

MIND CTI LTD  
Form 20-F/A  
December 06, 2007

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 20-F/A**

**(Amendment No. 1)**

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

**OR**

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

For the fiscal year ended December 31, 2006

**OR**

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

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

Commission file number 000-31215

**MIND C.T.I. LTD.**

---

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

**ISRAEL**

---

Edgar Filing: MIND CTI LTD - Form 20-F/A

(Jurisdiction of incorporation or organization)

Industrial Park, Building #7, Yoqneam, 20692, 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
<b>Ordinary Shares, nominal value NIS 0.01 per share</b>	<b>Nasdaq Global Market</b>

---

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

None

---

(Title of Class)

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

None

---

(Title of Class)

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

As of December 31, 2006, the Registrant had outstanding **21,547,019** Ordinary Shares, nominal value NIS 0.01 per share.

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

Yes  No

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

Yes  No

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  No

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

Item 17  Item 18

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

Yes  No

### **EXPLANATORY NOTE**

We are filing this Amendment No. 1 to our Annual Report on Form 20-F/A to reflect a restatement of our consolidated financial statements to correct an error in the balance sheet as of December 31, 2006 and in the statement of cash flows for the year ended December 31, 2006. The error relates to the classification of short-term investments in the amount of \$22.8 million relating to auction rate securities. Auction rate securities are long-term bonds that provide liquidity through a Dutch auction process that resets the applicable interest rate at pre-determined calendar intervals, generally every 28 days. This mechanism allows existing investors either to roll over their holdings, whereby they will continue to own their respective securities, or liquidate their holding by selling such securities at par. Given the liquid nature of such securities, they had previously been classified as cash equivalents on both the balance sheets and in the statements of cash flows. However, given that such auction rate securities have long-term stated maturities and that the issuers of such auction rate securities are under no obligation to redeem them prior to their stated maturities, the Company has determined that its investments in such securities, consisting of \$22.8 million as of December 31, 2006, should have been classified as short-term investments, rather than as cash equivalents.

This error has no impact on previously reported results of operations, cash flow from operating activities, total current assets, total assets or shareholders' equity.

In addition to the restated consolidated financial statements, which begin on page F-1 hereof, we have also revised Items 3, 5, 11, 15, 18 and 19, in order to reflect the effects of this restatement. Except with respect to these matters, this amended report does not reflect events occurring after the filing of the original Form 20-F on June 27, 2007. The filing of this Form 20-F/A shall not be deemed an admission that the original Form 20-F, when filed, included any untrue statement of a material fact or omitted to state a material fact necessary to make a statement not misleading.

Unless the context requires otherwise, "MIND", the "Company", "us", "we" and "our" refer to MIND C.T.I. Ltd. and its subsidiaries.

## **FORWARD LOOKING STATEMENTS**

Statements in this annual report concerning our business outlook or future economic performance; anticipated revenues, expenses or other financial items; introductions and advancements in development of products, and plans and objectives related thereto; and statements concerning assumptions made or expectations as to any future events, conditions, performance or other matters, are "forward-looking statements" as that term is defined under the United States Federal Securities Laws. Forward-looking statements are subject to risks, uncertainties and other factors, which could cause actual results to differ materially from those stated in such statements. Factors that could cause or contribute to such differences include, but are not limited to, those set forth under "Risk Factors" in this annual report as well as those discussed elsewhere in this annual report and in our other filings with the Securities and Exchange Commission.

# PART I

## Item 3. Key Information

### A. Selected Financial Data

Except as otherwise indicated, all financial statements and other financial information included in this annual report are presented solely under U.S. GAAP

The following table presents selected consolidated financial data as of and for each of the five years in the period ended December 31, 2006. The selected consolidated financial data presented below are derived from our audited consolidated financial statements for these periods, and should be read in conjunction with these financial statements and the related notes thereto. Our audited consolidated financial statements as of December 31, 2005 and 2006 and for each of the three years in the period ended December 31, 2006 and the related notes thereto are included elsewhere in this annual report. You should read the selected financial data in conjunction with Item 5 "Operating and Financial Review and Prospects."

	Years ended December 31,				
	2002	2003	2004	2005	2006
(In US \$ thousands, except share and per share data)					
<b>Consolidated Statement of Operations Data:</b>					
Revenues:					
Sales of licenses	\$ 6,535	\$ 8,105	\$ 11,699	\$ 7,420	\$ 8,467
Services	3,473	4,831	6,107	8,181	11,593
Total revenues	10,008	12,936	17,806	15,601	20,060
Cost of revenues	2,479	3,208	4,394	4,015	5,675
Gross profit	7,529	9,728	13,412	11,586	14,385
Research and development expenses	3,723	3,319	3,833	5,086	6,118
Selling, general and administrative expenses:					
Selling and marketing expenses	4,154	4,065	4,517	2,148	3,628
General and administrative expenses	1,279	1,115	1,857	1,507	2,135
Operating income (loss)	(1,627)	1,229	3,205	2,845	2,504
Financial income (expenses) - net	2,078	2,573	3,834	1,260	(222)
Income before taxes on income	451	3,802	7,039	4,105	2,282
Taxes on income	117	169	162	43	1,373
Net income	\$ 334	\$ 3,633	\$ 6,877	\$ 4,062	\$ 909
Earnings per ordinary share					
Basic	\$ 0.02	\$ 0.18	\$ 0.33	\$ 0.19	\$ 0.04

Edgar Filing: MIND CTI LTD - Form 20-F/A

Diluted	\$ 0.02	\$ 0.17	\$ 0.32	\$ 0.19	\$ 0.04
<hr/>					
Weighted average number of ordinary shares used in computation of earnings per ordinary share - in thousands:					
Basic	20,677	20,732	21,089	21,431	21,515
<hr/>					
Diluted	20,761	21,143	21,468	21,619	21,546
<hr/>					

As of December 31,

2002	2003	2004	2005	2006
<hr/>				

(In US \$ thousands)

**Consolidated Balance Sheet Data:**

Cash and cash equivalents	\$ 11,312	\$ 4,391	\$ 18,687	\$ 10,174	\$ 4,771
Working capital	11,334	4,006	18,866	9,471	28,926
Total assets	47,967	49,979	55,716	55,652	53,791
Share capital and additional paid-in capital	61,142	58,567	59,130	59,452	59,601
Total shareholders' equity	44,482	45,540	50,244	49,485	47,859

**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 would have a material adverse effect on our business, financial condition and results of operations.

**Risks Relating to Our Business**

**We seek to expand our business through acquisitions that could result in diversion of resources and extra expenses, and which may involve other risks that could disrupt our business and harm our financial condition.**

We pursue acquisitions of business, products and technologies, or the establishment of joint venture arrangements, that could expand our business. The negotiation of potential acquisitions or joint ventures as well as the integration of an acquired or jointly developed business, technology or product could cause diversion of management's attention from the day-to-day operation of our business. This could impair our relationships with our employees, customers, distributors, resellers and marketing allies. Future acquisitions could result in:

- potentially dilutive issuances of equity securities;
- the incurrence of debt and contingent liabilities;
- amortization of intangible assets;

- changes in our business model and margins;
- research and development write-offs; and
- other acquisition-related expenses.

Future acquisitions involve known and unknown risks that could adversely affect our future revenues and operating results. For example:

- we may fail to identify acquisitions that enable us to execute our business strategy;
- we compete with others to acquire companies. We believe that this competition has intensified and may result in decreased availability of, or increased prices for, suitable acquisition candidates;
- we may not be able to obtain the necessary regulatory approvals, including the approval of anti-competition regulatory bodies, in countries where we are seeking to consummate acquisitions;
- we may ultimately fail to consummate an acquisition even if we announce that we plan to acquire a company;
- we may fail to successfully integrate acquisitions in accordance with our business strategy;
- we may not be able to retain the skilled employees and experienced management that may be necessary to operate the businesses we acquire and, if we cannot retain such personnel, we may not be able to attract new skilled employees and experienced management to replace them; and
- we may purchase a company that has contingent liabilities that include, among others, known or unknown patent or product.

