



Financials

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Management's Discussion and Analysis

We may from time to time make written or oral forward-looking statements, including in filings with the United States Securities and Exchange Commission ("SEC"), in reports to shareholders and in press releases and investor webcasts. You can identify these forward-looking statements by use of words such as "strategy", "expects", "continues", "plans", "anticipates", "believes", "will", "estimates", "intends", "projects", "goals", "targets", and other words of similar meaning. You can also identify them by the fact that they do not relate strictly to historical or current facts.

We cannot assure you that any forward-looking statement will be realized, although we believe we have been prudent in our plans and assumptions. Achievement of future results is subject to risks, uncertainties and inaccurate assumptions. Should known or unknown risks or uncertainties materialize, or should underlying assumptions prove inaccurate, actual results could vary materially from those anticipated, estimated or projected. Investors should bear this in mind as they consider forward-looking statements and whether to invest or remain invested in NICE Systems Ltd.'s securities. The forward-looking statements relate to, among other things: operating results; anticipated cash flows; gross margins; adequacy of resources to fund operations; our ability to maintain our average selling prices despite the aggressive marketing and pricing strategies of our competitors; our ability to maintain and develop profitable relationships with our key distribution partners, one of which constitutes more than 20% of our revenues, and the financial strength of our key distribution partners.

In connection with the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995, we are identifying important factors that, individually or in the aggregate, could cause actual results and outcomes to differ materially from those contained in any forward-looking statements made by us; any such statement is qualified by reference to the following cautionary statements. Please read the section below entitled "Factors That May Affect Future Results" to review conditions that we believe could cause actual results to differ materially from those contemplated by the forward-looking statements. You should understand that it is not possible to predict or identify all risk factors. Consequently, you should not consider the following to be a complete discussion of all potential risks or uncertainties. Readers are cautioned not to place undue reliance on these forward-looking statements, which reflect our view only as of the date of this report. Except as required by law, we undertake no obligation to update these forward-looking statements to reflect future events or circumstances or the occurrence of unanticipated events.

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and the related notes and other financial information included elsewhere in this annual report.

Overview

We 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 into actionable knowledge for business and security performance management applications. Our solutions capture multiple forms of interaction, including voice, fax, email, web chat, radio, and video transmissions over wireline, wireless, packet telephony, terrestrial trunk radio and data networks. The markets from which we currently derive the majority of our revenues and expect to continue to do so in the future are highly competitive.

Our products are based on two types of recording platforms - audio and video - and are used primarily in contact centers, trading floors, public safety organizations, transportation, corporate security, gaming and correctional facilities as well as various government and intelligence agencies.

Our development efforts for our recording platforms are aimed at addressing several trends we see developing in the industry. The trend towards the proliferation of voice over IP-based networks is leading to a greater requirement for VOIP recording capabilities in financial trading, contact centers and public safety environments. The continued trend towards replacing analog video recording with digital video recording is leading to the need for network applications in the video recording area.

We also see the continuation of a trend towards requirements for multimedia recording capabilities, particularly in contact centers (voice, fax, email, chat, screen) and public safety (voice, radio, video, data) markets. We are beginning to see this same trend developing in the financial trading sector, and we expect some Homeland Security initiatives in areas such as border control, critical infrastructure security, first responder communications and lawful interception to require multimedia capture platforms as well.

Our software applications enable our customers to capture, store, retrieve and analyze unstructured data (multimedia interactions) and combine them with data from other systems to create actionable knowledge that can be distributed via reports and alerts to all relevant parties to improve performance.

There is growing demand from our customers for software applications that will leverage the wealth of unstructured data captured by the recording platform to improve overall performance. In turn, as these enhanced software applications are being added, customers are considering our systems "mission critical". We see an opportunity for more content analysis applications in contact centers for quality monitoring and contact center management as well as for enterprise-wide process improvement and business performance management. We see a trend towards more software applications in financial trading environment for compliance monitoring and dispute management to improve business performance. We see similar trends happening in digital video recording. We expect video content analysis applications to become increasingly important to building, campus, city center, and infrastructure perimeter security, loss prevention in casinos, retail and warehousing, as well as various homeland security applications to enable proactive security management.

We expect to see an increase in the demand for VOIP recording products, networked video security solutions, and multimedia recording solutions as well as to increase the proportion of software in our product revenue mix and gradually increase the amount of professional services and maintenance revenue.

Our 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. One distributor accounted for approximately 22%, 12%, and 19% of revenues in 2002, 2001 and 2000, respectively.

Acquisitions

We have consummated three acquisitions during the past three years. These acquisitions were accounted for as purchases, and, accordingly, the purchase price for each acquisition was allocated to the assets acquired and liabilities assumed based on their respective fair values. The results of operations related to each acquisition are included in our consolidated statement of operations from the date of acquisition. The following are details for each of these acquisitions:

- In November 2002, we consummated an agreement to acquire certain assets and liabilities of Thales Contact Solutions (or TCS), a developer of customer-facing technology for public safety, financial trading and customer contact centers, based in the United Kingdom. TCS was a unit of Thales Group, one of Europe's premier electronics companies. In connection with the acquisition, we paid an initial \$29.9 million in cash and issued 2,187,500 ordinary shares to Thales Group at a fair market value of \$18.1 million calculated at the date of closing. As a result, Thales Group holds approximately 14% of the Company's shares and two Thales executives were elected to the Board of Directors of NICE.

Under the terms of the agreement, the cash portion of the purchase price was subject to downward adjustment based on the value of net assets at closing and the full year 2002 sales of TCS. Based on the actual value of net assets acquired and 2002 sales of TCS, we reduced the cash portion of the purchase price as of December 31, 2002 by \$12.8 million. This amount is presented on our balance sheet as a Related Party Receivable. Thus, the adjusted purchase price paid, including \$4.5 million of capitalized acquisition costs, was recorded as \$39.7 million. Of the \$12.8 million adjustment referred to above, Thales paid us \$6.6 million in March 2003, and pending agreement on the actual value of net assets acquired, we expect to recover the outstanding balance during 2003. Should we and Thales not reach agreement on the net asset value, the matter will be submitted to binding arbitration in accordance with the terms of the acquisition agreement.

Also under the terms of the agreement, contingent cash payments of up to \$10 million in 2003, \$7.5 million in 2004, and \$7.5 million in 2005 would be due if certain financial performance criteria are met as part of a three-year earn-out provision related to the sale of a particular product in 2002 through 2004. The relevant criteria for 2002 were not met and therefore no contingent payment in respect of 2002 was recorded. Should any contingent payments be made under the agreement in the future, the additional consideration when determinable will increase the purchase price and accordingly additional goodwill will be recorded.

In the fourth quarter of 2002, we recorded a current liability of \$2.8 million and a long-term liability of \$13.5 million reflecting obligations under a long-term contract assumed by NICE in the TCS acquisition. We have entered into negotiations to amend

this contract but there can be no assurance that we will be successful in these negotiations.

- On December 5, 2000, we completed the acquisition of certain assets and liabilities of Stevens Communications Inc. (SCI). SCI is a systems distributor, whose activities included the promotion, distribution, installation and maintenance of our audio recording products and related software applications in North America. We paid \$7.0 million in cash and issued 426,745 ADSs of which 186,818 were deemed target shares contingent upon the achievement of certain objectives and events through 2002 and 38,914 ADSs were allotted for the benefit of certain SCI employees subject to vesting based on continued employment with the Company. The contingent target shares were released to SCI upon agreement as to the achievement of the determined objectives.

In October 2001, we entered into a final settlement agreement with SCI addressing a dispute with SCI regarding the fair value of the working capital acquired. The terms of the final settlement resulted in a charge to Other Expense, Net of \$4.4 million representing settlement of disputed items of \$3.6 million and obligations for future consulting services, which were no longer of value to us.

- In April 2000, we acquired all of the outstanding capital stock of Centerpoint Solutions Inc. (CPS) for \$3 million in cash and the issuance of 200,000 ADSs of NICE of which 50,000 were deemed target shares contingent upon the achievement of certain objectives, which were not met. CPS is a developer of internet-based applications for statistical monitoring, digital recording and automatic customer surveys for contact centers.
- In November 2002, we entered into a settlement agreement with Doug Chapiewski, the sole shareholder of CPS, in respect of allegations of misrepresentation, breach of contract and securities fraud in connection with the acquisition of CPS. The terms of the settlement agreement, which included 50,000 shares, resulted in a charge to Other Expense, Net of \$3.5 million.

Critical Accounting Policies

Our discussion and analysis of our financial condition and results of operations are based on our consolidated financial statements, which have been prepared in accordance with generally accepted accounting principles in the United States (“US GAAP”). Our significant accounting principles are presented within Note 2 to our Consolidated Financial Statements. While all the accounting policies impact the financial statements, certain policies may be viewed to be critical. These policies are those that are both 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 could differ from those estimates.

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

- Revenue recognition
- Allowance for doubtful accounts
- Inventory valuation
- Impairment of long-lived assets
- Deferred income taxes
- Contingencies
- Restructuring expenses

Revenues. We derive our revenue primarily from two sources: product revenues, which include hardware and software, and service revenues, which include, support and maintenance, installation, consulting and training revenue. Revenue related to sales of our products is generally recognized when persuasive evidence of an agreement exists; the product has been delivered and title and risk of loss have passed to the buyer; the sales price is fixed and 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.

Revenues from fixed-price contracts that require significant customization are recognized using the percentage-of-completion method generally on the basis of value added and results achieved out of the completeness of the product as a whole.

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

When transactions involve multiple elements, revenue is allocated to the elements based on Vendor Specific Objective Evidence (“VSOE”) of the relative fair values of each element in the arrangement, according to the residual method. Our VSOE used to allocate the sales price to support services and maintenance is based on the renewal price.

To assess the probability of collection for revenue recognition, we have an established credit policy that determines, by way of mathematical formulae based on the customers’ financial statements and payment history, the level of open account that is deemed probably collectible for each customer. These credit limits are reviewed and revised periodically on the basis of new customer financial statement information and payment performance.

We record a provision for estimated sales returns and allowances on product sales in the same period as the related revenues are recorded. We base these estimates on the historical sales returns ratio and other known factors. Actual returns could be different from our estimates and current provisions for sales returns and allowances may need to be increased.

Allowance for Doubtful Accounts. We evaluate the collectibility of our accounts receivable based on a combination of factors. In circumstances where we are aware of a specific customer’s inability to meet its financial obligations to us, we record a specific allowance against amounts due to reduce the net recognized receivable to the amount we reasonably believe will be collected. For all other customers, we recognize allowances for doubtful accounts based on the length of time the receivables are past due. Insured balances are not reserved. If the financial condition of one of our

significant customers or our customers in general should deteriorate, our revenue growth may be limited and additional allowances may be required.

Inventory valuation. At each balance sheet date, we evaluate our inventory balance for excess quantities and obsolescence. This evaluation includes analyses of sales levels by product line and projections of future demand. In addition, we write off inventories that are considered obsolete. Remaining inventory balances are adjusted to the lower of cost or market value. If future demand or market conditions are less favorable than our projections, additional inventory write-downs may be required and would be reflected in cost of sales in the period the revision is made.

During 2002 we completed the outsourcing of the manufacture of our audio and video product platforms. Under this arrangement, we take ownership of inventories at the conclusion of the manufacturing process, such inventories representing finished goods or spare parts. As we largely manufacture to order, we do not tend to accumulate finished goods. We are, however, liable to purchase above a certain level, which is based on historical level of orders to the contract manufacturer, excess raw material and subassembly inventories from the contract manufacturer deemed obsolete or slow-moving. We monitor the levels of the contract manufacturer's relevant inventories periodically and, if required, will write-off such deemed excess or obsolete inventory.

Impairment of long-lived assets. Our long-lived assets include property and equipment, long term investments, goodwill and other intangible assets. The fair value of the long-term investments is dependent upon the performance of the companies in which we have invested. In assessing potential impairment of these investments, we consider this factor as well as the forecast financial performance of the investees and other pertinent information. We record an investment impairment charge when we believe that the investment has experienced a decline in value that is other than temporary. During 2002, we recognized \$229 thousand of impairment losses related to our long-term investments. As of December 31, 2002, the carrying value of the Company's long-term investments was \$1.2 million.

In assessing the recoverability of our property and equipment, goodwill and other intangible assets, we must make assumptions regarding the estimated future cash flows and other factors to determine the fair value of the respective assets. If these estimates or their related assumptions change in the future, we may be required to record impairment charges for these assets.

In July 2001, the Financial Accounting Standards Board issued SFAS No. 142 "Goodwill and Other Intangible Assets". SFAS No. 142 addresses the initial recognition and measurement of intangible assets acquired in a business combination and the accounting for goodwill and other intangible assets subsequent to their acquisition. SFAS No. 142 provides that intangible assets with finite useful lives will be amortized and that goodwill and intangible assets with indefinite lives will not be amortized, but rather will be tested at least annually for impairment. We adopted SFAS No. 142 beginning January 1, 2002. Upon adoption of SFAS No. 142, we discontinued the amortization of recorded goodwill, which was approximately \$3.4 million on an annual basis at that time. We performed an impairment test of our goodwill as of January 1, 2002 under the transitional provisions of SFAS No. 142; our test did not indicate an impairment of goodwill. We confirmed that we have only one reporting unit (the Company) to which we allocated all recorded goodwill, as well as all assets and liabilities.

By October 1, 2002, our stock price had declined significantly from January 1, 2002, at which point our market capitalization, based on our stock price, was below book value. The price of our ADSs on January 2, 2002 was \$17.04 per ADS and declined to \$8.47 per ADS on October 1, 2002.

We determined the fair value of the Company based on relative market multiples for comparable businesses and a discounted cash flow model. This evaluation indicated that an impairment might exist. We then performed Step 2 under SFAS No. 142 in which the amount of the impairment loss, if any, must be measured. Four categories of intangible assets were identified as being separable from goodwill in accordance with SFAS No. 141. These included: trade names; an in-place distribution network; technology based intangible assets and maintenance contracts. In valuing the NICE trade name a relief from royalty method was used. Under this method, the value of a trade name reflects the savings realized by owning the trade name. The value of the intangible asset under the relief from royalty method is dependent upon the following factors: the selected royalty rate, the revenues expected to be generated from the underlying intellectual property, the discount rate and the expected life of the intellectual property. The value of our distribution network was determined through the use of the cost approach. Using this method, the value of the distribution network is estimated as the after-tax direct costs that a potential acquirer would avoid spending in recreating a similar functional distribution network. The value of the intangible asset under the cost method is dependent upon the estimated direct cost of establishing a new distributor relationship. Qualifying technology-based intangible assets consist of current and core technology and technologies that were under development at the valuation date. The current and core technology was valued using a derivation of the income approach, namely the excess earnings method. This method is used to analyze the earnings contribution of an intangible asset. Under this method, the excess earnings that an intangible asset generates are calculated over the intangible asset's expected life and discounted to the present to calculate the fair value of the intangible asset. Excess earnings are defined as the residual earnings after providing for appropriate returns on the other identified contributing assets. The value under the excess earnings method is dependent upon the following factors: the expected revenues generated by the intangible asset, the expected after-tax earnings on those revenues, the charges (or returns) required on other contributing assets and the discount rate. Our maintenance contracts, which are intangible assets under the contractual-legal criterion of SFAS No. 141, were valued using the excess earnings method. In determining the applicable discount rate to be used to estimate the fair value of our net assets, we calculated a market-derived rate based on the estimated weighted average cost of capital for the Company. In determining the cost of equity for the Company, we used a standard methodology based on the capital asset pricing model and analyzed selected guideline companies, industry data and factors specific to NICE. We expect to use a similar decision process in the future

Following these analyses, we compared the carrying amount of goodwill to the implied fair value of the goodwill and determined that an impairment loss existed. A non-cash charge totaling \$28.3 million was recorded in the fourth quarter of 2002 to write down goodwill to its fair value under the caption "Goodwill impairment". This impairment is primarily attributable to the change in evaluation criteria for goodwill from an undiscounted cash flow approach, which was previously used under the guidance in Accounting Principles Board Opinion No. 17 *Intangible Assets*, to the fair value approach stipulated in SFAS No.142. The valuation of long-lived assets requires significant estimates and assumptions. These estimates contain management's best estimates, using appropriate and customary assumptions and projections at the time. If different estimates or projections were used, it is reasonably possible that our analysis would have generated materially different results.

