AUDIOCODES LTD
Form 20-F
April 02, 2003

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 20 F

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

OR

X

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

For the fiscal year ended December 31, 2002

OR

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

For the transition period from

to

Commission file number 0-30070

AUDIOCODES LTD.

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

ISRAEL

(Jurisdiction of incorporation or organization)

4 Hahoresh Street, Yehud 56470, Israel

(Address of principal executive offices)

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

Title of each class

Name of each exchange on which registered

None

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

Ordinary Shares, nominal value NIS 0.01 per share

(Title of Class)

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

None

(Title of Class)

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

As of March 1, 2003, the Registrant had outstanding 37,371,686 Ordinary Shares, nominal value NIS 0.01 per share.

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

Yes **x** No

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

Item 17 Item 18 **x**

PART I

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

ITEM 1.

IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS

Not applicable.

ITEM 2.

OFFER STATISTICS AND EXPECTED TIMETABLE

Not applicable.

ITEM 3.

KEY INFORMATION

A.

SELECTED FINANCIAL DATA

We derived the consolidated statement of income data for the years ended December 31, 2000, 2001 and 2002 and consolidated balance sheet data as of December 31, 2001 and 2002 from the audited consolidated financial statements set forth elsewhere in this Annual Report. We derived the consolidated statement of operations data for the years ended December 31, 1998, and 1999 and the consolidated balance sheet data as of December 31, 1998, 1999 and 2000 from audited consolidated financial statements that are not included in this Annual Report.

On October 6, 2000, we effected a two-for-one stock split in the form of a stock dividend. All share and per share data for periods prior to and including that date have been retroactively adjusted to reflect this stock split. All figures relating to outstanding shares exclude shares held in treasury.

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

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Year Ended December 31,

	1998	**1999**	**2000**	**2001**	**2002**
Statement of Operations Data:					

Revenues	
	$9,175
	$31,204
	$71,798
	$35,734
	$27,189
Cost of revenues	
	3,258
	11,921
	28,029
	21,942
	13,006
Gross profit	
	5,917
	19,283
	43,769
	13,792
	14,183
Operating expense:	
Research and development, net	

					2,149
					4,812
					10,588
					13,807
					13,022
Sales and marketing					
					2,267
					4,262
					11,204
					13,852
					14,288
General and administrative					
					973
					1,665
					2,917
					5,044
					3,353
Total operating expenses					
					5,389
					10,739
					24,709
					32,703
					30,663

Operating income (loss)	
	528
	8,544
	19,060
	(18,911)
	(16,480)
Other expenses	
	-
	-
	-
	750
	-
Financial income, net	
	142
	2,471
	8,057
	6,388
	2,623
Income (loss) before income taxes	
	670
	11,015
	27,111
	(13,273)

	(13,857)
Income taxes	
	51
	355
	438
	-
	-
Net income (loss)	
	$ 619
	$10,660
	$26,679
	$(13,273)
	$(13,857)
Basic earnings (loss) per share	
	$ 0.03
	$ 0.35
	$ 0.68
	$ (0.34)
	$ (0.36)
Diluted earnings (loss) per share	
	$ 0.02
	$ 0.29

			$ 0.62
			$ (0.34)
			$ (0.36)
Number of shares used in computing basic earnings per share			
			22,056
			30,398
			39,273
			39,591
			38,518
Number of shares used in computing diluted earnings per share			
			26,074
			36,163
			43,051
			39,591

	38,518

Year Ended December 31,

	1998
	1999
	2000
	2001
	2002
Balance Sheet Data:	
Cash and cash equivalents	
	$2,581
	$ 60,500
	$ 9,575
	$ 50,086
	$ 47,799
Short-term deposits	
	1,029
	57,052
	135,598
	79,984
	63,074
Working capital	

	4,566
	119,372
	146,119
	126,242
	108,370
Total assets	
	8,713
	129,522
	174,329
	148,416
	130,114
Shareholders equity	
	5,145
	120,325
	149,720
	131,255
	113,684

B.

CAPITALIZATION AND INDEBTEDNESS

Not applicable.

C.

REASONS FOR THE OFFER AND USE OF PROCEEDS

Not applicable.

D.

RISK FACTORS

We believe that the occurrence of any one or some combination of the following factors could have a material adverse effect on our business, financial condition and results of operations.

Business, Market and Shareholder Risks

The slowdown in capital expenditures by telecommunications service providers has had and could continue to have a material adverse effect on our results of operations.