In addition, we have limited experience with respect to negotiating an acquisition and operating an acquired business. If future acquisitions disrupt our operations, our business may suffer.

**We might lose money from our investments.**

We invest most of our cash in a variety of financial instruments, including auction rate securities. If the obligor of any of the instruments we hold defaults or undergoes a reorganization in bankruptcy, we may lose all or a portion of such investment. In addition, to the extent there is a general downturn in the credit markets, the liquidity of our investments may be adversely affected and we may lose money. This could materially harm our financial condition. For information on the types of our investments as of December 31, 2006, see Item 5.B - "Liquidity and Capital Resources" and Item 11 - "Quantitative and Qualitative Disclosures About Market Risk."

**If we fail to attract and retain qualified personnel we will not be able to implement our business strategy or operate our business effectively.**

Our products require sophisticated research and development, sales and marketing, software programming and technical customer support. Our success depends on our ability to attract, train, motivate and retain highly skilled personnel within each of these areas of expertise. Qualified personnel in these areas are in great demand and are likely to remain a limited resource for the foreseeable future. We cannot assure you that we will be able to retain the skilled employees we require. In addition, the resources required to retain such personnel may adversely affect our operating margins. The failure to retain qualified personnel may harm our business. In particular, we maintain a large technical and support center in Jassy, Romania and have encountered many attempts from other technology companies to recruit our employees after we have trained them. If this phenomenon continues and increases, we may be forced to

raise the salaries of our Romanian employees and our results of operations will be harmed.

**Because a substantial majority of our revenues are generated outside of Israel, our results of operations could suffer if we are unable to manage international operations effectively.**

In 2005 and 2006, approximately 93% and 94% of our revenues, respectively, were generated outside of Israel. Our sales outside of Israel are made in more than 40 countries. We currently have sales and support offices located in Silver Spring, Maryland. In addition, we have a technical and support team in Jassy, Romania. We plan to establish additional facilities in other parts of the world, either through acquisitions or internal expansion based on market needs. The expansion of our existing international operations and entry into additional international markets will require significant management attention and financial resources. Our ability to penetrate some international markets may be limited due to different technical standards, protocols and requirements for our products in different markets. We cannot be certain that our investments in establishing facilities in other countries will produce desired levels of revenue. In addition, conducting our business internationally subjects us to a number of risks, including:

- staffing and managing foreign operations;
- increased risk of collection;
- potentially adverse tax consequences;
- the burden of compliance with a wide variety of foreign laws and regulations;
- burdens that may be imposed by tariffs and other trade barriers; and
- political and economic instability.

**Because some of our customers require a lengthy approval process before they order our products, our sales process is often subject to delays that may decrease our revenues and seriously harm our business.**

In 2006, we derived 86% of our revenues from the sale of software and related services to telecommunications service providers. Before we can sell our software to some of these customers, they conduct a lengthy and complex approval and purchasing process. The following factors, among others, affect the length of the approval process:

- the time required for our customers to determine and announce their specifications;
- the time required for the customer to receive the internal approvals necessary in order for it to commit significant resources towards acquisition of the billing solution;
- the build-up of the customer's network infrastructure; and
- the timely release of new versions of products comprising enhanced functionality, specifically requested by the customer.

Additional delays in product approval may decrease our revenues and could seriously harm our business and results of operations.

**A slow down in expenditures by telecommunications service providers could have a material adverse effect on our results of operations.**

There is a global uncertainty with respect to the direction of the economy and the telecommunications market. Many new and small service providers have failed and existing service providers have been reducing or delaying expenditures on new equipment and applications. A continuation of such delays or a decline in capital expenditures by telecommunications service providers may reduce our sales and could result in additional pressure on the price of our products, both of which would have a material adverse effect on our operating results.

**If we are unable to compete effectively in the marketplace, we may suffer a decrease in market share, revenues and profitability.**

Competition in our industry is intense and we expect competition to increase. We compete both with established global billing companies such as Comverse (after the acquisition by Comverse of the Global Software Services division of CSG Systems International) and Convergys Corporation (after the acquisition of Geneva Technology by Convergys) as well as with local billing companies. Some of our competitors have greater financial, technical, sales, marketing and other resources, and greater name recognition than we do. Current and potential competitors have established, and may establish in the future, cooperative relationships among themselves or with third parties to increase their ability to address the needs of prospective customers. Accordingly, new competitors or alliances among competitors may emerge and rapidly acquire significant market share. As a result, our competitors may be able to adapt more quickly than us to new or emerging technologies and changes in customer requirements, and may be able to devote greater resources to the promotion and sale of their products. We cannot guarantee that we will be able to compete effectively against current or future competitors or that competitive pressure will not harm our financial results.

**Our revenues and operating results may vary significantly from quarter to quarter.**

Our revenues and operating results may vary significantly from quarter to quarter due to a number of factors, including the following:

- the timing of orders for our software may be delayed as customers typically order our billing and customer care software only after other vendors have provided the network infrastructure, a process that is subject to delay. It is therefore difficult for us to predict the timing of orders for our products by customers;
- the ability of our customers to expand their operations and increase their subscriber base, including their ability to obtain financing;
- changes in our pricing policies or competitive pricing by our competitors; and
- the timing of product introductions by competitors.

In future quarters, our operating results may be below the expectations of public market analysts and investors, and as a result, the price of our ordinary shares may fall.

**The customer base for our traditional wireline and wireless billing and customer care products is characterized by small to medium size telephony carriers. If this market segment fails to grow, the demand for our billing and customer care software would diminish substantially.**

Our traditional wireline and wireless billing and customer care products target small to medium size telephony carriers. Our growth in this field depends on continued growth of these traditional telephony carriers. We cannot be certain that small to medium size telephony carriers will be able to successfully compete with large telephony carriers in existing markets or will successfully develop in new and emerging markets. If this market segment fails to grow, the demand for our billing and customer care software would diminish substantially and our business would suffer. In addition, there may never be significant demand for new billing and customer care software by providers of traditional



services.

**From time to time, our software and the systems into which it is installed contain undetected errors. This may cause us to experience a significant decrease in market acceptance and use of our software products and we may be subject to warranty and other liability.**

From time to time, our software, as well as the systems into which it is integrated, contain undetected errors. Because of this integration, it can be difficult to determine the source of the errors. Also, from time to time, hardware systems we resell contain certain defects or errors. As a result, and regardless of the source of the errors, we could experience one or more of the following adverse results:

- diversion of our resources and the attention of our personnel from our research and development efforts to address these errors;
- negative publicity and injury to our reputation that may result in loss of existing or future customers; and
- loss of or delay in revenue and loss of market share.

In addition, we may be subject to claims based on errors in our software or mistakes in performing our services. Our licenses and agreements generally contain provisions such as disclaimers of warranties and limitations on liability for special, consequential and incidental damages, designed to limit our exposure to potential claims. However, not all of our contracts contain these provisions and we cannot assure you that the provisions that exist will be enforceable. In addition, while we maintain product liability and professional indemnity insurance, we cannot assure you that this insurance will provide sufficient, or any, coverage for these claims. A product liability or professional indemnity claim, whether or not successful, could adversely affect our business by damaging our reputation, increasing our costs, and diverting the attention of our management team.

**Our business may be negatively affected by exchange rate fluctuations.**

Although most of our revenues are denominated in U.S. dollars, approximately 40% of our expenses are incurred in New Israeli Shekels, or NIS. As a result, we may be negatively affected by fluctuations in the exchange rate between the Euro or the NIS and the U.S. dollar. For example, in 2006, the value of the U.S. dollar decreased in relation to the NIS by 8.2%, while inflation decreased by only 0.1%. As a result, our salary expenses, which are primarily linked to the NIS, increased in U.S. dollar terms. We cannot predict any future trends in the rate of inflation in Israel or the rate of devaluation or appreciation of the NIS against the U.S. dollar. If the U.S. dollar cost of our operations in Israel increases, our U.S. dollar-measured results of operations will be adversely affected. In addition, devaluation in the Euro or local currencies of our customers relative to the U.S. dollar could cause customers to decrease or cancel orders or default on payment. We may choose to limit these exposures by entering into hedging transactions. However, hedging transactions may not enable us to avoid exchange-related losses, and our business may be harmed by exchange rate fluctuations. The imposition of price or exchange controls or other restrictions on the conversion of foreign currencies could affect our ability to collect payments, which in turn, could have a material adverse effect on our results of operations and financial condition.