Deferred income taxes. We record income taxes using the asset and liability approach. Deferred income tax assets and liabilities are recognized for future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective income tax bases, and net operating loss and tax credit carryforwards. Our financial statements contain fully reserved tax assets which have arisen as a result of net operating losses, primarily incurred in 2001 and 2002, as well as other temporary differences between book and tax

accounting. Significant 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. We have considered future taxable income, prudent and feasible tax planning strategies and other available evidence in determining the need for a valuation allowance. We evaluate all of these factors to determine whether it is more likely than not that some portion or all of the deferred income tax assets will not be realized. As a result of significant net operating losses incurred in 2001 and 2002, anticipated additional net operating losses for the first quarter of 2003 and uncertainty as to the extent and timing of profitability in future periods, we have continued to record a full valuation allowance, which was approximately \$14.8 million as of December 31, 2002. The establishment and amount of the valuation allowance requires significant estimates and judgment and can materially affect our results of operations. If the realization of deferred tax assets in the future is considered more likely than not, an adjustment to the deferred tax assets would increase net income in the period such determination was made.

Our effective tax rate may vary from period to period based on changes in estimated taxable income or loss, changes to the valuation allowance, changes to state or foreign tax laws, future expansion into geographic areas with varying country, state and local income tax rates, deductibility of certain costs and expenses by jurisdiction and as a result of acquisitions, divestitures and reorganizations.

Contingencies. From time to time, we are defendant or plaintiff in various legal actions, which arise in the normal course of business. We are also a defendant in an intellectual property infringement action. We are required to assess the likelihood of any adverse judgments or outcomes to these matters as well as potential ranges of probable losses. A determination of the amount of reserves required for these contingencies, if any, which would be charged to earnings, is made after careful and considered analysis of each individual action together with our legal advisors. The required reserves may change in the future due to new developments in each matter or changes in circumstances, such as a change in settlement strategy. A change in the required reserves would affect our earnings in the period the change is made.

Restructuring. We established exit plans for each of the restructuring activities which took place in 2001 and 2002. In early 2001, with mounting evidence of an economic slowdown in the information technology and telecommunications sectors as well as changing business dynamics, we conducted a comprehensive review of our strategy, products, organization and infrastructure. This review culminated in the restructuring of our global operations, including the reduction of approximately 340 of our 1,110 employees, consolidation of our field facilities in North America, expansion of our local presence in Europe and Asia, and various other actions aimed at focusing on our core markets, products and competencies. We accounted for the 2001 plan in accordance with EITF Issue No. 94-3 "Liability Recognition for Certain Employee Benefits and Other Costs to Exit an Activity (including Certain Costs incurred in a Restructuring)". Under EITF 94-3, an entity recognized a liability for an exit cost on the date that the entity committed itself to the exit plan. The exit cost included involuntary employee termination benefits, estimates regarding our ability to sub-lease vacated facilities, rates to be charged to a sub-tenant and the timing of the sub-lease arrangement and included an estimate of the timing of the pace and completion of the outsourcing of manufacturing to Flextronics, the contract manufacturer. During the fourth quarter of 2002, we reduced the restructuring accrual by \$400 thousand to reflect mainly lower than estimated employee termination costs. Our remaining cash lease commitments net of sub-lease income related to restructured facilities are approximately \$124 thousand, which is fully accrued in the accompanying balance sheet.

In July 2002, the Financial Accounting Standards Board issued SFAS No. 146 “Accounting for Costs Associated with Exit or Disposal Activities”, SFAS No. 146 requires that a liability for a cost that is associated with an exit activity be recognized only when the liability is incurred. It supersedes the guidance in EITF 94-3. In SFAS No. 146, an entity’s commitment to a plan does not, by itself, create a present obligation to other parties that meets the definition of a liability and establishes that fair value is the objective for the initial measurement of the liability. Although SFAS No. 146 became effective for exit or disposal activities initiated after December 31, 2002, we elected to adopt the new ruling in respect of our fourth quarter 2002 restructuring plan. With the acquisition of TCS, we identified an opportunity to increase flexibility and focus, improve responsiveness and reduce unnecessary overhead. We adopted a plan to achieve these objectives in December 2002 which involves the phased reduction of approximately 140 of our initially combined 1,077 staff and consolidation of certain offices. Some of the involuntary reductions were effected in December and the liability related to those terminations of \$282 thousand was included in our fourth quarter 2002 results. The remaining reductions in force are planned to be implemented over the first three quarters of 2003.

In the event that we redefine our strategic direction and/or difficult economic conditions continue to prevail, we may be required to implement further restructuring measures. We are not currently able to determine whether or to what extent such circumstances may continue or worsen.

Operating Results

The following table sets forth selected consolidated income statement data for NICE for each of the three years ended December 31, 2000, 2001, and 2002 expressed as a percentage of total revenues.

| | <u>Years Ended December 31,</u> | | |
|--------------------------------------|---------------------------------|----------------|----------------|
| | <u>2000</u> | <u>2001</u> | <u>2002</u> |
| Revenues | | | |
| Products | n/a % | 88.6 % | 82.9 % |
| Services | <u>n/a</u> | <u>11.4</u> | <u>17.1</u> |
| | 100.0 | 100.0 | 100.0 |
| Cost of revenues | | | |
| Products | n/a | 48.2 * | 43.5 * |
| Services | <u>n/a</u> | <u>134.4 *</u> | <u>94.0 *</u> |
| | 48.0 | 58.0 | 52.2 |
| Gross profit | 52.0 | 42.0 | 47.8 |
| Operating expenses | | | |
| Research and development, net | 12.7 | 15.1 | 11.0 |
| Selling and marketing | 23.1 | 27.6 | 24.9 |
| General and administrative | 18.5 | 21.4 | 14.6 |
| Restructuring and other | 0.0 | 11.5 | -0.3 |
| In-process research and development | 4.4 | 0.0 | 0.8 |
| Amortization of acquired intangibles | 0.6 | 2.7 | 0.0 |
| Goodwill impairment | <u>0.0</u> | <u>0.0</u> | <u>17.4</u> |
| Total operating expenses | 59.3 | 78.3 | 68.4 |
| Operating loss | -7.3 | -36.3 | -20.6 |
| Financial income, net | 4.0 | 3.3 | 2.4 |
| Other income (expenses), net | <u>0.0</u> | <u>-3.8</u> | <u>-2.5</u> |
| Loss before taxes on income | -3.3 | -36.8 | -20.7 |
| Taxes on income | <u>0.2</u> | <u>0.2</u> | <u>0.2</u> |
| Net loss | <u>-3.5 %</u> | <u>-37.0 %</u> | <u>-20.9 %</u> |

*Percent of related revenue.

Year Ended December 31, 2002 Compared to Year Ended December 31, 2001

Revenues. Our total revenues rose 28% to \$162.5 million in 2002 from \$127.1 million in 2001. Product revenues rose \$22.1 million or 20% to \$134.8 million in 2002 from \$112.6 million in the prior year due mainly to a net \$19.9 million (23%) increase in sales of our audio platform and related applications mainly to contact center and trading floor markets and an \$8.3 million (60%) increase in digital video platform sales. These increases were partially offset by a \$6.1 million (46%) decrease in sales of our COMINT/DF products. We believe that our growth in product sales to contact center and financial trading floor markets principally reflects market share gains but also the inclusion of \$6.8 million of revenues following the acquisition of TCS in November 2002. There can be no assurance that we will continue to experience market share gains or that, given the continuing weakened global economy, we will continue to report growth in audio platform and related software application sales. We believe that the high-end digital video market is still in its nascency and thus volatile; consequently, looking forward, we do not expect to experience the same degree of growth in revenues as we did in 2002.

Services revenues rose \$13.2 million (92%) to \$27.7 million in 2002 from \$14.5 million in the previous year. The increase reflects an increasing portion of our installed base engaging us for maintenance services, higher installation and training revenues related to the increase in contact center and financial trading floor sales and \$1.5 million in services revenue following the acquisition of TCS. Service revenues accounted for 17% of total revenues up from 11% in 2001. Although we generate lower profit margins on services than on products, our strategy is to continue to grow our global services business, which we believe increases the competitiveness of our product offerings, and thus expect services to represent a growing portion of total revenues in the future.

Revenues in 2002 in the Americas, which includes the United States, Canada, Latin and South America, rose 33% to \$88.4 million from \$66.3 million in 2001. The increase is largely attributable to higher sales of products and services to contact center and financial trading floor markets. Sales to Europe, Middle East and Africa (“EMEA”) rose 29% to \$51.2 million in 2002 from \$39.8 million in 2001. The increase is due mainly to the acquisition of TCS in November 2002 (\$6.6 million) and the more than doubling of digital video sales in this region. Sales to Asia-Pacific (“APAC”) increased 9% to \$22.8 million in 2002 from \$21.0 million in 2001.

Cost of Revenues. Cost of revenues was \$84.7 million in 2002 compared with \$73.8 million in 2001.

Cost of product revenues rose 8% to \$58.7 million in 2002 from \$54.3 million in 2001. The increase in cost in 2002 is due to the higher sales volume. Cost of services revenue rose 34% to \$26.1 million from \$19.4 million in 2001. The increase in cost is due principally to higher labor, travel and material costs associated with the growth in product installations and maintenance contracts and \$1.4 million of service costs incurred following the acquisition of TCS.

Gross Profit. Gross profit on product revenues represented 56.5% of product revenues in 2002 compared with 51.8% in 2001 due mainly to a higher proportion of sales of our comparatively higher margin audio platform and applications in the sales mix and product manufacturing cost efficiencies achieved through both the outsourcing of manufacturing to the contract manufacturer over the course of the year and engineering design modifications mainly to our digital video recording platform. Gross profit margin on services revenue was 6% in 2002 compared with a loss of 34% in 2001 due primarily

to the higher growth rate in services revenues as compared with service expenses. For the reasons mentioned above, gross profit was \$77.8 million or 47.8% of total revenues in 2002 compared with \$53.3 million or 42.0% of revenues in 2001. On a forward-looking basis, we expect our gross margins to increase gradually as we realize the benefit of contract manufacturing efficiencies, of leveraging our global service operations and of a growing proportion of software applications in our product revenue mix.

Research and Development, Net. Research and development expense, before capitalization of software development costs and grants, declined to \$24.7 million in 2002 from \$26.0 million in 2001 and represented 15.2% and 20.5% of revenues in 2002 and 2001, respectively. The decrease in gross outlays is due mainly to the impact of the approximate 7% annual devaluation of the New Israel Shekel to the US dollar on R&D labor costs, as approximately 75% of our R&D staff is based in Israel, and a lower average number of R&D staff in 2002 versus 2001.

Software development costs capitalized were \$4.6 million in 2002 compared with \$5.4 million in 2001. Net research and development expense decreased 7% in 2002 to \$17.9 million from \$19.2 million in 2001. Amortization of capitalized software development costs, included in cost of product revenues, was \$4.3 million and \$2.8 million in 2002 and 2001, respectively.

Selling and Marketing Expenses. Selling and marketing expenses in 2002 increased 16% to \$40.5 million from \$35.0 million in 2001. The increase in selling and marketing expenses was due principally to higher labor costs mainly from the acquisition of TCS, higher commission expenses and higher discretionary marketing outlays for trade shows and promotional activities. Selling and marketing expenses represented 24.9% of total revenues in 2002 compared with 27.6% in 2001. We expect that we will continue to leverage our global sales and distribution infrastructure in the future such that selling and marketing expenses, while increasing on an absolute dollar basis, will decline moderately as a percentage of total revenues.

General and Administrative Expenses. General and administrative expenses decreased 12% in 2002 to \$23.8 million from \$27.1 million in 2001. The reduction in cost in 2002 was due primarily to lower legal costs and general cost containment efforts only partly offset by higher corporate insurance premiums and allowances for doubtful accounts. The increase in the allowance for doubtful accounts in 2002 compared with 2001 is mainly due to specific accounts deemed uncollectible and an increase in the aging of receivables reflecting weak general economic conditions worldwide. On a forward-looking basis, general and administrative expenses are expected to increase in absolute terms due mainly to the inclusion for a full year of the operations of TCS and higher corporate insurance premiums.

Restructuring. In connection with the restructuring plan implemented in December 2002, we recorded restructuring and other related charges of \$282 thousand in accordance with SFAS No. 146. All of the staff whose termination costs were included in our fourth quarter 2002 financial statements were located in North America. The plan also included vacating a portion of our Southampton facility and the closing of our Herndon, Virginia and Bergisch Gladbach, Germany offices.

In the quarter ending December 31, 2002, we reduced the remaining 2001 restructuring plan accrual by \$400 thousand. The 2001 restructuring plan charge of \$14.6 million included severance and outplacement costs of \$9.6 million, consolidation of facility costs of \$1.9 million, related property write-downs of \$1.9 million and impairment of intangible assets and other of \$1.1 million. The 2001 restructuring plan was substantially completed by December 31, 2001 with the principal exception of

employee terminations related to the completion of the outsourcing of manufacturing of our products. The remaining amounts net of sub-lease income relating to the consolidation of facilities in Sunnyvale and Las Vegas of \$124 thousand will be paid over the respective lease terms mainly through 2005.

In-process Research and Development. In connection with the acquisition of TCS and in accordance with SFAS No. 2 “Accounting for Research and Development Costs”, a portion of the purchase price, \$1.3 million, was allocated to purchased in-process research and development. As part of the process of analyzing this acquisition, we made a decision to buy three technologies that had not yet been commercialized rather than develop those technologies internally. In doing so, we considered our internal research resource allocation and our progress on comparable technology, if any. At the date of the acquisition, technological feasibility had not yet been established for the in-process research and development projects and they had no alternative future use. Accordingly, the fair value allocated to these technologies, which was based on an analysis of the discounted excess earnings that the intangible assets generate over their expected lives, was immediately expensed at acquisition. Amortization of

Acquired Intangibles. Amortization expense was \$3.4 million in 2001. With the adoption of SFAS No. 142 as of January 1, 2002, we ceased to amortize acquired intangibles of indefinite lives, primarily goodwill.

Goodwill Impairment. During the fourth quarter of 2002 we performed our annual impairment test of acquired intangible assets as prescribed by SFAS No. 142. Our stock price had declined significantly from January 1, 2002, at which point our market capitalization, based on our stock price, was below book value. We determined the fair value of the Company based on relative market multiples for comparable businesses and a discounted cash flow model. This evaluation indicated that an impairment loss might exist. We then performed Step 2 under SFAS No. 142 and compared the carrying amount of goodwill to the implied fair value of the goodwill and determined that an impairment loss existed.

A non-cash charge totaling \$28.3 million was recorded in the fourth quarter of 2002 to write down the goodwill recorded primarily in the acquisitions of SCI, CPS and STS to its fair value. We will perform an impairment test at least annually and on an interim basis should circumstances indicate that an impairment loss may exist. The outcome of such testing may lead to the recognition of an impairment loss. As of December 31, 2002, we had \$33.7 million of non-amortizable goodwill and other intangible assets.

Financial Income, Net. Financial income, net decreased 6% to \$4.0 million in 2002 from \$4.3 million in 2001. The decrease in 2002 reflects lower prevailing average market interest rates in 2002 compared with 2001 only partly offset by exchange gains.

