



NICE SYSTEMS LTD. AND SUBSIDIARIES
CONSOLIDATED FINANCIAL STATEMENTS

AS OF DECEMBER 31, 2004

IN U.S. DOLLARS

INDEX

Report of Independent Registered Public Accounting Firm

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Shareholders of

NICE SYSTEMS LTD.

We have audited the accompanying consolidated balance sheets of NICE Systems Ltd. (“the Company”) and subsidiaries as of December 31, 2003 and 2004, and the related consolidated statements of operations, changes in shareholders’ equity and cash flows for each of the three years in the period ended December 31, 2004. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above, present fairly, in all material respects, the consolidated financial position of the Company and subsidiaries as of December 31, 2003 and 2004, and the consolidated results of their operations and cash flows for each of the three years in the period ended December 31, 2004, in conformity with accounting principles generally accepted in the United States.

Tel-Aviv, Israel
February 2, 2005

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

NICE SYSTEMS LTD. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

U.S. dollars in thousands

	<u>December 31,</u>	
	<u>2003</u>	<u>2004</u>
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 29,859	\$ 26,579
Short-term bank deposits	189	175
Marketable securities	17,187	24,348
Trade receivables (net of allowance for doubtful accounts of \$2,284 and \$2,661 in 2003 and 2004, respectively)	45,973	46,407
Other receivables and prepaid expenses	7,366	7,937
Related party receivables	4,013	—
Inventories	12,634	12,615
Assets of discontinued operation	<u>3,945</u>	<u>652</u>
Total current assets	<u>121,166</u>	<u>118,713</u>
LONG-TERM INVESTMENTS:		
Long-term marketable securities	60,034	114,805
Investment in affiliates	1,200	1,200
Severance pay fund	6,155	7,356
Long-term receivables and prepaid expenses	<u>729</u>	<u>854</u>
Total long-term investments	<u>68,118</u>	<u>124,215</u>
PROPERTY AND EQUIPMENT, NET	<u>18,627</u>	<u>16,981</u>
OTHER INTANGIBLE ASSETS, NET	<u>16,193</u>	<u>12,665</u>
GOODWILL	<u>25,311</u>	<u>25,745</u>
Total assets	<u>\$ 249,415</u>	<u>\$ 298,319</u>

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

NICE SYSTEMS LTD. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS
U.S. dollars in thousands (except share data)

	<u>December 31,</u>	
	<u>2003</u>	<u>2004</u>
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Trade payables	\$ 15,744	\$ 11,975
Accrued expenses and other liabilities	47,370	55,302
Liabilities of discontinued operation	1,878	8
Total current liabilities	<u>64,992</u>	<u>67,285</u>
LONG-TERM LIABILITIES:		
Accrued severance pay	6,925	8,163
Other long-term liabilities	667	—
Total long-term liabilities	<u>7,592</u>	<u>8,163</u>
COMMITMENTS AND CONTINGENT LIABILITIES		
SHAREHOLDERS' EQUITY:		
Share capital-		
Ordinary shares of NIS 1 par value:		
Authorized: 50,000,000 shares as of December 31, 2003 and 2004; Issued and outstanding: 16,748,953 and 18,180,260 shares as of December 31, 2003 and 2004, respectively		
	5,142	5,464
Additional paid-in capital	224,855	244,400
Accumulated other comprehensive income	3,888	5,506
Accumulated deficit	(57,054)	(32,499)
Total shareholders' equity	<u>176,831</u>	<u>222,871</u>
Total liabilities and shareholders' equity	<u>\$ 249,415</u>	<u>\$ 298,319</u>

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

NICE SYSTEMS LTD. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS
U.S. dollars in thousands (except per share data)

	Year ended December 31,		
	2002	2003	2004
Revenues:			
Products	\$ 127,896	\$ 168,055	\$ 182,616
Services	27,445	56,203	70,027
Total revenues	155,341	224,258	252,643
Cost of revenues:			
Products	55,453	64,231	64,432
Services	26,054	42,084	49,876
Total cost of revenues	81,507	106,315	114,308
Gross profit	73,834	117,943	138,335
Operating expenses:			
Research and development, net	17,122	22,833	24,866
Selling and marketing	38,743	53,701	62,172
General and administrative	23,806	29,840	31,269
Goodwill impairment	28,260	—	—
Restructuring expenses, in-process research and development write-off, settlement of litigation and other	832	7,082	—
Total operating expenses	108,763	113,456	118,307
Operating income (loss)	(34,929)	4,487	20,028
Financial income, net	3,992	2,034	3,556
Other income (expenses), net	(4,065)	292	54
Income (loss) before taxes on income	(35,002)	6,813	23,638
Taxes on income	350	1,205	2,319
Net income (loss) from continuing operations	(35,352)	5,608	21,319
Net income from discontinued operation	1,370	1,483	3,236
Net income (loss)	<u>\$ (33,982)</u>	<u>\$ 7,091</u>	<u>\$ 24,555</u>
Net earnings (loss) per share:			
Basic:			

Continuing operations	\$	(2.56)	\$	0.35	\$	1.22
Discontinued operation		<u>0.10</u>		<u>0.09</u>		<u>0.18</u>
	\$	<u>(2.46)</u>	\$	<u>0.44</u>	\$	<u>1.40</u>
<u>Diluted:</u>						
Continuing operations	\$	(2.56)	\$	0.33	\$	1.14
Discontinued operation		<u>0.10</u>		<u>0.09</u>		<u>0.17</u>
Net earnings (loss)	\$	<u>(2.46)</u>	\$	<u>0.42</u>	\$	<u>1.31</u>

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

NICE SYSTEMS LTD. AND SUBSIDIARIES

STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
U.S. dollars in thousands

	Share capital	Additional paid-in capital	Deferred stock compensation	Accumulated other comprehensive income (loss)	Accumulated deficit	Total comprehensive income (loss)	Total shareholders' equity
Balance as of January 1, 2002	\$ 4,398	\$ 192,845	\$ (24)	\$ (38)	\$ (30,163)		\$ 167,018
Issuance of shares of ESPP	28	1,355	—	—	—		1,383
Issuance of shares in respect of the acquisition of CPS	11	458	—	—	—		469
Issuance of shares in respect of the acquisition of TCS	458	17,593	—	—	—		18,051
Issuance of shares in respect of the acquisition of SCI	*) —	29	—	—	—		29
Amortization of deferred stock compensation	—	—	12	—	—		12
Exercise of share options	13	723	—	—	—		736
Comprehensive loss:							
Foreign currency translation adjustments	—	—	—	793	—	\$ 793	793
Unrealized gains on derivative instruments, net	—	—	—	27	—	27	27
Net loss	—	—	—	—	(33,982)	(33,982)	(33,982)
Total comprehensive loss						\$ (33,162)	
Balance as of December 31, 2002	4,908	213,003	(12)	782	(64,145)		154,536
Issuance of shares of ESPP	49	1,470	—	—	—		1,519
Amortization of deferred stock compensation	—	—	12	—	—		12
Exercise of share options	185	10,382	—	—	—		10,567
Comprehensive income:							
Foreign currency translation adjustments	—	—	—	3,031	—	\$ 3,031	3,031
Unrealized gains on derivative instruments, net	—	—	—	75	—	75	75
Net income	—	—	—	—	7,091	7,091	7,091
Total comprehensive income						\$ 10,197	
Balance as of December 31, 2003	5,142	224,855	—	3,888	(57,054)		176,831
Issuance of shares of ESPP	31	2,234	—	—	—		2,265
Exercise of share options	291	17,311	—	—	—		17,602
Comprehensive income:							
Foreign currency translation adjustments	—	—	—	1,617	—	\$ 1,617	1,617
Unrealized gains on derivative instruments, net	—	—	—	1	—	1	1
Net income	—	—	—	—	24,555	24,555	24,555
Total comprehensive income						\$ 26,173	
Balance as of December 31, 2004	\$ 5,464	\$ 244,400	\$ —	\$ 5,506	\$ (32,499)		\$ 222,871

Accumulated unrealized gains on derivative instruments	\$	65
Accumulated foreign currency translation adjustments		<u>5,441</u>
Accumulated other comprehensive income as of December 31, 2004	\$	<u>5,506</u>

*) Represents an amount lower than \$ 1.

