014          | NIS 32.24       | NIS 15.88 |
| 2013          | NIS 26.48       | NIS 11.37 |
| 2012          | NIS 15.99       | NIS 5.44  |
| 2011          | NIS 29.51       | NIS 8.65  |
| 2010          | NIS 23.25       | NIS 9.20  |

| Calendar Period                        | Price Per Share |           |
|--|-----------------|-----------|
| 2015                                   |                 |           |
| First quarter (through March 20, 2015) | NIS 22.50       | NIS 17.26 |
| 2014                                   |                 |           |
| Fourth quarter                         | NIS 19.64       | NIS 15.88 |
| Third quarter                          | NIS 25.40       | NIS 17.20 |
| Second quarter                         | NIS 26.01       | NIS 18.42 |
| First quarter                          | NIS 32.24       | NIS 23.40 |
| 2013                                   |                 |           |
| Fourth quarter                         | NIS 26.48       | NIS 19.38 |
| Third quarter                          | NIS 25.47       | NIS 15.31 |
| Second quarter                         | NIS 16.74       | NIS 11.64 |
| First quarter                          | NIS 18.38       | NIS 11.37 |

| Calendar Month | Price Per Share |           |
|----------------|-----------------|-----------|
|                | High            | Low       |
| 2015           |                 |           |
| February       | NIS 22.50       | NIS 19.55 |
| January        | NIS 20.45       | NIS 17.26 |
| 2014           |                 |           |
| December       | NIS 19.64       | NIS 16.57 |
| November       | NIS 19.39       | NIS 17.30 |
| October        | NIS 18.99       | NIS 15.88 |
| September      | NIS 21.36       | NIS 17.70 |

#### *B. PLAN OF DISTRIBUTION*

Not applicable.

*C. MARKETS*

Our ordinary shares are listed for trading on the NASDAQ Global Select Market under the symbol “AUDC.” Our ordinary shares are also listed for trading on The Tel-Aviv Stock Exchange under the symbol “AUDC.” In addition, we are aware of our ordinary shares being traded on the following markets: Frankfurt Stock Exchange, Berlin Stock Exchange, Munich Stock Exchange, Stuttgart Stock Exchange, the German Composite and XETRA.

*D. SELLING SHAREHOLDERS*

Not applicable.

*E. DILUTION*

Not applicable.

*F. EXPENSES OF THE ISSUE*

Not applicable.

**ITEM 10. ADDITIONAL INFORMATION**

*A. SHARE CAPITAL*

Not applicable.

*B. MEMORANDUM AND ARTICLES OF ASSOCIATION*

**Objects and Purposes**

We were incorporated in 1992 under the laws of the State of Israel. Our registration number with the Israeli Registrar of Companies is 520044132. Our objects and purposes, set forth in Section 2 of our memorandum of association, are:

· to plan, develop and market voice signal systems;

· to purchase, import, market and wholesale and retail distribute, in Israel and abroad, consumption goods and accompanying products;

· to serve as representatives of bodies, entrepreneurs and companies from Israel and abroad with respect to their activities in Israel and abroad; and

· to carry out any activity as determined by the lawful management.

## **Share Capital**

Our authorized share capital consists of NIS 1,025,000 divided into 100,000,000 ordinary shares, nominal value NIS 0.01 per share, and 2,500,000 preferred shares, nominal value NIS 0.01 per share. As of March 20, 2015, we had 41,621,886 ordinary shares outstanding (which does not include 13,269,051 treasury shares) and no preferred shares outstanding.

## **Borrowing Powers**

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

## **Amendment of Articles of Association**

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

## **Qualification of Directors**

No person shall be disqualified to serve as a Director by reason of his not holding shares in the Company or by reason of his having served as a Director in the past.

## **Dividends**

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





## **Voting Rights and Powers**

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

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

## **Business Combinations**

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

## **Winding Up**

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

## **Redeemable Shares**

Subject to our undertaking to the Tel-Aviv Stock Exchange as described above, we may issue and redeem redeemable shares.

## **Modification of Rights**

Subject to the provisions of our memorandum of association, and without prejudice to any special rights previously conferred upon the holders of our existing shares, we may, from time to time, by a resolution approved by the holders of 75% voting power represented at the meeting in person or by proxy and voting thereon, provide for shares with such preferred or deferred rights or rights of redemption, or other special rights and/or such restrictions, whether in regard to dividends, voting repayment of share capital or otherwise, as may be stipulated in such resolution.

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

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

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

## **Shareholders Meetings**

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

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

- at least two directors;

· at least one-quarter of the directors in office; or

· one or more shareholders who hold at least 5% of the outstanding share capital and at least 1% of the voting rights, or one or more shareholders who hold at least 5% of the outstanding voting rights.

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

### **Notice of General Meetings; Omission to Give Notice**

The provisions of the Companies Law and the related regulations override the provisions of our articles of association, and provide for notice of a meeting of shareholders to be sent to each registered shareholder at least 21 days or 35 days in advance of the meeting depending on the items included in the meeting agenda. Notice of a meeting of shareholders must also be published in two Israeli newspapers at least five days prior to the record date for the meeting.

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

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

### **Limitations on Foreign Shareholders to Hold or Exercise Voting Rights**

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

### **Fiduciary Duties; Approval of Transactions under Israeli Law**

***Fiduciary duties.*** The Companies Law codifies the fiduciary duties that office holders, which under the Companies Law includes our directors and executive officers, owe to a company. An office holder's fiduciary duties consist of a duty of loyalty and a duty of care.

The duty of loyalty requires an office holder to act in good faith and for the benefit of the company, including to avoid any conflict of interest between the office holder's position in the company and personal affairs, and prohibits any competition with the company or the exploitation of any business opportunity of the company in order to receive a personal advantage for himself or herself or for others. This duty also requires an office holder to reveal to the company any information or documents relating to the company's affairs that the office holder has received due to his or her position as an office holder. A company may approve any of the acts mentioned above provided that all the following conditions apply: the office holder acted in good faith and neither the act nor the approval of the act prejudices the good of the company and, the office holder disclosed the essence of his personal interest in the act, including any substantial fact or document, a reasonable time before the date for discussion of the approval. A director is required to exercise independent discretion in fulfilling his or her duties and may not be party to a voting agreement with respect to his or her vote as a director. A violation of these requirements is deemed a breach of the director's duty of loyalty.

The duty of care requires an office holder to act with a level of care that a reasonable office holder in the same position would employ under the same circumstances. This includes the duty to use reasonable means to obtain information regarding the advisability of a given action submitted for his or her approval or performed by virtue of his or her position and all other relevant information material to these actions.

***Disclosure of personal interest.*** The Companies Law requires that an office holder promptly disclose to the company any personal interest that he or she may have and all related material information or documents known to him or her, in connection with any existing or proposed transaction by the company. "Personal interest," as defined by the Companies Law, includes a personal interest of any person in an act or transaction of the company, including a personal interest of his relative or of a corporation in which that person or a relative of that person is a 5% or greater shareholder, a holder of 5% or more of the voting rights, a director or general manager, or in which he or she has the right to appoint at least one director or the general manager, and includes shares for which the person has the right to vote pursuant to a power-of-attorney. "Personal interest" does not apply to a personal interest stemming merely from holding shares in the company.

The office holder must make the disclosure of his personal interest no later than the first meeting of the company's board of directors that discusses the particular transaction. This duty does not apply to the personal interest of a relative of the office holder in a transaction unless it is an "extraordinary transaction." The Companies Law defines an "extraordinary transaction" as a transaction that is not 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.

**Approvals.** The Companies Law provides that a transaction with an office holder or a transaction in which an office holder has a personal interest requires board approval, unless the transaction is an extraordinary transaction or the articles of association provide otherwise. Our articles of association do not provide otherwise. The transaction may be approved only if it is in our best interest. If the transaction is an extraordinary transaction, then the approvals of the company's audit committee and the board of directors are required. If the transaction concerns exculpation, indemnification, insurance or compensation of an office holder, then the approvals of the company's compensation committee and the board of directors are required, except if the compensation arrangement is an immaterial amendment to an existing compensation arrangement of an officer who is not a director, in which case the approval of the compensation committee is sufficient. Exculpation, indemnification, insurance or compensation of a director or the Chief Executive Officer also requires shareholder approval.

A person who has a personal interest in a matter that is considered at a meeting of the board of directors or the audit committee generally may not attend that meeting or vote on that matter, unless a majority of the board of directors or the audit committee has a personal interest in the matter or if such person is invited by the chair of the board of directors or audit committee, as applicable, to present the matter being considered. If a majority of the board of directors or the audit committee has a personal interest in the transaction, shareholder approval also would be required.

## **Shareholders**

The Companies Law imposes on a controlling shareholder of a public company the same disclosure requirements described above as it imposes on an office holder. For this purpose, a "controlling shareholder" is any shareholder who has the ability to direct the company's actions, including any shareholder holding 25% or more of the voting rights if no other shareholder owns more than 50% of the voting rights in the company. Two or more shareholders with a personal interest in the approval of the same transaction are deemed to be one shareholder.

Approval of the audit committee, the board of directors and our shareholders, in that order, is required for extraordinary transactions, including a private placement, with a controlling shareholder or in which a controlling shareholder has a personal interest.

Approval of the compensation committee, the board of directors and our shareholders, in that order, is required for the terms of compensation or employment of a controlling shareholder or his or her relative, as an officer holder or employee of our company or as a service provider to the company, including through a company controlled by a controlling shareholder.

Shareholder approval must include the majority of shares voted at the meeting. In addition to the majority vote, the shareholder approval must satisfy either of two additional tests:

the majority includes at least a majority of the shares voted by shareholders who have no personal interest in the transaction; or

the total number of shares held by disinterested shareholders that voted against the approval of the transaction does not exceed 2% of the aggregate voting rights of our company.

Generally, the approval of such a transaction may not extend for more than three years, except that in the case of an extraordinary transaction, including a private placement, with a controlling shareholder or in which a controlling shareholder has a personal interest that does not concern compensation for employment or service, the transaction may be approved for a longer period if the audit committee determines that the approval of the transaction for a period longer than three years is reasonable under the circumstances.

### **Compensation of Executive Officers and Directors; Executive Compensation Policy**

In accordance with the Companies Law, we have adopted a compensation policy for our executive officers and directors. The purpose of the policy is to describe our overall compensation strategy for our executive officers and directors and to provide guidelines for setting their compensation, as prescribed by the Companies Law. In accordance with the Companies Law, the policy must be reviewed and readopted at least once every three years.

Approval of the compensation committee, the board of directors and our shareholders, in that order, is required for the adoption of the compensation policy. The shareholders' approval must include the majority of shares voted at the meeting. In addition to the majority vote, the shareholder approval must satisfy either of two additional tests:

· the majority includes at least a majority of the shares voted by shareholders other than our controlling shareholders or shareholders who have a personal interest in the adoption of the compensation policy; or

· the total number of shares held by non-controlling shareholders and disinterested shareholders that voted against the adoption of the compensation policy does not exceed 2% of the aggregate voting rights of our company.

Under the Companies Law, the compensation arrangements for officers (other than the Chief Executive Officer) who are not directors require the approval of the compensation committee and the board of directors; provided, however, that if the compensation arrangement is not in compliance with our executive compensation policy, the arrangement may only be approved by the compensation committee and the board of directors for special reasons to be noted, and the compensation arrangement shall also require a special shareholder approval. If the compensation arrangement is an immaterial amendment to an existing compensation arrangement of an officer who is not a director and is in compliance with our executive compensation policy, the approval of the compensation committee is sufficient.

Arrangements regarding the compensation of the Chief Executive Officer and directors require the approval of the compensation committee, the board and the shareholders, in that order. In certain limited cases, the compensation of a new Chief Executive Officer who is not a director may be approved without approval of the shareholders.

***Duties of Shareholders.*** Under the Israeli Companies Law, a shareholder also has a duty to act in good faith towards the company and other shareholders and refrain from abusing his or her power in the company, including, among other things, 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 related party transactions that require shareholder approval.

In addition, any controlling shareholder, any shareholder who can determine the outcome of a shareholder vote and any shareholder who, under the company's articles of association, can appoint or prevent the appointment of an office holder, is under a duty to act with fairness towards the company. The Israeli Companies Law also provides that a breach of the duty of fairness will be governed by the laws governing breach of contract; however, the Israeli Companies Law does not describe the substance of this duty.

### **Anti-Takeover Provisions Under Israeli Law**

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 hold 25% or more of the voting rights in the company, unless there is already another shareholder of the company with 25% or more of the voting rights. 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 hold more than 45% of the voting rights in the company, unless there is a shareholder with more than 45% of the voting rights in the company.

The Companies Law requires the parties to a proposed merger to file a merger proposal with the Israeli Registrar of Companies, specifying certain terms of the transaction. Each merging company's board of directors and shareholders must approve the merger. Shares in one of the merging companies held by the other merging company or certain of its affiliates are disenfranchised for purposes of voting on the merger. A merging company must inform its creditors of the proposed merger. Any creditor of a party to the merger may seek a court order blocking the merger, if there is a reasonable concern that the surviving company will not be able to satisfy all of the obligations of the parties to the merger. Moreover, a merger may not be completed until at least 50 days have passed from the time that the merger proposal was filed with the Israeli Registrar of Companies and at least 30 days have passed from the approval of the shareholders of each of the merging companies.

Finally, in general, Israeli tax law treats stock-for-stock acquisitions less favorably than does U.S. tax law. Israeli tax law provides for tax deferral in specified acquisitions, including transactions where the consideration for the sale of shares is the receipt of shares of the acquiring company. Nevertheless, Israeli tax law may subject a shareholder who exchanges his ordinary shares for shares in a foreign corporation to immediate taxation or to taxation before his investment in the foreign corporation becomes liquid, although in the case of shares of a foreign corporation that are traded on a stock exchange, the tax may be postponed subject to certain conditions.



## **Insurance, Indemnification and Exculpation of Directors and Officers; Limitations on Liability**

### *Insurance of Office Holders*

The Companies Law permits a company, if permitted by its articles of association, to insure an office holder in respect of liabilities incurred by the office holder as a result of:

- breach of the duty of care owed to the company or a third party;
  
- breach of the fiduciary duty owed to the company, provided that the office holder acted in good faith and had reasonable grounds to believe that his action would not harm the company's interests;
  
- monetary liability imposed on the office holder in favor of a third party; and

reasonable litigation expenses, including attorney fees, incurred by the office holder as a result of an administrative enforcement proceeding instituted against him (without limiting from the generality of the foregoing, such expenses will include a payment imposed on the office holder in favor of an injured party as set forth in Section 52(54)(a)(1)(a) of the Israel Securities Law, 5728-1968, as amended (the "Israeli Securities Law"), and expenses that the office holder incurred in connection with a proceeding under Chapters H'3, H'4 or I'1 of the Israeli Securities Law, including reasonable legal expenses, which term includes attorney fees).

### *Indemnification of Office Holders*

Under the Companies Law, a company can, if permitted by its articles of association, indemnify an office holder for any of the following obligations or expenses incurred in connection with his or her acts or omissions as an office holder:

- monetary liability imposed on an office holder in favor of a third party in a judgment, including a settlement or an arbitral award confirmed by a court;
  
- reasonable legal costs, including attorney's fees, expended by an office holder as a result of:

an investigation or proceeding instituted against the office holder by a competent authority, provided that such investigation or proceeding concludes without the filing of an indictment against the office holder, and either:

no financial liability was imposed on the office holder in lieu of criminal proceedings, or

financial liability was imposed on the office holder in lieu of criminal proceedings but the alleged criminal offense does not require proof of criminal intent; and (y) in connection with an administrative enforcement proceeding or a financial sanction (without derogating from the generality of the foregoing, such expenses will include a payment imposed on the Office Holder in favor of an injured party as set forth in Section 52(54)(a)(1)(a) of the Israeli Securities Law, and expenses that the Office Holder incurred in connection with a proceeding under Chapters H'3, H'4 or I'1 of the Israeli Securities Law, including reasonable legal expenses, which term includes attorney fees); and

reasonable legal costs, including attorneys' fees, expended by the office holder or for which the office holder is charged by a court:

in an action brought against the office holder by or on behalf of the company or a third party, or

in a criminal action in which the office holder is found innocent, or

in a criminal action in which the office holder is convicted and in which a proof of criminal intent is not required.

A company may indemnify an office holder in respect of these liabilities either in advance of an event or following an event. If a company undertakes to indemnify an office holder in advance of an event, the indemnification, other than legal costs, must be limited to foreseeable events in light of the company's actual activities when the company undertook such indemnification, and reasonable amounts or standards, as determined by the board of directors.

*Exculpation of Office Holders*

Under the Companies Law, a company may, if permitted by its articles of association, also exculpate an office holder in advance, in whole or in part, from liability for damages sustained by a breach of duty of care to the company, other than in connection with distributions.

*Limitations on Exculpation, Insurance and Indemnification*

Under the Companies Law, a company may indemnify or insure an office holder against a breach of duty of loyalty only to the extent that the office holder acted in good faith and had reasonable grounds to assume that the action would not prejudice the company. In addition, a company may not indemnify, insure or exculpate an office holder against a breach of duty of care if committed intentionally or recklessly (excluding mere negligence), or committed with the intent to derive an unlawful personal gain, or for a fine or forfeit levied against the office holder in connection with a criminal offense.

Our articles of association allow us to insure, indemnify and exculpate office holders to the fullest extent permitted by law, provided such insurance or indemnification is approved in accordance with law. Pursuant to the Companies Law, exculpation of, procurement of insurance coverage for, and an undertaking to indemnify or indemnification of, our office holders must be approved by our audit committee and our board of directors and, if the office holder is a director, also by our shareholders.

We have entered into agreements with each of our directors and senior officers to insure, indemnify and exculpate them to the full extent permitted by law against some types of claims, subject to dollar limits and other limitations. These agreements have been ratified by our audit committee, board of directors and shareholders. We have acquired directors' and officers' liability insurance covering our officers and directors and the officers and directors of our subsidiaries against certain claims.

*C. MATERIAL CONTRACTS*

Not applicable.

*D. EXCHANGE CONTROLS*

Non-residents of Israel who own our ordinary shares may freely convert all amounts received in Israeli currency in respect of such ordinary shares, whether as a dividend, liquidation distribution or as proceeds from the sale of the ordinary shares, into freely-repatriable non-Israeli currencies at the rate of exchange prevailing at the time of conversion (provided in each case that the applicable Israeli income tax, if any, is paid or withheld).

Since January 1, 2003, all exchange control restrictions on transactions in foreign currency in Israel have been eliminated, although there are still reporting requirements for foreign currency transactions. Legislation remains in effect, however, pursuant to which currency controls may be imposed by administrative action at any time.

The State of Israel does not restrict in any way the ownership or voting of our ordinary shares by non-residents of Israel, except with respect to subjects of countries that are in a state of war with Israel.

#### *E. TAXATION*

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

## **Israeli Tax Considerations and Government Programs**

The following is a brief summary of the material Israeli income tax laws applicable to us, and certain Israeli Government programs that benefit us. This section also contains a discussion of material Israeli income tax consequences concerning the ownership and disposition of our ordinary shares. This summary does not discuss all the aspects of Israeli tax law that may be relevant to a particular investor in light of his or her personal investment circumstances or to some types of investors subject to special treatment under Israeli law. Examples of such investors include residents of Israel or traders in securities who are subject to special tax regimes not covered in this discussion. Several parts of this discussion are based on new tax legislation that has not yet been subject to judicial or administrative interpretation.

### ***General Corporate Tax Structure in Israel***

Israeli companies were generally subject to corporate tax at the rate of 25% of their taxable income in 2013 and 2012, and are subject to corporate tax at the rate of 26.5% of their taxable income in 2014 and thereafter pursuant to a recent amendment adopted in July 2013. However, the effective tax rate payable by a company that qualifies as an Industrial Company that derives income from an Approved Enterprise, a Preferred Enterprise or a Beneficiary Enterprise (as discussed below) may be considerably less. Capital gains derived by an Israeli company are subject to the prevailing corporate tax rate.

### ***Law for the Encouragement of Capital Investments, 5719-1959***

The Law for the Encouragement of Capital Investments, 5719-1959, generally referred to as the Investment Law, provides certain incentives for capital investments in production facilities (or other eligible assets) by “Industrial Enterprises” (as defined under the Investment Law).

The Investment Law was significantly amended effective April 1, 2005 (the “2005 Amendment”), and further amended as of January 1, 2011 (the “2011 Amendment”). Pursuant to the 2005 Amendment, tax benefits granted in accordance with the provisions of the Investment Law prior to its revision by the 2005 Amendment remain in force but any benefits granted subsequently are subject to the provisions of the 2005 Amendment. Similarly, the 2011 Amendment introduced new benefits to replace those granted in accordance with the provisions of the Investment Law in effect prior to the 2011 Amendment. However, companies entitled to benefits under the Investment Law as in effect prior to January 1, 2011 were entitled to choose to continue to enjoy such benefits, provided that certain conditions are met, or elect instead irrevocably to forego such benefits and have the benefits of the 2011 Amendment apply.