Other Income (Expense), Net. Other expense, net was \$4.1 million in 2002 compared with \$4.8 million in 2001. In 2002, we recorded \$3.5 million in respect of the settlement of claims by Douglas Chapiewski, the sole shareholder of CPS; \$335 thousand representing the cost of moving our North American headquarters to a different facility, and \$229 thousand to write-off of our long-term investment in Espro Ltd. In 2001, we recorded a \$4.4 million charge following the settlement of a dispute with SCI relating to certain post-closing adjustments in connection with the acquisition of certain assets and liabilities by NICE.

Taxes on Income. In 2002, we recorded a provision for income taxes of \$350 thousand compared with \$198 thousand in 2001. The increase is primarily related to operating profits recorded at certain distribution subsidiaries where net operating loss carryforwards are not available to offset operating profits and changes in US state tax laws.

Net Loss. Net loss was \$34.0 million in 2002 compared with a net loss of \$46.8 million in 2001. The decrease in 2002 resulted primarily from the increase in revenues and gross margin.

Year Ended December 31, 2001 Compared to Year Ended December 31, 2000

Revenues. Our revenues decreased to \$127.1 million in 2001 from \$153.2 million in 2000. The 17% decrease in revenues in 2001 was due primarily to the overall slowdown in technology spending combined with the impact, particularly in North America, of internal operational changes implemented in early 2001. Sales in North America declined 26% in 2001 (after increasing 40% in 2000). Sales in Europe (including Israel) decreased 14% and sales in the rest of the world rose 2% in 2001. On a product line basis, sales of our audio recording platform and related applications for contact centers and financial trading floors decreased 22% to \$99.8 million in 2001 and represented 79% of total revenues; sales of digital video products declined 11% to \$14.1 million and represented 11% of total revenues, and revenues from sales of COMINT systems increased 52% to \$13.2 million and accounted for 10% of total revenues.

Cost of Revenues. Cost of revenues was \$73.8 million in 2001 compared with \$73.6 million in 2000. During 2000, we more than doubled the number of customer support staff who provide installation and technical support to our customers from about 100 at the start of the year to approximately 210 at the end of December 2000. Of the total, 37 support employees joined us as part of the December 2000 acquisition of the direct sales and customer support channel and service and maintenance agreements of our then largest distributor in North America, Stevens Communications, Inc. As a result, the increase in cost of revenues in 2001 was due primarily to the impact on an annual basis of the significant increase in the number of customer support employees and related costs without a commensurate increase in customer support revenue, which resulted in a substantial negative gross profit on customer support. This increase in customer support cost was only partly offset by lower sales volume and manufacturing labor costs.

Gross Profit. For the reasons mentioned above, gross profit was \$53.3 million in 2001 compared with \$79.6 million in 2000. Gross profit margin was 42.0% and 52.0% in 2001 and 2000, respectively.

Research and Development, Net. Research and development expense, before capitalization of software development costs and grants, rose to \$26.0 million in 2001 from \$25.4 million in 2000 and represented 20.5% and 16.6% of revenues in 2001 and 2000, respectively. The level of spending reflects our efforts to continue to improve our long-term competitive position. In 2000, we increased the number of R&D staff by 24% in order to support the development of new or enhanced products for each of our product lines. In 2001, these efforts included major functionality improvements to our voice recording platforms and quality monitoring and contact center performance applications as well as the market introduction of the *NiceVision Pro* high-end video recording platform and the *NiceTrack* telecommunications monitoring solution. The increase in gross research and development expense in 2001 resulted from the overall average higher level of R&D staff.

Software development costs capitalized were \$5.4 million in 2001 compared with \$4.7 million in 2000. Net research and development expense decreased 2% in 2001 to \$19.2 million from \$19.5 million in 2000. Amortization of capitalized software development costs, included in cost of revenues, was \$2.8 million and \$1.6 million in 2001 and 2000, respectively.

Selling and Marketing Expenses. Selling and marketing expenses in 2001 were \$35.0 million compared with \$35.4 million in 2000. The decrease in selling and marketing expenses was due principally to reductions in staff, lower revenue-related expenses and lower discretionary marketing outlays only partly offset by expansion of our sales and marketing infrastructure in Europe and Asia.

General and Administrative Expenses. General and administrative expenses were \$27.1 million in 2001 and \$28.3 million in 2000. The decrease in 2001 was due primarily to the reduction in administrative staff and cost containment efforts.

Restructuring. As a result of the decline in general economic and business conditions in late 2000 and the changing competitive environment, we implemented a restructuring program in 2001 to better align our cost structure with the current business environment and to focus our resources on the highest potential growth areas of our business. As a result, we incurred a \$14.6 million charge for restructuring costs in the first quarter of 2001.

Our restructuring program included a 30% reduction in force across all business functions. Approximately 60% of such employees were based in Israel and the remainder were based in primarily in North America. The workforce reduction resulted in a charge of \$9.6 million for termination benefits. We also consolidated our North American operations into two main facilities and eliminated excess field office space. The restructuring program included a charge of \$1.9 million for lease terminations and estimated losses on subleases and \$1.9 million for nonrecoverable investments in leasehold improvements and facility equipment. The restructuring program included exiting a product line acquired as part of the Dees transaction. As a result, a charge of \$1.1 million, relating to the impairment of the associated goodwill was taken.

The restructuring program was substantially completed by December 31, 2001 with the principal exception of employee terminations related to the completion of the outsourcing of manufacturing of our products. The cash impact of the total charge was \$11.0 million, of which \$9.0 million was paid in 2001 and the remainder was substantially paid by mid-2002. Amounts relating to the consolidation of facilities will be paid over the respective lease terms mainly through 2003.

Other Special Charges. In 2000, the Company recorded a charge of \$6.8 million related to in-process research and development of software acquired in the CenterPoint Solutions, Inc. transaction for which technological feasibility had not yet been established and for which no alternative future use existed.

Amortization of Acquired Intangibles. Amortization expense was \$3.4 million and \$0.9 million in 2001 and 2000, respectively. The increase in 2001 is due mainly to the acquisition of certain assets of SCI.

Financial Income, Net. Financial income, net decreased 31% to \$4.3 million in 2001 from \$6.2 million in 2000. The decrease in 2001 reflects lower average cash balances and lower average interest rates in 2001 compared with 2000.

Other Income (Expense), Net. Other expense, net was \$4.8 million in 2001 compared with other income, net of \$53 thousand in 2000. In 2001, we recorded a \$4.4 million charge following the settlement of a dispute with SCI relating to certain post-closing adjustments in connection with the acquisition of certain assets and liabilities by NICE.

Net Loss. Net loss was \$46.8 million in 2001 compared with \$5.3 million in 2000. The decrease in 2001 resulted primarily from the factors described above.

Liquidity and Capital Resources

We have historically financed our operations through cash generated from operations and sales of equity securities. We invest our excess cash in instruments that are highly liquid, investment grade securities. At December 31, 2002, we had approximately \$ 68.6 million of cash and cash equivalents and short and long-term investments compared with \$89.0 million at December 31, 2001 and \$98.0 million at December 31, 2000. The decrease in 2002 is due to the payment of \$29.9 million in the acquisition of TCS partly offset by net operating cash flow.

For 2002, cash provided by operations was \$20.1 million compared with \$2.3 million in 2001. The improvement in 2002 compared with 2001 was primarily attributable to the narrowed net loss and continued improvement in working capital. We place particular focus on managing our working capital, particularly the level of accounts receivable days sales outstanding and inventories. Days sales outstanding (DSO) in accounts receivable for 2002, excluding the effect of the acquisition of TCS, was 94 days compared with 99 days at the end of 2001. The improvement is primarily attributable to the implementation of process improvements and our credit policy. Including the impact of the acquisition of the assets of TCS, our DSO was 118 days. We expect to see our DSO return to levels below 100 days during the first half of 2003. In connection with the TCS acquisition, we recorded a current liability of \$2.8 million and a long-term liability of \$13.5 million reflecting obligations under a long-term contract assumed by NICE. We have entered into negotiations to amend this contract but there can be no assurance that we will be successful in these negotiations.

For 2001, cash provided by operations was \$2.3 million, compared with cash used in operations of \$2.1 million in 2000. The improvement in 2001 compared with 2000 was primarily attributable to an overall improvement in working capital associated with substantial reductions in accounts receivable and inventories largely offset by the \$46.8 million loss incurred in the year. Days sales outstanding (DSO) in accounts receivable was 99 days at the end of 2001 compared with 113 days at December 31, 2000.

Net cash used in investing activities was \$28.3 million compared with net cash provided by investing activities of \$2.5 million in 2001. The decrease in 2002 is due to the acquisition of TCS. Capital expenditures were \$5.4 million in 2002 and \$7.6 million in 2001. Capital expenditures in 2002 included investment in additional modules for our global ERP system including the implementation of the order management and financial system modules at TCS' Southampton facility following the acquisition and equipment for research and development and demonstration purposes. As of December 31, 2002, we have no material commitment for capital expenditures.

NICE SYSTEMS LTD. AND SUBSIDIARIES

Net cash provided by investing activities was \$2.5 million in 2001 and net cash used in investing activities was \$18.1 million in 2000. The increase in 2001 reflects lower capital expenditures and lower outlays for acquisitions. Capital expenditures were \$7.6 million and \$14.2 million in 2001 and 2000, respectively. 2001 capital expenditures related primarily to investment in a global ERP system and equipment for research and development purposes.

Net cash provided by financing activities (mainly net proceeds from the issuance of shares upon the exercise of stock options) was \$2.1 million, \$1.9 million and \$15.0 million in 2002, 2001 and 2000, respectively, primarily as a result of stock options exercised. We have available for use short-term revolving lines of credit at a number of commercial banks totaling up to \$25 million. As of December 2002, we also have available for use committed credit lines of \$22 million secured by one of our commercial bond portfolios. There are no financial covenants associated with these credit lines. As of December 31, 2002, we had less than \$0.1 million outstanding on our lines of credit. As of May 1, 2003, no amounts were drawn against our short-term lines of credit. The availability under the lines of credit has been reduced, however, by \$2.2 million in outstanding guarantees and letters of credit. Additionally, we have one advance payment guarantee in the amount of \$1.6 million which stipulates that the Company will have at least \$20 million of cash and long term investments and shareholders' equity of \$100 million.

We believe that based on our current operating forecast, the combination of existing working capital, expected cash flows from operations and available credit lines will be sufficient to finance our ongoing operations for the next twelve months. Depending upon our future growth, the success of our business initiatives and acquisition opportunities, we will consider from time to time various financing alternatives and may seek to raise additional capital to finance our strategic efforts through debt or equity financing, the sale of non-strategic assets or to enter into strategic arrangements.

Set forth below are our contractual obligations and other commercial commitments over the medium term as of December 31, 2002(\$ in thousands):

| | <i>Payments Due by Period</i> | | | | |
|------------------------------------|-------------------------------|-------------------------|-------------------|------------------|----------------------|
| <i>Contractual Obligations</i> | <i>Total</i> | <i>Less than 1 year</i> | <i>1- 3 years</i> | <i>4-5 years</i> | <i>After 5 years</i> |
| Operating Leases | 12,392 | 5,358 | 6,437 | 579 | 18 |
| Unconditional Purchase Obligations | 15,377 | 6,190 | 9,187 | | |
| Other Long-Term Obligations | | | | | |
| Total Contractual Cash Obligations | 27,769 | 11,548 | 15,624 | 579 | 18 |

| | <i>Total Amounts Committed</i> | <i>Amount of Commitment Expiration Per Period</i> | | | |
|--------------------------------|--------------------------------|---|-------------------|------------------|---------------------|
| | | <i>Less than 1 year</i> | <i>1- 3 years</i> | <i>4-5 years</i> | <i>Over 5 years</i> |
| Lines of Credit | | | | | |
| Standby Letters of Credit | | | | | |
| Guarantees | | | | | |
| Standby Repurchase Obligations | 3,778 | 800 | 2,488 | 490 | |
| Other Commercial Commitments | | | | | |
| Total Commercial Commitments | 3,778 | 800 | 2,488 | 490 | |

Qualitative and Quantitative Disclosure About Market Risk

Market risks relating to our operations result primarily from weak economic conditions in the markets in which we sell our products and changes in interest rates and exchange rates. To manage the volatility related to the latter exposure, we may enter into various derivative transactions. Our objective is to reduce, where it is deemed appropriate to do so, fluctuations in earnings and cash flows associated with changes in currency exchange rates. It is our policy and practice to use derivative financial instruments only to manage exposures. We do not use financial instruments for trading purposes and are not a party to any leveraged derivative.

Foreign Currency Risk. We conduct our business primarily in U.S. dollars but also in the currencies of the United Kingdom, Canada, the European Union and Israel. Thus, we are exposed to foreign exchange movements, primarily in UK, European and Israel currencies. We monitor foreign currency exposure and, from time to time, may enter into various contracts to preserve the value of sales transactions and commitments.

Interest Rate Risk. We invest in investment-grade U.S. corporate bonds and dollar deposits with FDIC-insured U.S. banks. Since these investments carry fixed interest rates and since our policy and practice is to hold these investments to maturity, interest income over the holding period is not sensitive to changes in interest rates. As of December 31, 2002, we had no other exposure to changes in interest rates and had no interest rate derivative financial instruments outstanding.

Recently Issued or Adopted Accounting Pronouncements

In June 2002, the FASB issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities", which addresses significant issues regarding the recognition, measurement, and reporting of costs associated with exit and disposal activities, including restructuring activities. SFAS No. 146 requires that costs associated with exit or disposal activities be recognized when they are incurred rather than at the date of a commitment to an exit or disposal plan. SFAS No. 146 is effective for all exit or disposal activities initiated after December 31, 2002. The Company elected early adoption of SFAS No. 146.

Factors That May Affect Future Results

We operate globally in a dynamic and changing environment that involves numerous risks and uncertainties. The following section lists some, but not all, of those risks and uncertainties that could cause actual results and outcomes to differ materially from those contained in any forward-looking statement made by or on behalf of the Company.

The Overall Economic Environment Continues to be Weak. We are subject to the effects of general global economic and market conditions. Our operating results have been materially adversely affected as a result of recent unfavorable economic conditions and reduced information technology spending, particularly in the product segments in which we compete. During 2002, there was an increase in demand for our type of products as customers allocated resources to enhance their recording and analysis capabilities for compliance and risk management and for security. However, customer purchase decisions may be significantly affected by a variety of factors including trends in spending for information technology, enterprise software, market competition, and the viability or announcement of alternative technologies. If economic conditions continue to be weak, demand for our products could decrease resulting in lower revenues, profits and cash flows.

Our Business Strategy Continues to Evolve. Historically we have supplied the hardware and some software for implementing multimedia recording solutions. Our shift to providing professional support services and now towards an enterprise software business model has required and will continue to require substantial change, potentially resulting in some disruption to our business. These changes may include changes in management and technical personnel; expanded or differing competition resulting from entering the enterprise software market; increased need to expand our distribution network to include system integrators which could impact revenues and gross margins, and, as our applications are sold either to our installed base or to new customers together with our recording platforms, the rate of adoption of our software applications by the market.

We May Experience Difficulty Managing Changes in Our Business. The changes in our business may place a significant strain on our operational and financial resources. We may experience substantial disruption from changes and could incur significant expenses and write-offs. If we do not carefully manage expense and inventory levels consistent with product demand and do not carefully manage accounts receivable to limit credit risk, this could materially adversely affect our results of operations.

Our Service Revenues are Dependent on Our Installed Base of Customers. We derive a significant portion of our revenues from services, which include maintenance, project management, support and training. As a result, if we lose a major customer or if a support contract is delayed or cancelled, our revenues would be adversely affected. In addition, customers who have accounted for significant services revenues in the past may not generate revenues in future periods. Our failure to obtain new customers or additional orders from existing customers could also materially affect our results of operations.