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

NICE SYSTEMS LTD. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS
U.S. dollars in thousands

	Year ended December 31,		
	2002	2003	2004
Cash flows from operating activities:			
Net income (loss)	\$ (33,982)	\$ 7,091	\$ 24,555
Less: net income from discontinued operation	(1,370)	(1,483)	(3,236)
Net income (loss) from continuing operations	(35,352)	5,608	21,319
Adjustments required to reconcile net income (loss) from continuing operations to net cash provided by operating activities from continuing operations:			
Depreciation and amortization	15,248	17,617	13,793
In-process research and development write-off	1,270	—	—
Stock compensation in respect of CPS acquisition	469	—	—
Amortization of deferred stock compensation	12	12	—
Accrued severance pay, net	(399)	124	37
Goodwill impairment	28,260	—	—
Impairment of investment in affiliate	229	—	—
Amortization of premium (accretion of discount) and accrued interest on held-to-maturity marketable securities	915	1,459	1,205
Decrease (increase) in trade receivables	(1,523)	3,901	(585)
Decrease (increase) in other receivables and prepaid expenses	(1,281)	1,208	(549)
Decrease (increase) in inventories	4,025	1,515	(122)
Decrease (increase) in long-term receivables and prepaid expenses	(483)	39	(105)
Increase (decrease) in trade payables	2,895	(104)	(3,761)
Increase in accrued expenses and other liabilities	2,051	4,819	13,043
Increase in long-term liabilities related to legal settlement	—	667	—
Other	315	(5)	(7)
Net cash provided by operating activities from continuing operations	16,651	36,860	44,268
Net cash provided by operating activities from discontinued operation	3,462	1,316	750
Net cash provided by operating activities	20,113	38,176	45,018

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

	<u>Year ended December 31,</u>		
	<u>2002</u>	<u>2003</u>	<u>2004</u>
<u>Cash flows from investing activities:</u>			
Purchase of property and equipment	(5,322)	(5,492)	(6,701)
Proceeds from sale of property and equipment	557	747	89
Purchase of other intangible assets	(610)	—	—
Investment in marketable securities	(16,936)	(72,077)	(122,192)
Proceeds from maturity of marketable securities	29,492	33,997	17,710
Proceeds from sale and call of held-to-maturity marketable securities	820	8,500	41,345
Investment in short-term bank deposits	(150)	(132)	(129)
Proceeds from short-term bank deposits	265	165	149
Payment for the acquisition of certain assets and liabilities of TCS (a)	(31,480)	(316)	—
Decrease in accrued acquisition costs	(214)	(3,008)	(75)
Payment in respect of terminated contract from TCS acquisition	—	(6,518)	(5,249)
Decrease in related party receivables from TCS acquisition	—	6,635	4,013
Capitalization of software development costs	(4,609)	(2,291)	(1,305)
Net cash used in investing activities from continuing operations	(28,187)	(39,790)	(72,345)
Net cash provided by (used in) investing activities from discontinued operation	(117)	(52)	4,136
Net cash used in investing activities	(28,304)	(39,842)	(68,209)
<u>Cash flows from financing activities:</u>			
Proceeds from issuance of shares upon exercise of options and ESPP, net	2,119	12,086	19,867
Short-term bank credit, net	24	(24)	—
Net cash provided by financing activities	2,143	12,062	19,867
Effect of exchange rate changes on cash	73	182	44
Increase (decrease) in cash and cash equivalents	(5,975)	10,578	(3,280)
Cash and cash equivalents at the beginning of the year	25,256	19,281	29,859
Cash and cash equivalents at the end of the year	<u>\$ 19,281</u>	<u>\$ 29,859</u>	<u>\$ 26,579</u>
<u>Supplemental disclosure of cash flows activities:</u>			
Cash paid during the year for:			
Income taxes	<u>\$ 445</u>	<u>\$ 564</u>	<u>\$ 598</u>

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

	<u>Year ended December 31,</u>		
	<u>2002</u>	<u>2003</u>	<u>2004</u>
<u>Payment for the acquisition of certain assets and liabilities of</u>			
<u>(a) TCS:</u>			
Fair value of assets acquired and liabilities assumed at the acquisition date:			
Working capital (excluding cash and cash equivalents)	\$ 8,347	\$ —	
Related party receivables	12,804	—	
Property and equipment	7,616	—	
Other intangible assets	9,320	—	
In-process research and development	1,270	—	
Other long-term liability	(13,500)	—	
Goodwill	<u>26,682</u>	<u>416</u>	
	52,539	416	
Less - amount acquired by issuance of shares	(18,051)	—	
Less - accrued acquisition costs	<u>(3,008)</u>	<u>(100)</u>	
	<u>\$ 31,480</u>	<u>\$ 316</u>	
<u>Non-cash activities:</u>			
<u>Issuance of additional shares related to settlement of SCI</u>			
<u>(a) acquisition:</u>			
Goodwill	<u>\$ 29</u>		
<u>(b) Adjustments of goodwill in respect of TCS acquisition:</u>			
Related party receivables		\$ 2,156	
Accrued expenses and other liabilities		(319)	
Other long-term liability		<u>(5,162)</u>	
		<u>\$ (3,325)</u>	
<u>(c) Adjustment of goodwill in respect of discontinued operation sale</u>			
			<u>\$ (250)</u>

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

NICE SYSTEMS LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 1:- GENERAL

a. General:

NICE Systems Ltd. (“NICE”) and subsidiaries (collectively - “the Company”) develop, market and support integrated, scalable multimedia digital recording platforms, enhanced software applications and related professional services. These solutions capture and analyze unstructured (non-transaction) data and convert it for business and security performance management applications. The Company’s solutions capture multiple forms of interaction, including voice, fax, email, web chat, radio, and video transmissions over wire line, wireless, packet telephony, terrestrial trunk radio and data networks.

The Company’s products are based on two types of recording platforms - audio and video. The Company’s solutions are offered to various vertical markets in two major sectors: (1) the Enterprise Interaction Solutions Sector - contact centers and trading floors and (2) the Public Safety and Security Sector - safety organizations, transportation, corporate security, gaming and correctional facilities and government and intelligence agencies.

The Company’s products are sold primarily through a global network of distributors, system integrators and strategic partners; a portion of product sales and most services are sold directly to end-users.

The Company’s markets are located primarily in North America, EMEA and the Far East.

The Company depends on a limited number of contract manufacturers for producing its products. If any of these manufacturers become unable or unwilling to continue to manufacture or fail to meet the quality or delivery requirements needed to satisfy the Company’s customers, it could result in the loss of sales, which could adversely affect the Company’s results of operations and financial position.

The Company relies upon a number of independent distributors to market, sell and service its products in certain markets. If the Company is unable to effectively manage and maintain relationships with its distributors, or to enter into similar relationships with others, its ability to market and sell its products in these markets will be affected. In addition, a loss of a major distributor, or any event negatively affecting such distributors’ financial condition, could cause a material adverse effect on the Company’s results of operations and financial position.

As for major customer data, see Note 16c.

b. Disposal by sale of the COMINT/DF operation:

In the fourth quarter of 2003, the Company reached a definitive agreement to sell the assets and liabilities of its COMINT/DF military-related business to ELTA Systems Ltd. for \$ 4,000 in cash. On March 31, 2004, the Company completed the sale of the COMINT/DF operation. The COMINT/DF business was treated as a discontinued operation in the financial statements.

The Company's balance sheets at December 31, 2003 and 2004 reflect the assets and liabilities of the COMINT/DF operation, as assets and liabilities of the discontinued operation within current assets and current liabilities.

The carrying amounts of the major classes of assets and liabilities included as part of the discontinued operation are:

	<u>December 31,</u>	
	<u>2003</u>	<u>2004</u>
Trade receivables	\$ 2,839	\$ 652
Other receivables and prepaid expenses	207	—
Severance pay fund	687	—
Property and equipment, net	<u>212</u>	<u>—</u>
Assets of discontinued operation	<u>\$ 3,945</u>	<u>\$ 652</u>
Trade payables	\$ 66	\$ —
Accrued expenses and other liabilities	982	8
Accrued severance pay	<u>830</u>	<u>—</u>
Liabilities of discontinued operation	<u>\$ 1,878</u>	<u>\$ 8</u>

Summarized selected financial information of the discontinued operation is as follows:

	<u>Year ended December 31,</u>		
	<u>2002</u>	<u>2003</u>	<u>2004</u>
Revenues	<u>\$ 7,164</u>	<u>\$ 6,510</u>	<u>\$ 816</u>
Net income	<u>\$ 1,370</u>	<u>\$ 1,483</u>	<u>\$ *) 3,236</u>

*) Includes gain from the sale in the amount of \$ 3,286.

c. Acquisition of Thales Contact Solutions:

In November 2002, the Company acquired certain assets and assumed certain liabilities of Thales Contact Solutions (“TCS”) for an aggregate consideration of \$ 52,539 including the issuance of 2,187,500 American Depositary Shares (“ADSs”) of NICE valued at \$ 18,051. TCS is a developer of customer-facing technology for Public Safety, Wholesale Trading and Call Centers, based in the United Kingdom. The acquisition was accounted for by the purchase method and accordingly, the purchase price has been allocated according to the estimated fair value of the assets acquired and liabilities assumed of TCS. The value of the shares issued was determined based on the market price of NICE’s shares on the acquisition date. The results of TCS’s operations have been included in the consolidated financial statements since November 2, 2002 (“the closing date”).