A deterioration of economies around the world and economic uncertainty in the telecommunications market began in 2000 and continued through 2002. This has resulted in a curtailment of capital investment by telecommunications carriers and service providers as well as users such in the enterprise market (businesses who use the equipment). It has also reduced our ability to forecast orders, also referred to as low visibility . For example, we revised downward our initial forecast for the first and third quarters of 2001. We believe that this slowdown in capital expenditures will continue for the foreseeable future and are uncertain as to when this slowdown will end. As a result of this slowdown, we reported a net loss of $13.9 million in 2002 and $13.3 million in 2001 compared to net income of $26.7 million in 2000. The decline in capital expenditures has reduced our sales, and may increase our inventories, result in additional pressure on the price of our products and prolong the time until we are paid, all of which would have a material adverse effect on the results of our operations.

The war in Iraq and the threat of terrorism worldwide are impacting the global economy. Combined with the political unrest in Israel, this could have a material adverse effect on our results of operations.

The war in Iraq, the threat of the use of weapons of mass destruction and global terrorism are impacting the global economy. The future course of the conflict in Iraq and its effect on the global economy and the telecommunications industry cannot be predicted. In addition, since September 2000, the State of Israel and its inhabitants have been subjected to repeated terrorist attacks. The hostilities between the State of Israel and the Palestinians continued during the past year, with no end in sight to this intense conflict. This conflict can have both direct and indirect impacts on our business as a result of, among other things, military service obligations of our key employees, changes in monetary and fiscal policies or the willingness of customers outside Israel to buy our products, including demands for additional assurances concerning availability of our products.

If new products we recently introduced or expect to introduce in the near future fail to generate the level of demand we originally anticipated because potential customers are deferring transitions to new products during the global economic slowdown, we will realize a lower than expected return from our investment in research and development with respect to those products, and our results of operations may suffer.

The slowdown in the global economy and reduction in demand for telecommunications products may adversely impact the transition or migration to new products we recently introduced or expect to introduce in the near future. If, during the global economic slowdown, potential customers defer transition or migration to new products, our return on our investment in research and development with respect to products recently introduced or expected to be introduced in the near future will be lower than we originally anticipated and our results of our operations may suffer.

Our industry is rapidly evolving and we may not be able to keep pace with technological changes, which could result in a loss of revenues.

The transmission of voice, data and fax over data networks is rapidly evolving. Our future success in generating revenues will depend on our ability to enhance our existing products and to develop and introduce new products and product features. These products and features must keep pace with technological developments and address the increasingly sophisticated needs of our customers.

We may not be able to keep pace with emerging industry standards, which may make our products unacceptable to potential customers.

The failure to comply with evolving standards will limit acceptance of our products by market participants. Since our products are integrated into networks consisting of elements manufactured by various companies, they must comply with a number of current and future industry standards and practices established by various international bodies and industry forums.

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

The standards in our market are continually evolving. Should new standards gain broad acceptance, we will be required to adopt those standards in our products. We may also decide to modify our products to meet additional existing standards or add features to our products. Standards may be adopted by various industry interest groups or may be proprietary and nonetheless accepted broadly in the industry. It may take us a significant amount of time to develop and design products incorporating these new standards. We may also have to pay additional fees to the developers of the technologies which constitute the newly adopted standards.

Our customers or potential customers may develop or prefer to develop their own technical solutions, and as a result, would not buy our products.

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

We have depended on a few large customers. The loss of one of these customers or the reduction in purchases by a significant customer could have a material adverse effect on our revenue.

Historically, a substantial portion of our revenue has come from large purchases by a small number of original equipment manufacturer, or OEM, customers. For example, our top three customers accounted for approximately 22.4% of our total revenues in 2002, 47.3% of our total revenues in 2001 and 40.4% of our total revenues in 2000. Sales to Clarent Corporation (now part of Verso Corporation) accounted for 31.7% of our total revenues in 2001 and 28.6% of our total revenues in 2000. Sales to Clarent accounted for less than 1% of our total revenues in 2002. Our future operating results may depend, in part, on the success of our largest OEM customers in selling products incorporating our components and on our success in selling large quantities of our products to them. We generally do not enter into long-term sales agreements with our top customers.

Based on our experience, we expect that our customer base may change from period to period. If we lose a large customer and fail to add new customers there could be a material adverse effect on our results of operations.

We do not sell to the end users of our equipment, which means that we have less information on the actual requirements of end users and their utilization of equipment. We also have less influence over the choice of equipment of such end users.