**If our products fail to achieve widespread market acceptance, our results of operations will be harmed.**

Our future growth depends on the continued commercial acceptance and success of our products. We first introduced our billing and customer care software for Voice over IP in 1997 and since then we have developed new versions that offer mediation, rating, billing and customer care for multiple services. Accordingly, we cannot be sure that our products will achieve widespread market acceptance. Our future performance will depend on the successful development, introduction and consumer acceptance of new and enhanced versions of our products. We are not certain that we will be able to develop new and enhanced products to meet changing market needs. If our new and enhanced

products are not well received in the marketplace, our business and results of operations will be harmed. We cannot assure you that we will be successful in developing and marketing new products.

**We depend on our marketing alliances and reseller arrangements with manufacturers of telecommunications equipment to market our products. If we are unable to maintain our existing marketing alliances, or enter into new alliances, our revenues and income will decline.**

We have derived, and anticipate that we will continue to derive, a significant portion of our market opportunities and revenues from our marketing alliances and reseller arrangements with major manufacturers of telecommunications equipment, including Alcatel, Cisco, Lucent and Siemens, which market or recommend our products to their customers. Our marketing alliances and reseller arrangements with these parties are nonexclusive and do not contain minimum sales or marketing performance requirements. In some instances, there is no formal contractual arrangement. As a result, these entities may terminate these arrangements without notice, cause or penalty. There is also no guarantee that any of these parties will continue to market our products. Our arrangements with our resellers and marketing allies do not prevent them from selling products of other companies, including products that compete with ours. Moreover, our marketing allies and resellers may develop their own internal mediation, rating, billing and customer care software products that compete with ours and sell them as part of their equipment. If we are unable to maintain our current marketing alliances and reseller relationships, or if these marketing allies and resellers develop their own competing mediation, rating, billing and customer care software products, our revenues and income will decline.

**If our software does not continue to integrate and operate successfully with the telecommunications equipment of the leading manufacturers, we may be unable to maintain our existing customer base and/or generate new sales.**

The success of our software depends upon the continued successful integration and operation of our software with the telecommunications equipment of the leading manufacturers. We currently target a customer base that uses a wide variety of network infrastructure equipment and software platforms, which are constantly changing. In order to succeed, we must continually modify our software as new telecommunications equipment is introduced. If our product line fails to satisfy these demanding and rapidly changing technological challenges, our existing customers will be dissatisfied. As a result, we may be unable to generate future sales and our business will be materially adversely affected.

**We depend on a limited number of key personnel who would be difficult to replace. If we lose the services of these individuals, our business will be harmed.**

Because our market is new and evolving, the success of our business depends in large part upon the continuing contributions of our senior management. Specifically, continued growth and success largely depend on the managerial and technical skills of Monica Eisinger, our President and Chief Executive Officer and one of our founders, and other members of senior management. Because the demand for highly qualified senior personnel exceeds the supply of this type of personnel, it will be difficult to replace members of our senior management if one or more of them were to leave us. If either Ms. Eisinger or other members of the senior management team are unable or unwilling to continue their employment with our company, our business will be harmed.

**Our success depends on our ability to continually develop and market new and more technologically advanced products and enhancements.**

The market for our products and the services they are used to support is characterized by:

- rapid technological advances like the development of new standards for communications protocols;

- frequent new service offerings and enhancements by our customers, such as value-added IP-based services and new rating plans; and
- changing customer needs.

We believe that our future success will largely depend upon our ability to continue to enhance our existing products and successfully develop and market new products on a cost-effective and timely basis. We cannot assure you that we will be successful in developing and marketing new products that respond adequately to technological change. Our failure to do so would have a material adverse effect on our ability to market our own products.

**If our billing and customer care software for IP services fails to achieve market acceptance among traditional telecommunications service providers, we may suffer a decrease in market share, revenues and profitability.**

We believe that as the demand for IP services grows, traditional telecommunications service providers will increasingly offer IP services to remain competitive and these providers will constitute a growing portion of the IP services market. These companies already have relationships with traditional billing and customer care software providers for their telephony services, and may wish to work with their current providers of billing and customer care software to enhance and modify that software for IP services. If our billing and customer care software for IP services fails to achieve market acceptance among traditional telecommunications service providers, we may suffer a decrease in market share, revenues and profitability.

**If we are unable to adequately protect our intellectual property or become subject to a claim of infringement, our business may be materially adversely affected.**

Our success and ability to compete depend substantially upon our internally developed or acquired technology. Any misappropriation of our technology could seriously harm our business. In order to protect our technology and products, we rely on a combination of trade secret, copyright and trademark law. Despite our efforts to protect our intellectual property rights, unauthorized parties may attempt to copy or otherwise obtain and use our software or technology or to develop software with the same functionality. Policing unauthorized use of our products is difficult and we cannot be certain that the steps we have taken will prevent misappropriation, particularly in foreign countries where the laws may not protect our intellectual property rights as fully as in the United States.

If anyone asserts a claim against us relating to proprietary technology or information, we might seek to license his intellectual property or to develop non-infringing technology. We might not be able to obtain a license on commercially reasonable terms or on any terms. Alternatively, our efforts to develop non-infringing technology could be unsuccessful. Our failure to obtain the necessary licenses or other right or to develop non-infringing technology could prevent us from selling our software and could therefore seriously harm our business.

**Breaches in the security of the data collected by our systems could adversely affect our reputation and hurt our business.**

Customers rely on third-party security features to protect privacy and integrity of customer data. Our products may be vulnerable to breaches in security due to failures in the security mechanisms, the operating system, the hardware platform or the networks linked to the platform. All our solutions provide web access to information, presenting additional security issues for our customers. Security vulnerabilities could jeopardize the security of information stored in and transmitted through the computer systems of our customers. A party that is able to circumvent our security mechanisms could misappropriate proprietary information or cause interruptions in the operations of our customers. Security breaches could damage our reputation and product acceptance would be significantly harmed, which would cause our business to suffer.

**We have not yet completed our evaluation of our internal control over financial reporting under Section 404 of the Sarbanes-Oxley Act.**

We are considered a "non-accelerated filer" under applicable SEC rules. As such, we are required to comply with internal control evaluation and certification requirements of Section 404 of the Sarbanes-Oxley Act of 2002 in the following manner: (1) reporting by management under Section 404(a) of the Sarbanes-Oxley Act will be required for the fiscal year ending on December 31, 2007, and (2) attestation by our independent auditors under Section 404(b) of the Sarbanes-Oxley Act will be required for the fiscal year ending December 31, 2008. Accordingly, we have begun to evaluate whether our existing internal control over financial reporting system is compliant with Section 404. As a result of this evaluation, we may be required to implement new internal control procedures over financial reporting. We may also experience higher than anticipated operating expenses and fees in this context, additional commitment of management's time and may need to hire additional qualified personnel in order to achieve compliance with Section 404. If we are unable to implement these changes effectively or efficiently, or if our internal controls are found to be ineffective in future periods, it could harm our operations, financial reporting or financial results and could result in our being unable to obtain an unqualified report in internal controls from our independent auditor.

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

**Our share price has fluctuated and could continue to fluctuate significantly.**

The market for our ordinary shares, as well as the prices of shares of other technology companies, has been volatile. The price of our ordinary shares has fluctuated significantly since our initial public offering in August 2000. A number of factors, many of which are beyond our control, may cause the market price of our ordinary shares to fluctuate significantly, such as:

- fluctuations in our quarterly revenues and earnings and those of our publicly held competitors;
- shortfalls in our operating results from the levels forecast by securities analysts;
- public announcements concerning us or our competitors;
- changes in pricing policies by us or our competitors;
- market conditions in our industry; and
- the general state of the securities market (particularly the technology sector).