With the acquisition of TCS, the Company significantly expanded its customer base, presence in Europe, and its network of distributors and partners. Additionally, the Company broadened its product offerings and global professional services team.

In the fourth quarter of 2002, the Company recorded a current liability of \$ 2,800 and a long-term liability of \$ 13,500 reflecting estimation of obligations under a long-term contract assumed by the Company in the TCS acquisition for which no future benefit exists. During the second quarter of 2003, the Company signed an agreement to amend and terminate the above mentioned agreement as of November 2004. The cost to the Company under the termination agreement was \$ 5,162 less than the amount provided in respect of the above mentioned agreement at the acquisition date. Consequently, goodwill has been reduced by \$ 5,162.

Under the terms of the agreement, the initial cash portion of the purchase price was adjusted downward in 2002 by \$ 12,804 in respect of the actual net value of assets acquired and 2002 sales of TCS. Thales disputed the net asset value at closing and in September 2003 the parties submitted the matter to binding arbitration by an independent accountant. In December 2003, an arbitration award was issued, according to which the related party receivables from Thales should be reduced by \$ 2,156. The Company recorded the \$ 2,156 as addition to goodwill in the fourth quarter of 2003. Due to the arbitration award and additional acquisition costs incurred during 2003, the acquisition cost totaled \$ 42,307 as of December 31, 2003.

The following table summarizes the fair values of the assets acquired and liabilities assumed:

Trade receivables	\$ 15,808
Other receivables and prepaid expenses	1,448
Inventories	6,776
Property and equipment	7,616
In-process research and development	1,270
Trademarks	1,040
Core technology	1,620
Distribution network	6,160
Maintenance contracts	500
Goodwill	<u>23,773</u>
Total assets acquired	66,011
Trade payables	(1,747)
Accrued expenses and other liabilities	(13,619)
Long-term liability	<u>(8,338)</u>
Total liabilities assumed	<u>(23,704)</u>
Net assets acquired	<u>\$ 42,307</u>

Other intangible assets with definite life in the amount of \$ 3,160 are amortized using the straight-line method at annual weighted average rate of 29%.

The \$ 1,270 assigned to in-process research and development was written off at the acquisition date in accordance with FASB Interpretation ("FIN") No. 4, "Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method".

The following represents the unaudited pro-forma condensed results of operations for the year ended December 31, 2002, assuming that the acquisition occurred on January 1, 2002. The pro-forma information is not necessarily indicative of the results of operations, which actually would have occurred if the acquisition had been consummated on January 1, 2002, nor does it purport to represent the results of operations for future periods.

	<u>Year ended December 31, 2002</u>
Revenues	\$ 206,838
Net loss	\$ (53,821)
Basic and diluted net loss per share	\$ (3.45)

The condensed results of operations of TCS are based on the results of operations of TCS for the period from January 1, 2002 to November 2, 2002 (the closing date), which were prepared by TCS's management and were submitted to the Company as part of the acquisition.

d. Acquisition of CenterPoint Solutions Inc.:

In April 2000, the Company acquired all of the outstanding capital stock of CenterPoint Solutions Inc. ("CPS") for a total consideration of \$ 12,886 including the issuance of 200,000 ADSs of NICE of which 50,000 were deemed target shares ("the target shares") contingent upon the achievement of certain objectives. The acquisition was accounted for by the purchase method and accordingly, the purchase price has been allocated according to the estimated fair value of the assets acquired and liabilities assumed of CPS.

CPS is a developer of Internet-based applications for statistical monitoring, digital recording and automatic customer surveys for customer contact centers.

On March 19, 2002, Mr. Chapiewski, a former shareholder of CPS, filed an action against the Company by complaint. In this complaint, Mr. Chapiewski alleged that the Company violated Sections 604(3) and 604(4) of the Colorado Securities Act, committed common law fraud and negligent misrepresentation, and breached representations and warranties in the agreement relating to the CPS acquisition, by misrepresenting to Mr. Chapiewski, either affirmatively or through omissions, the Company's financial results and value of securities. Mr. Chapiewski also claimed that NICE Centerpoint breached severance provisions of an employment agreement with him in the amount of \$ 80. Mr. Chapiewski sought damages in an unspecified amount. On November 25, 2002, the Company settled the claim with Mr. Chapiewski, without any admission of liability or wrongdoing on its part, for an amount of \$ 3,000 and the release from escrow of the target shares valued at \$ 469. The settlement agreement resulted in a one-time charge to other expenses of \$ 3,469 in 2002, of which \$ 300 was recovered from insurance proceeds in 2003.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements were prepared in accordance with United States Generally Accepted Accounting Principles (“U.S. GAAP”).

a. Use of estimates:

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

b. Financial statements in United States dollars:

The currency of the primary economic environment in which the operations of NICE and certain subsidiaries are conducted is the U.S. dollar (“dollar”); thus, the dollar is the functional currency of NICE and certain subsidiaries.

NICE and certain subsidiaries’ transactions and balances denominated in dollars are presented at their original amounts. Non-dollar transactions and balances have been remeasured to dollars in accordance with Statement of Financial Accounting Standards (“SFAS”) No. 52, “Foreign Currency Translation”. All transaction gains and losses from remeasurement of monetary balance sheet items denominated in non-dollar currencies are reflected in the statements of operations as financial income or expenses, as appropriate.

For those subsidiaries whose functional currency has been determined to be their local currency, assets and liabilities are translated at year-end exchange rates and statement of operations items are translated at average exchange rates prevailing during the year. Such translation adjustments are recorded as a separate component of accumulated other comprehensive income (loss) in shareholders’ equity.

c. Principles of consolidation:

Intercompany transactions and balances have been eliminated upon consolidation.

d. Cash equivalents:

The Company considers short-term unrestricted highly liquid investments that are readily convertible into cash, purchased with maturities of three months or less to be cash equivalents.

e. Short-term bank deposits:

Bank deposits with maturities of more than three months but less than one year are included in short-term bank deposits. Such short-term bank deposits are stated at cost.

f. Marketable securities:

The Company accounts for investments in debt securities in accordance with SFAS No. 115, “Accounting for Certain Investments in Debt and Equity Securities”.

Management determines the appropriate classification of its investments in debt securities at the time of purchase and reevaluates such determinations at each balance sheet date.

Debt securities are classified as held-to-maturity when the Company has the positive intent and ability to hold the securities to maturity and are stated at amortized cost. The cost of held-to-maturity securities is adjusted for amortization of premiums and accretion of discounts to maturity. Such amortization, accretion, decline in value judged to be other than temporary, and interest are included in financial income or expenses, as appropriate.

Interest income resulting from investments in structured notes that are classified as held to maturity is accounted for under the provision of EITF No. 96-12, "Recognition of Interest Income and Balance Sheet Classification of Structured Notes". Under Emerging Issues Task Force ("EITF") No. 96-12, the retrospective interest method is used for recognizing interest income.

Auction rate securities are classified as available-for-sale and accordingly, these securities are stated at fair value. Realized gains and losses on sales of securities, as determined on a specific identification basis, are included in the consolidated statement of operations.

g. Inventories:

Inventories are stated at the lower of cost or market value. The cost of raw materials and work-in-progress is determined by the "average cost" method, and the cost of finished goods on the basis of costs charged by third party manufacturer.

Inventory provisions are provided to cover risks arising from slow-moving items, technological obsolescence, excess inventories, discontinued products and for market prices lower than cost. Inventory provisions for 2002, 2003 and 2004, were \$ 1,650, \$ 2,368 and \$ 2,822, respectively, and have been included in cost of revenues.

h. Investment in affiliates:

The investments in affiliated companies are stated at cost, since the Company does not have the ability to exercise significant influence over operating and financial policies of those investees.

The Company's investment in affiliates is reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the investment may not be recoverable. In 2002, an impairment loss had been identified in the amount of \$ 229.

i. Property and equipment, net:

Property and equipment are stated at cost, net of accumulated depreciation.

Depreciation is calculated using the straight-line method over the estimated useful lives of the assets, at the following annual rates:

	<u>%</u>
Computers and peripheral equipment	33
Office furniture and equipment	6 - 15
Motor vehicles	15

Leasehold improvements are amortized by the straight-line method over the term of the lease or the estimated useful life of the improvements, whichever is shorter.

j. Other intangible assets, net:

Intangible assets are amortized over their useful lives using a method of amortization that reflects the pattern in which the economic benefits of the intangible assets are consumed or otherwise used, in accordance with SFAS No. 142, "Goodwill and Other Intangible Assets".

