VOCALTEC COMMUNICATIONS LTD
Form 20-F
June 25, 2007

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

FORM 20-F

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

OR

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

For the fiscal year ended December 31, 2006

OR

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

For the transition period from _____ to _____

OR

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

Date of event requiring this shell company report _____

Commission file number: 2-0-27648

VOCALTEC COMMUNICATIONS LTD.
(Exact name of registrant as specified in its charter and
translation into English)

STATE OF ISRAEL
(Jurisdiction of incorporation or organization)

60 MEDINAT HAYEHUDIM STREET
HERZLIYA 46140
ISRAEL
(Address of principal executive offices)

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

NONE.

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

ORDINARY SHARES, PAR VALUE OF NIS 0.13
Title of each class

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

NONE.

The number of outstanding shares of each of the issuer's classes of capital or common stock as of December 31, 2006

7,376,364 ORDINARY SHARES, PAR VALUE NIS 0.13 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 [X] 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 [X] No

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

[X] Yes [_] No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer.

[_] Large accelerate filer [_] Accelerate filer [X] Non-accelerated filer

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

[_] Item 17 [X] Item 18

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in rule 12b-2 of the Exchange Act)

[_] Yes [X] No

(APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY PROCEEDINGS DURING THE PAST FIVE YEARS)

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Sections 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court.

[_] Yes [_] No

PRELIMINARY NOTE

THIS ANNUAL REPORT CONTAINS HISTORICAL INFORMATION AND FORWARD-LOOKING

STATEMENTS WITHIN THE MEANING OF THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995 WITH RESPECT TO THE BUSINESS, FINANCIAL CONDITION AND RESULTS OF OPERATIONS OF VOCALTEC AND TDSOFT LTD. THE WORDS "ANTICIPATE," "BELIEVE," "ESTIMATE," "EXPECT," "INTEND," "MAY," "PLAN," "PROJECT" AND "SHOULD" AND SIMILAR EXPRESSIONS, AS THEY RELATE TO VOCALTEC OR ITS MANAGEMENT, ARE INTENDED TO IDENTIFY FORWARD-LOOKING STATEMENTS. SUCH STATEMENTS REFLECT THE CURRENT VIEWS AND ASSUMPTIONS OF VOCALTEC WITH RESPECT TO FUTURE EVENTS AND ARE SUBJECT TO RISKS AND UNCERTAINTIES. MANY FACTORS COULD CAUSE THE ACTUAL RESULTS, PERFORMANCE OR ACHIEVEMENTS OF VOCALTEC TO BE MATERIALLY DIFFERENT FROM ANY FUTURE RESULTS, PERFORMANCE OR ACHIEVEMENTS THAT MAY BE EXPRESSED OR IMPLIED BY SUCH FORWARD-LOOKING STATEMENTS, INCLUDING, AMONG OTHERS, CHANGES IN THE TELECOMMUNICATIONS AND VOIP MARKETS AND IN GENERAL ECONOMIC AND BUSINESS CONDITIONS, LOSS OF KEY CUSTOMERS AND UNPREDICTABLE SALES CYCLES, COMPETITIVE PRESSURES, MARKET ACCEPTANCE OF NEW PRODUCTS, INABILITY TO MEET EFFICIENCY AND COST REDUCTION OBJECTIVES, CHANGES IN BUSINESS STRATEGY AND VARIOUS OTHER FACTORS, BOTH REFERENCED AND NOT REFERENCED IN THIS ANNUAL REPORT. THESE RISKS ARE MORE FULLY DESCRIBED UNDER ITEM 3 - KEY INFORMATION - RISK FACTORS OF THIS ANNUAL REPORT. SHOULD ONE OR MORE OF THESE RISKS OR UNCERTAINTIES MATERIALIZE, OR SHOULD UNDERLYING ASSUMPTIONS PROVE INCORRECT, ACTUAL RESULTS MAY VARY MATERIALLY FROM THOSE DESCRIBED HEREIN AS ANTICIPATED, BELIEVED, ESTIMATED, EXPECTED, INTENDED, PLANNED OR PROJECTED. VOCALTEC DOES NOT INTEND OR ASSUME ANY OBLIGATION TO UPDATE THESE FORWARD-LOOKING STATEMENTS.

In this annual report, all references to "VocalTec," "we," "us" or "our" are to VocalTec Communications Ltd., a company organized under the laws of the State of Israel, and its wholly-owned subsidiaries.

VocalTec, Essentra, Internet Phone, the logo Internet I Phone Surf&Call (together with a third party), TdSoft, TdGATE and TdVIEW are registered trademarks of VocalTec Communications Ltd. and its wholly-owned subsidiaries. Other trademarks are the property of their respective holders.

In this annual report, unless otherwise specified or unless the context otherwise requires, all references to "$" or "dollars" are to U.S. dollars and all references to "NIS" are to New Israeli Shekels. Except as otherwise indicated, financial statements of, and information regarding, VocalTec are presented in U.S. dollars.

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SIGNATURES

PART ONE.

ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS

Not applicable.

ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE

Not applicable.

ITEM 3. KEY INFORMATION

3.A. SELECTED FINANCIAL DATA

In November 2005, VocalTec Communications Ltd., or the Company or VocalTec, acquired all of the issued and outstanding ordinary shares of Tdsoft Ltd., a privately-held company organized in Israel ("Tdsoft"), and as consideration issued to the Tdsoft shareholders ordinary shares of VocalTec constituting, immediately following such issuance, 75% of the issued and outstanding share capital of VocalTec (the "business combination"). The business combination was accounted under U.S. generally accepted accounting principles ("GAAP") as a reverse acquisition and therefore we are presenting in this report the consolidated financial statements of Tdsoft for the year ended December 31, 2004 and for the eleven months ended November 30, 2005, and the consolidated financial statements of the combined company for the period of December 1, 2005 - December 31, 2006.

Our historical consolidated financial statements are prepared in accordance with U.S. GAAP and are presented in U.S. dollars. Historical information as of and for the three years ended December 31, 2006 is derived from our consolidated financial statements, which have been audited by Kesselman & Kesselman, a Member of PriceWaterhouseCoopers (for the year ended December 31, 2004) and by Kost Forer Gabbay & Kasierer, a Member of Ernst & Young Global (for the years ended December 31, 2005 and 2006).

The information presented below is qualified by the more detailed historical consolidated financial statements set forth elsewhere in this report, and should be read in conjunction with those consolidated financial statements, the notes thereto and the discussion under "Operating and Financial Review and Prospects"

included elsewhere in this report.

STATEMENT OF OPERATIONS DATA - YEAR ENDED DECEMBER 31ST
(IN THOUSANDS OF U.S. DOLLARS, EXCEPT PER SHARE DATA)

	2002	2003	200
Sales			
Products	5,346	3,685	3,7
Services	104	248	4
	5,450	3,933	4,1
Cost of sales			
Products	1,819	1,174	1,5
Services	22	21	
	1,841	1,195	1,6
Inventory write off	-	-	
Amortization of intangibles assets	188	188	2
	2,029	1,383	1,8
Gross profit	3,421	2,550	2,3
Operating expenses:			
Research and development, net	5,235	3,243	5,4
Selling and marketing	3,599	2,314	1,9
General and administrative	1,075	919	8
Total operating expenses	9,909	6,476	8,1
Operating loss	(6,488)	(3,926)	(5,8
Other income, net	-	-	
Financial income, net	275	150	1
Loss before income taxes	(6,213)	(3,776)	(5,6
Tax benefit (income taxes)	(506)	-	
Net Loss	(6,719)	(3,776)	(5,6
Accretion of redeemable convertible Preferred shares	(3,256)	(3,256)	(3,2
Induced conversion of convertible Preferred shares	-	-	
Dividend in respect of reduction in exercise price of certain warrants			
Net loss attributable to common shareholders	(9,975)	(7,032)	(8,9
Basic and diluted net loss per Ordinary share	(26.96)	(19.00)	(24.

Weighted average number of Ordinary shares used in computing net loss per share-basic and diluted	370	370	3

BALANCE SHEET DATA - YEAR ENDED DECEMBER 31
(IN THOUSANDS OF U.S. DOLLARS, EXCEPT SHARE DATA)

	2002	2003	2004	2005	2006
Cash and cash equivalents and short term deposits	16,914	13,934	9,260	5,138	8,954
Working capital	17,315	14,400	9,595	925	8,196
Total assets	22,960	18,572	13,538	22,442	24,587
Total liabilities	3,035	2,640	2,878	9,579	6,049
Redeemable convertible Preferred shares	48,045	51,301	54,557	-	-
Capital stock	108	108	116	132	213
Accumulated deficit	(26,697)	(34,017)	(42,568)	(66,854)	(73,903)
Total shareholders' equity (deficiency)	(28,120)	(35,369)	(43,897)	12,863	18,538
Number of Ordinary shares outstanding	370,059	370,059	370,059	4,661,627	7,376,364

3.B. CAPITALIZATION AND INDEBTEDNESS

Not applicable.

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

Not applicable.

3.D. RISK FACTORS

Many factors could have an effect on our financial condition, cash flow and results of operations. We are subject to various risks resulting from changing economic, political, industry, business and financial conditions. The principal factors are described below.

EACH OF VOCALTEC (PRIOR TO THE BUSINESS COMBINATION) AND TDSOFT INCURRED SIGNIFICANT HISTORICAL OPERATING LOSSES AND THERE IS NO ASSURANCE THAT THE COMPANY WILL NOT CONTINUE TO INCUR OPERATING LOSSES IN THE FUTURE.

Since its incorporation in 1989, VocalTec (prior to the business combination) has had limited sales and has incurred significant operating losses. VocalTec (excluding the results of operations of Tdsoft) had operating losses in 2005 and 2004 of $9.5 million and $13.2 million, respectively. In 2005 and 2004, Tdsoft had operating losses of approximately $6.4 million and $5.9 million,

respectively. The combined company had an operating loss of $7.0 million in 2006 and may continue to incur operating losses in the future due to, among other reasons, the fact that the new Essentra products are offered in new target markets to new customers and have not yet obtained substantial credibility and market share of the VoIP equipment business. To achieve profitability and increased sales levels, the Company must, among other things, establish and increase market demand and acceptance of its products, respond effectively to competitive pressures, offer high quality customer service and support, introduce advanced versions and enhancements of its products and new products that meet market needs on a timely basis, and constantly increase operational efficiency.

The Company may continue to incur operating losses in 2007 and thereafter, if revenues are insufficient to cover sales and marketing, research and development, administrative and other expenses. If revenue levels do not increase sufficiently, operating results will be adversely affected because any reduction in expenses may not sufficiently cover a reduction in revenues. There is no assurance that the Company will achieve or sustain significant sales or profitability in the future.

WE HAVE EXPERIENCED AND MAY CONTINUE TO EXPERIENCE SIGNIFICANT FLUCTUATIONS IN OUR QUARTERLY RESULTS, WHICH MIGHT MAKE IT DIFFICULT FOR INVESTORS TO MAKE RELIABLE PERIOD-TO-PERIOD COMPARISONS AND MAY CONTRIBUTE TO VOLATILITY IN THE MARKET PRICE OF OUR ORDINARY SHARES.

The operating results of each of VocalTec and Tdsoft have fluctuated and may continue to fluctuate from period to period for a number of reasons. Although in recent years we have witnessed a general improvement in the market for telecommunication equipment, due to the past volatility of this market we cannot predict the duration or extent of this improvement market or the impact on our revenues or results of operations that any deterioration may have.

There are several market conditions that could continue to cause our customers and potential customers to be conservative in their spending:

- Networks that are based on old Time Division Multiplexing, or TDM, which have been used by telecommunications carriers for several decades, are still operating and generating revenues.

- Large and mid size carriers are showing an increased interest in migrating their TDM-based, Public Switch Telephone Networks, or PSTNs, to VoIP softswitch-based networks, in order to enable advanced, IP-based services and save costs, but there is still uncertainty with respect to the extent and timing of shifting PSTNs to VoIP softswitch networks.

- As a result of our long sales cycle (described below under "OUR ESSENTRA PRODUCTS GENERALLY HAVE A LONG SALES CYCLE, WHICH INCREASES OUR COSTS IN OBTAINING ORDERS, REDUCES THE PREDICTABILITY OF OUR EARNINGS AND REQUIRES HIGH WORKING CAPITAL"), we may need extended time to build up an order backlog.

These and other factors make the forecasting of sales inherently uncertain. Significant annual and quarterly fluctuations in our results of operations may also be caused by, among other factors, the timing and composition of orders from our customers, reduced prices for our products, the economic viability and credit-worthiness of our customers, the collectability of our receivables, the

timing of new product announcements and releases of new products by our company and our competitors.

In addition to our significant operating losses, generally depressed economic conditions have adversely affected our share price and trading volumes in recent years.

Factors that could cause the market price of our ordinary shares to further decrease significantly include the loss of any of our major customers or key personnel, new product developments or enhancements by our competitors, sales of our securities by our shareholders, quarterly fluctuations in actual or anticipated operating results (as described above), continued significant operating losses, market conditions in the industry, law suits against the Company, its officers or directors, analysts' reports, announcements by competitors, regulatory actions or other events or factors, including the risk factors described herein and general economic conditions. In the past, following decreases or volatility in the market price of a company's securities, securities class action litigation has often been instituted. Such litigation could result in substantial costs and a diversion of management's attention and resources, which would have a material adverse effect on our business, operating results and financial condition.

Our future results may also be affected by our ability to continue to develop, introduce and deliver enhanced and new products in a timely manner, to offer new products at competitive prices, to offer existing products at lower prices, to compete with competitors that are larger than us and to anticipate and meet customer demands. There can be no assurance that sales in any particular quarter will not be lower than those of the preceding quarters, including comparable quarters.

As a result, we believe that period-to-period comparisons of our results of operations are not necessarily meaningful and should not be relied upon as indications of future performance. The volatility in our operating results may also result in significant volatility in our share price. Furthermore, as described above, our share price is also subject to the price volatility experienced by many companies in the telecommunications sector, VoIP industry and related sectors. It is also possible that our quarterly results of operations may be below the expectations of public market analysts and investors. If this happens, the price of our ordinary shares is likely to decrease.

CERTAIN EXPECTED OUTCOMES OF THE BUSINESS COMBINATION WITH TDSOFT ARE NOT YET KNOWN AND THERE IS STILL NO ASSURANCE THAT THE BUSINESS COMBINATION WILL RESULT IN ALL OF THE BENEFITS, WHICH THE COMPANY CURRENTLY ANTICIPATES BEING REALIZED.

The main purpose of the business combination with Tdsoft was the companies' belief that the combined company would be better positioned to offer competitive VoIP and multi media solutions to existing and prospective customers. It is not yet clear whether all of the expected benefits of the business combination will be achieved. The Company believes that the following are among the factors that will affect whether such benefits will indeed be achieved, and when such results will be known:

(i) the VoIP market is somewhat different from the access gateways market in which Tdsoft operated prior to the business combination, and therefore it might take more time for the teams from both companies to learn each of the companies' markets and products;

(ii) the development tools and methodologies of VocalTec's Essentra family of products are different from those used in Tdsoft's products (embedded systems) and therefore the full integration of the companies' development teams and methodologies might require additional time; and

(iii) the customers of the combined company often require from the Company to provide a complete solution, which includes third party products, and requires the Company to assume more responsibility, provide more support and deal with more suppliers, things that Tdsoft was not used to doing in the past.

IF THE COMPANY FAILS TO MANAGE ITS POST-BUSINESS COMBINATION GROWTH EFFECTIVELY, OUR EXPENSES COULD INCREASE AND MANAGEMENT'S TIME AND ATTENTION COULD BE DIVERTED.

As part of the post business combination operations, the Company has been focusing on, among other matters, expanding the scope of its operations. As a result, its business, results of operations and financial condition will be substantially harmed if it is unable to manage its expanding operations efficiently. The Company plans to continue to expand its sales and marketing, customer support and research and development organizations. Any future growth may place a significant strain on its management systems and resources. The Company's failure to manage its growth efficiently could increase its expenses and divert management's time and attention.

Our ability to better manage our operations and growth will require us to continue to refine our operational, financial and management controls, human resource policies and reporting controls and procedures. Further, we intend to expand our business by entering into new markets, developing new product and service offerings and pursuing new customers. If we fail to timely or efficiently expand operational and financial systems in connection with such growth or if we fail to implement or maintain effective internal controls and procedures, the resulting operating inefficiencies could increase costs and expenses in excess of our current plan and might cause us to lose the ability to take advantage of market opportunities, enhance existing products, develop new products, satisfy customer requirements, respond to competitive pressures or otherwise execute our business plan. Additionally, if we increase our operating expenses in anticipation of the growth of our business and such growth does not meet our expectations, our financial results and the market price of our securities are likely to be adversely impacted.

Furthermore, in order to materially increase our revenues, we have to seek a larger number of opportunities with more customers and create more partnerships with more vendors, which requires the allocation of more resources by us. Unless we do so, or are able to successfully re-allocate our resources and reduce our operational expenses, reaching profitability could be delayed.

SINCE THE BUSINESS COMBINATION, THE COMPANY HAS BEEN DEVELOPING PRODUCTS AND TECHNOLOGIES LEVERAGING THE KNOW-HOW OF BOTH TDSOFT AND VOCALTEC. THERE IS NO ASSURANCE THAT WE WILL BE SUCCESSFUL IN OBTAINING AND MAINTAINING A SUFFICIENT MARKET SHARE FOR OUR PRODUCTS. IN ADDITION, WE HAVE BEEN ENCOUNTERING VARIOUS CHALLENGES AFFECTING THE SALE OF OUR PRODUCTS.

Since the consummation of the business combination, we have encountered various challenges inherent to entering into a new business, including learning and understanding the new target markets, positioning our products in an already competitive market, creating and maintaining relationships with new suppliers,

customers and other third parties and subjecting the products to testing and training of sales and marketing employees to enable them to successfully promote the sale of the Essentra products. This requires the allocation of substantial resources.

In addition, since the consummation of the business combination the Company has been focusing its development efforts on the Essentra line of products, while Tdsoft's TdGate IP has been re-positioned as part of the Essentra family and has been re-named as EssentraGate. The Essentra product solutions were already deployed by several customers and are carrying live traffic; however, certain elements of the products are still subject to additional development, testing and modifications and have not yet been used extensively by customers, which prevents us from demonstrating a proven track record and wide deployment references, which are crucial for our growth and expansion to larger carriers. Furthermore, unlike VocalTec's traditional H.323 and Tdsoft's TdGATE IP products, which were unique and the first of their kind to be introduced to the telecommunications market, our Essentra products compete with existing, comparable products of various companies, some of which have certain advantages over us, including larger financial resources, the ability to manufacture the hardware components used in their solutions, access to prospective customers and an established market for their products.

Our products must comply with various international and domestic regulations and standards defined by regulatory agencies. If we do not comply with existing or evolving industry standards and other regulatory requirements or if we fail to obtain in a timely manner any required domestic or foreign regulatory approvals or certificates, we will not be able to sell our products where these standards or regulations apply, which may harm our business.

Maintaining and increasing our revenues are dependent, among other things, upon the ability of our products to meet market and customer requirements. To this end, we are involved in a continuous process to evaluate changing market demands and customer requirements, and to develop and introduce new products, features and applications to meet such changing demands and requirements. In addition, prospective customers may require product features and capabilities that are not included in our current product offerings. The introduction of new or enhanced products also requires that we carefully manage the transition from our older products in order to minimize disruption in customer ordering patterns and ensure that adequate supplies of our new products can be delivered to meet anticipated customer demand. We also need to ensure the continued provision of maintenance and other services for our older products.

A number of risks are inherent in this process, including the fact that we may not successfully anticipate market requirements or complete the development or introduction of these products and that the development of new technologies and products is increasingly complex and uncertain. This can result in delays in the introduction of new technologies and products, and requires close collaboration and continued technological advancement involving multiple hardware and software design teams and outside suppliers of key components. The failure of any one of these elements could cause new products to fail to meet specifications, market requirements or customer demands, or to miss delivery schedules. As the variety and complexity of our product lines increase, the process of planning production and inventory levels also becomes increasingly complex. In addition, if we fail to develop products and offer services that satisfy customer requirements, or if we fail to effectively manage the transition from our older products to our new or enhanced products, our ability to create or increase demand for our products would be seriously harmed and we may lose current and prospective customers,

thereby harming our business.

Production and marketing of products in certain states and countries may subject us to environmental and other regulations including, in some instances, the requirement to provide to customers the ability to return products at the end of their useful life.

Further, our results could be adversely affected by factors such as lack of market acceptance of our products, development or manufacturing delays, and delays in customer purchases of products in anticipation of the introduction of new products and the rapidly changing landscape of emerging standards.

Further, telecommunications carriers increasingly require that VoIP products be designed to meet local homologation and regulatory requirements, such as lawful interception and other requirements to demonstrate interoperability with existing networks of incumbent telecommunications carriers, each of which may have different specifications. Failure to obtain such homologation certifications or other industry standard certifications for our products may result in decreased revenues, significant warranty, support and repair costs may divert the attention of our engineering personnel, and may cause significant customer relations problems.

Due to the fact that we have been developing and offering new products, some of which are targeted at new customers in new markets, we have encountered and expect to continue to encounter various challenges. In addition, while seeking midsize carriers, being new to this market, we had to consider offering solutions to alternative small carriers as well, raising the need for flexibility and competitiveness within a wide range of solutions. Also, our solutions have to be inter-operable with offerings of various third parties, which results in a more complex and expensive development and upgrading of the products. Furthermore, in recent years we have witnessed an increasing competition in the VoIP market, resulting in declining prices, as VoIP has become a mainstream technology. One of the main challenges in penetrating the market with the products offered by VocalTec relates to the ability to provide a broad, and to a certain extent complete, solution, which includes third party elements.

Therefore, there is no assurance that we will be successful in obtaining and maintaining a sufficient market share for the existing Essentra products and our future products.

COMMUNICATIONS AUTHORITIES MAY IMPOSE CHARGES, CONTRIBUTION AND OTHER COMMON CARRIER REGULATIONS ON IP TELEPHONY PROVIDERS.

At this time it is uncertain whether or to what extent the United States Federal Communications Commission ("FCC"), any US state communications authorities or the communications authorities of other countries will impose access charges, universal service contributions or other common carrier regulations on IP telephony providers or on VoIP solution providers. There can be no assurance that future action by any regulatory authorities will not have an impact on us, directly or indirectly.

OUR BUSINESS DEPENDS TO A CERTAIN EXTENT ON THE ABILITY OF OUR CHANNELS AND BUSINESS PARTNERS WHO PURCHASE OUR PRODUCTS TO ACHIEVE BROAD MARKET ACCEPTANCE FOR THEIR PRODUCTS. IF THESE CHANNELS AND BUSINESS PARTNERS DO NOT SUCCEED IN SELLING THEIR PRODUCTS, THIS WILL REDUCE DEMAND FOR OUR PRODUCTS AND OUR REVENUES WILL BE ADVERSELY AFFECTED.

Our products are normally sold through channels, i.e., vendors, system integrators and business partners, who repackage or resell our products, under varying types of OEM or reseller arrangements, to carriers (rather than selling our products directly to carriers).

To continue this method of sales, we will have to allocate resources to train vendors, system integrators and business partners as to the use of our products, resulting in additional costs and additional time until sales by such vendors, system integrators and business partners are made feasible. Our business depends to a certain extent upon the success of such channels and the broad market acceptance of their products. To the extent that our channels are unsuccessful in selling our products, our revenues and operating results will be adversely affected.

Many factors out of our control could interfere with our ability to market, license, implement or support our products with any of our channels, which in turn could harm our business. These factors include, but are not limited to, a change in the business strategy of our channels, the introduction of competitive product offerings by other companies that are sold through one or more of our channels, potential contract defaults by one or more of our channels or changes in ownership or management of one or more of our channels. Some of our competitors may have stronger relationships with our channels than we do, and we have limited control, if any, as to whether those channels implement our products rather than our competitors' products or whether they devote resources to market and support our competitors' products rather than our offerings. Also, the loss of or reduction in sales by these channels could reduce our revenues. If we fail to maintain relationships with these channels, fail to develop new channels, fail to effectively manage, train, or provide incentives to existing channels or if these channels are not successful in their sales efforts, sales of our products may decrease and our operating results would suffer.

OUR ESSENTRA PRODUCTS GENERALLY HAVE A LONG SALES CYCLE, WHICH INCREASES OUR COSTS IN OBTAINING ORDERS, REDUCES THE PREDICTABILITY OF OUR EARNINGS AND REQUIRES SIGNIFICANT WORKING CAPITAL.

Our Essentra products are technologically complex and are typically intended for use in solutions that may be critical to the business of our customers. Prospective customers for such products generally must make a significant commitment of resources to test and evaluate products and to integrate them into their solutions. As a result, the sales process for such products is long and often subject to delays associated with lengthy approval processes that typically accompany the design and testing of our customers' solutions. The sales cycles of our products to new customers currently average 6 to 12 months from the time we make a proposal to a customer until the time the customer begins using the relevant product in production mode. This requires us to invest significant resources to make sales, which increases our costs in obtaining orders and reduces the predictability of our sales. In addition, in some cases we need to finance the equipment that we install in our customers' premises during the period of installment, testing and approval of the equipment, which requires us to allocate working capital for the period of such financing. Furthermore, in many cases the sale of our products is conditioned upon a trial period during which the products are installed at the customers' premises, which installation requires an investment by us of capital and manpower, without assurance that the customers will purchase the products.

Long sales cycles also subject us to risks not usually encountered by companies

whose products have short sales cycles, complicating our planning processes and reducing the predictability of our earnings. These risks include:

- a pre-sale process that includes traveling, demonstrations, technical and commercial sessions, and trial procedure intended for defining customers' needs, all of which involve additional costs;

- the potential cancellation of orders based on our customers` changing budgetary constraints; and

- the shift in orders expected between quarters because of the timing of our customers` procurement decisions.

BECAUSE MANY OF OUR CURRENT AND PLANNED PRODUCTS ARE HIGHLY COMPLEX, THEY MAY CONTAIN DEFECTS OR ERRORS THAT ARE DETECTED ONLY AFTER DEPLOYMENT IN COMMERCIAL APPLICATIONS. MOREOVER, OUR CUSTOMERS MAY BUNDLE OUR PRODUCTS WITH THE PRODUCTS OF OTHER PROVIDERS THAT CONTAIN DEFECTS THAT ARE WHOLLY UNRELATED TO OUR PRODUCTS. IN EITHER INSTANCE, IF THIS OCCURS, IT COULD HARM OUR REPUTATION AND RESULT IN REDUCED REVENUES OR INCREASED EXPENSES.

Our products are highly complex and may contain undetected defects, errors or failures. These products are deployed in complex and versatile networks, which include complex equipment of other vendors. Although we invest heavily in testing our products, we cannot simulate and test all potential events and cases relating to the operation of our products, and as a result, in some cases our customers may discover errors after the products have been deployed. The occurrence of any defects, errors or failures could result in:

- product returns, repairs or replacements;

- cancellation of and reduction in orders;

- uncollectible accounts receivable and delays in collecting accounts receivable;

- diversion of our resources;

- legal actions by our customers or our customers' end users;

- adverse effect to our reputation;

- increased insurance costs; and

- other losses to us, our customers or the end users of our products.

Any of these occurrences could also result in the loss of or delay in market acceptance of our products and loss of sales, which would harm our business and adversely affect our results of operations. There can be no assurance that, despite testing by us or by our customers, errors will not be found in our products after commencement of commercial deployment. We have from time to time experienced defects in our products and expect to experience defects in the future. We may in the future incur costs associated with warranty claims. Although we have recently been experiencing less defects in our products, because the trend in our industry is moving toward even more complex solutions and products in the future this risk may intensify over time and may result in increased expenses.

In addition, our customers may bundle, incorporate or connect our products into or to complex systems that contain errors or defects that may be unrelated to our products. Such occurrences may result in undue delays or cancellations of the implementation of our customers' bundled products and services. In such cases, our reputation could be harmed and our results of operations could be adversely affected, which could result in reduced revenues or increased expenses.

IF OUR RELATIONSHIP WITH ANY OF OUR KEY CUSTOMERS IS TERMINATED, OUR REVENUES WILL DECLINE AND OUR BUSINESS WILL BE ADVERSELY AFFECTED.

During 2006, Deutsche Telecom and Lucent accounted for 18% and 13%, respectively, of our revenues.

If our relationship with Deutsche Telekom or Lucent is terminated, or if either of these key customers reduces purchases of our products or maintenance or replaces an existing equipment in its networks with competing products, then our business, financial condition and results of operations would be materially adversely affected. In recent years we were adversely affected by the termination of a relationship with a key customer, as well as reductions in orders from key customers. The impact of the termination or reduction of our key customer relationships would be intensified if we were unable to establish and increase sales to other customers in order to offset this termination or reduction.

WE DEPEND ON THIRD PARTIES FOR THE SUPPLY AND QUALITY OF COMPONENTS REQUIRED FOR THE MANUFACTURE OF OUR PRODUCTS, AND ANY DELAY OR DISRUPTION IN THE SUPPLY OF THESE PRODUCTS WILL ADVERSELY AFFECT OUR RESULTS. IN ADDITION, INACCURATE ESTIMATES OF OUR COMPONENT REQUIREMENTS COULD ADVERSELY AFFECT OUR RESULTS OF OPERATIONS.

We depend on third parties for the manufacture, supply and support of certain hardware and software components that are integrated into our Essentra products (including IBM BladeCenterT platform and blades, Dialogic signaling gateways, AudioCodes media gateways, TTI Telecom and various other suppliers for platforms, voice processing chips, DSP software, operating system software, SIP software SS7 software and other software and hardware elements). If we overestimate our component requirements, we could have excess inventory, which would increase our costs and result in write-downs harming our operating results. If we underestimate our requirements, we may not have an adequate supply, which could interrupt manufacturing of our products and result in delays in shipments and revenues. We currently do not have long-term supply contracts with our component suppliers and they are not required to supply us with products for any specified periods, in any specified quantities or at any set price, except as may be specified in a particular purchase order. Because the key components and assemblies of our products are complex, difficult to manufacture and require long lead times, in the event of a disruption or delay in supply or an inability to obtain products, we may not be able to develop an alternate source in a timely manner, at favorable prices, or at all.

Following the sale and installation of our products, we rely on our hardware and

software suppliers (to varying extents) for maintenance and support services that we provide to our customers. To that end, our agreements with our suppliers include obligations of our suppliers to provide us with certain levels of service and maintenance, as well as restrictions on the right of the supplier to discontinue the manufacture of the hardware components or the software support we purchase from them.

In addition, manufacturing problems may occur with these third parties. A supplier may supply us with products and components that do not meet our quality, quantity or cost requirement, or may cease to provide support with respect to the hardware and software purchased by the Company; therefore, we face the risk of inadequate component supply, price increases, late deliveries, poor component quality and failure in the availability and level of support and maintenance, as any supplier may terminate its relationship with us. If we were to lose our relationship with any of such suppliers, the lead time required to qualify new suppliers could be several months. Also, if we lose our relationship with any of such suppliers or these suppliers are otherwise unable to satisfy our volume and delivery schedule requirements, it may be difficult to locate alternative suppliers that are able to develop, manufacture, deliver and provide products, service and maintenance with respect to the specialized components we need for our products in the desired lead times and quality.

Furthermore, if we experience quality problems from any of our component suppliers, it could take us a significant amount of time to identify the problem as associated with a particular component, ascertain whether this is as a result of a design or a manufacturing flaw and either correct the problem, if possible, replace the components or find an alternate source of supply. Any such quality problem or delay could, in addition to causing us lost sales, detrimentally affect our reputation in the market and cause us to incur additional costs as a result of the recall and replacement of affected products.

Finally, our dependence on third party suppliers of hardware significantly limits our ability to compete successfully with some of our competitors, which supply themselves the hardware components that are used in their solutions and therefore have the flexibility of making more competitive offers to potential customers.

WE MAY BE UNABLE TO ADEQUATELY PROTECT OUR PROPRIETARY RIGHTS, WHICH MAY LIMIT OUR ABILITY TO COMPETE EFFECTIVELY.

Our success is dependent, to a significant extent, upon our proprietary technology. We currently rely on a combination of trade secret, patent, copyright and trademark law, together with non-disclosure, contractual licensing restrictions, and invention assignment agreements, to establish and protect the proprietary rights and technology used in our products. There can be no assurance, however, that such measures will provide commercially significant protection for our proprietary technology, that competitors will not develop products with features based upon, or otherwise similar to, our products or that we will be able to prevent competitors from selling similar products. Specifically, our ability to adequately protect our proprietary rights in Ukraine (where a portion of our research and development operations is outsourced to subcontractors) is unclear due to the political instability in such country and the fact that the protection of intellectual properties in eastern European countries has traditionally been difficult to achieve.

In addition, the software market has traditionally experienced widespread unauthorized reproduction of products in violation of manufacturers'

intellectual property rights. Such activity is difficult to detect and legal proceedings to enforce the manufacturers' intellectual property rights are often burdensome and involve a high degree of uncertainty and costs. Unauthorized use and reproduction of the registration codes contained in our various software products has occurred from time to time and may continue to occur in the future. There can be no assurance that our software products will not experience unauthorized use or reproduction on a massive scale, which may result in an adverse affect on our business, financial condition and results of operations.

WE MAY NOT BE ABLE TO ENFORCE AGAINST OUR EMPLOYEES AND SUBCONTRACTORS COVENANTS NOT TO COMPETE AND THEREFORE MAY BE UNABLE TO PREVENT OUR COMPETITORS FROM BENEFITING FROM THE EXPERTISE OF SOME OF OUR FORMER EMPLOYEES AND SUBCONTRACTORS.

We currently have non-competition clauses in the employment agreements of nearly all of our employees, including all of our key employees. The provisions of such clauses prohibit our employees, if they cease working for us, from directly competing with us or working for our competitors. Recently, Israeli courts have required employers, seeking to enforce non-compete undertakings against former employees, to demonstrate that the competitive activities of the former employees will cause harm to one of a limited number of material interests of the employer recognized by the courts (for example, the confidentiality of certain commercial information or a company's trade secrets). In the event that any of our employees chooses to work for one of our competitors, we may be unable to prevent our competitors from benefiting from the expertise of our former employees obtained from us, if we cannot demonstrate to the court that we would be harmed.

Additionally, our ability to enforce non-compete covenants against our sub-contractors in Ukraine, where we conduct a significant portion of our research and development operations, is unclear.

LITIGATION AND OTHER DISPUTES REGARDING OUR INTELLECTUAL PROPERTY OR THE INTELLECTUAL PROPERTY OF OUR SUPPLIERS COULD PROVE COSTLY AND THEREBY ADVERSELY IMPACT OUR FINANCIAL POSITION AND COULD ALSO RESULT IN AN INJUNCTION OR JUDGMENT AGAINST US, WHICH COULD ADVERSELY AFFECT OUR BUSINESS.

Third parties have asserted patent infringement and other claims against us from time to time. A number of these claims were directed at certain basic and fundamental components of our products. There can be no assurance that third parties will not assert such claims against us in the future or that such present and future claims will not be successful. In addition, third parties may in the future assert patent infringement and other claims against us in connection with components used in our products that are manufactured by our suppliers. Patents relating to basic technologies in the communications and multimedia areas have been recently allowed and patents may be filed in the future which relate to basic technologies incorporated in our products. Also, from time to time there have been claims challenging the ownership of open source software against companies that incorporate open source software into their products. We use certain open source software in our products and may use more open source software in the future. As a result, we could be subject to suits by parties claiming ownership of what we believe to be open source software. We would incur substantial costs and would experience diversion of management resources with respect to the defense of any claims relating to proprietary rights, and this could have a material adverse effect on our business, financial condition and results of operations. Furthermore, parties making such claims could secure a judgment awarding substantial damages, as well

as injunctive or other equitable relief which could effectively block our ability to make, use, sell, distribute or otherwise license our products in the United States or any other jurisdiction. Such a judgment could have a material adverse effect on our business, financial condition and results of operations. Litigation, which is generally costly and time consuming, may be necessary to determine the scope and validity of others' proprietary rights or to enforce any patents issued to us, in judicial or administrative proceedings. In the event a claim relating to proprietary technology or information is asserted against us, we may seek licenses for such intellectual property. There can be no assurance, however, that licenses could be obtained on commercially reasonable terms, if at all, or that the terms of any offered licenses will be acceptable to us. The failure to obtain the necessary licenses or other rights could preclude the sale, manufacture or distribution of our products and, therefore, could have a material adverse effect on our business, financial condition or results of operations. The cost of responding to any such claim may be material, whether or not the assertion of such claim is valid.