We do not control these matters and any of them may adversely affect our business internationally. In addition, trading in shares of companies listed on the Nasdaq Global Market in general and trading in shares of technology companies in particular has been subjected to extreme price and volume fluctuations that have been unrelated or disproportionate to operating performance. These broad market and industry factors may depress our share price, regardless of our actual operating results.

**Substantial sales of our ordinary shares could adversely affect our share price**

Sales of a substantial number of our ordinary shares could adversely affect the market price of our ordinary shares. Given the likely volatility that exists for our ordinary shares, such sales could cause the market price of our ordinary shares to decline.

As of June 1, 2007, we had 21,592,510 outstanding ordinary shares, of which approximately 17 million ordinary shares were freely tradable without restriction or further registration under the federal securities laws unless purchased

by our "affiliates", as that term is defined in Rule 144 under the Securities Act. As of June 1, 2007, there were outstanding options to purchase a total of 1,114,010 ordinary shares, of which 447,010 were vested. We were also authorized to grant options to purchase 2,215,700 additional ordinary shares. We have filed a registration statement on Form S-8 covering all of the ordinary shares issuable upon the exercise of options under our stock option plans, at which time these shares will be immediately available for sale in the public market, subject to the terms of the related options.

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

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

**Risks Relating to Our Location in Israel**

**Potential political, economic and military instability in Israel may harm our operating results.**

We are organized under the laws of the State of Israel and a substantial portion of our assets and our principal operations, are located in Israel. Accordingly, our operations, financial position and operating results are directly influenced by economic, political and military conditions in and relating to Israel. Since the establishment of the State of Israel in 1948, a condition of hostility, varying in degree and intensity, has led to security and economic problems for Israel. Since October 2000, there has been a high level of violence between Israel and the Palestinians which has strained Israel's relationship with its Arab citizens, Arab countries and, to some extent, with other countries around the world. The establishment in early 2006 of a government in the Palestinian Authority by representatives of the Hamas militant group has created additional unrest and uncertainty in the region. Further, in the summer of 2006, Israel fought a war against Hezbollah, a Lebanon-based Islamist Shiite militia group, which involved thousands of missile strikes and disrupted most day-to-day civilian activity in northern Israel. Any armed conflicts or political instability in the region could negatively affect business conditions and harm our results of operations. We cannot predict the effect on the region of the increase in the degree of violence between Israel and the Palestinians. Furthermore, several countries restrict business with Israel and Israeli companies, and additional countries may restrict doing business with Israel and Israeli companies as a result of the recent increase in hostilities. These restrictive laws and policies may seriously harm our operating results, financial condition or the expansion of our business. In addition, the current situation in Israel could adversely affect our operations if our customers and/or strategic allies believe that instability in the region could affect our ability to fulfill our commitments.

**We currently participate in or receive tax benefits from government programs. These programs require us to meet certain conditions and these programs and benefits may be terminated or reduced in the future.**

We receive tax benefits under Israeli law for capital investments, the Law for Encouragement of Capital Investments, 1959, as amended, or the Investments Law, that are designated as "Approved Enterprises". To maintain our eligibility for these tax benefits, we must continue to meet several conditions including making required investments in fixed assets. If we fail to comply with these conditions in the future, the tax benefits received could be cancelled. The termination or reduction of the tax benefits under the Investments Law could seriously harm our business, financial condition and operating results. For more information about Approved Enterprises, see Item 10.E "Taxation - Law for the Encouragement of Capital Investments, 1959" and Note 9 to our financial statements contained in Item 18.

**Because we have received grants from the Office of the Chief Scientist, we are subject to on-going restrictions that limit the transferability of our funded technology and of our right to manufacture outside of Israel any products developed with such technology, and certain of our large shareholders are required to undertake to observe such restrictions.**

We have received grants in the past from the Office of the Chief Scientist of the Israeli Ministry of Industry, Trade and Labor. According to Israeli law, generally, any products developed with grants from the Office of the Chief Scientist are required to be manufactured in Israel, unless we obtain prior approval of a governmental committee. In addition, we are prohibited from transferring out of Israel the know-how developed with these grants, without the prior approval of a governmental committee. Approval is not required for the sale or export of any products resulting from the funded know-how. Any shareholder who becomes a controlling shareholder of our company or any non-Israeli who becomes a direct holder of 5% or more of our outstanding ordinary shares will be required to notify the Office of the Chief Scientist and to undertake to observe the law governing the grant programs of the Office of the Chief Scientist, the principal restrictions of which are described above in this paragraph.

**Our operating results may be negatively affected by the obligation of some of our key personnel to perform military service.**

Some of our executive officers and employees in Israel are obligated to perform military reserve duty, which could accumulate annually from several days to up to two months in special cases and circumstances. The length of such reserve duty depends, among other factors, on an individual's age and prior position in the army. In addition, if a military conflict or war occurs, these persons could be required to serve in the military for extended periods of time. Our operations could be disrupted by the absence for a significant period of one or more of our executive officers or key employees due to military service. Any disruption in our operations would harm our business.

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

We are incorporated in the State of Israel. Substantially most of our executive officers and directors 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. We have been informed by our legal counsel in Israel that it may be difficult to bring original actions in Israel to enforce civil liabilities under the Securities Act and the Exchange Act. Israeli courts may refuse to hear a claim based on a violation of U.S. securities laws because Israel is not the most appropriate forum to bring such a claim. In addition, even if an Israeli court agrees to hear a claim, it may determine that Israeli law and not U.S. law is applicable to the claim. If U.S. law is found to be applicable, the content of applicable U.S. law must be proved as a fact, which can be a time-consuming and costly process. Certain matters of procedure will also be governed by Israeli law. There is little binding case law in Israel addressing these matters.

Subject to specified time limitations and legal procedures, under the rules of private international law currently prevailing in Israel, Israeli courts may enforce a United States final judgment in a civil matter, including judgments based upon the civil liability provisions of the U.S. securities laws and including a monetary or compensatory judgment in a non-civil matter, provided that:

- the judgment is enforceable in the state in which it was given;
- adequate service of process has been effected and the defendant has had a reasonable opportunity to present his arguments and evidence;
- the judgment and the enforcement thereof are not contrary to the law, public policy, security or sovereignty of the State of Israel;

- the judgment was not obtained by fraud and does not conflict with any other valid judgment in the same matter between the same parties; and
- an action between the same parties in the same matter is not pending in any Israeli court at the time the lawsuit is instituted in the United States court.

Therefore, it may be difficult for a shareholder, or any other person or entity, to collect a judgment obtained in the United States against us or any of these persons, or to effect service of process upon these persons in the United States.

**Provisions of Israeli law and our articles of association may delay, prevent or make difficult a change of control and therefore may depress the price of our stock.**

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.

In particular, our articles of association provide that our board of directors will be divided into three classes that serve staggered three-year terms and authorize our board of directors to adopt protective measures to prevent or delay a coercive takeover, including without limitation the adoption of a "Shareholder Rights Plan". In addition, Israeli corporate law regulates mergers and acquisitions of shares through tender offers, requires approvals for transactions involving significant shareholders and regulates other matters that may be relevant to these types of transactions. See Item 10.B "Memorandum and Articles of Associations - Mergers and Acquisitions under Israeli Law." Furthermore, Israeli tax law treats stock-for-stock acquisitions between an Israeli company and a foreign company less favorably than does U.S. tax law. For example, Israeli tax law may subject a shareholder who exchanges his ordinary shares for shares in another corporation to taxation prior to the sale of the shares received in such stock-for stock swap.

**Item 5. Operating and Financial Review and Prospects**

The following discussion and analysis is based on and should be read in conjunction with our consolidated financial statements, including the related notes, contained in Item 18.