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

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

Competition in our industry is intense, and we expect competition to increase. Acquisitions and strategic alliances in our industry have further increased competition. In recent years, Silicon Spice, Inc. was acquired by Broadcom Corporation, Intel Corporation acquired VxTel, Inc. and NMS Communications Corporation (formerly known as Natural MicroSystems Corporation) acquired InnoMediaLogic, Inc. (IML), Mobilee, Inc., and Lucent Technologies voice enhancement and echo cancellation business. Increased competition could result in lower prices for our products, reduced demand for our products and a corresponding reduction in our ability to recover development, engineering and manufacturing costs.

Competitors currently sell products that provide similar benefits to those that we sell.

Our principal competitors in the sale of signal processing chips include Telogy Networks, a division of Texas Instruments, VoicePump, a subsidiary of DSP Group, and Broadcom. We expect that large manufacturers of generic signal processors, like Siemens, Motorola and Agere Systems (formerly the microelectronics division of Lucent Technologies) and Intel (Vxtel) market competing processors.

Additionally, large semiconductor companies including Texas Instruments, Intel, Broadcom, and Conexant have entered this market through acquisitions. Centillium Communications, Broadcom, Intel, Mindspeed Technologies and Texas Instruments are manufacturers of high density Voice over Packet processors that compete with our high density Voice over Packet TrunkPack® Module products and chips. Other vendors of module products that compete with our high density module products include Mapletree Networks and Spectrum Signal Processing Inc.

Our principal competitors in the communications board market include NMS Communications, Dialogic Corporation (an Intel company), Blue Wave Systems (a Motorola Computer Group company), Brooktrout, Inc. and Acculab.

Our principal competitors in the area of analog media gateways (2 to 8 ports) for access and enterprise applications include Mediatrix Telecom, Inc., Vega Stream Limited, Innovaphone AG, Quintum Technologies, Tainet Communication System Corp., Anatel Corporation and D-Link Systems, Inc.

Our principal competitors in the area of digital media gateways include Cisco Systems, ECI Telecom (NGTS), Nuera, Santera, General Bandwidth, Quintum, Vega Stream Limited, Convergent, Telica and Commatch.

New entrants to the market may increase competition.

The increasing market acceptance of voice over packet technology is attracting, and is expected to continue to attract, new entrants. Some of the leading communications equipment manufacturers have entered our market through acquisitions, and many of them have greater resources than we do. Combinations between semiconductor companies and companies providing software to them, such as the acquisition of Telogy Networks, Inc. by Texas Instruments Incorporated and the acquisition of HotHaus Technologies Inc. and Silicon Spice, Inc. by Broadcom Corporation, could result in further competition for us.

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

AudioCodes has broadened its product offerings from chips to boards, subsystems and gateway level products (systems). These products could compete with products offered by our customers. These customers could decide to decrease purchases from us because of this competition. This could result in a material adverse effect on our results of operations.

We rely on others to assemble our products and therefore do not directly control manufacturing costs, product delivery schedules or manufacturing quality.

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

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

Texas Instruments Incorporated and DSP Group, Inc. supply all of the chips for our signal processor product line. Our signal processor line is used both as a product line in its own right and as a key component in our other product lines. Motorola manufactures all of the communications processors currently used on our communications boards. These suppliers also supply many of our competitors and have entered and may enter into additional relationships with them.

Texas Instruments is also one of our major competitors in providing signal processing solutions. An unexpected termination of the supply of the chips provided by Texas Instruments or Motorola or disruption in their timely delivery, would require us to make a large investment in capital and manpower resources to shift to using signal processors manufactured by other companies and may cause a large delay in introducing replacement products. An interruption in supply from any of these sources or an unexpected technical failure or termination of the manufacture of key electronic components could disrupt production, thereby adversely affecting our ability to deliver products to our customers. From time to time, product delivery requirements have required us to increase inventory levels and therefore incur higher costs.

We may not be able to retain a sufficient number of subcontractors to meet our production needs, which could hurt our ability to grow.

We have not entered into any long-term agreements or alternate source agreements with manufacturing subcontractors. Qualification of assembly and test subcontractors normally requires a significant investment of time. If our subcontractors are unable to provide us with components or assembled products on a timely basis or if we need to find alternative subcontractors, our product shipments could be delayed significantly and our growth may be slowed.

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

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

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

Our proprietary technology is difficult to protect, and our products may infringe on the intellectual property rights of third parties.

Our success and ability to compete depend in large part upon protecting our proprietary technology. We rely on a combination of patent, trade secret, copyright and trademark laws, nondisclosure and other contractual agreements and technical measures to protect our proprietary rights. These agreements and measures may not be sufficient to protect our technology from third-party infringement, or to protect us from the claims of others. Any intellectual property claims against us, even without merit, could cost us a significant amount of money to defend and divert management s attention away from our business. Additionally, our products may be sold in foreign countries that provide less protection to intellectual property than that provided under U.S. or Israeli laws.