WE MAY REQUIRE SIGNIFICANT CAPITAL TO PURSUE OUR GROWTH STRATEGY, BUT WE MAY NOT BE ABLE TO OBTAIN ADDITIONAL FINANCING ON FAVORABLE TERMS OR AT ALL. ANY FINANCING OBTAINED BY US MAY CAUSE DILUTION TO OUR SHAREHOLDERS OR IMPOSE ON US CERTAIN RESTRICTIVE COVENANTS

We may need to obtain additional financing to pursue our business strategy, to develop new products, to respond to competition and market opportunities and to acquire complementary businesses or technologies. There is no assurance that we will be able to obtain such financing on favorable terms or at all. If we raise additional capital through further sales of our equity securities, our shareholders would suffer dilution of their equity ownership in the Company. If we raise additional capital through the issuance of debt, we may not be able to comply with covenants assumed by us pursuant to such debt issuance, which may cause an acceleration of the repayment of the debt amount.

ANY FUTURE MERGERS WITH OR ACQUISITIONS OF COMPANIES OR TECHNOLOGIES AND THE RESULTING INTEGRATION PROCESS MAY DISTRACT THE ATTENTION OF OUR MANAGEMENT AND DISRUPT OUR BUSINESS.

In recent years, the telecommunications market has experienced consolidation. One of our business strategies is to pursue strategic partnerships, alliances, mergers and/or acquisitions of complementary businesses, products and technologies. Pursuit of such strategies requires significant investments in management time and attention, and we have limited experience in the consummation of strategic partnerships, alliances, mergers and acquisitions and in the post-transaction integration.

Mergers with or acquisitions of companies involve a number of risks including the difficulty of assimilating the operations and personnel of the merged or acquired companies and of maintaining uniform standards, controls and policies. There can be no assurance that technology or rights acquired by us will be incorporated successfully into products we introduce or market, that such products will achieve market acceptance or that we will not encounter other problems in connection with such acquisitions.

Such acquisitions may expose us to additional risks, including the following:

- we may find that the acquired company, asset or technology does not further our business strategy, that we overpaid for the company, asset or technology or that the economic conditions underlying our

acquisition decision have changed;

- we may have difficulty retaining the key personnel of the acquired company;

- our ongoing business and management's attention may be disrupted or diverted by transition or integration issues and the complexity of managing geographically or culturally diverse enterprises; and

- we may experience significant problems or liabilities associated with product quality, technology and legal contingencies relating to the acquired business or technology, such as intellectual property or employment matters.

In addition, if we proceed with one or more significant acquisitions or investments in which the consideration includes cash, we are likely to be required to use a substantial portion of our available cash. To the extent we issue securities as consideration in such acquisitions, existing shareholders might be diluted and earnings per share might decrease. In addition, acquisitions and investments may result in the incurrence of debt, large one-time write-offs, such as acquired in-process research and development costs, and restructuring charges.

WE MAY BE ADVERSELY AFFECTED IF THE RATE OF INFLATION IN ISRAEL EXCEEDS THE RATE OF DEVALUATION OF THE NEW ISRAELI SHEKEL (NIS) AGAINST THE DOLLAR.

A significant portion of our sales are made outside of Israel in dollars and we incur a significant portion of our expenses in NIS. The cost of our operations in Israel, as expressed in dollars, is influenced by the extent to which any increase in the rate of inflation is not offset by the devaluation of the NIS in relation to the dollar. During the calendar years 2004, 2005 and 2006 the annual rate of inflation (deflation) was 1.2%, 2.4% and (0.1%), respectively. In 2004, the NIS was appreciated against the dollar by 1.6%, in 2005 it devalued against the dollar by 6.8% and in 2006 it evaluated against the dollar by 8.2%. Although to date we have not purchased forward currency options to decrease our exchange rate risk, we may do so in the future, to the extent we deem it advisable.

WE ARE SUBJECT TO STRONG COMPETITION. ACCEPTANCE OF OUR COMPETITORS' PRODUCTS AND TECHNOLOGIES COULD RESULT IN REDUCED REVENUES OR GROSS MARGINS.

The competition in the VoIP communications market is very strong. Our competitors include telecommunications companies, data communication companies and pure VoIP companies. Almost all of our competitors are larger than we are, and can offer more comprehensive solutions either on their own or by partnering with others. In addition, many of our competitors have greater name recognition, larger installed customer bases, broader product offerings, and significantly greater financial, technical and marketing resources than we do. Finally, some of these competitors are not dependent, as we are, on third parties for the supply and quality of components required for the manufacture of their products. Such competition may result in a reduction in prices. Even if we reduce the prices of our products, there can be no assurance that we will be able to successfully launch our new products, or compete successfully and effectively for deals against our competitors' product offerings. Furthermore, if we reduce our prices below current levels due to competition, our operating losses may increase, which may limit our ability to increase our revenues and gross margins.

We expect that additional companies will compete in the IP-based voice networks market. In the future, we may also develop and introduce other products with new or additional telecommunications capabilities or services. As a result of any such development or introductions, we may compete directly with traditional telecommunications infrastructure and service providers. Additional competitors may include companies that currently provide computer software products and services, such as telephone, media and cable television. The ability of some of our competitors to bundle other enhanced services and other products with VoIP products could give these competitors an advantage over us.

WE ARE DEPENDENT UPON THE CONTINUED EMPLOYMENT OF KEY PERSONNEL.

Our future success depends to a significant extent upon the continued active participation of our directors, senior executive officers, management members and other key employees. The loss of the services of any such person could have a material adverse effect on our business. These persons are not bound by employment agreements for any specific term. The loss of the services of any of these persons may adversely affect the development and sales of our products, and the management of our company. Our success is also dependent upon our continuing ability to attract and retain highly qualified personnel and key engineers and sales and marketing personnel, to perform research and development, commercialize products, and perform the sales and marketing functions required to bring these products to the market. There can be no assurance that we will continue to attract and retain such personnel. Even if we are successful in hiring additional qualified sales and engineering personnel, we will incur additional costs and our operating results, including our gross margin, may be adversely affected.

OUR INTERNATIONAL OPERATIONS EXPOSE US TO THE RISKS INHERENT IN CONDUCTING BUSINESS IN INTERNATIONAL MARKETS.

A substantial portion of our sales is in international markets. In addition, a small, but growing portion of our research and development operations is outsourced to subcontractors in Ukraine. There are certain risks inherent in conducting business in international markets, including unexpected changes in regulatory requirements, export restrictions, homologation certifications, tariffs and other trade barriers, difficulties in staffing and managing foreign operations, longer payment cycles, credit-worthiness of potential customers, and political instability, all of which can adversely impact the success of our international operations. There can be no assurances that one or more of such factors will not have a material adverse effect on our international operations and, consequently, on our business, financial condition and results of operations.

OUR EARNINGS HAVE BEEN AND ARE LIKELY TO CONTINUE BEING ADVERSELY AFFECTED DUE TO COMPLIANCE WITH RECENT ACCOUNTING POLICIES RELATING TO THE EXPENSING OF STOCK OPTIONS.

We are required to prepare financial statements in accordance with the Financial Accounting Standards Board's (FASB) recently issued accounting standard SFAS 123(R), "Share-Based Payment." SFAS 123(R) requires the fair value of all equity-based awards granted to employees to be recognized in financial statements beginning in the first quarter of 2006. The result is that we will be required to record an expense with respect to stock option grants, even if the exercise price of the stock options is equal to the market price of the underlying shares on the date of grant. For the year ended December 31, 2006, the adoption of SFAS 123(R) affected our results of operations by $0.9 million.

We believe that the continued application of SFAS 123(R) will have a material adverse effect on our results of operations, although it will have no impact on our overall financial position or cash flows. SFAS 123(R) also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as required under current literature. This requirement reduces net operating cash flows and increases net financing cash flows. The impact depends on our levels of share-based payments granted in the future, among other things. See also "Item 5 - Operating and Financial Review and Prospects - Critical Accounting Policies".

OUR PRINCIPAL SHAREHOLDERS, INCLUDING OUR EXECUTIVE OFFICERS AND DIRECTORS, ARE ABLE TO INFLUENCE MATTERS REQUIRING SHAREHOLDER APPROVAL.

As of June 20, 2007 our principal shareholders (i.e., holders of more than 10% of our issued and outstanding share capital), together with our directors and executive officers, beneficially owned approximately 54.7% of our outstanding ordinary shares (including options that are exercisable on such date or within 60 days thereafter). As a result, such shareholders together have the ability to significantly influence the election of our directors and most corporate actions, including the ability to vote against merger and acquisitions, which other shareholders of he Company may believe to be beneficial to the shareholders.

CERTAIN PROVISIONS OF OUR ARTICLES OF ASSOCIATION AND ISRAELI LAW COULD DELAY, HINDER OR PREVENT A CHANGE IN OUR CONTROL.

Our articles of association contain provisions which could make it more difficult for a third party to acquire control of us, even if that change would be beneficial to our shareholders. Specifically, our articles of association provide that our board of directors is divided into three classes, each serving a three-year term. In addition, certain provisions of the Israeli Companies Law of 1999, or the Companies Law, could also delay or otherwise make more difficult a change in our control. The provisions of the Companies Law relating to mergers and acquisitions are discussed in greater detail in "Item 10 - Additional Information".

IT MAY BE DIFFICULT TO PURSUE AN ACTION IN THE U.S. OR TO ENFORCE A U.S. JUDGMENT, INCLUDING ACTIONS OR JUDGMENTS BASED UPON THE CIVIL LIABILITY PROVISIONS OF THE U.S. FEDERAL SECURITIES LAWS, AGAINST US AND OUR EXECUTIVE OFFICERS AND DIRECTORS, OR TO ASSERT U.S. SECURITIES LAWS CLAIMS IN ISRAEL.

Most of our directors and officers are not residents of the United States and most of their assets and our assets are located outside the United States. Without a consent to service of process, additional procedures may be necessary to serve individuals who are not U.S. residents. Therefore, it may be difficult to serve process on those directors, officers who are not U.S. residents, in order to commence any lawsuit against them before a U.S. court, including an action based on the civil liability provisions of U.S. federal securities laws.

An investor also may find it difficult to enforce a U.S. court judgment in an Israeli court, including a judgment based on federal securities laws. In accordance with the Israeli Law on Enforcement of Foreign Judgments, 5718-1958, and subject to certain time limitations, an Israeli court may declare a foreign civil judgment enforceable only if it finds that:

- the judgment was rendered by a court which was, according to the laws

of the state of the court, competent to render the judgment;

- the judgment may no longer be appealed;
- the obligation imposed by the judgment is enforceable according to the rules relating to the enforceability of judgments in Israel and the substance of the judgment is not contrary to public policy; and
- the judgment is executory in the state in which it was given.

Even if these conditions are satisfied, an Israeli court will not enforce a foreign judgment if it was given in a state whose laws do not provide for the enforcement of judgments of Israeli courts (subject to exceptional cases) or if its enforcement is likely to prejudice the sovereignty or security of the State of Israel. An Israeli court will also not declare a foreign judgment enforceable if:

- the judgment was obtained by fraud;
- there is a finding of lack of due process;

- the judgment was rendered by a court not competent to render it according to the laws of private international law in Israel;
- the judgment is in conflict with another judgment that was given in the same matter between the same parties and that is still valid; or
- at the time the action was instituted in the foreign court, a suit in the same matter and between the same parties was pending before a court or tribunal in Israel.

An investor may also find it difficult to bring an original action in an Israeli court to enforce liabilities based upon the U.S. federal securities laws against us, or against our directors and officers. Israeli courts may refuse to hear a claim based on a violation of U.S. securities laws and rule that Israel is not the most appropriate forum in which to bring such a claim. In addition, even if an Israeli court agrees to hear such 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.

OUR UNITED STATES INVESTORS COULD SUFFER ADVERSE TAX CONSEQUENCES IF WE ARE CHARACTERIZED AS A PASSIVE FOREIGN INVESTMENT COMPANY.

As more fully described in "Item 10 - Additional Information - Taxation and Government Programs", we could be characterized, for United States income tax purposes, as a passive foreign investment company ("PFIC"). Such characterization could result in adverse United States tax consequences to U.S. Holders (as defined in "Item 10 - Additional Information - Taxation and Government Programs"). Our status as a PFIC could cause, among other things, any gain recognized on the sale or disposition of our ordinary shares to be treated as ordinary income for U.S. Holders. Although we do not believe that we should have been characterized as a PFIC for any tax year through and including 2006, there can be no assurance that the United States Internal Revenue Service will agree with this conclusion. Furthermore, there can be no assurance that we will not be a PFIC in the future. For a further discussion of the consequences of our possible PFIC status, please refer to "Item 10 - Additional Information -

Taxation and Government Programs".

CERTAIN BENEFITS AVAILABLE TO US FROM ISRAELI GOVERNMENT PROGRAMS MAY BE DISCONTINUED OR REDUCED AT ANY TIME, WHICH WOULD LIKELY INCREASE OUR NET RESEARCH AND DEVELOPMENT EXPENSES.

We benefit from participation by the Office of the Chief Scientist of the State of Israel (the "Chief Scientist" or "OCS") in certain of our research and development projects. To be eligible for these participations, we must continue to meet certain conditions. There can be no assurance that such participations will be continued at their current levels or otherwise. The termination or reduction of the participation of the Chief Scientist in research and development projects is likely to increase our net research and development expenses or limit or terminate certain research and development projects. In addition, our royalty payment obligation towards the OCS will continue even if we receive no additional, or reduced, grants from the Chief Scientist.

THE GRANTS WE HAVE RECEIVED FROM THE ISRAELI GOVERNMENT FOR CERTAIN RESEARCH AND DEVELOPMENT EXPENDITURES RESTRICT 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.

Our research and development efforts have been financed, in part, through grants that we have received from the Chief Scientist. We, therefore, must comply with the requirements of the Israeli Law for the Encouragement of Industrial Research and Development, 1984 and related regulations, or the Research Law.

Under the Research Law, the discretionary approval of an OCS committee is required for any transfer of technology or manufacturing of products developed with OCS funding. OCS approval is not required for the export of any products resulting from the research or development. There is no assurance that we would receive the required approvals for any proposed transfer. Such approvals, if granted, may be subject to the following additional restrictions:

- we could be required to pay the OCS a portion of the consideration we receive upon any transfer of such technology to an entity that is not Israeli. Among the factors that may be taken into account by the OCS in calculating the payment amount are the scope of the support received, the royalties that were paid by us, the amount of time that elapsed between the date on which the know-how was transferred and the date on which the grants were received, as well as the sale price; and

- the transfer of manufacturing rights could be conditioned upon an increase in the royalty rate and payment of increased aggregate royalties and payment of interest on the grant amount.

These restrictions may impair our ability to sell our company, technology assets or to outsource manufacturing outside of Israel. The restrictions will continue to apply even after we have repaid the full amount of royalties payable for the grants.

POLITICAL, ECONOMIC AND MILITARY CONDITIONS IN DOMESTIC OR FOREIGN LOCATIONS, INCLUDING ISRAEL, COULD NEGATIVELY IMPACT OUR BUSINESS.

Most of our operations are conducted in the State of Israel. Although virtually all of our sales currently are made to customers outside Israel, we are

nonetheless directly influenced by the political, economic, military and other conditions in and around Israel and in other countries in which our business is located or in which our products are sold. In addition, any major hostilities involving Israel or the interruption or curtailment of trade between Israel and its present trading partners could have a material adverse effect on our business, financial conditions or results of operations.

Accordingly, political, economic and military conditions in Israel may directly affect our business. Since the establishment of the State of Israel in 1948, a number of armed conflicts have occurred between Israel and its Arab neighbors. During the summer of 2006, Israel was engaged in an armed conflict with Hezbollah, a Lebanese Islamist Shiite militia group and political party. This conflict involved missile strikes against civilian targets in northern Israel, and negatively affected business conditions in Israel. Although Israel has entered into various agreements with Egypt, Jordan and the Palestinian Authority, there has been an increase in unrest and terrorist activity, which began in September 2000 and has continued with varying levels of severity into 2007. The election in 2006 of representatives of the Hamas movement to a majority of seats in the Palestinian Legislative Council and the tension between the different Palestinian fractions may create additional unrest and uncertainty. Furthermore, several countries, principally in the Middle East, still restrict doing business with Israel and Israeli companies, and additional countries may impose restrictions on doing business with Israel and Israeli companies if hostilities in Israel increase. Any hostilities involving Israel or the interruption or curtailment of trade between Israel and its present trading partners, or a significant downturn in the economic or financial condition of Israel, could adversely affect our operations and product development, cause our revenues to decrease and adversely affect the share price of publicly traded companies having operations in Israel, such as us.

SOME OF OUR DIRECTORS, OFFICERS AND EMPLOYEES ARE OBLIGATED TO PERFORM MILITARY RESERVE DUTY.

Generally, all non-exempt male adult citizens and permanent residents of Israel under the age of 45 (or older, for citizens with certain occupations), including some of our Israeli directors, and many of our Israeli male officers and employees are obligated to perform up to 36 days of annual reserve duty. Additionally, all such persons are subject to being called to active duty at any time under emergency circumstances. In the event of severe unrest or other conflict, individuals could be required to serve in the military for extended periods of time. In response to increases in terrorist activity, including armed conflicts, there have been periods of significant call-ups of military reservists, and recently some of our employees have been called up in connection with the recent conflict with Hezbollah described above. Although we have operated effectively under these circumstances since we began operations, no assessment can be made as to the full impact of these requirements on our workforce or business if conditions should change, and we cannot predict the effect on us of any expansion of these obligations.

THE EXERCISE OF REGISTRATION RIGHTS GRANTED TO THE TDSOFT SHAREHOLDERS AND THE SALE OF SHARES (INCLUDING SHARES UNDERLYING WARRANTS) ISSUED BY THE COMPANY TO INVESTORS MAY RESULT IN A DECREASE OF THE TRADING PRICE OF THE COMPANY'S

ORDINARY SHARES.

None of the shareholders of the combined company are subject to any "lock up" arrangement with respect to their shares, and therefore all of them are free to sell their shares, subject to limitations imposed by applicable securities laws. For example, the Tdsoft shareholders may currently sell the Company shares they received pursuant to the business combination, subject to volume limitations under US federal securities laws. In addition, the Tdsoft shareholders have certain registration rights with respect to the shares issued to them at the closing of the business combination, including without limitation the right to demand until August 2013 that the Company register their shares. In addition, during 2006 the Company issued to investors an aggregate of 2,685,000 ordinary shares (constituting approximately 24% of our issued and outstanding share capital as of December 31, 2006) and warrants exercisable into an aggregate of 1,686,500 shares (constituting approximately 19% of our issued and outstanding share capital as of December 31, 2006 (assuming exercise of all such warrants)). The exercise of such registration rights and/or the sale by such investors of shares may result in an offer of a large number of shares, which may adversely affect the trading price of the Company's ordinary shares.

ITEM 4. INFORMATION ON THE COMPANY

4.A. HISTORY and DEVELOPMENT OF THE COMPANY.

Our corporate name is VocalTec Communications Ltd. for both legal and commercial purposes. VocalTec was organized under the laws of the State of Israel in 1989 and is subject to the Companies Law. In November 2005, we consummated the business combination with Tdsoft and the shareholders of Tdsoft, pursuant to which the Company acquired all of the issued and outstanding share capital of Tdsoft and as consideration issued to the Tdsoft shareholders ordinary shares that constituted, immediately following such issuance, 75% of the issued and outstanding share capital of the Company. Following consummation of the transaction, Tdsoft became a wholly owned subsidiary of the Company. Tdsoft was organized under the laws of the State of Israel in April 1994. Our principal executive offices are located at 60 Medinat HaYehudim Street, Herzliya Pituach, 46140, Israel, and the telephone number at that location is +972-9-970-3888. Our website is http://www.vocaltec.com.

We are a provider of carrier-class voice-over-IP solutions for communication service providers. We provide trunking, peering, service delivery and access gateway solutions that enable flexible deployment of next-generation networks (NGNs). We develop, market and support advanced telecom solutions that enable the smooth migration of telephony networks from legacy networks to next generation, IP based networks and the implementation of green field next generation telecom networks. Designed for carriers, our standards based solutions handle call control, media processing, signaling and security within state-of-the-art NGN networks. Our SIP-based solutions support a variety of other protocols, including Megaco/H.248, MGCP and H.323 and incorporate key elements of the IMS/TISPAN (IP Multimedia Subsystem) architecture.

Our Essentra product line was designed to replace legacy products and simplify the deployment of NGN networks and the migration of networks to new, SIP-based networks. During 2005 and 2006, there were initial deployments and field trials of the Essentra products, including Essentra CX, EX and BAX, to new and existing customers. Tdsoft's sales of products in 2005 included the TdGATE, TdMAX and legacy products that are a range of broadband and narrowband access gateways. The TdGATE, first deployed in 2000 to support Voice over ATM, has evolved to support voice over IP, supporting Megaco/H.248, MGCP, NCS, V5.2 and GR303.

Following completion of the business combination with Tdsoft in November 2005, the combined company focused on completing the integration of the companies' operations, including product development, marketing, sales, customer support, finance and administration. After careful analysis of the companies' core strengths, management decided to focus on providing VoIP solutions for carriers, by leveraging the VocalTec brand and the combined capabilities of both VocalTec and Tdsoft under the Essentra brand and product line. In addition, management identified carriers in several geographic areas, including Russia, the Commonwealth of Independent States ("CIS"), Eastern Europe, South East Asia and Africa as the Company's targeted growth markets. As part of the post business combination integration process, management allocated substantial resources to complete the integration, enhance our brand and market recognition, further develop our Essentra products, increase our market share in the target segments and improve our operational efficiencies. In addition, substantial resources were allocated to the development of an integrated product, an Intelligent Border Gateway, which leverages the capabilities and strengths of both VocalTec and Tdsoft, and the functionality of several Essentra elements into one integrated platform. In addition, during 2006 the Company completed two financing rounds, raising an aggregate net amount of $11.6 million.

In 2006, the Company's sales increased by approximately 59%, with gross margins, excluding amortization of intangible assets increasing to over 62%, while keeping a stable level of operating expenses along the year.

During 2006, we reopened an office in Singapore.

CAPITAL EXPENDITURES: The Company's capital expenditures for fiscal 2006 were $335,000. Tdsoft's capital expenditures for fiscal years 2005 and 2004 amounted to $308,000 and $189,000, respectively. These expenditures were primarily for hardware and software. VocalTec's capital expenditures for fiscal years 2005 and 2004 amounted to $138 and $457,000, respectively. These expenditures were primarily for hardware and software.

CAPITAL EXPENDITURES CURRENTLY IN PROGRESS: During the first quarter of 2007, the Company had capital expenditures in an aggregate amount of approximately $56,000, primarily for hardware and software. The capital expenditures currently in progress are being financed by the Company through the use of internal sources. Currently, the Company has no capital divestitures in progress.

4.B. BUSINESS OVERVIEW

Over a decade after first being introduced by VocalTec, Voice over IP (VoIP) technology has recently become part of the telecom mainstream. The demand for legacy, TDM based equipment is declining and all aspects of telephony, including networking, transport, control and services, are being gradually migrated to IP and to Voice over IP (VoIP). While most incumbent carriers are planning their migration strategy from the existing circuit switched network (which is the technology used during the last three decades), to VoIP next generation networks, new (greenfield) carriers, without legacy networks and migration considerations, are deploying new networks based solely on VoIP.

As the "first name in VoIP", we gained our experience in carrier-based VoIP solutions while deploying IP based networks using H.323 and SIP protocols for the past 10 years. For additional information, see "4.A - History and Development of the Company."

Following consummation of the business combination with Tdsoft in November 2005, we continue to develop and sell products and provide support and maintenance services to carriers and service providers that are migrating their network to NGNs, or building new VoIP networks. Our solutions provide carriers with call control and interface to legacy telephone systems, as well as peering with other NGNs. Our solutions enable carriers and service providers to reduce both capital and operating expenses and provide a platform for them to increase their revenues through the delivery of IP-based residential and enterprise voice and data services, such as long distance and peering services, Voice over Broadband and hosted Enterprise solutions (IP Centrex), thereby helping them to retain and expand their customer base.

REQUIREMENTS FOR THE NEW VOICE INFRASTRUCTURE SOLUTIONS

For voice traffic to run over packet networks, voice infrastructure solutions must satisfy a number of requirements that differ among carriers, including:

- Carrier class equipment that complies with telecommunications carriers' quality standards.
- Assured voice quality at a similar level to traditional TDM based voice.
- Scalable solutions that support incremental growth from entry level deployments to massive global networks.
- Interoperability with PSTNs, supporting the full range of traditional telephone signaling variants
- Mediation and peering capabilities between the various networks, to allow for seamless delivery of voice /multimedia services.
- Simple and rapid installation, deployment and support.

THE VOCALTEC SOLUTION

We develop, market and sell a variety of carrier-grade VoIP solutions for telecommunications service providers.

We believe that our particular advantages are:

- A wide product offering and solutions that enable fast deployment of VoIP networks;
- Mediation between the core VoIP network and various other networks, supporting a variety of connections including:
  - Peering with other VoIP networks; and
  - Connecting to Legacy Public Switches Telephony Networks (PSTNs); and

  - Connecting with a variety of Access equipment;
- Strong telecom signaling and signaling conversion technology and know-how;
- Significant SIP, H248, MGCP, SS7, H.323 and V5.2 experience, resulting from deployments in a large number of carrier networks worldwide;

- Flexible deployment options enabling cost-effective entry points as well as the ability to efficiently grow the network;

- Multi-tiered service provisioning and management for hosted services, enabling carriers to offer services to non-facility based carrier;

- Simple installation processes and ease of use and operation;

- More then ten years experience in developing and deploying VoIP products and networks.

THE ESSENTRA PRODUCT SUITE

Designed for easy integration in multi-vendor environments, VocalTec's best-of-breed solutions handle call control, media processing, signaling and security within state-of-the-art next generation networks. VocalTec's SIP-based solutions support a variety of protocols, including SIP, Megaco/H.248, MGCP, H.323 and SS7 and incorporate key elements of the IMS/TISPAN (IP Multimedia Subsystem) architecture.

The Essentra product suite is a modular set of open and highly focused VoIP products for next generation network operators. The Essentra products can be deployed individually or in any combination of groupings in order to provide tailored and cost-effective solutions for each carrier's specific service application needs. It enables carriers to seamlessly integrate state-of-the-art network components from VocalTec and third party vendors to create best-of-breed network solutions, and allows service providers to offer VoIP interconnection services, as well as services to residential and SOHO/SME customers over any broadband access infrastructure.

Essentra is a scalable, carrier-grade SIP-based solution for carriers looking to deploy a reliable next generation network (NGN) solution. Leveraging our extensive global experience in implementing large packet tandem networks, Essentra offers high quality voice services, carrier grade reliability and maximum service flexibility. Essentra enables quick and simple deployment of VoIP networks as well as smooth migration of legacy networks to NGN, while maintaining seamless connectivity to PSTN/SS7 and VoIP networks.

VOCALTEC PRODUCT OFFERINGS

The Essentra product family includes four major elements required when implementation a VoIP network: (i) trunking; (ii) peering, (iii) services and (iv) access.

Leveraging the products, technologies and capabilities of both VocalTec and Tdsoft under the combined company, VocalTec offers an extended product line of carrier grade VoIP products:

ESSENTRA CX MEDIA GATEWAY CONTROLLER: Essentra CX enables wholesale and retail long-distance carriers to build VoIP-based networks, with seamless connectivity to PSTN/SS7 services. This is a scalable, carrier-grade SIP-based media gateway controller.

ESSENTRA EX PEERING MANAGER: Essentra EX facilitates peering between SIP and/or H.323 networks. It addresses carriers' requirements in the areas of protocol interworking, security and intelligent voice routing.

ESSENTRA BAX APPLICATION SERVER: Essentra BAX enables the delivery of residential and hosted enterprise VoIP services over a wide variety of broadband infrastructures. With a cost effective entry point and the capability of scaling up to large numbers of subscribers over time, it allows service providers to take advantage of evolving IP opportunities.

ESSENTRA GATE: Essentra GATE (previously known as TdGate) enables a standards-based softswitch to control VoIP subscribers connected through V5.x and GR-303 legacy access systems. Essentra GATE enables incumbent carriers to leverage their investment and installed base of legacy access infrastructure - such as Digital Loop Carriers, Wireless Local Loop, FTTx, and Cable - by integrating it into the NGN core network

Using the Essentra products, a variety of NGN network solutions may be offered, to OEMs, resellers, existing carriers and emerging operators.

The following are some examples of such solutions:

VOIP BASED WHOLESALE CARRIERS AND INTERNATIONAL LONG DISTANCE CARRIERS

The Essentra suite may be used to build/migrate a wholesale carrier network to an NGN based solution. Using the Essentra EX Peering Manager and the Essentra CX Media Gateway Controller, plus additional optional Essentra elements, a carrier grade VoIP network may be built providing the needs of such carriers. The Essentra EX allows for un-matched connectivity to other peer IP networks, providing the required protocol mediation, security and routing schemes to allow for the appropriate network termination at any given time. The Essentra CX enables such carriers to carry traffic to the PSTN using the SS7 PSTN protocol, which is commonly used for Network to Network connectivity.

VOICE OVER BROADBAND/CLASS 5 REPLACEMENT

The standards-based Essentra(R) BAX application server can be quickly and easily deployed and integrated in the service provider's network. End users connect to the service through SIP-based Integrated Access Devices (IAD), SIP Phones, soft-phones and/or SIP-enabled PDAs. The VoIP telephone service includes traditional subscriber calling features (e.g., call waiting, call forward), new IP-enabled features (e.g., conferencing, "do not disturb") as well as web-based self-provisioning tools.

SOHO, SME AND CORPORATE HOSTED SERVICES

The Essentra BAX application server supports a powerful IP Centrex service which allows the service provider to offer its enterprise customers a wide array of enterprise telephony features from a single central location. In this manner, multiple enterprise customers, whether small or large and whether local or global in nature with distributed locations, can enjoy the benefits of VoIP telephony. One numbering plan across the entire corporation and short dialing within all corporate offices create the look and feel of one single office PBX. The rich feature set and supported executive desk telephone stations offer a solution that can compete with advanced PBX services.

LEGACY PRODUCTS

In the past, both VocalTec and Tdsoft developed and marketed products that used TDM, ATM and H.323 technologies. These products were sold in the past to several

carriers, who are still requiring support and maintenance services for these products. The Company's primary legacy products include:

- ATM Gateways, including two platforms: the TdGATE(tm) 3X00 and the HUNT 8110. The TdGATE 3X00 is a Voice Over Broadband Gateway that allows service providers to provide ISDN and telephony services over Broadband access infrastructure based on ATM AAL2 standards. The HUNT 8110 is a Broadband Access Concentrator that can aggregate several types of traffic coming from the Enterprise network, including TDM and IP, towards the ATM network.

- H323 Products, including VoIP Gateways, Gatekeapers and network management solutions. VoIP Gateways includes the VocalTec GW2000 and GW480 carrier grade Gateways, providing TDM to VoIP interconnection. The VocalTec VA Gatekeeper used to manage a network of Gateways and enable routing management of such networks and the VNM network management software, used to manage the network and provide element management and OSS functions to such networks.

OTHER PRODUCTS

VocalTec plans to further develop the Essentra product line ,leveraging the combined technology and know-how of Tdsoft and VocalTec. These new Essentra versions are planned to gradually become IMS/TISPAN compatible, handling multimedia, signaling, security, QoS advanced voice routing, service mediation and overlay services.

DEPENDENCE ON CONTRACTS WITH SUPPLIERS AND CUSTOMERS

We are dependent on the following suppliers for the manufacture, supply and support of hardware and software components that are integrated into our solutions: AudioCodes Ltd. for the supply of media gateways; Dialogic for the supply of SS7 signaling software and boards, IBM for the BladeCenterT platform and blades, Axerra networks for hardware platform and modules used for Tdgate / Essentra Gate and various other suppliers for voice processing chips, DSP software, Operating System Software, SIP software, SS7 Software and other software and hardware components. If our relationship with any of these suppliers is terminated, then we will need to invest time and resources to integrate our products with the hardware and software components of alternative suppliers. See "Item 3 - Key Information - Risk Factors - We depend on third parties for the supply and quality of components required for the manufacture of our products, and any delay or disruption in the supply of these products will adversely affect our results". Notwithstanding the foregoing, our dependency on the foregoing component suppliers is less than the dependency we had on suppliers of hardware components for our traditional H.323 products, since our Essentra products are based on Linux and general-purpose IBM servers.

The Essentra Gate and Tdsoft products include software and hardware modules that were designed in-house and hardware platforms, modules and components that are purchased from other suppliers on whom we are dependent.

In addition, our dependency on Dialogic for signaling software and boards has been reduced due to the support of the standard protocol Sigtran that is used in both our Essentra CX and on Dialoic components (Sigtran is a standard-based protocol, which is also available from other signaling gateway vendors). In developing our traditional H.323 products, we supported a proprietary protocol provided by Intel (now Dialogic), which was significantly harder to replace.

We are also dependent on contracts with certain customers. See "Item 3 - Key Information - risk factors - if our relationships with our key customers are terminated, our revenues will decline and our business will be adversely affected".

MARKETING, SALES AND DISTRIBUTION

We market and distribute our products both directly and via multiple distribution channels, and our main target customers include fixed line national and international long distance carriers, competitive local exchange carriers (CLEC), incumbent local exchange carriers (ILEC), alternative telephony carriers (which are virtual operators such as Vonage) and Internet Telephony Service Providers (ITSPs).

Since the business combination with Tdsoft, we have substantially increased our sales and marketing efforts, in order to enhance and leverage the VocalTec brand, and in order to penetrate specific geographic areas in which we believe our products can be successfully sold. Such areas include primarily Russia, CIS, South East Asia and Africa. As part of these efforts we reached agreements with a large number of local agents and distributors and in June 2006, we reopened the VocalTec office in Singapore and appointed a Vice President for Asia Pacific. These efforts resulted in new customers and increased deployments in the fourth quarter of 2006.

In addition, during 2006 we made significant efforts to establish relationships with channel partners, including resellers and other vendors, in order to leverage their market power and increase our market reach and sales. Initial sales through such channels commenced during the fourth quarter of 2006.

The sales cycles for our solutions are typically long as is common to the telecommunications market and the nature of our products and solutions. Once purchased by our end user customers, our solutions require installation in the network. After installation the system usually enters into a warranty period of three to fifteen months. We offer two maintenance and service agreements, which are renewed on an annual basis. The standard service is an 8X5 support service (i.e. during regular business hours), including fixing of errors and faulty hardware replacement. The premium service includes a 24X7 support service and versions updates.

INDUSTRY STANDARDS

We recognize that standards are important for interoperability and for providing the means for market growth. Since 1996, we have taken an active role in international standards bodies. Our strong involvement and contribution over the years led our employees to hold official positions in a number of international standards bodies, including: ITU (International Telecommunications Union), ETSI (the European Telecommunications Standards Institute), MSF Multiservice Switching Forum, the ATM Forum and IETF (the Internet Engineering Task Force).