**Overview**

We were incorporated in Israel in 1995 and started providing our enterprise software products in that year. In 1997, we introduced our billing and customer care software for Voice over IP. We have enhanced our billing solutions since then to support multiple IP services, wireless and wireline carriers and multiple play (voice, data and content) service providers. In 2006, 85.6% of our revenues were derived from providing our billing and customer care software and 14.4% were derived from providing our enterprise software. In 2006, license fees represented 42.2% of our revenues and professional services represented 57.8%. In 2005 and 2006, no customer accounted for 10% or more of our total revenues. However, we expect to continue to derive sizeable revenues from a small number of changing customers.

In 2001, we acquired the VeraBill product line for billing and customer care for traditional tier 3 wireline and wireless service providers. In August 2005, we acquired Sentori Inc., a leading provider of billing and customer care solutions to tier 3 and tier 2 wireless carriers and mobile virtual network operators, or MVNOs, mainly in the United States and the Caribbean. We evaluate acquisition opportunities pro-actively, based on our long-term policy of growing the scale of our business and enhancing our offering through acquisitions that are expected to enhance shareholder value.

In 2003 and 2004, we experienced quarterly sequential revenue growth and improved profitability and net income. Our revenue growth in 2004 was driven primarily by our winning larger projects than in the past, especially in Europe. In the first quarter of 2005, our revenue fell sharply to \$3.08 million from \$4.88 million in the previous quarter, due to loss of revenues caused by the cancellation of two large orders that we received in 2004 for reasons unrelated to us and in addition, the customer that represented 36% of our revenues in 2004, entered into a reorganization process and, as a result, the planned enhancements of our platform did not materialize. These three customers were expected to represent over 30% of our annual revenue. Consequently, our total 2005 revenue was lower than our 2004 revenue. In spite of the unexpected loss of revenue in first quarter of 2005, we succeeded in maintaining profitability and in showing sequential revenue growth for the four quarters thereafter. In 2006 we experienced significant growth in revenue driven primarily by our acquisition of Sentori in the third quarter of 2005, which strengthened our presence in the United States and in the mobile market generally.

As we increase our focus on end-to-end billing solutions for tier 2 and tier 3 service providers and our average deal size increases, our long-term business model changes as the professional services part of our business is increasing. An additional consequence is that projects are often now of a more complex nature, with revenue recognized over longer periods. These factors typically extend the recognition period of both license and service revenue streams and have some balance sheet impacts. We consider this a normal and expected development for our business as it grows and matures. In the last three years we significantly increased our professional services team to support the growth in services offered to customers. Since March 2002, we have deposited most of our cash in structured, callable time deposits. Under the arrangements with the banks, whether or not the deposits bear interest depends upon the prevailing U.S. dollar LIBOR rate. Interest is payable in respect of days during which the rate is within a certain range and no interest is payable in respect of days during which it exceeds the range. Until May 2005, we achieved relatively high interest rates of over 7% per annum. Since May 2005, due to the increase of the six-month LIBOR rate, the deposits did not bear interest, causing our financial income to decrease substantially starting in the third quarter of 2005. In the second quarter of 2006, we withdrew two of our three structured deposits in the aggregate amount of \$20 million. The financial expenses arising from the early redemption of these two deposits were \$1.33 million. In the fourth quarter of 2006 the third and last structured deposit in the amount of \$10 million was released with no penalty. Since December 2006, all our funds are invested in risk-free bank deposits and investment grade, interest-bearing bonds or debentures. See below under Item 5.B - "Liquidity and Capital Resources" for more information.

In July 2003, we adopted a dividend policy, according to which we declare, subject to specific board approval and applicable law, a dividend distribution once per year, in the amount of our net income from the previous year. Additionally the board approved dividend distributions in 2003 and 2007 that were subject to approvals from an Israeli Court in accordance with Section 303 of the Israeli Companies Law due to the fact that we did not have sufficient retained earnings. Since 2003 the Company distributed cash dividends of approximately \$0.85 per share to its shareholders: \$0.14 per share in 2003, \$0.13 per share in 2004, \$0.24 per share in 2005, \$0.14 per share in 2006 and \$0.20 per share in 2007. The board decision to approve the annual distribution is based, among other factors, on our cash position at that time, potential acquisitions and future cash needs. The board may decide to discontinue the dividend distribution in whole or in part at any time.

*Revenues.* We are paid license fees by our customers for the right to use our products, based on (1) traffic volume, which is measured by factors such as minutes per month, number of lines used, number of data sources and number of subscribers, and (2) the functionality of the system based on application modules that are added to the software. In relation to our professional services, other than maintenance services, we mainly quote a fixed price based on the type of service offered, estimated direct labor costs and the expenses that we will incur to provide these services. Fees for maintenance services are based on a fixed percentage of the license fee and are paid annually, quarterly or monthly.

We primarily use two business models when we sell our solutions, the license model and the managed services model. In the license model, the customer pays a one-time implementation fee, a one-time license fee for a perpetual license limited by the traffic metrics chosen by the customer, and additional fees to expand the scale of the network supported by our software. In addition, we are paid maintenance fees to renew periodically the maintenance agreement at the



customer discretion. In the managed services model, the customer pays a one-time implementation fee, a monthly fee that includes a periodic license limited by the traffic metrics chosen by the customer, maintenance and services fees, and additional fees to expand the scale of the network supported by our software.

We provide a revenue breakdown for our billing and customer care software and our enterprise call management software. We believe that this information provides a better understanding of our performance and allows investors to make a more informed judgment about our business.

*Cost of Revenues.* The cost of revenues consists primarily of direct labor costs and overhead expenses related to software installation and maintenance. Cost of revenues also includes, among other things, software license fees to Oracle, hardware, amortization of intangible assets, packaging and shipping costs. Our cost of professional services revenues consists primarily of direct labor costs and travel expenses. Our revenues from the sale of our licenses have a higher gross margin than that from providing our professional services. We incur variable direct labor costs when we provide professional services. There is no comparable variable direct labor cost incurred when we license our software.

*Research and Development Expenses.* Our research and development expenses consist primarily of compensation, overhead and related costs for research and development personnel and depreciation of testing and other equipment. Research and development costs related to software products are expensed as incurred until the "technological feasibility" of the product has been established. Because of the relatively short time period between "technological feasibility" and product release, no software development costs have been capitalized. We expect to continue to make substantial investments in research and development.

*Selling and Marketing Expenses.* Our selling expenses consist primarily of compensation, overhead and related costs for sales and marketing personnel, the operation of international sales offices, sales commissions, marketing programs, public relations, promotional materials, travel expenses, trade shows and exhibition expenses.

*General and Administrative Expenses.* Our general and administrative expenses consist primarily of compensation, overhead and related costs for executives and administrative personnel, accounting, professional fees, insurance, provisions for doubtful accounts and other general corporate expenses.

*Financial Income (Expenses), net.* Our financial income (expenses), net consists primarily of interest earned on bank deposits, gains and losses from the conversion of monetary balance sheet items denominated in non-dollar currencies into U.S. dollars, net of financing costs, loss from withdrawal of long-term bank deposits and bank charges in real terms as well as the devaluation of monetary assets and monetary liabilities.

*Taxes on Income.* Israeli companies are generally subject to income tax at the corporate tax rate of 34% for the 2005 tax year, 31% for the 2006 tax year and 29% for the 2007 tax year. Following an amendment to the Israeli Income Tax Ordinance that came into effect on January 1, 2006, the corporate tax rate is expected to decrease as follows: 27% for the 2008 tax year, 26% for the 2009 tax year and 25% for the 2010 tax year and thereafter. However, Israeli Companies are generally subject to capital gains tax at a rate of 25% for capital gains, other than gains deriving from the sale of listed securities, derived after January 1, 2003. Substantially all of our facilities, however, have been granted "approved enterprise" status under the Law for the Encouragement of Capital Investments, 1959. Income derived from the approved enterprise is tax exempt for a period of ten years commencing in the first year in which we earn taxable income from the approved enterprise, since we have elected the "alternative benefits route" (involving a waiver of investment grants) and our approved enterprises are located in a preferred geographic location. In the event of distribution of cash dividends from income that was tax exempt, we would have to pay up to 25% tax in respect of the amount distributed. In February 2007, we finalized tax assessments for the tax years 2003 to 2005, which resulted in additional tax expenses in 2006 of approximately \$1.5 million.

