MER TELEMANAGEMENT SOLUTIONS LTD
Form 20-F
March 30, 2007

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON D.C. 20549

FORM 20-F

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

OR

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

FOR THE FISCAL YEAR ENDED DECEMBER 31, 2006

OR

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

FOR THE TRANSITION PERIOD FROM __________ TO __________

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

Date of event requiring this shell company report.................

COMMISSION FILE NUMBER: 0-28950

MER TELEMANAGEMENT SOLUTIONS LTD.
(Exact Name of Registrant as specified in its charter and translation of Registrant's name into English)

ISRAEL
(Jurisdiction of incorporation or organization)

22 ZARHIN STREET, RA'ANANA 43662, 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
ORDINARY SHARES, NIS 0.1 PAR VALUE	NASDAQ CAPITAL MARKET

Securities registered or to be registered pursuant to Section 12(g) of the Act: NONE

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act: NONE

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:

ORDINARY SHARES, PAR VALUE NIS 0.01 PER SHARE............... 5,773,845
(as of December 31, 2006)

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

Yes [_] No [X]

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 [X]

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 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 [X]

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

Item 17 [_] Item 18 [X]

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 [X]

This Report on Form 20-F is incorporated by reference into our Form F-3 Registration Statement File No. 333-128225 and into our Form S-8 Registration Statements File No. 333-12014 and 333-123321.

INTRODUCTION

Mer Telemanagement Solutions Ltd. is a worldwide provider of solutions for telecommunications expense management, or TEM, used by enterprises, and business support systems, or BSS, used by information and telecommunication service providers, or ITSPs. Our TEM solutions assist enterprises and organizations to make smarter choices with their telecommunications spending at each stage of the service lifecycle, including allocation of cost, proactive budget control, fraud detection, processing of payments and spending forecasting. Our TEM solutions support our clients on an ongoing basis with both sophisticated software applications and a variety of managed services relationship models. Our converged BSS solutions for ITSPs have been successfully implemented worldwide by wireless providers, Voice over Internet Protocol, Internet Protocol Television, and content service providers. Our converged BSS solutions include charging and invoicing customers, interconnect billing and partner revenue management using pre-pay and post-pay schemes. Our pre-configured BSS solutions have been designed to be implemented quickly and are competitively priced.

Since our public offering in May 1997, our ordinary shares have been listed on the NASDAQ Stock Market (symbol: MTSL). As used in this annual report, the terms "we," "us" and "our" mean Mer Telemanagement Solutions Ltd. and its subsidiaries, unless otherwise indicated.

We have obtained a U.S. trademark registration for TABS by MER(R) and have common law rights in the trademarks TABS.IT, FACILITRAK, and PMSI, based on use of the marks in the United States. We have also acquired rights in the TOTAL-e(TM) trademark in connection with the products we acquired from Teleknowledge Group Ltd. in December 2004. Additionally, in connection with the assets we acquired from TelSoft Solutions, Inc. in July 2006, we have acquired the rights in the CALLTRAC(R) registered trademark and the common law trademarks and service marks TELSOFT SOLUTIONS, TELSOFT, MEGACALL, CALLTRAC LITE, MEGAPOLL, MEGABILL, MEGABILL-BACK and MEGASYNC. All other trademarks and trade names appearing in this annual report owned by their respective holders.

Our consolidated financial statements appearing in this annual report are prepared in U.S. dollars and in accordance with generally accepted accounting principles in the United States, or U.S. GAAP. All references in this annual report to "dollars" or "$" are to U.S. dollars and all references in this annual report to "NIS" are to New Israeli Shekels.

Statements made in this annual report concerning the contents of any contract, agreement or other document are summaries of such contracts, agreements or documents and are not complete descriptions of all of their terms. If we filed any of these documents as an exhibit to this annual report or to any registration statement or annual report that we previously filed, you may read the document itself for a complete description of its terms.

Except for the historical information contained in this annual report, the statements contained in this annual report are "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, and the Private Securities Litigation Reform Act of 1995, as amended, with respect to our business, financial condition and results of operations. Such forward-looking statements reflect our current view with respect to future events and financial results. We urge you to consider that statements which use the terms "anticipate," "believe," "do not believe," "expect," "plan," "intend," "estimate," "anticipate" and similar expressions are intended to identify forward-looking statements. We remind readers that forward-looking statements are merely predictions and therefore inherently subject to uncertainties and other factors and involve known and unknown risks that could cause the actual results, performance, levels of activity, or our achievements, or industry results, to be materially different from any future results, performance, levels of activity, or our achievements expressed or implied by such forward-looking statements. Such forward-looking statements are also included in Item 4 - "Information on the Company" and Item 5 - "Operating and Financial Review and Prospects." Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. Except as required by applicable law, including the securities laws of the United States, we undertake no obligation to publicly release any update or revision to any forward-looking statements to reflect new information, future events or circumstances, or otherwise after the date hereof. We have attempted to identify significant uncertainties and other factors affecting forward-looking statements in the Risk Factors section that appears in Item 3D. "Key Information - Risk Factors."

TABLE OF CONTENTS

PART I

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

The following selected consolidated financial data for and as of the five years ended December 31, 2006 are derived from our audited consolidated financial statements, which have been prepared in accordance with U.S. GAAP. Our audited consolidated financial statements with respect to the three years ended December 31, 2006 and as of December 31, 2005 and 2006 appear elsewhere in this Annual Report. Our selected consolidated financial data as of December 31, 2004, 2003 and 2002 and for the years ended December 31, 2003 and 2002 have been derived from audited consolidated financial statements not included in this Annual Report. The selected consolidated financial data set forth below should be read in conjunction with Item 5. "Operating and Financial Review and Prospects," and our consolidated financial statements and notes thereto included elsewhere in this annual report.