We actively support important communications standards in our products, including IETF SIP, ITU-T H.323, SS7, V5.2, GR-303, ISDN, ELCP, MEGACO, MGCP, SIGTRAN, Radius and others, and work closely with our carrier customers and equipment manufacturers in ensuring standards are correctly and uniformly implemented. The Essentra product suite was designed to meet the IMS specifications, which is rapidly being adopted by both wireless and fixed line operators. Our prime focus is on the TISPAN IMS family of standards, as most of

our customers are fixed line carriers.

COMPETITION

Our market is highly competitive and rapidly evolving, and is characterized by evolving standards, new alliances and consolidation. Since the Essentra solution combines trunking, peering, services and access elements, our competitive landscape includes providers of softswitches (class 4 and class 5), application servers and session border controllers. Our principal competitors include Huawei, Veraz, Cirpack (part of Thomson Technology), Sonus Networks Inc., Nortel, Siemens, Alcatel, Cisco systems, Italtel, Cantata andVerso as softswitch vendors; Broadsoft, NetCentrex (part of Comverse Technologies), and Sylantro as application server vendors; and AcmePacket, Nextone and Ditech as session border controller vendors.

Many of our competitors are difficult to compete with, as they are larger than we are, have stronger brand recognition, have greater long-term resources and can sustain larger price reductions for their products.

We believe that in such a rapidly changing market, key competitive factors include time to market, technology and experience, reputation, a broad base of users, strategic alliances, key reference customers, interoperability, product performance, product features and ease of use, price, customer support, distribution channels and the ability to respond quickly to emerging opportunities.

EFFECTS OF GOVERNMENTAL REGULATIONS

See "Item 10 - Additional Information - Taxation and Government Programs".

4.C. ORGANIZATIONAL STRUCTURE

We are organized under the laws of the State of Israel. Our principal operational direct and indirect wholly-owned subsidiaries and their countries of incorporation are:

- Tdsoft Ltd. (Israel)
- Tdsoft Communications Inc. (United States)
- Tdsoft BV (Netherlands)
- VocalTec Communications, Inc. (United States)
- VocalTec Communications Deutschland GmbH (Germany)
- VocalTec Communications Hong-Kong Limited (Hong-Kong)
- VocalTec Communications Singapore PTE Ltd. (Singapore)

4.D. PROPERTY, PLANTS AND EQUIPMENT

Our headquarters are located in Herzliya Pituach, Israel and occupy 21,500 square feet pursuant to a lease expiring during April 2010. We currently pay a total yearly rental amount of approximately $468,000. These facilities are used for management, marketing, sales, research and development and testing.

We maintain car leases, and our total liability for early termination of the leases is approximately $48,000.

ITEM 4A. UNRESOLVED STAFF COMMENTS

Not applicable.

ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS

THE FOLLOWING DISCUSSION OF OUR FINANCIAL CONDITION AND RESULTS OF OPERATIONS SHOULD BE READ IN CONJUNCTION WITH OUR CONSOLIDATED FINANCIAL STATEMENTS AND RELATED NOTES INCLUDED ELSEWHERE IN THIS ANNUAL REPORT. THIS DISCUSSION CONTAINS FORWARD-LOOKING STATEMENTS THAT INVOLVE RISKS AND UNCERTAINTIES. OUR ACTUAL RESULTS MAY DIFFER SIGNIFICANTLY FROM THOSE PROJECTED IN THE FORWARD-LOOKING STATEMENTS. FACTORS THAT MIGHT CAUSE FUTURE RESULTS TO DIFFER SIGNIFICANTLY FROM THOSE PROJECTED IN THE FORWARD-LOOKING STATEMENTS INCLUDE, BUT ARE NOT LIMITED TO, THOSE DISCUSSED BELOW AND ELSEWHERE IN THIS ANNUAL REPORT, PARTICULARLY THOSE DESCRIBED ABOVE UNDER "ITEM 3 - KEY INFORMATION - RISK FACTORS".

OVERVIEW

We are a provider of carrier-class multimedia and voice-over-IP (VoIP) solutions for communication service providers. We provide trunking, peering, service delivery and access gateway solutions that enable flexible deployment of next-generation networks (NGNs). Partnering with prominent system integrators, resellers and equipment manufacturers, we serve an installed base of leading service providers including Deutsche Telekom, and Telecom Italia San Marino. Designed for easy integration in multi-vendor and complex networks, our solutions handle call control, media processing, signaling and security within state-of-the-art NGN networks. Our SIP-based solutions support a variety of protocols, including Megaco/H.248, MGCP, H.323, V5.2 and GR-303, and incorporate key elements of the IMS/TISPAN (IP Multimedia Subsystem) architecture.

Growth in the VoIP market is being driven largely by new entrants and service providers looking to reduce operational costs and easily add new, advanced services to their offering. While there are favorable industry trends that we believe create an opportunity for us, the ultimate demand for our products will depend upon the magnitude and timing of capital spending on VoIP infrastructure by telecommunications service providers and our ability to penetrate the market with new products and win market share. We are also subject to downturns that may occur within the telecommunications equipment market, such as the downturn that occurred in 2001 through 2003 and negatively affected our revenue growth in that period.

In November 2005, VocalTec acquired all of the issued and outstanding ordinary shares of Tdsoft and as consideration issued to the Tdsoft shareholders ordinary shares of VocalTec constituting, immediately following such issuance, 75% of the issued and outstanding share capital of VocalTec. For accounting purposes, the business combination was accounted for as a reverse acquisition with Tdsoft treated as the accounting acquirer. Therefore, and in accordance with U.S. GAAP. The financial statements reflect TdSoft's financial results until the date of the business combination and the combined financial results of TdSoft and VocalTec from the date of the business combination. VocalTec acquired assets and assumed liabilities were recorded at fair value as of the date of the business combination.

REVENUES. In 2006, we had sales of $7.3 million, compared to $4.6 million in 2005. Through 2006, we generated our revenues from sales of our products and related services. Sales of products accounted for 65% of our revenues in 2006.

We expect to continue to generate revenues primarily from the sale of the Essentra family products, and to a lesser extent from sales of other products and maintenance services. As a result of the business combination with Tdsoft, we have been promoting sales of the expanded product offering to VocalTec's and Tdsoft's customers and channels. We have expanded offering and sales channels following the business combination of VocalTec and Tdsoft.

To date, we have derived a substantial portion of our revenues from a relatively small number of customers. Each of the following customers accounted for more than 10% of our revenues for the periods indicated:

	YEAR ENDED DECEMBER 31,		
	2004	2005	2006
Lucent	*	18%	13%
Graybar	12%	*	*
ECI	11%	*	*
OG Vodafone	13%	16%	*
VoIP Pty Ltd.	10%	*	*
Deutche telecom	*	*	18%

* less than 10%

Total sales to major customers representing each more than 10% of revenues accounted for 46%, 34% and 31% of our total revenues for the years ended December 31, 2004, 2005 and 2006, respectively.

Sales to our customers are generally made under short-term non-cancelable purchase orders. Although our customers may provide us with forecasts, our ability to predict revenues in any future period is limited and subject to change based on demand for our customers' equipment.

We market and sell our products worldwide. The percentages of our revenues by geographic area for the periods indicated were as follows:

	YEAR ENDED DECEMBER 31,		
	2004	2005	2006
	%	%	%
North and South America	16	22	11
Europe and Israel	70	72	66
Asia Pacific ("APAC"), Africa and Middle East	14	6	23
	100%	100%	100%

We attribute revenues to the geographic area where the customer, or its business unit that makes the purchase, is based.

COST OF SALES. Our cost of sales in 2006 was $3.1 million (including an amortization of acquired intangibles in the amount of $0.4 million), or 43% of sales, compared with $2.6 million (including an inventory write-off in the amount of $0.6 million and amortization of acquired intangibles in the amount of $0.2 million), or 56% of sales in 2005. Our cost of sales in 2006, excluding the amortization of acquired intangibles, was $2.7 million, or 38% of sales. The cost of our sales consists primarily of (i) the cost of hardware components (ii) salaries and other related expenses of our employees who are engaged in the production and support of our products and (iii) royalties paid by us to 3rd party software licenses and the Chief Scientist.

Our consolidated financial statements are prepared in accordance with U.S. GAAP, and are the basis for the discussion and analysis of our results of operations and liquidity and capital resources. Our functional and reporting currency is the U.S. dollar, which is the currency of the primary economic environment in which our consolidated operations are conducted. Transactions and balances originally denominated in dollars are presented at their original amounts. Transactions and balances in currencies other than dollars (including NIS) are re-measured in dollars in accordance with the principles set forth in FASB Statement No. 52 - "Foreign Currency Translation". Our reported amounts of assets, liabilities, revenues and expenses and the related disclosure of contingent assets and liabilities are based on certain estimates and judgments made in the preparation of our financial statements, which estimates and judgments are revised periodically as required. Our estimates and assumptions are based on factors such as analysis of prior years' experience, trends within the Company and the telecommunications industry, and general economic conditions. However, actual results may differ from our estimates and assumptions as a result of varying market and economic conditions, and may result in lower revenues and bigger operating losses.

CRITICAL ACCOUNTING POLICIES

Our discussion and analysis of our financial condition and the results of operations is based on our consolidated financial statements that have been prepared in accordance with US GAAP. The preparation of these consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. On an ongoing basis, we evaluate our estimates, including those related to revenue recognition, inventories and accounting for stock based compensation. We base our estimates on historical experience and on various other assumptions that we believe 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.

We have identified below our critical accounting policies. These policies are both the most important to the portrayal of our financial condition and results of operations and require our management's most difficult, subjective and complex judgments and estimates. Actual results may differ from these estimates under different assumptions or conditions.

REVENUE RECOGNITION: The Company generates revenues from licensing the rights to use its software products, from the sale of its systems and from providing maintenance and support services. The Company's products are sold also to resellers, who are considered end-users for the purpose of revenue

recognition (except as indicated below).

Revenue from software products is recognized when all criteria outlined in SOP 97-2 are met: persuasive evidence of an arrangement exists, the product has been delivered, no significant obligation to the customer remains, the sales price is fixed or determinable and collectibility is reasonably assured. The Company does not grant a right of return to its customers.

Revenue from sale of systems is recognized upon delivery to the end-user or the reseller. Provisions for warranty are made at the time of the sale. Such revenues are recognized in accordance with Staff Accounting Bulletin No. 104 "Revenue Recognition in Financial Statements" ("SAB No. 104")

Where software arrangements involve multiple elements, revenue is allocated to each undelivered element based on vendor specific objective evidence ("VSOE") of the fair value of the undelivered element. The VSOE used by the Company to allocate the arrangement fees to support services and maintenance is based on the price charged when these elements are sold separately (upon renewal). Revenues for the delivered product are recorded based on the "residual method" presented by SOP 98-9, "Modification of SOP 97-2, Software Revenue Recognition With Resepct to Certain Transactions", whereby the reminder of the arrangement fee, after allocating revenue to undelivered elements as described above is allocated to the delivered product. Under the residual method revenue is recognized for the delivered elements when (1) there is VSOE of fair value on all the undelivered elements and (2) all revenue recognition criteria of SOP 97-2 are satisfied. Under the residual method any discount in the arrangement is allocated to the delivered element.

When an arrangement provides for acceptance of the product by the customer, revenue is not recognized until such acceptance is received.

In certain cases, when the company sells its products through resellers in new and emerging market channels for which no comparable history has been established, the Company recognizes revenues only when all obligations to the end user have been completed, provided all other revenue recognition criteria have been met.

Arrangements including training and installation services are recognized only after the services are performed.

Revenue from software maintenance and technical support contracts is recognized on a straight line basis over the term of the maintenance and support arrangement.

Engineering services are recognized as services are performed.

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

For the sale of systems the Company records at the time of sale a provision to cover the expected costs in order to honor its warranty obligation. As of December 31, 2006 and 2005 the warranty provision amounted to $ 20 and $ 180, respectively.

BUSINESS COMBINATIONS AND PURCHASE PRICE ALLOCATION: As a result of the business combination with Tdsoft in November 2005, our balance sheet as of

December 31, 2006 includes acquired intangible assets and goodwill which totaled approximately $9,997,000 as of the balance sheet date. Business combinations are accounted for using the purchase method of accounting, under which the total purchase price is allocated to the acquired company's assets and liabilities, based on their estimated fair values, and the remainder, if any, is attributed to goodwill. The aggregate purchase price is being allocated to identifiable net assets, intangible assets other than goodwill, and to goodwill. The amounts allocated to intangible assets other than goodwill are amortized on a straight-line basis over their weighted average expected useful life.

Estimating the fair value of certain assets acquired and liabilities assumed is judgmental in nature and often involves the use of significant estimates and assumptions, mainly with respect to intangible assets. While there are a number of different methods for estimating the value of intangibles acquired, the primary method being used is the discounted cash flow approach. Some of the more significant estimates and assumptions inherent in the discounted cash flow approach include projected future cash flows, including their timing, a discount rate reflecting the risk inherent in the future cash flows and a terminal growth rate. Another area which required judgment which can impact our results of operations was estimating the expected useful lives of the intangible assets. To the extent intangible assets are ascribed with longer useful lives, there may be less amortization expenses recorded in any given period. As we operate in an industry which is rapidly evolving and extremely competitive, the value of the intangible assets, including goodwill, and their respective useful lives is exposed to future adverse changes which can result in a charge to our results of operations.

IMPAIRMENT OF GOODWILL AND OTHER INTANGIBLE ASSETS: In accordance with Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets", ("SFAS No. 142"), goodwill acquired in a business combination that closes on or after July 1, 2001 is deemed to have indefinite life and will not be amortized. SFAS No. 142 requires us to conduct an impairment review at least annually on goodwill and on an interim basis whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Factors that we may consider important which could trigger an impairment review include significant underperformance relative to historical or expected future operating results and significant negative industry or economic trends. We test for impairment at a level referred to as a reporting unit. Determining fair value involves the use of significant estimates and assumptions. These estimates and assumptions could have an impact on whether or not an impairment charge is recognized. To determine fair value, we may use a number of valuation methods including quoted market prices, discounted cash flows and revenue multipliers. As mentioned above, these approaches use estimates and assumptions including projected future cash flows, discount rate and terminal growth rate. Using different assumptions could result in different results. As we operate in an industry which is rapidly evolving and extremely competitive, it is possible that our estimates could change in the near term and there can be no assurance that future goodwill impairment review will not result in a charge to our results of operations. In 2006 and 2005, no impairment of good will was recorded. At December 31, 2006, goodwill amounted to approximately $ 7.0 million.

Other intangible assets with definite useful lives are to be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to the future undiscounted cash flows expected to be generated by the asset. If

an asset is considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the asset exceeds its fair value. In the evaluation of fair value, we may use significant estimates and assumptions such as projected future cash flows which are subject to high degree of judgment. As we operate in an industry which is rapidly evolving and extremely competitive, changes in the assumptions and estimates may affect the carrying value of the intangible assets, and could result in an impairment charge to our results of operations. In 2006 and 2005, no impairment of other intangible assets was recorded. At December 31, 2006, consolidated intangible assets, other than goodwill, amounted to approximately $3.0 million.

TAX ALLOWANCE PRACTICES: At the end of each reported period, we are required to estimate our actual current tax liabilities and make an assessment of temporary differences resulting from differing treatment of items for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included within our consolidated balance sheet. We must then assess the likelihood that our net deferred tax assets will be realized through future taxable income, and, to the extent we believe that realization is not likely, we must establish a valuation allowance. Management judgment is required in determining our provision for income taxes, our deferred tax assets and liabilities and any valuation allowance recorded against our net deferred tax assets. Our judgment as to the probability to realize our net deferred tax assets is largely based upon interpretations of certain tax laws and estimates and assumption. Changes in our assumptions and estimates may require us to increase (or decrease)_the valuation allowance and therefore we may be required to include an expense (or income) within the tax provision in our statement of operations.

As of December 31, 2006, VocalTec Ltd. and Tdsoft Ltd. have net operating loss carryforwards for tax purposes of approximately $ 117,000 and $ 43,000, respectively.

In July 2006, the FASB issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes, and Interpretation of FASB Statement No. 109" ("FIN 48"). FIN 48 clarifies the accounting for income taxes by prescribing the minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN 48 utilizes a two-step approach for evaluating tax positions. Recognition (step one) occurs when an enterprise concludes that a tax position, based solely on its technical merits, is more-likely-than-not to be sustained upon examination. Measurement (step two) is only addressed if step one has been satisfied (i.e. the position is more-likely-than-not to be sustained). Under step two, the tax benefit is measured as the largest amount of benefit, determined on a cumulative probability basis that is more-likely-than-not to be realized upon ultimate settlement. FIN 48 applies to all tax positions related to income taxes subject to the Financial Accounting Standard Board Statement No. 109, "Accounting for Income Taxes" ("FAS 109"). This includes tax positions considered to be "routine" as well as those with a high degree of uncertainty. FIN 48 has expanded disclosure requirements, which include a tabular roll forward of the beginning and ending aggregate unrecognized tax benefits as well as specific detail related to tax uncertainties for which it is reasonably possible the amount of unrecognized tax benefit will significantly increase or decrease within twelve months. These disclosures are required at each annual reporting period unless a significant change occurs in an interim period. FIN 48 is effective for fiscal years beginning after December 15, 2006. The cumulative effect of applying FIN 48 will be reported as an adjustment to the opening balance of retained earnings. We are currently reviewing this new standard to

determine its effect, if any, on our results of operations.

INVENTORIES: Our policy for valuation of inventory and commitments to purchase inventory, including the determination of obsolete or excess inventory, requires us to perform a detailed assessment of inventory at each balance sheet date which includes a review of, among other factors, an estimate of future demand for products, valuation of existing inventory, as well as product life-cycle and product development plans. Inventory reserves are also provided to cover risks arising from slow moving items. We write down our inventory for estimated obsolescence or unmarketable inventory equal to the difference between the cost of inventory and the market value based upon assumptions about future demand, market conditions and prices.

USE OF ESTIMATES: The preparation of the financial information requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate our estimates, mainly related to trade receivables, inventories, long-lived assets, restructuring charges, revenues and contingencies. We base our estimates on historical experience and on various other assumptions 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. Actual results may differ from these estimates under different assumptions or conditions.

STOCK OPTIONS: Until December 31, 2005, we elected to follow the intrinsic value-based method prescribed by Accounting Principles Board Opinion 25, "Accounting for Stock Issued to Employees," or APB 25, and related interpretations in accounting for employee stock options rather than adopting the alternative fair value accounting provided under Statement of Financial Accounting Standards, or SFAS, No. 123, "Accounting for Stock Based Compensation." Therefore, in these years we have not recorded any compensation expense for stock options we granted to our employees where the exercise price equals the fair market value of the shares on the date of grant and the exercise price, number of shares eligible for issuance under the options and vesting period are fixed. However, where the exercise price is less than the fair market value of the shares on the date of grant, compensation expense was recognized..

We complied with the disclosure requirements of SFAS No. 123 and SFAS No. 148, which require that we disclose our pro forma net income or loss and net income or loss per ordinary share as if we had expensed the fair value of the options. In calculating such fair value, there are certain assumptions that we use, as disclosed in Note 2 of our consolidated financial statements included elsewhere in this annual report. For purposes of this pro forma disclosure, we estimated the fair value of stock options issued to employees using the Black-Scholes option pricing model. In addition, option valuation models require the input of highly subjective assumptions, including the expected life of options and our expected share price volatility. Therefore, the estimated fair value of our employee stock options could vary significantly as a result of changes in the assumptions used.

Effective January 1, 2006, the Company adopted FASB Statement No. 123 (revised 2004), "Share-Based Payment" ("SFAS 123(R)") , and related Securities and Exchange Commission rules included in Staff Accounting Bulletin No. 107, which requires companies to expense the fair value of employee stock options and other forms of share-based compensation. Accordingly, SFAS 123(R) eliminates the use of the intrinsic value method to account for share-based compensation

transactions as provided under APB Opinion No. 25. Under SFAS 123(R), we are required to determine the appropriate fair value model to be used for valuing share-based payments, the amortization method for compensation cost and the transition method to be used at date of adoption. We currently use the Black-Scholes option-pricing model to value options for pro forma financial statement disclosure purposes. The use of a different model to value options may result in a different fair value than the use of the Black-Scholes option-pricing model. Deferred compensation is amortized to compensation expense over the vesting period of the options, generally four or five years, on a straight-line basis.

5A. OPERATING RESULTS

YEAR ENDED DECEMBER 31, 2006 COMPARED TO YEAR ENDED DECEMBER 31, 2005

SALES

We recorded sales of $7.3 million in 2006 compared to $4.6 million in 2005 (which comprised primarily of the Tdsoft operations), an increase of 59%. The increase in sales in 2006 compared with 2005 was attributable to the inclusion of the results of operations of VocalTec, which were not included in 2005.

Product sales in 2006 were $4.7 million, an increase of 29% compared to $3.7 million in 2005 (which comprised primarily of the Tdsoft products), mainly attributable to the inclusion of VocalTec products (which were not included in 2005), offset by a decrease in sales of Tdsoft's products.

Revenues from engineering, maintenance, support and other services in 2006 were $2.5 million, an increase of 275% compared to 2005 support services revenues of $0.9 million. Services revenues increased in 2006 compared with 2005 due to the inclusion of maintenance services provided to VocalTec's customers and engineering services which were not included in the 2005 results.

To date, most of our global sales have been in U.S. dollars and have not been adversely affected by foreign currency fluctuations. If global business conditions require us to sell our solutions in other local currencies, our sales may be adversely affected by devaluation of local currencies against the U.S. dollar. If, on the other hand, such local currencies' value increases against the U.S. dollar, our sales (in U.S. dollar terms) will be positively affected.

We plan to increase our market share in the growing VoIP market. In 2006, we started selling our products in new regions, including Russia, Africa and Vietnam.

COST OF SALES

Cost of sales in 2006 was $3.1 million, or 43% of sales (including an amortization of acquired intangibles in the amount of $0.4 million), compared with $2.6 million, or 56 % of sales (including an inventory write-off in the amount of $0.6 million and amortization of acquired intangibles in the amount of $0.2 million), in 2005. The decrease in the cost of sales in percentage in 2006 compared to 2005 resulted from a write-off of $0.6 million of obsolete inventories in 2005 and of a provision for warranty of $0.2 million in 2005, reversed in 2006 due to a decrease in sales of related products, offset by an increase in amortization of acquired intangibles from $0.2 million in 2005 to $0.4 million in 2006

Cost of products was $2.2 million in 2006 compared with $1.5 million in 2005. Cost of services was $0.6 million in 2006 compared with $0.3 million in 2005. The increase in cost of products in 2006 compared to 2005 was mainly due to the increase in sales.

Cost of our sales consists primarily of the cost of hardware components, salaries and other related expenses of our employees who are engaged in the production and support of our products and royalties paid by us to licensors of software and to the Chief Scientist.

In 2006, gross margins were 57%, including amortization of acquired intangibles, or 62%, excluding amortization of acquired intangibles. In 2005, gross margins were 44%, including inventory write-off and amortization of acquired intangibles, or 62%, excluding inventory write-off and amortization of acquired intangibles.

OPERATING EXPENSES

RESEARCH AND DEVELOPMENT, NET

Research and development costs, net were $4.6 million in 2006, or 63% of sales, compared with $4.4 million, or 95% of sales, in 2005. Research and development costs, net consist principally of salaries and benefits for software and hardware engineers and sub contractors, related facilities costs and activities and expenses associated with computer, software and other equipment used in software and hardware development and testing. Research and development costs, net in 2006 included stock-based compensation amount of $248,000 due to the implementation of FASB 123 in 2006. Research and development costs, net in 2005 included a non recurring stock-based compensation amount of $522,000 which resulted from the amount of VocalTec shares issued to founders and employees of Tdsoft pursuant to the business combination being in excess of the pro rata holding percentage of such founders and employees of Tdsoft prior to the business combination. None of our software or hardware development costs have been capitalized during any of the reported periods, as the amount of software and hardware development costs eligible for capitalization at this stage has historically been insignificant. The increase in research and development costs, net, in absolute numbers in 2006 compared to 2005, resulted mainly from a decrease in the participation of the BIRD (Bi-national Industrial Research and Development) foundation in our research and development expenses.

We believe that continued investment in research and development is essential to remain competitive in the marketplace and is directly related to the timely development of new and enhanced products. Specifically, in order to bring our future products to maturity and thereafter increase sales, we are allocating significant resources to research and development activities, including outsourcing certain research and development assignments.

Our research and development efforts have been financed from internal resources and through programs sponsored by the Chief Scientist and the BIRD foundation. As a result of the acquisition of the assets owned by Cisco Systems and the assets of Be-Connected in 2001 and 2004, respectively, Tdsoft assumed the liability to pay royalties to the Chief Scientist in connection with grants

received prior to the purchase of such products. Such royalties were paid during 2004, 2005 and 2006. Pursuant to the terms of the Chief Scientist royalty-bearing program, we are required to pay royalties of between 3% and 4.5% of sales of products and related services developed in any project partially funded by the Chief Scientist, up to an amount of 100% of the grant obtained. For grants received under programs approved subsequent to January 1, 1999, royalties are payable up to 100% of the grant obtained plus interest at LIBOR. Pursuant to the terms of the BIRD foundation royalty-bearing program, we are required to pay royalties of 5% of sales of products and related services developed in any project partially funded by the BIRD foundation, up to an amount of 150% of the grant obtained, depending on the year following the termination of the agreement with the BIRD foundation on which the grant is fully paid. We expect to participate only in royalty bearing programs but we cannot make any assurances that we will be awarded any future grants.

Our research and development expenses in 2006 and 2005 were net of participation from the Chief Scientist and the BIRD foundation. In 2006, participation received or accrued from the Chief Scientist and the BIRD foundation was $0.8 million compared with $1.3 million in 2005. In 2006, we paid or accrued royalties to the Chief Scientist in an aggregate amount of approximately $201,000 compared with $63,000 in 2005. Our contingent liability to the BIRD foundation amounts to approximately $770,000. Our contingent liability to the Chief Scientist amounts to approximately $19 millions.

SELLING AND MARKETING

In 2006, selling and marketing expenses were $4.1 million, or 57% of sales, compared with $2.8 million or 60% of sales in 2005. Selling and marketing expenses include salaries and benefits, sales commissions, travel expenses and related costs for our sales, marketing, and distribution personnel, reserves for potential damages to, loss of, or obsoleteness of trial systems. Selling and marketing expenses in 2006 included stock-based compensation amount of $138,000 due to the implementation of FASB 123 in 2006. Selling and marketing expenses in 2005 included a non recurring stock-based compensation amount of $13,000 which resulted from the amount of VocalTec shares issued to founders and employees of Tdsoft pursuant to the business combination being in excess of the pro rata holding percentage of such founders and employees of Tdsoft prior to the business combination. Selling and marketing expenses also include the costs of programs aimed at increasing revenue, such as advertising, trade shows and other market development programs. The increase in selling and marketing expenses in absolute numbers in 2006 compared to 2005 resulted primarily from an increase in salaries and benefits related to increase in personnel engaged in selling and marketing activities and due to amortization of the intangibles acquired in the business combination between Tdsoft and VocalTec, offset by a decrease in material use for selling and marketing activities.

GENERAL AND ADMINISTRATIVE

General and administrative expenses consist principally of salaries and benefits, outside legal, accounting and consultant fees, travel expenses and related costs for management, finance, logistics, human resources, communication, legal, information systems and administrative personnel. General and administrative expenses in 2006 included stock-based compensation amount of $554,000 due to the implementation of FASB 123 in 2006. General and administrative expenses in 2005 included a non recurring stock-based compensation amount of $268,000 which resulted from the amount of VocalTec shares issued to founders and employees of Tdsoft pursuant to the business

combination being in excess of the pro rata holding percentage of such founders and employees of Tdsoft prior to the business combination. General and administrative expenses also include expenses associated with computing equipment and software used in the administration operations General and administrative expenses consist. General and administrative expenses were $2.5 million, or 34% of sales, in 2006, compared with $1.7 million, or 38% of sales, in 2005. The increase in general and administrative expenses in absolute numbers resulted primarily from an increase in salaries and benefits related to personnel engaged in general and administrative activities and to an increase in stock based compensation expenses.

OTHER INCOME (EXPENSE), NET

We had immaterial other income in 2006 and 2005.

FINANCIAL INCOME, NET

Financial income, net in 2006 consisted principally of interest income received in connection with our bank deposits, bank charges and currency differences between the NIS and US dollar. In 2006, financial income, net was $32,000 - less than 1% of sales, compared to $0.2 million, or 4% of sales, in 2005.

TAXES ON INCOME, TAX REFUNDS AND TAX BENEFITS

In 2006, Vocaltec and Tdsoft had two and four, respectively, Approved Enterprise programs under the Law for the Encouragement of Capital Investments, 1959, respectively. Such programs are eligible for certain tax benefits for the first several years in which they generate taxable income. Income derived from an Approved Enterprise is subject to a zero tax rate for two years and up to an additional eight years of reduced corporate tax rate of 25% until the earlier of (i) seven to ten consecutive years, commencing in the year in which the specific Approved Enterprise first generates taxable income (which income is not offset by deductions attributable to the other sources), (ii) twelve years from commencement of production or (iii) fourteen years from the date of approval of the Approved Enterprise status. Some of our production and development facilities have been granted Approved Enterprise status. To date, neither of our Approved Enterprise programs has generated any taxable income.

As of December 31, 2006, we had net operating loss carryforwards in Israel of approximately $160 million ($117 million allocated to VocalTec and $43 million allocated to Tdsoft), and an aggregate net operating loss carryforwards in the U.S. of approximately $8.5 million. These net operating losses may be carried forward and offset against future taxable income under applicable tax laws. Tax benefits, which apply to us under Israeli law, do not apply to any income generated by any of our other subsidiaries.

NET INCOME (LOSS)

Net loss in 2006 was $7.0 million, representing 96% of sales, compared with a net loss of $6.6 million, representing 144% of sales in 2005.

Our financial statements are reported in dollars and the vast majority of our sales are made in U.S. dollars. Most of our expenses are in New Israeli Shekels (NIS) and dollars. The cost of our operations in Israel, as expressed in dollars, is influenced by the extent to which any increase/decrease in the rate of inflation in Israel is not offset by the appreciation/depreciation of the NIS in relation to the dollar. In 2006, the rate of inflation in Israel was -0.1%

and the rate of depreciation of the NIS in relation to the dollar was -8.2%.

YEAR ENDED DECEMBER 31, 2005 COMPARED TO YEAR ENDED DECEMBER 31, 2004

SALES

We recorded sales of $4.6 million in 2005 compared to $4.2 million in 2004, an increase of 11%. The increase in sales in 2005 compared with 2004 was attributable to the increase from maintenance and other support services.

Product sales in 2005 were $3.7 million, essentially the same as in 2004. A decrease in sales of a product that is being phased out was offset by increased sales of other products including the TdMAX product.

Revenues from engineering, maintenance and other support services in 2005 were $925,000, an increase of 114% compared to 2004 support services revenues of $433,000. Support service revenues increased in 2005 compared with 2004 due to an increased for maintenance services by various then current customers, engineering services provided to a certain customer in for the first time in 2005 and maintenance services provided by VocalTec in December 2005.

COST OF SALES

Cost of sales in 2005 was $2.6 million, or 56% of sales (including an inventory write-off in the amount of $0.6 million and amortization of acquired intangibles in the amount of $0.2 million), compared with $1.8 million, or 44 % of sales (including the amortization of acquired intangibles in the amount of $0.2 million), in 2004. The increase in cost of sales in 2005 compared to 2004 resulted from a write-off of $0.6 million of obsolete inventories and a provision for warranty of $0.2 million representing the cost of fixing technical problems at customers' sites.

Cost of products was $1.5 million in 2005 compared with $1.6 million in 2004. Cost of services was $0.3 million in 2005 compared with $22,000 in 2004. The decrease in cost of products in 2005 compared to 2004 was due to a decrease in the cost of production resulting from sales of TdGate to certain customers that involved no costs of production, and from decreased sales of Tdsoft's TAS product. The reduction in the cost of production was off-set by a provision for warranty in the amount of $180,000. The increase in the cost of services in 2005 compared to 2004 was due primarily to cost incurred by us in connection with a turnkey engineering project that commenced in 2005.

Cost of sales of products primarily includes the cost of hardware in our products, reserves for products, royalties to third parties, and other expenses associated with the provisioning of products. Cost of services primarily consists of salaries and travel expenses for rendering maintenance, support and engineering services to customers.

In 2005 and 2004, cost of sales increased as a percentage of sales compared to 2003 due to increased competition in the market, resulting in lower prices for our products. In 2005, we wrote off obsolete inventory in the amount of $0.6 million. Excluding such write-off, cost of sales in 2005 remained materially the same as in 2004.

Amortization of acquired intangibles in 2005 was $0.2 million, or 4% of sales, compared to $0.2 million, or 5% of sales, in 2004. Amortization of acquired intangibles in 2004 included $188,000 from the Hunt product line acquired from

Cisco Systems during 2001 and $18,000 for the TAS product acquired through the acquisition of the assets of Be-Connected. Amortization of acquired intangibles in 2005 consisted of $94,000 (the remaining amortization amount of the Hunt product), $41,000 for the TAS product and $37,000 reflecting one month of amortization of the intangibles acquired in the business combination between Tdsoft and VocalTec.

In 2005, gross margins were 44%, including inventory write-off and amortization of acquired intangibles, or 62%, excluding inventory write-off and amortization of acquired intangibles, compared to 56%, including amortization of acquired intangibles, or 61%, excluding amortization of acquired intangibles, in 2004. Our gross margins increased slightly from 61% in 2004 to 62% in 2005.

OPERATING EXPENSES

RESEARCH AND DEVELOPMENT, NET

Research and development costs, net were $4.4 million in 2005, or 95% of sales, compared with $5.5 million, or 132% of sales, in 2004. Research and development costs, net in 2005 included a non recurring stock-based compensation amount of $522,000 which resulted from the amount of VocalTec shares issued to founders and employees of Tdsoft pursuant to the business combination being in excess of the pro rata holding percentage of such founders and employees of Tdsoft prior to the business combination. The decrease in research and development costs, net, both in absolute numbers and as a percentage of sales in 2005 compared to 2004, resulted from participation of the Chief Scientist and the BIRD (Bi-national Industrial Research and Development) foundation in our research and development expenses.

Our research and development expenses in 2005 were net of participation from the Chief Scientist and the BIRD foundation. In 2005, participation received or accrued from the Chief Scientist and the BIRD foundation was $1.3 million compared with $0 in 2004. All of these participations are related to royalty bearing programs. In 2005, we paid or accrued royalties to the Chief Scientist in an aggregate amount of approximately $63,000 compared with $67,000 in 2004. Our contingent liability to the BIRD foundation amounts to approximately $749,000.

SELLING AND MARKETING

In 2005, selling and marketing expenses were $2.8 million, or 60% of sales, compared with $1.9 million or 46% of sales in 2004. Selling and marketing expenses in 2005 included a non recurring stock-based compensation amount of $13,000 which resulted from the amount of VocalTec shares issued to founders and employees of Tdsoft pursuant to the business combination being in excess of the pro rata holding percentage of such founders and employees of Tdsoft prior to the business combination. The increase in selling and marketing expenses both in absolute numbers and as a percentage of sales in 2005 compared to 2004 resulted from an increase in salaries and benefits and in travel expenses, both related to an increase in personnel engaged in selling and marketing activities, and from the write-off of obsolete trial systems.

GENERAL AND ADMINISTRATIVE

General and administrative expenses in 2005 included a non recurring stock-based compensation amount of $268,000 which resulted from the amount of VocalTec shares issued to founders and employees of Tdsoft pursuant to the business

combination being in excess of the pro rata holding percentage of such founders and employees of Tdsoft prior to the business combination. General and administrative expenses were $1.7 million, or 38% of sales, in 2005, compared with $0.8 million, or 19% of sales, in 2004. The increase in general and administrative expenses both in absolute numbers and as a percentage of sales resulted primarily from the inclusion of VocalTec's general and administrative expenses during December 2005 and increases in provisions related to social benefits and outside legal, accounting and consulting fees.