Risks Associated with Our Distribution Channels May Materially Adversely Affect Our Financial Results. We have agreements in place with many distributors, dealers and resellers to market and sell our products and services in addition to our direct sales force. We derive a significant percentage of our revenues from one or more of our distributor channels. Our financial results could be materially adversely affected if our contracts with channel partners were terminated, if our relationship with channel partners were to deteriorate or if the financial condition of our channel partners were to weaken. In addition, as our market opportunities change, we may have increased reliance on particular channel partners, which may negatively impact gross margins. There can be no assurance that we will be successful in maintaining or expanding these channels. If we are not successful, we may lose sales opportunities, customers and market share. In addition, there can be no assurance that our channel partners will not develop or market products or services in competition with us in the future.

Our Uneven Sales Patterns Could Significantly Impact Our Quarterly Revenues and Earnings. The sales cycle for our solutions is variable, typically ranging between a few weeks to several months from initial contact with the potential client to the signing of a contract. Frequently, sales orders accumulate towards the latter part of a given quarter. Looking forward, given the lead-time required by our contract manufacturer, if a large portion of sales orders are received late in the quarter, we may not be able to deliver product within the quarter and thus such sales will be deferred to a future quarter. There can be no assurance that such deferrals will result in sales in the near term, or at all. Thus, delays in executing client orders may affect our revenue and cause our operating results to vary widely. Additionally, as a high percentage of our expenses, particularly employee compensation, is relatively fixed, a variation in the level of sales, especially at or near the end of any quarter, may have a material adverse impact on our quarterly operating results.

Competitive Pricing and Difficulty Managing Product Costs Could Materially Adversely affect Our Revenues and Earnings. The market for our products and related services, in general, is highly competitive. Additionally, some of our principal competitors such as Witness Inc., Verint, Inc., and ASC may have significantly greater resources and larger customer bases than do we. We have seen evidence of deep price reductions by our competitors and expect to continue to see such behavior in the future, which, if we are required to match such discounting, will adversely affect our gross margins and results of operations. To date, we have been able to manage our product design and component costs. However, there can be no assurance that we will be able to continue to achieve reductions in component and product design costs. Further, the relative and varying rates of increases or decreases in product price and cost could have a material adverse impact on our earnings.

Our Gross Margins are Highly Dependent upon Our Product Mix. It is difficult to predict the exact mix of products for any period between hardware, software and services as well as within the product category between audio platforms and related applications, digital video and COMINT.

If Our Suppliers Are Not Able to Meet Our Requirements, We Could Have Decreased Revenues and Earnings. We migrated the manufacturing of all of our key products to a contract manufacturer. The TCS product line is also manufactured by a third party. We may experience delivery delays due the inability of the outsourcers to consistently meet our quality or delivery requirements. If these suppliers or any other supplier were to cancel contracts or commitments with us or fail to meet the quality or delivery requirements needed to satisfy customer orders for our products, we could lose time-sensitive customer orders and have significantly decreased quarterly revenues and earnings, which would have a material adverse effect on our business, results of operations and financial condition.

Should we have on-going performance issues with our contract manufacturers, the process to move from one contractor to another is a lengthy and costly process that could affect our ability to execute customer shipment requirements and /or might negatively affect revenue and/or costs.

We depend on certain critical components in the production of our products and parts. Some of these components are obtained only from a single supplier and only in limited quantities. In addition, some of our major suppliers use proprietary technology and software code that could require significant redesign of our products in the case of a change in vendor. Further, if suppliers discontinue their products, or modify them in manners incompatible with our current use, or use manufacturing processes and tools that could not be easily migrated to other vendors, we could have significant delays in product availability, which would have a significant adverse impact on our results of operations and financial condition.

Undetected Problems in Our Products Could Directly Impair our Financial Results. If flaws in design, production, assembly or testing of our products (by us or our suppliers) were to occur, we could experience a rate of failure in our products that would result in substantial repair, replacement or service costs and potential liability and damage to our reputation. There can be no assurance that our efforts to monitor, develop, modify and implement appropriate test and manufacturing processes for our products will be sufficient to permit us to avoid a rate of failure in our products that results in substantial delays in shipment, significant repair or replacement costs or potential damage to our reputation, any of which could have a material adverse effect on our business, results of operations and financial condition.

Our Growth is Dependent upon Recruiting and Retaining Key Personnel. If our growth continues, we will be required to hire and integrate new employees. There can be no assurance that we will be able to successfully recruit and integrate new employees. Competition for highly skilled employees, including sales, technical and management personnel, may again become high in the technology industry. We may experience personnel changes as a result of our move from multimedia recording equipment towards business performance solutions. Our failure to attract talented employees or retain the services of key personnel, could have a material adverse effect on our results of operations and financial position.

We May Experience Difficulty Managing Operational Expansion. We have recently established a sales infrastructure in Hong Kong by relocating a portion of our Israel-based sales operations and by recruiting new managers and sales persons in order to bring about a growth in revenue in the Asia Pacific market. We may establish additional operations within the region where growth opportunities are projected to warrant the investment. However, we cannot assure you that our revenues will increase as a result of this expansion or that we will be able to recover the expenses we incurred in effecting the expansion. Our failure to effectively manage our expansion of our sales, marketing, service and support

organizations could have a negative impact on our business. To accommodate our global expansion, we are continuously implementing new or expanded business systems, procedures and controls. There can be no assurance that the implementation of such systems, procedures, controls and other internal systems can be completed successfully.

Changes in Foreign Conditions Could Materially Adversely Affect our Financial Results.

Approximately half of our revenues are derived from sales outside the United States. Accordingly, our future results could be materially adversely affected by a variety of factors including changes in exchange rates, general economic conditions, regulatory requirements, tax structures or changes in tax laws, and longer payment cycles in the countries in our geographic areas of operations.

Our Business Could Be Materially Adversely Affected as a Result of the Risks Associated with Acquisitions and Investments. As part of our growth strategy, we have made a number of acquisitions and have made minority investments in complementary businesses, products or technologies. We frequently evaluate the tactical or strategic opportunity available related to complementary businesses, products or technologies. The process of integrating an acquired company's business into our operations and/or of investing in new technologies, may result in unforeseen operating difficulties and large expenditures and may absorb significant management attention that would otherwise be available for the ongoing development of our business. Other risks commonly encountered with acquisitions include the effect of the acquisition on our financial and strategic position and reputation; the failure of the acquired business to further our strategies, the inability to successfully integrate or commercialize acquired technologies or otherwise realize anticipated synergies or economies of scale on a timely basis and the potential impairment of acquired assets. Moreover, there can be no assurance that the anticipated benefits of any acquisition or investment will be realized. Future acquisitions or investments contemplated and/or consummated could result in potentially dilutive issuances of equity securities, the incurrence of debt and contingent liabilities, amortization expenses related to intangible assets, any of which could have a material adverse effect on our operating results and financial condition. We have also invested in companies, which can still be considered in the start-up or development stages. These investments are inherently risky as the market for the technologies or products they have under development are typically in the early stages and may never materialize. We could lose our entire initial investment in these companies.

We May Be Unable to Keep Pace with Rapid Industry, Technological and Market Changes. The market for our products and services is subject to rapid technological change and new product introductions. Current competitors and/or new market entrants may develop new, proprietary products with features that could adversely affect the competitive position of our products. We may not successfully anticipate market demand for new products or services, or introduce them in a timely manner. The convergence of voice and data networks, wired and wireless communications could require substantial modification and customization of our current products and business models, as well as the introduction of new products. Further, customer acceptance of these new technologies may be slower than we anticipate. We may not be able to compete effectively in these markets. In addition, our products must readily integrate with major third party security, telephone, front-office and back-office systems. Any changes to these third party systems could require us to redesign our products, and any such redesign might not be possible on a timely basis or achieve market acceptance. Additional factors that may cause actual results to differ materially from our expectations include industry specific factors; our ability to continuously develop, introduce and deliver commercially viable products, solutions and technologies, and the market's rate of acceptance of the solutions we offer and our ability to keep pace with market and technology changes and to compete successfully.

We face potential product liability claims against us. We may be subject to claims that our products are defective or that some function or malfunction of our products caused or contributed to property, bodily or consequential damages. We minimize this risk by incorporating provisions into our distribution and standard sales agreements that are designed to limit our exposure to potential claims of liability. We carry product liability insurance in the amount of \$10,000,000 per occurrence and \$10,000,000 overall. No assurance can be given that all claims will be covered either by the contractual provisions limiting liability or by the insurance, or that the amount of any individual claim or all claims will be covered by the insurance or that the amount of any individual claim or all claims in the aggregate will not exceed policy coverage limits.

Our Business May Suffer if We Cannot Protect our Intellectual Property. Our success is dependent, to a certain extent, upon our proprietary technology. We currently rely on a combination of patent, trade secret, copyright and trademark law, together with non-disclosure and non-compete agreements, to establish and protect the technology used in our systems. However, we cannot assure you that such measures will protect our proprietary technology that competitors will not develop products with features based upon, or otherwise similar to, our systems or that we will prevail in any proceeding instituted by us in order to enjoin competitors from selling similar products.

We Are Involved in Litigation and May Become Involved in Litigation that May Materially Adversely Affect Us. In our industry, there has been extensive litigation regarding patents and other intellectual property rights. Although we believe that our products do not infringe upon the proprietary rights of third parties, we cannot assure you that one or more third parties will not make a contrary claim or that we will be successful in defending such claim. In June 2000, Dictaphone Corporation, one of our competitors, filed a patent infringement claim relating to certain technology embedded in some of our products. The claim is for damages for past infringement and enjoinder of any continued infringement of Dictaphone patents. In the court's discretion, the damages may be trebled and attorney fees awarded. As a result we might be forced to pay significant damages and licensing fees, modify our business practices or even be enjoined from conducting a significant part of our U.S. business. Any such results could materially harm our business. We believe, however, that we have a valid defense to this claim and are vigorously defending it. We have received notification from our insurance company indicating that the claim is not covered by our insurance policy; however, our insurance company has agreed to reimburse for us all legal expenses that we are expending in defense of the claim while reserving its final decision on this matter until the final outcome of the litigation. The discovery period is closed, dispositive motions have been filed with the Court, and we are awaiting the Court's decisions on these motions as well as scheduling for trial.

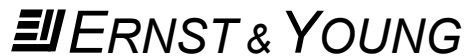
In April 2002, we received a letter from Dictaphone stating that several of our products were using technology protected by additional Dictaphone patents and offering us a licensing arrangement for these patents. We believe that none of our products infringe upon those patents. We cannot assure you, however, that we will be successful in defending the Dictaphone infringement claim or other claims, or that infringement claims or other claims, if asserted, will not have a material adverse effect on our business, financial condition or results of operations. Any claims, with or without merit, could be costly and time-consuming to defend, divert our management's attention, cause product delays and have an adverse effect on our revenues and operating results. If any of our products were found to infringe a third party's proprietary rights, we could be required to enter into royalty or licensing agreements to be able to sell our products, which may not be available on terms acceptable to us or at all.

Changes in Israeli Government Benefit Programs Could Materially Adversely Affect Us. We derive and expect to continue to derive significant benefits from various programs and laws in Israel including tax benefits relating to our “Approved Enterprise” programs and grants from the Office of the Chief Scientist, or OCS, for research and development. To be eligible for these grants, programs and tax benefits, we must continue to meet certain conditions, including making certain specified investments in fixed assets. From time to time, the Israeli Government has discussed reducing or eliminating the availability of these grants, programs and benefits. Pursuant to an amendment to Israeli regulations, income from two of our “Approved Enterprises” is exempt from income tax for only two years. Following this two year period, the “Approved Enterprise” will be subject to corporate tax at a reduced rate of 10-25% (based on the percentage of foreign ownership in each taxable year) for the following eight years. Income from the other two “Approved Enterprises” are tax exempt for four years. Following this four year period, the “Approved Enterprises” are subject to corporate tax at a reduced rate of 10-25% (based on the percentage of foreign ownership in each taxable year) for the following six years. If grants, programs and benefits available to us or the laws under which they were granted are eliminated or their scope is further reduced, or if we fail to meet the conditions of existing grants, programs or benefits and are required to refund grants or tax benefits already received (together with interest and certain inflation adjustments) or fail to receive approval for future Approved Enterprises, our business, financial condition and results of operations could be materially adversely affected.

We May Have Exposure to Additional Income Tax Liabilities. As a global corporation, we are subject to income taxes both in Israel and various foreign jurisdictions. Our domestic and international tax liabilities are subject to the allocation of revenues and expenses in different jurisdictions and the timing of recognizing revenues and expenses. Additionally, the amount of income taxes paid is subject to our interpretation of applicable laws in the jurisdictions in which we file. From time to time, we are subject to income tax audits. While we believe we comply with all applicable income tax laws, there can be no assurance that a governing tax authority will not have a different interpretation of the law and assess us with additional taxes. Should we be assessed additional taxes, there could be a material adverse affect on our results of operations and financial condition.

Our Business Could be Materially Adversely Affected By War, Terrorism and Natural Disaster. In the event of war, acts of terrorism or natural disaster, such as widespread disease, earthquake and flood, we could experience significant business interruption. Such conflicts may also cause damage or disruption to transportation and communication systems, which could affect our suppliers’ ability to deliver products and to our employees’ and distributors’ ability to conduct business and provide services.

Our Stock Price is Volatile. Numerous factors, some of which are beyond our control, may cause the market price of our ordinary shares or the American Depositary Shares (ADSs) representing our ordinary shares to fluctuate significantly. These factors include, among other things, announcements of technological innovations, customer orders or new products by us or our competitors, earning releases by us or our competitors, market conditions in the industry and the general state of the securities markets (with particular emphasis on the technology and Israeli sectors of the securities markets).



REPORT OF INDEPENDENT AUDITORS

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, 2001 and 2002, 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, 2002. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our 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, 2001 and 2002, and the consolidated results of their operations and cash flows for each of the three years in the period ended December 31, 2002, in conformity with accounting principles generally accepted in the United States.

As discussed in Note 21 to the consolidated financial statements, the Company adopted Statement of Financial Accounting Standards No. 142 "Goodwill and Other Intangible Assets" effective January 1, 2002.