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

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

Changes in governmental regulations in the United States could slow the growth of the Internet protocol telephony market and reduce the demand for our customers products, which, in turn, could reduce the demand for our products.

In the United States, changes in governmental regulation are being considered that may negatively impact the Internet protocol telephony market. For example, the Federal Communications Commission (FCC) has to date treated providers of telephone services over the public Internet as enhanced service providers . Enhanced service providers are currently exempt from federal and state regulations governing common carriers, including the obligation to pay access charges and contribute to the universal service fund. The FCC is examining whether certain forms of telephone services over the Internet should be subject to the same FCC regulations as telecommunications services. If the FCC were to determine that telephony providers over the public Internet, or the services they provide, are subject to FCC regulations, then some of the service providers that buy equipment from our customers may be forced to pay these

access charges and make universal service contributions.

Regulation of communications over the public Internet could have a material adverse effect on our customers (and their customers) businesses and could therefore adversely affect sales of our products. It is not yet known what effect, if any, possible legislative reforms may have on private telecommunication networks.

Changes in regulations affecting the telecommunications industry worldwide may reduce our customer base and sales.

Changes in regulations affecting the telecommunications industry worldwide may adversely affect the businesses of our present and potential customers. As competition intensifies, these customers may be forced to cut costs, which may negatively impact our sales. Also, these customers may be forced to combine with other manufacturers, thereby reducing the number of our potential customers.

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

Foreign currency fluctuations may affect the prices of our products. Our prices in all countries are denominated in dollars. If there is a significant devaluation in a specific country, the prices of our products will increase relative to the local currency and may be less competitive. We cannot be sure that our international customers will continue to place orders denominated in dollars. The introduction into circulation of the Euro in January 2002 may place pressure on us to sell to European customers in Euro rather than dollar prices. This could make our revenues subject to fluctuation in the Euro/dollar exchange rate. In 2002, we did not make any sales based on Euro prices, but this could change in the future.

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

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

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

We develop complex and evolving products. Despite testing by us and our customers, errors may be found in existing or new products. The risk is higher with products still in the development stage, where full testing or certification is not yet completed. This could result in, among other things, a delay in recognition or loss of revenues, loss of market share or failure to achieve market acceptance. We could be subject to material claims by customers. We have product liability insurance to protect us against losses caused by defects in our products, including errors and omissions insurance.

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

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

market, we may be unable to sell the product in that market.

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

Because our products are complex and our market is evolving, the success of our business depends in large part upon the continuing contributions of our management and key personnel. Specifically, we rely heavily on the services of Shabtai Adlersberg, our Chief Executive Officer. If Shabtai Adlersberg is unable or unwilling to continue with us, our results of operations could be materially and adversely affected. Until February 2003, we maintained key man life insurance on Shabtai Adlersberg in the amount of approximately $2.7 million. We do not intend to continue to maintain this insurance in effect.

The success of our business also depends upon our continuing ability to attract and retain other highly-qualified management, technical, sales and marketing personnel. We need highly-qualified technical personnel who are capable of developing technologies and products and providing the technical support required by our customers. Such personnel were and may again be in great demand and we may not be successful in attracting, integrating or retaining them when and as required.

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

We may need to raise additional capital in the future to continue our longer term expansion plans. We cannot be certain that we will be able to obtain additional financing on commercially reasonable terms, or at all. This could inhibit our growth and increase our financing costs.

The market price of our ordinary shares has fluctuated and may continue to fluctuate significantly.

Our stock price has fluctuated and may continue to fluctuate significantly. Fluctuations in our share price can occur for reasons that may be unrelated to operating results, including stock market-wide downturns and events in the technology industry as well as in the United States and Israel. These fluctuations may adversely affect the market price of our ordinary shares.

Our ordinary shares are traded on more than one market and this may result in price variations.

Our ordinary shares are traded primarily on the Nasdaq National Market and on The Tel Aviv Stock Exchange. Trading in our ordinary shares on these markets is made in different currencies (U.S. dollars on the Nasdaq National Market, and New Israeli Shekels on The Tel Aviv Stock Exchange), and at different times (resulting from different time zones, different trading days and different public holidays in the United States and Israel). Consequently, the trading prices of our ordinary shares on these two markets often differ, resulting from the factors described above as well as differences in exchange rates. Any decrease in the trading price of our ordinary shares on one of these markets could cause a decrease in the trading price of our ordinary shares on the other market.