Amortization is calculated using the straight-line method over the estimated useful lives at the following annual rates:

	<u>Weighted average %</u>
Capitalized software development costs (see o)	33
Core technology	28
Trademarks	34
Maintenance contracts	33

In accordance with the requirement of SFAS No. 142, intangible assets deemed to have indefinite lives are no longer amortized after January 1, 2002. The distribution network is deemed to have an indefinite useful life because it is expected to generate cash flows indefinitely. In accordance with SFAS No. 142, the Company evaluates the remaining useful life each year to determine whether events and circumstances continue to support an indefinite useful life. The Company performed annual impairment test in 2004, and did not identify any impairment.

k. Impairment of long-lived assets:

The Company's long-lived assets and certain identifiable intangibles are reviewed for impairment in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of the assets to the future undiscounted cash flows expected to be generated by the assets. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell. In 2004, no impairment indicators have been identified.

l. Goodwill:

Goodwill represents the excess of the cost over the fair value of the net assets of businesses acquired. Under SFAS No. 142, goodwill acquired in a business combination consummated on or after July 1, 2001, is not amortized. Goodwill arising from acquisitions prior to July 1, 2001 was amortized until December 31, 2001 on a straight-line basis over 10 years.

SFAS No. 142 requires goodwill to be tested for impairment at least annually or between annual tests in certain circumstances, and written down when impaired, rather than amortized as previous accounting standards required. Goodwill is tested for impairment by comparing the fair value of the reporting unit with its carrying value. Fair value is determined using discounted cash flows and market capitalization. Significant estimates used in the fair value methodologies include estimates of future cash flows, future growth rates and the weighted average cost of capital of the reporting unit. The Company performed annual impairment tests during the fourth quarter of 2002, 2003 and 2004, and recognized impairment losses of \$ 28,260, \$ 0 and \$ 0, respectively.

m. Revenue recognition:

The Company generates revenues from sales of products, which include hardware and software, software licensing, professional services and maintenance.

The Company sells its products indirectly through a global network of distributors, system integrators and strategic partners, all of whom are considered end-users, and through its direct sales force.

Revenues from product sales and software license agreements are recognized when all criteria outlined in Statement Of Position (“SOP”) 97-2, “Software Revenue Recognition” (as amended by SOP 98-9) are met. Revenue from products and license fees is recognized when persuasive evidence of an agreement exists, delivery of the product has occurred, the fee is fixed or determinable, no further obligations exist and collectibility is probable. Sales agreements with specific acceptance terms are not recognized until the customer has confirmed that the product or service has been accepted.

Where software license arrangements involve multiple elements, revenue is allocated to each element based on Vendor Specific Objective Evidence (“VSOE”) of the relative fair values of each element in the arrangement, in accordance with the residual method. The Company’s VSOE used to allocate the sales price to maintenance is based on the renewal percentage. Under the residual method, revenue is recognized for the delivered elements when (1) there is VSOE of the fair values of all the undelivered elements, and (2) all revenue recognition criteria of SOP 97-2, as amended, are satisfied. Under the residual method any discount in the arrangement is allocated to the delivered element.

The Company maintains a provision for product returns in accordance with SFAS No. 48, “Revenue Recognition When Right of Return Exists”. The provision is estimated based on the Company’s past experience and is deducted from revenues. Trade receivables as of December 31, 2003 and 2004, are presented net of provision for product returns in the amounts of \$ 2,079 and \$ 1,617, respectively.

Revenues from maintenance and professional services are recognized ratably over the contractual period or as services are performed.

Deferred revenue includes advances and payments received from customers, for which revenue has not yet been recognized.

n. Warranty costs:

Provisions for warranty costs are made at the time revenues are recognized, for estimated costs during the warranty period based on the Company's experience. Provision for warranty as of December 31, 2003 and 2004, amounted to \$ 446 and \$ 498, respectively. A tabular reconciliation of the changes in the Company's aggregate product warranty liability was not provided due to immateriality.

o. Research and development costs:

Research and development costs (net of grants and participations) incurred in the process of software production before establishment of technological feasibility, are charged to expenses as incurred. Costs of the production of a product master incurred subsequent to the establishment of technological feasibility are capitalized according to the principles set forth in SFAS No. 86, "Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed". Based on the Company's product development process, technological feasibility is established upon completion of a detailed program design or a working model.

Costs incurred by the Company between completion of the detailed program design or working model and the point at which the product is ready for general release have been capitalized.

Capitalized software development costs are amortized commencing with general product release by the straight-line method over the estimated useful life of the software product.

p. Income taxes:

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

q. Government grants:

Non-royalty bearing grants from the Government of Israel for funding research and development projects are recognized at the time the Company is entitled to such grants on the basis of the related costs incurred and recorded as a deduction from research and development costs.

r. Concentrations of credit risk:

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

The Company's cash and cash equivalents and short-term bank deposits are invested in deposits mainly in dollars with major international banks. Such deposits in the United States may be in excess of insured limits and are not insured in other jurisdictions. Management believes that the financial institutions that hold the Company's investments are financially sound and, accordingly, minimal credit risk exists with respect to these investments.

The Company's trade receivables are derived from sales to customers located primarily in North America, EMEA and the Far East. The Company performs ongoing credit evaluations of its customers and obtains letter of credit and bank guarantees for certain receivables. Additionally, the Company insures certain of its receivables with a credit insurance company. An allowance for doubtful accounts is provided with respect to specific debts that the Company has determined to be doubtful of collection and a general provision on the remaining balance, based on the length of time the receivables are past due.

The Company's marketable securities include investment in U.S. corporate debentures, U.S. government debentures, structured notes and auction rate securities. Management believes that the portfolio is well diversified, and accordingly, minimal credit risk exists with respect to those marketable securities.

The Company entered into forward contracts and option strategies (together: "derivative instruments") intended to protect against the increase in value of forecasted non-dollar currency cash flows and the increase/decrease in fair value of non-dollar liabilities/assets. The derivative instruments effectively hedge the Company's non-dollar currency exposure (see Note 10).

s. Severance pay:

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

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

Severance pay expense for 2002, 2003 and 2004, was \$ 1,869, \$ 2,745 and \$ 2,956, respectively.

t. Basic and diluted net earnings (loss) per share:

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

The weighted average number of shares related to outstanding antidilutive options excluded from the calculations of diluted net earnings (loss) per share was 5,315,170, 1,935,692 and 1,094,775 for the years ended December 31, 2002, 2003 and 2004, respectively.

u. Stock-based compensation:

The Company has elected to follow APB No. 25, "Accounting for Stock Issued to Employees" and FIN No. 44, "Accounting for Certain Transactions Involving Stock Compensation" in accounting for its employee stock option plan. Under APB No. 25, when the exercise price of the Company's options is less than the market value of the underlying shares on the date of grant, compensation expense is recognized and amortized ratably over the vesting period of the options.

The Company adopted the disclosure provisions of SFAS No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure", which amended certain provisions of SFAS No. 123. The Company continues to apply the provisions of APB No. 25, in accounting for stock-based compensation.

Pro forma information regarding net income (loss) and net earnings (loss) per share is required by SFAS No. 123, "Accounting for Stock-Based Compensation", and has been determined as if the Company had accounted for its employee options under the fair value method prescribed by that statement. The fair value for these options was estimated at the date of grant using the Black-Scholes option pricing model with the following assumptions:

	Year ended December 31,		
	2002	2003	2004
Risk free interest rate	1.7%	1.8%	2.7%
Dividend yield	0%	0%	0%
Volatility factor	0.827	0.545	0.457
Expected life of the options	4.3	3	3

Black-Scholes pricing-model also was used to estimate the fair value of the ESPP compensation; assumptions are not provided due to the immateriality of the ESPP portion.

Pro forma information under SFAS No. 123:

	<u>Year ended December 31,</u>		
	<u>2002</u>	<u>2003</u>	<u>2004</u>
Net income (loss) as reported	\$ (33,982)	\$ 7,091	\$ 24,555
Add: Stock-based compensation expense included in the determination of net income (loss) as reported	12	12	—
Deduct: Stock-based compensation expense determined under fair value method for all awards	<u>(18,467)</u>	<u>(10,350)</u>	<u>(7,182)</u>
Pro forma net income (loss)	<u>\$ (52,437)</u>	<u>\$ (3,247)</u>	<u>\$ 17,373</u>
Basic net earnings (loss) per share as reported	<u>\$ (2.46)</u>	<u>\$ 0.44</u>	<u>\$ 1.40</u>
Diluted net earnings (loss) per share as reported	<u>\$ (2.46)</u>	<u>\$ 0.42</u>	<u>\$ 1.31</u>
Pro forma basic net earnings (loss) per share	<u>\$ (3.80)</u>	<u>\$ (0.20)</u>	<u>\$ 0.99</u>
Pro forma diluted net earnings (loss) per share	<u>\$ (3.80)</u>	<u>\$ (0.20)</u>	<u>\$ 0.93</u>

v. Fair value of financial instruments:

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

The carrying amount reported in the balance sheet for cash and cash equivalents, short-term bank deposits, trade receivables, short-term bank credit and trade payables approximates their fair value due to the short-term maturities of such instruments.