## **A. Operating Results**

Edgar Filing: MIND CTI LTD - Form 20-F/A

The following discussion of our results of operations for 2004, 2005 and 2006, including the percentage data in the following table, is based upon our statements of operations contained in our financial statements for those periods, and the related notes, included in this annual report:

	Years ended December 31,		
	2004	2005	2006
Revenues:	100.0%	100.0%	100.0%
Cost of revenues	24.7	25.7	28.3
Gross profit	75.3	74.3	71.7
Research and development expenses	21.5	32.6	30.5
Selling, general and administrative expenses:			
Selling and marketing expenses	25.4	13.8	18.1
General and administrative expenses	10.4	9.7	10.6
Operating Income	18.0	18.2	12.5
Financial income (expenses) - net	21.5	8.1	(1.1)
Income before taxes on income	39.5	26.3	11.4
Taxes on income	0.9	0.3	6.8
Net income	38.6	26.0	4.6

*Comparison of 2004, 2005 and 2006*

*Revenues*

	Years ended December 31, (\$ in millions)			% Change 2005 vs. 2004	% Change 2006 vs. 2005
	2004	2005	2006		
License sales	11.7	7.4	8.5	(36.6)	14.1
Professional services	6.1	8.2	11.6	34.0	41.7
Total revenues	17.8	15.6	20.1	(12.4)	28.6

Revenues in 2005 decreased in comparison to 2004 due to the unexpected cancellation of large orders from two customers and due to the cancellation of the planned orders from our largest customer (that represented 36% of our revenues in 2004) in the first quarter of 2005. Our revenues in 2006 in comparison to 2005 increased by 28.6% mainly because of the acquisition of Sentori, which strengthened our presence in the United States and in the mobile market generally. Revenues from our billing and customer care product solutions for service providers decreased from \$15.2 million in 2004 to \$12.7 million in 2005 and increased to \$17.2 million in 2006. Revenues from our enterprise products increased from \$2.6 million in 2004 to \$2.9 million in 2005 and remained almost unchanged from 2005 to 2006. The increase from 2004 to 2005 was driven primarily by our winning larger projects.

Revenues from professional services as a percentage of total revenues increased from 34% in 2004 to 52% in 2005 due to the lower 2005 revenue and further increased to 58% in 2006 as a result of the growth in our customer base that provides more maintenance revenues and as a result of our focus on larger deals, which are often of a more complex nature and require more professional services.

The following table presents the geographic distribution of our revenues:

Edgar Filing: MIND CTI LTD - Form 20-F/A

Years ended December 31,

	2004	2005	2006
The Americas	11.1%	35.6%	48.1%
Asia Pacific and Africa	16.1	17.3	8.1
Europe	67.5	40.3	38.3
Israel	5.3	6.8	5.5
Total	100.0%	100.0%	100.0%

Our sales in the Americas steadily increased between 2004 and 2006 as the result of our acquisition of Sentori in the third quarter of 2005 which strengthened our presence in the United States and in the mobile market generally. Our sales in Europe decreased in 2005 due to the fact that a customer which represented 36% of our revenues in 2004 entered into a reorganization process and, as a result, the planned enhancement of our platform did not materialize.

*Cost of Revenues*

	Years ended December 31, (\$ in millions)			% Change	% Change
	2004	2005	2006	2005 vs. 2004	2006 vs. 2005
Total cost of revenues	4.4	4.0	5.7	(8.6)	41.3

The decrease in 2005 in our cost of revenues was mainly due to the decrease in revenues, which in turn caused a decrease in the cost of revenue related to third parties, offset by an increase in the cost of employment. The increase in our cost of revenues in 2006 was primarily due to the increase in our revenues from professional services (as explained above) and due to the continued increase in employee payroll costs, driven by an increase in the cost of employment per employee as well as an increase in the total number of employees engaged in support and maintenance.

Gross profit as a percentage of revenues decreased from 75.3% in 2004 to 74.3% in 2005 and to 71.7% in 2006, due to the increase in our revenues from professional services as a percentage of total revenues as well as the increase in employee payroll costs, driven by the continued increase in the cost of employment per employee as well as an increase in the total number of employees engaged in support and maintenance.

*Operating Expenses*

	Years ended December 31, (\$ in millions)			% Change	% Change
	2004	2005	2006	2005 vs. 2004	2006 vs. 2005
Research and development	3.8	5.1	6.1	32.7	20.3
Selling and marketing	4.5	2.1	3.6	(52.4)	68.9
General and administrative	1.9	1.5	2.1	(18.8)	41.7

*Research and Development.* We make substantial investment in research and development to maintain our advanced technology and add functionality to our products. The increase in 2005 and 2006 in our research and development expenses was primarily due to an increase in the cost attributable to payroll and related expenses of our employees engaged in research and development resulting from an increase in the salary per employee and an increase in the total number of employees engaged in research and development. Research and development expenses as a percentage of revenues increased from 21.5% in 2004 to 32.6% in 2005 and slightly decreased to 30.5% in 2006. The increase between 2004 and 2005 was due to an increase of research and development expenses accompanied by a decrease in

revenues. The decrease between 2005 and 2006 was due to an increase in revenues in excess of the increase in research and development expenses.

*Selling and Marketing Expenses.* Selling and marketing expenses substantially decreased from \$4.5 million in 2004 to \$2.1 million in 2005, primarily reflecting a decrease in commission expenses (normally incurred as a percentage of revenue), as a result of the decrease in revenues in 2005. In 2006 selling and marketing expenses increased to \$3.6 million mainly due to a significant increase of our sales teams (especially in the United States as a result of the acquisition of Sentori), and due to an increase in commission expenses as the result of the increase in revenues. Selling and marketing expenses as a percentage of revenues decreased from 25.4% in 2004 to 13.8% in 2005 due to a decrease in expenses in excess of the decrease in revenues. Selling and marketing expenses as percentage of revenues increased to 18.1% in 2006 due to an increase in selling and marketing expenses in excess of the increase of revenues.

*General and Administrative Expenses.* General and administrative expenses decreased from \$1.9 million in 2004 to \$1.5 million in 2005 and increased to \$2.1 million in 2006. The decrease between 2004 and 2005 was mainly because of a decrease in the allowance for doubtful accounts. The increase between 2005 and 2006 was mainly due to additional professional services, mainly legal.

*Financial Income (Expenses).* Financial income decreased from \$3.8 million in 2004 to \$1.3 million in 2005. This decrease resulted from the increase in the rate of the six-month LIBOR, which resulted in our three long-term bank deposits ceasing to bear interest starting in May 2005. We did not receive any interest on deposits in the aggregate amount of \$30 million until June 2006, and we did not receive any interest on a deposit in the amount of \$10 million from June thru December 2006. Financial income further decreased from \$1.3 million in 2005 to financial expenses of \$0.2 million in 2006. This decrease resulted mainly from a one-time penalty in the amount of approximately \$1.3 million for premature withdrawal of two of our three deposits. See also below Item 5.B Liquidity and Capital Resources - Cash Deposits.

#### *Corporate Tax Rate*

The general corporate tax rate in Israel is 34% for the 2005 tax year, 31% for the 2006 tax year and 29% for the 2007 tax year. Following an amendment to the Israeli Income Tax Ordinance that came into effect on January 1, 2006, the corporate tax rate is expected to decrease as follows: 27% for the 2008 tax year, 26% for the 2009 tax year and 25% for the 2010 tax year and thereafter. However, Israeli companies are generally subject to capital gains tax at a rate of 25% for capital gains, other than gains deriving from the sale of listed securities, derived after January 1, 2003. Our effective tax rate, however, was 1% in 2004, 1% in 2005 and 3% in 2006 (before taking in consideration the one-time tax expenses in 2006 resulting from the finalization of the tax assessment for tax years 2003 to 2005). We experienced the lower effective tax rates in 2004 and 2005 primarily because of tax reductions to which we are entitled under Israel's Law for Encouragement of Capital Investments, 1959. In February 2007 we finalized tax assessments for the tax years 2003 to 2005 which resulted in an additional tax expense in 2006 of approximately \$1.5 million. We cannot assure you that the low effective tax rates in 2004, 2005 and 2006 will be available for us in the future. For more information about the taxes to which we are subject, see above under the caption "Overview - Taxes on Income" and below under Item 10.E "Taxation."