There may be an adverse effect on the market price of our shares as a result of shares being available for sale in the future.

If our shareholders sell substantial amounts of our ordinary shares, including shares issued upon the exercise of outstanding options, the market price of our ordinary shares may fall. These sales also might make it more difficult for us to sell equity or equity-related securities in the future at a time and place that we deem appropriate.

Our principal shareholders, executive officers and directors have substantial control over most matters submitted to a vote of the shareholders, thereby limiting the power of other shareholders to influence corporate action.

As of December 31, 2002, our officers, directors and principal shareholders beneficially owned 48.8% of our ordinary shares. As a result, these shareholders may have the power to control the outcome of most matters submitted to a vote of shareholders, including the election of members of our board and the approval of significant corporate transactions. This concentration of ownership may also have the effect of making it more difficult to obtain approval for a change in control of us.

As a result of an agreement among our principal shareholders, it will be difficult for minority shareholders to influence the choice of our board of directors.

Our articles of association provide that our board will be divided into three classes. Members of each class will hold their office for three-year staggered terms. Our principal shareholders, divided into four groups, have entered into an agreement stating that as long as each group owns at least 7.5% of our outstanding shares they would each vote for the nominees of the other principal shareholder groups. The provisions of this shareholders agreement, when coupled with the provision of our articles of association authorizing the board to fill vacant directorships or to increase the size of the board, may deter public investors from influencing the selection of directors, removing incumbent directors or gaining control of the board.

The effects of anti-takeover provisions could inhibit the acquisition of us by others.

Some of the provisions of our articles of association and Israeli law could, together or separately:

- discourage potential acquisition proposals;
- delay or prevent a change in control; and
- limit the price that investors might be willing to pay in the future for our ordinary shares.

Under the Israeli Companies Law, a merger is generally required to be approved by the shareholders and the board of directors of each of the merging companies. Shares held by a party to the merger are not counted toward the required approval. If the share capital of the company that will not be the surviving company is divided into different classes of shares, the approval of each class is required. A merger may not be approved if the surviving company will not be able to satisfy its obligations. At the request of a creditor, a court may prohibit a merger on these grounds. In addition, a merger can be completed only after all approvals have been submitted to the Israeli Registrar of Companies and 70 days have passed from the time that a proposal for approval of the merger was filed with the Registrar.

The Israeli Companies Law provides that an acquisition of shares in a public company must be made by means of a tender offer if as a result of the acquisition the purchaser would become a 25% shareholder of the company. Similarly, the Israeli Companies Law provides that an acquisition of shares in a public company must be made by means of a tender offer if as a result of the acquisition the purchaser would become a 45% shareholder of the company, unless someone else already holds a majority of the voting power of the company. Regulations promulgated under the Israeli Companies Law provide that these tender offer requirements do not apply to companies whose shares are listed for trading outside of Israel if, according to the law in the country in which the shares are traded, including the rules and regulations of the stock exchange on which the shares are traded either:

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there is a limitation on acquisition of any level of control of the company; or

•

the acquisition of any level of control requires the purchaser to do so by means of a tender offer to the public.

Israel s Companies Law provides specific rules and procedures for the acquisition of shares held by minority shareholders, if the majority shareholder holds 90% or more of the outstanding shares.

In addition, our articles limit our ability to engage in any merger, asset or share sale or other similar transaction with a shareholder holding 15% or more of our voting shares. Israeli tax law treats certain acquisitions, particularly stock-for-stock exchanges between an Israeli company and a foreign company, less favorably than United States tax law.

Risks Relating to Operations in Israel

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

We are incorporated under the laws of the State of Israel, and our principal offices are located in the State of Israel. Political, economic and military conditions in Israel directly affect our operations. Terrorist attacks against Israel have greatly intensified during the past two years, which have led to ongoing hostilities. We cannot predict the effect on AudioCodes of the increase in the degree of violence by Palestinians against Israel. Additionally, we cannot predict the effect on AudioCodes of any possible military action elsewhere in the Middle East, such as the war in Iraq. Some of our officers and employees in Israel are obligated to perform up to 36 days of military reserve duty annually and are subject to being called for additional active duty under emergency circumstances. While AudioCodes has operated effectively under these requirements since its incorporation, we cannot predict the full impact of such conditions on AudioCodes in the future, particularly if emergency circumstances occur. If many of AudioCodes employees are called for active duty, our operations in Israel and our business may be adversely affected. Additionally, a number of countries continue to restrict or ban business with Israel or Israeli companies, which may limit our ability to make sales in those countries.