The fair value for marketable securities is based on quoted market prices and does not differ significantly from the carrying amount (see Note 3).

w. Advertising expenses:

Advertising expenses are charged to expense as incurred. Advertising expenses for the years 2002, 2003 and 2004, was \$ 1,760, \$ 2,077 and \$ 2,621, respectively.

x. Derivatives and hedging activities:

SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities" requires the Company to recognize all of its derivative instruments as either assets or liabilities on the balance sheet at fair value. The accounting for changes in the fair value (i.e., gains or losses) of a derivative instrument depends on whether it has been designated and qualifies as part of a hedging relationship and further, on the type of hedging relationship. For those derivative instruments that are designated and qualify as hedging instruments, a company must designate the hedging instrument, based upon the exposure being hedged, as a fair value hedge, cash flow hedge or a hedge of a net investment in a foreign operation.

For derivative instruments that are designated and qualify as a fair value hedge (i.e., hedging the exposure to changes in the fair value of an asset or a liability or an identified portion thereof that is attributable to a particular risk), the gain or loss on the derivative instrument as well as the offsetting loss or gain on the hedged item attributable to the hedged risk are recognized in the line item associated with the hedged item in earnings during the period of the change in fair values. For derivative instruments that are designated and qualify as a cash flow hedge (i.e., hedging the exposure to variability in expected future cash flows that is attributable to a particular risk), the effective portion of the gain or loss on the derivative instrument is reported as a component of accumulated other comprehensive income and reclassified into earnings in the line item associated with the hedged transaction in the period or periods during which the hedged transaction affects earnings. The remaining gain or loss on the derivative instrument in excess of the cumulative change in the present value of future cash flows of the hedged item, if any, is recognized in financial income/expense in the period of change.

y. Impact of recently issued accounting standards:

On December 16, 2004, the Financial Accounting Standards Board (FASB) issued Statement No. 123 (revised 2004), "Share-Based Payment" ("Statement 123R"), which is a revision of FASB Statement No. 123, "Accounting for Stock-Based Compensation" ("Statement 123"). Generally, the approach in Statement 123R is similar to the approach described in Statement 123. However, Statements 123 permitted, but not required, share-based payments to employees to be recognized based on their fair values while Statement 123R requires all share-based payments to employees to be recognized based on their fair values. Statement 123R also revises, clarifies and expands guidance in several areas, including measuring fair value, classifying an award as equity or as a liability and attributing compensation cost to reporting periods. The new Standard will be effective for the Company in the first fiscal year beginning after June 15, 2005. The adoption of Statement 123R will have a significant effect on the Company's results of operations.

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

z. Reclassification:

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

NOTE 3:- MARKETABLE SECURITIES

- a. The following table summarizes amortized costs, gross unrealized gains and losses and estimated fair values of held-to-maturity marketable securities as of December 31, 2003 and 2004:

	Amortized cost		Gross unrealized gains		Gross unrealized losses		Estimated fair value	
	December 31,		December 31,		December 31,		December 31,	
	2003	2004	2003	2004	2003	2004	2003	2004
U.S. corporate debentures	\$ 40,216	\$ 37,968	\$ 164	\$ 1	\$ 67	\$ 368	\$ 40,313	\$ 37,601
U.S. government debentures	19,505	74,805	24	11	77	560	19,452	74,256
Structured notes	17,500	12,680	—	—	7	—	17,493	12,680
	<u>\$ 77,221</u>	<u>\$ 125,453</u>	<u>\$ 188</u>	<u>\$ 12</u>	<u>\$ 151</u>	<u>\$ 928</u>	<u>\$ 77,258</u>	<u>\$ 124,537</u>

Information about gross unrealized losses based on the length of time that individual securities have been in a continuous unrealized loss position was not provided due to immateriality.

As of December 31, 2003 and 2004, all the Company's U.S. corporate debentures, U.S. government debentures and structured notes were classified as held-to-maturity.

In 2002 and 2004, the Company sold debt securities, which were classified as held-to-maturity, due to a rating decrease, in consideration of \$ 820 and \$ 911, respectively. As a result of the sale, the Company recorded a loss of \$ 55 and \$ 14, respectively. In 2003, the Company did not sell any securities prior to their maturity and accordingly, did not realize any gains or losses on held-to-maturity securities in that year. During 2003 and 2004, held-to-maturity marketable securities in the amount of \$ 8,500 and \$ 40,434, respectively, were called by the issuers prior to maturity.

The scheduled maturities of held-to-maturity marketable securities at December 31, 2004 are as follows:

	<u>Amortized cost</u>	<u>Estimated fair value</u>
<u>Held-to-maturity:</u>		
Due within one year	\$ 10,648	\$ 9,091
Due after one year through five years	109,805	110,446
Due after five years through ten years	<u>5,000</u>	<u>5,000</u>
	<u>\$ 125,453</u>	<u>\$ 124,537</u>

- b. Auction rate securities amounting to \$ 13,700 as of December 31, 2004, were classified as available-for-sale marketable securities and were presented as short-term marketable securities.

NOTE 4:- OTHER RECEIVABLES AND PREPAID EXPENSES

	<u>December 31,</u>	
	<u>2003</u>	<u>2004</u>
Government authorities	\$ 1,670	\$ 1,848
Interest receivable	1,151	994
Prepaid expenses	3,064	4,250
Other	<u>1,481</u>	<u>845</u>
	<u>\$ 7,366</u>	<u>\$ 7,937</u>

NOTE 5:- INVENTORIES

	<u>December 31,</u>	
	<u>2003</u>	<u>2004</u>
Raw materials	\$ 2,574	\$ 1,286
Work-in-progress	120	71
Finished goods	<u>9,940</u>	<u>11,258</u>
	<u>\$ 12,634</u>	<u>\$ 12,615</u>

NOTE 6:- PROPERTY AND EQUIPMENT, NET

	<u>December 31,</u>	
	<u>2003</u>	<u>2004</u>
Cost:		
Computers and peripheral equipment	\$ 44,144	\$ 50,474
Office furniture and equipment	13,105	13,701
Motor vehicles	134	—
Leasehold improvements	<u>3,658</u>	<u>3,823</u>
	<u>61,041</u>	<u>67,998</u>
Accumulated depreciation:		
Computers and peripheral equipment	35,992	42,454
Office furniture and equipment	4,749	6,501
Motor vehicles	99	—
Leasehold improvements	<u>1,574</u>	<u>2,062</u>
	<u>42,414</u>	<u>51,017</u>
Depreciated cost	<u>\$ 18,627</u>	<u>\$ 16,981</u>

Depreciation expense totaled \$ 9,775, \$ 10,547 and \$ 8,603 for the years ended December 31, 2002, 2003 and 2004, respectively.

NOTE 7:- OTHER INTANGIBLE ASSETS, NET

- a. Other intangible assets

	<u>December 31,</u>	
	<u>2003</u>	<u>2004</u>
Original amounts:		
Capitalized software development costs	\$ 22,979	\$ 19,355
Core technology	4,419	4,419
Trademarks	1,040	1,040
Maintenance contracts	<u>548</u>	<u>576</u>
	<u>28,986</u>	<u>25,390</u>
Accumulated amortization:		
Capitalized software development costs	15,838	14,980
Core technology	3,078	3,695
Trademarks	408	726
Maintenance contracts	<u>213</u>	<u>416</u>
	<u>19,537</u>	<u>19,817</u>

Amortized cost	9,449	5,573
Distribution network	<u>6,744</u>	<u>7,092</u>
Total other intangible assets	<u>\$ 16,193</u>	<u>\$ 12,665</u>

- b. Amortization expense amounted to \$ 5,473, \$ 7,070 and \$ 5,190 for the years ended December 31, 2002, 2003 and 2004, respectively.
- c. Estimated amortization expense for the years ended (excluding amortization of capitalized software development costs):

	<u>December 31,</u>
2005	\$ 665
2006	188
2007	188
2008	157
	<u>\$ 1,198</u>

NOTE 8:- GOODWILL

The changes in the carrying amount of goodwill for the years ended December 31, 2003 and 2004 are as follows:

Balance as of January 1, 2003	\$ 27,417
Adjustments to goodwill	(2,909)
Foreign currency translation adjustments	<u>803</u>
Balance as of December 31, 2003	\$ 25,311
Applied against sale of discontinued operation	(250)
Foreign currency translation adjustments	<u>684</u>
Balance as of December 31, 2004	<u>\$ 25,745</u>

NOTE 9:- ACCRUED EXPENSES AND OTHER LIABILITIES

	<u>December 31,</u>	
	<u>2003</u>	<u>2004</u>
Employees and payroll accruals	\$ 11,580	\$ 13,228
Accrued expenses	22,966	19,949
Restructuring accrual	604	256
Deferred revenues	10,054	18,677
Other	<u>2,166</u>	<u>3,192</u>
	<u>\$ 47,370</u>	<u>\$ 55,302</u>

NOTE 10:- DERIVATIVE INSTRUMENTS

To protect against changes in the value of forecasted foreign currency transactions and balances, the Company has instituted a foreign-currency hedging program. The Company hedges portions of its forecasted cash flows and balances denominated in foreign currencies with forward contracts and option strategies (together: “derivative instruments”).