OTHER INCOME (EXPENSE), NET

We had immaterial other income in 2005 and no other income in 2004.

FINANCIAL INCOME, NET

Financial income, net consists principally of interest income received in connection with our bank deposits held in the U.S. In 2005, financial income, net was $0.2 million, or 4% of sales, essentially the same as in 2004.

TAXES ON INCOME, TAX REFUNDS AND TAX BENEFITS

In 2005 Tdsoft and VocalTec had four and two Approved Enterprise programs under the Law for the Encouragement of Capital Investments, 1959, respectively.

As of December 31, 2005, we had net operating loss carryforwards in Israel of approximately $136 million ($99 million allocated to VocalTec and $37 million allocated to Tdsoft), and an aggregate net operating loss carryforwards in the U.S. of approximately $8.5 million. These net operating losses may be carried forward and offset against future taxable income under applicable tax laws. Tax benefits, which apply to us under Israeli law, do not apply to any income generated by any of our other subsidiaries. In 2005 we received a tax refund of one of our foreign subsidiaries in the amount of $19,000.

NET INCOME (LOSS)

Net loss in 2005 was $6.6 million, representing 144% of sales, compared with a net loss of $5.7 million, representing 137% of sales in 2004.

In 2005, the rate of inflation in Israel was 2.4% and the rate of depreciation of the NIS in relation to the dollar was 6.8%.

5B. LIQUIDITY AND CAPITAL RESOURCES

During the past three years, we covered our cash flow requirements from operating revenues , cash proceeds from the issuance of shares and warrants to investors, and grants from the Chief Scientist and the BIRD foundation.

As of December 31, 2006, we had approximately $9.0 million in cash, cash equivalents and bank deposits, comprised of $6.0 million in cash and cash equivalents and $3.0 million in bank deposits. As of December 31, 2005, we had approximately $5.1 million in cash and cash equivalents, which excluded $0.2 million in restricted cash.

As of December 31, 2006, we had working capital of approximately $8.2 million, compared with $0.9 million as of December 31, 2005. The net increase in working capital during 2006 resulted primarily from cash received from the issuance of shares to investors and a decrease in trade payables and other accrued expenses.

On November 27, 2006, we received and accepted orders from Israeli institutional investors for a private placement of 1,750,000 ordinary shares at a price of $4.3 per share. As part of the offering, the Company issued to the investors warrants exercisable during a period ending on June 30, 2011 into 1,312,500 additional ordinary shares and warrants for 87,500 additional ordinary shares as a finder's fee, at an exercise price per share of $5.5.

In May 2006, we consummated a private placement with various US investors, pursuant to which we issued to such investors an aggregate of 935,000 ordinary shares for an aggregate purchase price of $5.1 million, or $5.5 per ordinary share (our net proceeds were $4.7 million). We also issued to the investors warrants to purchase up to an aggregate of 374,000 ordinary shares and warrants for 50,050 additional ordinary shares as a finder's fee, at an exercise price of $7.9 per share. The warrants became exercisable on November 24, 2006 and will remain exercisable until May 24, 2011. During December 2006, we agreed to reduce the exercise price of the warrants issued in the foregoing private placement to $6.87 per share.

In July 2005, VocalTec received a loan in the amount of $1,000,000 from Deutsche Telekom, then a holder of approximately 15.3% of VocalTec's issued and outstanding obligation. The Company paid back the loan and all interest accrued thereon (at an annual rate of 7.05%) in July 2006.

Net cash used in operating activities was $7.4 million, $4.8 million and $4.5 million for the years ended December 31, 2006, 2005 and 2004, respectively. The principal use of cash in each of these years was to fund our operations.

Net cash provided by (used in) investing activities was $(2.5) million, $0.5 million and $(0.1) million for the years ended December 31, 2006, 2005 and 2004, respectively. Cash used for purchase of equipment was $0.3 million, $0.3 million and $0.2 million for 2006, 2005 and 2004, respectively. Proceeds from the sale of equipment were $26,000, $0.1 million and $0.2 million for 2006, 2005 and 2004, respectively. Cash provided by the business combination in 2005 was $0.7 million. Investment in short term deposit in 2006 was $3.0 million. Net cash generated by financing activities in 2006 from exercise of stock options by employees was $0.2 million. Net cash from issuance of shares in 2006 was $11.6 million.

We anticipate that operating expenses may exceed revenues, net of cost of sales in 2007 and possibly beyond if we do not sufficiently increase sales and reduce our costs. We believe that current cash and cash equivalents balances, cash flows from operations and grants from the Chief Scientist are sufficient to meet our anticipated cash needs for working capital and capital expenditures for at least the next 12 months.

If our revenues do not increase substantially, whether due to a failure to increase the market share for our products, evolving industry standards and rapid technological changes that could result in our products being no longer in demand, the reduction in our product prices, slower pace of expansion or voice over IP penetration, or our failure to retain our customers, we will need to reduce our operating expenses or use more of our cash reserves to fund operating

expenses. Similarly, in the event that the amounts we receive from research and development grants decline, we will need to reduce operating expenses or utilize more of our cash reserves for our operations. If such measures are insufficient, we may attempt to establish lines of credit or sell additional equity or debt securities.

Capital expenditures in 2006 were approximately $335,000, compared with $308,000 in 2005 and $189,000 in 2004.

We maintained annual car leases in the amount of approximately $470,000 in 2006, and our total liability for early termination of the leases is in the amount of up to approximately $48,000.

INVENTORY AND RECEIVABLES

Inventories as of December 31, 2006 were $1.1 million, compared to $1.0 million as of December 31, 2005.

Trade receivables are from purchases of our products, primarily by telecommunications System Integrators, Resellers and service providers. Trade receivables are presented at gross value less reserves for doubtful accounts of $120,000 and $50,000 as of December 31, 2006 and 2005, respectively. Trade receivables, net, as of December 31, 2006 were $1.4 million, compared to trade receivable, net of $0.6 million as of December 31, 2005. The increase in trade receivable, net resulted from an increase in sales.

Prepaid expenses and other receivables were $0.8 million as of December 31, 2006, compared with $1.4 million as of December 31, 2005. The decrease in 2006 was mainly due to the payment by the Chief Scientist of the receivable outstanding as of December 31, 2005, partially offset by a receivable relating to a new plan approved by the Chief Scientist for 2006.

5C. RESEARCH AND DEVELOPMENT, PATENTS AND LICENSES

INTELLECTUAL PROPERTY

We believe that the improvement of existing products, our technologies and the development of new products are important in establishing and maintaining a competitive advantage. We believe that the value of our products is dependent, to a certain extent, upon the maintenance of patent, trade secret or copyright protection of our proprietary software and technologies. We rely on a combination of trade secrets, copyright, trademark and patent law, together with non-disclosure and invention assignment agreements, to establish and protect the technology used in our products.

We have filed numerous patent applications in the United States and other countries with respect to certain technologies employed in our products. Some of those applications have already registered and we own those registered patents. In addition, we have filed trademark applications in the United States and other countries with respect to trademarks associated with us, and our products. Some of those applications have already been registered and we own those registered trademarks.

Generally, we enter into non-disclosure and invention assignment agreements with our employees, and into non-disclosure agreements with our consultants, subcontractors and distributors and channel partners. However, there can be no assurance that such measures will protect our proprietary technology, that

competitors will not develop products with features based upon, or otherwise similar to, our products or that we will be able to enjoin competitors from selling similar products.

Although we do not believe that our products infringe on any valid claim of a patent owned by any third party, third parties have asserted infringement and other claims against us from time to time. These claims have been directed at certain basic and fundamental components of our products, those of which were not abandoned were resolved by successfully implementing a licensing agreement. There can be no assurance that third parties will not assert such claims against us in the future or that such claims will not be successful.

We could incur substantial costs and diversion of management resources with respect to the defense of any claims relating to proprietary rights that could have a material adverse effect on our business, financial condition or results of operations. If any such claims or actions are asserted or prosecuted against us, we may seek to obtain a license under a third party's intellectual property rights. There can be no assurance, however, that under such circumstances a license would be available on reasonable terms or at all. In the event a party that is successful in asserting a claim against us does not grant a license, such party could secure a judgment resulting in the award of damages, as well as injunctive or other equitable relief which could effectively block us from manufacturing, using, selling, or otherwise distributing its products.

VocalTec, Essentra, Internet Phone Surf&Call, TdSOFT, TdGATE and TdVIEW are trademarks or registered trademarks of VocalTec and its fully owned subsidiaries. All other trademarks or registered trademarks used in this Annual Report are the property of their respective owners.

RESEARCH AND DEVELOPMENT

We believe that our ability to enhance our current products, develop and introduce new products on a timely basis, maintain technological competitiveness and meet customer requirements is essential to our future success. Accordingly, we devote and intend to continue to devote a significant portion of our personnel and financial resources to research and development. We also intend to continue seeking and maintaining close relationships with our customers in order to remain responsive to their needs. We have an educated and experienced research and development team that specializes in telecommunications and networking, computer and networking software, server and embedded software, hardware integration and communications protocols and drivers. We seek to employ highly qualified technical personnel in order to maintain and expand our technological expertise.

The Company may engage in the future in joint research and development projects with third parties. The ownership of any intellectual or other proprietary property developed in such projects shall be negotiated between the Company and the relevant third party. During 2005, Tdsoft and Nuera commenced developing, as part of a joint project, certain hardware and software of a VoIP gateway platform. Following completion of the project, each of Tdsoft and Nuera could add its application software on top of the platform, to further develop it into a generally available product, targeting various gateway applications. Both companies have full ownership rights with respect to the platform, including intellectual property, manufacturing and marketing rights.

In connection with that project, Tdsoft has been engaged by Nuera to develop certain application software that will integrate with the platform. The

intellectual property rights of this application software shall be owned solely by Nuera. That project was terminated in mid 2006 after the acquisition of Nuera by AudioCodes.

See "Item 5 - Operating and Financial Review and Prospects - Operating Results - Research and development costs, net".

5D. TREND INFORMATION

We believe that our business is subject to the following trends:

TRENDS IN THE COMMUNICATIONS INDUSTRY

Service providers worldwide are facing an increasing array of challenges given the ongoing regulatory changes and technological advances in the communications industry. Global deregulation is promoting competition to incumbent service providers from both new entrants and operators in adjacent industries, such as wireless, satellite, Internet and cable television service providers. At the same time, end user demands are rapidly evolving. While in the past, communications traffic consisted primarily of traditional voice communications and basic data traffic, such as email and facsimiles, in recent years , with the wide acceptance of the Internet and broadband infrastructure, end users are increasingly seeking fast, personalized, content-rich, easy-to-use communications and are relying on these applications in both their professional and personal lives. Accordingly, this trend is increasing demand for high-speed access services, including voice, video, data and wireless.

The combination of competitive pressures and end user demands is placing pressure on service providers to add new services to their existing offerings quickly, with the flexibility to continue to add functionality and to scale as needed. Many new and incumbent service providers presently offer a bundle of voice, video and data services to end users, often referred to as "triple-play, or "multi-play"." For example, these services may include both traditional and enhanced voice services, broadcast television and on-demand video, and high-speed Internet access delivered over a converged broadband connection to the home or office. Operators also are increasingly adding wireless to the triple-play bundle, referred to as "quad-play," which has contributed to consolidation in the service provider market. The bundling of services enables service providers to generate new sources of revenue and enhance customer relationships.

The initial capital costs and ongoing operating expense associated with the deployment of new services are considerable. Many service providers have significant investments in their existing network infrastructures, which may consist of disparate media, such as copper, coaxial and fiber, as well as numerous protocol families based on Internet Protocol, or IP, Asynchronous Transfer Mode, or ATM, and Time Division Multiplexing, or TDM. Service providers generally seek to maximize their return on investment by leveraging existing infrastructure to offer new services. This has increased the demand both for upgrades to existing equipment and for cost-effective new equipment that supports disparate media and numerous protocol families.

INVESTMENT MADE BOTH IN THE CORE AND IN THE ACCESS NETWORK: As voice, video and data traffic travels over communications network infrastructure, it typically passes through the core and access networks before arriving at the customer premise, or destination. The growing demand for Internet bandwidth over the last decade prompted service providers to make significant capacity investments in

the core network, which is the part of the network that is responsible for transporting large volumes of traffic between and within cities. Service providers have also made significant investments in upgrading the core network to a mostly IP-based infrastructure to more efficiently manage the increased data traffic.

The access network is located between the core network and the customer premise and is integral to the aggregation and distribution of network services and to the creation of new services. Service providers have begun to spend a greater proportion of their capital budgets on the development of their access networks to enable deployment of new services with ever-increasing bandwidth requirements, such as video or bundled services. To complement the investments previously made in the core network and to combine voice, video and data over a common network, service providers are increasingly seeking to upgrade access networks to emerging IP standards. Increasingly, the use of IP as a transport technology to combine voice, video and data over a common network is emerging as the principal network architecture for service providers. The access networks, better known as the "last mile", have been the most significant factor in the limitation of competition in the local telephony exchange business. In an effort to overcome this barrier, incumbent carriers were forced by law to agree to rent unbundled network elements to competitive carriers. This had a limited success in opening up the local telecom market for competition. Wireless technologies provided an alternative low cost method of offering last mile services. The demand for broadband connectivity to the Internet and the cable competition led incumbent local exchange carriers to offer broadband over copper to the residential market. This was offered using ADSL technology. The fast deployment of ADSL opened up an opportunity for alternative carriers to offer voice over this broadband connection, bypassing the need for any permission from the provider of the ADSL service. This is a very significant factor in the ability to offer Essentra BAX as a service delivery platform, for providing Class 5 Voice over Broadband (VoBB) services. Various market research firms estimate that in 2010 approximately 20% of all wire line telephone lines will implement Voice over Broadband (VoBB) technology.

CONVERGENCE OF VOICE AND DATA: The maturing VoIP technology and the advantages of an IP network, not is leading to the convergence of the two - data and voice networks - and the offering of a mix of data and voice services over a single packet based IP network. This trend is expected to change telephony network deployment and operation by removing all territorial/localized networks and the localization aspect of the telephone number and possibly even replacing traditional telephone numbers with an alternative personal ID. Converged networks will reduce (according to various estimates - by 60%) the cost of deployment of telephony switching equipment. Converged networks will also reduce the cost of operation as the same packet-based network will serve voice and data. Soft-switch technology is at the heart of this evolution. The soft-switch will not only replace the legacy TDM switch, but it will no longer be an integral part of each and every neighborhood. Fewer high capacity soft switches will serve larger populations. The physical location of the soft switch will not be related to the subscribers that it will serve. Massive efforts and large projects are planned by most telephony service providers, which will result in over 390 million telephony lines connected to soft switches by 2010 (according to a 2006 Frost & Sullivan report). Essentra product family aims at this market, which is expected to grow by an annual average of 33% in the coming years.

WIRE LINE AND MOBILE CONVERGENCE: A new network architecture has been defined by the Internet Multimedia Subsystem (IMS), a mobile standards committee. This will be the network architecture for the mobile third generation migration to

packetized voice. The unique abilities of IMS to offer fast implementations of new services and the comfortable handling of access networks led the industry to consider the adoption of IMS for the wire line business, especially for VoIP technology to be used as an access network. In few years, we expect to start experiencing IMS offering Fixed-Mobile Convergence (FMC), where the same handset will be used in both networks and offer identical services to the consumer. This will be the final step in convergence of all multimedia fixed and mobile networks, offering a single service platform to all terminals, being either a computer, a PDA, a wire line phone or a mobile phone. Essentra architecture has followed the guidelines of IMS, and more adjustments will be needed as implementation of IMS commences.

INCREASING NEED FOR VOIP INTERCONNECTION: With the dramatic rise in Broadband infrastructure and access throughout the world, service providers and end user demand for VoIP is growing rapidly. Established global telecommunications service providers such as British Telecom, AT&T and KDDI are joining new entrants such as Skype and Vonage, as well as cable operators such as Comcast and Cablevision in offering IP telephony services. Currently, there are over 1,600 VoIP providers operating throughout the world. Some offer stand-alone telephony service, while others bundle VoIP with Internet access and video service for a full triple play suite.

With this tremendous growth come a variety of challenges for carriers and service providers as they either build out their networks or migrate from legacy TDM technology to an IP-based infrastructure.

Traditional fixed-line service providers are not the only ones migrating to IP, several leading mobile operators have announced plans to convert to an IP-based infrastructure in the coming years. The growing implementation of IP communications, coupled with the emerging fixed-mobile convergence over IP and the migration from TDM to ATM and IP-based networks, are driving the need for more sophisticated infrastructure solutions that can facilitate smooth deployments and transitions.

Unlike traditional telephony service, there is no single global standard for VoIP. As such, VoIP implementations are based on a variety of different standards, making VoIP networks essentially a growing number of islands.

In order to ensure a successful VoIP roll out and generate steady revenues for providers, these islands need to be connected to one another in a manner that is secure, reliable and seamless. While traditional architecture was once an effective way in which to connect multiple islands, it is becoming increasingly necessary for carriers to rely on IP-based solutions for VoIP interconnection.

HOSTED SERVICES FOR ENTERPRISES: Carriers have never succeeded to offer more than basic services to enterprises. The basic services included E1/T1 trunking with PRI, or Primary Rate Interface (an ISDN link between customer premises, usually a PBX, and the Class 5 switch) and DID, or Direct Inward Dialing (which allows to call a person's office telephone extension from an outside telephone service). Centrex services have been offered by carriers, mainly in the US, since the early 1980's, but it never became a significant business. Soft switch technology combined with application servers offering a rich PBX-type set of features and the trends of outsourcing such services as IT lead to the reevaluation of the potential of the new Centrex services. The availability of web based self service encourages carriers to offer Centrex as a competing service to IPPBX solutions. IP technology adds the ability to combine Centrex with VPN to interconnect multiple corporate offices which may be given the feel

and look of one office. Considering this, Essentra is offering rich Centrex features combined with VPN capability and corporate level provisioning tools. The expected size of the Centrex market is currently unclear, but the feature set is becoming a must in every sale of a soft switch.

CONSOLIDATION: In recent years, we have witnessed a consolidation in our industry. Large service providers are acquiring other service providers, and large equipment vendors are acquiring smaller vendors, in order to leverage the benefits of synergies, size and to provide their customers with a complete solution. The new VocalTec is the result of a merger with Tdsoft. We expect such trend to continue in the near future.

OTHER TRENDS: In addition to the foregoing, we have identified the following trends:

(i) VoIP networks have emerged in many business segments, in both the carrier and the enterprise market. Due to reasons such as security, protocol variance and other reasons, these networks are still not linked to each other using native IP. This has created an opportunity, which the Company is planning to leverage using the Essentra EX Peering Manager and derivatives of that product, to provide products that meet the need to connect these islands;

(ii) Adoption of a standard called IMS (IP Multimedia Subsystem) by a majority of carriers and vendors, including mobile and fixed carriers and networks, resulting in a new definition of telecom infrastructure, focusing on IP multimedia service implementation. To address this trend, the Company's strategy is in alignment with the functional description described in the standard;

(iii) Conveyance between fixed and mobile networks, both on the infrastructure and the service and business aspects, with respect to which the Company offers a vertical solution providing some of the elements in an FMC (fixed mobile conveyance)-type implementation. This trend is characterized by the unification of infrastructures (including unification at the infrastructure and service layers);

(iv) The recent transition of existing and newly formed service providers towards packet-based networks, creating a variety of network islands, has resulted in IP peering among the islands (which traditionally were connected through PSTNs), due in part to the fact that being connected using IP is more cost-effective than being connected through PSTNs;

(v) Distribution of soft switch functions towards the border (the gateway) and the application services layer (which enables the application service vendors to function as a soft switch), the Company can now transfer a portion of the intelligence from the BAX product to the border (the gateway);

(v) Entry of large Chinese vendors into the VoIP market, resulting in a dramatic reduction in the prices of commodity-based products. To overcome this difficulty, the Company is focusing on the development of a product that is less commoditized; and has a higher barrier of entry.

5E. OFF-BALANCE SHEET ARRANGEMENTS

There are no off-balance sheet arrangements that have or are reasonably likely to have a current or future material effect on the company's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources.

5F. TABULAR DISCLOSURE OF CONTRACTUAL OBLIGATIONS

Contractual Obligations	Payment Due by Period (in thousands of dollars)				
	Total	Less than 1 Year	1-3 Years	3-5 years	More than 5 Years
Contractual obligations					
Short term debt obligations	-	-	-	-	-
Operating Lease Obligations	1,468	415	936	117	-
Other Long Term Liabilities Reflected on the Registrant's Balance Sheet under U.S. GAAP	1,938*	217	-	-	1,721
Total	3,406	632	936	117	1,721

* As of December 31, 2006 we had 1,277 in severance pay funds to cover such liabilities.

ITEM 6. DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES

6.A. DIRECTORS AND SENIOR MANAGEMENT

The following sets forth certain information regarding our directors and executive officers:

NAME	POSITION
Joseph Albagli (1)	Director, President and Chief Executive Officer
Ilan Rosen (1)	Chairman of the Board of Directors
Robert Wadsworth	Director
Joseph Atsmon (1)(2)	Director
Michal Even-Chen (2)	External Director
Lior Bregman	Director
Yoseph Dauber (1)(2)	External Director
Eli Gendler	Chief Financial Officer

Set forth below is a biographical summary of the business experience of each of the Directors and executive officers named above:

JOSEPH ALBAGLI was appointed as a director and as the Company's President and Chief Executive Officer in November 2005 (following and pursuant to the business combination). Mr. Albagli is a co-founder of Tdsoft and has served as its President, Chief Executive Officer and as a director since Tdsoft was founded in 1994. Mr. Albagli has over two decades of technical and management experience gained prior to founding Tdsoft at Tadiran Telecommunications, the Israeli Aircraft Industries and the Israel Defense Forces. He received a diploma in Practical Electronics Engineering from Bosmat, Haifa in 1972, a B.Sc. (cum

laude) in Civil Engineering from the Technion - Israel Institute of Technology in 1980, and a diploma in Computer Science from the Tel Aviv University in 1989.

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(1) Member of the Compensation Committee

(2) Member of the Audit Committee

ILAN ROSEN was appointed as Chairman of the Board of Directors in November 2005 (following and pursuant to the business combination). He has been a member of the board of directors of Tdsoft since 1997, and has served as Chairman of Tdsoft's board of directors since 1997. Mr. Rosen has served as a special advisor to HarbourVest Partners LLC since March 2003 and is an observer on the board of directors of Telrad Networks Ltd. and PacketLight Networks Ltd. Between 1989 and 1993, Mr. Rosen served on various boards of directors as a Business Manager at Polar Investments Ltd., an investment company of Bank Hapoalim Ltd. From 1993 to 1996, he served as President of Adsha Development & Investments Ltd., an Israeli investment company that was listed on the Tel Aviv Stock Exchange, and in that capacity served on various boards of directors. From November 1996 through January 2004, Mr. Rosen served as Vice President of Teledata Networks (formerly ADC Telecommunications, Israel and prior thereto Teledata Communications Ltd.) and in that capacity, in addition to serving as a board member of Tdsoft, Mr. Rosen served on the board of directors of each of G-Connect Ltd., VManage Ltd., Mind CTI Ltd. and various other companies. In early 2000, ADC Telecommunications Inc. launched a project in the name of ADC Ventures, and Mr. Rosen served as the Managing Director of this project in Israel. Mr. Rosen received a B.Sc. (cum laude) in mechanical engineering from Tel Aviv University in 1979, and an M.B.A. from Tel Aviv University in 1986.

ROBERT M. WADSWORTH was appointed as a director in November 2005 (following and pursuant to the business combination). He is Managing Director of HarbourVest Partners, LLC. Mr. Wadsworth oversees many of HarbourVest's investment activities in both the industrial and information technology sectors. He is currently a director of Network Engines, Inc. and Trintech Group PLC, which are both public companies. He is also a director of Akibia, AWS Convergence (Weatherbug), Kinaxis, Loxam and several other U.S. and non-U.S. private companies. His prior experience includes management consulting with Booz, Allen & Hamilton, where he specialized in the areas of operations strategy and manufacturing productivity. Mr. Wadsworth received a B.S. (magna cum laude) in Systems Engineering and Computer Science from the University of Virginia in 1982 and an MBA (with distinction) from Harvard Business School in 1986.

JOSEPH ATSMON was appointed as a director in November 2005 (following and pursuant to the business combination). He currently serves as Vice-Chairman of the board of directors of NICE Systems Ltd. and as a director of Ceragon Networks and Radvision Ltd. From 1995 until 2000, Mr. Atsmon served as Chief Executive Officer of Teledata Communications Ltd., a public company acquired by ADC Telecommunications Inc. in 1998. Prior thereto, Mr. Atsmon had a twenty-year career with Tadiran Ltd. In his last role at Tadiran Ltd., Mr. Atsmon served as Corporate VP - Business Development. Prior thereto, he served as president of various military communications divisions. Mr. Atsmon received a B.Sc. in Electrical Engineering, suma cum laude, from the Technion, Israel Institute of Technology in 1975.

MICHAL EVEN-CHEN has served as a director since November 2004. Until the end of 2003, she served as Vice President - Business Development of Bezeq Ltd., Israel's national telecommunications company, and was also the driving force and executor on Bezeq's part of the creation of the venture capital fund Stage-One. Subsequently, Ms. Even-Chen served for two years as Chairwoman of the fund's Investment Committee. She also represented Bezeq on the Investment Committee of Eurofund, a fund managed by Federman Enterprises. Prior to her positions at Bezeq, Ms. Even-Chen was Vice President of Marketing for 012 Golden Lines, a telecom and Internet provider. Ms. Even-Chen previously held the position of Head of Strategy Department at Bezeq Ltd., and prior thereto worked in the Budget Department of the Ministry of Finance of the State of Israel, supervising Water and Sewage divisions. Ms. Even-Chen qualifies as an External Director under the Companies Law. Ms. Even-Chen holds a BA in economics and international relations from the Hebrew University of Jerusalem.

LIOR BREGMAN served from 1988 to 2001 as a Managing Director with CIBC/Oppenheimer. Mr. Bregman was involved in the development of CIBC/Oppenheimer's high technology effort, with responsibility for its telecommunication equipment research effort in general, and the wireless communication area in particular, as well as its research on defense and Israeli companies. Until 2001, Mr. Bregman was also a partner in Genesis I, an Israeli-based venture capital fund, and also served on the investment committee of Genesis II. Prior to joining CIBC/Oppenheimer, Mr. Bregman served as a research analyst at Hambrecht & Quist. Mr. Bregman is currently a director of ViryaNet Ltd. Mr. Bregman holds a BA from the Hebrew University of Jerusalem and an MBA from Stanford University.

YOSEPH DAUBER has served as a director of NICE Systems Ltd. since April 2002. Mr. Dauber has served in various senior positions at Bank Hapoalim since 1973. Until June 2002, he was Deputy Chairman of the Board of Management and joint Managing Director of Bank Hapoalim and was responsible for the commercial division of the bank. Between 1994 and 1996 and until June 2002, Mr. Dauber served as Chairman of Poalim American Express and of the Isracard Group. From 2002 to 2003, he served as Chairman of the Israel Maritime Bank Ltd. He currently serves as a director of Bank Hapoalim. He also serves as a director of Clal Insurance Holding Ltd., Vita Pri Galil Ltd., Lodzia Rotex Ltd., Afcon Industries Ltd. and Orbit Alchut Technologies Ltd. Mr. Dauber holds a Bachelor's degree in Economics and Statistics from the Hebrew University in Jerusalem and a Masters degree in Law from Bar Ilan University. Mr. Dauber qualifies as an External Director under the Companies Law.

ELI GENDLER joined VocalTec in June 2006. Prior to joining VocalTec, Mr. Gendler held a number of key positions, including Chief Financial Officer at each of (i) Zone IP Ltd. (formerly Ki-Bi Mobile Technologies Ltd.), currently engaged in the development of Video Over IP products listed on the AIM in London, (ii) Cimatron Ltd., a developer of software tools listed on NASDAQ, and (iii) IFN, Israel File Net, listed on the Tel-Aviv Stock Exchange. Mr. Gendler holds a B.A. in Accounting and Economics from the Tel-Aviv University and a Masters degree in Law from Bar-Ilan University.

6.B. COMPENSATION OF DIRECTORS AND EXECUTIVE OFFICERS

The aggregate compensation paid to VocalTec's directors and executive officers as a group during the fiscal year ended December 31, 2006 was approximately

$0.75 million in salaries, directors' fees and bonuses (including bonuses in the aggregate amount of $65,000 for 2005). No additional amounts were set aside or accrued by the Company or its subsidiaries in 2006 to provide pension retirement or similar benefits to the directors and executive officers.

During the fiscal year ended December 31, 2006, 15,385 options were granted to each of Lior Bregman and Yoseph Dauber, at an exercise price per share of $5.93.

6.C. BOARD PRACTICES

The period during which our directors and senior management have each served in their respective offices is set forth in "Item 6 - Directors, Senior Management and Employees - Directors and Senior Management". There is no date of expiration of the current term of office of any of the senior management members. The expiration date of the terms of office of our directors are as follows: (a) Ilan Rosen and Joseph Atsmon - at the annual shareholders meeting in 2008 (at which time each of them may be re-appointed as a director); (b) Michal Even-Chen, who was elected as an external director in November 2004, will serve in such position for three years and may then be appointed for an additional three-year term as an external director; (c) Joseph Albagli and Robert Wadsworth - at the annual shareholders meeting to be held in 2009 (at which time each of them may be re-appointed as a director); (d) Yoseph Dauber, who was elected as an external director in August 2006, will serve in such position for three years and may then be appointed for an additional three-year term as an external director; and (e) Lior Bregman at the annual shareholders meeting to be held in 2007 (at which time he may be re-appointed as a director).

There are no service contracts between us or any of our subsidiaries and our directors in their capacity as directors providing for benefits upon termination of employment, except for the termination provisions included in the employment agreement of Joseph Albagli, our President and Chief Executive Officer, which provide for: (i) the vesting acceleration with respect to a portion of the options granted to him and (ii) his entitlement, in addition to payment received during the 90-day notice period, to severance pay and to an amount equal to his then Basic Salary (as such term is defined in his employment agreement) and the benefits payable to him under the employment agreement, multiplied by six. In addition, Mr. Albagli may exercise his options to purchase shares of the Company during the eighteen-month period following termination of his employment.

In November 2005, we entered into new indemnification agreements with our directors at such time, in which the Company undertook to indemnify the directors for the matters and in the circumstances described in such indemnification agreements, in an aggregate amount of up to $4 million, provided that if such amount is insufficient to cover all amounts to which such persons are entitled pursuant to such undertaking of the Company, such amount shall be allocated among the indemnified persons pro rata to the amounts to which they are so entitled. During 2007, we entered into similar indemnification agreements with Messrs. Yoseph Dauber and Lior Bregman, who were elected as directors in August 2006, which agreements are subject to approval of our shareholders. All the indemnification agreements provide protection against personal liability due to an act performed or failure to act in the capacity as a director or officer.

Under the Companies Law, the board of directors of any publicly traded company must also appoint an audit committee, comprised of at least three directors, including all of the external directors, but excluding:

- the chairman of the board of directors;

- any controlling shareholder or a relative of a controlling shareholder; and

- any director employed by the Company or who provides services to the Company on a regular basis.

Our audit committee is comprised of Joseph Atsmon, Yoseph Dauber and Michal Even-Chen. We believe that Mr. Atsmon and Mr. Dauber qualify as audit committee financial experts (as such term is defined under the US Securities Exchange Act of 1934 (the "Exchange Act")), and that all three directors qualify as independent directors (as such term is defined under the Nasdaq rules). The purpose of the audit committee is to provide assistance to the Board of Directors in fulfilling its legal and fiduciary obligations with respect to matters involving the accounting, auditing, financial reporting and internal control functions of VocalTec and its subsidiaries as well as complying with the legal requirements under Israeli law and the Sarbanes-Oxley Act of 2002. The following are examples of functions within the authority of the audit committee:

- To detect irregularities in the management of our business and our internal controls procedures through, among other things, consultation with our internal and external auditors and to suggest to the Board of Directors methods to correct those irregularities.

- To decide whether to approve acts or transactions involving directors, executive officers, controlling shareholders and third parties in which directors, executive officers or controlling shareholders have an interest.

- To assist our Board of Directors in performing its duties to oversee our accounting and financial policies, internal controls, and financial reporting practices and to communicate on a regular basis with the company's outside auditors and review their operation and remuneration.

- To maintain and facilitate communication between our Board of Directors and our financial management and auditors.

In addition, the approval of the audit committee is required to effect specified actions and transactions with office holders, controlling shareholders and third parties in which an office holder or controlling shareholder has a personal interest (as such term is interpreted under Israeli law).

An audit committee may not approve an action or a transaction with an office holder or a controlling shareholder or an entity in which either of them has a personal interest unless at the time of approval the two external directors are serving as members of the audit committee and at least one of the external directors is present at the meeting in which an approval is granted.

Our audit committee convenes at least once per quarter to review the Company's quarterly financial results, and as necessary to resolve issues that are in the scope of responsibility of the committee.

Our compensation committee is comprised of Joseph Albagli, Yoseph Dauber, Joseph Atsmon and Ilan Rosen, and meets several times per year regarding option grants and general compensation issues relating to our employees.

6.D. EMPLOYEES

As of December 31, 2006, we employed 72 full time employees and 3 part-time employees, of which 39 were employed in research and development, 21 were employed in sales and marketing, 11 were employed in general and administrative, and 4 were employed in operations. Of these employees, 73 were based in our facilities in Israel, 1 in Singapore and 1 in Europe.

We believe that our relations with our employees are good. Neither our employees nor we are parties to any collective bargaining agreements, except for provisions of such agreements that are applicable to the industry in which the Company is engaged by virtue of extension orders issued under applicable Israeli laws.

6.E. SHARE OWNERSHIP

As of June 20, 2007, each of the individuals listed in "Item 6 - Directors, Senior Management and Employees - Directors and Senior Management" (other than Mr. Joseph Albagli) beneficially owned less than 1% of our ordinary shares, and each such person's individual share ownership has not been previously disclosed to shareholders or otherwise made public.

In the past, each of VocalTec and Tdsoft had adopted various plans for the grant of options to their employees, directors and consultants. In August 2005, the board of directors of VocalTec resolved to transfer to the 2003 Master Stock Option Plan all of the shares then available for grants of options under the other VocalTec option plans. Pursuant to the business combination, the number of shares underlying the 2003 Master Stock Option Plan was increased by 576,923 shares and the Company adopted each of Tdsoft's option plans, such that all outstanding options granted under the various Tdsoft option plans to purchase ordinary shares of Tdsoft were assumed by VocalTec, except that the Tdsoft ordinary shares underlying such options were replaced by VocalTec's ordinary shares in amounts and for exercise prices in accordance with a conversion ratio set forth in the agreement for the business combination (and which options continued to be subject, except as set forth herein, to the terms of the Tdsoft option plans under which they were granted).

Following consummation of the business combination, the Company's board of directors resolved (i) to effect certain amendments to the 2003 Master Stock Option Plan and (ii) that options granted under older stock option plans shall revert to the amended 2003 Master Stock Option Plan upon the expiration or cancellation of such option.

On February 15, 2006, we filed with the U.S. Securities and Exchange Commission a registration statement on Form S-8, pursuant to which we registered for resale all of the shares underlying our amended 2003 Master Stock Option Plan that had not been registered previously. As of the date hereof, the Company has registered for resale an aggregate of 1,038,461 (reflecting the 1-for-13 reverse split effected on November 25, 2005) ordinary shares that have been or may in the future be granted under the Company's option plans. Options generally have a term of seven (7) years. However, options granted prior to December 13, 2005 have a term of ten (10) years. Earlier termination may occur if the employee's employment with us is terminated or if certain corporate changes or transactions occur. Our Board of Directors determines the grant and the exercise price at the time the options are granted upon recommendation of the Compensation Committee.