The Israeli rate of inflation may negatively impact our costs if it exceeds the rate of devaluation of the New Israeli Shekel against the U.S. dollar.

A portion of the cost of our Israeli operations, mainly personnel and facility-related, is incurred in New Israeli Shekels. In 2002, approximately 38% of our costs were incurred in New Israeli Shekels. As a result, we bear the risk that the rate of inflation in Israel will exceed the rate of devaluation of the New Israeli Shekel in relation to the dollar, which will increase our costs as expressed in dollars.

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

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

We benefit from certain government programs and tax benefits, particularly as a result of exemptions and reductions resulting from the Approved Enterprise status of our existing production facilities and programs in Israel . To be eligible for these programs and tax benefits, we must continue to meet conditions, including making specified investments in fixed assets and financing a percentage of investments with share capital. If we fail to meet such conditions in the future, the tax benefits would be canceled and we could be required to refund the tax benefits already received. The law and regulations prescribing the benefits provide an expiration date for the grant of new benefits. The expiration date has been extended several times in the past. The expiration date currently in effect is May 2003, and no new benefits will be granted after that date unless the expiration date is extended again. A governmental committee is reviewing the benefits program under the law. There can be no assurance that new benefits will be available after May 2003. There can be no assurance that such benefits will be continued in the future at their current levels or at any level.

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

We are incorporated in Israel. Substantially all of our executive officers and directors and our Israeli auditors are nonresidents of the United States, and a substantial portion of our assets and the assets of these persons are located outside the United States. Therefore, it may be difficult to enforce a judgment obtained in the United States against us or any such persons.

Additionally, there is doubt as to the enforceability of civil liabilities under the Securities Act and the Securities Exchange Act in original actions instituted in Israel. However, subject to specified time limitations, an Israeli court may declare a foreign civil judgment enforceable if it finds that:

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the judgment was rendered by a court which was, according to the laws of the state of the court, competent to render the judgment;

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the judgment is no longer appealable;

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the obligation imposed by the judgment is enforceable according to the rules relating to the enforceability of judgments in Israel and the substance of the judgment is not contrary to public policy; and

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the judgment is executory in the state in which it was given.

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

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the judgment was obtained by fraud;

- there was no due process;
- the judgment was rendered by a court not competent to render it according to the laws of private international law in Israel;
- the judgment is at variance with another judgment that was given in the same matter between the same parties and which is still valid; or
- at the time the action was brought in the foreign court a suit in the same matter and between the same parties was pending before a court or tribunal in Israel.

If a foreign judgment is enforced by an Israeli court, it generally will be payable in New Israeli Shekels, which can then be converted into non-Israeli currency and transferred out of Israel. The usual practice in an action to recover an amount in non-Israeli currency is for the Israeli court to render judgment for the equivalent amount in New Israeli Shekels at the rate of exchange on the date of payment, but the judgment debtor also may make payment in non-Israeli currency. Pending collection, the amount of the judgment of an Israeli court stated in New Israeli Shekels ordinarily will be linked to the Israel Consumer Price Index plus interest at the annual rate (set by Israeli law) prevailing at that time. Judgment creditors bear the risk of unfavorable exchange rates.

ITEM 4.

INFORMATION ON THE COMPANY

A.

HISTORY AND DEVELOPMENT OF THE COMPANY

AudioCodes Ltd. was incorporated in 1992 under the laws of the State of Israel. Our principal executive offices are located at 4 Hahoresh Street, Yehud 56470, Israel. Our telephone number is 972-3-539-4000. Our agent in the United States is AudioCodes Inc., 2890 Zanker Road, Suite 200, San Jose, California 95134.

B.

BUSINESS OVERVIEW

Introduction

We design, develop and market enabling technologies and system products for the transmission of voice, data and fax over packet networks. Our products enable our customers to build high-quality packet networking equipment and provide the building blocks to connect traditional telephone networks with packet networks. Our products are sold to leading original equipment manufacturers, or OEM, system integrators and network equipment providers in the

telecommunications and networking industries.

Packet networks are data communications networks that transport information compressed into packets over circuits shared simultaneously by several users. Equipment based on advanced voice communications standards enable packet networks to carry voice and data more efficiently and at lower cost than the traditional telephone networks, which were designed principally to transmit high quality voice calls.

Our voice compression technology permits the high quality transmission of voice over packet networks using substantially less network capacity than used in traditional telephone networks. Our products enable our customers to build highly-efficient, high capacity gateways and access equipment that are used to connect traditional telephone networks with packet networks. In addition, our gateway product offering provides our customers with a substantial building block for Voice over Packet carrier based solutions, as an alternative to our customers developing or building their own gateways.