The Company entered into derivative instrument arrangements to hedge a portion of anticipated New Israeli Shekel (“NIS”) payroll payments. These derivative instruments are designated as cash flows hedges, as defined by SFAS No. 133, as amended, and are all highly effective as hedges of these expenses when the salary is recorded. The effective portion of the derivative instruments is included in payroll expenses in the statements of operations.

In addition, the Company entered into derivative instruments to hedge certain trade receivables, trade payable payments, expected payments under fixed price contracts denominated in foreign currency, liabilities to employees and other long-term liability. The purpose of the Company’s foreign currency hedging activities is to protect the Company from changes in the foreign currency exchange rate to the dollar.

At December 31, 2004, the Company expects to reclassify \$ 65 of net gains on derivative instruments from accumulated other comprehensive income to earnings during the next twelve months.

NOTE 11:- RESTRUCTURING EXPENSES

Following the acquisition of TCS, the Company identified an opportunity to increase flexibility and focus, improve responsiveness and reduce unnecessary overhead. In December 2002, the Company adopted a plan (“the 2002 Plan”) to achieve these objectives, which involved the phased reduction of approximately 75 of the initially combined 1,077 staff and consolidation of certain field offices. The Company expects to incur a total cost of \$ 2,170 in connection with this plan. The Company elected early adoption of SFAS No. 146, “Accounting for Costs Associated with Exit or Disposal Activities”. The major components of the 2002 Plan are as follows:

	<u>Employee termination benefits</u>	<u>Facility closure</u>	<u>Loss on disposal of property and equipment</u>	<u>Total restructuring charge</u>
Total amount expected to be incurred	\$ 1,544	\$ 605	\$ 21	\$ 2,170
Costs incurred in 2002	\$ 282	\$ —	\$ —	\$ 282
Restructuring accrual as of December 31, 2002	282	—	—	282
Costs incurred in 2003	1,262	605	21	1,888
Costs paid in 2003	<u>(1,443)</u>	<u>(139)</u>	<u>(21)</u>	<u>(1,603)</u>
Restructuring accrual as of December 31, 2003	101	466	—	567
Additional restructuring expenses (reversal of over accrued amounts)	(16)	16	—	—
Costs paid in 2004	<u>(85)</u>	<u>(239)</u>	<u>—</u>	<u>(324)</u>
Restructuring accrual as of December 31, 2004	<u>\$ —</u>	<u>\$ 243</u>	<u>\$ —</u>	<u>\$ 243</u>

Remaining amount expected to be incurred \$ — \$ — \$ — \$ —

At December 31, 2004, a total amount of \$ 256 is included in accrued expenses and other liabilities for the above-mentioned plan and for the 2001 plan together.

NOTE 12:- COMMITMENTS AND CONTINGENT LIABILITIES

a. Lease commitments:

The Company leases office space, office equipment and various motor vehicles under operating leases.

1. The Company's office space and office equipment are rented under several operating leases.

Future minimum lease commitments under non-cancelable operating leases for the years ended December 31, are as follows:

2005	\$ 5,842
2006	4,724
2007	2,637
2008	1,568
2009 and thereafter	<u>610</u>
	<u>\$ 15,381</u>

Rent expenses for the years ended December 31, 2002, 2003 and 2004 were approximately \$ 5,761, \$ 6,554 and \$ 6,107, respectively.

2. The Company leases its motor vehicles under cancelable operating lease agreements.

The minimum payment under these operating leases, upon cancellation of these lease agreements was \$ 768 as of December 31, 2004.

Lease expenses of vehicles for the years ended December 31, 2002, 2003 and 2004 were \$ 1,616, \$ 2,124 and \$ 2,396, respectively.

b. Other commitments:

The Company is obligated under certain agreements with its suppliers to purchase goods and under an agreement with its manufacturing subcontractor to purchase excess inventory. Non cancelable obligations as of December 31, 2004, were approximately as follows:

2005	\$ 2,887
2006	1,335
2007	144
2008	144
2009	<u>144</u>
	<u>\$ 4,654</u>

c. Legal proceedings:

1. On October 19, 2004, CipherActive filed an action against the Company in the District Court of Tel Aviv, State of Israel. In this lawsuit, CipherActive claimed that under a development agreement with the Company, it is entitled to receive license fees in respect of certain software that it allegedly developed for the Company and which has been embedded in one of the Company's products. CipherActive claimed that it is entitled to license fees in the amount of \$ 600, in addition to the amount of \$ 100 already paid to CipherActive by the Company in respect of such license fees. In the Company's statement of defense it claimed that the software developed by CipherActive under the agreement has not been successful in the market, is no longer embedded in the Company's product and, therefore, CipherActive is not entitled to any additional license fees.
2. In July 2004, the Company's wholly owned subsidiary, STS Software Systems Ltd. ("STS"), filed a lawsuit in the U.S. District Court for the Southern District of New York charging Witness Systems, Inc. ("Witness") with infringement of the one of the Company's VoIP patents in the U.S, by marketing and selling products that incorporate methods of detecting, monitoring and recording information - all fully protected by that patent. STS is seeking an injunction against Witness, preventing the sale of any solution which infringes the Company's patent.

In August 2004, Witness filed a patent infringement action in the Federal Court for the Northern District of Georgia against the Company's wholly owned subsidiary NICE Systems, Inc. Witness subsequently filed an identical action in February 2005 against NICE in the same court. The two actions were consolidated in March 2005. Witness accuses the Company of infringing two U.S patents relating to certain technology used with some of the Company's products. Witness is requesting a permanent injunction against alleged future infringement and damages for past alleged infringement. The Company has responded to Witness' claims and has asserted that the patents are invalid and not infringed. At this stage the Company cannot predict the outcome of the claim, nor can it make any estimate of the amount of damages, if any, for which it will be held responsible in the event of a negative conclusion to the claim.

3. The U.S Consumer Product Safety Commission has brought to the Company's attention and provided it an opportunity to comment on an alleged incident of a fire allegedly involving a NICE product used in a school building in the Evesham New Jersey School District. The Company has retained specialized counsel and engineering consultants and is investigating this matter. The Company believes, as advised by outside counsel, that based on the facts known at present, it is not expected that this matter will result in any regulatory action.

NOTE 13:- CREDIT LINES

As of December 31, 2004, the Company had authorized credit lines from banks in the amount of \$ 139,000. When utilized, the credit lines will be denominated in dollars and will bear interest at the rate of up to LIBOR + 1.5 %. An amount of \$ 116,000 out of the total credit lines is secured by the Company's marketable securities. There are no financial covenants associated with these credit lines. As of December 31, 2004, \$ 5,756 of the \$ 139,000 referred to above was used for bank guarantees.

NOTE 14:- TAXES ON INCOME

- a. Measurement of taxable income:

Results for tax purposes are measured in real terms, in accordance with the changes in the Israeli Consumer Price Index ("CPI") or changes in the exchange rate of the NIS against the dollar for a "foreign investors" company. NICE has elected to measure its results for tax purposes on the basis of the changes in the exchange rate of NIS against the dollar.

- b. Tax benefits under the Israel Law for the Encouragement of Capital Investments, 1959 ("the Law"):

Certain production facilities of NICE have been granted the status of "Approved Enterprise" under the Law, in four separate investment programs.

According to the provisions of the Law, NICE elected the "alternative benefits" and waived government grants in return for a tax exemption.

Income derived from the first and second program was tax-exempt for a period of four years, commencing 1999 and 1997, respectively, and is taxed at the reduced corporate tax rate of 10%-25% (based on the percentage of foreign ownership in each taxable year) for an additional period of six years.

Income derived from the third and fourth programs will be tax-exempt for a period of two years, commencing with the year NICE first earns taxable income, and will be taxed at the reduced corporate tax rate of 10%-25% (based on the percentage of foreign ownership in each taxable year) for an additional period of eight years.

The period of tax benefits detailed above is subject to limits of the earlier of 12 years from the commencement of production or 14 years from receiving the approval.

The entitlement to the above benefits is conditional upon NICE's fulfilling the conditions stipulated by the above Law, regulations published thereunder and the certificates of approval for the specific investments in an "Approved Enterprise". In the event of failure to comply with these conditions, the benefits may be canceled and NICE may be required to refund the amount of the benefits, in whole or in part, including interest. As of December 31, 2004, management believes that NICE is in compliance with all the conditions required by the law.