The Company's shareholders approved at the extraordinary general meeting of

shareholders held on April 11, 2007, an annual increase of the number of ordinary shares underlying the Company's 2003 Amended Master Stock Option Plan by such number of ordinary shares that shall equal 3% of the issued and outstanding share capital of the Company, on a fully diluted basis, at the time of the relevant increase, starting in 2008 (each such increase to be effected immediately following the annual general meeting of the Company's shareholders in the relevant year). Such 3% increase, will replace, commencing in 2008, the annual increase of 180,000 shares that was approved by the Company's shareholders at the annual general meeting held on August 21, 2006 (which is in effect for 2007).

The exercise price per share is determined by the Board, or the Compensation Committee, and is usually granted at the approximate fair market value of the shares on the date of grant, as determined by the closing price of our ordinary shares as reported by Nasdaq on the business day prior to the date of grant.

Each stock option agreement specifies the date and period over which the option becomes exercisable. Options granted by us to employees generally vest over a period of four years, either in equal quarterly installments of 6.25% of the option shares, starting three months after the date of grant, or 25% of the option shares are vested one year following option grant, and the remaining 75% vest in equal quarterly installments of 6.25% over the remaining three years. Vesting of options granted to employees is conditional upon the grantee remaining continuously employed by VocalTec or its subsidiaries.

ITEM 7. MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS

7.A. MAJOR SHAREHOLDERS

The following table sets forth, as of June 20, 2007, the number of our ordinary shares, which constitute our only voting securities, beneficially owned by (i) all shareholders known to us to own more than five percent (5%) of our outstanding ordinary shares, and (ii) all of our directors and executive officers as a group.

	ORDINARY SHARES BE
NAME AND ADDRESS	NUMBER
Cisco Systems International BV (1)	1,673,549
HarbourVest International Private Equity Partners III - Direct Fund L.P. (1) (2)	1,218,444
Various entities affiliated with LibertyView Capital (3).	990,899
Various entities affiliated with Apex (4)	630,000
Various entities affiliated with Excellence Nessuah (5)	420,000
The Israeli Aircraft Industries Workers' Provident Fund (5)	420,000
Provident Funds of the First International Bank of Israel Ltd. (5)	412,917
Officers and directors as a group (8 persons) (6)	422,274

(1) These shareholders are parties to a shareholders agreement dated December 7, 2005, to which certain other shareholders of the Company are parties, and pursuant to which the parties to such agreement have agreed to vote their Company shares for the voting of certain persons as directors of the Company. As a result, the shareholders that are parties to such agreement

may be deemed to constitute a "group" pursuant to Rule 13d-5 of the Exchange Act. Each of these shareholders disclaims any beneficial ownership of the Company shares held by the other shareholder party to such agreement.

(2) Includes 88,000 ordinary shares underlying outstanding warrants that are currently exercisable.

(3) Includes 240,000 ordinary shares underlying outstanding warrants that are currently exercisable.

(4) Includes 270,000 ordinary shares underlying outstanding warrants that are currently exercisable.

(5) Includes 180,000 ordinary shares underlying outstanding warrants that are currently exercisable.

(6) Includes 137,078 ordinary shares for which options or warrants granted to officers and directors of the Company are exercisable within 60 days of the date hereof.

Our major shareholders do not have different voting rights from each other or from other shareholders.

To our knowledge, (A) we are not directly or indirectly owned or controlled (i) by another corporation or (ii) by any foreign government or (iii) by any other natural or legal persons and (B) there are no arrangements, the operation of which may at a subsequent date result in a change in control of VocalTec.

For information as to the portion of each class of securities held in the United States and the number of record holders see "Item 9 - The Offer and Listing".

7.B. RELATED PARTY TRANSACTIONS

None.

7.C. INTERESTS OF EXPERTS AND COUNSEL

Not applicable.

ITEM 8. FINANCIAL INFORMATION

8.A. CONSOLIDATED STATEMENTS AND OTHER FINANCIAL INFORMATION

Our consolidated financial statements are set forth in Item 18 of this document.

EXPORT SALES

Export sales of VocalTec in 2006 were $8 million or 94% of sales compared with export sales in 2005 which were $3.8 million or almost 100% of sales, and with $5.5 million or 100% of sales in 2004.

LEGAL PROCEEDINGS

From time to time, we are involved in various routine legal proceedings incidental to the ordinary course of our business. We do not believe that the outcome of these pending legal proceedings will have a material adverse effect

on our business or consolidated financial condition.

DIVIDENDS

We have never declared or paid cash dividends on the ordinary shares. We intend to retain our earnings for future growth and therefore do not anticipate paying any cash dividends in the foreseeable future.

8.B. SIGNIFICANT CHANGES

Except as disclosed elsewhere in this annual report, there have been no other significant changes since December 31, 2006.

ITEM 9. THE OFFER AND LISTING

9.A. OFFER AND LISTING DETAILS

Through June 20, 2007, for the periods indicated, the high and low reported trading prices of our ordinary shares as reported by Nasdaq were as follows:

	HIGH	LOW
2002	3.02	0.26
2003	7.60	0.47
2004	6.90	1.06
2005 (1)	24.7	3.45
2006	10.40	3.00
2004		
First quarter	6.90	3.19
Second quarter	4.20	1.90
Third quarter	2.27	1.07
Fourth quarter	1.77	1.06
2005		
First Quarter	1.90	1.06
Second Quarter	1.33	0.64
Third Quarter	0.95	0.50
Fourth Quarter(1)	14.75	3.11
2006		
First Quarter	10.40	7.01
Second Quarter	5.69	4.01
Third Quarter	4.05	3.00
Fourth Quarter	4.89	3.85
2007		
First Quarter	4.09	3.10
MOST RECENT SIX MONTHS		
December 2006	4.89	3.85
January 2007	4.30	3.03
February 2007	3.71	3.10
March 2007	4.00	3.10
April 2007	3.36	3.05
May 2007	3.68	2.66

Closing price on the first trading day of:

December 2006 - $4.50
January 2007 - $4.09
February 2007 - 3.23
March 2007 - $3.25
April 2007 - $3.23
May 2007 - $3.05

As of May 31, 2007, 7,376,364 of our ordinary shares were issued and outstanding. At such date, the last reported sale price of the ordinary shares was $3.05 per share, and the ordinary shares were held by 77 record holders. Of those 77 record holders, 65 are shown on our records as having United States addresses. We believe that as of May 31, 2007 approximately 91% of our outstanding ordinary shares were held in the United States.

9.B. PLAN OF DISTRIBUTION

Not applicable.

9.C. MARKETS

Our ordinary shares were initially quoted on the Nasdaq National Stock Market on February 7, 1996 under the symbol "VOCLF," which was changed to "VOCL" on April 20, 1999. Our ordinary shares were quoted on the Nasdaq Stock Market from October 17, 2000 until December 2002, under the symbol "VOCL". In December 2002, we transferred to the Nasdaq Capital Market (formerly: Nasdaq SmallCap), in July 2003 we transferred back to the Nasdaq National Market and in April 2005, due to the fact that we no longer satisfied the minimum stockholders' equity continued listing requirement of the Nasdaq National Market, we transferred back to the Nasdaq Capital Market, where our shares continue to be listed under the trading symbol VOCL. In August 2005, we were notified by Nasdaq Capital Market that we were not in compliance with its minimum stockholders' equity standard listing requirements. On November 25, 2005, following the consummation of the transaction with Tdsoft, and in order for our shares to continue to be listed on the Nasdaq Capital Market, we effected a 1-for-13 reverse split of our issued and outstanding share capital, resulting in the par value of our ordinary shares being increased to NIS 0.13 per share. On November 28, 2005, the Nasdaq Capital Market informed us that we complied with all initial listing requirements of the Nasdaq Capital Market. Our shares traded on the Nasdaq Capital Market under the symbol "VOCLD" from November 28, 2005 through December 27, 2005 and under the symbol "VOCL" since December 28, 2005.

9.D. SELLING SHAREHOLDERS

Not applicable.

9.E. DILUTION

Not applicable.

9.F. EXPENSES OF THE ISSUE

Not applicable.

ITEM 10. ADDITIONAL INFORMATION

10.A. SHARE CAPITAL

Not applicable

10.B. MEMORANDUM AND ARTICLES OF ASSOCIATION

VocalTec is a public company organized in the State of Israel under the Companies Law. We are registered with the Registrar of Companies of the State of Israel and have been assigned company number 52-004262-3.

OBJECTS AND PURPOSES

The objects and purposes of our company are to engage in any legal occupation and/or business.

RIGHTS, PREFERENCES AND RESTRICTIONS UPON SHARES

Our articles of association authorize one class of shares, which are our ordinary shares. We may declare a dividend to be paid to the holders of our ordinary shares according to their rights and interests in our profits. Our board may declare interim dividends and a final dividend for any fiscal year only out of retained earnings, or earnings derived over the two most recent fiscal years, whichever is higher. The Companies Law and our articles provide that our board may declare and pay dividends (subject to certain limitations) without any further action by our shareholders. All unclaimed dividends may be invested or otherwise used by the board for our benefit until those dividends are claimed. In the event an unclaimed dividend is claimed, only the principal amount of the dividend will be paid to the person entitled to the dividend. Subject to the creation of any special rights regarding the distribution of dividends, any dividends we declare will be distributed to shareholders in proportion to their holdings.

If we liquidate, after satisfying liabilities to creditors, our assets will be distributed to the holders of ordinary shares in proportion to their holdings.

Holders of ordinary shares have one vote for each paid-up ordinary share on all matters submitted to a vote of our shareholders. These voting rights may be affected by the grant of any special voting rights to the holders of a class of shares with preferential rights that may be authorized in the future.

Our articles provide that directors are elected by an ordinary resolution of a general meeting of our shareholders. Our ordinary shares do not have cumulative voting rights in the election of directors. Accordingly, the holders of ordinary shares representing more than 50% of the voting power in our company have the power to elect all directors. However, our board of directors (other than the external directors) is divided into three classes, the members of each of which are elected for a three-year term.

We may, subject to the applicable provisions of the Companies Law, issue redeemable shares and subsequently redeem them. In addition, our board may make calls upon shareholders in respect of any sum, which has not been paid up in

respect of any shares held by those shareholders.

Under the Companies Law, the disclosure requirements that apply to an office holder and are described below under "Approval of Related Party Transactions Under Israeli Law" also apply to a controlling shareholder of a public company. A shareholder that holds more than 50% of the voting rights in a public company is deemed to be a controlling shareholder. A shareholder that holds more than 25% of the voting rights in a public company may also be deemed to be a controlling shareholder, for purposes of approval of certain related party transactions, if there is no other shareholder holding more than 25% of the voting rights at such time. Extraordinary transactions with a controlling shareholder or in which a controlling shareholder has a personal interest, and the terms of compensation of a controlling shareholder who is an office holder, require the approval of the audit committee, the board of directors and the shareholders of the company, in such order, provided that either (i) the shareholder approval includes the approval of the holders of at least one third of the shares of shareholders having no personal interest in the transaction who vote at the meeting, or (ii) the total number of shares of shareholders having no personal interest in the transaction who vote against the transaction does not exceed one percent of the aggregate voting rights in the company.

The Companies Law also requires a shareholder to act in good faith towards a company in which he holds shares and towards other shareholders and to refrain from abusing his power in the company, including in connection with the voting at a shareholders' meeting on:

- Any amendment to the articles of association;
- An increase in the company's authorized capital;
- A merger; or
- Approval of certain transactions with control person and other related parties, which require shareholder approval.

A shareholder has the general duty to refrain from depriving other shareholders of their rights. Any controlling shareholder, any shareholder that knows that it possesses the power to determine the outcome of a shareholder vote and any shareholder that, under the provisions of the articles of associations, has the power to appoint an office holder in the company, is under a duty to act in fairness towards the company. The Companies Law does not describe the substance of this duty (except by providing that the remedies generally available upon a breach of contract will be available also in the event of a breach of the duty to act with fairness) and such substance has not yet been adjudicated by Israeli courts.

MODIFICATIONS OF SHARE RIGHTS

Under our articles of association, the rights attached to any class may be varied by adoption of the necessary amendment of the articles, provided that the holders of shares of the affected class approve the change by a class meeting in which the holders of at least 75% of the voting power represented at the meeting and voting on the issue approve the change. Our articles differ from the Companies Law in this respect as under the law, changes in the rights of shareholders require the consent of more than 50% of the voting power of the affected class represented at the meeting and voting on the change.

SHAREHOLDERS MEETINGS AND RESOLUTIONS

We are required to hold an annual general meeting of our shareholders once every calendar year, but no later than 15 months after the date of the previous annual general meeting. All meetings other than the annual general meeting of shareholders are referred to as extraordinary general meetings. Extraordinary general meetings may be called by our board whenever it sees fit, at such time and place, within or without the State of Israel, as the board may determine. In addition, the Companies Law provides that the board of a public company is required to convene an extraordinary meeting upon the request of (a) any two directors of the company or one quarter of the company's board of directors or (b) one or more shareholders holding, in the aggregate, (i) five percent of the outstanding shares of the company and one percent of the voting power in the company or (ii) five percent of the voting power in the company.

The quorum required for a meeting of shareholders consists of at least two shareholders present in person or by proxy who hold or represent between them at least 33.3% of our issued share capital. A meeting adjourned for lack of a quorum is adjourned to the same day in the following week at the same time and place or any time and place as the chairman of the meeting determines. At such reconvened meeting, the required quorum consists of any two shareholders present in person or by proxy.

Notwithstanding the foregoing, our articles provide that a resolution in writing signed by all our shareholders then entitled to attend and vote at general meetings or to which all such shareholders have given their written consent (by letter, telegram, facsimile or otherwise) shall be deemed to have been unanimously adopted by a duly convened general meeting.

Our articles enable our board to fix a record date to allow us to determine the shareholders entitled to notice of, or to vote at, any general meeting of our shareholders. The record date may not be more than 40 days and not less than four days before the date of the meeting. Each shareholder of record as of the record date determined by the board may vote the shares then held by that shareholder unless all calls and other sums then payable by the shareholder in respect of its shares have not been paid.

LIMITATION ON OWNERSHIP OF SECURITIES

The ownership and voting of our ordinary shares by non-residents of Israel are not restricted in any way by our articles or by the laws of the State of Israel, except for shareholders who are subjects of countries that are enemies of the State of Israel.

MERGERS AND ACQUISITIONS; TENDER OFFERS; ANTI-TAKEOVER PROVISION

The Companies Law includes provisions allowing corporate mergers. These provisions require that the board of directors of each company that is party to the merger approve the transaction. In addition, the shareholders of each company must approve the merger by a vote of the majority of the company's shares, present and voting on the proposed merger at a shareholders' meeting, called on at least 35 days' prior notice. In determining whether the requisite majority has approved the merger, shares held by the other party to the merger or any person holding at least 25% of such other party are excluded from the vote. If the merger would have been approved but for the exclusion of the votes of certain shareholders as provided above, a court may still approve the merger upon the request of holders of at least 25% of the voting rights of a company,

if the court holds that the merger is fair and reasonable, taking into account the value of the parties to the merger and the consideration offered to the shareholders. Upon the request of a creditor of either party to the proposed merger, the court may delay or prevent the merger if it concludes that there exists a reasonable concern that, as a result of the merger, the surviving company will be unable to satisfy the obligations of any of the parties to the merger, and the court may also provide instructions to assure the rights of creditors. In addition, a merger may not be completed unless at least 50 days have elapsed from the date that a proposal for approval of the merger was filed with the Israel Registrar of Companies and at least 30 days have elapsed from the date that shareholder approval of both merging companies was obtained. Notwithstanding the foregoing, a merger is not subject to shareholders approval if (i) the target company is a wholly-owned subsidiary of the acquiring company and (ii) the acquiring company is issuing to the shareholders of the target company up to 20% of its share capital and no person will become, as a result of the merger, a control person, subject to certain limitation relating to the counting of the votes, at a meeting of the shareholders of a company that is a party to the merger, of any entity or person that is either the other party to the merger or a control person thereof.

The Companies Law also provides that, except in certain circumstances set forth in the Companies Law, the acquisition of shares in a public company must be made by means of a special tender offer if, as a result of the acquisition, the purchaser would become a 25% shareholder of the company. The rule does not apply if there already is another 25% shareholder of the company. Similarly, the law provides that an acquisition of shares in a public company must be made by means of a special tender offer if, as a result of the acquisition, the purchaser would become a 45% shareholder of the company, unless there already is a 45% shareholder of the company. These requirements do not apply if, in general, the acquisition (1) was made in a private placement that received the approval of the company's shareholders; (2) was from a 25% or greater shareholder of the company which resulted in the acquirer becoming a 25% or greater shareholder of the company, or (3) was from a 45% or greater shareholder of the company which resulted in the acquirer becoming a 45% or greater shareholder of the company. The tender offer must be extended to all shareholders, but the offeror is not required to purchase more than 5% of the company's outstanding shares, regardless of how many shares are tendered by shareholders (if more shares are tendered than proposed by the purchaser to be purchased, the purchaser will purchase shares from all tendering shareholders the amount of shares proposed by the purchase to be purchased, on a pro rata basis). The tender offer may be consummated only if (i) at least 5% of the company's outstanding shares will be acquired by the offeror, and (ii) the number of shares tendered in the offer exceeds the number of shares, the holders of which objected to the offer.

If, following any acquisition of shares, the purchaser would hold 90% or more of the shares of the company, such acquisition must be made by means of a tender offer for all of the target company's shares. An acquirer who wishes to eliminate all minority shareholders must do so by means of a tender offer and acquire such amount of shares that will cause him to hold at least 95% of the outstanding shares of the target company. If less than 5% of the outstanding shares are not tendered, all of the shares that the acquirer offered to purchase will be transferred to the acquirer by operation of law. The Companies Law provides for appraisal rights if any shareholder files a request in court within three months following the consummation of a full tender offer. If more than 5% of the outstanding shares are not tendered in the tender offer, the acquirer may not acquire tendered shares if by doing so the acquirer would own more than 90% of the outstanding shares of the target company.

Our articles contain provisions that could delay, defer or prevent a change in our control. These provisions include advance notice requirements and a staggered board. Under the advance notice requirements, shareholders seeking to propose items for inclusion on the agenda for a general meeting of shareholders, must submit those items in writing to our corporate secretary not less than 60 days (or not less than 90 days for the nomination of candidates for election of directors) and not more than 120 days prior to the particular meeting. The staggered board provisions of our articles are described above under "Item 6 - Directors, Senior Management and Employees - Board practices."

BOARD PRACTICES

Under our articles of association, our board can, at its discretion, cause the Company to borrow money or secure the payment of any sum upon terms and conditions it deems fit. The board can utilize this power through various methods, including the issuance of bonds or debentures, or mortgages, charges or other securities on the whole of the Company or any part of it.

Our directors are not subject to any age limit requirement, nor are they disqualified from serving on the board because of a failure to own VocalTec shares.

Directors (other than external directors) are classified into three classes. Each class has a nearly equal number of directors, as determined by the Board of Directors. The terms for these classes of directors will expire at the annual shareholder meetings in 2007, 2008 and 2009. At each shareholder meeting, the successors of each class of directors whose terms expire are elected to hold office for a term expiring at the annual shareholders meeting held in the third year following the year of their election. The staggered board structure may not be amended without the approval of the greater of (i) holders of not less than 75% of the voting power represented at a meeting in person or by proxy and voting thereon, or (ii) holders of a majority of the outstanding voting power of all shares of the Company.

EXTERNAL DIRECTORS

We are subject to the provisions of the Companies Law. Under the Companies Law, companies incorporated under the laws of the State of Israel whose shares have been offered to the public in or outside of Israel are required to appoint at least two external directors. Certain regulations promulgated recently under the Companies Law set out the conditions and criteria for a director qualifying as having a "financial and accounting expertise" or a "professional qualification". A director with financial and accounting expertise is a director who, due to his education, experience and skills, possesses capabilities relating to and an understanding of business and accounting matters and financial statements, which enable him to understand in depth the company's financial statements and to initiate a debate regarding the manner in which the company's financial information is presented. A director who meets a professional qualification is a director who satisfies one of the following requirements: (i) the director holds an academic degree in either economics, business administration, accounting, law or public administration, (ii) the director either holds another academic degree or has obtained other high education in the company's primary field of business or in an area that is relevant to his position, (iii) the director has at least five (5) years of experience serving in one of the following capacities or an aggregate of at least five (5) years of experience in two or more of the following capacities: (a) a senior business management position of a company

with a substantial scope of business, (b) a senior position in the primary field of business of the company or (c) a senior public administration position. A proposed external director must submit to the company a declaration as to his or her compliance with the requirements for his or her election as an external director (including with respect to such person's financial and according expertise or professional qualification). At least one of the external directors should have a "financial and accounting expertise" and the other external directors should have a "professional qualification". The board of directors should determine the minimum number of directors who should have financial and accounting expertise in addition to at least one external director. In determining such number, the board of directors shall consider, among other things, the type and size of the company and the scope and complexity of its operations. The Companies Law provides that a person may not be appointed as an external director if the person or the person's relative, partner, employer or any entity under the person's control, has, as of the date of the person's appointment to serve as external director, or had, at any time during the two years preceding that date, any affiliation with the company, any entity controlling the company or any entity controlled by the company or by the controlling entity of the company. The term "affiliation" includes:

- an employment relationship;
- a business or professional relationship maintained on a regular basis;
- control; and
- service as an office holder (other than as a director that has been appointed as an external director of a company that is intending to consummate its initial public offering).

"Office holder" is defined as a director, general manager, chief business manager, deputy general manager, vice general manager, executive vice president, vice president, other manager directly subordinate to the general manager or any other person assuming the responsibilities of any of the foregoing positions, without regard to such person's title.

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

External directors are to be elected by a majority vote at a shareholders' meeting, provided that either (i) the shareholder approval includes the approval of the holders of at least one third of the shares of non-controlling shareholders who vote at the meeting or (b) the total number of shares of non-controlling shareholders who vote against the transaction does not exceed one percent of the aggregate voting rights in the company.

The initial term of an external director is three years, and he or she may be reelected to one additional term of three years. External directors may be removed only by the same percentage of shareholders as is required for their election, or by a court, and then only if the external directors cease to meet the statutory qualifications for their appointment or if they violate their duty of loyalty to the company. If an external directorship becomes vacant, our board of directors is required under the Companies Law to call a shareholders' meeting immediately to appoint a new external director. Each committee of a company's board of directors that has the power to exercise discretion of the board is required to include at least one external director, and all external directors have to be members of the company's audit committee. If at the time of appointment of an external director all of the members of the board of directors are of one gender, the appointed external director must be of the other gender.

External directors are entitled to compensation as provided in regulations promulgated under the Companies Law and are otherwise prohibited from receiving any other compensation, directly or indirectly, from the company.

INDEPENDENT DIRECTORS

We are subject to the rules of Nasdaq applicable to listed companies. Under the Nasdaq rules, a majority of our board of directors must be comprised of independent directors and we are required to appoint a minimum of three independent directors. The independence standard under the Nasdaq rules excludes current employees, former employees of a company or of any of its affiliates for a period of three years after cessation of employment, as well as any immediate family member of an executive officer of a company or of any of its affiliates. Five of our current directors meet the independence standards of the Nasdaq rules and we currently comply with the foregoing requirements.

AUDIT COMMITTEE

See "Item 6 - Directors, Senior Management and Employees - Board Practices".

INTERNAL AUDITOR

The Companies Law also requires us to appoint an internal auditor nominated by the audit committee. The role of the internal auditor is to examine, among other matters, whether the company's actions comply with the law and orderly business procedure. Under the Companies Law, the internal auditor may not be an interested party, an office holder or an affiliate, or a relative of an interested party, an office holder or an affiliate, nor may the internal auditor be the company's independent accountant or its representative. In October 2000, VocalTec (prior to the business combination) appointed the firm of Brukner Ingber as the company's internal auditor in accordance with the requirements of the Companies Law.

APPROVAL OF RELATED PARTY TRANSACTIONS UNDER ISRAELI LAW

The Companies Law imposes a duty of care and a duty of loyalty on all of a company's office holders (as defined under "External Directors" above), including directors and executive officers. The duty of care requires an office holder to act with the level of care that a reasonable office holder in the same position would have acted under the same circumstances. The duty of loyalty generally requires an office holder to act in good faith and for the benefit of the company.

The Companies Law requires that an office holder of a company promptly disclose any personal interest that he may have and all related material information known to him, in connection with any existing or proposed transaction contemplated by the company. Once an office holder complies with these disclosure requirements, the board of directors may approve a transaction between the company and the office holder, or a third party in which an office holder has a personal interest, unless the articles of association provide otherwise.

A transaction that is adverse to the company's interest cannot be approved. If the transaction is an extraordinary transaction under the Companies Law, then, in addition to any approval stipulated by the articles of association, it also requires audit committee approval before board approval and, in certain specified circumstances, subsequent shareholder approval.

Under the Companies Law, the disclosure requirements that apply to an office holder also apply to a controlling shareholder of a public company. A controlling shareholder includes a shareholder that holds 25% or more of the voting rights in a public company if no other shareholder owns more than 50% of the voting rights in the company. A shareholder that holds more than 25% of the voting rights in a public company may also be deemed to be a controlling shareholder, for purposes of approval of certain related party transactions, if there is no other shareholder holding more than 25% of the voting rights at such time. Extraordinary transactions with a controlling shareholder or in which a controlling shareholder has a personal interest, and the terms of compensation of a controlling shareholder who is an office holder, require the approval of the audit committee, the board of directors and the shareholders of the company, provided that either (i) the shareholder approval includes the approval of the holders of at least one third of the shares of shareholders having no personal interest in the transaction who vote at the meeting or (ii) the total number of shares of shareholders having no personal interest in the transaction who vote against the transaction does not exceed one percent of the aggregate voting rights in the company.

For information concerning the direct and indirect personal interests of certain of our office holders and principal shareholders in specified transactions with us, see Item 7 - Major Shareholders and Related Party Transactions - Major Shareholders".

Under the Companies Law, the entering by a company into a contract with a non controlling director as to the terms of his office, requires the approval of the board of directors followed by the approval of the shareholders of the company, and in a public company, the transaction requires the approval of the audit committee followed by the approval of the board of directors and the shareholders of the company.

A director who has a personal interest in the approval of a transaction that is submitted to approval of the audit committee or the board of directors shall not be present during the deliberations and shall not take part in the voting of the audit committee or of the board of directors on such transaction. Notwithstanding the above, a director may be present at a deliberation of the audit committee and the board of directors and may take part in the voting, if the majority of the members of the audit committee or the board of directors, as the case may be, have a personal interest in the approval of the transaction, in which case the transaction shall also require the approval of the shareholders of the company.

EXEMPTION, INSURANCE AND INDEMNIFICATION OF DIRECTORS AND OFFICERS

EXEMPTION

Under the Companies Law, an Israeli company may not exempt an office holder from liability with respect to a breach of his duty of loyalty, but may exempt in advance an office holder from his liability to the company, in whole or in part, with respect to a breach of his duty of care (other than with respect to a breach of duty of care with respect to the distribution of a dividend or redemption of the company's securities). Under the Companies Law, a company may not indemnify an office holder, nor enter into an insurance contract that would provide coverage for any monetary liability incurred as a result of any of the following:

- a breach by the office holder of his duty of loyalty, unless the office holder acted in good faith and had a reasonable basis to believe that the act would not prejudice the company;
- a breach by the office holder of his duty of care, if such breach was done intentionally or in disregard of the circumstances of the breach or its consequences, other than a breach committed solely by negligence;
- any act or omission done with the intent to derive an illegal personal benefit; or
- any fine levied against the office holder as a result of a criminal offense.

OFFICE HOLDER INSURANCE

Our Articles of Association provide that, subject to the provisions of the Companies Law, we may enter into a contract for the insurance of the liability of any of our office holders with respect to:

- a breach of his duty of care to us or to another person;
- a breach of his duty of loyalty to us, provided that the office holder acted in good faith and had reasonable cause to assume that his act would not prejudice our interests; or
- a financial liability imposed upon him in favor of another person concerning an act performed by him in his capacity as an office holder.

INDEMNIFICATION OF OFFICE HOLDERS

Our Articles of Association provide that we may indemnify an office holder against:

- a financial liability imposed on him in favor of another person by any judgment, including a settlement or an arbitrator's award approved by a court concerning an act performed in his capacity as an office holder;
- reasonable litigation expenses, including attorneys' fees, expended by the office holder or charged to him by a court, in proceedings we

institute against him or instituted on our behalf or by another person, or in a criminal charge from which he was acquitted; or

- reasonable litigation expenses, including attorneys' fees, expended by the office holder as a result of an investigation or proceeding instituted against him by an authority authorized to conduct such investigation or proceeding, provided that (i) no indictment (as defined in the Companies Law) was filed against such office holder as a result of such investigation or proceeding, and (ii) no financial liability as a substitute for the criminal proceeding (as defined in the Companies Law) was imposed upon him as a result of such investigation or proceeding or if such financial liability was imposed, it was imposed with respect to an offence that does not require proof of criminal intent.

Under the Companies Law, our Articles of Association may also include a provision authorizing us to grant in advance an undertaking to indemnify an office holder, provided that the undertaking is limited to such events which the board of directors shall deem to be likely to occur in light of the operations of the Company at the time that the undertaking to indemnify is made and for such amounts or criteria which the board of directors may, at the time of the giving of such undertaking to indemnify, deem to be reasonable under the circumstances. Such undertaking shall set forth such events which the board of directors shall deem to be likely to occur in light of the operations of the Company at the time that the undertaking to indemnify is made, and the amounts and/or criteria which the board of directors may, at the time of the giving of such undertaking to indemnify, deem to be reasonable under the circumstances; and a provision authorizing us to retroactively indemnify an office holder.

REQUIRED APPROVALS

In addition, under the Companies Law, indemnification of, and procurement of insurance coverage for, our office holders must be approved by our audit committee and our board of directors and, with respect to directors, by our shareholders.

THRESHOLD FOR DISCLOSURE OF SHARE OWNERSHIP

We are subject to the rules of the US Securities and Exchange Commission, and our shareholders are subject to the requirements under Section 13 of the Exchange Act with respect to disclosure of their holding percentage in the Company. Under such Section and the rules promulgated thereunder, each of our shareholders that owns 5% or more of our outstanding share capital must file with the US Securities and Exchange Commission a form disclosing such shareholder's holding percentage and certain other information (and provide us with a copy of such form).

CERTAIN LISTING REQUIREMENTS OF NASDAQ

We are not in compliance with Nasdaq Marketplace Rules 4350(c)(4)(B) (requiring companies to adopt a formal written charter or board resolution addressing the company's nominations process) and 4350(c)(2) (Regularly scheduled meetings of the company's independent directors). Under Israeli law, the nominations process is conducted by the full board of directors. Similarly, under Israeli law all matters that are subject to the approval of a company's board of directors are discussed by the full board of directors.

10.C. MATERIAL CONTRACTS NOT IN THE ORDINARY COURSE OF BUSINESS

- On November 27, 2006, we received and accepted orders from Israeli institutional investors for a private placement of 1,750,000 ordinary shares at a price of $4.3 per share. As part of the offering, the Company issued to the investors warrants exercisable during a period ending on June 30, 2011 into 1,312,500 additional ordinary shares at an exercise price per share of $5.5.

- In May 2006, we consummated a private placement with various investors, pursuant to which we issued to such investors an aggregate of 935,000 ordinary shares for an aggregate purchase price of $5.1 million, or $5.5 per ordinary share (our net proceeds were $4.7 million). We also issued to the investors warrants to purchase up to an aggregate of 374,000 ordinary shares, at an exercise price of $7.9 per share. The warrants became exercisable on November 24, 2006 and will remain exercisable until May 24, 2011. During December 2006, we agreed to reduce the exercise price of the warrants issued in the foregoing private placement to $6.87 per share.

- In November 2005, we consummated the business combination with Tdsoft and its shareholders. See "Item 3 - Key Information - Selected Financial Data and Item 4 - Information on the Company - History and Development of the Company".

- In July 2005, we received a bridge loan in the amount of $1,000,000 from Deutsche Telekom, which at the time of the loan held approximately 15.3% of our issued and outstanding share capital. The loan bears an interest rate of 7.05% per annum in July 2006. In connection with the loan, we agreed to deposit the source code of one of our products in escrow in favor of Deutsche Telekom and not to create, without the approval of Deutsche Telekom, any security interest over such source code.

10.D. EXCHANGE CONTROLS

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

Non-residents of Israel who purchase our securities with non-Israeli currency will be able to repatriate dividends (if any), liquidation distributions and the proceeds of any sale of such securities, into non-Israeli currencies at the rate of exchange prevailing at the time of repatriation, provided that any applicable Israeli taxes have been paid (or withheld) on such amounts.

Neither our Articles of Association nor the laws of the State of Israel restrict in any way the ownership or voting of ordinary shares by non-residents of Israel, except with respect to citizens of countries that are in a state of war with Israel.

10.E. TAXATION AND GOVERNMENT PROGRAMS

The following is a summary of the current tax structure, which is applicable to companies in Israel, with special reference to its effect on us and our group companies. The following also contains a discussion of material Israeli and U.S. tax consequences to our shareholders and government programs from which we and some of our group companies benefit. The following also contains a discussion of certain Israeli and U.S. tax consequences to persons purchasing our ordinary shares. To the extent that the discussion is based on new tax legislation, which has yet to be subject to judicial or administrative interpretation, there can be no assurance that the views expressed in the discussion will accord with any such interpretation in the future. The discussion is not intended and should not be construed as legal or professional tax advice and is not exhaustive of all possible tax considerations.

In July 2002, the Israeli Parliament approved a law enacting extensive changes to Israel's tax law (the "Tax Reform Legislation") generally effective January 1, 2003. Among the key provisions of the Tax Reform Legislation were (i) changes which may result in the imposition of taxes on dividends received by an Israeli company from its foreign subsidiaries; and (ii) the introduction of the "controlled foreign corporation" concept according to which an Israeli company may become subject to Israeli taxes on certain income of a non-Israeli subsidiary if the subsidiary's primary source of income is passive income (such as interest, dividends, royalties, rental income or capital gains). An Israeli company that is subject to Israeli taxes on the income of its non-Israeli subsidiaries will receive a credit for income taxes paid/withheld or that will be paid/withheld by the subsidiary in its country of residence, according to the terms and conditions determined in the Israeli Tax Ordinance.

The following summary is included herein as general information only and is not intended as a substitute for careful tax planning. Accordingly, each investor should consult his or her own tax advisor as to the particular tax consequences to such investor of the purchase, ownership or sale of an ordinary share, including the effect of applicable state, local, foreign or other tax laws and possible changes in tax laws.

ISRAEL CORPORATE TAX CONSIDERATIONS

GENERAL CORPORATE TAX STRUCTURE

The regular rate of corporate tax, which Israeli companies were subject to in 2006 was 31% (such tax rate has been reduced to 29% in 2007). However, the effective rate of tax payable by a company (such as ours) which derives income from an "Approved Enterprise" (as further discussed below) may be considerably lower.

LAW FOR THE ENCOURAGEMENT OF CAPITAL INVESTMENTS, 1959

GENERAL. Certain of our production and development facilities have been granted approved enterprise status pursuant to the Law for the Encouragement of Capital Investments, 1959 (the "Investment Law"). The Investment Law provides that a capital investment in eligible facilities may, upon application to the Investment Center of the Ministry of Industry and Trade of the State of Israel, or the Investment Center, be designated as an Approved Enterprise. Each certificate of approval for an Approved Enterprise relates to a specific investment program delineated both by its financial scope, including its capital sources, and by its physical characteristics, e.g., the equipment to be purchased and utilized pursuant to the program. The tax benefits derived from any such certificate of approval relate only to taxable income attributable to

the specific Approved Enterprise.

Subject to certain provisions concerning income and subject to the Alternative Benefits (see below), any distributed dividends are deemed attributable to the entire enterprise, and the effective tax rate and the effective withholding tax rates represent the weighted combination of the various applicable tax rates.