#### *Critical Accounting Policies*

To improve understanding of our financial statements, it is important to obtain some degree of familiarity with our critical or principal accounting policies. These policies are described in note 1 to the consolidated financial statements contained in Item 18. We review our accounting policies annually to ensure that the financial statements developed, in part, on the basis of these accounting policies provide complete, accurate and transparent information concerning the financial condition of our company. As part of this process, we reviewed the selection and application of our critical accounting policies and financial disclosures as of December 31, 2006, and we believe that the consolidated financial statements contained in Item 18 present fairly, in all material respects, the consolidated financial position of our

company as of that date.

In preparing our financial statements in accordance with generally accepted accounting policies in the United States of America, our management must often make estimates and assumptions which may affect the reported amounts of assets, liabilities, revenues, expenses and related disclosures as of the date of the financial statements and during the reporting period. Some of those judgments can be subjective and complex, and consequently actual results may differ from those estimates. For any given individual estimate or assumption made by our management, there may be alternative estimates or assumptions which are also reasonable. However, we believe that, given the facts and circumstances before our management at the time of making the relevant judgments, estimates or assumptions, it is unlikely that applying any such other reasonable judgment would cause a material adverse effect on the consolidated results of operations, financial position or liquidity for the periods presented in the consolidated financial statements included in this annual report.

We are also subject to risks and uncertainties that may cause actual results to differ from estimates and assumptions, such as changes in the economic environment, competition, customer claims, foreign exchange, taxation and governmental programs. Certain of these risks, uncertainties and assumptions are discussed under the heading Cautionary Statement Regarding Forward-Looking Information and in Item 3.D - Risk Factors.

We consider our most significant accounting policies to be those discussed below:

*Revenue Recognition* We apply the provisions of Statement of Position 97-2 of the American Institute of Certified Public Accounts ("SOP 97-2"), "Software Revenue Recognition" and Statement of Position 81-1 ("SOP 81-1") "Accounting for performance of construction type and certain production type contracts", as follows:

*i) Sales of licenses:* Revenue from sale of products is recognized when delivery has occurred, persuasive evidence of an arrangement exists, the sales price is fixed or determinable and collection is probable. Customization of the product, if any, is performed before delivery occurs. If collection is not considered probable, revenue is recognized when the fee is collected.

We generally do not grant a right of return on products sold to customers, distributors and resellers. In the event the right of return is granted, revenue is recognized after such right has expired.

*ii) Services:* The services we provide consist of implementation, training, hardware installation, maintenance, support, managed services and project management.

All services are priced on a fixed price basis and are recognized ratably over the period in which the services are provided except services which are recognized under the percentage-of-completion method as described below.

Revenues from managed services include a monthly fee for services and for right of use and are recorded as service revenues and license revenues, respectively. The monthly fee is based on number of subscribers and the agreements include a minimum monthly charge. These revenues are recognized on a monthly basis.

Products are mainly supplied with maintenance and support services for a period of one year from delivery. When revenue on sale of the products is recognized, we defer a portion of the sales price and recognize it as maintenance and support service revenue ratably over the above period. The portion of the sales price that is deferred is determined based on the fair value of the service as priced in transactions in which we render solely maintenance and support services.

Where the services are considered essential to the functionality of the software products, both the software product revenue and the revenue related to the integration and implementation services are recognized under the percentage-of-completion method in accordance with SOP 81-1. We generally determine the

percentage-of-completion by comparing the costs incurred to date to the estimated total costs required to complete the project. When the estimate indicates that a loss will be incurred, such loss is recorded in the period identified. Significant judgments and estimates are involved in determining the percent complete of each contract. Different assumptions could yield materially different results.

*Provision for Doubtful Accounts.* The provision for doubtful accounts is for estimated losses resulting from the inability of our customers to make required payments. We regularly evaluate the adequacy of this provision by taking into account variables such as past experience, age of the receivable balance, and current economic conditions that may affect a customer's ability to pay. The use of different estimates or assumptions could produce different provision balances. If collection is not probable at the time the transaction is consummated, we do not recognize revenue until cash collection. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional provision for doubtful accounts may be required.

*Taxes on Income.*

Substantially all of our production facilities in Israel have been granted Approved Enterprise status under the Law for the Encouragement of Capital Investments, 1959. Income we have derived from the Approved Enterprise is tax exempt. In the event of distribution of cash dividends from tax-exempt income, we are required to pay up to 25% tax in respect of the amount distributed. For more information about Approved Enterprises, see Item 10.E "Taxation - Law for the Encouragement of Capital Investments, 1959" and Note 9 to our financial statements contained in Item 18.

In previous years, we did not provide for deferred taxes because we intended to reinvest the amounts of all such income and not to distribute dividends from such income. Commencing 2003, we changed our policy with regard to distribution of dividends out of earnings derived from tax-exempt income.

Due to the accumulated tax losses, no additional tax liability will be incurred by the Company as a result of dividend distribution from the balance of undistributed income.

*Recently Issued Accounting Pronouncements.*

Recently issued accounting pronouncements are described in note 1 paragraph t to the consolidated financial statements contained in Item 18.

*Our Functional Currency*

The currency of the primary economic environment in which we operate is the U.S. dollar. In 2006, approximately 94% of our revenues were derived from sales outside Israel, which were denominated primarily in U.S. dollars. In addition, most of our marketing costs are incurred outside Israel, primarily in U.S. dollars. Transactions and balances originally denominated in U.S. dollars are presented at their original amounts. Balances in non-dollar currencies are remeasured into U.S. dollars using historical and current exchange rates for non-monetary and monetary balances, respectively. For non-dollar transactions and other items reflected in our income statements, the following exchange rates are used:

- for transactions, exchange rates at the transaction dates or average rates; and
- for other items (derived from non-monetary balance sheet items such as depreciation and amortization, changes in inventories or similar items), historical exchange rates.

The resulting currency transaction gains or losses are reported as financial income or expenses as appropriate.

*Impact of Foreign Currency Fluctuations on Results of Operations*

The U.S. dollar cost of our operations is influenced by the extent to which any inflation in Israel is offset, on a lagging basis, or is not offset by the devaluation of the NIS in relation to the U.S. dollar. When the rate of inflation in Israel exceeds the rate of devaluation of the NIS against the U.S. dollar, companies experience increases in the U.S. dollar cost of their operations in Israel. Unless offset by a devaluation of the NIS against the U.S. dollar, inflation in Israel or weakening of the U.S. dollar in global markets will have a negative effect on our profitability as we receive payment in U.S. dollars for most of our sales while we incur a portion of our expenses, principally salaries and related personnel expenses, in NIS.

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

<u>Years ended December 31,</u>	<u>Israeli Inflation Rate</u>	<u>Israeli Devaluation Rate</u>	<u>Israel Inflation Adjusted for Devaluation</u>
2002	6.5	7.3	(0.8)
2003	(1.9)	(7.6)	5.7
2004	1.2	(1.6)	2.8
2005	2.4	6.8	(4.4)
2006	(0.1)	(8.2)	(8.1)

We cannot assure you that we will not be materially and adversely affected in the future if inflation in Israel exceeds the devaluation of the NIS against the U.S. dollar or if the timing of the devaluation lags behind inflation in Israel.