As of December 31, 2004, approximately \$ 18,214 was derived from tax-exempt profits earned by NICE's "Approved Enterprises". NICE has decided not to declare dividends out of such tax-exempt income. Accordingly, no deferred tax liabilities have been provided on income attributable to NICE's "Approved Enterprises". If the net retained tax exempt income is distributed, it would be taxed at the corporate tax rate applicable to such profits as if NICE had not elected the alternative tax benefits (currently - 20% of the gross distributed amount) and an income tax liability would be incurred of approximately \$ 4,554 as of December 31, 2004.

Income of NICE from sources other than the "Approved Enterprise" during the period of benefits will be taxable at the regular corporate tax rate.

A recent amendment to the Law, which has been officially published effected as of April 1, 2005 (the "Amendment") has changed certain provisions of the Law. The Amendment enacted changes in the manner in which tax benefits are awarded under the law so that companies no longer require Investment Center approval in order to qualify for tax benefits. The Company's existing Approved Enterprises will generally not be subject to the provisions of the Amendment.

c. Tax benefits under the Israeli Law for the Encouragement of Industry (Taxation), 1969:

NICE is an industrial company under the above law and as such is entitled to certain tax benefits including accelerated depreciation, deduction of public offering expenses in three equal annual installments and amortization of other intangible property rights as a deduction for tax purposes.

d. Reduction in corporate tax rate:

In June 2004, the Israeli Parliament approved an amendment to the Income Tax Ordinance (No. 140 and Temporary Provision), which progressively reduces the regular corporate tax rate from 36% to 35% in 2004, 34% in 2005, 32% in 2006 and to a rate of 30% in 2007.

e. Net operating loss carryforward:

As of December 31, 2004, the Company had carryforward tax losses totaling approximately \$ 25,468, most of which can be carried forward and offset against taxable income with expiration dates from 2005 to 2022. Utilization of U.S. net operating losses may be subject to the substantial annual limitation due to the "change in ownership" provisions of the Internal Revenue Code of 1986 and similar state provisions. The annual limitation may result in the expiration of net operating losses before utilization.

f. Deferred income taxes:

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

	<u>December 31,</u>	
	<u>2003</u>	<u>2004</u>
Net operating loss carryforward	\$ 12,478	\$ 8,712
Reserves and allowances	<u>709</u>	<u>720</u>
Net deferred tax asset before valuation allowance	13,187	9,432
Valuation allowance	<u>(13,187)</u>	<u>(9,432)</u>
Net deferred tax asset	<u>\$ —</u>	<u>\$ —</u>

The Company has provided valuation allowances in respect of deferred tax assets resulting from tax loss carry forwards and other reserves and allowances due to uncertainty concerning its realization of these deferred tax assets.

g. Reconciliation between the theoretical tax expenses assuming all income is taxed at the statutory tax rate applicable to income of NICE and the actual tax expense as reported in the consolidated statements of operations is as follows:

	<u>Year ended December 31,</u>		
	<u>2002</u>	<u>2003</u>	<u>2004</u>
Income (loss) before taxes on income, as reported in the consolidated statements of operations	<u>\$ (35,002)</u>	<u>\$ 6,813</u>	<u>\$ 23,638</u>
Statutory tax rate in Israel	<u>36%</u>	<u>36%</u>	<u>35%</u>
Theoretical income tax expense (benefit)	\$ (12,601)	\$ 2,453	\$ 8,273
Losses and other items for which a valuation allowance was provided	3,218	174	3,055
Non-deductible acquisition-related costs (income)	11,201	(108)	71
Tax exempt interest income	(1,145)	—	—
Utilization of net operating losses for which a valuation allowance was provided	(676)	(2,014)	(9,490)
Non-deductible expenses	407	515	420
Other	<u>(54)</u>	<u>185</u>	<u>(10)</u>
Actual tax expense	<u>\$ 350</u>	<u>\$ 1,205</u>	<u>\$ 2,319</u>

- h. Income (loss) before taxes on income is comprised as follows:

	<u>Year ended December 31,</u>		
	<u>2002</u>	<u>2003</u>	<u>2004</u>
Domestic	\$ (34,043)	\$ 4,345	\$ 15,367
Foreign	(959)	2,468	8,271
	<u>\$ (35,002)</u>	<u>\$ 6,813</u>	<u>\$ 23,638</u>

- i. The provision for income taxes is comprised as follows:

Current taxes	<u>\$ 350</u>	<u>\$ 1,205</u>	<u>\$ 2,319</u>
Domestic	\$ 126	\$ 949	\$ 1,836
Foreign	224	256	483
	<u>\$ 350</u>	<u>\$ 1,205</u>	<u>\$ 2,319</u>

NOTE 15:- SHAREHOLDERS' EQUITY

- a. The Ordinary shares of the Company are traded on the Tel Aviv Stock Exchange and its ADSs are traded on NASDAQ.
- b. Share option plans:

In 1995, the Company adopted an employee share option plan ("the 1995 Option Plan"). Under the 1995 option plan, employees and officers of the Company may be granted options to acquire Ordinary shares. The options to acquire Ordinary shares, which may only be determined by the Board of Directors of the Company, are granted at an exercise price, subject to certain exceptions, of not less than the fair market value of the Ordinary shares on the grant date. 8,345,566 options of the 1995 Option Plan were granted.

The options generally vest gradually over a four-year period from the date of grant. As of February 15, 2000, the Board of Directors of the Company adopted a resolution amending the exercise terms for any option granted subsequent to February 15, 2000 under the 1995 Option Plan whereby 25% of the stock options granted become exercisable on the first anniversary of the date of grant and 6.25% become exercisable once every quarter during the subsequent three years. The options expire no later than 6 years from the date of grant.

In 1996, the Company adopted the 1997 Executive Share Option Plan (“the 1997 Option Plan”). Under the terms of the 1997 Option Plan, stock options will be exercisable during a 60-day period ending four years after grant. The plan met the definition of Time Accelerated Restricted Stock Award Options Plan (“TARSAP”). The TARSAP includes an acceleration feature based on the following: if the year-end earnings per share of the Company shall reach certain defined targets, 40% of such stock options shall become exercisable; if earnings per share shall reach certain higher defined targets, an additional 30% of such stock options shall become exercisable; and if earnings per share shall reach certain higher defined targets, an additional 30% of such stock options shall become exercisable, provided that with respect to all of the above-referenced periods, the operating profit of the Company shall not be less than 10% of revenues and earnings per share shall exclude any non-recurring expenses related to mergers and acquisitions. Notwithstanding the foregoing, none of the stock options shall be exercisable before the expiration of two years from the date of issuance. 950,000 options of the 1997 Option Plan were granted. As of December 31, 2004, none of the targets specified under the TARSAP were met and accordingly there was no acceleration of options.

In 2001, the Company adopted the 2001 Stock Option Plan (“the 2001 Option Plan”). The options to acquire Ordinary shares, which may only be determined by the Board of Directors of the Company, are granted at an exercise price, of not less than the fair market value of the Ordinary shares on the grant date. 2,959,750 options of the 2001 Option Plan were granted. Under the terms of the 2001 Option Plan, a one third of the stock options granted became exercisable ten months after the grant date and the remaining two thirds will become exercisable on the first and second anniversaries of the first date of exercise so long as the grantee is, subject to certain exceptions, employed by the Company at the date the stock option becomes exercisable. The third portion of the options may be exercised at the end of the second year following the first date of exercise, if the Company meets a pre-tax profit target of 20% of revenues. Unless otherwise determined by the Company’s Board of Directors as of the date of grant, the stock options expire six years after the date of grant. As of December 31, 2004, none of the targets specified were met and accordingly there was no acceleration of options.

In 2003, the Company adopted the 2003 Stock Option Plan (“the 2003 Option Plan”). Under the 2003 option plan, employees and officers of the Company may be granted options to acquire Ordinary shares. The options to acquire Ordinary shares, which may only be determined by the Board of Directors of the Company, are granted at an exercise price, subject to certain exceptions, of not less than the fair market value of the Ordinary shares on the grant date. 1,368,500 options of the 2003 Option Plan were granted. Unless otherwise determined by the Company’s Board of Directors as of the date of grant, the stock options expire six years after the date of grant.