/s/ Kost Forer&Gabay

Tel-Aviv, Israel
May 28, 2003

KOST FORER & GABBAY
A Member of Ernst & Young
Global

CONSOLIDATED BALANCE SHEETS**U.S. dollars in thousands**

| | December 31, | |
|---|---------------------|-------------------|
| | 2001 | 2002 |
| ASSETS | | |
| CURRENT ASSETS: | | |
| Cash and cash equivalents | \$ 25,256 | \$ 19,281 |
| Short-term bank deposits | 311 | 208 |
| Marketable securities | 29,270 | 33,853 |
| Trade receivables (net of allowance for doubtful accounts of \$ 3,146 and \$ 6,010 in 2001 and 2002, respectively) | 28,435 | 45,863 |
| Unbilled receivables | 6,574 | 7,495 |
| Other receivables and prepaid expenses | 5,465 | 8,234 |
| Related party receivables | - | 12,804 |
| Inventories | 11,057 | 13,480 |
| <u>Total current assets</u> | <u>106,368</u> | <u>141,218</u> |
| LONG-TERM INVESTMENTS: | | |
| Long-term marketable securities | 34,176 | 15,247 |
| Investment in affiliates | 1,429 | 1,200 |
| Severance pay fund | 5,357 | 5,490 |
| Long-term receivables and prepaid expenses | 471 | 888 |
| <u>Total long-term investments</u> | <u>41,433</u> | <u>22,825</u> |
| PROPERTY AND EQUIPMENT, NET | <u>22,111</u> | <u>24,345</u> |
| INTANGIBLE ASSETS, NET | <u>11,900</u> | <u>20,483</u> |
| GOODWILL | <u>28,200</u> | <u>27,417</u> |
| <u>Total assets</u> | <u>\$ 210,012</u> | <u>\$ 236,288</u> |

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

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

| | December 31, | |
|---|---------------------|-------------------|
| | 2001 | 2002 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| CURRENT LIABILITIES: | | |
| Short-term bank credit | \$ - | \$ 24 |
| Trade payables | 11,123 | 16,129 |
| Accrued expenses and other liabilities | 25,314 | 45,859 |
| Total current liabilities | 36,437 | 62,012 |
| LONG-TERM LIABILITIES: | | |
| Accrued severance pay | 6,543 | 6,240 |
| Other long-term liabilities | 14 | 13,500 |
| Total long-term liabilities | 6,557 | 19,740 |
| COMMITMENTS AND CONTINGENT LIABILITIES | | |
| SHAREHOLDERS' EQUITY: | | |
| Share capital- | | |
| Ordinary shares of NIS 1 par value: | | |
| Authorized: 50,000,000 shares as of December 31, 2001 and 2002; | | |
| Issued and outstanding: 13,273,798 and 15,704,425 shares as of December 31, 2001 and 2002, respectively | 4,398 | 4,908 |
| Additional paid-in capital | 192,845 | 213,003 |
| Deferred stock compensation | (24) | (12) |
| Accumulated other comprehensive income (loss) | (38) | 782 |
| Accumulated deficit | (30,163) | (64,145) |
| Total shareholders' equity | 167,018 | 154,536 |
| Total liabilities and shareholders' equity | \$ 210,012 | \$ 236,288 |

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

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

| | Year ended December 31, | | |
|---|--------------------------------|--------------------|--------------------|
| | 2000 | 2001 | 2002 |
| Revenues | | | |
| Products | \$*) - | \$ 112,634 | \$ 134,783 |
| Services | *) - | 14,474 | 27,722 |
| Total revenues | <u>153,163</u> | <u>127,108</u> | <u>162,505</u> |
| Cost of revenues | | | |
| Products | *) - | 54,321 | 58,693 |
| Services | *) - | 19,446 | 26,054 |
| Total cost of revenues | <u>73,554</u> | <u>73,767</u> | <u>84,747</u> |
| Gross profit | <u>79,609</u> | <u>53,341</u> | <u>77,758</u> |
| Operating expenses: | | | |
| Research and development, net | 19,502 | 19,190 | 17,925 |
| Selling and marketing | 35,448 | 35,046 | 40,494 |
| General and administrative | 28,300 | 27,143 | 23,806 |
| Amortization of acquired intangible assets, restructuring expenses, in-process research and development and goodwill impairment | <u>7,646</u> | <u>17,967</u> | <u>29,092</u> |
| <u>Total operating expenses</u> | <u>90,896</u> | <u>99,346</u> | <u>111,317</u> |
| Operating loss | (11,287) | (46,005) | (33,559) |
| Financial income, net | 6,188 | 4,254 | 3,992 |
| Other income (expenses), net | <u>53</u> | <u>(4,846)</u> | <u>(4,065)</u> |
| Loss before taxes on income | (5,046) | (46,597) | (33,632) |
| Taxes on income | <u>273</u> | <u>198</u> | <u>350</u> |
| Net loss | <u>\$ (5,319)</u> | <u>\$ (46,795)</u> | <u>\$ (33,982)</u> |
| Basic and diluted net loss per share | <u>\$ (0.43)</u> | <u>\$ (3.59)</u> | <u>\$ (2.46)</u> |

*) Not available.

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

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) | Retained earnings (accumulated deficit) | Total comprehensive loss | Total shareholders' equity |
|---|------------------|----------------------------------|-----------------------------------|--|--|--------------------------------|----------------------------------|
| Balance as of January 1, 2000 | \$ 4,062 | \$ 153,160 | \$ (103) | \$ - | \$ 21,951 | | \$ 179,070 |
| Issuance of shares of ESPP | 7 | 934 | - | - | - | | 941 |
| Issuance of shares in respect of the acquisition of CPS | 37 | 9,349 | - | - | - | | 9,386 |
| Issuance of shares in respect of the acquisition of SCI | 54 | 10,267 | - | - | - | | 10,321 |
| Deferred stock compensation | - | 72 | (72) | - | - | | - |
| Amortization of deferred stock compensation | - | - | 128 | - | - | | 128 |
| Exercise of share options and warrants | 153 | 13,897 | - | - | - | | 14,050 |
| Comprehensive loss: | | | | | | | |
| Net loss | - | - | - | - | (5,319) | \$ (5,319) | (5,319) |
| Total comprehensive loss | | | | | | <u>\$ (5,319)</u> | |
| Balance as of December 31, 2000 | 4,313 | 187,679 | (47) | - | 16,632 | | 208,577 |
| Issuance of shares of ESPP | 31 | 1,408 | - | - | - | | 1,439 |
| Issuance of shares related to a settlement agreement in respect of the acquisition of SCI | 46 | 3,345 | - | - | - | | 3,391 |
| Amortization of deferred stock compensation | - | - | 23 | - | - | | 23 |
| Exercise of share options | 8 | 413 | - | - | - | | 421 |
| Comprehensive loss: | | | | | | | |
| Unrealized gains (losses) on derivative instruments, net | - | - | - | (38) | - | \$ (38) | (38) |
| Net loss | - | - | - | - | (46,795) | (46,795) | (46,795) |
| Total comprehensive loss | | | | | | <u>\$ (46,833)</u> | |
| Balance as of December 31, 2001 | 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 settlement agreement | 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 (losses) on derivative instruments, net | - | - | - | 27 | - | 27 | 27 |
| Net loss | - | - | - | - | (33,982) | (33,982) | (33,982) |
| Total comprehensive loss | | | | | | <u>\$ (33,162)</u> | |
| Balance as of December 31, 2002 | <u>\$ 4,908</u> | <u>\$ 213,003</u> | <u>\$ (12)</u> | <u>\$ 782</u> | <u>\$ (64,145)</u> | | <u>\$ 154,536</u> |
| Accumulated unrealized losses on derivative instruments | | | | \$ (11) | | | |
| Accumulated foreign currency translation adjustments | | | | 793 | | | |
| Accumulated other comprehensive income as of December 31, 2002 | | | | <u>\$ 782</u> | | | |

Represents an amount lower than \$ 1. *)

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

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

| | Year ended December 31, | | |
|--|--------------------------------|--------------|---------------|
| | 2000 | 2001 | 2002 |
| <u>Cash flows from operating activities:</u> | | | |
| Net loss | \$ (5,319) | \$ (46,795) | \$ (33,982) |
| Adjustments required to reconcile net loss to net cash provided by (used in) operating activities: | | | |
| Depreciation and amortization | 11,725 | 15,266 | 15,665 |
| Write-off of acquired in-process research and development | 6,786 | - | 1,270 |
| Stock compensation in respect of SCI acquisition | - | 476 | - |
| Stock compensation in respect of CPS settlement | - | - | 469 |
| Amortization of deferred stock compensation | 128 | 23 | 12 |
| Accrued severance pay, net | 899 | (330) | (436) |
| Loss on disposal of property and equipment and goodwill impairment in respect of restructuring | - | 3,062 | - |
| Goodwill impairment | - | - | 28,260 |
| Impairment of investment in affiliate | - | - | 229 |
| Amortization of discount (premium) and accrued interest on held-to-maturity marketable securities | (345) | 183 | 915 |
| Loss on sale of assets of Dees | - | 281 | - |
| Decrease (increase) in trade and unbilled receivables | (12,968) | 12,459 | (2,146) |
| Decrease (increase) in other receivables and prepaid expenses | (82) | 6,512 | (1,254) |
| Decrease (increase) in inventories | (10,006) | 9,635 | 4,510 |
| Increase in long-term prepaid expenses | - | (471) | (446) |
| Increase (decrease) in trade payables | 1,438 | (1,527) | 3,199 |
| Increase in accrued expenses and other liabilities | 5,729 | 3,392 | 3,533 |
| Other | (53) | 113 | 315 |
| Net cash provided by (used in) operating activities | <u>(2,068)</u> | <u>2,279</u> | <u>20,113</u> |

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

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

| | Year ended December 31, | | |
|--|--------------------------------|------------------|------------------|
| | 2000 | 2001 | 2002 |
| Cash flows from investing activities: | | | |
| Purchase of property and equipment | (14,161) | (7,623) | (5,439) |
| Proceeds from sale of property and equipment | 394 | 1,301 | 557 |
| Purchase of intangible assets | - | (25) | (610) |
| Investment in held-to-maturity marketable securities | (45,138) | (48,601) | (16,936) |
| Proceeds from maturity of held-to-maturity marketable securities | 38,525 | 39,977 | 29,492 |
| Proceeds from sale of a held-to-maturity marketable security | - | - | 820 |
| Investment in short-term bank deposits | (31,028) | (384) | (150) |
| Proceeds from short-term bank deposits | 49,454 | 24,448 | 265 |
| Investment in affiliates | (1,200) | - | - |
| Payment for the acquisition of CPS (a) | (3,189) | - | - |
| Payment for the acquisition of assets and liabilities of SCI (b) | (6,960) | - | - |
| Proceeds from sale of assets of Dees (c) | - | 255 | - |
| Payment for the acquisition of TCS (d) | - | - | (31,480) |
| Decrease in accrued acquisition costs | - | (1,436) | (214) |
| Capitalization of software development costs | (4,730) | (5,435) | (4,609) |
| Other | (80) | - | - |
| Net cash provided by (used in) investing activities | <u>(18,113)</u> | <u>2,477</u> | <u>(28,304)</u> |
| Cash flows from financing activities: | | | |
| Proceeds from issuance of shares and exercise of share options and warrants, net | 14,991 | 1,860 | 2,119 |
| Short-term bank credit, net | (3) | - | 24 |
| Net cash provided by financing activities | <u>14,988</u> | <u>1,860</u> | <u>2,143</u> |
| Effect of exchange rate changes on cash | <u>-</u> | <u>-</u> | <u>73</u> |
| Increase (decrease) in cash and cash equivalents | (5,193) | 6,616 | (5,975) |
| Cash and cash equivalents at the beginning of the year | <u>23,833</u> | <u>18,640</u> | <u>25,256</u> |
| Cash and cash equivalents at the end of the year | <u>\$ 18,640</u> | <u>\$ 25,256</u> | <u>\$ 19,281</u> |
| Supplemental disclosure of cash flows activities: | | | |
| Cash paid during the year for: | | | |
| Income taxes | <u>\$ 105</u> | <u>\$ 257</u> | <u>\$ 445</u> |

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

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

| | Year ended December 31, | | |
|--|-------------------------|--------------|------|
| | 2000 | 2001 | 2002 |
| (a) <u>Payment for the acquisition of CPS:</u> | | | |
| Net fair value of assets acquired and liabilities assumed at the acquisition date: | | | |
| Working capital (excluding cash and cash equivalents) | \$ 158 | | |
| Property and equipment | 185 | | |
| Long-term investments | 93 | | |
| Long-term liabilities | (42) | | |
| In-process research and development | 6,786 | | |
| Core technology | 2,189 | | |
| Assembled work-force | 409 | | |
| Goodwill | 2,797 | | |
| | 12,575 | | |
| Less - amount acquired by issuance of shares | (9,386) | | |
| | <u>\$ 3,189</u> | | |
| (b) <u>Payment for the acquisition of certain assets and liabilities of SCI:</u> | | | |
| Estimated fair value of assets acquired and liabilities assumed at the acquisition date: | | | |
| Working capital deficiency | \$ (5,231) | | |
| Assembled work-force | 523 | | |
| Goodwill | 23,639 | | |
| | 18,931 | | |
| Less – amount acquired by issuance of shares | (10,321) | | |
| Less – accrued acquisition costs | (1,650) | | |
| | <u>\$ 6,960</u> | | |
| <u>Issuance of additional shares in respect of SCI acquisition:</u> | | | |
| Adjustment to working capital | \$ (282) | \$ - | |
| Goodwill | 3,197 | 29 | |
| | <u>\$ 2,915</u> | <u>\$ 29</u> | |

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

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

| | <u>Year ended December 31,</u> | | |
|--|--------------------------------|---------------|------------------|
| | <u>2000</u> | <u>2001</u> | <u>2002</u> |
| (c) <u>Proceeds from sale of assets of Dees:</u> | | | |
| Working capital | | \$ 536 | |
| Loss on sale | | <u>(281)</u> | |
| | | <u>\$ 255</u> | |
| (d) <u>Payment for the acquisition of certain assets and liabilities of TCS</u> | | | |
| Estimated 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 |
| Intangible assets | | | 9,320 |
| In-process research and development | | | 1,270 |
| Other long-term liability | | | (13,500) |
| Goodwill | | | <u>26,682</u> |
| | | | 52,539 |
| Less - amount acquired by issuance of shares | | | (18,051) |
| Less - accrued acquisition costs | | | <u>(3,008)</u> |
| | | | <u>\$ 31,480</u> |

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

NOTES TO THE FINANCIAL STATEMENTS

U.S. dollars in thousands (except per share data)

NOTE 1:- GENERAL

- a. 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 into actionable knowledge 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 - and are used primarily in contact centers, trading floors, public safety organizations, transportation, corporate security, gaming and correctional facilities, as well as various 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, Europe and the Far East.

The Company depends on 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 its 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 certain 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.

NOTES TO THE FINANCIAL STATEMENTS**U.S. dollars in thousands (except per share data)****NOTE 1:- GENERAL (Cont.)**

b. Acquisition of Thales Contact Solutions:

In November 2002, the Company acquired certain assets and assumed certain liabilities of Thales Contacts 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.

Under the terms of the acquisition agreement ("the agreement"), contingent cash payments of up to \$ 10,000 in 2003, \$ 7,500 in 2004 and \$ 7,500 in 2005 would be due if certain financial performance criteria are met as part of a three-year earn-out provision covering 2002 through 2004. The relevant criteria for 2002 were not met and therefore no contingent payment in respect of 2002 was recorded. Should any contingent payment be made under the agreement in the future, the additional consideration, when determinable, will increase the purchase price and accordingly additional goodwill will be recorded.

In the fourth quarter of 2002, the Company recorded a current liability of \$ 2,800 and a long-term liability of \$ 13,500 reflecting obligations under a long-term contract assumed by the Company in the TCS acquisition for which no future benefit exists. See also Note 12b(1).

Under the terms of the agreement, the initial cash portion of the purchase price was adjusted downward by \$ 12,804 in respect of the actual net value of assets acquired and 2002 sales of TCS. This amount is presented on the balance sheet as related party receivables. As a result of the purchase price adjustment, the acquisition cost was reduced to \$ 39,735.

The following table summarizes the estimated fair values of the assets acquired and liabilities assumed at the date of acquisition:

NOTES TO THE FINANCIAL STATEMENTS

U.S. dollars in thousands (except per share data)

NOTE 1:- GENERAL (Cont.)

| | |
|--|------------------|
| 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 | 26,682 |
| | <hr/> |
| Total assets acquired | 68,920 |
| Trade payables | (1,747) |
| Accrued expenses and other liabilities | (13,938) |
| Long-term liability | (13,500) |
| | <hr/> |
| Total liabilities assumed | (29,185) |
| | <hr/> |
| Net assets acquired | <u>\$ 39,735</u> |

The \$ 1,270 assigned to in-process research and development was written off at the date of acquisition 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 years ended December 31, 2001 and 2002, assuming that the acquisition occurred on January 1, 2001 and January 1, 2002, respectively. The pro-forma information is not necessarily indicative of the results of operations, which actually would have occurred if the acquisition had been consummated at the beginning of each year presented, nor does it purport to represent the results of operations for future periods.

| | <u>Year ended December 31,</u> | |
|--------------------------------------|--------------------------------|--------------------|
| | <u>2001</u> | <u>2002</u> |
| Revenues | <u>\$ 202,439</u> | <u>\$ 214,002</u> |
| Net loss | <u>\$ (61,846)</u> | <u>\$ (53,821)</u> |
| Basic and diluted net loss per share | <u>\$ (4.06)</u> | <u>\$ (3.45)</u> |

The condensed results of operations of TCS are based on the financial statements of TCS for the year ended December 31, 2001 and 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. The 2001 financial statements of TCS were prepared in conformity

NOTES TO THE FINANCIAL STATEMENTS

U.S. dollars in thousands (except per share data)

NOTE 1:- GENERAL (Cont.)

with U.S GAAP and were audited by TCS's independent auditors, who provided an unqualified opinion.

c. Acquisition of Stevens Communications Inc.