***Tax Benefits Prior to the 2005 Amendment***

An investment program that is implemented in accordance with the provisions of the Investment Law prior to the 2005 Amendment, referred to as an “Approved Enterprise,” is entitled to certain benefits. A company that wished to receive benefits as an Approved Enterprise must have received approval from the Investment Center of the Israeli Ministry of Industry, Trade and Labor, or the Investment Center. Each certificate of approval for an Approved Enterprise relates to a specific investment program in the Approved Enterprise, delineated both by the financial scope of the investment and by the physical characteristics of the facility or the asset.

In general, an Approved Enterprise is entitled to receive a grant from the Government of Israel and certain tax benefits under the “Grant Track” or an alternative package of tax benefits under the “Alternative Track”. The tax benefits from any certificate of approval relate only to taxable profits attributable to the specific Approved Enterprise. Income derived from activity that is not approved by the Investment Center or not integral to the activity of the Approved Enterprise does not enjoy tax benefits.

The tax benefits include a tax exemption for at least the first two years of the benefit period (depending on the geographic location of the Approved Enterprise facility within Israel) and the taxation of income generated from an Approved Enterprise at a reduced corporate tax rate of up to 25% for the remainder of the benefit period. The benefit period is ordinarily seven years commencing with the year in which the Approved Enterprise first generates taxable income. The benefit period is limited to 12 years from the operational year as determined by the Investment Center or 14 years from the start of the tax year in which approval of the Approved Enterprise is obtained, whichever is earlier. This limitation does not apply to the exemption period under the Approved Enterprise status.

A company that has an Approved Enterprise program is eligible for further tax benefits if it qualifies as a Foreign Investors Company, or a FIC, which is a company with a level of foreign investment, as defined in the Investment Law, of more than 25%. The level of foreign investment is measured as the percentage of rights in the company (in terms of shares, rights to profits, voting and appointment of directors), and of combined share and loan capital, that are owned, directly or indirectly, by persons who are not residents of Israel. The determination as to whether a company qualifies as a FIC is made on an annual basis. A company that qualifies as a FIC and has an Approved Enterprise program is eligible for an extended 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 benefit 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.

If a company elects the Alternative Track and distributes a dividend out of income derived from the Approved Enterprise during the tax exemption period, such dividend will be subject to tax on the gross amount distributed. The tax rate will be the rate which would have been applicable had the company not elected the alternative package of benefits. This rate is generally 10%-25%, depending on the percentage of the company's shares held by foreign shareholders. The dividend recipient is subject to withholdings of tax at the source by the company at the reduced rate applicable to dividends from Approved Enterprises, which is 15% if the dividend is distributed during the tax exemption period or within 12 years after the period. This limitation does not apply to an FIC.

The Investment 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 during the first five years in which the equipment is used.

The benefits available to an Approved Enterprise are subject to the fulfillment of conditions stipulated in the Investment Law and its regulations and the criteria in the specific certificate of approval. If a company does not meet these conditions, it would be required to refund the amount of tax benefits, as adjusted by the Israeli consumer price index, and interest.

Our production facilities in Israel have been granted the status of an Approved Enterprise in accordance with the Investment Law under four separate investment programs. In accordance with the provisions of the Investment Law, we have elected the Alternative Track.

Therefore, our income derived from the Approved Enterprise will be entitled to a tax exemption for a period of two years and to an additional period of five to eight years of reduced tax rates of 10% -25% (based on the percentage of foreign ownership). As noted above, the benefit period is limited to 12 years from the operational year as determined by the Investment Center or 14 years from the start of the tax year in which the applicable approval of the Approved

Enterprise was obtained, whichever is earlier. This limitation does not apply to the exemption period under the Approved Enterprise status.

***Tax Benefits Subsequent to the 2005 Amendment***

The 2005 Amendment changed certain provisions of the Investment Law. As a result of the 2005 Amendment, a company was no longer obliged to obtain Approved Enterprise status in order to receive the tax benefits previously available under the Alternative Track, and therefore generally there was no need to apply to the Investment Center for this purpose (Approved Enterprise status remains mandatory for companies seeking cash grants). Rather, the Company may claim the tax benefits offered by the Investment Law directly in its tax returns by notifying the Israeli Tax Authority within 12 months of the end of that year, provided that its facilities meet the criteria for tax benefits set out by the 2005 Amendment. Companies are also granted the right to approach the Israeli Tax Authority for a pre-ruling regarding their eligibility for benefits under the 2005 Amendment.

The 2005 Amendment applies to new investment programs and investment programs with an election year commencing after 2004, but does not apply to investment programs approved prior to April 1, 2005. The 2005 Amendment provides that terms and benefits included in any certificate of approval that was granted before the 2005 Amendment became effective (April 1, 2005) will remain subject to the provisions of the Investment Law as in effect on the date of such approval.

Tax benefits are available under the 2005 Amendment to production facilities (or other eligible facilities), which are generally required to derive more than 25% of their business income from export to specific markets with a population of at least 12 million (following an amendment which became effective as of July 2013, the export criteria was increased to markets with population of at least 14 million; such export criteria will further increase in the future by 1.4% per annum) and meet additional criteria stipulate in the amendment (referred to as a “Beneficiary Enterprise”). In order to receive the tax benefits, the 2005 Amendment states that a company must make an investment which meets all of the conditions, including exceeding a minimum investment amount specified in the Investment 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 its Beneficiary Enterprise (the “Year of Election”).



The extent of the tax benefits available under the 2005 Amendment to qualifying income of a Beneficiary Enterprise depend on, among other things, the geographic location in Israel of the Beneficiary Enterprise. The geographic location of the company at the year of election will also determine the period for which tax benefits are available. Such tax benefits include an exemption from corporate tax on undistributed income for a period of between two to ten years, depending on the geographic location of the Beneficiary Enterprise in Israel, and a reduced corporate tax rate of between 10% to 25% for the remainder of the benefits period, depending on the level of foreign investment in the company in each year if it is a qualified FIC. A company qualifying for tax benefits under the 2005 Amendment which pays a dividend out of income derived by its Beneficiary Enterprise during the tax exemption period will be subject to corporate tax in respect of the gross amount of the dividend at the otherwise applicable rate of 10%-25%. Dividends paid out of income attributed to a Beneficiary Enterprise are generally subject to withholding tax at source at the rate of 15% or such lower rate as may be provided in an applicable tax treaty.

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 benefits available to a Beneficiary Enterprise are subject to the fulfillment of conditions stipulated in the Investment Law and its regulations. If a company does not meet these conditions, it may be required to refund the amount of tax benefits, as adjusted by the Israeli consumer price index, and interest, or other monetary penalties.

We have elected 2008 and 2011 as “Years of Election” under the Investment Law for our Beneficiary Enterprise status.

### ***Tax Benefits under the 2011 Amendment***

The 2011 Amendment canceled the availability of the benefits granted to companies under the Investment Law prior to 2011 and, instead, introduced new benefits for income generated by a “Preferred Company” through its “Preferred Enterprise” (as such terms are defined in the Investment Law) as of January 1, 2011. Similarly to “Beneficiary Company”, a Preferred Company is an industrial company owning a Preferred Enterprise which meets certain conditions (including a minimum threshold of 25% export). However, under this new legislation the requirement for a minimum investment in productive assets was cancelled.

Pursuant to the 2011 Amendment, a Preferred Company is entitled to a reduced corporate tax rate of 15% with respect to its income derived by its Preferred Enterprise in 2011 and 2012, unless the Preferred Enterprise is located in a specified development zone, in which case the rate will be 10%. Under the 2011 Amendment, such corporate tax rate will be reduced from 15% and 10%, respectively, to 12.5% and 7%, respectively, in 2013 and to 16% and 9% in 2014 and thereafter, respectively.

Dividends paid out of income attributed to a Preferred Enterprise during 2014 and thereafter are generally subject to withholding tax at the rate of 20% or such lower rate as may be provided in an applicable tax treaty. However, if such dividends are paid to an Israeli company, no tax is required to be withheld (however, if afterward distributed to individuals or non-Israeli company a withholding of 20% or such lower rate as may be provided in an applicable tax treaty, will apply).

The 2011 Amendment also provided transitional provisions to address companies already enjoying existing tax benefits under the Investment Law. These transitional provisions provide, among other things, that unless an irrevocable request is made to apply the provisions of the Investment Law as amended in 2011 with respect to income to be derived as of January 1, 2011: (i) the terms and benefits included in any certificate of approval that was granted to an Approved Enterprise which chose to receive grants and certain tax benefits under the Grant Track before the 2011 Amendment became effective will remain subject to the provisions of the Investment Law as in effect on the date of such approval, and subject to certain conditions; and (ii) terms and benefits included in any certificate of approval that was granted to an Approved Enterprise under the Alternative Track before the 2011 Amendment became effective will remain subject to the provisions of the Investment Law as in effect on the date of such approval, provided that certain conditions are met; and (iii) a Beneficiary Enterprise can elect to continue to benefit from the benefits provided to it before the 2011 Amendment came into effect, provided that certain conditions are met.

We have reviewed and evaluated the implications and effect of the benefits under the 2011 Amendment, and, while potentially eligible for such benefits, we have not yet chosen to be subject to the tax benefits introduced by the 2011 Amendment.

From time to time, the Israeli Government has discussed reducing the benefits available to companies under the Investment Law. The termination or substantial reduction of any of the benefits available under the Investment Law could materially increase our tax liabilities.

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

Israeli tax law allows, under specific conditions, a tax deduction for research and development expenditures, including capital expenditures, relating to scientific research and development projects, for the year in which they are incurred. Such expenditures must be approved by the relevant Israeli government ministry, determined by the field of research, and the research and development must be for the promotion or development of the enterprise. The amount of such deductible expenses is reduced by the sum of any funds received through government grants for the finance of such scientific research and development projects. Expenditures not approved by the relevant Israeli government ministry, but otherwise qualifying for deduction, are deductible over a three-year period.

The Government of Israel encourages research and development projects through the OCS pursuant to the Law for the Encouragement of Industrial Research and Development, 5744-1984, and the regulations promulgated thereunder (the "Research and Development Law"). Under the Research and Development Law, research and development programs that meet specified criteria and are approved by the research committee of the OCS are eligible for funding of up to 75% of certain approved expenditures of such programs, as determined by such committee. The recipients of such funding are subject to the Research and Development Law, which sets various limitations and obligation, including those described below.

A recipient of OCS funding is required to pay the OCS royalties from the revenues derived from products and services incorporating know-how developed within the framework of each such program or derived from such program, usually up to an aggregate of 100% of the dollar-linked value of the total funding received in respect of such program (or, for funding received on or after January 1, 1999, until 100% of the dollar value plus LIBOR interest is repaid). The royalty rates range generally from 1.3% to 6%, depending on the number of years that lapse between receipt of the funding and repayment, as well as on other circumstances.

The Research and Development Law generally requires that a product developed under a program be manufactured in Israel unless the OCS approves otherwise in writing in advance. Upon the approval of a governmental committee under the Research and Development Law, some of the manufacturing volume may be performed outside of Israel, provided that the funding recipient pays royalties at an increased rate, which may be substantial (and possibly higher than 6%), and the aggregate repayment amount may be increased up to 300% of the funding and applicable LIBOR interest, depending on the portion of the total manufacturing volume that is performed outside of Israel. A recent amendment to the Research and Development Law further permits the OCS, among other things, to approve in certain conditions the transfer of manufacturing rights outside of Israel in exchange for the import of a different manufactured product or manufacturing rights into Israel as a substitute, in lieu of the increased royalties. The Research and Development Law also allows for the approval of funding in cases in which an 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, subject to the payment of an increased royalty rate. In this case, the applicant is still required to adhere to its specific manufacturing allocation in Israel.

The technology and know-how developed in connection with the OCS funding or any rights therein (either legal ownership or actual transfer of know-how) must not be transferred to others (including affiliated companies), including non-residents of Israel, without the prior approval of a governmental committee under the Research and Development Law. Acquisition of shares and other actions which do not include the transfer of OCS' supported know-how do not fall under this definition. Pending the governmental committee' approval, transfer of technology and/or OCS' supported know-how to a non-resident of Israel may also require a payment to the OCS according to the formulas and rules that are set in the Research and Development Law (which may reach up to six times the amount of the OCS funding received plus the applicable LIBOR). The Research and Development Law authorizes the OCS to approve only certain kind of transfer of know-how and in any case such an approval is not guaranteed.

The OCS approval, however, is not required for the export of any products developed using the OCS funding. Approval of the transfer of technology and know-how to residents of Israel may be granted in specific circumstances, only if the recipient abides by the provisions of the Research and Development Law and related regulations, including the restrictions on the transfer of know-how and manufacturing activity, as well as the obligation to pay royalties in an amount that may be increased.

The limitations and obligations under the Research and Development Law apply even after the payment of all royalties, or even if no production or sales are carried out based on the OCS-funded know-how. The Research and Development Law ceases to apply to an OCS-funded company only after the know-how connected with the OCS funding is fully transferred outside of Israel to another entity with the approval of the OCS and compliance with the required process and regulations. Violation of the Research and Development Law may result, among other things, in a requirement to repay the any OCS funding, including interest, differentials and penalties and criminal sanctions. As of this date, there are no OCS audits, actions, claims, suits, proceedings or investigations against us.

The funds available for OCS funding out of the annual budget of the State of Israel have been reduced in the past and may be further reduced in the future. We cannot predict whether, if at all, we would be entitled to any future funding or the amounts of any such funding. In return for the Israel government's participation payments in programs approved by the OCS, we are obligated to pay royalties at a rate of 1.3% to 6% of sales of developed products until the OCS is repaid in full. As of December 31, 2014, we have a contingent obligation to pay royalties in the amount of approximately \$39.6 million. We may, in the future, apply for additional OCS funding.

***Law for the Encouragement of Industry (Taxes), 5729-1969***

The Law for the Encouragement of Industry (Taxes), 5729-1969 (the "Industry Encouragement Law"), generally referred to as the Industry Encouragement Law, provides several tax benefits for "Industrial Companies." We currently qualify as an Industrial Company within the meaning of the Industry Encouragement Law.

The Industry Encouragement Law defines an “Industrial Company” as a company resident in Israel, of which 90% or more of its income in any tax year, other than income from defense loans, is derived from an “Industrial Enterprise” owned by it. An “Industrial Enterprise” is defined as an enterprise whose principal activity in a given tax year is industrial production.

The following corporate tax benefits, among others, are available to Industrial Companies:

- amortization over an eight-year period of the cost of purchased know-how and patents and rights to use a patent and know-how which are used for the development or advancement of the company;
- under limited conditions, an election to file consolidated tax returns with related Israeli Industrial Companies; and
- expenses related to a public offering are deductible in equal amounts over a three-year period.

Eligibility for benefits under the Industry Encouragement Law is not contingent upon the approval of any governmental authority. The Israeli tax authorities may determine that we do not qualify as an Industrial Company, which could entail our loss of the benefits that relate to this status. There can be no assurance that we will continue to qualify as an Industrial Company or that the benefits described above will be available in the future.

### ***Taxation of our Shareholders***

*Capital Gains Taxes Applicable to Non-Israeli Resident Shareholders.* A non-Israeli resident who derives capital gains from the sale of shares in an Israeli resident company that were purchased after the company was listed for trading on a stock exchange outside of Israel will be exempt from Israeli tax so long as the shares were not held through a permanent establishment that the non-resident maintains in Israel. However, non-Israeli corporations will not be entitled to the foregoing exemption if Israeli residents: (i) have a controlling interest of 25% or more in such non-Israeli corporation or (ii) are the beneficiaries of, or are entitled to, 25% or more of the revenues or profits of such non-Israeli corporation, whether directly or indirectly. Additionally, such exemption is not applicable to a person whose gains from selling or otherwise disposing of the shares are deemed to be business income.

Additionally, a sale of securities by a non-Israeli resident may be exempt from Israeli capital gains tax under the provisions of an applicable tax treaty. For example, under the United States-Israel Tax Treaty, the disposition of shares by a shareholder who is a United States resident (for purposes of the treaty) holding the shares as a capital asset is generally exempt from Israeli capital gains tax unless, among other things, (i) the capital gain arising from the disposition is attributed to business income derived by a permanent establishment of the shareholder in Israel; (ii) the

shareholder holds, directly or indirectly, shares representing 10% or more of the voting capital during any part of the 12-month period preceding the disposition; or (iii) such U.S. resident is an individual and was present in Israel for 183 days or more during the relevant taxable year.

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

*Taxation of Non-Israeli Shareholders on Receipt of Dividends.* Non-Israeli residents generally will be subject to Israeli income tax on the receipt of dividends paid on our ordinary shares at the rate of 25%, which tax will be withheld at source, unless relief is provided in a treaty between Israel and the shareholder's country of residence. With respect to a person who is a "substantial shareholder" at the time of receiving the dividend or on any time during the preceding twelve months, the applicable tax rate is 30%. A "substantial shareholder" is generally a person who alone or together with such person's relative or another person who collaborates with such person on a permanent basis, holds, directly or indirectly, at least 10% of any of the "means of control" of the corporation. "Means of control" generally include the right to vote, receive profits, nominate a director or an executive officer, receive assets upon liquidation, or order someone who holds any of the aforesaid rights how to act, regardless of the source of such right.

However, a distribution of dividends to non-Israeli residents is subject to withholding tax at source at a rate of 15% if the dividend is distributed from income attributed to an Approved Enterprise, a Preferred Enterprise or a Beneficiary Enterprise, unless a reduced tax rate is provided under an applicable tax treaty. Pursuant to the Tax Amendment, effective January 1, 2014, if the dividend is being paid out of certain income attributable to a Preferred Enterprise, the dividend will be subject to tax at the rate of 20% (and not 15%). A different rate may be provided in a treaty between Israel and the shareholder's country of residence, as mentioned below.

In this regard, under the United States-Israel Tax Treaty, the maximum rate of tax withheld at source in Israel on dividends paid to a holder of our ordinary shares who is a United States resident (for purposes of the United States-Israel Tax Treaty) is 25%. Consequently, distributions to U.S. residents of income attributed to an Approved Enterprise, a Preferred Enterprise or a Beneficiary Enterprise will be subject to withholding tax at a rate of 15%. However, generally, the maximum rate of withholding tax on dividends, not generated by an Approved Enterprise, a Preferred Enterprise or a Beneficiary Enterprise, that are paid to a United States corporation holding 10% or more of the outstanding voting capital throughout the tax year in which the dividend is distributed as well as during the previous tax year, is 12.5%, provided that not more than 25% of the gross income for such preceding year consists of certain types of dividends and interest. We cannot assure you that we will designate the profits that we may distribute in a way that will reduce shareholders' tax liability.

*U.S. Federal Income Tax Considerations*

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

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

This summary does not consider all aspects of U.S. federal income taxation that may be relevant to particular U.S. Holders by reason of their particular circumstances, including potential application of the U.S. federal alternative minimum tax, or any aspect of state, local or non-U.S. federal tax laws or U.S. federal tax laws other than U.S. federal income tax laws. In addition, this summary is directed only to U.S. Holders that hold our ordinary shares as “capital assets” within the meaning of Section 1221 of the Code and does not address the considerations that may be applicable to particular classes of U.S. Holders, including U.S. expatriates, financial institutions, regulated investment companies, real estate investment trusts, pension funds, insurance companies, broker-dealers, tax-exempt organizations, grantor trusts, partnerships or other pass-through entities, partners or other equity holders in partnerships or other pass-through entities, holders whose functional currency is not the U.S. dollar, holders who have elected mark-to-market accounting, holders who acquired our ordinary shares through the exercise of options or otherwise as compensation, holders who hold our ordinary shares as part of a “straddle,” “hedge” or “conversion transaction,” holders selling our ordinary shares short, holders deemed to have sold our ordinary shares in a “constructive sale,” and holders, directly, indirectly or through attribution, of 10% or more (by vote or value) of our outstanding ordinary shares.