A summary of the Company's stock options activity and related information for the years ended December 31, 2002, 2003 and 2004, is as follows:

	2002		2003		2004	
	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price
Outstanding at the beginning of the year	6,408,825	\$ 29.31	5,965,980	\$ 25.74	4,910,389	\$ 26.80
Granted	981,000	\$ 11.49	390,000	\$ 22.55	997,500	\$ 21.33
Exercised	(60,830)	\$ 12.10	(823,363)	\$ 12.83	(1,291,394)	\$ 13.63
Forfeited	(1,363,015)	\$ 32.87	(622,228)	\$ 32.52	(346,178)	\$ 40.46
Outstanding at the end of the year	<u>5,965,980</u>	<u>\$ 25.74</u>	<u>4,910,389</u>	<u>\$ 26.80</u>	<u>4,270,317</u>	<u>\$ 28.40</u>
Exercisable at the end of the year	<u>2,373,039</u>	<u>\$ 34.46</u>	<u>2,790,417</u>	<u>\$ 33.55</u>	<u>2,556,779</u>	<u>\$ 34.59</u>

The options outstanding as of December 31, 2004, have been separated into exercise price categories as follows:

Ranges of exercise price	Options outstanding as of December 31, 2004	Weighted average remaining contractual life (Years)	Weighted average exercise price	Options exercisable as of December 31, 2004	Weighted average exercise price of options exercisable
\$			\$		\$
7.83-11.14	334,325	3.74	9.98	104,105	10.19
12.00-16.81	1,395,531	2.62	12.97	1,177,463	12.81
19.33-28.07	1,453,761	5.07	21.91	188,511	23.09
30.13-40.94	41,000	0.86	39.62	41,000	39.62
48.13-70.88	702,500	1.51	57.36	702,500	57.36
75.63-78.88	343,200	1.16	75.87	343,200	75.87
	<u>4,270,317</u>	<u>3.23</u>	<u>28.40</u>	<u>2,556,779</u>	<u>34.59</u>

Weighted average fair values and weighted average exercise prices of options whose exercise price is equal or higher than the market price of the shares at date of grant are as follows:

	Weighted average fair value of options granted at an exercise price			Weighted average exercise price of options granted at an exercise price		
	Year ended December 31,					
	2002	2003	2004	2002	2003	2004
Equal to fair value at date of grant	<u>\$ 8.03</u>	<u>\$ 8.36</u>	<u>\$ 7.14</u>	<u>\$ 12.99</u>	<u>\$ 22.55</u>	<u>\$ 21.33</u>

Higher than fair value at
date of grant

\$ 5.19 \$ — \$ — \$ 10.51 \$ — \$ —

c. Employee Stock Purchase Plan (“ESPP”):

In February 1999, the Company’s Board of Directors adopted the Employee Stock Purchase Plan (“the Purchase Plan”). Eligible employees can have up to 10% of their earnings withheld, up to certain maximums, to be used to purchase Ordinary shares. The price of Ordinary shares purchased under the Purchase Plan will be equal to 85% of the lower of the fair market value of the Ordinary shares on the commencement date of each offering period or on the semi-annual purchase date.

During 2002, 2003 and 2004, employees purchased 131,667, 221,184 and 139,913 shares at average prices of \$ 10.51, \$ 6.86 and \$ 16.20 per share, respectively.

d. Dividends:

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

NOTE 16:- MAJOR CUSTOMER AND GEOGRAPHIC INFORMATION

a. Summary information about geographic areas:

The Company manages its business on a basis of one reportable segment. See Note 1a for a brief description of the Company’s business. The following data is presented in accordance with SFAS No. 131, “Disclosure About Segments of an Enterprise and Related Information”. Total revenues are attributed to geographic areas based on the location of end customers.

The following table presents total revenues and long-lived assets for the years ended December 31, 2002, 2003 and 2004 and as of December 31, 2002, 2003 and 2004 respectively:

	2002		2003		2004	
	Total revenues	Long-lived assets	Total revenues	Long-lived assets	Total revenues	Long-lived assets
Americas	\$ 86,938	\$ 10,835	\$ 118,594	\$ 9,926	\$ 121,578	\$ 10,130
EMEA*)	45,236	18,489	70,926	19,586	89,768	19,372
Far East	20,679	95	31,832	72	37,779	140
Israel	2,488	42,345	2,906	30,547	3,518	25,749
	<u>\$155,341</u>	<u>\$ 71,764</u>	<u>\$224,258</u>	<u>\$ 60,131</u>	<u>\$252,643</u>	<u>\$ 55,391</u>

*) Includes Europe, the Middle East (excluding Israel) and Africa.

b. Market sectors:

Total revenues from external customers divided on the basis of the Company's market sectors are as follows:

	<u>Year ended December 31,</u>		
	<u>2002</u>	<u>2003</u>	<u>2004</u>
Enterprise Interaction Solutions	\$ 122,422	\$ 171,381	\$ 194,111
Public Safety and Security sector	32,919	52,877	58,532
	<u>\$ 155,341</u>	<u>\$ 224,258</u>	<u>\$ 252,643</u>

c. Major customers' data as a percentage of total revenues:

Customer A	<u>23.3%</u>	<u>20.0%</u>	<u>18.8%</u>
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NOTE 17:- SELECTED STATEMENTS OF OPERATIONS DATA

a. Research and development, net:

	<u>Year ended December 31,</u>		
	<u>2002</u>	<u>2003</u>	<u>2004</u>
Total costs	\$ 23,363	\$ 26,384	\$ 27,512
Less - grants and participations	(1,632)	(1,260)	(1,341)
Less - capitalization of software development costs	<u>(4,609)</u>	<u>(2,291)</u>	<u>(1,305)</u>
	<u>\$ 17,122</u>	<u>\$ 22,833</u>	<u>\$ 24,866</u>

b. Financial income (expenses), net:

	<u>Year ended December 31,</u>		
	<u>2002</u>	<u>2003</u>	<u>2004</u>
Financial income:			
Interest and amortization/accretion of premium/discount of marketable securities	\$ 2,747	\$ 1,821	\$ 2,349
Interest	551	422	1,427
Foreign currency translation	<u>1,152</u>	<u>405</u>	<u>1,078</u>
	<u>4,450</u>	<u>2,648</u>	<u>4,854</u>
Financial expenses:			
Interest	(15)	(79)	(2)
Foreign currency translation	(95)	(204)	(894)
Other	<u>(348)</u>	<u>(331)</u>	<u>(402)</u>

	<u>(458)</u>	<u>(614)</u>	<u>(1,298)</u>
	<u>\$ 3,992</u>	<u>\$ 2,034</u>	<u>\$ 3,556</u>

- c. Restructuring expenses, in-process research and development write-off, settlement of litigation and other:

	<u>Year ended December 31,</u>		
	<u>2002</u>	<u>2003</u>	<u>2004</u>
Restructuring expenses (income) (Note 11)	\$ (118)	\$ 1,888	\$ —
In-process research and development write-off (Note 1c)	1,270	—	—
Settlement of litigation (*)	—	5,194	—
Other	(320)	—	—
	<u>\$ 832</u>	<u>\$ 7,082</u>	<u>\$ —</u>

- (*) In the fourth quarter of 2003, the Company reached a settlement agreement with one of its competitors to settle a patent infringement claim filed by the competitor in June 2000. Under the settlement agreement the Company paid to the competitor \$ 10,000 (of which approximately \$ 4,800 was covered by insurance).

- d. Net earnings (loss) per share:

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

1. Numerator:

	<u>Year ended December 31,</u>		
	<u>2002</u>	<u>2003</u>	<u>2004</u>
Numerator for basic and diluted net earnings (loss) per share -			
Net income (loss) from continuing operations	\$ (35,352)	\$ 5,608	\$ 21,319
Net income from discontinued operation	1,370	1,483	3,236
Net income (loss) available to Ordinary shareholders	<u>\$ (33,982)</u>	<u>\$ 7,091</u>	<u>\$ 24,555</u>

2. Denominator (in thousands):

Denominator for basic net earnings (loss) per share -			
Weighted average number of shares	13,795	16,038	17,497
Effect of dilutive securities:			
Add - Employee stock options	—	731	1,198
Add - ESPP	—	12	8
Denominator for diluted net earnings (loss) per share - adjusted weighted average shares	<u>13,795</u>	<u>16,781</u>	<u>18,703</u>

The effect of the inclusion of the options and warrants in 2002 would be anti-dilutive. Because of the loss in 2002, all potential dilutive securities are anti-dilutive.

NOTE 18:- SUBSEQUENT EVENT (UNAUDITED)

On April 11, 2005, the Company signed a definitive agreement to acquire the assets and assume certain liabilities of Dictaphone's Communications Recording Systems ("CRS") business for approximately \$ 38,500. Dictaphone's CRS business is a leading provider of liability and quality management systems for first responders, critical facilities, contact centers and financial trading floors. The closing took place on June 1, 2005.

SIGNATURES

Pursuant to the requirements of Section 12 of the Securities Exchange Act of 1934, the Registrant certifies that it meets all of the requirements for filing on Form 20-F and has duly caused this Annual Report to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Ra'anana, State of Israel, on the 29th day of June, 2005.

NICE-SYSTEMS LTD.

By: /s/ Haim Shani

Haim Shani

Chief Executive Officer