In December 2000, the Company acquired certain assets and assumed certain liabilities of Stevens Communications Inc. ("SCI") for an aggregate consideration of \$ 18,931 including the issuance of up to 426,745 ADSs of NICE of which 186,818 ADSs were target shares contingent upon the achievement of certain objectives and events through 2002 and 38,914 ADSs are for the benefit of certain SCI's employees. 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 SCI.

SCI is a systems distributor, whose activities included the promotion, distribution, installation and maintenance of the Company's products in North America.

An amount of \$ 24,162, out of the total acquisition cost, was attributed to goodwill and assembled work force.

In 2001, the Company entered into a final settlement agreement with SCI addressing a dispute with SCI regarding the fair value of SCI's working capital. The adjustments from the terms of the final settlement resulted in a one-time charge to other expense of \$ 4,448 representing a lump-sum settlement of disputed items of \$ 3,600 and obligations for future consulting services, which are no longer of value to the Company. In addition, the Company released from escrow the 186,818 ADS contingent target shares upon the achievement of the determined objectives and events and accordingly, recorded approximately \$ 3 million to goodwill.

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.

In connection with the CPS acquisition, the Company recorded in the second quarter of 2000, a one-time expense of \$ 6,786 to write-off software acquired from CPS for which technological feasibility has not yet been established and for which no

NOTES TO THE FINANCIAL STATEMENTS

U.S. dollars in thousands (except per share data)

NOTE 1:- GENERAL (Cont.)

alternative future use exists. An amount of \$ 5,395 out of the total acquisition cost was attributed to goodwill and other intangible assets.

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 Chapiewsky, 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.

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 effect 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 its U.S subsidiary are conducted is the U.S. dollar ("dollar"); thus, the dollar is the reporting and functional currency of the Company.

The Company's transactions and balances denominated in dollars are represented 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.

NOTES TO THE FINANCIAL STATEMENTS

U.S. dollars in thousands (except per share data)

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

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 converted into cash, originally 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 amortized cost of held-to-maturity securities is adjusted for amortization of premiums and accretion of discounts to maturity. Such amortization, decline in value judged to be other than temporary, and interest are included in financial income or expenses, as appropriate.

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 computed manufacturing costs.

NOTES TO THE FINANCIAL STATEMENTS

U.S. dollars in thousands (except per share data)

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

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 2000, 2001 and 2002 were \$ 2,675, \$ 3,400 and \$ 1,650, respectively, and have been included in cost of revenues.

h. Investment in affiliates:

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

The Company's investments in other companies are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an investment may not be recoverable, in accordance with Accounting Principle Board Opinion ("APB") No. 18 "The Equity Method of Accounting for Investments in Common Stock".

As of December 31, 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:

| | % |
|------------------------------------|--------|
| 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. 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 an asset to the future undiscounted cash flows expected to be generated by the assets. If such

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

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 2002, no impairment losses have been identified.

k. Intangible assets:

Intangible assets subject to amortizations, which arose from acquisitions prior to July 1, 2001 are being amortized on a straight-line basis over their useful lives in accordance with APB No. 17 "Intangible Assets". Intangible assets acquired in a business combination on or after July 1, 2001, 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".

In accordance with the requirement of SFAS No. 142, intangible assets deemed to have indefinite lives are no longer amortized after January 1, 2002. Under SFAS No. 142 the Company will perform an annual test for impairment of intangible assets with indefinite lives.

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

| | % |
|--|------------|
| Capitalized software development costs (see o) | 33 |
| Distribution network | Indefinite |
| Core technology | 17 – 33 |
| Trademarks | 17 - 50 |
| Maintenance contracts | 33 |
| Other intangible assets | 33 |

l. Goodwill

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

SFAS No.142 requires goodwill be tested for impairment on adoption and at least annually thereafter or between annual tests in certain circumstances, and written down when impaired, rather than 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, market multiples and market capitalization. Significant estimates used in the fair value

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

methodologies include estimates of future cash flows, future short-term and long-term growth rates, weighted average cost of capital and estimates of market multiples of the reportable unit. The Company performed the transitional impairment test during the first quarter of 2002, and did not recognize any impairment loss. The Company performed the annual impairment test during the fourth quarter of 2002, and recognized an impairment loss of \$ 28,260.

m. Revenue recognition:

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

The Company sells its products indirectly through resellers, integrators and distributors, 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) and Staff Accounting Bulletin ("SAB") No. 101 "Revenue

Recognition in the Financial Statements" 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 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 professional services and maintenance is based on the renewal price. 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 was estimated based on the Company's past experience and was deducted from revenues.

Trade receivables as of December 31, 2001 and 2002 are presented net of provision for product returns in the amounts of \$ 2,455 and \$ 2,311, respectiveThe Company recognizes revenues from fixed price contracts that require significant customization, integration and installation based on SOP No. 81-1 "Accounting for Performance of

NOTES TO THE FINANCIAL STATEMENTS

U.S. dollars in thousands (except per share data)

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Construction – Type and Certain Production – Type Contracts" using the percentage-of-completion method of accounting based on the value added and results achieved out of the completeness of the product as a whole. In order to verify the measure of the added value, the Company identifies elements or sub-components of those elements. Provisions for estimated losses on uncompleted contacts are made in the period in which such losses are determined. As of December 31, 2002, no such estimated losses were identified.

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 are made at the time revenues are recognized for estimated material costs during the warranty period based on the Company's experience.

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 on a product-by-product basis commencing with general product release by the greater of the amount computed using the: (i) ratio that current gross revenues from sales of the software bear to the total of current and anticipated future gross revenues from sales of that software, or (ii) the straight-line method over the estimated useful life of the software product.

The Company assesses the recoverability of the unamortized capitalized cost on a regular basis by determining whether the amortization of the asset over its remaining life can be recovered through undiscounted future operating cash flows from the specific software product sold. Based on its most recent analyses, management

NOTES TO THE FINANCIAL STATEMENTS

U.S. dollars in thousands (except per share data)

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

believes that no impairment of capitalized software development costs exists as of December 31, 2002.

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 reduction to 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 and unbilled receivables, marketable securities and related party receivables.

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 and unbilled receivables are derived from sales to customers located primarily in North America, Europe 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.

The Company's marketable securities include investment in debentures of U.S. corporations. Management believes that those corporations are financially sound, the portfolio is well diversified, and accordingly, minimal credit risk exists with respect to those marketable securities.

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

Related party receivables are balances due from Thales SA. Management believes that minimal credit risk exists with respect to this balance.

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. 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 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, deposits with 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 surrendered value of these policies and includes immaterial profits.

Severance pay expense for 2000, 2001 and 2002, was \$ 1,255, \$ 2,428 and \$ 2,003, respectively.

t. Basic and diluted net loss per share:

Basic net loss per share is computed based on the weighted average number of Ordinary shares outstanding during each year. Diluted net loss per share is 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".

All outstanding stock options and warrants have been excluded from the calculation of the diluted net loss per share because all such securities are anti-dilutive for all periods presented. The total weighted average number of shares related to the outstanding options and warrants excluded from the calculations of diluted net loss per share was 3,583,149, 4,929,910 and 5,315,170 for the years ended December 31, 2000, 2001 and 2002, 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

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

underlying shares on the date of grant, compensation expense is recognized and amortized over the vesting period. The pro forma information with respect to the fair value of the options is provided in accordance with the provisions of SFAS No. 123 "Accounting for Stock-based Compensation".

In December 2002, the FASB issued SFAS No. 148, "Accounting for Stock Based Compensation - Transition and Disclosure - an amendment of SFAS No. 123". SFAS No. 148 permits two additional transition methods for entities that adopt the fair value based method of accounting for stock-based employee compensation. The transition guidance and annual disclosure provisions of SFAS No. 148 are effective for fiscal years ending after December 15, 2002, with earlier application permitted in certain circumstances. The interim disclosure provisions are effective for financial reports containing financial statements for interim periods beginning after December 15, 2002. As at the balance sheet date, the Company continues to apply APB No. 25.

Pro forma information regarding net income (loss) and net earnings (loss) per share is required by SFAS No. 123, 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 a Black-Scholes option pricing model with the following weighted-average assumptions for 2000, 2001 and 2002: risk-free interest rates of 6%, 4.3% and 1.7%, respectively dividend yields of 0%, 0% and 0%, respectively volatility factors of the expected market price of the Company's Ordinary shares of 0.821, 0.506 and 0.827, respectively, and a weighted average expected life of the option of 3.5, 4.3 and 4.3 years, respectively.

Pro forma information under SFAS No. 123:

| | Year ended December 31, | | |
|---|--------------------------------|--------------------|--------------------|
| | 2000 | 2001 | 2002 |
| Net loss as reported | \$ (5,319) | \$ (46,795) | \$ (33,982) |
| Add: Stock based compensation expense included in the determination of net loss as reported | 128 | 23 | 12 |
| Deduct: Stock based compensation expense determined under fair value method for all awards | <u>(43,972)</u> | <u>(31,636)</u> | <u>(18,467)</u> |
| Pro forma net loss | <u>\$ (49,163)</u> | <u>\$ (78,408)</u> | <u>\$ (52,437)</u> |
| Basic and diluted net loss per share as reported | <u>\$ (0.43)</u> | <u>\$ (3.59)</u> | <u>\$ (2.46)</u> |
| Pro forma basic and diluted net loss per share | <u>\$ (3.97)</u> | <u>\$ (6.01)</u> | <u>\$ (3.80)</u> |

NOTES TO THE FINANCIAL STATEMENTS

U.S. dollars in thousands (except per share data)

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

- 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 and unbilled receivables, related party 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 U.S. corporate securities is based on quoted market prices and does not differ significantly from the carrying amount (see Note 3).

The fair value of other long-term liabilities is estimated by discounting the future cash flows using the current interest rate for liabilities of similar terms and maturities. The fair value of other long-term liabilities, which carrying amount as of December 31, 2002 was \$ 13,500, is approximated to \$ 12,400.

- w. Advertising expenses:

Advertising expenses are charged to expense as incurred (see Note 17d).

- 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 same line item associated with the hedged item in current 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

NOTES TO THE FINANCIAL STATEMENTS

U.S. dollars in thousands (except per share data)

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

instrument is reported as a component of other comprehensive income and reclassified into earnings in the same line item associated with the hedged transaction in the same 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 current earnings during the period of change.

For derivative instruments not designated as hedging instruments, the gain or loss is recognized in financial income/expense in current earnings during the period of change.

y. Impact of recently issued accounting standards:

In June 2002, the FASB issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities", which addresses significant issue regarding the recognition, measurement, and reporting of costs associated with exit and disposal activities, including restructuring activities. SFAS No. 146 requires that costs associated with exit or disposal activities be recognized when they are incurred rather than at the date of a commitment to an exit or disposal plan. SFAS No. 146 is effective for all exit or disposal activities initiated after December 31, 2002. The Company elected early adoption of SFAS No. 146.

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 loss, shareholder's equity or cash flows.

NOTE 3:- MARKETABLE SECURITIES

| | Amortized cost | | Gross unrealized gains | | Gross unrealized losses | | Estimated fair value | |
|---------------------------|----------------|-----------|------------------------|--------|-------------------------|--------|----------------------|-----------|
| | December 31, | | December 31, | | December 31, | | December 31, | |
| | 2001 | 2002 | 2001 | 2002 | 2001 | 2002 | 2001 | 2002 |
| U.S. corporate debentures | \$ 63,446 | \$ 49,100 | \$ 988 | \$ 330 | \$ 314 | \$ 309 | \$ 64,120 | \$ 49,121 |

As of December 31, 2001 and 2002, all the Company's securities were classified as held-to-maturity.

In 2000 and 2001 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 these years.

NOTES TO THE FINANCIAL STATEMENTS

U.S. dollars in thousands (except per share data)

NOTE 3:- MARKETABLE SECURITIES (Cont.)

In 2002, the Company sold one security, which was classified as held-to-maturity, due to a rating decrease, and accordingly recorded a loss of \$ 55.

The scheduled maturities of held-to-maturity securities at December 31, 2002, are as follows:

| <u>Held-to-maturity:</u> | <u>Amortized cost</u> | <u>Estimated fair value</u> |
|---------------------------------------|---------------------------|---------------------------------|
| Due within one year | \$ 33,853 | \$ 33,616 |
| Due after one year through five years | 15,247 | 15,505 |
| | <u>\$ 49,100</u> | <u>\$ 49,121</u> |

NOTE 4:- OTHER RECEIVABLES AND PREPAID EXPENSES

| | <u>December 31,</u> | |
|------------------------|---------------------|-----------------|
| | <u>2001</u> | <u>2002</u> |
| Government authorities | \$ 2,475 | \$ 4,010 |
| Interest receivable | 637 | 301 |
| Prepaid expenses | 1,243 | 2,694 |
| Other | 1,110 | 1,229 |
| | <u>\$ 5,465</u> | <u>\$ 8,234</u> |

NOTE 5:- INVENTORIES

| | <u>December 31,</u> | |
|------------------|---------------------|------------------|
| | <u>2001</u> | <u>2002</u> |
| Raw materials | \$ 6,995 | \$ 4,880 |
| Work-in-progress | 843 | 535 |
| Finished goods | 3,219 | 8,065 |
| | <u>\$ 11,057</u> | <u>\$ 13,480</u> |

NOTES TO THE FINANCIAL STATEMENTS**U.S. dollars in thousands (except per share data)****NOTE 6:- PROPERTY AND EQUIPMENT, NET**

| | | |
|------------------------------------|------------------|------------------|
| Cost: | | |
| Computers and peripheral equipment | \$ 34,373 | \$ 40,828 |
| Office furniture and equipment | 6,362 | 12,017 |
| Motor vehicles | 2,853 | 1,570 |
| Leasehold improvements | 3,335 | 3,567 |
| | <u>46,923</u> | <u>57,982</u> |
| Accumulated depreciation: | | |
| Computers and peripheral equipment | 20,711 | 28,830 |
| Office furniture and equipment | 1,975 | 2,941 |
| Motor vehicles | 1,242 | 792 |
| Leasehold improvements | 884 | 1,074 |
| | <u>24,812</u> | <u>33,637</u> |
| Depreciated cost | <u>\$ 22,111</u> | <u>\$ 24,345</u> |

Depreciation expense totaled \$ 8,101, \$ 8,044 and \$ 10,192 for the years ended December 31, 2000, 2001 and 2002, respectively.

As for pledges, see Note 12c.