**Each U.S. Holder should consult with its own tax advisor as to the particular tax consequences to it of the acquisition, ownership and disposition of our ordinary shares, including the effects of applicable tax treaties,**

**state, local, foreign or other tax laws and possible changes in the tax laws.**

### **Distributions With Respect to Our Ordinary Shares**

We do not expect to pay cash dividends for the foreseeable future. In the event we do make a distribution with respect to our ordinary shares, subject to the discussion below under “Passive Foreign Investment Company Status,” for U.S. federal income tax purposes, the amount of the distribution will equal the U.S. Dollar value of the gross amount of cash and/or the fair market value of any property distributed, including the amount of any Israeli taxes withheld on such distribution as described above under “Israeli Tax Considerations – Taxation of Non-Israeli Shareholders on Receipt of Dividends.” Other than distributions in liquidation or in redemption of our ordinary shares that are treated as exchanges, a distribution with respect to our ordinary shares to a U.S. Holder generally will be treated as a dividend to the extent of our current and accumulated earnings and profits, as determined for U.S. federal income tax purposes. The amount of any distribution that exceeds these earnings and profits will be treated first as a non-taxable return of capital, reducing the U.S. Holder’s tax basis in its ordinary shares (but not below zero), and then generally as capital gain from a deemed sale or exchange of such ordinary shares. Corporate U.S. Holders generally will not be allowed a deduction under Section 243 of the Code for dividends received on our ordinary shares and thus will be subject to tax at the rate applicable to their taxable income. Currently, a noncorporate U.S. Holder’s “qualified dividend income” generally is subject to tax at a rate of 20%. For this purpose, “qualified dividend income” generally includes dividends paid by a foreign corporation if, among other things, the noncorporate U.S. Holder meets certain minimum holding period requirements and either (a) the stock of such corporation is readily tradable on an established securities market in the U.S., including the NASDAQ Global Select Market, or (b) such corporation is eligible for the benefits of a comprehensive income tax treaty with the United States that includes an information exchange program and is determined to be satisfactory by the U.S. Secretary of the Treasury. The U.S. Secretary of the Treasury has indicated that the income tax treaty between the United States and Israel is satisfactory for this purpose. Dividends paid by us will not qualify for the 20% U.S. federal income tax rate, however, if we are treated, for the tax year in which the dividends are paid or the preceding tax year, as a “passive foreign investment company” for U.S. federal income tax purposes. See the discussion below under the heading “Passive Foreign Investment Company Status.” A noncorporate U.S. Holder may be subject to an additional tax based on its “net investment income,” (which generally is computed as gross income from interest, dividends, annuities, royalties and rents and gain from the sale of property (other than property held in the active conduct of a trade or business that does not regularly trade financial instruments or commodities), less the amount of deductions properly allocable to such income or gain. Such tax is equal to 3.8% of the lesser of an individual U.S. Holder’s (i) net investment income or (ii) the excess of such U.S. Holder’s “modified adjusted gross income” (adjusted gross income plus the amount of any foreign earned income excluded from income under Section 911(a)(1) of the Code, net of deductions and exclusions disallowed with respect to such foreign earned income) over a specified threshold amount (\$250,000 in the case of a joint return or surviving spouse, \$125,000 in the case of a married individual filing a separate return and \$200,000 in any other case). In the case of a U.S. Holder which is an estate or trust, the tax is equal to 3.8% of the lesser of (i) undistributed net investment income or (ii) the excess of adjusted gross income (as defined in Section 67(e) of the Code) over the dollar amount at which the highest tax bracket applicable to an estate or trust begins.



**U.S. Holders are urged to consult their own tax advisors regarding the U.S. federal income tax consequences of their receipt of any distributions with respect to our ordinary shares.**

A dividend paid by us in NIS will be included in the income of U.S. Holders at the U.S. dollar amount of the dividend, based on the “spot rate” of exchange in effect on the date of receipt or deemed receipt of the dividend, regardless of whether the payment is in fact converted into U.S. dollars. U.S. Holders will have a tax basis in the NIS for U.S. federal income tax purposes equal to that U.S. dollar value. Any gain or loss upon the subsequent conversion of the NIS into U.S. dollars or other disposition of the NIS will constitute foreign currency gain or loss taxable as ordinary income or loss and will be treated as U.S.-source income or loss for U.S. foreign tax credit purposes.

Dividends received with respect to our ordinary shares will constitute “portfolio income” for purposes of the limitation on the deductibility of passive activity losses and, therefore, generally may not be offset by passive activity losses. Dividends received with respect to our ordinary shares also generally will be treated as “investment income” for purposes of the investment interest deduction limitation contained in Section 163(d) of the Code, and generally as foreign-source passive income for U.S. foreign tax credit purposes. Subject to certain limitations, U.S. Holders may elect to claim as a foreign tax credit against their U.S. federal income tax liability any Israeli income tax withheld from distributions with respect to our ordinary shares which constitute dividends under U.S. income tax law. A U.S. Holder that does not elect to claim a foreign tax credit may instead claim a deduction for Israeli income tax withheld, but only if the U.S. Holder elects to do so with respect to all foreign income taxes in such year. In addition, special rules may apply to the computation of foreign tax credits relating to “qualified dividend income,” as defined above. The calculation of foreign tax credits and, in the case of a U.S. Holder that elects to deduct foreign income taxes, the availability of deductions involve the application of complex rules that depend on a U.S. Holder’s particular circumstances. U.S. Holders are urged to consult their own tax advisors regarding the availability to them of foreign tax credits or deductions in respect of any Israeli tax withheld or paid with respect to any dividends which may be paid with respect to our ordinary shares.

**Disposition of Our Ordinary Shares**

Subject to the discussion below under “Passive Foreign Investment Company Status,” a U.S. Holder’s sale, exchange or other taxable disposition of our ordinary shares generally will result in the recognition by such U.S. Holder of capital gain or loss in an amount equal to the difference between the U.S. dollar value of the amount realized and the U.S. Holder’s tax basis in the ordinary shares disposed of (measured in U.S. dollars). This gain or loss will be long-term capital gain or loss if such ordinary shares have been held or are deemed to have been held for more than one year at the time of the disposition. Individual U.S. Holders currently are subject to a maximum tax rate of 20% on long-term capital gains, also may be subject to the additional tax on “net investment income” described above in “Distributions With Respect to Our Ordinary Shares.” If the U.S. Holder’s holding period on the date of the taxable disposition is one year or less, such gain or loss will be a short-term capital gain or loss. Short-term capital gains generally are taxed at the same rates applicable to ordinary income. See “Israeli Tax Considerations - Capital Gains Taxes Applicable to Non-Israeli Resident Shareholders” for a discussion of taxation by Israel of capital gains realized on sales of our ordinary shares. Any capital loss realized upon the taxable disposition of our ordinary shares generally will be

deductible only against capital gains and not against ordinary income, except that noncorporate U.S. Holders generally may deduct annually from ordinary income up to \$3,000 of net capital losses. In general, any capital gain or loss recognized by a U.S. Holder upon the taxable disposition of our ordinary shares will be treated as U.S.-source income or loss for U.S. foreign tax credit purposes, although the tax treaty between the United States and Israel may permit gain derived from the taxable disposition of ordinary shares by a U.S. Holder to be treated as foreign-source income for U.S. foreign tax credit purposes under certain circumstances.

A U.S. Holder's tax basis in its ordinary shares generally will be equal to the U.S. dollar purchase price paid by such U.S. Holder to acquire such ordinary shares. The U.S. dollar cost of ordinary shares purchased with foreign currency generally will be equal to the U.S. dollar value of the purchase price on the date of purchase or, in the case of ordinary shares that are purchased by a cash basis U.S. Holder (or an accrual basis U.S. Holder that so elects), on the settlement date for the purchase. Such an election by an accrual basis U.S. Holder must be applied consistently from year to year and cannot be revoked without the consent of the U.S. Internal Revenue Service. The holding period of each ordinary share owned by a U.S. Holder will commence on the day following the date of the U.S. Holder's purchase of such ordinary share and will include the day on which the ordinary share is sold by such U.S. Holder.

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

### **Passive Foreign Investment Company Status**

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

There is no definitive method prescribed in the Code, U.S. Treasury Regulations or relevant administrative or judicial interpretations for determining the value of a publicly-traded foreign corporation's assets for purposes of the Asset Test. The legislative history of the U.S. Taxpayer Relief Act of 1997 (the "1997 Act") indicates that for purposes of the Asset Test, "the total value of a publicly-traded foreign corporation's assets generally will be treated as equal to the sum

of the aggregate value of its outstanding stock plus its liabilities.” It is unclear whether other valuation methods could be employed to determine the value of a publicly-traded foreign corporation’s assets for purposes of the Asset Test.

We must make a separate determination each taxable year as to whether we are a PFIC. As a result, our PFIC status may change from year to year. Based on the composition of our gross income and the composition and value of our gross assets for each taxable year from 2004 through 2014, we do not believe that we were a PFIC during any of such tax years. It is likely, however, that under the asset valuation method described in the legislative history of the 1997 Act, we would have been classified as a PFIC for each of 2001, 2002 and 2003 primarily because (a) a significant portion of our assets consisted of the remaining proceeds of our two public offerings of ordinary shares in 1999, and (b) the public market valuation of our ordinary shares during such years was relatively low. There can be no assurance that we will not be deemed a PFIC for any future tax year in which, for example, the value of our assets, as measured by the public market valuation of our ordinary shares, declines in relation to the value of our passive assets (generally, cash, cash equivalents and marketable securities). If we are treated as a PFIC with respect to a U.S. Holder for any tax year, the U.S. Holder will be deemed to own ordinary shares in any of our subsidiaries that are also PFICs.

If we are treated as a PFIC for U.S. federal income tax purposes for any year during a U.S. Holder’s holding period of our ordinary shares and the U.S. Holder does not make a QEF Election or a “mark-to-market” election (both as described below), the U.S. Holder would be subject to the following rules:

- the U.S. Holder would be required to (a) report as ordinary income any “excess distributions” (as defined below) allocated to the current tax year and any period prior to the first day of the first tax year in which we were a PFIC, (b) pay tax on amounts allocated to each prior tax year in which we were a PFIC at the highest rate for individuals or corporations as appropriate in effect for such prior year, and (c) pay an interest charge on the tax due for prior tax years in which we were a PFIC at the rate applicable to deficiencies of U.S. federal income tax. “Excess distributions” with respect to any U.S. Holder are amounts received by such U.S. Holder with respect to our ordinary shares in any tax year that exceed 125% of the average distributions received by such U.S. Holder from us during the shorter of (i) the three previous years, or (ii) such U.S. Holder’s holding period of our ordinary shares before the then-current tax year. Excess distributions must be allocated ratably to each day that a U.S. Holder has held our ordinary shares.

- (ii) the entire amount of any gain realized by the U.S. Holder upon the sale or other disposition of our ordinary shares also would be treated as an “excess distribution” subject to tax as described above.

the tax basis in ordinary shares acquired from a decedent who was a U.S. Holder generally would not receive a (iii) step-up to fair market value as of the date of the decedent’s death, but instead would be equal to the decedent’s basis, if lower.

If we are a PFIC for any tax year in which a U.S. Holder holds our ordinary shares, we generally will continue to be treated as a PFIC as to such U.S. Holder for all subsequent years during the U.S. Holder’s holding period unless we cease to be a PFIC and the U.S. Holder elects to recognize gain based on the unrealized appreciation in such U.S. Holder’s ordinary shares through the close of the tax year in which we cease to be a PFIC. Thereafter, so long as we do not again become a PFIC, such U.S. Holder’s ordinary shares for which an election was made will not be treated as shares in a PFIC.

A U.S. Holder who beneficially owns shares of a PFIC must file U.S. Internal Revenue Service Form 8621 (Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund) with the U.S. Internal Revenue Service for each tax year in which such U.S. Holder recognizes gain upon a disposition of our ordinary shares, receives certain distributions from us or makes the QEF Election or mark-to-market election described below.

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

A U.S. Holder may make a QEF Election with respect to a PFIC for any tax year. The election is effective for the tax year for which it is made and all subsequent tax years of the U.S. Holder. Procedures exist for both retroactive elections and the filing of protective statements. A QEF Election is made by completing U.S. Internal Revenue Service Form 8621 and attaching it to a timely-filed (including extensions) U.S. federal income tax return for the first tax year to which the election will apply. A U.S. Holder must satisfy additional filing requirements each year the election remains in effect. Upon a U.S. Holder’s request, we will provide to such U.S. Holder the information required to make a QEF Election and to make subsequent annual filings.

As an alternative to a QEF Election, a U.S. Holder generally may elect to mark its ordinary shares to market annually, recognizing ordinary income or loss (subject to certain limitations) equal to the difference, as of the close of each tax year, between the fair market value of its ordinary shares and the adjusted tax basis of such shares. If a mark-to-market election with respect to ordinary shares is in effect on the date of a U.S. Holder’s death, the normally available step-up

in tax basis to fair market value generally will not be available. Rather, the tax basis of ordinary shares in the hands of a U.S. Holder who acquired them from a decedent will be the lesser of the decedent's tax basis or the fair market value of the ordinary shares. Once made, a mark-to-market election generally continues unless revoked with the consent of the U.S. Internal Revenue Service.

**Due to the complexity of the PFIC rules and the uncertainty of their application in many circumstances, U.S. Holders should consult their own tax advisors with respect to the U.S. federal income tax risks related to owning and disposing of our ordinary shares, the consequence of our status as a PFIC and, if we are treated as a PFIC, compliance with the applicable reporting requirements and the eligibility, manner and advisability of making a QEF Election or a mark-to-market election.**

### **Information Reporting and Backup Withholding**

Payments in respect of our ordinary shares that are made in the United States or by certain U.S.-related financial intermediaries may be subject to information reporting requirements and U.S. backup withholding tax, currently at a rate of 28%. The information reporting requirements will not apply, however, to payments to certain exempt U.S. Holders, including corporations and tax-exempt organizations. In addition, backup withholding will not apply to a U.S. Holder that furnishes a correct taxpayer identification number on U.S. Internal Revenue Service Form W-9 (or substitute form). The backup withholding tax is not an additional tax. Amounts withheld under the backup withholding tax rules may be credited against a U.S. Holder's U.S. federal income tax liability, and a U.S. Holder may obtain a refund of any excess amounts withheld under the backup withholding tax rules by filing the appropriate claim for refund with the U.S. Internal Revenue Service. U.S. Holders should consult their own tax advisors regarding their qualification for an exemption from the backup withholding tax and the procedures for obtaining such an exemption, if applicable.

## Foreign Asset Reporting

A U.S. Holder with interests in “specified foreign financial assets” (including, among other assets, our ordinary shares, unless such ordinary shares are held on such U.S. Holder’s behalf through a financial institution) may be required to file an information report with the U.S. Internal Revenue Service if the aggregate value of all such assets exceeds \$50,000 on the last day of the taxable year or \$75,000 at any time during the taxable year (or such higher dollar amount as may be prescribed by applicable U.S. Internal Revenue Service guidance). Each U.S. Holders should consult with its own tax advisor regarding its obligation to file such information reports in light of its own particular circumstances.

**The foregoing discussion of certain U.S. federal income tax considerations is a general summary only and should not be considered as income tax advice or relied upon for tax planning purposes. Accordingly, each U.S. Holder should consult with its own tax advisor regarding U.S. federal, state, local and non-U.S. income and other tax consequences of the acquisition, ownership and disposition of our ordinary shares.**

### *F. DIVIDENDS AND PAYING AGENTS*

Not applicable.

### *G. STATEMENT BY EXPERTS*

Not applicable.

### *H. DOCUMENTS ON DISPLAY*

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

As a foreign private issuer, we are exempt from the rules under the Exchange Act prescribing the furnishing and content of proxy statements, and our officers, directors and principal shareholders are exempt from the reporting and “short-swing” profit recovery provisions contained in Section 16 of the Exchange Act. In addition, we are not required under the Exchange Act to file periodic reports and financial statements with the SEC as frequently or as promptly as United States companies whose securities are registered under the Exchange Act. However, we file with the Securities and Exchange Commission an annual report on Form 20-F containing consolidated financial statements audited by an independent accounting firm. We also furnish reports on Form 6-K containing unaudited financial information after the end of each of the first three quarters. We intend to post our Annual Report on Form 20-F on our website ([www.audiocodes.com](http://www.audiocodes.com)) promptly following the filing of our Annual Report with the Securities and Exchange Commission.

### *I. SUBSIDIARY INFORMATION*

Not applicable.

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

We are exposed to financial market risk associated with changes in foreign currency exchange rates. To mitigate these risks, we use derivative financial instruments. The majority of our revenues and expenses are generated in U.S. dollars. A portion of our expenses, however, is denominated in NIS. In order to protect ourselves against the volatility of future cash flows caused by changes in foreign exchange rates, we use currency forward contracts and currency options. We hedge the part of our forecasted expenses denominated in NIS. If our currency forward contracts and currency options meet the definition of a hedge, and are so designated, changes in the fair value of the contracts will be offset against changes in the fair value of the hedged assets or liabilities through earnings. For derivative instruments not designated as hedging instruments, the gain or loss is recognized in current earnings during the period of change. Our hedging program reduces, but does not eliminate, the impact of foreign currency rate movements and due to the general economic slowdown along with the devaluation of the dollar, our results of operations may be adversely affected. Without taking into account the mitigating effect of our hedging activity, a 10% decrease in the U.S. dollar exchange rates in effect for the year ended December 31, 2014 would cause a decrease in net income of approximately \$5 million.



We are subject to market risk from exposure to changes in interest rates relating to borrowings under our loan agreements. The interest rate on these borrowings is based on LIBOR. Based on our the scheduled amount of these borrowings to be outstanding in 2014, we estimate that each 100 basis point increase in our borrowing rates would result in additional interest expense to us of approximately \$74,000.

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

Not applicable.

## **PART II**

## **ITEM 13. DEFAULTS, DIVIDEND ARREARAGES AND DELINQUENCIES**

Not applicable.

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

Not applicable.

## **ITEM 15. CONTROLS AND PROCEDURES**

### *Disclosure Controls and Procedures*

Our management, with the participation of our Chief Executive Officer and our Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures (as defined in 13a-15(e) under the Securities Exchange Act) as of December 31, 2014. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of such date, our disclosure controls and procedures were (i) designed to ensure that material information relating to us, including our consolidated subsidiaries, is made known to our management, including our Chief Executive Officer and Chief Financial Officer, by others within those entities, as appropriate to allow timely decisions regarding required disclosure, particularly during the period in which this report was being prepared and (ii) effective, in that they provide reasonable assurance that information required to be disclosed by us in the reports that

we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

*Management's Annual Report on Internal Control Over Financial Reporting*

Our management, under the supervision of our Chief Executive Officer and our Chief Financial Officer, is responsible for establishing and maintaining adequate internal control over our financial reporting, as defined in Rules 13a-15(f) of the Exchange Act. Our internal control over financial reporting is designed to provide reasonable assurance to our management and board of directors regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Internal control over financial reporting includes policies and procedures that:

pertain to the maintenance of our records that in reasonable detail accurately and fairly reflect our transactions and asset dispositions;

provide reasonable assurance that our transactions are recorded as necessary to permit the preparation of our financial statements in accordance with generally accepted accounting principles;

provide reasonable assurance that our receipts and expenditures are made only in accordance with authorizations of our management and board of directors (as appropriate); and

provide reasonable assurance regarding the prevention or timely detection of unauthorized acquisition, use or disposition of our assets that could have a material effect on our financial statements.

Due to its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. In addition, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Under the supervision and with the participation of our management, including our principal executive officer and our principal financial officer, we conducted an evaluation of the effectiveness of our internal control over financial reporting as of December 31, 2014 based on the framework for Internal Control - Integrated Framework set forth by the Committee of Sponsoring Organizations of the Treadway Commission (2013 framework) (COSO). Based on our assessment under that framework and the criteria established therein, our management concluded that the Company's internal control over financial reporting were effective as of December 31, 2014.

*Attestation Report of the Registered Public Accounting Firm*

This annual report includes an attestation report of our registered public accounting firm regarding internal control over financial reporting on page F-3 of our audited consolidated financial statements set forth in Item 18 – “Financial Statements,” and is incorporated herein by reference.

*Changes in Internal Control Over Financial Reporting*

There were no changes in our internal controls over financial reporting identified with the evaluation thereof that occurred during the period covered by this annual report 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 Joseph Tenne is an “audit committee financial expert” as defined in Item 16A of Form 20-F and is “independent” as defined in the applicable regulations.

**ITEM 16B. CODE OF ETHICS**

We have adopted a Code of Conduct and Business Ethics that applies to our chief executive officer, chief financial officer and other senior financial officers. This Code has been posted on our website, [www.audiocodes.com](http://www.audiocodes.com).

#### ITEM 16C. PRINCIPAL ACCOUNTANT FEES AND SERVICES

Kost Forer Gabbay & Kasierer, a member of Ernst & Young Global, has served as our independent public accountants for each of the years in the three-year period ended December 31, 2014. The following table presents the aggregate fees for professional audit services and other services rendered by Kost Forer Gabbay & Kasierer in 2013 and 2014.

|                    | Year Ended December 31,<br>(Amounts in thousands) |        |
|--------------------|---|--------|
|                    | 2013  | 2014   |
| Audit Fees         | \$ 340  | \$ 365 |
| Audit Related Fees | 45  | 63     |
| Tax Fees           | 80  | 92     |
| Total              | \$ 465  | \$ 520 |

Audit Fees consist of fees billed for the annual audit of the company's consolidated financial statements and the statutory financial statements of the company. They also include fees billed for other audit services, which are those services that only the external auditor reasonably can provide, and include services rendered for the integrated audit over internal controls as required under Section 404 of the Sarbanes-Oxley Act applicable in 2013 and 2014, the provision of consents and the review of documents filed with the SEC.