TAX BENEFITS. Taxable income of a company derived from an Approved Enterprise is subject to company tax at the rate of up to 25% (rather than the tax rates referred to under "General Corporate Tax Structure" above) for a certain period of time. The benefit period is a period of seven years commencing in the year in which the Approved Enterprise first generates taxable income. The benefits may be shorter as it is limited to 12 years from the commencement of production of the Approved Enterprise or 14 years from the date of approval, whichever is earlier. Under certain circumstances (as further detailed below), the benefit period may extend to a maximum of ten years from the commencement of the benefit period. A company which operates under more than one approval or that has capital investments which are only partly approved (such a company being designated as a Mixed Enterprise), may have an effective company tax rate that is the result of a weighted combination of the various applicable rates.

A company owning an approved enterprise which was approved after April 1, 1986 may elect to forego the entitlement to grants or state guarantees and apply for an alternative package of tax benefits. These benefits provide that undistributed income from the approved enterprise is fully tax exempt from corporate tax for a defined period, which ranges between two and ten years from the first year of taxable income, subject to the limitations described above, depending principally upon the geographic location within Israel and the type of the approved enterprise. Upon expiration of such period, the approved enterprise is eligible for a beneficial tax rate (25% or lower in the case of an FIC, as described below), for the remainder of the otherwise applicable period of benefits, as described above.

Should the percentage of share capital of the companies having Approved Enterprises held by foreign shareholders exceed 25%, future Approved Enterprises of such companies would qualify for reduced tax rates for an additional three years period, after the seven years mentioned above.

The company tax rate applicable to income earned from Approved Enterprise programs (currently, for programs on which an application for an approved enterprise status was submitted before December 31, 2004) in the benefit period by a company meeting these qualifications is as follows:

% OF FOREIGN OWNERSHIP	TAX RATE
Over 25% but less than 49%	25%
49% or more but less than 74%	20%
74% or more but less than 90%	15%
90% or more	10%

Entitlement to these benefits is subject to the final ratification of the Investment Center, and is conditioned upon fulfillment of all terms of the approved program. However, there can be no assurance that our group companies which enjoy Approved Enterprise benefits will obtain approval for additional Approved Enterprises, or that the provisions of the Investment Law will not change with respect to future approvals, or that the above-mentioned shareholding portion will be reached for each subsequent year. In the event of

our failure to comply with these conditions, the tax and other benefits could be canceled, in whole or in part, and we might be required to refund the amount of the canceled benefits, together with the addition of CPI linkage difference and interest. We believe that our Approved Enterprise substantially complies with all such conditions at present, but there can be no assurance that it will continue to do so.

The undistributed income derived from each of our approved enterprise programs is tax-exempt for a two year period beginning with the first year in which it generates otherwise taxable income and is subject to a reduced tax rate for the remainder of the benefit period.

A company that pays a dividend out of income derived from the Approved Enterprise(s) during the tax exemption period will be subject to deferred company tax in respect of the amount distributed (including the recipient's tax thereon) at the rate which would have been applicable had such company not elected the Alternative Package. This rate is generally 10% to 25%, depending on the extent to which non-Israeli shareholders hold such company's shares.

The dividend recipient is taxed at the reduced rate applicable to dividends from Approved Enterprises (generally 15% as compared to 25% for individuals or an exemption for companies), if the dividend is distributed during the tax benefit period or within 12 years after this period. However, the limitation does not apply if the company qualifies as a foreign investors' company. This tax must be withheld by such company at source, regardless of whether the dividend is converted into foreign currency.

Subject to certain provisions concerning income subject to Mixed Enterprises, all dividends are considered to be attributable to the entire enterprise and the effective tax rate on the dividend is the result of a weighted combination of the various applicable tax rates. However, such company is not obliged to distribute exempt retained profits under the Alternative Package, and such company may generally decide from which year's profits to declare dividends.

Each application to the Investment Center is reviewed separately, and a decision as to whether or not to approve such application is based, among other things, on the then prevailing criteria set forth in the Investment Law, on the specific objectives of the applicant company set forth in such application and on certain financial criteria of the applicant company. Accordingly, there can be no assurance that any such application by any of our group companies will be approved. In addition, the benefits available to an Approved Enterprise are conditional upon the fulfillment of certain conditions stipulated in the Investment Law and its regulations and the criteria set forth in the certificate of approval, as described above. In the event that these conditions are violated, in whole or in part, a company with an Approved Enterprise would be required to refund the amount of tax benefits, with the addition of the Israeli consumer price index linkage differences and interest.

A company which qualifies as a foreign investment company (FIC) is a company, like us, in which more than 25% of the share capital (in terms of shares, rights to profit, voting and appointment of directors) and of the combined share and loan capital is owned, directly or indirectly, by non-residents of Israel and is therefore entitled to further tax benefits relating to its approved enterprises. Such a company will be eligible for an extension of the period of tax benefits for its approved enterprises (up to ten years) and further tax benefits, should the level of foreign ownership in it increase above 49%.

Notwithstanding the foregoing, proceeds received from the sale of our products may be deemed to be royalties under the domestic law of the country of residence of the purchaser/licensee or under an applicable tax treaty and as such subject to withholding tax in such country. For instance, proceeds received by our company from the sale of our software in the United States might be treated as royalties and as such subjected to U.S. withholding tax of either 10% or 15%, pursuant to the U.S.-Israel Tax Treaty.

Where withholding tax is paid by our company to the country of residence of the purchaser/licensee, such tax would generally be creditable by our company for Israeli income tax purposes, pursuant to any relevant income tax treaty and under Israeli law against income derived from the same source. However, where we do not have taxable income for Israeli tax purposes because of the application of a tax exemption available to an Approved Enterprise or because of losses for tax purposes, we would have no Israeli tax liability against which to credit the foreign tax withheld and paid by us. Furthermore, under Israeli law, we cannot carry forward such unused credit to future tax years.

From time to time, the Government of Israel 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 have a material adverse effect on future investments by our company in Israel.

Notwithstanding the foregoing, on March 29, 2005, the Israeli Parliament passed an amendment to the Investment Law, which revamps the Israeli tax incentives for future industrial and hotel investments (the "2005 amendment"). A tax "holiday" package can now be elected for up to 15 years for a "Privileged Enterprise" as defined in the 2005 amendment, if certain conditions are met, without needing to obtain approval. The extent of the tax benefits available depends upon the level of foreign investment.

The 2005 amendment became effective on April 1, 2005. Taxpayers may, under certain conditions, claim Privileged Enterprise status for new and expanded enterprises with respect to 2004 or subsequent years, unless the Investment Center granted such taxpayer Approved Enterprise status prior to December 31, 2004.

Subject to certain conditions, various alternative tax-only benefit packages can now be elected with respect to investments in a "Privileged Enterprise", without prior approval. Companies in industry or tourism in Israel may elect between:

- Tax "holiday" package - for a "Privileged Enterprise": a tax exemption applies to undistributed profits for 2 to 15 years depending on geographical location of the "Privileged Enterprise" and the level of foreign ownership. Company tax rates of between 10% and 25% apply to distributed exempt profits or profits derived subsequent to the exempt period. The total period of tax benefits is 7 to 15 years, or

- Grant / Reduced tax package - for an "Approved Enterprise": Fixed asset grants of between 20% and 32% for enterprises in a development area and reduced company tax rates between 0% and 25% for 7 to 15 years.

Dividend withholding tax also applies at a rate of 4% or 15% depending on the package selected.

GRANTS UNDER THE LAW FOR THE ENCOURAGEMENT OF INDUSTRIAL RESEARCH AND DEVELOPMENT, 1984

Israeli tax laws have allowed, under certain conditions, a tax deduction for expenditures (including capital expenditures) in scientific research and development projects, if the expenditures are approved or funded by the Israeli Government and the research and development is for the promotion of the enterprise and is carried out by or on behalf of the company seeking such deduction. Expenditures not approved as above or funded are deductible in equal portions over a three-year period.

Under the law for the Encouragement of Industrial Research and Development, 1984 (the "Research Law"), research and development programs that meet specified criteria and are approved by a committee of the Chief Scientist, are eligible for grants of up to 50% of the program's expenses. Under the provisions of Israeli law in effect until 1996, royalties of 2%-3% of the revenues derived in connection with products developed according to, or as a result of, a research and development program funded by the Chief Scientist had to be paid to the State of Israel. Pursuant to an amendment effected in 1996 effective with respect to Chief Scientist programs funded in or after 1994, royalties at the rate of 3% during the first three years, 4% over the following three years and 5% in or after the seventh year of the revenues derived in connection with products developed according to such programs are payable to the State of Israel. The maximum aggregate royalties will not exceed 100% (or, for funding prior to 1994, 100%-150%) of the dollar-linked value of the total grants received. Pursuant to an amendment effected in 2000, effective with respect to Chief Scientist programs funded in or after 2000, the royalty rates described above were updated to 3% during the first three years and 3.5% in or after the fourth year, of the revenues derived in connection with products developed under such programs. Pursuant to an amendment effected on January 1, 1999, effective with respect to Chief Scientist programs approved in or after 1999, funds received from the Chief Scientist shall bear annual interest at a rate equal to LIBOR for twelve months.

Generally, the Research Law requires that the manufacturing of any product developed through research and development funded by the Israeli Government shall be in Israel. It also provides that know-how from the research and development that is used to produce the product may not be transferred to third parties without the approval of a research committee of the Chief Scientist. Such approval is not required for the export of any products resulting from such research and development.

However, under the Regulations, in the event that any portion of the manufacturing is not performed in Israel, if approved by the Chief Scientist, we would be required to pay an increased royalty at the rates of 120%, 150% or 300% of the grant if the manufacturing portion that is performed outside of Israel is less than 50%, between 50% and 90% and more than 90%, respectively.

In 2002, the Research Law was amended to, among other things, enable companies applying for grants from the Chief Scientist to seek prior approval for conducting manufacturing activities outside of Israel without being subject to increased royalties. However, this amendment will not apply to any of our existing grants. In addition, the amendment provides that one of the factors to be taken into consideration by the Chief Scientist in deciding whether to

approve a grant application is the percentage of the manufacturing of the relevant product that will be conducted outside of Israel. Accordingly, should we seek additional grants from the Chief Scientist in connection with which we also seek prior approval for manufacturing products outside of Israel, we may not receive such grant or may receive a grant in an amount that is less than the amount we sought.

In March 2005, an amendment to the Research Law was enacted. One of the main modifications included in the amendment was an authorization to the research committee to allow transfer outside of Israel of know-how derived from an approved program and the related manufacturing rights. Essentially the research committee may approve transfer of know-how in limited circumstances as follows:

- in the event of a sale of the know-how itself to a non affiliated third party, provided that upon such sale the owner of the know-how pays to the Chief Scientist a certain amount of cash payment set forth in the Research Law. In addition, the amendment provides that if the purchaser of the know-how gives the selling Israeli company the right to exploit the know-how by way of an exclusive, irrevocable and unlimited license, the research committee may approve such transfer in special cases without requiring the payment of payment of such amount.

- in the event of a sale of the company which is the owner of the know-how, pursuant to which the company ceases to be a an Israeli company, provided that upon such sale the owner of the know-how pays to the Chief Scientist a certain cash payment set forth in the Research Law.

- in the event of an exchange of know-how such that in exchange for the transfer of know-how outside of Israel, the recipient of such know-how transfers know-how to the company in Israel such that the Chief Scientist is convinced that the benefit to the Israeli economy as a result of such exchange is greater then the benefit without such exchange.

Another provision in the amendment concerns the transfer of manufacture rights. The research committee may, in special cases, approve the transfer of manufacture or of manufacturing rights of a product developed within the framework of the approved program or which results therefrom, outside of Israel.

If the research committee does approve a transfer of manufacturing rights out of Israel, the aggregate total of royalties' payments under the royalties regulations increases to an amount of 120%-300% of the grants, depending on the portion of manufacture transferred. The rates of royalties may also increase upon "export of manufacturing rights".

LAW FOR THE ENCOURAGEMENT OF INDUSTRY (TAXES), 1969

Pursuant to the Law for the Encouragement of Industry (Taxes), 1969, a company qualifies as an "Industrial Company" if it is a resident of Israel and at least 90% of its gross income in any tax year (exclusive of income from certain defense loans, capital gains, interest and dividends) is derived from an "industrial enterprise" it owns. An "industrial enterprise" is defined as an enterprise whose major activity, in a given tax year, is industrial manufacturing.

We believe that we currently qualify as an Industrial Company. Accordingly, we are entitled to certain tax benefits, including a deduction of 12.5% per annum on the purchase of patents or certain other intangible property rights (other than goodwill) used for the development or promotion of the industrial enterprise over a period of eight years beginning with the year in which such rights were first used.

The tax laws and regulations dealing with the adjustment of taxable income for local inflation provide that an industrial enterprise, like us, is eligible for special rates of depreciation deductions. These rates vary in the case of plant and machinery according to the number of shifts in which the equipment is being operated and range from 20% to 40% on a straight-line basis, or 30% to 50% on a declining balance basis (instead of the regular rates which are applied on a straight-line basis).

Moreover, industrial enterprises which are approved enterprises (see below) can choose between (a) the special rates referred to above and (b) accelerated regular rates of depreciation applied on a straight-line basis with respect to property and equipment, generally ranging from 200% (with respect to equipment) to 400% (with respect to buildings) of the ordinary depreciation rates during the first five years of service of these assets, provided that the depreciation on a building may not exceed 20% per annum. In no event may the total depreciation exceed 100% of the cost of the asset.

In addition, Industrial Companies may (i) amortize the cost of purchased know-how and patents over an eight-year period for tax purposes, (ii) elect to file consolidated tax returns with additional related Israeli Industrial Companies and (iii) deduct expenses related to public offerings in equal amounts over three-years.

Eligibility for benefits under the Encouragement of Industry Law is not contingent upon the approval of any governmental authority. No assurance can be given that we will continue to qualify as an Industrial Company, or will avail ourselves of any benefits under this law in the future or that Industrial Companies will continue to enjoy such tax benefits in the future.

EMPLOYEE STOCK OPTIONS

Effective from January 1, 2003, the Tax Reform Legislation enables a company to grant options through one of three tax tracks:

(a) the income tax track through a trustee pursuant to which the optionee pays income tax rate (according to the marginal tax rate of the optionee - up to 49% tax) plus payments to the National Insurance Institute and health tax on the profit gained upon the earlier to occur of the transfer of the options or the underlying shares from the trustee to the optionee or the sale of the options or the underlying shares by the trustee, and the company may recognize expenses pertaining to the options for tax purposes. The options (or upon their exercise, the underlying shares), must be held by a trustee for a period of 12 months commencing from the end of the year in which the options were granted. Options that were granted following January 1, 2006 must be held by a trustee for a period of 24 months commencing on the date on which the options were granted; or

(b) the capital gains tax track through a trustee pursuant to which the optionee pays capital gains tax at a rate of 25% on the profit upon, the earlier to occur of the transfer of the options or the underlying shares

from the trustee to the optionee or the sale of the options or the underlying shares by the trustee (in this track the optionee is not required to make payments to the National Insurance Institute and health tax) and the Company may not recognize expenses pertaining to the options for tax purposes. Options (or upon their exercise, the underlying shares) granted Prior to January 1, 2006, must be held by a trustee for either (i) a period of 24 months commencing from the end of the year in which the options were granted or (ii) for a period of 30 months commencing on the date on which the options were granted, at the optionee's discretion. Options that were granted following January 1, 2006 must be held by a trustee for a period of 24 months commencing on the date on which the options were granted; or

(c) the income tax track without a trustee pursuant to which the optionee pays income tax rate (according to the marginal tax rate of the optionee up to 49% tax) plus payments to the National Insurance Institute and health tax on the profit upon the sale of the underlying shares, and the company may not recognize expenses pertaining to the options for tax purposes.

In accordance with the provisions of the Tax Reform Legislation, if a company has selected the capital gains track, the company must continue granting options under the selected capital gains track until the end of the year following the year in which the first grant of options under that trustee track will be made. Notwithstanding the above, the company may at any time also grant options under the provisions of the income tax track without a trustee.

The above rules apply only to employees, including officer holders but excluding controlling shareholders.

TAXATION OF OUR SHAREHOLDERS

CAPITAL GAINS AND INCOME TAXES; ESTATE AND GIFT TAX

Israeli law imposes a capital gains tax on the sale of capital assets. The law distinguishes between the Real Gain and the Inflationary Surplus. The Real Gain is the excess of the total capital gain over the Inflationary Surplus, computed on the basis of the increase of the consumer price index between the date of purchase and date of sale. The Inflationary Surplus accumulated until December 31, 1993 is taxed at a rate of 10% for residents of Israel (reduced to no tax for non-residents if calculated according to the exchange rate of the foreign currency lawfully invested in shares of an Israeli resident company, instead of the consumer price index). Inflationary Surplus accumulated from and after December 31, 1993 is exempt from any capital gains tax, while the Real Gain is added to ordinary income, which effective until December 31, 2002 is taxed at the marginal rate of up to 49% for individuals and 34% for corporations (in 2005).

Until January 1, 2003 (the "Effective Date"), the basic capital gains tax rate applicable to corporations was 36% and the capital gains tax rate for individuals was based on the individual's tax bracket up to 50%. For 2005, the basic capital gains tax rate applicable to corporations was 34%. Since the Effective Date the real capital gains tax rate for both individuals and corporations is up to 25%. However, gains derived from the sale of listed securities are taxed at the prevailing corporate tax rates (31% for the 2006 tax year). Specific tax rates apply to sales of publicly traded securities as described below. These tax rates are subject to the provisions of any applicable bilateral double taxation treaty. The treaty concerning double taxation between

the United States and Israel (the "Treaty") is discussed below.

Since January 1, 2006, under current law, so long as our ordinary shares are listed on a stock exchange the sale of these shares is subject to 25% (15% prior to January 1, 2006) tax in case the shares were purchased after December 31, 2002, and in case the shares were purchased before that date the sale will be subject to a blended tax in which the portion of the gain accrued until December 31, 2002 will be exempt from Israeli capital gains tax and the portion of the real gain accrued from the Effective Date until the date of sale will be subject to 25% tax (15% prior to January 1, 2006). Since January 1, 2006, an individual shareholder holding less than 10% of the means of control in the company in a 12 months period prior to the sale shall be subject to 20% tax. The taxable real gain will be based on the difference between the adjusted average value of the shares during the last three trading days before the Effective Date (or the adjusted original cost if it is higher than the adjusted average value) and the value of the shares at the date of sale. In the event the above mentioned calculation creates a loss, such loss can only be offset against a capital gain from other traded securities according to the provisions of the Israeli law. The amount of the loss is limited to the difference between the adjusted average value and the value of the shares at the date of sale.

However, as of the Effective Date non-residents of Israel will be exempt from capital gains tax in relation to the sale of our ordinary shares for so long as (a) our ordinary shares are listed for trading on a stock exchange outside of Israel, (b) the capital gains are not accrued or derived by the non-resident shareholder's permanent enterprise in Israel, (c) the ordinary shares in relation to which the capital gains are accrued or derived were acquired by the non-resident shareholder after the initial listing of the ordinary shares on a stock exchange outside of Israel and (d) neither the shareholder nor the particular capital gain is otherwise subject to certain sections of the Israeli Income Tax Ordinance. In addition, under the Treaty, a holder of ordinary shares who is a United States resident will be exempt from Israeli capital gains tax on the sale, exchange or other disposition of such ordinary shares unless the holder owns, directly or indirectly, 10% or more of our voting power during the 12 months preceding such sale, exchange or other disposition.

Individuals who are non-residents of Israel are subject to a graduated income tax on income accrued or derived from sources in Israel. On the distribution of dividends other than stock dividends, income tax at the rate of up to 25% (15% in the case of dividends distributed from the taxable income attributable to an Approved Enterprise) is withheld at source, unless a different rate is provided in a treaty between Israel and the shareholder's country of residence. In the U.S., if the dividend recipient holds 10% of our voting stock for a certain period prior to the declaration and payment of the dividend, we are only required to withhold income tax at a 12.5% rate. A non-resident of Israel who has interest, dividend or royalty income derived from or accrued in Israel, from which tax was withheld at source, is generally exempt from the duty to file tax returns in Israel in respect of such income, provided such income was not derived from a business conducted in Israel by the taxpayer.

Israel presently has no estate or gift tax.

U.S.-ISRAEL TAX TREATY

Pursuant to the Convention Between the Government of the United States of America and the Government of Israel with respect to Taxes on Income (referred to as the U.S.-Israel Tax Treaty), the sale, exchange or disposition of ordinary

shares by a person who qualifies as a resident of the United States within the meaning of the U.S.-Israel Tax Treaty and who is entitled to claim the benefits afforded to such resident by the U.S.-Israel Tax Treaty (called a Treaty U.S. Resident) will not be subject to Israeli capital gains tax unless (a) such Treaty U.S. Resident is an individual and was present in Israel for more than 183 days during the relevant taxable year or (b) such Treaty U.S. Resident holds, directly or indirectly, shares representing 10% or more of the voting power of a company during any part of the 12-month period preceding such sale, exchange or disposition. A sale, exchange or disposition of shares by a Treaty U.S. Resident who is an individual and was present in Israel for more than 183 days during the relevant taxable year or who holds, directly or indirectly, shares representing 10% or more of the voting power of a company at any time during such preceding 12-month period would be subject to such Israeli tax, to the extent applicable, unless the aforementioned exemption from capital gain tax for shares listed on the Tel-Aviv Stock Exchange applies; however, in case under the U.S.-Israel Tax Treaty and the Israeli tax law a Treaty U.S. Resident will be subject to capital gain tax in Israel, such Treaty U.S. Resident would be permitted to claim a credit for such taxes against U.S. income tax , subject to the limitations in U.S. laws applicable to foreign tax credits.

UNITED STATES FEDERAL INCOME TAX CONSIDERATIONS

The following discussion of United States federal income tax considerations is based on the United States Internal Revenue Code of 1986, as amended (the "Code"), Treasury regulations, judicial decisions and published positions of the United States Internal Revenue Service (the "IRS"), all as in effect on the date hereof. This discussion does not address all aspects of United States federal income taxation (including potential application of the alternative minimum tax) that may be relevant to a particular shareholder based on such shareholder's particular circumstances. In particular, the following discussion does not address the United States federal income tax consequences of purchasing, holding or disposing of our ordinary shares to shareholders who own (directly, indirectly or through attribution) 10% or more of our outstanding voting stock or who are broker-dealers, insurance companies, tax-exempt organizations, financial institutions, non-resident aliens of the United States or U.S. Holders (as defined below) whose functional currency is not the U.S. dollar. The following discussion also does not address any aspect of state, local or non-United States tax laws. Further, this summary generally considers only a U.S. Holder that will own our ordinary shares as capital assets (generally, assets held for investment). Each prospective investor should consult its tax advisor with respect to the specific United States federal, state and local tax consequences of purchasing, holding or disposing of our ordinary shares.

IRS CIRCULAR 230 DISCLOSURE

To ensure compliance with requirements imposed by the IRS, we inform you that: (i) any United States federal tax advice contained in this document (including any attachment) is not intended or written by us to be used, and cannot be used, by any taxpayer for the purpose of avoiding tax penalties under the Code; (ii) such advice was written in connection with the promotion or marketing of the transactions or matters addressed herein; and (iii) taxpayers should seek advice based on their particular circumstances from an independent tax advisor.

TAXATION OF U.S. HOLDERS

For purposes of this discussion, a "U.S. Holder" means any beneficial owner of our ordinary shares who, for United States federal income tax purposes, is: (i)

a citizen or resident of the United States; (ii) a corporation or entity treated as a corporation organized in or under the laws of the United States or any state thereof or the District of Columbia; (iii) an estate the income of which is subject to United States federal income taxation regardless of source; or (iv) a trust, if a United States court is able to exercise primary supervision over its administration and one or more United States persons have the authority to control all of its substantial decisions or a trust that was in existence on August 20, 1996 and validly elected to continue to be treated as a domestic trust. A "Non-U.S. Holder" is any beneficial owner other than a U.S. Holder. If a partnership or any other entity or arrangement treated as a partnership holds our ordinary shares, the United States federal income tax treatment of a partner generally will depend upon the status of the partner and the activities of the partnership. If you are a partner in a partnership holding our ordinary shares, you should consult your tax advisor.

DISTRIBUTIONS. We do not anticipate that we will make distributions to shareholders in the foreseeable future. If we do make any such distributions, the gross amount of such distributions (before reduction for any Israeli withholding tax) will be included in the gross income of U.S. Holders to the extent of our earnings and profits, as calculated under United States federal income tax principles. Such dividends will not qualify for the dividends received deduction available in certain circumstances to corporate holders. In the case of an individual holder, dividends received before January 1, 2009 will be eligible for a maximum tax rate of 15% provided such holder holds our ordinary shares for at least 60 days of the 121-day period beginning on the date that is 60 days before the ex-dividend date and provided we are not a PFIC in the year in which the dividend is paid or in the preceding year. Subject to the PFIC discussion below, to the extent that any such distribution exceeds our earnings and profits, such distribution will be treated as a non-taxable return of capital to the extent of the U.S. Holder's adjusted basis in our ordinary shares and thereafter as taxable capital gain. For United States federal income tax purposes, the amount of any dividend that we pay in NIS to a U.S. Holder will equal the U.S. dollar value of such NIS at the exchange rate in effect on the date the dividend is considered to be received by the U.S. Holder, regardless of whether the NIS are actually converted into U.S. dollars at that time. A U.S. Holder who receives a foreign currency distribution and converts the foreign currency into U.S. dollars subsequent to receipt will have foreign exchange gain or loss, based on any appreciation or depreciation in the value of the foreign currency against the U.S. dollar, which will generally be United States source ordinary income or loss.

CREDIT FOR ISRAELI TAXES WITHHELD. Any dividends that we pay to a U.S. Holder with respect to our ordinary shares generally will be treated for United States federal income tax purposes as foreign-source income. Subject to certain conditions and limitations, any Israeli taxes withheld or paid with respect to dividends on our ordinary shares generally will be eligible for credit against the U.S. Holder's United States federal income tax liability. Such limitations include extensive separate computation rules under which foreign tax credits allowable with respect to specific classes of foreign-source income cannot exceed the United States federal income taxes otherwise payable with respect to such classes of income. Subject to the particular circumstances of a U.S. Holder, any dividends with respect to our ordinary shares generally will be classified as "passive income" for foreign tax credit purposes.

Alternatively, a U.S. Holder may elect to claim a United States tax deduction for any such Israeli tax, but only for a tax year in which the U.S. Holder elects to do so with respect to all foreign income taxes paid. In addition, a

non-corporate U.S. Holder cannot elect to deduct Israeli taxes if such U.S. Holder does not itemize deductions.

DISPOSITIONS. In general, any gain or loss recognized by a U.S. Holder on the sale or other disposition of our ordinary shares will be United States-source income or loss for purposes of the United States foreign tax credit limitation. U.S. Holders should consult their tax advisors regarding the application of the United States foreign tax credit limitation to gain or loss recognized on the disposition of our ordinary shares and the treatment of any foreign currency gain or loss on any NIS received in respect of the sale or other disposition of our ordinary shares.

PASSIVE FOREIGN INVESTMENT COMPANY STATUS.

Generally a non-United States corporation is treated as a passive foreign investment company ("PFIC") for United States federal income tax purposes if either (i) 75% or more of its gross income (including the pro rata gross income of any company (United States or non-United States) in which such corporation is considered to own 25% or more of the stock by value) for the taxable year is passive income, generally referred to as the "income test," or (ii) 50% or more of the average value of its assets (including the pro rata value of the assets of any company in which such corporation is considered to own 25% or more of the stock by value) during the taxable year, measured at the end of each quarter, produce or are held for the production of passive income in the taxable year, generally referred to as the "asset test".

We do not believe that we should be treated as a PFIC for any tax year through and including the tax year ended December 31, 2006. However, the statutory provisions, legislative history and administrative pronouncements with respect to the principles under which the asset test is to be implemented leave unanswered a number of questions pertaining to the application of the asset test to us. In the absence of regulations, case law or other guidance from the IRS that addresses these questions, there can be no assurance that we are not, and have not been, a PFIC. In view of this uncertainty, U.S. Holders are urged to consult their tax advisors for guidance.

If we were deemed to be a PFIC for any taxable year during which a U.S. Holder held ordinary shares and such holder failed to make either a "QEF election" or a "mark-to-market election" (each as described below):

- gain recognized by the U.S. Holder upon the disposition of, as well as income recognized upon receiving certain dividends on, our ordinary shares would be taxable as ordinary income;
- the U.S. Holder would be required to allocate such dividend income and/or disposition gain ratably over such holder's entire holding period for such ordinary shares;
- the amount allocated to each year other than the year of the dividend payment or disposition would be subject to tax at the highest individual or corporate tax rate, as applicable, and an interest charge would be imposed with respect to the resulting tax liability;
- the U.S. Holder would be required to file an annual return on IRS Form 8621 regarding distributions received on, and gain recognized on dispositions of, our ordinary shares; and

- any U.S. Holder who acquired our ordinary shares upon the death of a U.S. Holder would not receive a step-up of the income tax basis to fair market value of such shares. Instead, such U.S. Holder beneficiary would have a tax basis equal to the decedent's basis, if lower.

Although a determination as to a corporation's PFIC status is made annually, an initial determination that a corporation is a PFIC for any taxable year generally will cause the above described consequences to apply for all future years to U.S. Holders who held shares in the corporation at any time during a year when the corporation was a PFIC and who did not timely make a QEF election or mark-to-market election (each as described below) with respect to such shares with their United States federal income tax return for the first tax year in which such U.S. Holder owned the shares and the corporation was a PFIC. This will be true even if the corporation ceases to be a PFIC in later years. However, with respect to a PFIC that does not make any distributions or deemed distributions, the above tax treatment would apply only to U.S. Holders who realize gain on their disposition of shares in the PFIC.

In the event that we were deemed to be a PFIC for any taxable year, if a U.S. Holder made a timely and valid QEF election with respect to our ordinary shares:

- the U.S. Holder would be required for each taxable year for which we are a PFIC to include in income such holder's pro rata share of our (i) ordinary earnings as ordinary income and (ii) net capital gain as long-term capital gain, in each case computed under United States federal income tax principles, even if such earnings or gains have not been distributed, unless the shareholder makes an election to defer this tax liability and pays an interest charge;

- the U.S. Holder would not be required to include any amount in income for any taxable year during which we do not have ordinary earnings or net capital gain; and

- the U.S. Holder would not be required to include any amount in income for any taxable year for which we are not a PFIC.

The QEF election is made on a shareholder-by-shareholder basis. Thus, any U.S. Holder of our ordinary shares can make its own decision whether to make a QEF election. A QEF election applies to all shares of the PFIC held or subsequently acquired by an electing U.S. Holder and can be revoked only with the consent of the IRS. It should be noted that U.S. Holders may not make a QEF election with respect to an option to acquire ordinary shares, and that certain classes of investors (for example, consolidated groups and grantor trusts) are subject to special rules regarding the QEF election.

In the event that we were deemed to be a PFIC for any taxable year and a U.S. Holder failed to make a QEF election for the first taxable year that we were a PFIC and such U.S. Holder owned our ordinary shares, the U.S. Holder could obtain treatment similar to that afforded a shareholder who has made a timely QEF election by making a QEF election and a deemed sale election or "purging election" for the same taxable year. If a purging election is made, the U.S. Holder will be treated if it had sold our ordinary shares for their fair market value on the last day of the taxable year and will recognize gain, but not loss, on such deemed sale in accordance with the general PFIC rules, including the interest charge provisions described above. Thereafter, the U.S. Holder's

interest will be treated as an interest in a qualified electing fund.

Alternatively, a U.S. Holder of shares in a PFIC can elect to mark the shares to market annually, recognizing as ordinary income or loss each year the shares are held, as well as on the disposition of the shares, in an amount equal to the difference between the U.S. Holder's adjusted tax basis in the PFIC stock and its fair market value. Losses are allowed only to the extent of net mark-to-market gains previously included in income by the U.S. Holder under the election in prior taxable years. As with the QEF election, a U.S. Holder who makes a mark-to-market election will not be subject to the ratable allocations of gain, the interest charge, and the denial of basis step-up at death described above. A mark-to-market election is irrevocable (except to the extent that our ordinary shares are no longer marketable or the IRS consents to a revocation of the election) and continues to apply even if the PFIC loses its status as such.

U.S. HOLDERS OF OUR ORDINARY SHARES SHOULD CONSULT THEIR TAX ADVISORS ABOUT THE PFIC RULES, INCLUDING THE POSSIBILITY, AND ADVISABILITY OF, AND THE PROCEDURE AND TIMING FOR MAKING A QEF OR MARK-TO-MARKET ELECTION IN CONNECTION WITH THEIR HOLDING OF ORDINARY SHARES, INCLUDING OPTIONS TO ACQUIRE OUR ORDINARY SHARES.

CONTROLLED FOREIGN CORPORATION STATUS

We have not determined whether we meet the definition of a controlled foreign corporation ("CFC") for United States federal income tax purposes. We would be a CFC if U.S. persons each owning (directly, indirectly or by attribution) 10% or more of the voting power of our shares ("10% Shareholders") own in the aggregate more than 50% of the voting power or value of our shares. If we were a CFC, 10% Shareholders could have adverse consequences, including being required to include a portion of our undistributed income as constructive dividends in taxable income each year.

U.S. HOLDERS OF OUR ORDINARY SHARES WHO MAY BE 10% SHAREHOLDERS SHOULD CONSULT THEIR INDEPENDENT TAX ADVISORS ABOUT THE CFC RULES.

TAXATION OF NON-U.S. HOLDERS

Subject to the discussion below with respect to the United States backup withholding tax, a Non-U.S. Holder generally will not be subject to United States federal income tax on dividends from us, if any, or gain from the sale or other disposition of ordinary shares, unless (i) such income is effectively connected with the conduct by the Non-U.S. Holder of a United States trade or business, and in the case of a resident of a country which has an income tax treaty with the United States, such income is attributable to a permanent establishment (or in the case of an individual, a fixed place of business) in the United States; or (ii) with respect to any gain on the sale or other disposition of ordinary shares realized by an individual Non-U.S. Holder, such individual Non-U.S. Holder is present in the United States for 183 days or more in the taxable year of the sale or other disposition and meets certain other conditions.

BACKUP WITHHOLDING AND INFORMATION REPORTING

Under the Code, under certain circumstances, United States tax information reporting and "backup withholding" of United States federal income tax on dividends on, and the proceeds of dispositions of, our ordinary shares may apply to both U.S. Holders and Non-U.S. Holders. Backup withholding will not apply, however, to a holder who furnishes a correct taxpayer identification number or certificate of foreign status and makes any other required certification or who is otherwise exempt from backup withholding. Generally, a U.S. Holder will provide such certification on IRS Form W-9, and a non-U.S. Holder will provide such certification on IRS Form W-8. Any amounts withheld under the United States backup withholding rules will be allowed as a refund or credit against the U.S. Holder's or the non-U.S. Holder's United States federal income tax liability, provided the required information is furnished to the IRS.

10.F. DIVIDENDS AND PAYING AGENTS

Not applicable.

10.G. STATEMENT BY EXPERTS

Not applicable.

10.H. DOCUMENTS ON DISPLAY

We are subject to certain of the information reporting requirements of the Exchange Act. As a "foreign private issuer" we are exempt from the rules and regulations 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, with respect to their purchase and sale of our shares. In addition, we are not required to file reports and financial statements with the Securities and Exchange Commission as frequently or as promptly as U.S. 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 financial statements audited by an independent accounting firm, within 180 days after the end of each fiscal year.