NOTES TO THE FINANCIAL STATEMENTS

U.S. dollars in thousands (except per share data)

NOTE 7:- INTANGIBLE ASSETS, NET

a. Intangible assets

| | December 31, | |
|--|---------------------|------------------|
| | 2001 | 2002 |
| Original amounts: | | |
| Capitalized software development costs | \$ 16,078 | \$ 20,687 |
| Core technology | 2,189 | 4,419 |
| Trademarks | - | 1,040 |
| Maintenance contracts | - | 510 |
| Other intangible assets | 1,498 | 279 |
| | <u>19,765</u> | <u>26,935</u> |
| Accumulated amortization: | | |
| Capitalized software development costs | 5,868 | 10,174 |
| Core technology | 1,217 | 2,219 |
| Trademarks | - | 58 |
| Maintenance contracts | - | 28 |
| Other intangible assets | 780 | 253 |
| | <u>7,865</u> | <u>12,732</u> |
| Amortized cost | 11,900 | 14,203 |
| Distribution network | <u>-</u> | <u>6,280</u> |
| Total intangible assets | <u>\$ 11,900</u> | <u>\$ 20,483</u> |

b. Amortization expense amounted to \$ 2,954, \$ 4,278 and \$ 5,473 for the years ended December 31, 2000, 2001 and 2002, respectively.

c. Estimated amortization expense for the years ended:

| | December 31, |
|---------------------|---------------------|
| 2003 | \$ 6,344 |
| 2004 | 4,820 |
| 2005 | 2,258 |
| 2006 | 436 |
| 2007 and thereafter | <u>345</u> |
| | <u>\$ 14,203</u> |

NICE SYSTEMS LTD. AND SUBSIDIARIES

NOTES TO THE FINANCIAL STATEMENTS

U.S. dollars in thousands (except per share data)

NOTE 8:- GOODWILL

The changes in the carrying amount of goodwill for the year ended December 31, 2002 are as follows:

| | |
|--|------------------|
| Balance as of January 1, 2002 | *) \$ 28,813 |
| Goodwill acquired during the year | 26,682 |
| Impairment losses | (28,260) |
| Foreign currency translation adjustments and other | 182 |
| | <u>182</u> |
| Balance as of December 31, 2002 | <u>\$ 27,417</u> |

*) Includes an amount of \$ 613 of assembled workforce that was classified as goodwill effective January 1, 2002.

The unaudited results of operations presented below for the three years ended December 31, 2000, 2001 and 2002, respectively, reflect the impact on results of operations had the Company adopted the non-amortization provisions of SFAS No. 142 effective January 1, 2000:

| | Year ended December 31, | | |
|---|--------------------------------|--------------------|--------------------|
| | 2000 | 2001 | 2002 |
| Reported net loss | \$ (5,319) | \$ (46,795) | \$ (33,982) |
| Goodwill amortization | 670 | 2,944 | - |
| | <u>\$ (4,649)</u> | <u>\$ (43,851)</u> | <u>\$ (33,982)</u> |
| Adjusted net loss | | | |
| Basic and diluted net loss per share: | | | |
| Reported net loss | \$ (0.43) | \$ (3.59) | \$ (2.46) |
| Goodwill amortization | 0.05 | 0.23 | - |
| | <u>\$ (0.38)</u> | <u>\$ (3.36)</u> | <u>\$ (2.46)</u> |
| Adjusted basic and diluted net loss per share | | | |

NOTE 9:- ACCRUED EXPENSES AND OTHER LIABILITIES

| | December 31, | |
|--------------------------------|---------------------|------------------|
| | 2001 | 2002 |
| Employees and payroll accruals | \$ 8,445 | \$ 9,249 |
| Accrued expenses | 9,001 | 23,694 |
| Restructuring accrual | 2,444 | 406 |
| Deferred revenues | 5,013 | 10,728 |
| Other | 411 | 1,782 |
| | <u>\$ 25,314</u> | <u>\$ 45,859</u> |

NOTES TO THE FINANCIAL STATEMENTS

U.S. dollars in thousands (except per share data)

NOTE 10:- DERIVATIVE INSTRUMENTS

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

During 2001 and 2002, the Company entered into derivative instruments to hedge portions of the 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 hedged instruments is included in payroll expenses in the statements of operations.

In addition, the Company entered into forward foreign exchange contracts to hedge certain trade and unbilled receivables, trade payable payments and expected payments under a fixed price contract denominated in foreign currency. 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, 2002, the Company expects to reclassify \$ 11 of net losses on derivative instruments from accumulated other comprehensive income to earnings during the next twelve months.

NOTE 11:- RESTRUCTURING EXPENSES

As part of the Company's strategic plan to address the changing business dynamics in the markets for its products and offerings, the Company recorded a restructuring charge in the amount of \$ 14,554 in the first quarter of 2001, in accordance with EITF 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (Including Certain Costs in a Restructuring)" and SAB No. 100 "Restructuring and Impairment Charges". The restructuring consisted of a series of actions to improve the

NOTES TO THE FINANCIAL STATEMENTS

U.S. dollars in thousands (except per share data)

NOTE 11:- RESTRUCTURING EXPENSES (Cont.)

Company's long-term strategic opportunity including a reduction of 30% of the workforce (approximately 340 employees), consolidation of functions, the closing of certain facilities (mainly in the U.S.), and the disposal of assets that were no longer required due to the change in strategic direction. In addition, goodwill impairment was recognized for the effect of discontinuing a certain product line, which was acquired in the 1997 Dees transaction.

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 to achieve these objectives, which involves the phased reduction of approximately 140 of the initially combined 1,077 staff and consolidation of certain field offices. The Company expects to incur a total cost of \$ 3,000 in connection with this plan. The Company elected early adoption of SFAS No. 146 "Accounting for Costs Associated with Exit or Disposal Activities". SFAS No. 146 requires that a liability for a cost that is associated with an exit activity be recognized only when the liability is incurred. It supersedes the guidance in EITF 94-3. In SFAS No. 146, an entity's commitment to a plan does not, by itself, create a present obligation to other parties that meets the definition of a liability. Additionally, SFAS No. 146 establishes that fair value is the objective for the initial measurement of the liability. Accordingly, the liability related to the involuntary reductions that were effected in December 2002 of \$ 282 was included in the Company's balance sheet. The remaining reductions in force are planned to be implemented over the first three quarters of 2003 and will be recognized as incurred.

At December 31, 2002, a total amount of \$ 406 is included in accrued expenses and other liabilities. The major components of the fiscal 2001 and 2002 restructuring costs are as follows:

NOTES TO FINANCIAL STATEMENTS**U.S. dollars in thousands (except per share data)****NOTE 11:- RESTRUCTURING EXPENSES (Cont.)**

| | Employee termination benefits | Facility closure | Loss on disposal of property and equipment | Goodwill impairment | Total charge |
|--|--|-----------------------------|---|--------------------------------|-------------------------|
| <u>2001 Plan:</u> | | | | | |
| Original provision | \$ 9,564 | \$ 1,928 | \$ 1,946 | \$ 1,116 | \$ 14,554 |
| Utilized: | | | | | |
| Cash | (7,997) | (1,051) | - | - | (9,048) |
| Non-cash | - | - | (1,946) | (1,116) | (3,062) |
| Balance as of | | | | | |
| December 31, 2001 | 1,567 | 877 | - | - | 2,444 |
| Utilized: | | | | | |
| Cash | (1,043) | (877) | - | - | (1,920) |
| Non-cash | - | - | - | - | - |
| Additional restructuring expenses (reversal of over accrued amounts) | (524) | 124 | - | - | (400) |
| Balance as of | | | | | |
| December 31, 2002 | - | 124 | - | - | 124 |
| <u>2002 Plan:</u> | | | | | |
| Original provision | 282 | - | - | - | 282 |
| Balance as of | | | | | |
| December 31, 2002 | 282 | - | - | - | 282 |
| 2001 and 2002 plans as of | | | | | |
| December 31, 2002 | <u>\$ 282</u> | <u>\$ 124</u> | <u>\$ -</u> | <u>\$ -</u> | <u>\$ 406</u> |

NOTES TO FINANCIAL STATEMENTS**U.S. dollars in thousands (except per share data)****NOTE 12:- COMMITMENTS AND CONTINGENT LIABILITIES**

a. Lease commitments:

The Company leases various office space, office equipment and 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:

| | |
|---------------------|------------------|
| 2003 | \$ 5,358 |
| 2004 | 2,685 |
| 2005 | 2,485 |
| 2006 | 1,267 |
| 2007 and thereafter | <u>597</u> |
| | <u>\$ 12,392</u> |

Rent expense for the years ended December 31, 2000, 2001 and 2002, was approximately \$ 4,011, \$ 5,190 and \$ 5,761, respectively.

2. The Company leases its motor vehicles under cancelable operating lease agreements for periods through 2003.

The minimum payment under these operating leases, upon cancellation of these lease agreements, amounted to \$ 1,268 as of December 31, 2002.

Lease expenses for the years ended December 31, 2000, 2001 and 2002, were \$ 70, \$ 1,677 and \$ 1,616, respectively.

b. Other commitments:

1. During 2002 the Company completed a contract manufacturing agreement with a third party contractor ("the contractor"). Under the manufacturing agreement ("the agreement"), the contractor provides the Company with a turnkey manufacturing solution for all of its products. The Company is liable under the agreement to purchase above a certain level specified in the agreement, which is based on historical level of orders to the contractor, excess raw material and subassembly inventories deemed obsolete or slow moving. As of December 31, 2002 there were no such obsolete or slow moving inventories.

NOTES TO FINANCIAL STATEMENTS**U.S. dollars in thousands (except per share data)****NOTE 12:- COMMITMENTS AND CONTINGENT LIABILITIES (Cont.)**

In addition, the Company assumed an outsourcing manufacturing agreement in the acquisition of TCS (see also Note 1b). The minimum payments under this non-cancelable manufacturing agreement for which future benefit exists for the years ended December 31, are as follows:

| | | |
|------|----|--------------|
| 2003 | \$ | 3,109 |
| 2004 | | 2,104 |
| 2005 | | 1,448 |
| 2006 | | 515 |
| | \$ | <u>7,176</u> |

2. The company is committed under non-cancelable services agreements to pay minimum payments to its suppliers. The minimum payments under these services agreements for the years ended December 31, are as follows:

| | | |
|------|----|--------------|
| 2003 | \$ | 2,798 |
| 2004 | | 2,513 |
| 2005 | | 2,513 |
| 2006 | | 94 |
| | \$ | <u>7,918</u> |

- c. Security interests and pledges:

The Company provided a guarantee in the amount of \$ 52 to the Israeli Chamber of Commerce and Industry to secure the return of equipment shipped abroad; in the amount of \$ 1,133 in respect of liability for projects in progress; in the amount of \$ 1,901 for the performance of projects for customers who made advance payments in respect of said projects and in the amount of \$ 257 to the Ministry of Finance of Belgium in respect of VAT registration. The Company also provided a guarantee in the amount of \$ 34 in respect of premises leased in France, \$ 35 in respect of warranty of its products, \$ 330 in respect of bids and \$ 36 in respect of customs.

- d. Legal proceedings

1. In June 2000, Dictaphone Corporation, one of the Company's competitors, filed a patent infringement claim relating to certain technology embedded in some of the Company's products. The claim is for damages for past infringement and enjoinder of any continued infringement of Dictaphone patents. In the court's discretion, the damages may be trebled and attorney fees awarded. As a result the Company might be forced to pay significant damages and licensing fees, modify its business practices or even be enjoined from conducting a significant part of its U.S. business. Any such results could materially harm the Company's business. The Company believes, however, that it has a valid defense to this claim and is

NOTES TO FINANCIAL STATEMENTS**U.S. dollars in thousands (except per share data)**

NOTE 12:- COMMITMENTS AND CONTINGENT LIABILITIES (Cont.)

vigorously defending it. The Company has received notification from its insurance company indicating that the claim is not covered by the Company's insurance policy; however, the insurance company has agreed to reimburse for all legal expenses that the Company is expending in defense of the claim while reserving its final decision on this matter until the final outcome of the litigation. The discovery period is closed, dispositive motions have filed with the Court, and the Company is awaiting the Court's decisions on these motions as well as scheduling for trial.

2. On February 8, 2001, the trading price of the Company's securities dropped, following the Company's announcements that, among other things, the Company would be restating its revenue for fiscal year 1999 and the first three quarters of 2000 and that the Company was revising downward its revenue estimates for the final quarter of 2000. Thereafter, various plaintiffs filed in the United States District Court for the District of New Jersey fourteen putative class action securities lawsuits against the Company and several of its present or former officers and directors. The first of these actions was commenced on February 13, 2001. All of the actions have been allocated to the Newark vicinage of the District of New Jersey, and all have been assigned to the Hon. Joseph A. Greenaway, Jr., U.S.D.J.

The complaint in each action alleges that the Company and the individual defendants violated Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b), and Rule 10b-5 promulgated there under. The plaintiffs also attempt to state a "control person" claim against several of the individual defendants under Section 20(a) of the Exchange Act, 15 U.S.C. § 78t(a). While there are differences among the fourteen complaints, the plaintiffs essentially contend that the Company and the individual defendants misrepresented to investors, either affirmatively or through omissions, the Company's financial results and the value of its securities. The plaintiffs seek damages in an unspecified amount. The plaintiffs in each such action seek to represent a class of investors in the Company's securities throughout a specified period, approximately from February 2000 to February 2001.

On April 11, 2001, the Company and several of the individual defendants successfully moved to consolidate the various actions under the caption "In re: Nice Systems Ltd. Securities Litigation," Master File No. 01-CV-00737 (JAG), and to establish a schedule for the filing by plaintiffs of an amended consolidated complaint and the Company and the individual defendants' response to such complaint.

NOTES TO FINANCIAL STATEMENTS

U.S. dollars in thousands (except per share data)

NOTE 12:- COMMITMENTS AND CONTINGENT LIABILITIES (Cont.)

By Order dated May 21, 2001, a group of plaintiffs were appointed "lead plaintiffs" pursuant to the Private Securities Litigation Reform Act of 1995, 15 U.S.C. § 78u-4(a)(3)(B). On August 20, 2001, the Lead Plaintiffs filed and served a Consolidated Amended Class Action Complaint, purporting to bring their securities claims on behalf of a class of persons who purchased the Company's ADSs between November 3, 1999, and February 7, 2001. On October 22, 2001, the Company and the individual defendants moved to dismiss the consolidated complaint in its entirety, for failure to state a claim upon which relief could be granted, for failure to plead fraud with the requisite particularity and on grounds of forum non conveniens in favor of proceedings in Israel. Briefing on that motion was completed on December 27, 2001.

Before that motion was decided by the Court, the parties to the litigation entered into a settlement of the claim, without any admission of liability or wrongdoing on the Company's part, in the amount of \$ 10,000 dollars, including attorneys' fees. The Company received the funds for this settlement through its directors and officers' insurance policy.

Because the action was brought as a class action, the settlement was subject to court approval. By Order dated April 7, 2003, the settlement was approved by the United States District Court for the District of New Jersey, over the objections of two shareholders. On April 30, 2003, one of those shareholders, James J. Hayes, appealed from that Order to the United States Court of Appeals for the Third Circuit.

NOTE 13:- CREDIT LINES

As of December 31, 2002, the Company had authorized credit lines from banks in the amount of \$ 47,000. When utilized, the credit lines will be denominated in dollars and will bear interest at the rate of up to LIBOR + 1.6%. An amount of \$ 22,000 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, 2002, \$2,200 were 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, or changes in the exchange rate of the NIS against the dollar, for a "foreign investors" company. Until taxable year 2001, NICE measured its results for tax purposes in accordance with changes in the Israeli consumer price

NOTES TO FINANCIAL STATEMENTS**U.S. dollars in thousands (except per share data)****NOTE 14:- TAXES ON INCOME (Cont.)**

index. Commencing with taxable year 2002, 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. This election obligates NICE for three years.

- 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 the consolidated complaint in its entirety, for failure to state a claim upon which relief could be granted, for failure to plead fraud with the requisite particularity.

Income derived from the first program is tax-exempt for a period of four years, commencing 1999, 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 six years.

Income derived from the second program is tax-exempt for a period of four years, commencing 1997, 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 six years.

Income derived from the third and fourth programs will be tax-exempt for a period of two years, commencing with the year the Company 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.

In December 2002, the Company filed an application for a fifth "Approved Enterprise" investment program for its facilities in Israel. To date, the Company has not received a notice of approval for this fifth program.