Audit Related Fees consist of fees billed for assurance and related services that are reasonably related to the performance of the audit or review of the company's financial statements and include operational effectiveness of systems. Audit Related Fees in 2014 also included fees in connection with our public offering in March 2014.

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

### **Audit Committee Pre-approval Policies and Procedures**

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

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

The Audit Committee pre-approves fee levels annually for the audit services. Non-audit services are pre-approved as required. The Chairman of the Audit Committee may approve non-audit services of up to \$25,000 and then request the Audit Committee to ratify his decision.

During 2014, no services provided to AudioCodes by Kost Forer Gabbay & Kasierer were approved by the Audit Committee pursuant to the de minimis exception to the pre-approval requirement provided by paragraph (c)(7)(i)(C) of Rule 2-01 of Regulation S-X. We approve all such compensation by the audit committee.

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

Not applicable.

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

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In 2014, we repurchased a total of 1,048,891 of our Ordinary Shares at a total cost of \$5.3 million, as set forth below:

| Period                    | (a) Total Number of Ordinary Shares Purchased (1) | (b) Average Price per Ordinary Share (2) | (c) Total Number of Ordinary Shares Purchased as Part of Publicly Announced Program | (d) Maximum Approximate Dollar Value of Shares Available for Repurchase under the Program |
|---------------------------|---|--|---|---|
| August 7- August 31       | 185,820   | 5.43                                     | 185,820   | 18,000,000  |
| September 1- September 30 | 319,859   | 5.34                                     | 319,859   | 16,986,150  |
| October 1 - October 31    | 58,100  | 4.57                                     | 58,100  | 15,267,351  |
| November 1 - November 30  | -   | -  | -   | 15,000,176  |
| December 1 - December 31  | 485,112   | 4.64                                     | 485,112   | 12,732,991  |
| Total                     | 1,048,891   | 4.99                                     | 1,048,891   | 12,732,991  |

(1) On August 7, 2014, we announced that our Board had authorized a program to repurchase up to \$3 million of our ordinary shares. In November 2014, we received court approval in Israel to repurchase up to an additional \$15 million of our ordinary shares.

(2) Excluding commissions.

## **ITEM 16F. CHANGE IN REGISTRANT'S CERTIFIED ACCOUNTANT**

Not applicable.

## **ITEM 16G. CORPORATE GOVERNANCE**

As a foreign private issuer whose shares are listed on the NASDAQ Global Select Market, we are permitted to follow certain home country corporate governance practices instead of certain requirements of the NASDAQ Marketplace Rules.

We do not comply with the NASDAQ requirement that we obtain shareholder approval for certain dilutive events, such as for the establishment or amendment of certain equity based compensation plans. Instead, we follow Israeli law and practice which permits the establishment or amendment of certain equity based compensation plans approved by our board of directors without the need for a shareholder vote, unless such arrangements are for the compensation of directors and the chief executive officer, in which case they also require compensation committee and shareholder approval.

We may elect in the future to follow Israeli practice with regard to, among other things, director nomination, composition of the board of directors and quorum at shareholders' meetings. In addition, we may follow Israeli law, instead of the NASDAQ Marketplace Rules, which require that we obtain shareholder approval for an issuance that will result in a change of control of the company, certain transactions other than a public offering involving issuances of a 20% or more interest in the company and certain acquisitions of the stock or assets of another company.

A foreign private issuer that elects to follow a home country practice instead of NASDAQ requirements, must submit to NASDAQ in advance a written statement from an independent counsel in its home country certifying that its practices are not prohibited by the home country's laws. In addition, a foreign private issuer must disclose in its annual reports filed with the Securities and Exchange Commission or on its website each such requirement that it does not follow and describe the home country practice followed by the issuer instead of any such requirement. Accordingly, our shareholders may not be afforded the same protection as provided under NASDAQ's corporate governance rules.

For a discussion of the requirements of Israeli law with respect to these matters, see Item 6.C. "Directors, Senior Management and Employees -Board Practices," and Item 10.B. "Additional Information - Memorandum and Articles of Association."

**ITEM 16H.MINE SAFETY DISCLOSURE**

Not applicable.

**PART III**

**ITEM 17.FINANCIAL STATEMENTS**

Not applicable.

**ITEM 18.FINANCIAL STATEMENTS**

Reference is made to pages 1 to 48 of the financial statements attached hereto.

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**ITEM 19.EXHIBITS**

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

| <b>Exhibit No.</b> | <b>Document</b>   | <b>Incorporated by Reference</b> |                 |                   |
|--------------------|---|----------------------------------|-----------------|-------------------|
|                    |   | <b>Form</b>                      | <b>File No.</b> | <b>Date Filed</b> |
| 1.1‡               | Memorandum of Association of Registrant.  | F-1                              | 333-10352       | 5/13/1999         |
| 1.2                | Articles of Association of Registrant, as amended.  | 20-F<br>(2011)                   | 000-30070       | 4/19/2012         |
| 4.1                | AudioCodes Ltd. 1997 Key Employee Option Plan (C).  | F-1                              | 333-10352       | 5/13/1999         |
| 4.2                | AudioCodes Ltd. 1997 Key Employee Option Plan, Qualified Stock Option Plan-U.S. Employees (D).  | F-1                              | 333-10352       | 5/13/1999         |
| 4.3                | License Agreement between AudioCodes Ltd. and DSP Group, Inc., dated as of May 6, 1999.   | F-1                              | 333-10352       | 5/22/1999         |
| 4.4                | AudioCodes Ltd. 1997 Key Employee Option Plan (D).  | F-1                              | 333-10352       | 5/13/1999         |
| 4.5                | AudioCodes Ltd. 1997 Key Employee Option Plan (E).  | F-1                              | 333-10352       | 5/13/1999         |
| 4.6                | AudioCodes Ltd. 1999 Key Employee Option Plan (F), as amended.  | 20-F<br>(2002)                   | 000-30070       | 3/27/2002         |
| 4.7                | AudioCodes Ltd. 1997 Key Employee Option Plan, Qualified Stock Option Plan-U.S. Employees (E).  | F-1                              | 333-10352       | 5/13/1999         |
| 4.8                | AudioCodes Ltd. 1999 Key Employee Option Plan, Qualified Stock Option Plan-U.S. Employees (F).  | 20-F<br>(2002)                   | 000-30070       | 3/27/2002         |
| 4.9                | AudioCodes Ltd. 2001 Employee Stock Purchase Plan-Global Non U.S., as amended.  | S-8                              | 333-144823      | 7/24/2007         |
| 4.10               | AudioCodes Ltd. 2001 U.S. Employee Stock Purchase Plan, as amended.   | S-8                              | 333-144823      | 7/24/2007         |
| 4.11               | AudioCodes Ltd. 2007 U.S. Employee Stock Purchase Plan.   | S-8                              | 333-144825      | 7/24/2007         |
| 4.12               | Sublease Agreement between AudioCodes USA, Inc. and Continental Resources, Inc., dated December 30, 2003.                                     | 20-F<br>(2003)                   | 000-30070       | 6/30/2004         |
| 4.13               | Addendum No. 2, dated November 6, 2013, to Sublease Agreement, dated December 30, 2003, between Continental Resources, Inc., as landlord, and | 6-K                              | 000-30070       | 3/04/2014         |

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AudioCodes USA Inc., as tenant.

|       |   |                |           |            |
|-------|---|----------------|-----------|------------|
| 4.13  | Employment Agreement between AudioCodes Ltd. and Shabtai Adlersberg.  | 6-K            | 000-30070 | 11/12/2009 |
| 4.14  | Amendment No. 1 to Employment Agreement between AudioCodes Ltd. and Shabtai Adlersberg.   | 6-K            | 000-30070 | 8/8/2013   |
| 4.15† | Building and Tenancy Lease Agreement, dated May 11, 2007, by and between Airport City Ltd. and AudioCodes Ltd.  | 20-F<br>(2006) | 000-30070 | 6/27/2007  |
| 4.16† | English Summary of Addendum, dated September 23, 2013, to Lease and Construction Agreement of November 14, 2000, between Airport City Ltd., as landlord and AudioCodes Ltd., as tenant. | 6-K            | 000-30070 | 1/6/2014   |

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| Exhibit No. | Document  | Incorporated by Reference |            |            |
|-------------|---|---------------------------|------------|------------|
|             |   | Form                      | File No.   | Date Filed |
| 4.17        | AudioCodes Ltd. 2008 Equity Incentive Plan.   | 20-F<br>(2008)            | 000-30070  | 6/30/2009  |
| 4.18        | Amendment to AudioCodes Ltd. 2008 Equity Incentive Plan.  | S-8                       | 333-170676 | 11/18/2010 |
| 4.19        | Amendment No. 2 to AudioCodes Ltd. 2008 Equity Incentive Plan.  | S-8                       | 333-190437 | 8/07/2013  |
| 4.20‡       | Loan Requests, dated May 13, 2008, between First International Bank of Israel, as lender, and AudioCodes Ltd., as borrower.   | 20-F<br>(2012)            | 000-30070  | 4/11/2013  |
| 4.21‡       | Loan Requests, dated September 27, 2011, between First International Bank of Israel, as lender, and AudioCodes Ltd., as borrower.   | 20-F<br>(2012)            | 000-30070  | 4/11/2013  |
| 4.22‡       | Restated Undertaking Letter to First International Bank of Israel, dated May 6, 2008.   | 20-F<br>(2012)            | 000-30070  | 4/11/2013  |
| 4.23‡       | Amendments to Undertaking Letter to First International Bank of Israel, dated September 15, 2009, February 16, 2009, September 26, 2011, December 29, 2011 and July 23, 2012. | 20-F<br>(2012)            | 000-30070  | 4/11/2013  |
| 4.24‡       | Letter Agreement, dated July 14, 2008, between Bank Mizrahi Tefahot Ltd., as lender, and AudioCodes Ltd., as borrower.  | 20-F<br>(2012)            | 000-30070  | 4/11/2013  |
| 4.25‡       | Secured Bond, dated July 14, 2008, delivered by AudioCodes Ltd., as borrower, in favor of Bank Mizrahi Tefahot Ltd., as lender.   | 20-F<br>(2012)            | 000-30070  | 4/11/2013  |
| 4.26‡       | Undertaking Letter to Bank Mizrahi Tefahot Ltd, dated December 12, 2011.  | 20-F<br>(2012)            | 000-30070  | 4/11/2013  |
| 4.27‡       | Deed of Pledge of Rights, dated December 12, 2011, delivered by AudioCodes Ltd., as borrower, in favor of Bank Mizrahi Tefahot Ltd., as lender.                               | 20-F<br>(2012)            | 000-30070  | 4/11/2013  |
| 4.28‡       | Amendment to Undertaking Letter to Bank Mizrahi Tefahot Ltd., dated July 23, 2012.  | 20-F<br>(2012)            | 000-30070  | 4/11/2013  |
| 4.29‡       | Loan Requests, dated September 27, 2011, between Bank Leumi Israel Ltd., as lender, and AudioCodes Ltd., as borrower.   | 20-F<br>(2012)            | 000-30070  | 4/11/2013  |
| 4.30‡       | Undertaking Letter to Bank Leumi Israel Ltd., dated December 12, 2011.  | 20-F<br>(2012)            | 000-30070  | 4/11/2013  |
| 4.31‡       | Amendment to Undertaking Letter to Bank Leumi Israel Ltd., dated July 24, 2012.   | 20-F<br>(2012)            | 000-30070  | 4/11/2013  |

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|      |   |                |           |            |
|------|---|----------------|-----------|------------|
| 4.32 | Form of Insurance, Indemnification and Exculpation Agreement between the Registrant and each of its directors and executive officers. | 6-K            | 000-30070 | 11/10/2011 |
| 4.33 | AudioCodes Ltd. Executive Compensation Plan.  | 6-K            | 000-30070 | 11/10/2011 |
| 8.1  | Subsidiaries of the Registrant.   | 20-F<br>(2012) | 000-30070 | 4/11/2013  |

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| <b>Exhibit No.</b> | <b>Document</b>  | <b>Incorporated by Reference Form File No. Date Filed</b> |
|--------------------|--|---|
| 12.1*              | Certification of Shabtai Adlersberg, President and Chief Executive Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.             |   |
| 12.2*              | Certification of Guy Avidan, Chief Financial Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.                                   |   |
| 13.1*              | Certification by Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |   |
| 13.2*              | Certification by Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |   |
| 15.1*              | Consent of Kost Forer Gabbay & Kasierer, a member of Ernst & Young Global.   |   |
| 101.1*             | Interactive Data Files (XBRL-Related Documents).   |   |

English summary of Hebrew original.

English translation of Hebrew original.

\*Filed herewith.

**SIGNATURES**

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

AUDIOCODES LTD.

By: /s/ SHABTAI ADLERSBERG  
Shabtai Adlersberg  
President and Chief Executive Officer

Date: March 24, 2015

**AUDIOCODES LTD.**

**CONSOLIDATED FINANCIAL STATEMENTS**

**AS OF DECEMBER 31, 2014**

**IN U.S. DOLLARS**

**INDEX**

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## **REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

**To the Board of Directors and Shareholders of**

### **AUDIOCODES LTD.**

We have audited the accompanying consolidated balance sheets of AudioCodes Ltd. (the "Company") as of December 31, 2013 and 2014, and the related consolidated statements of operations, comprehensive income (loss), changes in equity and cash flows for each of the three years in the period ended December 31, 2014. 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. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company as of December 31, 2013 and 2014, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2014, in conformity with United States generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of December 31, 2014, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 framework) and our report dated March 24, 2015 expressed an unqualified opinion thereon.



/s/ KOST FORER GABBAY & KASIERER  
Tel-Aviv, Israel KOST FORER GABBAY & KASIERER  
March 24, 2015 A Member of Ernst & Young Global

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## **REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

**To the Board of Directors and Shareholders of**

### **AUDIOCODES LTD.**

We have audited AudioCodes Ltd's (the "Company") internal control over financial reporting as of December 31, 2014, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 framework) (the COSO criteria). The Company's management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit 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 effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the Company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2014, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of the Company as of December 31, 2013 and 2014 and the related consolidated statements of operations, comprehensive income (loss), changes in equity and cash flows for each of the three years in the period ended December 31, 2014 and our report dated March 24, 2015 expressed an unqualified opinion thereon.

/s/ KOST FORER GABBAY & KASIERER

Tel-Aviv, Israel KOST FORER GABBAY & KASIERER

March 24, 2015 A Member of Ernst & Young Global

**AUDIOCODES LTD.****CONSOLIDATED BALANCE SHEETS****U.S. dollars in thousands**

|   | December 31,     |                  |
|---|------------------|------------------|
|   | 2013             | 2014             |
| <b>ASSETS</b>   |                  |                  |
| <b>CURRENT ASSETS:</b>  |                  |                  |
| Cash and cash equivalents   | \$30,763         | \$14,797         |
| Short-term and restricted bank deposits   | 9,101            | 7,630            |
| Short-term marketable securities and accrued interest   | 15,706           | 543              |
| Trade receivables (net of allowance for doubtful accounts of \$ 2,347 and \$ 2,437 at December 31, 2013 and 2014, respectively) | 26,431           | 31,056           |
| Other receivables and prepaid expenses  | 3,922            | 6,244            |
| Deferred income tax assets, net   | 2,277            | 3,320            |
| Inventories   | 13,811           | 14,736           |
| <b><u>Total</u> current assets</b>  | <b>102,011</b>   | <b>78,326</b>    |
| <b>LONG-TERM ASSETS:</b>  |                  |                  |
| Long-term marketable securities   | -                | 58,684           |
| Long-term and restricted bank deposits and accrued interest   | 6,697            | 4,066            |
| Deferred income tax assets, net   | 4,855            | 872              |
| Severance pay funds   | 19,549           | 17,835           |
| <b><u>Total</u> long-term assets</b>  | <b>31,101</b>    | <b>81,457</b>    |
| <b>PROPERTY AND EQUIPMENT, NET</b>  | <b>3,191</b>     | <b>3,856</b>     |
| <b>INTANGIBLE ASSETS, NET</b>   | <b>4,252</b>     | <b>2,996</b>     |
| <b>GOODWILL</b>   | <b>33,749</b>    | <b>33,749</b>    |
| <b><u>Total</u> assets</b>  | <b>\$174,304</b> | <b>\$200,384</b> |

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



**AUDIOCODES LTD.**

## CONSOLIDATED BALANCE SHEETS

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

|   | December 31, |            |
|---|--------------|------------|
|   | 2013         | 2014       |
| <b>LIABILITIES AND EQUITY</b>   |              |            |
| <b>CURRENT LIABILITIES:</b>   |              |            |
| Short-term bank loans and current maturities of long-term bank loans  | \$4,686      | \$4,686    |
| Trade payables  | 7,215        | 10,111     |
| Senior convertible notes  | 353          | -          |
| Other payables and accrued expenses   | 17,958       | 15,758     |
| Deferred revenues   | 6,940        | 10,233     |
| <u>Total</u> current liabilities  | 37,152       | 40,788     |
| <b>LONG-TERM LIABILITIES:</b>   |              |            |
| Accrued severance pay   | 19,845       | 17,908     |
| Long-term bank loans  | 9,791        | 5,105      |
| Deferred revenues and other liabilities   | 2,707        | 2,862      |
| <u>Total</u> long-term liabilities  | 32,343       | 25,875     |
| <b>COMMITMENTS AND CONTINGENT LIABILITIES</b>   |              |            |
| <b>EQUITY:</b>  |              |            |
| Share capital -   |              |            |
| Ordinary shares of NIS 0.01 par value -   |              |            |
| Authorized: 100,000,000 shares at December 31, 2013 and 2014; Issued: 50,090,696 and 54,785,756 shares at December 31, 2013 and 2014, respectively; Outstanding: 38,733,989 and 42,380,158 shares at December 31, 2013 and 2014, respectively | 114          | 125        |
| Additional paid-in capital  | 201,248      | 235,760    |
| Treasury stock at cost- 11,356,707 and 12,405,598 shares at December 31, 2013 and 2014, respectively  | (35,768 )    | (41,032 )  |
| Accumulated other comprehensive loss  | -            | (261 )     |
| Accumulated deficit   | (60,785 )    | (60,871 )  |
| <u>Total</u> equity   | 104,809      | 133,721    |
| <u>Total</u> liabilities and equity   | \$ 174,304   | \$ 200,384 |

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

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**AUDIOCODES LTD.**

## CONSOLIDATED STATEMENTS OF OPERATIONS

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

|  | Year ended December 31, |            |            |   |
|--|-------------------------|------------|------------|---|
|  | 2012                    | 2013       | 2014       |   |
| Revenues:  |                         |            |            |   |
| Products   | \$ 103,651              | \$ 111,750 | \$ 118,561 |   |
| Services   | 23,839                  | 25,482     | 33,018     |   |
| <u>Total</u> revenues  | 127,490                 | 137,232    | 151,579    |   |
| Cost of revenues:  |                         |            |            |   |
| Products   | 48,371                  | 51,996     | 54,349     |   |
| Services   | 5,923                   | 6,568      | 8,243      |   |
| <u>Total</u> cost of revenues  | 54,294                  | 58,564     | 62,592     |   |
| Gross profit   | 73,196                  | 78,668     | 88,987     |   |
| Operating expenses:  |                         |            |            |   |
| Research and development, net  | 28,677                  | 28,194     | 32,275     |   |
| Selling and marketing  | 40,040                  | 39,279     | 45,534     |   |
| General and administrative   | 8,214                   | 8,456      | 7,677      |   |
| <u>Total</u> operating expenses  | 76,931                  | 75,929     | 85,486     |   |
| Operating income (loss)  | (3,735                  | ) 2,739    | 3,501      |   |
| Financial income (expenses), net   | 453                     | 96         | (196       | ) |
| Income (loss) before taxes on income   | (3,282                  | ) 2,835    | 3,305      |   |
| Income tax benefit (expense), net  | (541                    | ) 1,404    | (3,391     | ) |
| Equity in losses of an affiliated company  | (354                    | ) (21      | ) -        |   |
| Net income (loss)  | \$(4,177                | ) \$4,218  | \$(86      | ) |
| Earnings (loss) per share - basic and diluted  | \$(0.11                 | ) \$0.11   | \$(0.00    | ) |
| Weighted average number of shares used in computations of earnings (loss) per share: |                         |            |            |   |
| Basic  | 39,125,129              | 38,241,258 | 42,285,919 |   |



|         |            |            |            |
|---------|------------|------------|------------|
| Diluted | 39,125,129 | 39,096,758 | 42,285,919 |
|---------|------------|------------|------------|