Our products, which enable the transmission of high quality voice, data and fax over packet networks, include:

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signal processor chips, which process voice and fax signals and compress the information into packets so that they can be sent between the traditional telephone networks and the packet networks;

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communications boards and modules for access and enterprise applications, which enable voice, data and fax communications through gateway equipment employing Internet and other protocols, as well as the possibility of addition of third party equipment to provide enhanced services;

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system products for access and enterprise applications, such as low density analog media gateways and high density digital media gateways, which enable voice, data and fax communications employing Internet and other protocols (typically such equipment is sold by our customers in conjunction with their own or third party solutions such as call management applications), as well as the possibility of addition of third party equipment to provide enhanced services;

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communications software used to process and format compressed voice and fax information into packets; and

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element management software to manage our system products.

Our products are based upon voice compression and fax detection technologies, which transform voice and fax transmissions into small digital packets. We have co-authored the voice coding standard that was adopted for use in packet networks by the Voice over IP Forum, an industry group founded to ensure the interoperability and high quality of telephone service over packet networks. We have also developed advanced technologies for processing compressed voice transmissions and have significant voice communication system design expertise.

We sell our products to leading original equipment manufacturers in the telecommunications and networking industries for use in markets providing:

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telephony over packet networks based on Internet protocols or networks based on asynchronous transfer mode standards, known as ATM standards;

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telephony over the wireless or cable television infrastructure; and

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telephone service over new generation high speed modems operating over wireless links or data modems, known as digital subscriber line, or DSL, modems.

Customers for our products include Alcatel S.A., Oki, Interactive Intelligence and Siemens. In addition, our proprietary voice compression technology is licensed to a broad group of companies that manufacture equipment for a variety of markets. As one of the original developers of the standards for voice compression technology used in packet networks, we are positioned to take advantage of the rapidly growing demand for advanced communications components enabling high quality converged voice and data services.

Industry Background

Market Trends

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

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Growth in data communications traffic. The growth of the Internet has led to a surge in data communications traffic. This growth has been fueled by the increasing number of users of the Internet, as well as by the increased use of electronic mail, multimedia content and the increased volume of information retrieved from the World Wide Web. In addition, organizations are increasingly turning to the use of intranets and private networks to increase productivity and create competitive advantages. This proliferation of intranets and private networks has further contributed to the surge in data traffic.

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Emergence of packet networks and advances in networking technologies. Traditional voice communications networks were not designed to handle the dramatic increase in data traffic, the need for high-speed data communication and the need to serve a much larger number of users. As data traffic becomes the dominant factor in communications and as service providers begin to build and maintain converged networks for integrated voice and data services, a new generation of data-centric networks is being developed. This development has been enabled by a new generation of packet networking technologies. The capabilities to effectively carry voice and fax and preserve the quality of communications over these new networks have been made possible by the recent rapid advances in voice compression technologies, the advent of digital signal processing chips and new packet voice, fax and data networking technologies and protocols. The surge in data traffic has led to the need for new packet-based infrastructures. As a result, providers are seeking to exploit the advances in high speed and packet voice networking technologies to build networks that are more cost effective than the traditional circuit-switched telephone networks.

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Competition in the telecommunications industry. Competitive local exchange carriers are trying to penetrate the local telephone market with varying degrees of success by bypassing the incumbent local telephone company network through the use of emerging packet technologies in new functions like telephony transmission over cable networks and digital subscriber line networks. In addition, there is a growth of toll bypass service providers, who seek to use public or private networks in order to bypass incumbent networks. Although these new and traditional service providers are not our direct customers, they are creating market demand for equipment manufactured by our customers. The surge in data traffic and the growth in overall volume and capacity of infrastructures has also caused a need for new infrastructure equipment that is capable of more efficient utilization of the available networks.

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New technologies. The expected extension of Voice over Packet technologies into wireless networks alongside the introduction of new wireless standards (referred to often as Second and Third Generations) and cable networks suggest a business opportunity for the deployment of such technologies and products in these market segments. It is possible that the introduction of Voice over Packet technologies into wireless and cable networks will then place pressure on the traditional circuit switch service providers to modernize their equipment so as to be able to compete with the new offerings, including price reductions of these alternative networks.