You may read and copy any document we file with the SEC at its public reference facilities at, 100 F Street, N.E., Room 1580, Washington, D.C. 20549 and at the SEC's regional offices at 233 Broadway, New York, NY 10279 and Citicorp Center, 500 West Madison Street, Suite 1400, Chicago, IL 60661. You may also obtain copies of the documents at prescribed rates by writing to the Public Reference Section of the SEC at 100 F Street, N.E., Room 1580, Washington, D.C. 20549. The SEC also maintains a web site that contains reports, proxy and information statements and other information regarding registrants that file electronically with the SEC. The address of this web site is http://www.sec.gov. Please call the SEC at 1-800-SEC-0330 for further information on the operation of the public reference facilities.

10.I. SUBSIDIARY INFORMATION

Not applicable.

ITEM 11. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We do not use derivative financial instruments in our investment portfolio to hedge foreign currency or other types of market risks. We place our investments in instruments that meet high credit quality standards. We generally invest cash

in time deposit. We do not expect any material loss with respect to our investment portfolio.

The table below provides information about our investment portfolio. For investment securities, the table presents principal cash flows and related weighted average interest rates by expected maturity dates. Our investment policy requires that all investments mature in two years or less.

Principal (Notional) Amounts by Expected Maturity in U.S. Dollars:

FAIR MARKET VALUE ON DECEMBER 31
(IN THOUSANDS, EXCEPT INTEREST RATES AND DURATION)

	2004(1)	2005(2)	20
Total Portfolio	9,260	5,291	9,
Average Interest Rate	2.2%	4.2%	
Average Duration (Month)	0.25	0.25	0
Cash Equivalents (up to three months maturity)	9,260	5,291	6,
Average Interest Rate	2.2%	4.2%	
Short Term Investments (three-twelve months maturity)	-	-	3,
Average Interest Rate	-	-	

ITEM 12. DESCRIPTION OF SECURITIES OTHER THAN EQUITY SECURITIES

Not applicable.

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(1) Data relates to Tdsoft prior to the business combination.

(2) Data relates to the combined company.

PART TWO.

ITEM 13. DEFAULTS, DIVIDEND ARREARAGES AND DELINQUENCIES

The Company is not in default of any payment of principal, interest, sinking or purchase fund installment, or indebtedness of the Company or any of its subsidiaries exceeding 5% of total assets on a consolidated basis. There has been no payment of dividends that is in arrears, and there has been no material delinquency relating to any class of preferred stock in the Company or its subsidiaries.

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

There have been no material changes to or limitations on the rights of the holders of any class of registered shares caused by the changes in the terms of the securities or the issuance or modification of a different class of securities. There has been no material withdrawal or substitution of assets.

ITEM 15. CONTROLS AND PROCEDURES

15.A. EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES

The Company's management, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, have evaluated the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) as of the end of the period covered by this annual report. Based on such evaluation, the Company's Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of such period, the Company's disclosure controls and procedures are effective in recording, processing, summarizing and reporting, on a timely basis, information required to be disclosed by the Company in reports that it files or submits under the Exchange Act.

15.B. CHANGES IN INTERNAL CONTROLS OVER FINANCIAL REPORTING

There have not been any changes in the Company's internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) or in other factors during the period covered by this annual report that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

ITEM 16.A. AUDIT COMMITTEE FINANCIAL EXPERT.

The Company's audit committee is comprised of Joseph Atsmon, Yoseph Dauber and Michal Even-Chen. We believe that Mr. Atsmon and Mr. Dauber qualify as audit committee financial experts as such term is defined in the Form 20-F.

ITEM 16.B. CODE OF ETHICS.

We have adopted a written code of ethics that applies to our principal executive officer, principal financial officer, executive vice president global sales, principal controller, treasurer and to persons performing similar functions. A copy of our code of ethics was filed with our annual report on Form 20-F for the year ended December 31, 2003 as Exhibit 11.

We have also adopted written standards of business conduct that apply to all directors, officers and employees. During 2006, our board of directors adopted certain amendments to the insider trading policy included in such standards of business conduct. A copy of the amended insider trading policy is filed as an exhibit to this annual report.

ITEM 16.C. PRINCIPAL ACCOUNTANT FEES AND SERVICES.

Our audit committee pre-approval policies and procedures for audit and non-audit services are referred to in Exhibit 4.1(f) to this annual report.

The auditors of VocalTec billed for the following fees for audit and audit-related services in 2005 and 2006 (in thousands of U.S. dollars):

	Year Ended December 31,			
	2005		2006	
Services rendered	Fees	Percentages	Fees	Percentages

Audit (1)	30.0	61%	71.0	70%
Audit-related (2)	0	0%	16.0	16%
Tax (3)	12.0	24%	15.0	14%
Other (4)	8.0	15%	-	%
Total	50.0	100%	102	100%

(1) Audit fees consist of services that would normally be provided in connection with statutory and regulatory filings or engagements, including services that generally only the independent accountant can reasonably provide.

(2) Audit-related fees relate to assurance and associated services that traditionally are performed by the independent auditor, including: accounting consultation and consultation concerning financial accounting and reporting standards.

(3) Tax fees relate to tax compliance, planning and advice.

(4) Other fees relate to consulting services.

All of the services referred to in clauses (2), (3) and (4) above were approved by the audit committee of VocalTec.

ITEM 16D. EXEMPTIONS FROM THE LISTING STANDARDS FOR AUDIT COMMITTEES - NONE.

ITEM 16E. PURCHASES OF EQUITY SECURITIES BY THE ISSUER AND AFFILIATED PURCHASERS - NONE.

PART THREE.

ITEM 17. FINANCIAL STATEMENTS

Not applicable.

ITEM 18. FINANCIAL STATEMENTS

CONSOLIDATED FINANCIAL STATEMENTS AS OF DECEMBER 31, 2006

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VOCALTEC COMMUNICATIONS LTD. AND ITS SUBSIDIARIES

CONSOLIDATED FINANCIAL STATEMENTS

AS OF DECEMBER 31, 2006

IN U.S. DOLLARS

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[ERNST & YOUNG LOGO]

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

TO THE BOARD OF DIRECTORS AND SHAREHOLDERS OF

VOCALTEC COMMUNICATIONS LTD.

We have audited the accompanying consolidated balance sheets of VocalTec Communications Ltd. ("the Company") and its subsidiaries as of December 31, 2006 and 2005, and the related consolidated statements of operations, changes in shareholders' equity and cash flows for the years then ended. 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 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 the financial statements are free of material misstatement. We were not engaged to perform an audit of the Company's and its subsidiaries' internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's and its subsidiaries' internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts

and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company and its subsidiaries as of December 31, 2006 and 2005, and the consolidated results of their operations and their cash flows for the years then ended , in conformity with U.S. generally accepted accounting principles.

As discussed in Note 2 to the consolidated financial statements, effective January 1, 2006 the Company adopted Statement of Financial Accounting Standards Board No. 123 (revised 2004) "Share Based Payment".

Tel-Aviv, Israel
March 30, 2007

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

[KESSELMAN & KESSELMAN, A MEMBER OF PRICEWATERHOUSECOOPERS]

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

TO THE SHAREHOLDERS OF

TDSOFT LTD.

We have audited the accompanying consolidated balance sheet of Tdsoft Ltd. (the "Company") and its subsidiaries as of December 31, 2004 and the related consolidated statements of operations, changes in capital deficiency and cash flows for each of the two years in the period ended December 31, 2004. These consolidated financial statements are the responsibility of the Company's board of directors and 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 the Company's Board of Directors and 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 and its subsidiaries as of December 31, 2004 and the results of their operations, changes in capital deficiency and their cash flows for each of the two years in the period ended December 31, 2004, in conformity with accounting principles generally accepted in the United States of America.

As more fully described in Note 1b to the accompanying consolidated financial statements, subsequent to December 31, 2005, the Company may be dependent on obtaining additional funding in order to continue its activities.

Tel-Aviv, Israel

November 17, 2005 except shares and per share data as to which the date is April 20, 2006

VOCALTEC COMMUNICATIONS LTD.
AND ITS SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

U.S. DOLLARS IN THOUSANDS

	NOTE	DECEMBER 31, 2006
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents		$ 5,954
Short term deposit	4	3,000
Restricted cash		162
Trade receivables (net of allowance for doubtful accounts of $120 and $50 as of December 31, 2006 and 2005, respectively		1,443
Prepaid expenses and other accounts receivable	5	768
Severance pay funds		91
Inventories	6	1,098
TOTAL current assets		12,516
SEVERANCE PAY FUNDS		1,186
PROPERTY AND EQUIPMENT, NET	7	888
INTANGIBLE ASSETS:	3,8	
Goodwill		6,950
Other intangible assets		3,047
TOTAL intangible assets		9,997
Total assets		$24,587

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

VOCALTEC COMMUNICATIONS LTD.
AND ITS SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

U.S. DOLLARS IN THOUSANDS, EXCEPT SHARE DATA

	NOTE	DECEMB 2006
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Trade payables		$ 930
Accrued expenses and other accounts payable	9	2,996
Accrued severance pay		217
Loan from shareholder	10	-
Deferred revenues		177
TOTAL current liabilities		4,320
LONG-TERM LIABILITIES:		
Other liabilities		8
Accrued severance pay		1,721
TOTAL long-term liabilities		1,729
TOTAL liabilities		6,049
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Share capital		
Ordinary shares of NIS 0.13 par value: Authorized - 150,000,000 shares at December 31, 2006 and 2005; Issued and outstanding - 7,376,364 and 4,661,627 shares at December 31, 2006 and 2005, respectively		213
Deferred stock based compensation		-
Additional paid-in capital		92,228
Accumulated deficit		(73,903)
TOTAL shareholders' equity		18,538
		$ 24,587

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

VOCALTEC COMMUNICATIONS LTD.
AND ITS SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

U.S. DOLLARS IN THOUSANDS, EXCEPT PER SHARE DATA

	NOTE	YEAR ENDED DECEMB 2006	2005
Sales:	14		
Products		$ 4,738	$ 3,668
Services		2,542	925
		7,280	4,593
Cost of sales **):			
Products		2,171	1,450
Services		563	315
		2,734	1,765
Inventory write-off		-	639
Amortization of intangible assets		392	172
		3,126	2,576
Gross profit		4,154	2,017
Operating expenses:			
Research and development, net **)	15	4,619	4,363
Selling and marketing **)		4,147	2,763
General and administrative **)		2,474	1,748
TOTAL operating expenses		11,240	8,874
Operating loss		(7,086)	(6,857)
Other income, net		42	24
Financial income, net	16	32	184
Loss before tax benefit		(7,012)	(6,649)
Tax benefit	17	-	19

Net loss		$ (7,012)	$ (6,630)
Accretion of redeemable convertible Preferred shares	12	$ -	$ (348)
Induced conversion of convertible Preferred shares	12	-	(17,406)
Cumulative dividend on convertible Preferred shares		-	(2,585)
Dividend in respect of reduction in exercise price of certain warrants		(37)	-
Net loss attributable to common shareholders		$ (7,049)	$(26,969)
Basic and diluted net loss per Ordinary share	13	$ (1.30)	$ (34.05)
Weighted average number of Ordinary shares used in computing net loss per Ordinary share - basic and diluted		5,436	792

*) See Note 3a

**) Expenses include stock based compensation related to employees as follows:

Cost of sales	$ 8	$ -
Research and development, net	248	522
Selling and marketing	138	13
General and administrative	554	268
	$ 948	$ 803

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

VOCALTEC COMMUNICATIONS LTD.
AND ITS SUBSIDIARIES

STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (DEFICIENCY)

U.S. DOLLARS IN THOUSANDS, EXCEPT SHARE DATA

	NUMBER OF SHARES (*)			
	ORDINARY	ORDINARY A	PREFERRED	ORDINA
Balance as of January 1, 2004	370,059	-	83,479	$ 14
Issuance of Ordinary A shares	-	45,590	-	-
Forfeiture of options granted to				

employees, net	-	-	-	-
Accretion of redeemable convertible Preferred shares	-	-	-	-
Net loss	-	-	-	-
Balance as of December 31, 2004	370,059	45,590	83,479	14
Accretion of redeemable convertible Preferred shares	-	-	-	-
Conversion of redeemable convertible Preferred B and C shares into Preferred shares	-	-	70,752	-
Stock based compensation related to shares and options issued to employees	122,343	-	-	3
Conversion of convertible Preferred shares into Ordinary shares	199,821	(45,590)	(154,231)	6
Issuance of shares and options pursuant to the merger with VocalTec	1,162,142	-	-	32
Exercise of employees stock options	17,979	-	-	-
Induced conversion of convertible Preferred shares	2,789,283	-	-	77
Net loss	-	-	-	-
Balance as of December 31, 2005	4,661,627	-	-	132
Reclassification of deferred stock compensation due to the adoption of SFAS 123(R)	-	-	-	-
Stock based compensation related to options issued to employees				
Exercise of employees stock options	29,737	-	-	1
Issuance of ordinary shares and warrants in private placements	2,685,000			80
Dividend in respect of reduction in exercise price of certain warrants				
Net loss				
Balance as of December 31, 2006	7,376,364	-	-	213

	ADDITIONAL PAID-IN CAPITAL	TREASURY STOCK AT COST	DEFERRED STOCK BASED COMPENSATION	ACCUMULA DEFICI
Balance as of January 1, 2004	$ -	$ (1,445)	$(15)	$(33,9
Issuance of Ordinary A shares	**) 445	-	-	
Forfeiture of options granted to employees, net	(47)	-	15	
Accretion of redeemable convertible Preferred shares	(398)	-	-	(2,8
Net loss	-	-	-	(5,6
Balance as of December 31, 2004	-	(1,445)	-	(42,4
Accretion of redeemable convertible Preferred shares	-	-	-	(3

Conversion of redeemable convertible Preferred B and C shares into Preferred shares	54,903	-	-	
Stock based compensation related to shares and options issued to employees	867	-	(67)	
Conversion of convertible Preferred shares into Ordinary shares	-	-	-	
Issuance of shares and options pursuant to the merger with VocalTec	6,401	1,445	-	
Exercise of employees stock options	152	-	-	
Induced conversion of convertible Preferred shares	17,329	-	-	(17,4
Net loss	-	-	-	(6,6
Balance as of December 31, 2005	79,652	-	(67)	(66,8
Reclassification of deferred stock compensation due to the adoption of SFAS 123(R)	(67)	-	67	
Stock based compensation related to options issued to employees	948	-		
Exercise of employees stock options	149	-	-	
Issuance of ordinary shares and warrants in private placements	**)11,509			
Dividend in respect of reduction in exercise price of certain warrants	37			(
Net loss				(7,0
Balance as of December 31, 2006	92,228	-	-	(73,9

*) For the periods until the date of the business combination (November 2005) - restated to reflect the number of the Company's shares issued in exchange for each type of Tdsoft shares in the business combination - see Notes 3a and 12a.

**) Net of issuance expenses of $ 1,075 and $ 217 and $ 50 in 2006, 2005 and 2004, respectively.

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

VOCALTEC COMMUNICATIONS LTD.
AND ITS SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. DOLLARS IN THOUSANDS

	YEAR ENDED DE	
	2006	2005

CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$ (7,012)	$(6,63
Adjustments required to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	1,428	81
Changes in the accrued liability for severance pay	(697)	7
Compensation expense related to shares and options issued to employees, net	948	80
Gain on sale of equipment	(19)	(
Loss (gain) on amounts funded in respect of severance pay	(158)	1
Decrease (increase) in trade receivables, net	(868)	37
Decrease (increase) in prepaid expenses and other receivables	610	(62
Decrease (increase) in inventories	(43)	50
Increase (decrease) in trade payables	(483)	(42
Increase (decrease) in accrued expenses and other liabilities	(1,142)	29
Increase (decrease) in deferred revenues	6	3
Net cash used in operating activities	(7,430)	(4,76
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of property and equipment	(335)	(30
Cash and cash equivalents resulting from the merger between VocalTec and Tdsoft (schedule A)	-	72
Cash and cash equivalents resulting from the acquisition of Be-Connected (schedule B)	-	
Proceeds from sale of property and equipment	26	10
Investment in short term deposit	(3,000)	
Amounts withdrawn (funded) in respect of severance pay funds, net	847	(3
Net cash provided by (used in) investing activities	(2,462)	49
CASH FLOWS FROM FINANCING ACTIVITIES:		
Repayment of loan from shareholder	(1,031)	
Proceeds from issuance of shares upon exercise of stock options by employees	150	15
Issuance of shares, net	11,589	
Issuance expenses for Ordinary A shares	-	
Net cash provided by (used in) financing activities	10,708	15
Increase (decrease) in cash and cash equivalents	816	(4,12
Cash and cash equivalents at the beginning of the year	5,138	9,26
Cash and cash equivalents at the end of the year	$ 5,954	$ 5,13
SUPPLEMENTAL CASH FLOWS INFORMATION:		
Cash paid during the year for income taxes	$ 27	$ 1

*) See Note 3a.

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

VOCALTEC COMMUNICATIONS LTD.
AND ITS SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. DOLLARS IN THOUSANDS

SCHDULE A:

CASH AND CASH EQUIVALENTS RESULTING FROM THE MERGER BETWEEN VOCALTEC AND TDSOFT

	YEAR ENDED DECEMBER 31,		
	2006	2005	2004
Working capital deficiency, excluding cash	$ -	$ 3,708	$ -
Loan granted to VocalTec prior to the acquisition	-	341	-
Accrued severance pay, net	-	261	-
Property and equipment	-	(328)	-
Intangible assets other than goodwill	-	(3,896)	-
Goodwill	-	(7,237)	-
Issuance of shares	-	7,878	-
	$ -	$ 727	$ -

SCHEDULE B:

CHANGE IN CASH AND CASH EQUIVALENTS RESULTING FROM THE ACQUISITION OF BE-CONNECTED

	YEAR ENDED DECEMBER 31,		
	2006	2005	2004
Assets of business upon acquisition:			
Inventories	$ -	$ -	(236)
Trade receivables	-	-	(64)
Fixed assets	-	-	(3)
Issuance of shares			496
Intangible assets	-	-	(213)
	$ -	$ -	$ (20)

The accompanying notes are an integral part of the consolidated financial

statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA

NOTE 1:- GENERAL

a. VocalTec Communications Ltd. ("VocalTec") and its subsidiaries ("the Company"), is a global provider of carrier-class multimedia and voice-over-IP solutions for communication service providers. The Company provides trunking, peering, access gateway and service delivery solutions that enable flexible deployment of next-generation networks (NGNs).

b. On November 24, 2005, VocalTec acquired all of the issued and outstanding Ordinary shares of Tdsoft Ltd. ("Tdsoft"), a privately-held company organized in Israel, and as consideration issued to Tdsoft shareholders Ordinary shares of VocalTec constituting, immediately following such issuance, 75% of the issued and outstanding share capital of VocalTec. For accounting purposes, the transaction was accounted for as a reverse acquisition, with Tdsoft treated as the accounting acquirer. Accordingly, the acquisition was accounted for as a purchase business combination using Tdsoft's historical financial information and recording VocalTec acquired assets and assumed liabilities at fair value as of November 24, 2005 (see Note 3a).

c. During 2006, 2005 and 2004, 31%, 34% and 46% of the Company's revenues, respectively, were derived from major customers (see Note 14).

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States ("U.S. GAAP"). The significant accounting policies followed in the preparation of the financial statements, applied on a consistent basis, are:

a. Use of estimates:

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements, and the reported amounts of income and expenses during the reported period. Actual results could differ from those estimates.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

b. Financial statements in U.S. dollars:

The financial statements have been prepared in U.S. dollars ("dollar"), since the currency of the primary economic environment in which the operations of the Company are conducted is the dollar. Most of the Company's revenues are generated in dollar. In addition, a considerable portion of the Company's costs is incurred in dollars and the Company's financing is obtained in dollar. The Company's management believes that the dollar is the currency of the primary economic environment in which the Company operates. Thus, the functional and reporting currency of the Company is the dollar. Accordingly, the Company's and its subsidiaries' transactions and balances denominated in dollars are presented at their original amounts. Transactions and balances in other currencies have been remeasured into dollars in accordance with the guidance in Statements of the Financial Accounting Standard No. 52, "Foreign Currency Translation" ("SFAS No. 52").

Amounts in currencies other than the dollar have been translated as follows:

Monetary balances - at the exchange rate in effect on the balance sheet date.

Revenues and costs - at the exchange rates in effect as of the date of recognition of the transactions.

All exchange gains and losses from the remeasurement mentioned above are reflected in the statement of operations under financial income, net.

The representative rate of exchange for the new Israeli shekel ("NIS") and the U.S. dollar at December 31, 2006 was $ 1.00 = NIS 4.225 (December 31, 2005 - NIS 4.603 and December 31, 2004 - NIS 4.308).

c. Principles of consolidation:

The consolidated financial statements include the accounts of the Company and its directly and indirectly wholly-owned subsidiaries. As of the balance sheet date the only significant subsidiary is Tdsoft Ltd.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

d. Business combination:

Business combinations have been accounted for using the purchase method of accounting. Under the purchase method of accounting the results of operations of the acquired business are included from the effective date of acquisition. The costs to acquire companies, including transactions costs, have been allocated to the underlying net assets of the acquired company in proportion to their respective fair values. Any excess of the purchase price over estimated fair values of the identifiable net assets acquired has been recorded as goodwill.

e. Cash equivalents, restricted cash and short term bank deposits:

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

Restricted cash is invested in highly liquid deposits, which are used as security for bank guarantees provided primarily to lessors of office premises and motor vehicles.

Short term bank deposits with original maturities of more than three months but less than one year are presented as part of short-term investments. Such deposits are presented at cost including accrued interest. Interest on the deposits is recorded as financial income.

f. Inventories:

Inventories are stated at the lower of cost or market value. Inventory write-offs are provided to cover risks arising from slow-moving items, technological obsolescence and discontinued products. Costs are determined as follows:

Components cost is determined by the average-cost method.

Finished goods are determined on the basis of direct costs, with costs measured on an average basis.

Write-off of inventories for the years ended December 31,2006, 2005 and 2004 amounted to $0, $639 and $0, respectively.

g. Fair value of financial instruments:

SFAS No. 107 "Disclosure about Fair Value of Financial Instruments", requires disclosure of an estimate of the fair value of certain financial instruments. The Company's financial instruments consist of cash and cash equivalents, short-term deposit, trade receivables, other accounts receivable, trade payables, other accounts payable and other liabilities. The estimated fair value of these financial instruments approximates their carrying value as of December 31, 2006 and 2005 due to the short term maturities of those instruments.

U.S. DOLLARS IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

h. Property and equipment, net:

Equipment is stated at cost less 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 related equipment	33
Office furniture and equipment	6 - 25
Motor vehicles	15
Leasehold improvements	Over the shorter of the term of the lease or the life of the asset *)

*) See also Note 11d.

i. Impairment and disposal of long-lived assets:

The Company's amortizable long-lived assets are reviewed for impairment in accordance with Statement of Financial Accounting Standards No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to the future undiscounted cash flows expected to be generated by the asset. If an asset is considered to be impaired, the impairment is measured by the difference between the carrying amount of the asset and its fair value. During the periods presented no impairment changes were recorded.

j. Intangible assets:

Intangible assets include mainly goodwill technology, customers relations, customer contracts and other identifiable intangible assets acquired in connection with the purchase of businesses. Technology and other identifiable intangible definite lived assets are amortized over their estimated useful lives.

The Company evaluates the amortization periods of all identifiable intangible assets to determine whether events or circumstances warrant revised estimates of useful lives.

Under Statement of Financial Accounting Standard No. 142 "Goodwill and other Intangible Assets" ("SFAS 142") goodwill is no longer amortized but instead is tested for impairment at least annually (or more frequently if impairment indicators arise).

SFAS No. 142 requires to compare the fair value of the reporting unit to its carrying amount on an annual basis to determine if there is a potential impairment. If the fair value of the reporting unit is less than its carrying value, an impairment loss is recorded to the extent that the implied fair value of the goodwill within the reporting unit is less than its carrying value. The fair value of the reporting unit is determined based on market capitalization. During the periods presented no impairment charges were recorded.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

k. Revenue recognition:

The Company generates revenues from licensing the rights to use its software products, from the sale of its systems and from providing maintenance and support services. The Company's products are sold also to resellers, who are considered end-users for the purpose of revenue recognition (except as indicated below).

Revenue from software products is recognized when all criteria outlined in SOP 97-2 are met: persuasive evidence of an arrangement exists, the product has been delivered, no significant obligation to the customer remains, the sales price is fixed or determinable and collectibility is reasonably assured. The Company does not grant a right of return to its customers.

Revenue from sale of systems is recognized upon delivery to the end-user or the reseller. Provisions for warranty are made at the time of the sale. Such revenues are recognized in accordance with Staff Accounting Bulletin No. 104 "Revenue Recognition in Financial Statements" ("SAB No. 104")

Where software arrangements involve multiple elements, revenue is allocated to each undelivered element based on vendor specific objective evidence ("VSOE") of the fair value of the undelivered element. The VSOE used by the Company to allocate the arrangement fees to support services and maintenance is based on the price charged when these elements are sold separately (upon renewal). Revenues for the delivered product are recorded based on the "residual method" presented by SOP 98-9, "Modification of SOP 97-2, Software Revenue Recognition With Resepct to Certain Transactions", whereby the reminder of the arrangement fee, after allocating revenue to undelivered elements as described above is allocated to the delivered product. Under the residual method revenue is recognized for the delivered elements when (1) there is VSOE of fair value on all the undelivered elements and (2) all revenue recognition criteria of SOP 97-2 are satisfied. Under the residual method any discount in the arrangement is allocated to the delivered element.

When an arrangement provides for acceptance of the product by the customer, revenue is not recognized until such acceptance is received.

In certain cases, when the company sells its products through resellers in new and emerging market channels for which no comparable history has been established, the Company recognizes revenues only when all obligations to the end user have been completed, provided all other revenue recognition criteria have been met.

Arrangements including training and installation services are recognized only after the services are performed.

Revenue from software maintenance and technical support contracts is recognized on a straight line basis over the term of the maintenance and support arrangement.

Engineering services are recognized as services are performed

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

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

For the sale of systems the Company records at the time of sale a provision to cover the expected costs in order to honor its warranty obligation. As of December 31, 2006 and 2005 the warranty provision amounted to $ 20 and $ 180, respectively.

l. Research and development costs, net:

Research and development costs, net of grants received, are charged to the statement of operations as incurred. Statement of Financial Accounting Standard No. 86, "Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed", ("SFAS No. 86"), requires capitalization of certain software development costs subsequent to the establishment of technological feasibility. Costs incurred by the Company between the establishment of technological feasibility and the point at which the products are ready for general release, have been insignificant. Therefore, all research and development costs have been expensed. Research and development grants were deducted from research and development costs (See m below).

m. Royalties-bearing grants

Royalty-bearing grants from the Government of Israel and other governmental institutions for funding approved research and development projects are recognized at the time the Company is entitled to such grants, on the basis of the research and development costs incurred. Such grants are included as a deduction of research and development costs since at the time received it is not probable the Company will generate sales from these projects and pay the royalties resulting from such sales. For the grants received and deducted from the research and development costs - see Note 15.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

n. Income taxes:

Income taxes are accounted for in accordance with Statement of Financial Accounting Standard No. 109, "Accounting for Income Taxes" ("SFAS No. 109"). This statement prescribes the use of the liability method whereby deferred tax asset and liability account balances are determined based on temporary differences between financial reporting and tax bases of assets and liabilities and for carry forward losses. Deferred taxes are measured using the enacted tax rates that will be in effect when the differences are expected to reverse. The Company provides a valuation allowance, to reduce deferred tax assets to their estimated realizable value.

o. Share-based compensation:

Until January 1, 2006, the Company has elected to follow Accounting Principles Board Statement No. 25, "Accounting for Stock Options Issued to Employees" ("APB No. 25") and Financial Accounting standard Board (FASB) Interpretation No. 44, "Accounting for Certain Transactions Involving Stock Compensation" ("FIN No. 44") in accounting for its employee stock option plans. According to APB No. 25, compensation expense is measured under the intrinsic value method, whereby compensation expense is equal to the excess, if any, of the quoted market price of the stock over the exercise price at the grant date of the award. Forfeitures are accounted for as occurred.

Effective January 1, 2006, the Company adopted FASB Statement No. 123 (revised 2004), "Share-Based Payment" ("SFAS 123(R)") , and related Securities and Exchange Commission rules included in Staff Accounting Bulletin No. 107, on a modified prospective basis. Under this method, compensation cost recognized in 2006 includes costs related to 1) all share-based payments granted prior to but not yet vested as of January 1, 2006, based on the grant-date fair value estimated in accordance with the original provisions of SFAS 123 and 2) all share-based payments granted subsequent to January 1, 2006 based on the grant-date fair value estimated in accordance with the provisions of SFAS 123(R). Results for prior periods have not been restated. Compensation cost for stock options is recognized ratably over the vesting period using the straight line method.

SFAS No. 123(R) 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 income statements.

As a result of adopting Statement 123(R) on January 1, 2006 the Company's loss before income taxes and net loss for the year ended December 31, 2006 are $585 higher, respectively, than if the Company had continued to account for share-based compensation under Opinion 25. Basic and diluted loss per share for the year ended December 31, 2006 are $0.11 higher, respectively, than if the Company had continued to account for share-based compensation under Opinion 25.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

The Company estimates the fair value of stock options on the grant date using the Black-Scholes option-pricing model with the following weighted average assumptions:

	2006	2005	2004
Dividend yield	0%	0%	0%
Expected volatility	105%	102%	94%
Risk-free interest rate	4.9%	4.4%	3.9%
Weighted average expected life	4.6 years	4.17 years	5.0 years
Forfeiture rate	7.5%	-	-

The Company is required to assume a dividend yield as an input in the Black-Scholes model. The dividend yield assumption is based on Company's historical and expectation of future dividend. The dividend yield used for the twelve months ended December 31, 2006 was 0%, as the Company does not expect to pay dividend over the option terms.

The weighted average volatility used for the twelve months ending December 31, 2006 was 105%. This assumption is based on the historical volatility of the Company's stock over a period equal to the expected life of the option.

The risk-free interest rate assumption is based on observed interest rates appropriate for the term of the Company's employee stock options. Weighted average interest rate used for the twelve months ended December 31, 2006 was 4.9%.

The Company determined the expected life of the options according to the "simplified method" allowed under SAB107, which is the average of the vesting and the contractual term of the Company's stock options. Expected life used for the twelve months ended December 31, 2006 was 4.6 years.

The computation of the forfeiture rate is based on the historical observation of employees pre-vesting termination behavior.

The Company's aggregate compensation cost for the twelve months ended December 31, 2006 totaled $948.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

The following table illustrates the effect on net and net earnings loss per share, assuming that the Company had applied the fair value recognition provisions of SFAS 123 to options granted under the Company's stock options plans in all periods presented prior to the adoption of SFAS 123(R). For purposes of this pro forma disclosure, the value of the options is estimated using a Black-Scholes-Merton option-pricing model and amortized to expense over the options' vesting periods using the accelerated attribution method.

	YEAR ENDED DECEMBER 31	
	2005	2004
Net loss as reported	$ (6,630)	$(5,686)
Add: stock based employee compensation expense (reversal income) included in reported net loss for the year	803	(32)
Deduct: stock based employee compensation expense reversal income determined under fair value method for all options granted	(1,129)	(220)
Pro forma net loss	$ (6,956)	$(5,938)
Accretion of redeemable convertible Preferred shares	$ (348)	$(3,256)
Induced conversion of convertible Preferred shares	(17,406)	-
Cumulative dividend on convertible preferred shares	(2,585)	-
Pro forma net loss attributable to common shareholders	$(27,295)	$(9,194)
Basic and diluted net loss per Ordinary share:		
Net loss per Ordinary share as reported	$ (34.05)	$(24.16)
Pro forma net loss per Ordinary share	$ (34.46)	$(24.84)

The Company's additional disclosures required by SFAS 123(R) are provided in Note 12.

As of December 31, 2006, the total unrecognized estimated compensation cost related to non-vested stock options granted prior to that date was $2,545, which is expected to be recognized over a period of up to four years. The total intrinsic value of stock options exercised during 2006 was $102. The Company recorded cash received from the exercise of stock options of $150 during the year ended December 31, 2006.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

p. Severance pay:

The Company's liability for severance pay for its Israeli employees is calculated pursuant to Israel's Severance Pay Law and employment agreements based on the most recent salary of the employees. The Company's liability for all of its employees, is fully covered for by monthly deposits with insurance policies and by an accrual. The value of these insurance policies is recorded as an asset in the Company's balance sheet.

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

Severance expense for the years ended December 31, 2006, 2005 and 2004 amounted to approximately $ 170, $ 77 and $ 157, respectively.

q. Concentration of credit risks:

Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of cash and cash equivalents, restricted cash, marketable securities and trade receivables.

Cash and cash equivalents and the short term deposit are invested in U.S. dollars with major banks in the United States and in Israel. Management believes that the financial institutions that hold the Company investments are financially sound and, accordingly, minimal credit risk exists with respect to these investments.

The Company's trade receivables are generally derived from sales of products and services rendered to large and solid organizations located primarily in Europe, North America, and the Far East. The Company performs ongoing credit evaluations of its customers. To date the Company has not experienced any material losses in respect of its trade receivable. For new customers, the Company may require a letter of credit or. An allowance for doubtful accounts is determined based on Management's estimation and historical experience.

Expense resulting from the net increase in the allowance for doubtful accounts was $ 70, $ 0 and $ 38 for the years ended December 31, 2006, 2005 and 2004, respectively.

As of December 31, 2006, there is no significant off-balance sheet concentration of credit risk such as foreign exchange contracts, options contracts or other foreign hedging arrangements.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

r. Net loss per share:

Basic net loss per share is computed using the weighted average number of Common shares outstanding during the period, and excludes any dilutive effects of options. Diluted net loss per share is computed using the weighted average number of Common shares plus dilutive potential shares of Ordinary stock considered outstanding during the period. In accordance with Emerging Issues Task Force Issue 03-6 "Participating Securities and the Two-Class Method under FASB Statement No. 128" ("EITF 03-6"), participating convertible securities are excluded from the computation since there is no contractual obligation for these securities to share in the Company net loss.

In the years ended December 31, 2006, 2005 and 2004, all outstanding stock options and in the years ended December 31, 2005 and 2004 also all the series of Preferred shares have been excluded from the calculation of the diluted net loss per Ordinary share since such securities were anti-dilutive.

s. Recently issued Accounting Standards:

In September 2006, the Financial Accounting Standards Board ("FASB") issued SFAS No. 157, "Fair Value Measurements". This Standard defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The Company has not yet determined the effect that adoption of SFAS No. 157 will have on its consolidated Financial Statements.

In June 2006, the FASB issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" ("FIN 48"), an interpretation of SFAS 109, "Accounting for Income Taxes". FIN 48 prescribes a comprehensive model for how companies should recognize, measure, present and disclose, in their financial statements uncertain tax positions taken or expected to be taken on a tax return. Under FIN 48, tax positions shall initially be recognized in the financial statements when it is more-likely-than-not the position will be sustained upon examination by the tax authorities. Such tax positions shall initially and subsequently be measured as the largest amount of tax benefit that is greater than 50% likely of being realized upon ultimate settlement with the tax authority assuming full knowledge of the position and all relevant facts. FIN 48 also revises disclosure requirements to include an annual tabular rollforward of unrecognized tax benefits. The provisions of this Interpretation are required to be adopted for fiscal periods beginning after December 15, 2006. The Company will be required to apply the provisions of FIN 48 to all tax positions upon initial adoption with any cumulative effect adjustments to be recognized as an adjustment to retained earnings. The Company has not yet determined the effect of adoption of FIN No. 48 will have on its consolidated Financial Statements.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities," ("SFAS No. 159"), which permits companies to choose to measure certain financial instruments and other items at fair value that are not currently required to be measured at fair value. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. The Company will adopt SFAS No. 159 no later than January 1, 2008. The Company has not yet determined the effect that the adoption of SFAS No. 159 will have on its consolidated financial statements.

t. Reclassification:

Certain figures from prior years have been reclassified in order to conform to the 2006 presentation.