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

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**AUDIOCODES LTD.****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)****U.S. dollars in thousands**

|   | Year ended December 31, |         |         |
|---|-------------------------|---------|---------|
|   | 2012                    | 2013    | 2014    |
| Net income (loss)   | \$(4,177)               | \$4,218 | \$(86 ) |
| Other comprehensive income (loss) ("OCI") related to:                                     |                         |         |         |
| Change in unrealized loss on marketable securities:                                       |                         |         |         |
| Unrealized loss on marketable securities recognized in OCI                                | -                       | -       | (388)   |
| Change in unrealized gains (losses) on cash flow hedges:                                  |                         |         |         |
| Gain (loss) on derivatives recognized in OCI  | 1,211                   | 1,292   | (367)   |
| Loss (gain) on derivatives (effective portion) recognized in income                       | 332                     | (2,595) | 494     |
| Other comprehensive income (loss), related to unrealized gains (loss) on cash flow hedges | 1,543                   | (1,303) | 127     |
| Other comprehensive income (loss)   | 1,543                   | (1,303) | (261)   |
| Total comprehensive income (loss)   | \$(2,634)               | \$2,915 | \$(347) |

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

**AUDIOCODES LTD.****STATEMENTS OF CHANGES IN EQUITY****U.S. dollars in thousands**

|  | Share<br>capital | Additional<br>paid-in<br>capital | Treasury<br>stock | Accumulated<br>other<br>comprehensive<br>income<br>(loss) | Accumulated<br>deficit | Total<br>equity |
|--|------------------|----------------------------------|-------------------|---|------------------------|-----------------|
| Balance as of January 1, 2012  | \$ 119           | \$ 196,021                       | \$(29,055)        | \$ (240 )   | \$ (60,826 )           | \$ 106,019      |
| Purchase of treasury stock   | (7 )             | -                                | (6,713 )          | -   | -                      | (6,720 )        |
| Issuance of shares upon exercise of options                                  | -                | 103                              | -                 | -   | -                      | 103             |
| Stock compensation related to options granted to employees and non-employees | -                | 1,529                            | -                 | -   | -                      | 1,529           |
| Other comprehensive income   | -                | -                                | -                 | 1,543   | -                      | 1,543           |
| Net loss   | -                | -                                | -                 | -   | (4,177 )               | (4,177 )        |
| Balance as of December 31, 2012  | 112              | 197,653                          | (35,768)          | 1,303   | (65,003 )              | 98,297          |
| Issuance of shares upon exercise of options                                  | 2                | 1,894                            | -                 | -   | -                      | 1,896           |
| Stock compensation related to options granted to employees and non-employees | -                | 1,701                            | -                 | -   | -                      | 1,701           |
| Other comprehensive loss   | -                | -                                | -                 | (1,303 )  | -                      | (1,303 )        |
| Net income   | -                | -                                | -                 | -   | 4,218                  | 4,218           |
| Balance as of December 31, 2013  | 114              | 201,248                          | (35,768)          | -   | (60,785 )              | 104,809         |
| Purchase of treasury stock   | (3 )             | -                                | (5,264 )          | -   | -                      | (5,267 )        |
| Issuance of ordinary shares  | 12               | 29,732                           | -                 | -   | -                      | 29,744          |
| Issuance of shares upon exercise of options                                  | 2                | 2,234                            | -                 | -   | -                      | 2,236           |
| Stock compensation related to options granted to employees and non-employees | -                | 2,546                            | -                 | -   | -                      | 2,546           |
| Other comprehensive loss   | -                | -                                | -                 | (261 )  | -                      | (261 )          |
| Net loss   | -                | -                                | -                 | -   | (86 )                  | (86 )           |
| Balance as of December 31, 2014  | \$ 125           | \$ 235,760                       | \$(41,032)        | \$ (261 )   | \$ (60,871 )           | \$ 133,721      |

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



**AUDIOCODES LTD.****CONSOLIDATED STATEMENTS OF CASH FLOWS****U.S. dollars in thousands**

|  | Year ended December 31, |          |          |
|--|-------------------------|----------|----------|
|  | 2012                    | 2013     | 2014     |
| Cash flows from operating activities:  |                         |          |          |
| Net income (loss)  | \$(4,177)               | \$4,218  | \$(86 )  |
| Adjustments required to reconcile net income (loss) to net cash provided by operating activities:  |                         |          |          |
| Depreciation and amortization  | 2,883                   | 3,207    | 3,230    |
| Amortization of marketable securities premiums and accretion of discounts, net                     | 436                     | 349      | 820      |
| Equity in losses of an affiliated company, net of interest on loans to an affiliated company       | 350                     | 21       | -        |
| Stock-based compensation related to options granted to employees and non-employees                 | 1,529                   | 1,701    | 2,546    |
| Decrease in accrued interest on loans, marketable securities, convertible notes, and bank deposits | 4                       | 73       | 152      |
| Decrease (increase) in deferred income tax assets, net   | 14                      | (1,946 ) | 2,940    |
| Decrease (increase) in trade receivables, net  | 6,725                   | (2,254 ) | (4,625 ) |
| Decrease (increase) in other receivables and prepaid expenses                                      | 127                     | 110      | (2,249 ) |
| Decrease (increase) in inventories   | 3,618                   | 2,986    | (925 )   |
| Increase (decrease) in trade payables  | (5,545)                 | 403      | 2,896    |
| Increase (decrease) in other payables and accrued expenses and other liabilities                   | (3,054)                 | 2,577    | (2,114 ) |
| Increase in deferred revenues  | 270                     | 3,138    | 3,595    |
| Decrease in accrued severance pay, net   | (184 )                  | (495 )   | (223 )   |
| Net cash provided by operating activities  | 2,996                   | 14,088   | 5,957    |
| Cash flows from investing activities:  |                         |          |          |
| Net loans provided to an affiliated company  | (183 )                  | (1,211 ) | -        |
| Purchase of marketable securities  | -                       | -        | (60,286) |
| Purchase of property and equipment   | (2,006)                 | (1,586 ) | (2,539 ) |
| Short-term and restricted bank deposits, net   | 3,678                   | 1,229    | 1,471    |
| Proceeds from redemption of marketable securities upon maturity                                    | -                       | 7,600    | 15,390   |
| Proceeds from redemption of long-term bank deposits  | -                       | 2,623    | 2,685    |
| Purchase of intangible asset   | -                       | -        | (100 )   |
| Investment in long-term and restricted bank deposits   | (131 )                  | -        | -        |
| Net cash provided by (used in) investing activities  | 1,358                   | 8,655    | (43,379) |

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

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**AUDIOCODES LTD.****CONSOLIDATED STATEMENTS OF CASH FLOWS****U.S. dollars in thousands**

|  | Year ended December 31, |            |          |
|--|-------------------------|------------|----------|
|  | 2012                    | 2013       | 2014     |
| Cash flows from financing activities:  |                         |            |          |
| Purchase of treasury stock   | (6,917 )                | -          | (5,267 ) |
| Repayment of senior convertible notes  | -                       | -          | (338 )   |
| Repayment of long-term bank loans  | (10,242)                | (8,436 )   | (4,686 ) |
| Payment for acquisition of NSC non-controlling interest                                  | (336 )                  | (515 )     | -        |
| Payment related to the acquisition of Mailvision   | -                       | -          | (233 )   |
| Proceeds from issuance of shares in a public offering, net                               | -                       | -          | 29,744   |
| Proceeds from issuance of shares upon exercise of options and warrants                   | 103                     | 1,752      | 2,236    |
| Net cash provided by (used in) financing activities                                      | (17,392)                | (7,199 )   | 21,456   |
| Increase (decrease) in cash and cash equivalents   | (13,038)                | 15,544     | (15,966) |
| Cash and cash equivalents at the beginning of the year                                   | 28,257                  | 15,219     | 30,763   |
| Cash and cash equivalents at the end of the year   | \$15,219                | \$30,763   | \$14,797 |
| Supplemental disclosure of cash flow activities:   |                         |            |          |
| Cash paid during the year for income taxes   | \$313                   | \$429      | \$658    |
| Cash paid during the year for interest   | \$789                   | \$583      | \$415    |
| Supplemental disclosures of non-cash operating, financing and investing activities       |                         |            |          |
| Net change in gain (loss) on foreign currency cash flow hedges and marketable securities | \$1,543                 | \$(1,303 ) | \$(261 ) |

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

**AUDIOCODES LTD.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

NOTE 1:- GENERAL

a. Business overview:

AudioCodes Ltd. (the "Company") and its subsidiaries (together the "Group") design, develop and market products and services for voice, data and video over IP networks to service providers and channels (such as distributors), OEMs, network equipment providers and systems integrators.

The Company operates through its wholly-owned subsidiaries in the United States, Europe, Asia, Latin America, Australia and Israel.

b. Acquisition of Natural Speech Communication Ltd. ("NSC"):

In January 2010, the Company entered into an agreement to acquire all of the outstanding equity of NSC that it did not own as of December 31, 2009. The closing of this transaction occurred in May 2010.

The liability recorded in connection with this acquisition was comprised of two components: (i) the contingent payments for which the Company recorded a contingent consideration liability of \$329 based on its estimated fair value as of the closing date of the transaction (the "Contingent Payment"). This amount was estimated by utilizing an income approach, taking into account the potential cash payments based on the Company's expectation as to NSC's future revenues in each of the years ended December 31, 2010, 2011 and 2012, and was discounted to arrive at a present value amount. The discount rate was based on the market interest rate and NSC's estimated operational capitalization rate. The Contingent Payment liability was marked to market at fair value at each reporting date based on the Company's policy with subsequent changes in the value of the liability recorded in financial expenses in the statement of operations, while changes due to changes in estimates were recorded within operating income or expenses; and (ii) a liability with respect to the commitment for future payments was recorded at present value which amounted to \$967 (the "Committed Payment"). The Committed Payment liability is not re-measured in subsequent periods and would only be adjusted for changes in time value.



As of December 31, 2012, the Committed Payment liability estimated fair value amounted to \$391 and the Contingent Payment liability amounted to \$115. During the year ended December 31, 2013, an amount of \$395 was paid with respect to the Committed Payment liability and an amount of \$120 was paid in respect of the Contingent Payment liability, since certain aggregate revenue milestones were met for the years ended December 31, 2010, 2011 and 2012.

c. Asset Purchase Agreement with Mailvision Ltd ("Mailvision"):

In April 2013, the Company entered into an asset purchase agreement with Mailvision, an Israeli company which develops, markets and licenses VoIP solutions for mobile, PC and tablet devices for telecom operators and service providers, in which the Company held 29.2% of the outstanding share capital. Pursuant to the agreement, in May 2013, the Company acquired certain assets and assumed certain liabilities of Mailvision, (see also Note 3).

**AUDIOCODES LTD.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

NOTE 1:- GENERAL (Cont.)

The Group is dependent upon sole source suppliers for certain key components used in its products, including certain digital signal processing chips. Although there are a limited number of manufacturers of these particular d. components, management believes that other suppliers could provide similar components at comparable terms. A change in suppliers, however, could cause a delay in manufacturing and a possible loss of sales, which could adversely affect the operating results of the Group and its financial position.

The Group had a major customer in the years ended December 31, 2012, 2013 and 2014, which accounted for 13.7%, 17.8% and 14.9%, respectively, of the total revenues in those years. In addition, during the year ended e. December 31, 2014, the Company had an additional major customer which accounted for 10.5% of the total revenues in that year. No other customer accounted for more than 10% of the Group's revenues in those periods.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES

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

a. Use of estimates:

The preparation of the consolidated financial statements in conformity with U.S. GAAP requires management to make estimates, judgments and assumptions. Management believes that the estimates, judgments and assumptions used are reasonable based upon information available at the time they are made. These estimates, judgments and assumptions can affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the financial statements, and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

b. Financial statements in U.S. dollars ("dollars"):

A majority of the Group's revenues is generated in dollars. In addition, most of the Group's costs are denominated and determined in dollars and in new Israeli shekels. Management believes that the dollar is the currency in the primary economic environment in which the Group operates. Thus, the functional and reporting currency of the Group is the dollar.

Accordingly, monetary accounts maintained in currencies other than the dollar are remeasured into dollars in accordance with Accounting Standards Codification ("ASC") 830, "Foreign Currency Matters". All transaction gains and losses of the remeasured monetary balance sheet items are reflected in the statements of operations as financial income or expenses, as appropriate.

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**AUDIOCODES LTD.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

c. Principles of consolidation:

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. Intercompany transactions and balances, including profits from intercompany sales not yet realized outside the Group, have been eliminated upon consolidation.

d. Cash equivalents:

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

e. Short-term and restricted bank deposits:

Short-term and restricted bank deposits are deposits with maturities of more than three months, but less than one year. The deposits are mainly in dollars and bear interest at an average rate of 0.97% and 1.51% for the years ended December 31, 2013 and 2014, respectively. Short-term and restricted deposits are presented at their cost. Any accrued interest on these deposits is included in other receivables and prepaid expenses.

In connection with the long-term bank loans and their related covenants, the Company is required to maintain compensating balances with the banks and to maintain deposits in the same banks that provided the Company's loans (see Note 12). In addition, the Company maintains restricted deposits in connection with foreign exchange derivatives, guarantees for prepayment of account receivables and an office lease agreement (see also Note 13a). Out of the short-term and restricted bank deposits, a total of \$7,321 and \$7,097 are restricted short-term deposits as of December 31, 2013 and 2014, respectively.

f. Marketable securities:

The Group accounts for investments in debt securities in accordance with ASC 320, "Investments-Debt and Equity Securities".

Management determines the appropriate classification of its investments in marketable debt securities at the time of purchase and reevaluates such determinations at each balance sheet date.

As of December 31, 2013, all securities were classified as held-to-maturity since the Group had the intent and ability to hold the securities to maturity and, accordingly, debt securities were stated at amortized cost. During the year ended December 31, 2014, all of the marketable securities held as of December 31, 2013 matured.

During April, May and June 2014, the Group purchased new securities that are expected to mature between 2016 and 2019. The Group classified the securities as held-to-maturity on the purchase date since the Group had the intent and ability to hold the securities to maturity and, accordingly, debt securities were stated at amortized cost.

**AUDIOCODES LTD.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

In November 2014, the Group no longer had the intent to hold the securities to maturity and therefore classified the securities as available-for-sale.

As of December 31, 2014, the Group classifies all of its marketable securities as available-for-sale. Available-for-sale securities are carried at fair value, with the unrealized gains and losses, net of tax, reported in “accumulated other comprehensive income (loss)” in shareholders’ equity. Realized gains and losses on sale of investments are included in “financial income (expenses), net” and are derived using the specific identification method for determining the cost of securities.

The amortized cost of debt securities is adjusted for amortization of premiums and accretion of discounts to maturity. Such amortization together with interest on securities is included in “financial income (expenses), net”.

The Group recognizes an impairment charge when a decline in the fair value of its investments in debt securities below the cost basis of such securities is judged to be other than-temporary. Factors considered in making such a determination include the duration and severity of the impairment, the reason for the decline in value, the potential recovery period and the Group’s intent to sell, including whether it is more-likely-than-not that the Group will be required to sell the investment before recovery of cost basis. For securities that are deemed other-than-temporarily impaired, the amount of impairment is recognized in the statements of operations and is limited to the amount related to credit losses, while impairment related to other factors is recognized in other comprehensive income (loss).

For the years ended December 31, 2012, 2013 and 2014, no other-than-temporary impairment losses have been identified.

g.

Inventories:

Inventories are stated at the lower of cost or market value. Cost is determined as follows:

Raw materials - using the "weighted average cost" method.

Finished products - using the "weighted average cost" method with the addition of direct manufacturing costs.

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

h. Long-term and restricted bank deposits:

Bank deposits and the related accrued interest with maturities of more than one year are included in long-term investments and presented at their cost. Accrued interest that is paid within a one year period is included in other receivables and prepaid expenses. The deposits are denominated in dollars and bear interest at an average rate of 2.57% and 2.54% for the years ended December 31, 2013 and 2014, respectively. In connection with the long-term bank loans, the Company is required to maintain compensating balances with the banks (see also Note 12). Out of the total long-term bank deposits, a total of \$ 6,596 and \$ 4,005 are restricted long-term deposits as of December 31, 2013 and 2014, respectively.

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**AUDIOCODES LTD.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

**i. Investment in an affiliated company:**

The Company accounts for investment in affiliated company in which it has the ability to exercise significant influence over the operating and financial policies, using the equity method of accounting in accordance with the requirements of ASC 323, "Investments - Equity Method and Joint Ventures" ("ASC 323").

Investment in affiliated company represents investment in ordinary shares, preferred shares, convertible loans and non-convertible loans. According to ASC 323, additional losses of such company in excess of the carrying amount of the equity investment are recognized based on the seniority level (priority in liquidation) of the particular type of investment held by the Company.

The Company's investment is reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the investment may not be recoverable in accordance with ASC 323. During the years ended December 31, 2012, 2013 and 2014, no impairment losses had been identified. In May 2013, the Company acquired the activity of the affiliated company. (See also Note 3).

**j. Property and equipment:**

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

|                                    | %   |
|------------------------------------|---|
| Computers and peripheral equipment | 33  |
| Office furniture and equipment     | 6 - 20 (mainly 15)  |
| Leasehold improvements             | Over the shorter of the term of the lease or the useful life of the asset |



The Group's long-lived assets are reviewed for impairment in accordance with ASC 360-10-35, "Property, Plant and Equipment - Subsequent Measurement", whenever events or changes in circumstances indicate that the carrying amount of an asset (or asset group) may not be recoverable. Recoverability of assets (asset group) to be held and used is measured by a comparison of the carrying amount of an asset (asset group) to the future undiscounted cash flows expected to be generated by the asset 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 (asset groups) exceeds the fair value of the assets (asset groups). The loss is allocated to the long-lived assets of the Group on a pro rata basis using the relative carrying amounts of those assets, except that the loss allocated to an individual long-lived asset of the Group will not reduce the carrying amount of that asset below its fair value whenever that fair value is determinable. During the years ended December 31, 2012, 2013 and 2014, no impairment losses had been identified for property and equipment since the fair value of those assets (asset groups) was higher than their carrying amounts.

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**AUDIOCODES LTD.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

k. Intangible assets:

Intangible assets are comprised of acquired technology, customer relations and licenses.

Intangible assets that are not considered to have an indefinite useful life are amortized using the straight-line basis over their estimated useful lives, which range from four and a half to ten years. Recoverability of these assets is measured by a comparison of the carrying amount of the asset to the undiscounted future cash flows expected to be generated by the assets. If the assets are considered to be impaired, the amount of any impairment is measured as the difference between the carrying value and the fair value of the impaired assets.

During the years ended December 31, 2012, 2013 and 2014, no impairment losses were identified.

l. Goodwill:

Goodwill and certain other purchased intangible assets have been recorded as a result of acquisitions. Goodwill represents the excess of the purchase price in a business combination over the fair value of net tangible and intangible assets acquired. Goodwill is not amortized, but rather is subject to an impairment test.

The Group performs an annual impairment test during the fourth quarter of each fiscal year, or more frequently if impairment indicators are present. The Group operates in one operating segment, and this segment comprises its only reporting unit.

ASC 350, "Intangibles – Goodwill and Other", prescribes a two-phase process for impairment testing of goodwill. The first phase screens for impairment, while the second phase (if necessary) measures impairment. Goodwill impairment is deemed to exist if the net book value of a reporting unit exceeds its estimated fair value. In such case, the second

phase is then performed, and the Group measures impairment by comparing the carrying amount of the reporting unit's goodwill to the implied fair value of that goodwill. An impairment loss is recognized in an amount equal to the excess. The Group has an option to perform a qualitative assessment to determine whether it is more-likely-than-not that the fair value of a reporting unit is less than its carrying amount prior to performing the two-step goodwill impairment test. If this is the case, the two-step goodwill impairment test is required. If it is more-likely-than-not that the fair value of a reporting unit is greater than its carrying amount, the two-step goodwill impairment test is not required.

**AUDIOCODES LTD.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

For each of the three years in the period ended December 31, 2014, the Group performed an annual impairment analysis, using market capitalization, and no impairment losses have been identified.

m. Revenue recognition:

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

Revenues from products and services are recognized in accordance with ASC 605, "Revenue Recognition", ("ASC 605"), when the following criteria are met: persuasive evidence of an arrangement exists, delivery of the product has occurred, the fee is fixed or determinable, and collectability is probable. The Group has no remaining obligation to customers after the date on which products are delivered other than pursuant to warranty obligations and right of return.

In a multiple element arrangement, Accounting Standards Update ("ASU") 2009-13, Topic 605 - "Multiple-Deliverable Revenue Arrangements" requires the allocation of arrangement consideration to each deliverable to be based on the relative selling price.