A devaluation of the NIS in relation to the U.S. dollar has the effect of reducing the U.S. dollar amount of any of our expenses or liabilities which are payable in NIS, unless these expenses or payables are linked to the U.S. dollar. This devaluation also has the effect of decreasing the U.S. dollar value of any asset, which consists of NIS or receivables payable in NIS, unless the receivables are linked to the U.S. dollar. Conversely, any increase in the value of the NIS in relation to the U.S. dollar has the effect of increasing the U.S. dollar value of any unlinked NIS assets and the U.S. dollar amounts of any unlinked NIS liabilities and expenses. Because exchange rates between the NIS and the U.S. dollar fluctuate continuously, exchange rate fluctuations and especially larger periodic devaluations will have an impact on our profitability and period-to-period comparisons of our results. The effects of foreign currency re-measurements are reported in our consolidated financial statements in current operations.

## **B. Liquidity and Capital Resources**

Since our inception, we have financed our operations mainly through cash generated by operations. We supplemented this source by two private rounds of equity financing, the first in 1997 (with a follow-on in 1999) and the second in 2000 and our initial public offering in 2000, which raised total net proceeds in the amount of \$44.3 million.

As of December 31, 2006, we had approximately \$37.6 million in cash, cash equivalents, short-term investments and long-term marketable debentures, and our working capital was \$28.9 million. In our opinion, our working capital is sufficient for our requirements for the foreseeable future.

*Net Cash Provided by/Used in Operating Activities.* Net cash provided by operating activities in 2004 was \$7.7 million, attributable to our net income of \$6.9 million and non-cash related items, net, in the amount of \$0.9 million, offset by a net decrease in operating assets and liabilities items in the amount of \$0.1 million. Net cash provided by operating activities in 2005 was \$0.9 million, attributable to our net income of \$4.1 million and non-cash related items, net, in the amount of \$0.8 million, offset by a net decrease in operating assets and liabilities items in the amount of \$4.0 million. Net cash provided by operating activities in 2006 was \$0.6 million, attributable to our net income of \$0.9 million and non-cash related items, net, in the amount of \$1.6 million, offset by a net decrease in operating assets and liabilities items in the amount of \$1.9 million.

*Cash Deposits.* Since March 2002, we have deposited most of our cash in structured, callable time deposits. Under the arrangements with the banks, whether or not the deposits bear interest depends upon the prevailing U.S. dollar LIBOR

rate. Interest is payable in respect of days during which the rate is within a certain range and no interest is payable in respect of days during which it exceeds the range. Until May 2005, we achieved relatively high interest rates of over 7% per annum. Starting in May 2005, due to the increase of the six-month LIBOR rate, the deposits did not bear interest, causing our financial income to decrease substantially starting in the third quarter of 2005. In the second quarter of 2006, we withdrew two of our three structured deposits accounts in the amount of \$20 million. The financial expenses arising from the early redemption of these two deposits were \$1.33 million. In the fourth quarter of 2006, the third and last structured deposit in the amount of \$10 million was released with no penalty.

In December 2006 we purchased marketable debentures in the amount of \$10 million for 54 months. The debentures mature in one settlement in 2011 and the issuer has a call option in December 2007. The debentures bear interest at an annual rate of 5.4% and are presented in our balance sheet among the investment and other non-current assets.

At December 31, 2006, we had investments in auction rate securities in the amount of \$22.8 million, bearing interest at an annual rate of 5.34% and presented in our balance sheet as current assets.

In accordance with our existing cash management policy, all our funds are currently invested in risk-free bank deposits and interest-bearing, investment grade bonds or debentures.

*Net Cash Provided by/Used in Investing Activities.* During 2004, 2005 and 2006, our principal investment activity was long-term bank deposits, short-term investments and marketable debentures. In 2005 we also used \$4.2 million for the acquisition of Sentori, Inc.

*Net Cash Provided by/Used in Financing Activities.* In 2004, our financing activities used \$2.2 million due to a cash dividend of \$2.7 million, offset by \$0.5 million in proceeds from the exercise of employee stock options. In 2005, our financing activities used \$4.8 million due to a cash dividend of \$5.1 million, offset by \$0.3 million in proceeds from the exercise of employee stock options. In 2006, our financing activities used \$2.9 million due to cash dividend of \$3.0 million, offset by \$0.1 million in proceeds from the exercise of employee stock options.

*Capital Expenditures.* During 2004, 2005 and 2006, the aggregate cash amounts of our capital expenditures were \$1.2 million, \$0.6 million and \$0.4 million, respectively. These expenditures were principally for the purchase of property and other equipment. Although we have no material commitments for capital expenditures, we anticipate an increase in capital expenditures if we decide to construct a building for our office in Romania or if we purchase or merge with companies or purchase assets in order to obtain complementary technology and to expand our product offerings, customer base and geographical presence.

*Cash Dividends.* Since 2003 the Company distributed cash dividends of approximately \$0.85 per share to its shareholders: \$0.14 per share in 2003, \$0.13 per share in 2004, \$0.24 per share in 2005, \$0.14 per share in 2006 and \$0.20 per share in 2007. For information about our dividend policy, please see Item 8 - "Financial Information-Dividend Policy."

### **C. Research and Development, Patents and Licenses, etc.**

We believe that significant investment in research and development is essential for maintaining and expanding our technological expertise in the market for billing and customer care software and to our strategy of being a leading provider of new and innovative convergent billing products. We work closely with our partners, customers and distribution channels, who provide significant feedback for product development and innovation.

We have invested significant time and resources to create a structured process for undertaking research and product development. We believe that the method that we use for our product development and testing is well suited for identifying market needs, addressing the activities required to release new products, and bringing development projects to market successfully. Our product development activities also include the release of new versions of our



products. Although we expect to develop new products internally, we may, based upon timing and cost considerations, acquire or license technologies or products from third parties.

Our research and development personnel include engineers and software developers with experience in the development and design of billing and customer care software. As of December 31, 2006, our research and development department consisted of 182 employees out of a total of 317 employees.

#### D. Trend Information

Our billing and customer care solutions target tier 2 and tier 3 service providers. The need for comprehensive billing solutions is driven by the market trend that requires service providers to introduce new services more rapidly, to be innovative in creating new product offers and to optimize business processes for maximum efficiency. In this environment, flexible and stable billing software is seen as business critical. If a system fails, or service quality is degraded, it can be highly detrimental to both a carrier's ability to collect revenue and to its customer relations.

In our experience, the most active market lately is the Next Generation Network ("NGN") market. Many service providers are moving towards networks where IP-based equipment will carry a large proportion, and in some cases all, of their traffic. These NGNs offer cost savings over traditional switched networks, as well as the potential to offer new services like VoIP. We have a strong reputation in areas such as mediation and VoIP billing, and our products are designed to work with NGN's.

Integrating voice and data in enterprise switches (the IP private branch exchanges, or IP PBX's) is a trend in which we are participating. Our goal is to develop marketing and sales relationships with the vendors of IP PBX's such as Avaya, Cisco Systems and 3Com under which our enterprise software will be sold together with these vendors' systems. This requires us to develop new sales channels with the distributors of IP PBX's. This process is time consuming and requires the investment of some resources to conclude the necessary agreements and to certify and train these new channel partners.

#### E. Off-balance Sheet Arrangements

We do not have any off-balance sheet arrangements.

#### F. Tabular Disclosure of Contractual Obligations

Contractual Obligations	Payment due by period				
	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
Long-Term Debt Obligations	0	0	0	0	0
Capital (Finance) Lease Obligations	0	0	0	0	0
Operating Lease Obligations	\$ 1,556,000	\$ 613,000	\$ 943,000	0	0
Purchase Obligations	0	0	0	0	0
Other Long-Term Liabilities Reflected on our Balance Sheet under U.S. GAAP	0	0	0	0	0
Total	\$ 1,556,000	\$ 613,000	\$ 943,000	0	0

#### Item 11. Quantitative and Qualitative Disclosures about Market Risk

Market risk represents the risk of changes in the value of our financial instruments as a result of fluctuations in foreign currency exchange rates.

The following table sets forth our consolidated balance sheet exposure with respect to change in foreign currency exchange rates as of December 31, 2006.

**Currency**