NOTE 3:- BUSINESS COMBINATION

a. TdSoft:

On November 24, 2005 VocalTec acquired all the issued and outstanding Ordinary shares of Tdsoft Ltd. ("Tdsoft"), a provider of Voice over IP gateways for carriers, in consideration for issuance of shares to Tdsoft shareholders representing as of the closing date of the transaction 75% of the issued and outstanding share capital of VocalTec. As a result, Tdsoft became a wholly-owned subsidiary of VocalTec. Although the merger with Tdsoft was formed as a merger of Tdsoft into VocalTec, immediately after the merger the shareholders of Tdsoft held the majority of VocalTec outstanding Ordinary shares. Accordingly, for accounting and financial reporting purposes, the merger was treated as a reverse acquisition of VocalTec by Tdsoft under the purchase method of accounting pursuant to Statement of Financial Accounting Standard No. 141 "Business Combination" ("SFAS 141"). The financial statements of the combined company reflect the financial statements of Tdsoft on a historical basis and include the results of operations and cash flows of VocalTec from November 24, 2005. However, Tdsoft's shareholders' equity was restated retroactively to reflect the transaction as a reverse recapitalization. As such, all share capital (number and amounts) reflect Vocaltec shares exchanged for the Tdsoft shares existing at each relevant date.

The fair value of the Ordinary shares of VocalTec was determined based on the average market price of the shares during the period of two days before and ending two days after the date VocalTec and Tdsoft announced the merger agreement on October 28, 2005. The purchase price also included the fair value of the VocalTec stock options and other costs of the transaction. Accordingly, the total purchase price was as follows:

Number of shares of VocalTec outstanding as of November 24, 2005	$1,162,142
VocalTec's average share price for the two trading days before through the two trading days after October 28, 2005, the date VocalTec and Tdsoft announced their merger	6.77
Fair value of VocalTec's Ordinary shares	$ 7,869
Fair value of 186,597 VocalTec share options *)	226
Transaction costs of Tdsoft	138
Purchase price	$ 8,233

*) The fair value of the options was determined based on the Black & Scholes options pricing model.

NOTE 3:- BUSINESS COMBINATION (CONT.)

The purchase price was allocated based on an estimate of the fair value of the assets acquired and the liabilities assumed as of November 24, 2005, as follows:

Current assets	$ 2,009
Severance pay funds	1,123
Equipment	328
TOTAL tangible assets	3,460
Identifiable intangible assets:	
Current Essentra technology (7 years useful life)	1,963
Current VEA technology (2 years useful life)	123
Customer contract (1 year useful life)	372
Customer relations (7 years useful life)	887

Trade name (10 years useful life)	301
Patents (10 years useful life)	250
Goodwill (*)	6,950
TOTAL intangible assets acquired	10,846
TOTAL tangible and intangible assets acquired	14,306
TOTAL liabilities assumed (*)	(6,073)
Net assets acquired	$ 8,233

(*) After reduction of $287 due to adjustments to the estimated fair value of the inventory acquired and certain liabilities assumed, mainly the accrued expenses with respect to office lease.

The resulting goodwill is attributed but is not limited to the synergistic value and potential benefits that could be realized by the Company from the acquisition, as well as VocalTec's skilled and specialized workforce. The goodwill is not deductible for tax purposes. In accordance with Statement of Financial Accounting Standards No. 142 ("SFAS 142") "Goodwill and Other Intangible Assets", goodwill arising from acquisition will not be amortized.

Values assigned to intangible assets were determined using the income approach by discounting the future cash flows an asset will generate over its remaining useful life. Current assets and liabilities were recorded at their carrying value since such carrying amounts were proxies for their market values due to their short-term maturities.

NOTE 3:- BUSINESS COMBINATION (CONT.)

b. Be-Connected:

In May 2004, Tdsoft entered into an Assets Purchase Agreement with Be-Connected Ltd., an Israeli privately held company, pursuant to which Tdsoft acquired Be-Connected's assets, including the intellectual property rights and the business of the TAS product, a multi service access platform and assumed certain liabilities, primarily related to supporting customers and paying royalties to the Office of the Chief Scientist of the Ministry of Industry and Trade in Israel. The purchase was in consideration of $ 20 in cash and issuance of 45,439 Ordinary A shares, representing 8% ownership of Tdsoft, which were valued at approximately $ 496, based on the Tdsoft's average share price of $ 0.25, as determined by an external appraiser. Tdsoft incurred $ 50 of issuance expenses with respect to the issuance

of the shares. In addition, the results of Be Connected operation have been included in the consolidated financial statements since May 1, 2004.

The acquisition was accounted for using the purchase method under SFAS No. 141. The purchase price was allocated to those assets acquired based on the estimated fair value of those assets as of the acquisition date, as follows:

Current assets	$ 300
Property and equipment	3
Identifiable intangible assets:	
Technology (11 years useful life)*	182
Customer backlog (1 year useful life)	3
Customer relationship (5 years useful life)	28
Assets acquired	$ 516
Excess of net fair value over purchase price allocated to none-current assets	$1,197

(*) In 2005 the Company changed estimated useful life acquired technology from 11 to 5 years.

c. Supplemental pro forma information (unaudited):

The unaudited pro forma information regarding 2005 and 2004 presents the results of operations of Tdsoft after giving effect to the merger with Vocaltec in 2005 and the acquisition of Be-Connected in 2004, and includes the effect of amortization of intangible assets from these dates. The pro forma information is based upon the historical financial statements of VocalTec, TdSoft and Be-Connected. The pro forma data does not incorporate, nor does it assume, any benefits from cost savings or synergies of the combined companies. The pro forma data is presented for comparative purposes only and is not necessary indicative of the operating results that would have occurred had the merger been consummated at the dates indicated, nor are they necessarily indicative of future operating results or financial conditions.

NOTE 3:- BUSINESS COMBINATION (CONT.)

YEAR ENDED

	DECEMBER 31,	
	2005	2004
	(UNAUDITED)	
Sales	$ 8,427	$ 9,987
Operating loss	$ (16,833)	$(20,227)
Net loss	$ (15,137)	$(19,893)
Basic and diluted net loss per Ordinary share	$ (19.28)	$ (15.11)
Weighted average number of Ordinary shares used in computation of basic and diluted net loss per share	1,840	1,532

NOTE 4:- SHORT TERM DEPOSIT

Includes a bank deposit in U.S. dollars, bearing an annual weighted average interest rate of 5.2% per annum.

NOTE 5:- PREPAID EXPENSES AND OTHER ACCOUNTS RECEIVABLE

	DECEMBER 31,	
	2006	2005
Prepaid expenses	$ 112	$ 105
Research and development participation and grants receivable	460	970
Government authorities	162	226
Other	34	86
	$ 768	$1,387

NOTE 6:- INVENTORIES

	DECEMBER 31,	
	2006	2005
Components and work in progress	$ 538	$752
Finished goods **)	560	199
	1,098	$951

*) Write-off of inventories for the years ended December 31, 2006, 2005 and 2004 amounted to $ 0, $ 757 and $ 0, respectively.

**) As of December 31, 2006 and 2005, $ 560 and $ 199, respectively, finished goods were delivered to customers' sites and were not recognized as cost of sales since revenue recognition criteria for the related sales have not been met.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA

NOTE 7:- PROPERTY AND EQUIPMENT, NET

	DECEMBER 31,	
	2006	2005
Cost:		
Computers and related equipment	$4,409	$4,083
Office furniture, equipment and leasehold improvements	1,304	1,295
Motor vehicle	29	122
	5,742	5,500
Less - accumulated depreciation	4,854	4,418
Depreciated cost	$ 888	$1,082

Nearly all of the property and equipment is located in Israel.

Depreciation expense was $ 522, $ 581 and $ 484 for the years ended December 31, 2006, 2005 and 2004, respectively.

NOTE 8- GOODWILL AND OTHER INTANGIBLE ASSETS

	DECEMBER 31,	
	2006	2005
Cost:		
Technology, customer relations and other intangible assets (1)	$4,859	$ 4,859
Accumulated amortization:		
Technology, customer relations and other intangible assets (1)	1,812	906
	3,047	3,953

	------	-------
Goodwill	6,950	7,237
	------	-------
Amortized cost	$9,997	$11,190
	======	=======

1. The future annual estimated amortization expense in the next 5 years relating to VocalTec's amortizable intangible assets existing as of December 31, 2006, is approximately as follows:

	TOTAL AMORTIZATION
2007	$ 566
2008	511
2009	462
2010	462
2011	462

NOTE 8:- GOODWILL AND OTHER INTANGIBLE ASSETS (CONT.)

2. The changes in the carrying amount of goodwill for the period ended December 31, 2006 is as follows:

Balance as of December 31, 2004	$ -

Newly consolidated Company	7,237
Balance as of December 31, 2005	$ 7,237
Adjustment to the initial allocation of the purchase price resulted from changes in the estimated fair value of Vocaltec assets acquired and liabilities assumed (see note 3a)	(287)

Balance as of December 31, 2006	$ 6,950
	=======

3. Amortization expenses amounted to approximately $ 906, $ 230 and $ 206 for the years ended December 31, 2006, 2005 and 2004, respectively.

4. In 2005, Tdsoft changed the estimated useful life of the acquired technology acquired, as part of the Be-Connected asset purchase from May 2004 from 11 years to 5 years (see Note 3b) in order to reflect the expected useful life of the assets as a result of the rapid changes in the industry. Accordingly, the amortization expenses were

increased by $ 20 in 2005.

NOTE 9:- ACCRUED EXPENSES AND OTHER ACCOUNTS PAYABLE

	DECEMBER 31	
	2006	2005
Employees and payroll accruals	$ 948	$ 773
Accrued expenses	303	777
Accrued vacation pay	620	778
Government Institutions	962	911
Office lease	97	288
Directors and officers insurance	-	438
Other	66	163
	$2,996	$4,128

NOTE 10- LOAN FROM SHAREHOLDER

In July 2005, the Company received a bridge loan in the amount of $ 1,000 from Deutsche Telekom, one of its major shareholders prior to the merger with Tdsoft Ltd. The loan bears interest at the rate of 7.05% per annum payable along with the principal in July 2006. In connection with the loan, the Company agreed to put the source code of one of its products in escrow in favor of Deutsche Telekom and not to create, without the approval of Deutsche Telekom, any security interest over such source code. During July 2006, the loan was fully repaid, including accrued interest.

NOTE 11: COMMITMENTS AND CONTINGENCIES

a. In connection with its research and development activities through December 31, 2006, the Company received and accrued participation payments from the Office of the Chief Scientist of the Ministry of Industry and Trade in Israel ("OCS"). In return for the Government of Israel's participation, the Company is committed to pay royalties at a rate of 3.5% - 4.5% of sales of the developed product, up to 100% of the amount of grants received linked to the U.S. dollar (for grants received under programs approved subsequent to January 1, 1999, 100% plus interest at LIBOR).

The Company's total contingent liability for royalties payable to the OCS with respect to future sales, based on Government of Israel participations received or accrued, net of royalties paid or accrued, totaled approximately $ 19,322 as of December 31, 2006 and $17,128 as of December 31, 2005. 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.

Cost of sales includes royalties paid and accrued to the Government of Israel in the amount of $ 201, $ 63 and $ 67 for the years ended December 31, 2006, 2005, and 2004, respectively.

b. In April 2005, Tdsoft entered into a co-operation and project funding agreement effective as of December 1, 2004, with Nuera Communications, Inc. ("Nuera") and the Israel-United States Bi-national Industrial Research and Development Fund ("BIRD"), for the development of "Next Generation VoIP Gateway" with certain funding assistance from the BIRD.

Under the agreement, Tdsoft shall be reimbursed by the BIRD for 50% of its research and development expenses, up to an aggregate amount of $ 770. In accordance with the agreement with BIRD, Tdsoft is obligated to pay royalties at the rate of 5% of the sales of the developed products up to a maximum of 150% of the amount received depending of the year following the termination of the agreement in which the participation is fully paid. During 2006 and 2005, grants received and accrued from BIRD amounted to $ 21 and 749, respectively. Tdsoft's contingent liability to the BIRD amounts to approximately $ 770. 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.

The Company has no future commitments for royalties in respect of other participations received.

c. Certain allegations, mainly for patent infringement and breach of contract have been made against VocalTec Ltd., Tdsoft Ltd. or its U.S. subsidiary. These allegations have not resulted in any action brought against the Company. The Company's management does not believe that it is probable that the above mentioned allegations will result in a loss to the Company. Accordingly, no provision was recorded with respect to these allegations.

NOTE 11: COMMITMENTS AND CONTINGENCIES (CONT.)

d. The Company's facilities in Israel are rented under operating leases with different periods ending through April 2010 (with renewal option). Rent expense amounted to $ 256, $ 308 and $ 368 for the years ended December 31, 2006, 2005 and 2004, respectively. Annual minimum rental commitments under non-cancelable leases at balance sheet date are approximately as follows:

2007	$ 415
2008	468
2009	468
2010	117
Total	$ 1,468

The Company also maintains motor vehicle leases. The total liability for early termination of such leases is approximately $ 48. Motor vehicle lease expense amounted to $ 470, $ 390 and $ 130 for the years ended December 31, 2006, 2005 and 2004, respectively.

e. Under the purchase agreement with Be-Connected (see Note 3b), the bank provided the shareholders of Be-Connected on behalf of Tdsoft a bank guarantee of $ 500, in respect of certain guarantees that a shareholder of Be-Connected gave to its customers. $ 140 out of the $ 500 expired in November 2006, the other $ 360 will expire in May 2009.

f. The bank provided with respect to offices lessors bank guarantee on behalf of Tdsoft, in the amount of $ 166.

The bank provided certain lessors bank guarantees in the total amount of $ 140 on behalf of the Company, primarily in connection with its offices and motor vehicles.

NOTE 12:- SHARE CAPITAL

a. Share capital

1. All Ordinary shares of the Company have the same rights. Dividends declared by the company will be distributed to shareholders in proportion to their holdings. If the Company is liquidated, after satisfying liabilities to creditors, the Company's assets will be distributed to the holders of Ordinary shares in proportion to their holdings.

Holders of Ordinary shares have one vote for each paid-up Ordinary share on all matters submitted to a vote of our shareholders. These voting rights may be affected by the grant of any special voting rights to the holders of a class of shares with preferential rights that may be authorized in the future.

NOTE 12:- SHARE CAPITAL (CONT.)

2. Pursuant to an amendment to the articles of association of Tdsoft, which amendment was adopted immediately prior to the consummation of the business combination between VocalTec and TdSoft in November 2005, all series of convertible Preferred shares were converted into Ordinary shares of TdSoft. Immediately after, all the Ordinary shares of TdSoft were exchanged for VocalTec Ordinary shares. The conversion ratio was established for each class of shares. The group of the founders and the employees of the Company received a preferred conversion ratio, according to which the founders and the employees received approximately twice the amount received by the other Ordinary shareholders. Accordingly the Company recorded stock-based compensation in the amount of $ 870, of which $ 803 was recorded in the statement of operations in 2005.

In addition, the Preferred shareholders also received a preferred conversion ratio over the Ordinary Shares, although the original terms of the convertible Preferred shares provided for a conversion at the ratio of 1:1. Consequently, as required by EITF D-42, "The Effect on the Calculation of Earnings per Share to the Redemption or Induced Conversion of Preffered Stock" and EITF D-53, "Compatation of Earnings per Share for a Period that Includes a Redemption or an Induced Conversion of a Portion of a Class of Preffered Stock", the financial statements for the year ended December 31, 2005 include an amount of $ 17,406 attributed to the value of the incremental number of Ordinary shares received by the holders of the preferred stock upon the conversion of the preferred stock as part of the business combination with VocalTec.

All the share stock amounts have been restated to reflect the Ordinary shares received as part of the business combination, as described in Note 3a.

3. Prior to the conversion and exchange of all the shares of TdSoft, the holders of series B and C Preferred shares of Tdsoft had certain redemption rights. In February 2005, all redemption rights were waived and the redeemable convertible Preferred shares were converted into convertible Preferred shares.

   The Preferred shares also held certain liquidation preferences over Ordinary shares (Preferred C prior to Preferred A and Preferred B, Preferred A and B prior to all Ordinary shares and Ordinary A shares prior to Ordinary shares), and were convertible into Ordinary shares as follows: each series A Preferred share, series B and B-2 Preferred share and series C Preferred share was convertible at any time into an Ordinary share at the option of the holder.

   In addition, holders of series A, series B, series B-2 and series C convertible Preferred shares were entitled to receive cumulative dividends in preference to the holders of Ordinary and Ordinary A shares at the rate of 8% per annum. Such dividends would accrue quarterly for the benefit of the holders of the Preferred shares.

4. On November 25, 2005, the Company effected a reverse split of its issued and outstanding share capital of 1:13. All the stock share amounts were adjusted to reflect the reverse split.

NOTE 12:- SHARE CAPITAL (CONT.)

b. In May 2006 the Company issued in a private placement in consideration for $ 4,591, net of issuance expenses of $ 548, 935,000 Ordinary Shares and warrants to purchase up to 424,050 Ordinary Shares at an exercise price of $ 7.9 per share. The warrants became exercisable 6 months after issuance and will remain exercisable until the fifth anniversary of the date of issuance. According to the agreements, the

investors have the right to receive payment for liquidated damages if a registration statement on Form F-3 is not declared effective within 60 days from the date of the closing and/or the failure to maintain the registration Statement effective. The liquidated damages will be in the amount of 0.0333% of the purchase price paid by the investors for each day of delay up to 10% of the proceeds received. The shares and shares to be derived from the warrants were registered for trading on NASDAQ on May 22, 2006. As of December 31, 2006 no liability was recorded in respect of the liquidated damages as the Company does not deem it probable that such liquidated damages will be made.

In December 2006 the Company decided to reduce the exercise price of the warrants issued by the Company to the investors from $7.9 per share to $6.87 per share - the closing price of the Company's ordinary shares on the Nasdaq Capital Market at the close of business immediately prior to execution of the agreement relating to the May 2006 issuance. The benefit of $37 to the warrant holders from the aforementioned reduction in the exercise price was recorded as a preferred dividend to the warrant holders.

As of December 31, 2006, none of these warrants were exercised into the Company's ordinary shares.

c. In November 2006 the Company issued in a private placement in consideration for $ 6,998, net of issuance expenses of $ 527, 1,750,000 Ordinary Shares and warrants to purchase up to 1,400,000 Ordinary Shares at an exercise price of $ 5.5 per share. The warrants are exercisable during a period ending June 30, 2011. The shares were registered for trading on NASDAQ on December 4, 2006. As of December 31, 2006, none of these warrants were exercised into the Company's ordinary shares.

d. Share option plans:

Tdsoft had seven Share Option Plans, which provided for the grant by Tdsoft of option awards to purchase Ordinary shares of Tdsoft to officers, employees and directors of Tdsoft and its subsidiaries. Immediately upon allotment, the Ordinary shares purchased in exercise of the options would have the same rights as other Tdsoft Ordinary shares. The options vest ratably over vesting periods ranging from three to five years (mainly 5 years). The options expire 84 months from the date of issuance which was extended by the board of directors by additional 36 months. The exercise price of options under the plans is to be determined by the compensation committee. The exercise price for options granted in 2005, 2004 and 2003 was determined at fair market value at the date of each grant.

NOTE 12:- SHARE CAPITAL (CONT.)

In August 2005, the board of directors of VocalTec resolved to transfer to the VocalTec 2003 Master Stock Option Plan all of the

shares then available for grants of options under the other VocalTec option plans. Pursuant to the business combination, the number of shares underlying the 2003 Master Stock Option Plan was increased by 576,923 to a total of 1,038,462 shares, and VocalTec adopted each of Tdsoft's option plans, such that all outstanding options granted under the various Tdsoft option plans to purchase Ordinary shares of Tdsoft were assumed by VocalTec, except that the Tdsoft Ordinary shares underlying such options were replaced by VocalTec's Ordinary shares in amounts and for exercise prices in accordance with the conversion ratio set forth in the agreement for the business combination (and which options continued to be subject, except as set forth herein, to the terms of the Tdsoft option plans under which they were granted).

Following consummation of the business combination, the Company's board of directors resolved (i) to effect certain amendments to the 2003 Master Stock Option Plan and (ii) that options granted under older stock option plans shall revert to the amended 2003 Master Stock Option Plan upon the expiration or cancellation of such option.

Options granted under the VocalTec amended 2003 Master Stock Option Plan generally have a term of seven (7) years. However, options granted prior to December 13, 2005 have a term of ten (10) years. Earlier termination may occur if the employee's employment with the Company is terminated or if certain corporate changes or transactions occur. The Company's board of directors determines the grant and the exercise price at the time the options are granted upon recommendation of the compensation committee.

Each stock option agreement specifies the date and period over which the option becomes exercisable. Options granted generally vest over a period of four years, either in equal quarterly installments of 6.25% of the option shares, starting three months after the date of grant, or 25% of the option shares are vested one year following option grant, and the remaining 75% vest in equal quarterly installments of 6.25% over the remaining three years. Vesting of options granted to employees is conditional upon the grantee remaining continuously employed by VocalTec or its subsidiaries.

As of December 31, 2006, 357,670 share options are still available for future grants under the Company's existing plans, including an annual increase of 180,000 share options approved by the 2006 annual general meeting of the shareholders. Options which are cancelled or forfeited before expiration, become available for future grants.

NOTE 12:- SHARE CAPITAL (CONT.)

A summary of the Company's share option activity under the plans is as follows:

	YEAR ENDED DECEMBER 31,

	2005		2004	
	AMOUNT OF OPTIONS *)	WEIGHTED AVERAGE EXERCISE PRICE	AMOUNT OF OPTIONS *)	WEIGHTED AVERAGE EXERCISE PRICE
Outstanding - beginning of year	52,315	$ 8.05	49,776	$ 8.68
Granted	860,416	$11.92	15,372	$ 3.50
Exercised	(17,979)	$ 8.44	-	$ -
Forfeited	(25,852)	$44.51	(12,833)	$ 5.04
Outstanding - end of year	868,900	$10.79	52,315	$ 8.05
Options exercisable - end of year	214,817	$26.68	22,357	$11.57

*) The number and the exercise price of the options were restated to reflect such amounts and exercise prices as adjusted in business combination.

	YEAR ENDED DECEMBER 31, 2006			
	AMOUNT OF OPTIONS	WEIGHTED AVERAGE EXERCISE PRICE	WEIGHTED AVERAGE REMAINING CONTRACTUAL TERM	AGGREGATE INTRINSIC VALUE
Outstanding - beginning of year	868,900	$10.79		
Granted	148,870	$ 5.62		
Exercised	(29,776)	$ 5.04		
Forfeited	(278,141)	$14.24		
Outstanding - end of year	709,853	$ 8.60	6.14	$ 27
Vested and expected to vest - end of year	608,713	$ 6.14	6.11	$ 26
Options exercisable - end of year	227,986	$ 7.13	5.77	$ 17

The weighted average fair values of the options granted during 2006, 2005 and 2004, were $ 3.22, $ 3.42 and $ 0.38, respectively. The total intrinsic value of options exercised during the year ended December 31,2006 was $102. All options were granted at an exercise price equal to the market value of the share at the date of grant.

The following table summarizes information about options outstanding and exercisable at December 31, 2006:

	OPTIONS OUTSTANDING			OPTIONS EXERCISABLE	
RANGE OF EXERCISE PRICES	AMOUNT OUTSTANDING AT DECEMBER 31, 2006	WEIGHTED-AVERAGE REMAINING CONTRACTUAL LIFE (YEARS)	WEIGHTED AVERAGE EXERCISE PRICES	AMOUNT OUTSTANDING AT DECEMBER 31, 2006	WEIGHTED AVERAGE EXERCISE PRICES
$ 3.00-7.50	649,935	6.35	$ 5.42	171,565	$ 5.42
$ 7.50-18.75	18,969	4.78	$ 11.07	16,216	$ 9.97
$ 18.75-46.88	20,934	5.21	$ 26.59	20,430	$ 26.26
$ 46.88-117.20	17,919	2.21	$ 84.33	17,679	$ 84.68
$ 117.20-224.25	2,096	2.80	$154.79	2,096	$154.79
	709,853	6.14	$ 8.60	227,986	$ 15.07

NOTE 13:- NET LOSS PER SHARE

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

	YEAR ENDED DECEMBER 31,		
	2006	2005	200
Numerator:			
Net loss	$(7,012)	$ (6,630)	$(5,6
Accretion of redeemable convertible Preferred shares	-	(348)	(3,2
Induced conversion of convertible Preferred shares	-	(17,406)	
Cumulative dividend on convertible preferred shares	-	(2,585)	
Dividend in respect to reduction in exercise price of certain warrants	(37)		
Net loss attributable to common shareholders after allocation of undistributed earnings to convertible			

Preferred shares	$(7,049)	$(26,969)	$(8,9
Denominator:			
Weighted average number of Ordinary shares outstanding during the year used to compute basic and diluted net loss per Ordinary share	5,436	792	3
Basic and diluted net loss per Ordinary share	$ (1.30)	$ (34.05)	$(24.

NOTE 14:- GEOGRAPHIC AND MAJOR CUSTOMERS INFORMATION

The Company manages its business on a basis of one reportable segment. The Company follows the guidance in Statement of Financial Accounting Standards No. 131, "Disclosure about Segment of an Enterprise and Related Information".

	YEAR ENDED DECEMBER 31,		
	2006	2005	2004
Sales classified by geographic areas based on end-customer location:			
Europe	$4,299	$2,718	$1,599
Americas (principally United States)	770	992	655
Asia	882	275	567
Israel	540	608	1,331
Africa and Middle East	789	-	-
	$7,280	$4,593	$4,152

NOTE 14:- GEOGRAPHIC AND MAJOR CUSTOMERS INFORMATION (CONT.)

	YEAR ENDED DECEMBER 31,		
	2006	2005	2004
		%	

Sales to a single customer exceeding 10%:*)			
Customer A	13	18	*
Customer B	*)	*)	1
Customer C	*)	*)	1
Customer D	*)	16	1
Customer E	*)	*)	1
Customer F	18	*)	*

*) Less than 10%

NOTE 15:- RESEARCH AND DEVELOPMENT, NET

	YEAR ENDED DECEMBER 31,		
	2006	2005	2004
Research and development expenses	$5,439	$5,669	$5,474
Less- participations from:			
OCS	799	557	-
BIRD	21	749	-
	$4,619	$4,363	$5,474

NOTE 16:- FINANCIAL INCOME, NET

	YEAR ENDED DECEMBER 31,		
	2006	2005	2004
Financial income :			
Interest on cash and cash equivalents, net of bank fees	$ 112	$173	$ 168
Foreign currency translation adjustments, net	(80)	11	(3)
	$ 32	$184	$ 165

NOTE 17:- TAXES ON INCOME

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

Results for tax purposes are measured and reflected in real terms in accordance with the change in the Israeli Consumer Price Index ("CPI"). As explained in Note 2b, the consolidated financial statements are presented in U.S. dollars. The differences between the change in Israel's CPI and in the NIS/U.S. dollar exchange rate causes a difference between taxable income or loss and the income or loss before taxes reflected in the consolidated financial statements. In accordance with paragraph 9(f) of SFAS No. 109, VocalTec Ltd. and Tdsoft Ltd. have not provided deferred income taxes on the differences resulting from changes in exchange rates and indexing for tax purposes.

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

VocalTec Ltd. and Tdsoft Ltd. are considered each an "industrial company", as defined by the Law for the Encouragement of Industry (Taxes), 1969, and as such, are entitled to certain tax benefits, mainly the right to claim public issuance expenses and accelerated depreciation.

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

Certain investments of VocalTec Ltd. and Tdsoft Ltd. received "Approved Enterprise" status through the "Alternative Benefits" track, and, as such, are eligible for various benefits. VocalTec Ltd. and Tdsoft Ltd. currently have two and four "Approved Enterprise" programs, respectively. These benefits include accelerated depreciation of equipment used in the investment program, as well as a full tax exemption on undistributed income for a period of two years and reduced tax rates of 25% or less for an additional period of up to eight years (depending on the percentage of foreign ownership), commencing with the date on which taxable income is first earned. Since VocalTec Ltd. and Tdsoft Ltd. have had no taxable income since inception, the benefits period has not yet commenced.

The period of tax benefits detailed above, except in the full tax exemption period, is subject to a limit of 12 years from the commencement of production, or 14 years from the approval date, whichever is earlier. The entitlement to the above benefits is conditional upon VocalTec Ltd. and Tdsoft Ltd. fulfilling the conditions stipulated by the above law, regulations published there-under and the letters of approval for the specific investments in "Approved Enterprises". In the event of failure to comply with these conditions, the benefits may be cancelled and VocalTec Ltd. and Tdsoft Ltd. may be required to refund the amount of the benefits, in whole or in part, including interest. As of December 31, 2006, management believes that VocalTec Ltd. and Tdsoft Ltd. are meeting all of the aforementioned conditions.

NOTE 17:- TAXES ON INCOME (CONT.)

The tax-exempt income attributable to the "Approved Enterprise" can be distributed to shareholders without subjecting the distributing company to taxes only upon the complete liquidation of the company. If these retained tax-exempt profits are distributed in a manner other than in the complete liquidation of the company, they would be taxed at the corporate tax rate applicable to such profits as if the company had not elected the alternative track of benefits, currently 25% for an "Approved Enterprise". As of December 31, 2006, the accumulated deficit of each company does not include tax-exempt profits earned by their "Approved Enterprise".

Income from sources other than the "Approved Enterprise" during the benefit period will be subject to tax at the regular corporate tax rate of 31%. The regular corporate tax rate is to be gradually reduced to 25% by 2010 (29% in 2007, 27% in 2008, 26% in 2009 and 25% in 2010).

d. VocalTec Ltd. received final tax assessment for the tax years up to 2000. Tdsoft Ltd. received final tax assessment for the tax years up to 2001.

e. VocalTec Ltd. and Tdsoft Ltd. have net operating loss carryforwards for tax purposes of approximately $ 117,000 and $ 43,000 as of December 31, 2006, respectively, which may be carried forward indefinitely. VocalTec Communications Inc. and Tdsoft Communications, Inc., which are subject to U.S. income taxes, have a loss for tax purposes of approximately $9,000 as of December 31, 2006. These losses can be carried forward until 2025. A valuation allowance was recorded for the entire deferred tax asset in respect of the carryforward losses, due to the uncertainty regarding future realization. Management currently believes that since the Company has a history of losses it is more likely than not that the deferred tax regarding the loss carryforward will not be realized in the foreseeable future.

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.

f. Tax benefit is comprised as follows:

	YEAR ENDED DECEMBER 31,		
	2006	2005	2004
Foreign:			
Current taxes	$ -	$ 19	$ -

NOTE 17:- TAXES ON INCOME (CONT.)

g. Deferred taxes on income:

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

	DECEMBER 31	
	2006	2005
Deferred tax asset:		
Reserves and allowances	$ 468	$ 707
Net operating losses carryforward	42,250	36,063
Net deferred tax asset before valuation allowance	42,718	36,770
Valuation allowance	(42,718)	(36,770)
Net deferred tax asset	$ -	$ -

Management currently believes that since the Company has a history of losses, it is more likely than not that the deferred tax asset will not be utilized.

h. Loss before income taxes is comprised as follows:

	YEAR ENDED DECEMBER 31,		
	2006	2005	2004
Israel	$(6,396)	$(6,429)	$(5,392)
Foreign	(616)	(220)	(294)
	$(7,012)	$(6,649)	$(5,686)

i. The difference between the theoretical tax computed and the actual tax expense resulted mainly from valuation allowance recorded with respect to carryforward losses and other temporary differences, primarily related to severance and vacation reserves.

ITEM 19. EXHIBITS

1. Amended and Restated Articles of Association.

2.1 Form of Share Certificate of VocalTec Communications Ltd., previously filed with the SEC on April 21, 2006 as Exhibit 2.1 to the Company's Annual Report on Form 20-F for the year ended December 31, 2005 (as

amended on May 16, 2006) and incorporated herein by reference.

4.1 (a) 2003 Amended Master Stock Option Plan previously filed with the SEC on February 15, 2006 as Exhibit 99.2 to the Company's registration statement on Form S-8 (File Number 333-131870) and incorporated herein by reference.

(b) Summary of the lease agreement between Tdsoft and Limor Hugi and others dated April 26, 2004, previously filed with the SEC on April 21, 2006 as Exhibit 4.1(b) to the Company's Annual Report on Form 20-F for the year ended December 31, 2005 (as amended on May 16, 2006) and incorporated herein by reference.

(c) Share Sale and Purchase Agreement dated as of October 27, 2005 by and among the Company, Tdsoft and the shareholders of Tdsoft, previously filed with the SEC on November 7, 2005 as Exhibit 99 to the Company's Report on Form 6-K, as amended on November 8, 2005, and incorporated herein by reference.

(d) Form of security purchase agreement dated May 18, 2006, pursuant to which the Company issued to institutional investors ordinary shares at a price per share of $5.5 and warrants to purchase Company shares, at an exercise price per share of $7.9 (which exercise price was amended in December 2006 to $6.87 per share), previously filed with the SEC on May 25, 2006 as an exhibit to the Company's Report on Form 6-K and incorporated herein by reference.

(e) Form of Order to Purchase Securities dated November 27, 2006, pursuant to which the Company issued to institutional investors ordinary shares at a price per share of $4.3 and warrants to purchase Company shares at a price per share of $5.5.

(f) Audit committee pre-approval policies and procedures for audit and non-audit services, previously filed with the SEC on April 2, 2004 as Exhibit 4.1(k) to the Company's Annual Report on Form 20-F for the year ended December 31, 2003, and incorporated herein by reference.

(g) Form of indemnification undertaking dated as of November 24, 2005 between the Company and each of Joseph Albagli, Ilan Rosen, Robert Wadsworth and Joseph Atsmon, previously filed with the SEC on April 21, 2006 as Exhibit 4.1(g) to the Company's Annual Report on Form 20-F for the year ended December 31, 2005 (as amended on May 16, 2006) and incorporated herein by reference.

(h) Form of indemnification undertaking dated as of November 24, 2005 between the Company and each of Dr. Elon Ganor, Yoav Chelouche and Michal Even Chen, previously filed with the SEC on April 21, 2006 as Exhibit 4.1(h) to the Company's Annual Report on Form 20-F for the year ended December 31, 2005 (as amended on May 16, 2006) and incorporated herein by reference.

(i) Loan agreement dated July 21, 2005 between the Company and Deutsche Telekom AG, previously filed with the SEC on April 21, 2006 as Exhibit 4.1(i) to the Company's Annual Report on Form 20-F for the year ended December 31, 2005 (as amended on May 16, 2006) and incorporated herein by reference.

(j) Registration rights agreement dated November 24, 2005 by and among the Company and the shareholders of Tdsoft Ltd., previously filed with the SEC on April 21, 2006 as Exhibit 4.1(j) to the Company's Annual Report on Form 20-F for the year ended December 31, 2005 (as amended on May 16, 2006) and incorporated herein by reference.

8. List of Subsidiaries.

11. (a) Code of ethics for our principal executive officer, principal financial officer, executive vice presidents, principal controller, treasurer and persons performing similar functions, previously filed with the SEC on April 2, 2004 as Exhibit 11 to the Company's Annual Report on Form 20-F for the year ended December 31, 2003 and incorporated herein by reference.

(b) Amended insider trading policy.

12. Certifications of CEO and CFO of VocalTec Communications Ltd. required by Rule 13a-14(a) (17 CFR 240.13a - 14(a)) or Rule 15d-14(a) (17 CFR 240.15d - 14(a)).

13. Certifications of CEO and CFO of VocalTec Communications Ltd. required by Rule 13a-14(b) (17 CFR 240.13a - 14(b)) or Rule 15d-14(b) (17 CFR 240.15d - 14(b)).

SIGNATURES

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

By: /s/ Joseph Albagli

Joseph Albagli
Chief Executive Officer

Date: June 20, 2007