The selling price for a deliverable is based on its vendor-specific objective evidence ("VSOE") if available, third-party evidence ("TPE") if VSOE is not available, or estimated selling price ("ESP") if neither VSOE nor TPE is available. The Group then recognizes revenue on each deliverable in accordance with its policies for product and service revenue recognition. VSOE of selling price is based on the price charged when the element is sold separately. In determining VSOE, the Group requires that a substantial majority of the selling prices fall within a narrow range based on stand-alone rates. TPE of selling price is established by evaluating largely interchangeable competitor products or services in stand-alone sales to similarly situated customers. However, as the Group's products contain a significant element of proprietary technology and its solutions offer substantially different features and functionality,

the comparable pricing of products with similar functionality typically cannot be obtained. Additionally, as the Group is unable to reliably determine what competitors products' selling prices are on a stand-alone basis, the Group is not typically able to determine TPE. The ESP is established considering multiple factors including, but not limited to, pricing practices in different geographical areas and through different sales channels, gross margin objectives, internal costs, competitors' pricing strategies, and industry technology lifecycles. The selling price of the products and professional services was based on ESP. Maintenance selling price was based on VSOE.

The Group limits the amount of revenue recognition for delivered elements to the amount that is not contingent on the future delivery of products or services or subject to customer- specific return or refund privileges. The Group evaluates each deliverable in an arrangement to determine whether they represent separate units of accounting.

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**AUDIOCODES LTD.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

The Group grants to certain customers a right of return or the ability to exchange a specific percentage of the total price paid for products they have purchased over a limited period for other products. The Group maintains a provision for product returns and exchanges and other incentives based on its experience with historical sales returns, analysis of credit memo data and other known factors, in accordance with ASC 605. The provision was deducted from revenues and amounted to \$ 1,288 and \$ 1,338 as of December 31, 2013 and 2014, respectively.

Revenues from the sale of products which were not yet determined to be final sales due to acceptance provisions are deferred and included in deferred revenues. In cases where collectability is not probable, revenues are deferred and recognized upon collection.

Deferred revenues include amounts invoiced to customers for which revenue has not yet been recognized.

**n. Warranty costs:**

The Group usually provides a warranty period of 12 months at no extra charge. The Group estimates the costs that may be incurred under its basic limited warranty and records a liability in the amount of such costs at the time product revenue is recognized. Factors that affect the Group's warranty liability include the number of installed units, historical and anticipated rates of warranty claims, and cost per claim. The Group periodically assesses the adequacy of its recorded warranty liability and adjusts the amount as necessary. As of December 31, 2013 and 2014, the provision for warranty amounted to \$ 406 and \$ 458, respectively.

**o. Research and development costs:**

Accounting Standards Codification No. 985-20, requires capitalization of certain software development costs subsequent to the establishment of technological feasibility.

Based on the Company's product development process, technological feasibility is established upon the completion of a working model. The Company does not incur material costs between the completion of a working model and the point at which the products are ready for general release. Therefore, research and development costs are charged to the consolidated statement of comprehensive loss as incurred.

Participation grants from the Office of the Chief Scientist of the Ministry of Industry, Trade and Labor in Israel ("OCS") for research and development activity are recognized at the time the Company is entitled to such grants on the basis of the costs incurred and included as a deduction of research and development costs. Research and development grants recognized during the years ended December 31, 2012, 2013 and 2014 were \$2,729, \$2,799 and \$3,871, respectively.

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**AUDIOCODES LTD.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

p. Income taxes:

The Group accounts for income taxes in accordance with ASC 740, "Income Taxes", ("ASC 740"). ASC 740 prescribes the use of the liability method whereby deferred tax asset and liability account balances are determined based on differences between the financial reporting and tax bases of assets and liabilities and for carry forward tax losses. Deferred taxes are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. The Group records a valuation allowance, if necessary, to reduce deferred tax assets to their estimated realizable value if it is more-likely-than-not that some portion or all of the deferred tax asset will not be realized.

In addition, ASC 740 prescribes a recognition threshold and measurement attribute for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The first step is to evaluate the tax position taken or expected to be taken in a tax return. This is done by determining if the weight of available evidence indicates that it is more-likely-than-not that, on an evaluation of the technical merits, the tax position will be sustained on audit, including resolution of any related appeals or litigation processes. The second step is to measure the tax benefit as the largest amount that is more than 50% likely to be realized upon ultimate settlement.

Interest and penalties assessed by taxing authorities on an underpayment of income taxes are included as a component of income tax expense in the consolidated statements of operations.

q. Comprehensive income (loss):

The Group accounts for comprehensive income (loss) in accordance with ASC 220, "Comprehensive Income" ("ASC 220"). ASC 220 establishes standards for the reporting and display of comprehensive income and its components in a full set of general purpose financial statements. Comprehensive income (loss) generally represents all changes in shareholders' equity during the period except those resulting from investments by, or distributions to, shareholders. The Group determined that its items of comprehensive income (loss) relate to gains and losses on hedging derivatives instruments and unrealized gains and losses on available-for-sale marketable securities.



The Group presents total comprehensive income (loss) in accordance with ASU 2011-05, Topic 220, "Presentation of Comprehensive Income" ("ASU 2011-05") and ASU 2011-12, Topic 220 - Comprehensive Income. ASU 2011-05 requires an entity to present, the components of net income (loss), and the components of other comprehensive income (loss) either in a single continuous statement of comprehensive income or in two separate but consecutive statements and eliminates the option to present the components of other comprehensive income as part of the statement of changes in equity. The Company chose to present the components of net income (loss) and other comprehensive income (loss) in two separate but consecutive statements.

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**AUDIOCODES LTD.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

r. Concentrations of credit risk:

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

The majority of the Group's cash and cash equivalents and bank deposits are invested in dollar instruments with major banks in Israel and the United States. Such investments in the United States may be in excess of insured limits and are not insured in other jurisdictions. Management believes that the financial institutions that hold the Group's investments are corporations with high credit standing. Accordingly, management believes that low credit risk exists with respect to these financial investments.

Marketable securities include investments in dollar linked corporate bonds. Marketable securities consist of highly liquid debt instruments with high credit standing. The Company's investment policy, approved by the Board of Directors, limits the amount the Group may invest in any one type of investment or issuer, thereby reducing credit risk concentrations. Management believes that the portfolio is well diversified and, accordingly, minimal credit risk exists with respect to these marketable debt securities.

The trade receivables of the Group are derived from sales to customers located primarily in the Americas, the Far East, Israel and Europe. Under certain circumstances, the Group may require letters of credit, other collateral, additional guarantees or advance payments. Regarding certain credit balances, the Group is covered by foreign trade risk insurance. The Group performs ongoing credit evaluations of its customers and establishes an allowance for doubtful accounts based upon a specific review.

s. Senior convertible notes:

The Company accounts for senior convertible notes in accordance with ASC 470-20, "Debt with Conversion and Other Options" ("ASC 470-20"). ASC 470-20 specifies that issuers of such instruments should separately account for

the liability and equity components on the issuance day in a manner that will reflect the entity's nonconvertible debt borrowing rate when interest cost is recognized in subsequent periods. See also Note 11.

The Company presents the outstanding principal amount of its senior convertible notes as a long-term liability, in accordance with ASC 210-10-45, "Other Presentation Matters", (based on its expected redemption, taking into consideration redemption options of the holders). The debt is classified as a long-term liability until the date of conversion on which it would be reclassified to equity, or within one year of the first contractual redemption date, on which it would be reclassified as a short-term liability. Accrued interest on the senior convertible notes is included in "other payables and accrued expenses".

According to ASC 470-20, if an instrument within its scope is repurchased, an issuer shall allocate the consideration transferred and related transaction costs incurred, to the extinguishment of the liability component and the reacquisition of the equity component. See also Note 11.

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**AUDIOCODES LTD.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

t. Basic and diluted earnings (loss) per share:

Basic earnings (loss) per share are computed based on the weighted average number of ordinary shares outstanding during each year. Diluted earnings (loss) per share are computed based on the weighted average number of ordinary shares outstanding during each year, plus potential dilutive ordinary shares considered outstanding during the year, in accordance with ASC 260, "Earnings per Share".

Senior convertible notes and certain outstanding stock options, restricted share units ("RSUs") and warrants have been excluded from the calculation of the diluted earnings per share since such securities are anti-dilutive for all years presented. The total weighted average number of shares related to the senior convertible notes and outstanding options, RSUs and warrants that have been excluded from the calculation of diluted earnings (loss) per share was 4,072,517, 1,545,867 and 954,823 for the years ended December 31, 2012, 2013 and 2014, respectively.

u. Accounting for stock-based compensation:

The Company accounts for stock-based compensation in accordance with ASC 718, "Compensation-Stock Compensation" ("ASC 718"). ASC 718 requires companies to estimate the fair value of equity-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as an expense over the requisite service periods in the Company's consolidated statement of operations.

The Company recognizes compensation expenses for the value of its awards based on the accelerated method over the requisite service period of each of the awards, net of estimated forfeitures. ASC 718 requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Estimated forfeitures are based on actual historical pre-vesting forfeitures.

The Company applies ASC 718 and ASC 505-50, "Equity-Based Payments to Non-Employees" ("ASC 505-50") with respect to options and warrants issued to non-employees. Accordingly, the Company uses option valuation models to measure the fair value of the options and warrants at the measurement date as defined in ASC 505-50.

The Company accounted for changes in award terms as a modification in accordance with ASC 718. A modification to the terms of an award should be treated as an exchange of the original award for a new award with total compensation cost equal to the grant-date fair value of the original award plus the incremental value measured at the same date. Under ASC 718, the calculation of the incremental value is based on the excess of the fair value of the new (modified) award based on current circumstances over the fair value of the original award measured immediately before its terms are modified based on current circumstances.

**AUDIOCODES LTD.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands, except share and per share data**

## NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

The weighted-average estimated fair value of employee stock options granted during the years ended December 31, 2012, 2013 and 2014, was \$1.35, \$3.00 and \$2.97 per share, respectively, using the Black-Scholes option pricing formula. Fair values were estimated using the following weighted-average assumptions (annualized percentages):

|                     | <b>Year ended December 31,</b> |                 |                 |
|---------------------|--------------------------------|-----------------|-----------------|
|                     | <b>2012</b>                    | <b>2013</b>     | <b>2014</b>     |
| Dividend yield      | 0%                             | 0%              | 0%              |
| Expected volatility | 56.6%-61.5%                    | 58.9%-61.9%     | 54.8%-59.4%     |
| Risk-free interest  | 0.54%-1.04%                    | 0.63%-1.78%     | 1.48%-1.86%     |
| Expected life       | 4.79-5.70 years                | 4.72-5.67 years | 4.74-5.43 years |
| Forfeiture rate     | 5.5%                           | 4.0%            | 4.0%            |

The Company used its historical volatility in accordance with ASC 718. The computation of volatility uses historical volatility derived from the Company's exchange traded shares. The expected term of options granted is estimated based on historical experience and represents the period of time that options granted are expected to be outstanding. The risk free interest rate assumption is the implied yield currently available on United States treasury zero-coupon issues with a remaining term equal to the expected life of the Company's options. The dividend yield assumption is based on the Company's historical experience and expectation of no future dividend payouts and may be subject to substantial change in the future. The Company has historically not paid cash dividends and has no foreseeable plans to pay cash dividends in the future.

The total equity-based compensation expenses relating to all of the Company's equity-based awards recognized for the years ended December 31, 2012, 2013 and 2014 were included in items of the consolidated statements of operations as follows:

|  | <b>Year ended December 31,</b> |             |             |
|--|--------------------------------|-------------|-------------|
|  | <b>2012</b>                    | <b>2013</b> | <b>2014</b> |

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|  |         |         |         |
|--|---------|---------|---------|
| Cost of revenues                         | \$61    | \$62    | \$89    |
| Research and development expenses, net   | 430     | 408     | 585     |
| Selling and marketing expenses           | 437     | 625     | 1,105   |
| General and administrative expenses      | 601     | 606     | 767     |
| Total equity-based compensation expenses | \$1,529 | \$1,701 | \$2,546 |

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**AUDIOCODES LTD.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

v. Treasury stock:

The Company has repurchased its ordinary shares from time to time in the open market and holds such shares as treasury stock. The Company presents the cost to repurchase treasury stock as a reduction of shareholders' equity. See also Note 14a.

w. Severance pay:

The liability for severance pay for Israeli employees is calculated pursuant to Israel's Severance Pay Law, 1963, based on the most recent salary of the employees multiplied by the number of years of employment as of the balance sheet date for all employees in Israel. Employees who have been employed for more than one year period, are entitled to one month's salary for each year of employment, or a portion thereof. The Group's liability for all of its Israeli employees is fully provided for by monthly deposits with severance pay funds, pension funds, insurance policies and by an accrual. The value of these deposits is recorded as an asset in the Company's balance sheet.

The deposited funds include profits accumulated up to the balance sheet date. The deposited funds may be withdrawn only upon the fulfillment of the obligation pursuant to Israel's Severance Pay Law, 1963 or labor agreements.

Since March 2011, the Group's agreements with new Israeli employees are under Section 14 of the Israeli Severance Pay Law, 1963. The Company's contributions for severance pay have replaced its severance obligation. Upon contribution of the full amount of the employee's monthly salary for each year of service, no additional calculations are conducted between the parties regarding the matter of severance pay and no additional payments are made by the Company to the employee. The Group is legally released from the obligations to employees once the deposit amounts have been paid, and therefore the severance pay liability is not reflected in the balance sheet.

Severance pay expenses for the years ended December 31, 2012, 2013 and 2014, amounted to \$1,850, \$1,878 and \$1,961, respectively.



x. Employee benefit plan:

The Group has 401(k) defined contribution plans covering employees in the U.S. All eligible employees may elect to contribute a portion of their annual compensation to the plan through salary deferrals, subject to the IRS limit of \$17.5 during the years ended December 31, 2013 and 2014, plus a catch-up contribution of \$5.5 for participants age 50 or over. The Group matches 50% of employees contributions, up to a maximum of 6% of the employees annual pay. In the years ended December 31, 2012, 2013 and 2014, the Group matched contributions in the amount of \$276, \$244 and \$284, respectively.

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**AUDIOCODES LTD.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

y. Advertising expenses:

Advertising expenses are charged to the statements of operations as incurred. Advertising expenses for the years ended December 31, 2012, 2013 and 2014 amounted to \$ 329, \$ 342 and \$ 562, respectively.

z. Fair value of financial instruments:

The estimated fair value of financial instruments has been determined by the Group using available market information and valuation methodologies. Considerable judgment is required in estimating fair values. Accordingly, the estimates may not be indicative of the amounts the Group could realize in a current market exchange.

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

The carrying amounts of cash and cash equivalents, short-term bank deposits, trade receivables, trade payables, other receivables and other payables and accrued expenses approximate their fair value due to the short-term maturity of such instruments. The fair value of long-term bank loans and senior convertible loans also approximates their carrying value, since they bear interest at rates close to the prevailing market rates.

The fair value of foreign currency contracts is estimated by obtaining current quotes from banks and market observable data of similar instruments.

The fair value of marketable securities is estimated by obtaining the fair value of the marketable securities from the bank, which is based on current quotes and market value provided by external service providers.

Fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or a liability. As a basis for considering such assumptions, ASC 820, "Fair Value Measurements and Disclosures" ("ASC 820") establishes a three-tier value hierarchy, which prioritizes the inputs used in the valuation methodologies in measuring fair value:

Level 1 - Observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets

Level 2 - Observable inputs, other than quoted prices included in Level 1, such as quoted prices for similar assets and liabilities in active markets; quoted prices for identical or similar assets and liabilities in markets that are not active; or other inputs that are observable or can be corroborated by observable market data

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**AUDIOCODES LTD.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Level 3 - Unobservable inputs which are supported by little or no market activity and that are significant to the fair value of the assets and liabilities. This includes certain pricing models, discounted cash flow methodologies and similar techniques that use significant unobservable inputs

The fair value hierarchy also requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. See also Note 9.

aa. Derivatives and hedging:

The Group accounts for derivatives and hedging based on ASC 815, "Derivatives and Hedging" ("ASC 815").

The Group accounts for its derivative instruments as either assets or liabilities and carries them at fair value. Derivative instruments that are not designated and qualified as hedging instruments must be adjusted to fair value through earnings. The changes in fair value of such instruments are included as earnings in "Financial income (expenses), net" at each reporting period.

For derivative instruments that hedge the exposure to variability in expected future cash flows that are designated as cash flow hedges, the effective portion of the gain or loss on the derivative instrument is reported as a component of accumulated other comprehensive income (loss) in equity and reclassified into earnings in the same period or periods during which the hedged transaction affects earnings and is classified as payroll and rent expenses. The ineffective portion of the gain or loss on the derivative instrument is recognized in current earnings and classified as financial income or expenses. To receive hedge accounting treatment, cash flow hedges must be highly effective in offsetting changes to expected future cash flows on hedged transactions.

During the year ended December 31, 2013, the Group recorded accumulated other comprehensive loss in the amount of \$1,303 from its forward and options collar (cylinder) contracts with respect to payroll expenses that were incurred

during the year ended December 31, 2013. Such amount was classified into losses during the year ended December 31, 2013.

During the year ended December 31, 2014, the Group recorded accumulated other comprehensive income in the amount of \$127 from its forward and options collar (cylinder) contracts with respect to payroll and rent expenses to be incurred during the year ending December 31, 2015. Such amount will be reclassified into earnings during the year ending December 31, 2015. See also Note 19.

ab. Impact of recently issued accounting pronouncements:

In April 2014, the Financial Accounting Standards Board ("FASB") issued ASU 2014-08, "Presentation of Financial Statements (Topic 205) and Property, Plant, and Equipment (Topic 360): Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity" ("ASU 2014-08").

**AUDIOCODES LTD.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

ASU 2014-08 raises the threshold for a disposal to qualify as a discontinued operation and requires new disclosures of both discontinued operations and certain other disposals that do not meet the definition of a discontinued operation. The guidance is effective for annual periods beginning on or after December 15, 2014 (January 1, 2015 for the Company). Early adoption is permitted but only for disposals that have not been reported in financial statements previously issued. The Company does not expect the impact of the adoption of ASU 2014-08 to be material to the consolidated financial statements.

In May 2014, the FASB issued ASU 2014-09, "Revenue from Contracts with Customers" ("ASU 2014-09"). ASU 2014-09 supersedes the revenue recognition requirements in "Revenue Recognition (Topic 605)", and requires entities to recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled to in exchange for those goods or services. ASU 2014-09 is effective for annual reporting periods beginning after December 15, 2016 (January 1, 2017 for the Company), including interim periods within that reporting period. Early adoption is not permitted. The Company is currently in the process of evaluating the impact of the adoption of ASU 2014-09 on its consolidated financial statements.

**NOTE 3:- ASSET PURCHASE AGREEMENT WITH MAILVISION**

On May 13, 2013 (the "Closing Date"), pursuant to an Asset Purchase Agreement with Mailvision (the "APA"), the Company acquired certain assets and assumed certain liabilities of Mailvision.

The APA also provides that, under certain limited circumstances, if the Company were to sell the acquired assets and assumed liabilities of Mailvision to a third party prior to May 2014, the proceeds from such sale in excess of a specified amount would be payable to Mailvision, and, if the purchase price offered by a third party prior to May 2014 exceeds a specified amount, subject to a number of conditions, the Company would be required to sell the acquired assets and assumed liabilities (the "Sale Option").

The acquisition was accounted for using the purchase method. The \$ 3,434 in consideration for the acquisition was composed of the following amounts: (i) \$ 221, which represented the present value of a payment of \$ 233 payable on the anniversary date of the acquisition in 2014. The \$ 233 was paid in May 2014; (ii) \$ 432, which represented the fair

value of the estimated earn-out consideration, that is payable in 2015 and 2016, if certain milestones of revenues from the sale of Mailvision's product are met during the three annual periods following the Closing Date (the "Earn-Out"). (iii) waiver of \$ 1,472 of debt owed by Mailvision to the Company; and (iv) \$ 376, which represented the fair value of the Sale Option. In addition, on the Closing Date, the Company revalued its investment in Mailvision (see Note 6) to its fair value in the amount of \$ 933 in accordance with ASC 805, "Business Combination". As a result of the revaluation of investment in Mailvision, the Company recognized a gain of \$ 95 that was recorded in equity in losses of affiliated company, net in the statement of operations.

The payment of the consideration can be made, at the Company's option, in any combination of cash and the Company's ordinary shares.

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**AUDIOCODES LTD.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands, except share and per share data**

## NOTE 3:- ASSET PURCHASE AGREEMENT WITH MAILVISION (Cont.)

The following table summarizes, as of May 13, 2013, the estimated fair values of the assets acquired and liabilities assumed with respect to the acquisition:

|                               |             |
|-------------------------------|-------------|
| Core technology               | \$2,322     |
| Customer relationships        | 266         |
| Goodwill                      | 1,654       |
| <br>Total assets acquired     | <br>4,242   |
| Net working capital           | (529 )      |
| Other assumed liabilities     | (279 )      |
| <br>Total assumed liabilities | <br>(808 )  |
| <br>Net assets acquired       | <br>\$3,434 |

The fair values of the acquired core technology and customer relationships were valued using the income approach. This method utilized a forecast of expected cash inflows, cash outflows and contributory charges for economic returns on tangible and intangible assets employed.