Circuit-Switched versus Packet Networks

Traditionally, voice and data communications have been transmitted and managed on separate networks, each with its own distinct industry standards and protocols. Voice, data and fax have been transmitted primarily over the traditional telephone network that is based on circuit-switched technology. When a call is placed on a circuit-switched network, a dedicated circuit is established between the two callers and is maintained for the duration of the call. This dedicated channel, which requires bandwidth of 64 kilobits per second, is unavailable for use by other callers on the network until the call is terminated.

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

Packet networks offer a number of advantages over circuit-switched networks. Rather than requiring a dedicated circuit for each individual call, packet networks commingle packets of voice, fax and data from several communications sources on a single physical link. This provides superior utilization of network resources, especially in dealing with information sources with bursts of information followed by periods of silence. This superior utilization means that the same amount of traffic can be carried using fewer network resources. Additionally, the integration of voice and data communications makes possible an enrichment of services and an entire range of new, value-added applications, such as unified messaging and voice enabled web sites. In addition, voice traffic over packet networks is usually compressed to provide a further reduction in the use of or demand for bandwidth. For example, the rate at which information is transmitted over packet networks is generally between 6.3 and 8 kilobits per second as compared to 64 kilobits per second over circuit-switched telephone networks.

Convergence of Voice and Data

The proliferation of data-centric networks since the mid-1990s has made the transmission of voice and fax over these networks a cost-effective alternative to existing circuit-switched telephone networks. Most of the recent growth in packet networks has taken place over networks based on Internet protocols, and, to a lesser extent, on packet networks

based on other protocols. Voice over IP , or VoIP, is the industry terminology used to describe the transmission of voice over Internet protocol-based networks.

The need to re-route voice and fax traffic from the traditional circuit-switched networks onto the new packet networks has led to the development of interface equipment between the two networks, generally referred to as gateways or access equipment, depending on the type of network. The processing of the voice and fax signals in gateway and access equipment is done according to industry-wide standards. These standards are needed to ensure that all traditional telephony traffic is seamlessly switched and routed over the packet network and vice versa.

Gateway equipment for Internet protocol-based packet networks has continued to experience significant development and growth. The gateway equipment can be generally divided into two key categories: open telecommunications architecture systems, built around industry-standard PC and workstation platforms for which components are available from a number of suppliers, and proprietary architecture-based gateways which are built around a custom design of a telecommunications equipment manufacturer. Voice over IP gateway equipment can be generally segmented into three classes: carrier class gateways for use in central office facilities; enterprise gateways for use by corporations and in small offices; and residential gateways for use at homes.

The Challenges

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

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

The Gateway Reliability Problem. In order for a packet network to be efficient for voice or fax transmission, the gateway equipment must be able to deliver an equivalent level of performance to that of existing central offices switching equipment. The telephony providers central offices contain circuit-switching equipment that typically handles tens of thousands of lines and is built to meet severe performance criteria relating to reliability, capacity, size, power consumption and cost. To date, the gateways available for use in packet networks have not been able to cost-effectively achieve these same levels of reliability in handling similar numbers of voice and fax calls. As a result, new generation gateway equipment that meets the same performance level as current circuit-switch technologies needs to be developed.

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

Return on Investment. With the reduction in profitability of service providers there is an even greater need for them to achieve better returns on investment from capital expenditures on new equipment. Given the evolving nature of

packet technologies and capabilities, there is greater pressure to provide cost effective technological solutions.

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

The AudioCodes Solution: AudioCoded™ Products

Using our proprietary voice compression algorithms and industry standards, advanced digital signal processing techniques and voice communications system design expertise, we design and develop new packet networking solutions that alleviate many of the quality of service and gateway efficiency problems associated with the transmission of voice, fax and data over packet networks. Our product lines include signal processor chips, modules, communications boards, low density analog media gateways and high density digital media gateways for access and enterprise applications and communications software packages implementing evolving industry standards and protocols.

Our products have successfully addressed the quality of service problems posed by packet delay, packet delay jitter and packet loss. As a result, we enable our customers to build packet networking equipment that provides communication quality comparable to the traditional telephone networks. In addition, our communications boards and modules improve gateway efficiency and provide the building blocks for high performance, large capacity, open telecommunications platform-based gateways. We work closely with our customers, tailor our products to meet their specific needs, assist them in integrating our products within their systems and help them bring their systems to market on a timely basis. We also work with our customers in deploying their systems in various network environments.

We have been able to develop our products and provide services to our customers based on the following strengths:

Our strengths:

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

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

- *Compressed voice communications systems design expertise.* We have the expertise to design and develop the various building blocks required for complete voice over packet systems. In building these systems, we develop hardware architectures, voice packetization software and signaling software and integrate them with our signal proc