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 Law also entitles NICE to claim accelerated depreciation on equipment used by the "Approved Enterprise" during five tax years.

The entitlement to the above benefits is conditional upon NICE's fulfilling the conditions stipulated by the above Law, regulations published hereunder and the instruments 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 the Company may be required to refund the amount of the benefits, in whole or in part, including interest. As of December 31, 2002 the Company is in compliance with all the conditions required by the law.

The tax-exempt income attributable to the "Approved Enterprise" can be distributed to shareholders without subjecting NICE to taxes only upon the complete liquidation of NICE. As of December 31, 2002, approximately \$ 16,029 was derived from tax-

NOTES TO FINANCIAL STATEMENTS**U.S. dollars in thousands (except per share data)****NOTE 14:- TAXES ON INCOME (Cont.)**

exempt profits earned by NICE's "Approved Enterprise". NICE has decided not to declare dividends out of such tax-exempt income. Accordingly, no deferred income taxes have been provided on income attributable to NICE's "Approved Enterprises".

If the net retained tax exempt income is distributed in a manner other than in the complete liquidation of NICE, 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 \$ 4,007 as of December 31, 2002.

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

- 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. Net operating loss carryforward:

As of December 31, 2002, the Company had carryforward tax losses totaling approximately \$ 69,752, most of which can be carried forward and offset against taxable income indefinitely. The remaining carryforward tax losses can be carried forward and offset against taxable income with expiration dates from 2003 to 2021. 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.

- e. 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:

NICE SYSTEMS LTD. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS

U.S. dollars in thousands (except per share data)

NOTE 14:- TAXES ON INCOME (Cont.)

| | December 31, | |
|---|---------------------|-------------|
| | 2001 | 2002 |
| Net operating loss carryforward | \$ 11,954 | \$ 10,994 |
| Reserves and allowances | 3,320 | 3,787 |
| Net deferred tax asset before valuation allowance | 15,274 | 14,781 |
| Valuation allowance | (15,274) | (14,781) |
| Net deferred tax asset | \$ - | \$ - |

The Company has provided valuation allowances in respect of deferred tax assets resulting from tax loss carryforwards, due to its history of operating losses and current uncertainty concerning its ability to realize these deferred tax assets in the future.

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

| | Year ended December 31, | | |
|--|--------------------------------|-------------|-------------|
| | 2000 | 2001 | 2002 |
| Loss before taxes on income, as reported in the consolidated statements of operations | \$ (5,046) | \$ (46,597) | \$ (33,632) |
| Statutory tax rate in Israel | 36% | 36% | 36% |
| Theoretical income tax benefit | \$ (1,817) | \$ (16,775) | \$ (12,108) |
| Losses and other items for which a valuation allowance was provided | 2,456 | 12,837 | 2,725 |
| Non-deductible acquisition-related costs | 2,761 | 338 | 11,201 |
| Tax exempt interest income | (2,117) | (1,554) | (1,145) |
| Utilization of net operating losses for which a valuation allowance was provided | - | - | (676) |
| Non-deductible expenses | 244 | 257 | 407 |
| Increase (decrease) from difference between Israeli currency income and US dollar income | (1,159) | 5,031 | - |
| Other | (95) | 64 | (54) |
| Actual tax expense | \$ 273 | \$ 198 | \$ 350 |

NOTES TO FINANCIAL STATEMENTS

U.S. dollars in thousands (except per share data)

NOTE 14:- TAXES ON INCOME (Cont.)

- g. Loss before taxes on income is comprised as follows:

| | Year ended December 31, | | |
|----------|--------------------------------|--------------------|--------------------|
| | 2000 | 2001 | 2002 |
| Domestic | \$ 2,740 | \$ (31,057) | \$ (32,673) |
| Foreign | (7,786) | (15,540) | (959) |
| | <u>\$ (5,046)</u> | <u>\$ (46,597)</u> | <u>\$ (33,632)</u> |

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

| | | | |
|---------------|---------------|---------------|---------------|
| Current taxes | <u>\$ 273</u> | <u>\$ 198</u> | <u>\$ 350</u> |
| Domestic | \$ 90 | \$ 100 | \$ 126 |
| Foreign | <u>183</u> | <u>98</u> | <u>224</u> |
| | <u>\$ 273</u> | <u>\$ 198</u> | <u>\$ 350</u> |

- i. Israeli tax reform:

On January 1, 2003, a comprehensive tax reform took effect in Israel. Pursuant to the reform, resident companies are subject to Israeli tax on income accrued or derived in Israel or abroad.

In addition, the concept of "controlled foreign corporation" was introduced, 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). The tax reform also substantially changed the system of taxation of capital gains.

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.

In April 2000, the Company issued 150,000 ADSs to the sole shareholder of CPS as part of the consideration for the acquired shares of CPS (See Note 1d).

In December 2000, the Company issued 220,523 ADSs of NICE as part of the consideration for the acquisition of certain assets and liabilities of SCI (See Note 1c).

In December 2001, the Company issued 186,818 ADSs of NICE as part of a settlement agreement with SCI (See Note 1c).

NOTES TO FINANCIAL STATEMENTS**U.S. dollars in thousands (except per share data)****NOTE 15:- SHAREHOLDERS' EQUITY (Cont.)**

In November 2002, the Company issued 2,187,500 ADSs as part of the consideration in the acquisition of certain assets and liabilities of TCS (See Note 1b).

In November 2002, the Company released from escrow 50,000 ADSs of NICE as part of the settlement agreement with Mr. Chapiewsky (See Note 1d).

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 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. 8,310,566 of the 1995 options were granted at an exercise price of not less than the fair market value of the Ordinary shares at the date of grant.

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 to be 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 ("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 of the 1997 options were granted at an exercise price of not less than the fair market value of the Ordinary shares at the date of grant. As of December 31, 2002, none of the targets specified under the TARSAP were met and accordingly there was no acceleration of options.

NOTES TO FINANCIAL STATEMENTS

U.S. dollars in thousands (except per share data)**NOTE 15:- SHAREHOLDERS' EQUITY (Cont.)**

In 2001, the Company adopted the 2001 Stock Option Plan (the "2001 Option Plan"). The options to acquire Ordinary shares, which may 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 of the 2001 options were granted at an exercise price of not less than the fair market value of the Ordinary shares at the date of grant. Under the terms of the 2001 Plan, a 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%, as determined by the Board of Directors and at its discretion. 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.

In 2001, the Company adopted the 2001 Stock Option Plan for Transitional Employees (the "2001 Transitional Employees Plan") for the terminated employees as part of the restructuring plan (See Note 11). The options to acquire Ordinary shares, which may 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. 96,800 of the 2001 transitional employees options were granted at an exercise price of not less than the fair market value of the Ordinary shares at the date of grant. Under the terms of the 2001 Transitional Employees Plan, each share option granted generally becomes exercisable upon the optionee's termination of employment in accordance with the optionee's termination agreement with the Company and will remain exercisable until the first to occur of the date which is six months following the date of such termination and the expiration of the share option's term. Unless otherwise determined by the Board of Directors as of the date of grant, the stock options expired on December 31, 2002.

NICE SYSTEMS LTD. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS

U.S. dollars in thousands (except per share data)

NOTE 15:- SHAREHOLDERS' EQUITY (Cont.)

A summary of the Company's stock options activity and related information for the years ended December 31, 2000, 2001 and 2002, is as follows:

| | 2000 | | 2001 | | 2002 | |
|--|-------------------|---------------------------------|-------------------|---------------------------------|-------------------|---------------------------------|
| | 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 | 3,036,591 | \$ 26.37 | 4,463,523 | \$ 50.58 | 6,408,825 | \$ 29.31 |
| Granted | 3,116,200 | \$ 69.48 | 4,030,700 | \$ 12.62 | 981,000 | \$ 11.49 |
| Exercised | (615,643) | \$ 21.79 | (33,809) | \$ 11.61 | (60,830) | \$ 12.10 |
| Forfeited | (981,125) | \$ 51.83 | (2,051,589) | \$ 43.08 | (1,363,015) | \$ 32.87 |
| Cancelled | (92,500) | \$ 70.88 | - | \$ - | - | \$ - |
| Outstanding at the end of the year | <u>4,463,523</u> | <u>\$ 50.58</u> | <u>6,408,825</u> | <u>\$ 29.31</u> | <u>5,965,980</u> | <u>\$ 25.74</u> |
| Exercisable at the end of the year | <u>307,744</u> | <u>\$ 27.45</u> | <u>1,393,959</u> | <u>\$ 46.25</u> | <u>2,373,039</u> | <u>\$ 34.46</u> |

The options outstanding as of December 31, 2002, have been separated into exercise price categories as follows:

| Ranges of exercise price | Options outstanding as of December 31, 2002 | Weighted average remaining contractual life (Years) | Weighted average exercise price | Options Exercisable as of December 31, 2002 | Weighted Average Exercise price of options exercisable |
|--------------------------|---|---|---------------------------------|---|--|
| \$ | | | \$ | | \$ |
| 7.83 - 11.14 | 656,500 | 5.63 | 10.09 | 52,500 | 10.95 |
| 12.00 - 16.81 | 3,355,494 | 4.55 | 12.81 | 970,937 | 12.69 |
| 21.38 - 30.13 | 508,194 | 1.77 | 23.06 | 427,319 | 23.07 |
| 40.94 - 55.5 | 637,280 | 3.47 | 51.02 | 389,530 | 50.19 |
| 64.88 -76.25 | 808,512 | 3.28 | 73.88 | 532,753 | 74.09 |
| | <u>5,965,980</u> | <u>4.14</u> | <u>25.74</u> | <u>2,373,039</u> | <u>34.46</u> |

NOTES TO FINANCIAL STATEMENTS

U.S. dollars in thousands (except per share data)

NOTE 15:- SHAREHOLDERS' EQUITY (Cont.)

When the Company has recorded deferred stock compensation for options issued with an exercise price below the fair value of the Ordinary shares, the deferred compensation is amortized and recorded as compensation expense ratably over the vesting period of the options.

Weighted average fair values and weighted average exercise prices of options whose exercise price is equal, less 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, | | | | | |
| | 2000 | 2001 | 2002 | 2000 | 2001 | 2002 |
| Less than fair value at date of grant | \$ 55.11 | \$ - | \$ - | \$ 22.707 | \$ - | \$ - |
| Equal to fair value at date of grant | \$ 38.93 | \$ 5.66 | \$ 8.03 | \$ 69.042 | \$ 12.664 | \$ 12.991 |
| Higher than fair value at date of grant | \$ - | \$ - | \$ 5.19 | \$ - | \$ - | \$ 10.507 |

c. Employee Stock Purchase Plan:

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 share purchased under the Purchase Plan will be equal to 85% of the lower of the fair market value of the Ordinary share on the commencement date of each offering period or on the semi-annual purchase date.

During 2000, 2001 and 2002, employees purchased 28,626, 128,303 and 131,667 shares at average prices of \$ 32.89, \$ 11.21 and \$ 10.51 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.

NOTES TO FINANCIAL STATEMENTS

U.S. dollars in thousands (except per share data)

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 presents total revenues and long-lived assets for the years ended December 31, 2000, 2001 and 2002:

| | 2000 | | 2001 | | 2002 | |
|----------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
| | Total revenues | Long-lived assets | Total revenues | Long-lived assets | Total revenues | Long-lived assets |
| Americas | \$ 90,540 | \$ 37,213 | \$ 66,324 | \$ 34,183 | \$ 88,426 | \$ 10,843 |
| EMEA (*) | 39,901 | 97 | 34,955 | 110 | 47,684 | 18,489 |
| Far East | 18,232 | - | 21,015 | 87 | 22,829 | 95 |
| Israel | 4,490 | 28,367 | 4,814 | 27,831 | 3,566 | 42,818 |
| | <u>\$ 153,163</u> | <u>\$ 65,677</u> | <u>\$ 127,108</u> | <u>\$ 62,211</u> | <u>\$ 162,505</u> | <u>\$ 72,245</u> |

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

- b. Product lines:

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

| | Year ended December 31, | | |
|--------------------------------|-------------------------|-------------------|-------------------|
| | 2000 | 2001 | 2002 |
| Digital audio and applications | \$ 128,655 | \$ 99,785 | \$ 132,408 |
| Digital video | 15,824 | 14,084 | 22,933 |
| COMINT | 8,684 | 13,239 | 7,164 |
| | <u>\$ 153,163</u> | <u>\$ 127,108</u> | <u>\$ 162,505</u> |

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

| | | | |
|------------|-------------|-------------|-------------|
| Customer A | <u>18.6</u> | <u>12.3</u> | <u>22.3</u> |
|------------|-------------|-------------|-------------|

NICE SYSTEMS LTD. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS

U.S. dollars in thousands (except per share data)

NOTE 17:- SELECTED STATEMENTS OF OPERATIONS DATA

| | Year ended December 31, | | |
|---|--------------------------------|------------------|------------------|
| | 2000 | 2001 | 2002 |
| a. Research and development, net: | | | |
| Total costs | \$ 25,406 | \$ 26,017 | \$ 24,742 |
| Less: grants and participations | (1,174) | (1,392) | (2,208) |
| Less - capitalization of software development costs | (4,730) | (5,435) | (4,609) |
| | <u>\$ 19,502</u> | <u>\$ 19,190</u> | <u>\$ 17,925</u> |
| b. Financial income, net: | | | |
| Financial income: | | | |
| Interest and amortization/accretion of premium/discount of marketable securities | \$ 3,326 | \$ 3,371 | \$ 2,747 |
| Interest | 3,433 | 1,294 | 551 |
| Foreign currency translation | - | 166 | 1,411 |
| Other | - | 12 | - |
| | <u>6,759</u> | <u>4,843</u> | <u>4,709</u> |
| Financial expenses: | | | |
| Interest | (80) | (38) | (15) |
| Foreign currency translation | (163) | - | (95) |
| Other | (328) | (551) | (607) |
| | <u>(571)</u> | <u>(589)</u> | <u>(717)</u> |
| | <u>\$ 6,188</u> | <u>\$ 4,254</u> | <u>\$ 3,992</u> |
| c. Amortization of acquired intangible assets, restructuring expenses, in-process research and development and goodwill impairment: | | | |
| Amortization of acquired intangibles | \$ 860 | \$ 3,413 | \$ |
| Restructuring expenses (Note 11) | - | 14,554 | (118) |
| In-process research and development write-off (Note 1b, d) | 6,786 | - | 1,270 |
| Goodwill impairment | - | - | 28,260 |
| Other | - | - | (320) |
| | <u>\$ 7,646</u> | <u>\$ 17,967</u> | <u>\$ 29,092</u> |
| d. Advertising expenses | <u>\$ 1,485</u> | <u>\$ 1,265</u> | <u>\$ 1,760</u> |

NOTES TO FINANCIAL STATEMENTS**U.S. dollars in thousands (except per share data)****NOTE 17:- SELECTED STATEMENTS OF OPERATIONS DATA (Cont.)**

- e. Net loss per share:

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

1. Numerator:

| | Year ended December 31, | | |
|--|--------------------------------|--------------------|--------------------|
| | 2000 | 2001 | 2002 |
| Numerator for basic and diluted net loss per share - Loss available to Ordinary shareholders | <u>\$ (5,319)</u> | <u>\$ (46,795)</u> | <u>\$ (33,982)</u> |

2. Denominator (in thousands):

| | | | |
|--|---------------|---------------|---------------|
| Denominator for basic net loss per share - Weighted average number of shares | <u>12,317</u> | <u>13,047</u> | <u>13,795</u> |
| Denominator for diluted net loss per share - adjusted weighted average shares assuming exercise of options | <u>12,317</u> | <u>13,047</u> | <u>13,795</u> |

The effect of the inclusion of the options and warrants in 2000, 2001 and 2002 would be anti-dilutive. Because of the loss in 2000, 2001 and 2002, all potential dilutive securities are anti-dilutive.