The excess of the purchase price over the preliminary assessment of the net tangible and intangible assets acquired resulted in goodwill of \$ 1,654. The acquired core technology and customer relationships are being amortized on a straight-line basis over a period of 5.5 and 4.5 years, respectively.

The fair value of the Earn-Out was estimated by utilizing the income approach, taking into account the potential cash payments discounted to arrive at a present value amount, based on the Company's expectation as to future revenues of Mailvision's products in the three subsequent annual periods following the Closing Date. The discount rate was based on the market interest rate and estimated operational capitalization rate. The fair value of the Sale Option granted was valued by using the Black-Scholes call option pricing model.



The fair value of the Sale Option was estimated using the following assumptions (annualized percentages):

|                     | December 31,<br>2013 |   |
|---------------------|----------------------|---|
| Exercise price      | \$ 7,124             |   |
| Dividend yield      | 0                    | % |
| Expected volatility | 50                   | % |
| Risk-free interest  | 0.1                  | % |
| Expected life       | 0.4 years            |   |

In accordance with ASC 815, the Company measured the Sale Option at its fair value at each reporting date, with changes in the fair values being recognized in the Company's statement of operations as financial income or expense.

**AUDIOCODES LTD.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands, except share and per share data****NOTE 3:- ASSET PURCHASE AGREEMENT WITH MAILVISION (Cont.)**

As of December 31, 2013, the Earn-Out and the Sale Option estimated fair value amounted to \$446 and \$110, respectively, of which an aggregate amount equal to \$446 was classified as a long-term liability. In May 2014, the Sale Option expired. As of December 31, 2014, the Earn-Out estimated fair value amounted to \$443.

**NOTE 4:- MARKETABLE SECURITIES AND ACCRUED INTEREST**

The following is a summary of held to maturity marketable securities:

|                          | December 31, 2013 |                     |                      | Fair     |
|--------------------------|-------------------|---------------------|----------------------|----------|
|                          | Amortized<br>cost | Unrealized<br>gains | Unrealized<br>losses | Value    |
| Corporate bonds:         |                   |                     |                      |          |
| Maturing within one year | \$15,438          | \$ 35               | \$ -                 | \$15,473 |
| Accrued interest         | 268               | -                   | -                    | 268      |
|                          | \$15,706          | \$ 35               | \$ -                 | \$15,741 |

The following is a summary of available for sale marketable securities:

|                                    | December 31, 2014 |                     |                      | Fair     |
|------------------------------------|-------------------|---------------------|----------------------|----------|
|                                    | Amortized<br>cost | Unrealized<br>gains | Unrealized<br>losses | Value    |
| Corporate bonds:                   |                   |                     |                      |          |
| Maturing between one to five years | \$59,072          | \$ 12               | \$ (400)             | \$58,684 |
| Accrued interest                   | 543               | -                   | -                    | 543      |
|                                    | \$59,615          | \$ 12               | \$ (400)             | \$59,227 |

These investments were issued by highly rated corporations. Accordingly, it is expected that the securities would not be settled at a price less than the amortized cost of the Group's investment. As of December 31, 2013 and 2014, the Group did not have any investment in marketable securities that was in an unrealized loss position for a period of twelve months or greater. Since the Group had the ability and intent to hold these investments until an anticipated recovery of fair value, which may be until maturity, the Group did not consider these investments to be other-than-temporarily impaired as of December 31, 2014. Unrealized gains (losses) are valued using alternative pricing sources and models utilizing observable market inputs.

**AUDIOCODES LTD.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands, except share and per share data****NOTE 5:- INVENTORIES**

|                   | December 31, |          |
|-------------------|--------------|----------|
|                   | 2013         | 2014     |
| Raw materials     | \$5,931      | \$6,794  |
| Finished products | 7,880        | 7,942    |
|                   | \$13,811     | \$14,736 |

In the years ended December 31, 2012, 2013 and 2014, the Group wrote-off inventories in a total amount of \$2,306, \$1,746 and \$82, respectively.

**NOTE 6:- INVESTMENT IN AN AFFILIATED COMPANY**

As of December 31, 2012, the Company owned 25.61% of Mailvision's outstanding share capital. The Company had an investment in equity in the amount of \$1,655, convertible and non-convertible loans in the principal amount of \$398, and accumulated net loss in the amount of \$969. In April 2013, the Company entered into an asset purchase agreement with Mailvision, pursuant to which in May 2013, the Company acquired certain assets and assumed certain liabilities of Mailvision (See also Note 3). As of December 31, 2013 and 2014, the Company owned 29.6% of the outstanding share capital of Mailvision which has no operations, assets or liabilities.

Operation transactions with Mailvision were as follows:

|                                    | Year ended December 31, |        |      |
|------------------------------------|-------------------------|--------|------|
|                                    | 2012                    | 2013   | 2014 |
| Amounts charged - cost of revenues | \$ 1,414                | \$ 432 | -    |



**AUDIOCODES LTD.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands, except share and per share data**

## NOTE 7:- PROPERTY AND EQUIPMENT, NET

|                                    | December 31, |          |
|------------------------------------|--------------|----------|
|                                    | 2013         | 2014     |
| Cost:                              |              |          |
| Computers and peripheral equipment | \$24,871     | \$26,647 |
| Office furniture and equipment     | 10,753       | 10,861   |
| Leasehold improvements             | 2,253        | 2,908    |
|                                    | 37,877       | 40,416   |
| Accumulated depreciation:          |              |          |
| Computers and peripheral equipment | 23,075       | 24,607   |
| Office furniture and equipment     | 9,650        | 9,873    |
| Leasehold improvements             | 1,961        | 2,080    |
|                                    | 34,686       | 36,560   |
| Depreciated cost                   | \$3,191      | \$3,856  |

Depreciation expenses amounted to \$ 1,755, \$ 2,014 and \$ 1,874 for the years ended December 31, 2012, 2013 and 2014, respectively.

## NOTE 8:- INTANGIBLE ASSETS, NET

|                                 | Useful life | December 31, |          |
|---------------------------------|-------------|--------------|----------|
|                                 | (years)     | 2013         | 2014     |
| a. Impaired cost:               |             |              |          |
| Acquired technology and license | 5 - 10      | \$17,839     | \$17,939 |
| Customer relationship           | 4.5 - 9     | 4,438        | 4,438    |
|                                 |             | 22,277       | 22,377   |
| Accumulated amortization:       |             |              |          |
| Acquired technology and license |             | 14,255       | 15,247   |
| Customer relationship           |             | 3,770        | 4,134    |

|                |         |         |
|----------------|---------|---------|
|                | 18,025  | 19,381  |
| Amortized cost | \$4,252 | \$2,996 |

b. Amortization expenses related to intangible assets amounted to \$ 1,128, \$ 1,193 and \$ 1,356 for the years ended December 31, 2012, 2013 and 2014, respectively.

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**AUDIOCODES LTD.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

NOTE 8:- INTANGIBLE ASSETS, NET (Cont.)

c. Expected amortization expenses are as follows:

Year ending December 31,

|      |         |
|------|---------|
| 2015 | \$1,200 |
| 2016 | 866     |
| 2017 | 501     |
| 2018 | 409     |
| 2019 | 20      |
|      | \$2,996 |

NOTE 9:- FAIR VALUE MEASUREMENTS

In accordance with ASC 820, the Group measures its foreign currency derivative instruments, marketable securities, and its contingent consideration to Mailvision, at fair value. Investments in foreign currency derivative instruments and marketable securities are classified within Level 2 value hierarchy. This is because these assets are valued using alternative pricing sources and models utilizing market observable inputs. The contingent consideration of the Earn-Out and the Sale Option provided to Mailvision are classified within Level 3 value hierarchy because these liabilities are based on present value calculations and an external valuation models whose inputs include market interest rates, estimated operational capitalization rates and volatilities. Unobservable inputs used in these models are significant.

The Group's financial assets and liabilities measured at fair value on a recurring basis, consisted of the following types of instruments as of the following dates:

December 31, 2013  
Fair value measurements using input type



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|  | Level<br>2 | Level 3   | Total     |
|--|------------|-----------|-----------|
| Contingent consideration related to Mailvision | \$ -       | \$ (556 ) | \$ (556 ) |
| Total financial liability                      | \$ -       | \$ (556 ) | \$ (556 ) |

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**AUDIOCODES LTD.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands, except share and per share data**

## NOTE 9:- FAIR VALUE MEASUREMENTS (Cont.)

|   | December 31, 2014 |           |           |
|---|-------------------|-----------|-----------|
|   | Level 2           | Level 3   | Total     |
| Financial assets related to foreign currency derivative hedging contracts | \$ 220            | \$ -      | \$ 220    |
| Marketable securities   | 59,227            | -         | 59,227    |
| Contingent consideration related to Mailvision                            | -                 | (443 )    | (443 )    |
| Total Financial asset (liability)   | \$ 59,447         | \$ (443 ) | \$ 59,004 |

Fair value measurements using significant unobservable inputs (Level 3):

|   |         |
|---|---------|
| Balance at January 1, 2014              | \$(556) |
| Adjustment due to time change value     | 85      |
| Adjustment due to change in assumptions | 28      |
| Balance at December 31, 2014            | \$(443) |

## NOTE 10:- OTHER PAYABLES AND ACCRUED EXPENSES

|   | December 31, |          |
|---|--------------|----------|
|   | 2013         | 2014     |
| Payroll and other employee related accruals | \$4,112      | \$3,995  |
| Vacation accrual                            | 2,990        | 2,669    |
| Royalties provision                         | 500          | 929      |
| Government authorities                      | 667          | 468      |
| Accrued expenses                            | 9,351        | 7,146    |
| Others                                      | 338          | 551      |
|   | \$17,958     | \$15,758 |



**AUDIOCODES LTD.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 11:- SENIOR CONVERTIBLE NOTES**

In November 2004, the Company issued an aggregate of \$125,000 principal amount of its 2% Senior Convertible Notes due November 9, 2024 (the "Notes"). The Company was obligated to pay interest on the Notes semi-annually on May 9 and November 9 of each year.

The Notes were convertible, at the option of the holders, at any time before the maturity date, into ordinary shares of the Company at a conversion rate of 53.4474 ordinary shares per \$1 principal amount of Notes, representing a conversion price of approximately \$18.71 per share. Upon such conversion in lieu of the delivering of ordinary shares, the Company could elect to pay the holders cash or a combination of cash and ordinary shares. The Notes were subject to redemption at any time, in whole or in part, at the option of the Company, at a redemption price of 100% of the principal amount plus accrued and unpaid interest. Notes in an aggregate of \$124,650 principal amount were repurchased by the Company in the years 2008, 2009 and 2010. The Notes were subject to repurchase, at the holders' option, on November 9, 2014 or November 9, 2019, at a repurchase price equal to 100% of the principal amount plus accrued and unpaid interest, if any, on such repurchase date. The Company could choose to settle in cash upon conversion.

As of December 31, 2013 there was \$353 in principal amount plus accrued and unpaid interest of the Notes outstanding. The effective interest rate for the years ended December 31, 2012 and 2013 amounted to 2% per year.

During the year ended December 31, 2014, the Company repurchased the full remaining principal amount of the Notes plus accrued and unpaid interest of \$353. As of December 31, 2014, there was no principal amount of Notes outstanding.

**NOTE 12:- LONG-TERM BANK LOANS**

In April and July 2008, the Company entered into loan agreements with Israeli commercial banks that provided for loans in the total principal amount of \$30,000 (the "2008 Loans"). As of December 31, 2013, the 2008 Loans were

fully paid.

In September and December 2011, the Company entered into loan agreements with Israeli commercial banks that provided loans in the total principal amount of \$23,750 (the "2011 Loans"). Certain amounts of the 2011 Loans were required to be maintained as a compensating bank deposits that decrease as the loans are repaid. The 2011 Loans bear interest at LIBOR plus 2.1%-4.35% with respect to \$19,850 of the principal amount. The remaining \$3,900 of principal amount bear interest at 0.5% above the interest rate paid on the bank deposit. Of these 2011 Loans, \$19,850 of the principal amount is repayable in 20 equal quarterly installments and the remaining \$3,900 of principal amount is repayable in 10 equal semiannual payments through September 2017.

As of December 31, 2013 and 2014, the banks have a lien on the Company's assets that secures the 2011 Loans. As of December 31, 2013 and 2014, the Company is required to maintain a total of \$7,239 and \$4,896, respectively, in compensating balances with the banks, to secure the 2011 Loans. As of December 31, 2013 and 2014, the compensating balances are included in \$2,343 and \$2,343 of short-term and restricted bank deposits and \$4,896 and \$2,553 of long-term and restricted bank deposits, respectively. The amount of the compensating balances that is required decreases as the loan is repaid. The agreements with respect to the 2011 Loans require the Company, among other things, to meet certain financial covenants such as maintaining shareholders' equity, cash balances, and liabilities to banks at specified levels, as well as achieving certain levels of operating income (the "Covenants").

**AUDIOCODES LTD.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

NOTE 12:- LONG-TERM BANK LOANS (Cont.)

As of December 31, 2013 and 2014, the Company was in compliance with all the Covenants.

NOTE 13:- COMMITMENTS AND CONTINGENT LIABILITIES

a. Lease commitments:

The Group's facilities are leased under several lease agreements in Israel, Europe, Asia and the Americas for periods ending in 2024.

In addition, the Company has various operating lease agreements with respect to motor vehicles. The terms of the lease agreements are for 36 months, which expire on various dates, the latest of which is in 2017.

Future minimum rental commitments under non-cancelable operating leases are as follows:

Year ending December 31,

|             |         |
|-------------|---------|
| 2015        | \$6,463 |
| 2016        | 6,418   |
| 2017        | 6,234   |
| 2018        | 5,771   |
| 2019 and on | 27,322  |

Total minimum lease payments \*) \$52,208

\*) Minimum payments have been reduced by minimum sublease rental of \$835 due in the future under non-cancelable subleases.

In connection with the Company's facilities lease agreement in Israel, the lessor has a lien of approximately \$5,000 on certain bank deposits as of December 31, 2014. These deposits are included in short-term and restricted bank deposits.

Lease expenses for the years ended December 31, 2012, 2013 and 2014, were approximately \$5,745, \$5,282 and \$6,236, respectively.

b. Inventory purchase commitments:

The Group is obligated under certain agreements with its suppliers to purchase specified items of excess inventory which is expected to be utilized in 2015. As of December 31, 2014, non-cancelable purchase obligations were approximately \$13,395.

**AUDIOCODES LTD.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 13:- COMMITMENTS AND CONTINGENT LIABILITIES (Cont.)**

c. Royalty commitment to the Office of the Chief Scientist of the Israeli Ministry of Economy ("OCS"):

Under the research and development agreements of the Company and its Israeli subsidiaries with the OCS and pursuant to applicable laws, the Company and its Israeli subsidiaries are required to pay royalties at the rate of 1.3%-5% on sales to end customers of products developed with funds provided by the OCS, up to an amount equal to 100% of the OCS research and development grants received, linked to the dollar plus interest on the unpaid amount received based on the 12-month LIBOR rate (from the year the grant was approved) applicable to dollar deposits. The Company and its Israeli subsidiaries are obligated to repay the Israeli Government for the grants received only to the extent that there are sales of the funded products.

The place of manufacturing of a product that was developed with the support of the OCS, or based on know-how developed with the support of the OCS, shall be according to the supported company's declaration in the application for support (including manufacturing abroad). In case the Company or any of its Israeli subsidiaries wish to transfer their manufacturing activities abroad, in addition to their statement in the application for support, they will be required to receive approval from the OCS research committee. The committee is entitled to increase both the royalty liability and the rate of the royalty payments. The increased repayment is calculated according to the percentage of the manufacturing activities that are intended to be carried out outside Israel, and can reach up to 300% of the original sum. When the manufacturing of the product is being done outside of Israel, the Company or any of its Israeli subsidiaries are required to pay an increased royalty rate of an additional 1% (instead of paying 1.3%-5%).

As of December 31, 2013 and 2014, the Company and its Israeli subsidiaries have a contingent obligation to pay royalties in the amount of approximately \$34,034 and \$39,559, respectively.

As of December 31, 2013 and 2014, the Company and its Israeli subsidiaries have paid or accrued royalties to the OCS in the amount of \$2,408 and \$3,423, respectively, which were recorded in cost of revenues.

d. Royalty commitments to third parties:



The Group has entered into technology licensing fee agreements with third parties. Under the agreements, the Group agreed to pay the third parties royalties, based on sales of relevant products. See also Note 10.

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**AUDIOCODES LTD.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 13:- COMMITMENTS AND CONTINGENT LIABILITIES (Cont.)**

e. Legal proceedings:

In May 2014, one of the Company's former senior executives filed a claim with the Israeli labor court claiming an amount of NIS 2,500 (approximately \$625) relating to the termination of his employment. The Company has denied his allegations and believes that it has valid defenses to this claim. A preliminary hearing was held in January 2015 during which the parties mutually agreed to refer the dispute to a mediator. In the event that mediation is unsuccessful the parties will continue with the claim in Israeli labor court.

In November 2013, a former employee filed a claim against the Company's subsidiary in Brazil alleging that he is entitled to approximately \$600 as a result of the termination of his employment by the subsidiary. The Group believes that it has valid defenses to the claim and a provision is not required.

**NOTE 14:- EQUITY**

a. Treasury stock:

During the year ended December 31, 2014, the Company's Board of Directors approved a program to repurchase up to \$3,000 of its ordinary shares which is the amount that the Company could repurchase according to Israeli law without further approval from the Israeli court. In addition, the Company applied to the competent court in Israel for authorization to repurchase up to an additional \$15,000 of its ordinary shares. In November 2014, the Company received the court's approval to purchase up to an additional \$15,000 of its ordinary shares. As of December 31, 2014, pursuant to this program, the Company had repurchased a total of 12,405,598 of its ordinary shares at a total cost of \$41,064 (of which 1,048,091 shares were repurchased during 2014 for aggregate consideration of \$5,267).

b. Issuance of ordinary shares:

On March 10, 2014, the Company sold in a public offering 4,025,000 of its ordinary shares, including 525,000 shares sold pursuant to the underwriters' full exercise of their over-allotment option, at a price of \$8.00 per share. The

Company's net proceeds from this offering were \$29,744, after deducting underwriting discounts, commissions and other offering expenses which amounted to \$2,456.

c. Employee and non-employee Stock Option Plan:

In 2008, the Company's Board of Directors approved the 2008 Equity Incentive Plan (the "Plan") that became effective in January 2009. As of December 31, 2014, the total number of shares authorized for future grant under the Plan is 814,813.

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

**AUDIOCODES LTD.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands, except share and per share data**

## NOTE 14:- EQUITY (Cont.)

The following is a summary of the Company's stock option activity and related information for the year ended December 31, 2014:

|  | Amount<br>of options | Weighted<br>average<br>exercise<br>price | Weighted<br>average<br>remaining<br>contractual<br>term (in<br>years) | Aggregate<br>intrinsic<br>value |
|--|----------------------|--|---|---------------------------------|
| Options outstanding at beginning of year | 3,193,543            | \$ 4.09                                  | 4.5   | \$ 9,845                        |
| Changes during the year:                 |                      |  |   |                                 |
| Granted                                  | 823,329              | \$ 5.27                                  |   |                                 |
| Exercised                                | (531,013 )           | \$ 4.08                                  |   |                                 |
| Forfeited                                | (88,000 )            | \$ 4.63                                  |   |                                 |
| Expired                                  | (140,000 )           | \$ 7.34                                  |   |                                 |
| Options outstanding at end of year       | 3,257,859            | \$ 4.23                                  | 4.7   | \$ 2,440                        |
| Vested and expected to vest              | 3,127,545            | \$ 4.23                                  | 4.7   | \$ 2,342                        |
| Options exercisable at end of year       | 1,409,727            | \$ 3.88                                  | 3.6   | \$ 1,467                        |

The weighted-average grant-date fair value of options granted during the years ended December 31, 2012, 2013 and 2014 was \$1.35, \$3.00 and \$3.00, respectively. The aggregate intrinsic value in the table above represents the total intrinsic value (the difference between the Company's closing stock price on the last trading day of the fiscal year and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on the last trading day of the fiscal year. This amount changes based on the fair market value of the Company's shares.

Total intrinsic value of options exercised for the years ended December 31, 2012, 2013 and 2014 was \$63, \$2,052 and \$1,870, respectively.

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**AUDIOCODES LTD.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands, except share and per share data**

## NOTE 14:- EQUITY (Cont.)

During the year ended December 31, 2013, the Company granted 100,000 performance based options. These options will expire five years from the date of grant. The Company currently expects that the performance targets will not be met and therefore no equity based compensation expenses related to these options were recognized. As of December 31, 2014, all the 100,000 options are outstanding.

The following is a summary of the Company's restricted stock units ("RSUs") activity and related information for the year ended December 31, 2014:

|                                       | Number of<br>shares | Weighted<br>average grant<br>date fair value |
|---------------------------------------|---------------------|--|
| RSUs outstanding at beginning of year | 272,461             | \$ 4.54                                      |
| Changes during the year:              |                     |  |
| Granted                               | 79,715              | \$ 5.23                                      |
| Exercised                             | (121,172 )          | \$ 4.56                                      |
| Forfeited                             | (10,000 )           | \$ 4.38                                      |
| RSUs outstanding at end of year       | 221,004             | \$ 4.79                                      |

During the years ended December 31, 2012, 2013 and 2014, the share based compensation expenses related to the RSUs granted amounted to \$435, \$371 and \$517, respectively.

The following is a summary of warrants issued to non-employees:

|   | Number of<br>shares | Weighted<br>average<br>exercise price |
|---|---------------------|---------------------------------------|
| Warrants outstanding at beginning of year | 80,000              | \$ 4.37                               |
| Changes during the year:                  |                     |                                       |
| Granted                                   | 105,000             | \$ 4.81                               |
| Exercised                                 | (15,375 )           | \$ 4.45                               |
| Forfeited                                 | (4,625 )            | \$ 3.91                               |
| Warrants outstanding at end of year       | 165,000             | \$ 4.65                               |
| Warrants exercisable at end of year       | 15,000              | \$ 4.38                               |

The Group recorded immaterial compensation expenses with respect to the grants of these warrants in accordance with ASC 505-50.

**AUDIOCODES LTD.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands, except share and per share data**

## NOTE 14:- EQUITY (Cont.)

As of December 31, 2014, there was \$3,727 of total unrecognized compensation cost related to non-vested share-based compensation arrangements granted under the Company's stock option plan. That cost is expected to be recognized over a weighted-average period of 1.11 years.

The options and warrants outstanding as of December 31, 2014, have been separated into ranges of exercise prices, as follows:

| Range of exercise price | Options outstanding as of December 31, 2014 | Weighted average remaining contractual life (Years) | Weighted average exercise price | Options exercisable as of December 31, 2014 | Weighted average exercise price of exercisable options |
|-------------------------|---|---|---------------------------------|---|--|
| \$H.00-1.10             | 12,500                                      | 4.47  | \$ 0.00                         | 6,875                                       | \$ 0.00  |
| \$I.50-2.51             | 266,175                                     | 3.63  | \$ 2.06                         | 155,425                                     | \$ 2.10  |
| \$J.57-4.00             | 1,264,835                                   | 4.22  | \$ 3.22                         | 759,556                                     | \$ 3.17  |
| \$L.08-6.49             | 1,586,818                                   | 5.46  | \$ 4.99                         | 392,114                                     | \$ 5.13  |
| \$N.51-9.24             | 292,531                                     | 5.05  | \$ 6.90                         | 110,757                                     | \$ 7.16  |
|                         | 3,422,859                                   | 4.8   | \$ 4.25                         | 1,424,727                                   | \$ 3.89  |

## NOTE 15:- TAXES ON INCOME

a.

Israeli taxation:

1. Measurement of taxable income in U.S. dollars:



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. Accordingly, results for tax purposes are measured in terms of earnings in dollars.

2. Tax benefits under the Israeli Law for the Encouragement of Capital Investments, 1959 (the "Investment Law"):

The Company's production facilities in Israel have been granted the status of an "Approved Enterprise" in accordance with the Investment Law under four separate investment programs. According to the provisions of the Investment Law, the Company has been granted the "Alternative Benefit Plan", under which the main benefits are tax exemptions and reduced tax rates.

Therefore, the Company's income derived from the "Approved Enterprise" will be entitled to a tax exemption for a period of two years and to an additional period of five to eight years of reduced tax rates of 10% - 25% (based on the percentage of foreign ownership). The duration of tax benefits of reduced tax rates is subject to a limitation of the earlier of 12 years from commencement of production, or 14 years from the approval date. The Company utilized tax benefits from the first program in 1998 and has been no longer eligible for benefits since 2007.

**AUDIOCODES LTD.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 15:- TAXES ON INCOME (Cont.)**

As of December 31, 2014, retained earnings included approximately \$ 540 in tax-exempt income earned by the Company's "Approved Enterprise". The Company's Board of Directors has decided not to declare dividends out of such tax-exempt income. Accordingly, no deferred income taxes have been provided on income attributable to the Company's "Approved Enterprise".

The entitlement to the above benefits is conditional upon the Company fulfilling the conditions stipulated by the Investment Law, regulations published thereunder and the certificate of approval for the specific investments in "Approved Enterprises". In the event of failure to comply with these conditions, the benefits may be canceled and the Company may be required to refund the amount of the benefits, in whole or in part, including interest. As of December 31, 2014, management believes that the Company is in compliance with all of the aforementioned conditions.

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

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

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

tax liability with respect to such tax-exempt income. As of December 31, 2014, there was no taxable income attributable to the Beneficiary Enterprise.

In December 2010, another amendment to the Investment Law came into effect ("the 2010 Amendment"). The 2010 Amendment became effective as of January 1, 2011. According to the 2010 Amendment, the benefit tracks in the Investment Law were modified and a flat tax rate applies to the Company's entire income subject to this amendment (the "Preferred Income"). The Company may elect to adopt the 2010 Amendment. Once an election is made, the Company's income will be subject to the amended tax rate which ranges from 9% to 16% from 2014 and thereafter.

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**AUDIOCODES LTD.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

NOTE 15:- TAXES ON INCOME (Cont.)

The Company does not currently intend to adopt the 2010 Amendment, and intends to continue to comply with the Investment Law as in effect prior to enactment of the 2010 Amendment.

3. Net operating loss carry-forward:

As of December 31, 2014, the Company has cumulative losses for tax purposes in the amount of approximately \$10,500, which can be carried forward and offset against taxable income in the future for an indefinite period. As of December 31, 2014, the Company recorded a net deferred tax asset of \$2,232 in respect of such carry-forward tax losses, since it believes it is more-likely-than-not it will utilize carry-forward tax losses.

As of December 31, 2014, the Company's Israeli subsidiaries have estimated total available carry-forward tax losses of approximately \$68,000. The net operating losses may be claimed and offset against taxable income in the future for an indefinite period.

4. Tax benefits under the law for the Encouragement of Industry (taxes), 1969 (the "Encouragement Law"):

The Encouragement Law provides several tax benefits for industrial companies. An industrial company is defined as a company resident in Israel, at least 90% of the income of which in a given tax year exclusive of income from specified Government loans, capital gains, interest and dividends, is derived from an industrial enterprise owned by it. An industrial enterprise is defined as an enterprise whose major activity in a given tax year is industrial production activity.

Management believes that the Company is currently qualified as an "industrial company" under the Encouragement Law and, as such, is entitled to tax benefits, including: (1) deduction of purchase of know-how and patents and/or right to use a patent over an eight-year period; (2) the right to elect, under specified conditions, to file a consolidated tax return with additional related Israeli industrial companies and an industrial holding company; (3) accelerated depreciation rates on equipment and buildings; and (4) expenses related to a public offering on the Tel-Aviv Stock

Exchange and on recognized stock markets outside of Israel, are deductible in equal amounts over three years.

Eligibility for benefits under the Encouragement Law is not subject to receipt of prior approval from any Governmental authority. No assurance can be given that the Israeli tax authorities will agree that the Company qualifies, or, if the Company qualifies, that the Company will continue to qualify as an industrial company or that the benefits described above will be available to the Company in the future.

**AUDIOCODES LTD.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

NOTE 15:- TAXES ON INCOME (Cont.)

5. Tax rates:

Taxable income of Israeli companies was subject to tax at the rate of 25% in the years ended December 31, 2012 and 2013.

On July 30, 2013, the Israeli Parliament passed a law, which, among other things, was designated to increase the tax levy for 2014 and thereafter (the "New Law"). The New Law increases the Israeli corporate tax rate from 25%, which was the tax rate in effect for the year ended December 31, 2013, to 26.5%.

The effective tax rate payable by a company which is taxed under the Investment Law may be considerably lower (see also .a2 above).

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

|          | Year ended December 31, |         |         |
|----------|-------------------------|---------|---------|
|          | 2012                    | 2013    | 2014    |
| Domestic | \$(2,555)               | \$475   | \$1,087 |
| Foreign  | (727 )                  | 2,360   | 2,218   |
|          | \$(3,282)               | \$2,835 | \$3,305 |

c. Taxes on income are comprised as follows:

|  | Year ended December 31, |      |      |
|--|-------------------------|------|------|
|  | 2012                    | 2013 | 2014 |

|                |        |             |          |
|----------------|--------|-------------|----------|
| Current taxes  | \$ 527 | \$ 542      | \$ 451   |
| Deferred taxes | 14     | (1,946 )    | 2,940    |
|                | \$ 541 | \$ (1,404 ) | \$ 3,391 |

|          |        |             |          |
|----------|--------|-------------|----------|
| Domestic | \$ 283 | \$ (634 )   | \$ 2,122 |
| Foreign  | 258    | (770 )      | 1,269    |
|          | \$ 541 | \$ (1,404 ) | \$ 3,391 |

**AUDIOCODES LTD.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands, except share and per share data**

## NOTE 15:- TAXES ON INCOME (Cont.)

## d. Deferred income taxes:

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

|  | December 31, |          |
|--|--------------|----------|
|  | 2013         | 2014     |
| Deferred tax assets:                               |              |          |
| Net operating loss carry-forward                   | \$52,976     | \$48,392 |
| Reserves and allowances                            | 7,843        | 9,780    |
| Net deferred tax assets before valuation allowance | 60,819       | 58,172   |
| Less - Valuation allowance                         | (53,687)     | (53,980) |
| Deferred tax asset                                 | \$7,132      | \$4,192  |
| Domestic:  |              |          |
| Short-term deferred tax asset                      | \$1,397      | \$2,200  |
| Long-term deferred tax asset                       | 2,953        | 32       |
|  | \$4,350      | \$2,232  |
| Foreign:   |              |          |
| Short-term deferred tax asset                      | \$880        | \$1,120  |
| Long-term deferred tax asset                       | 1,902        | 840      |
|  | \$2,782      | \$1,960  |

The Company's U.S. subsidiary has estimated total available carry-forward tax losses of approximately \$77,000 to offset against future U.S federal taxable income and \$14,000 to offset against state taxable income in the U.S. These carry-forward tax losses expire between 2020 and 2032. As of December 31, 2014, the Company's U.S subsidiary recorded a deferred tax asset of \$1,960 relating to the available net carry forward tax losses.



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

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**AUDIOCODES LTD.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands, except share and per share data**

## NOTE 15:- TAXES ON INCOME (Cont.)

## e. Reconciliation of the theoretical tax expenses:

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

|   | Year ended December 31, |   |            |   |          |   |
|---|-------------------------|---|------------|---|----------|---|
|   | 2012                    |   | 2013       |   | 2014     |   |
| Income (loss) before taxes, as reported in the consolidated statements of operations                    | \$ (3,282)              |   | \$ 2,835   |   | \$ 3,305 |   |
| Statutory tax rate  | 25                      | % | 25         | % | 26.5     | % |
| Theoretical tax expense (benefit) on the above amount at the Israeli statutory tax rate                 | \$ (821 )               |   | \$ 709     |   | \$ 876   |   |
| Income tax at rate other than the Israeli statutory tax rate  | (55 )                   |   | 310        |   | 353      |   |
| Tax advances, withholding tax and non-deductible expenses, including equity based compensation expenses | 807                     |   | 518        |   | 897      |   |
| Losses for which a valuation allowance was provided (utilized)  | 755                     |   | (2,929)    |   | 1,101    |   |
| Tax adjustment in respect of different tax rates  | -                       |   | (148 )     |   | -        |   |
| Taxes in respect to prior years   | (162 )                  |   | -          |   | -        |   |
| State and Federal taxes   | 48                      |   | 163        |   | 136      |   |
| Foreign exchange  | 89                      |   | (20 )      |   | 17       |   |
| Impairment of tax advances  | -                       |   | 64         |   | -        |   |
| Other   | (120 )                  |   | (71 )      |   | 11       |   |
| Actual tax expense (benefit)  | \$ 541                  |   | \$ (1,404) |   | \$ 3,391 |   |

## f. Unrecognized tax benefits:

The Company's unrecognized tax benefits as of December 31, 2013 and 2014 is \$198 and \$158, respectively.

The Company recognized interest and penalties related to unrecognized tax benefits in tax expenses in the amount of \$9, \$8 and \$8 for the years ended December 31, 2012, 2013 and 2014, respectively. The liability for unrecognized tax benefits does not include the liability recorded for accrued interest and penalties of \$204 and \$212 at December 31, 2013 and 2014, respectively.

The Company has received final tax assessment through the tax year 2010.

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**AUDIOCODES LTD.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands, except share and per share data****NOTE 16:- BASIC AND DILUTED EARNINGS (LOSS) PER SHARE**

|   | Year ended December 31, |            |            |
|---|-------------------------|------------|------------|
|   | 2012                    | 2013       | 2014       |
| Numerator:  |                         |            |            |
| Net income (loss)   | \$(4,177 )              | \$4,218    | \$(86 )    |
| Denominator:  |                         |            |            |
| Denominator for basic earnings (loss) per share - weighted average number of ordinary shares, net of treasury stock | 39,125,129              | 38,241,258 | 42,285,919 |
| Effect of dilutive securities:  |                         |            |            |
| Employee stock options  | *) -                    | 855,500    | *) -       |
| Senior convertible notes  | *) -                    | *) -       | ***) -     |
| Denominator for diluted earnings (loss) per share - adjusted weighted average number of shares                      | 39,125,129              | 39,096,758 | 42,285,919 |

\*) Antidilutive.

\*\*) Insignificant.

**NOTE 17:- FINANCIAL INCOME (EXPENSES), NET**

|  | Year ended December 31, |          |         |
|--|-------------------------|----------|---------|
|  | 2012                    | 2013     | 2014    |
| Financial expenses:  |                         |          |         |
| Loss related to non-hedging derivative instruments                             | \$-                     | \$(191 ) | \$-     |
| Interest   | (900 )                  | (617 )   | (415 )  |
| Amortization of marketable securities premiums and accretion of discounts, net | (436 )                  | (349 )   | (820 )  |
| Exchange rate  | (4 )                    | -        | (722 )  |
| Others   | (201 )                  | (229 )   | (205 )  |
|  | (1,541)                 | (1,386)  | (2,162) |
| Financial income -   |                         |          |         |
| Gain related to non-hedging derivative instruments                             | 452                     | -        | 196     |
| Interest and others  | 1,542                   | 1,294    | 1,770   |
| Exchange rate  | -                       | 188      | -       |

|       |       |          |
|-------|-------|----------|
| 1,994 | 1,482 | 1,966    |
| \$453 | \$96  | \$(196 ) |

**AUDIOCODES LTD.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands, except share and per share data****NOTE 18:- GEOGRAPHIC INFORMATION**

## a. Summary information about geographic areas:

The Group manages its business on a basis of one reportable segment (see Note 1 for a brief description of the Group's business). The data is presented in accordance with ASC 280, "Segment Reporting". Revenues in the table below are attributed to geographical areas based on the location of the end customers.

The following presents total revenues for the years ended December 31, 2012, 2013 and 2014 and long-lived assets as of December 31, 2012, 2013 and 2014.

|          | 2012      |            | 2013      |            | 2014      |            |
|----------|-----------|------------|-----------|------------|-----------|------------|
|          | Total     | Long-lived | Total     | Long-lived | Total     | Long-lived |
|          | revenues  | assets     | revenues  | assets     | revenues  | assets     |
| Israel   | \$7,773   | \$3,227    | \$7,887   | \$2,941    | \$7,994   | \$3,576    |
| Americas | 66,443    | 230        | 71,527    | 147        | 76,429    | 141        |
| Europe   | 35,876    | 119        | 37,310    | 74         | 43,989    | 56         |
| Far East | 17,398    | 43         | 20,508    | 29         | 23,167    | 83         |
|          | \$127,490 | \$3,619    | \$137,232 | \$3,191    | \$151,579 | \$3,856    |

## b. Product lines:

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

|                         |      |      |  |
|-------------------------|------|------|--|
| Year ended December 31, |      |      |  |
| 2012                    | 2013 | 2014 |  |

|            |           |           |           |
|------------|-----------|-----------|-----------|
| Technology | \$24,673  | \$22,048  | \$19,680  |
| Networking | 102,817   | 115,184   | 131,899   |
|            | \$127,490 | \$137,232 | \$151,579 |

## NOTE 19:- DERIVATIVE INSTRUMENTS

The Group enters into hedge transactions with a major financial institution, using derivative instruments, primarily forward contracts and options to purchase and sell foreign currencies, in order to reduce the net currency exposure associated with anticipated expenses (primarily salaries and rent expenses) in currencies other than the dollar. The Group currently hedges such future exposures for a maximum period of one year. However, the Group may choose not to hedge certain foreign currency exchange exposures for a variety of reasons, including but not limited to immateriality, accounting considerations and the prohibitive economic cost of hedging particular exposures. There can be no assurance the hedges will offset more than a portion of the financial impact resulting from movements in foreign currency exchange rates.

**AUDIOCODES LTD.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands, except share and per share data**

## NOTE 19:- DERIVATIVE INSTRUMENTS (Cont.)

The Group records all derivatives in the consolidated balance sheet at fair value. The effective portions of cash flow hedges are recorded in other comprehensive income until the hedged item is recognized in earnings. The ineffective portions of cash flow hedges are adjusted to fair value through earnings in financial income or expense.

As of December 31, 2013, there was no deferred gain or loss associated with cash flow hedges recorded in other comprehensive income. As of December 31, 2014, the Group had a net deferred gain associated with cash flow hedges of \$127 recorded in other comprehensive income.

The Group entered into forward and options contracts that did not meet the requirement for hedge accounting. The Group measured the fair value of the contracts in accordance with ASC 820, at Level 2. The net gains (losses) recognized in "financial and other expenses, net" during the years ended December 31, 2012, 2013 and 2014 were \$452, \$(191) and \$196, respectively.

As of December 31, 2013, the Group had no outstanding forward and options collar (cylinder) contracts. As of December 31, 2014, the Group had outstanding forward and options collar (cylinder) contracts in the amount of \$43,500 which were designated as payroll and rent hedging contracts.

The fair value of the Group's outstanding derivative instruments and the effect of derivative instruments in cash flow hedging relationship on other comprehensive income for the years ended December 31, 2013 and 2014 are summarized below:

| Foreign exchange forward<br>and options contracts                                 | Balance sheet                               | December 31, |         |
|---|---|--------------|---------|
|   |   | 2013         | 2014    |
| Fair value of foreign exchange forward and options collar<br>(cylinder) contracts | "Other receivables and prepaid<br>expenses" | \$-          | \$446   |
|   | "Other payables and accrued<br>expenses"    | \$-          | \$(319) |



|  |                                     |                 |
|--|-------------------------------------|-----------------|
| Gains (losses) recognized in other comprehensive income (loss) (effective portion) | "Other comprehensive income (loss)" | \$(1,303) \$127 |
|--|-------------------------------------|-----------------|

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**AUDIOCODES LTD.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands, except share and per share data**

## NOTE 19:- DERIVATIVE INSTRUMENTS (Cont.)

The effect of derivative instruments in cash flow hedging relationship on income for the years ended December 31, 2013 and 2014 is summarized below:

|   | Comprehensive                          | Year ended   |         |
|---|--|--------------|---------|
|   | Income (loss)                          | December 31, |         |
|   |  | 2013         | 2014    |
| Foreign exchange forward<br>and options contracts   |  |              |         |
| Comprehensive income (loss) from derivatives before<br>reclassifications                      | "Other comprehensive income<br>(loss)" | \$1,292      | \$(367) |
| Income (loss) reclassified from accumulated other comprehensive<br>income (effective portion) | "Operating expenses"                   | \$2,595      | \$(494) |

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**EXHIBIT INDEX**

**Exhibit No. Document**

- |       |  |
|-------|--|
| 12.1  | Certification of Shabtai Adlersberg, President and Chief Executive Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.             |
| 12.2  | Certification of Guy Avidan, Chief Financial Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.                                   |
| 13.1  | Certification by Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 13.2  | Certification by Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 15.1  | Consent of Kost Forer Gabbay & Kasierer, a member of Ernst & Young Global.   |
| 101.1 | Interactive Data Files (XBRL-Related Documents).   |