STATEMENT OF OPERATIONS DATA:

	Year Ended December 31,			
	2002	2003	2004	20
	(in thousands, except share and per shar			
Revenues	$ 9,787	$ 9,230	$ 9,413	$ 1
Cost of revenues	1,896	1,849	2,814	
Gross profit	7,891	7,381	6,599	
Selling and marketing	3,954	3,916	6,300	
Research and development, net	2,127	1,825	2,362	
General and administrative	1,858	1,830	2,101	
Operating loss	(48)	(190)	(4,164)	(
Financial income (expenses), net	(6)	130	78	
Loss before taxes on income	(54)	(60)	(4,086)	(
Taxes on income	52	198	266	
Net loss before equity in earnings of affiliate	(106)	(258)	(4,352)	(
Equity in earnings of affiliate	236	345	225	
Net loss	$ 130	$ 87	$ (4,127)	$ (
Basic and diluted net loss per share	$ 0.03	$ 0.02	$ (0.89)	$
Weighted average number of ordinary shares used in computing basic net loss per share	4,709,796	4,617,099	4,634,413	5,09
Weighted average number of ordinary shares used in computing diluted net loss per share	4,709,796	4,628,249	4,634,413	5,09

BALANCE SHEET DATA:

	As of December 31,				
	2002	2003	2004	2005	2006
	(in thousands)				
Working capital	$ 9,244	$ 9,437	$ 2,773	$ 2,065	$ 186
Total assets	17,707	18,182	15,323	13,816	14,054
Long-term loans	8	--	--	--	583
Shareholders' equity	14,013	14,464	10,657	9,174	7,542

B. CAPITALIZATION AND INDEBTEDNESS

Not applicable.

C. REASONS FOR THE OFFER AND USE OF PROCEEDS

Not applicable.

D. RISK FACTORS

INVESTING IN OUR ORDINARY SHARES INVOLVES A HIGH DEGREE OF RISK AND UNCERTAINTY. YOU SHOULD CAREFULLY CONSIDER THE RISKS AND UNCERTAINTIES DESCRIBED BELOW BEFORE INVESTING IN OUR ORDINARY SHARES. IF ANY OF THE FOLLOWING RISKS ACTUALLY OCCURS, OUR BUSINESS, PROSPECTS, FINANCIAL CONDITION AND RESULTS OF OPERATIONS COULD BE HARMED. IN THAT CASE, THE VALUE OF OUR ORDINARY SHARES COULD DECLINE, AND YOU COULD LOSE ALL OR PART OF YOUR INVESTMENT.

RISKS RELATING TO OUR BUSINESS AND MARKET

WE HAVE HAD A RECENT HISTORY OF OPERATING LOSSES AND MAY NOT ACHIEVE OR SUSTAIN PROFITABILITY IN THE FUTURE.

We have incurred operating losses in each of the last five fiscal years and we may not be able to achieve or sustain profitable operations in the future. To the extent that we continue to incur operating losses, we may not have sufficient working capital to fund our operations in the future. If we do not generate sufficient cash from operations, we will be required to obtain additional financing or reduce level of expenditure. Such financing may not be available in the future, or, if available, may not be on terms satisfactory to us.

OUR OPERATING RESULTS FLUCTUATE SIGNIFICANTLY.

Our quarterly results have fluctuated significantly in the past and are likely to fluctuate significantly in the future. Our future operating results will depend on many factors, including, but not limited to the following:

- demand for our products;
- changes in our pricing policies or those of our competitors;
- new product announcements by us and our competitors;
- the number, timing and significance of product enhancements;
- product life cycles;
- our ability to develop, introduce and market new and enhanced products on a timely basis;
- changes in the level of our operating expenses;

- budgeting cycles of our customers;
- customer order deferrals in anticipation of enhancements or new products that we or our competitors offer;
- changes in our strategy;
- seasonal trends and general domestic and international economic and political conditions, among others; and
- currency exchange rate fluctuations and economic conditions in the

geographic areas where we operate.

Due to the foregoing factors, quarterly revenues and operating results are difficult to forecast, and it is likely that our future operating results will be adversely affected by these or other factors.

Revenues are also difficult to forecast because the market for telecommunication management and billing solutions is rapidly evolving and our sales cycle for our solutions, from initial evaluation to purchase, is lengthy and varies substantially from customer to customer.

We typically ship orders for our TABS product line shortly after receipt of a purchase order and, consequently, order backlog at the beginning of any quarter has in the past represented only a small portion of that quarter's revenues. As a result, license revenues from our TABS product line in any quarter depend substantially on orders for TABS products that have been booked and shipped in that quarter. Also, we can not predict whether revenues from our Application Suite will be recognized in any quarter because the delivery and, in some cases, the implementation of all the components of the Application Suite (including among, other things, customer training) are dependent on the customers individual timing requirements, which can delay the completion of these orders. In addition, revenues from our billing solutions are generated by using contract accounting on a percentage of completion method and because the completion pace varies from quarter to quarter and is dependent on different variables that are out of our control, billing solutions revenues in any quarter depend on our customers' operational plans, which can delay our ability to progress and complete the projects.

Due to all of the foregoing, we cannot predict revenues for any future quarter with any significant degree of accuracy. Accordingly, we believe that period-to-period comparisons of our operating results are not necessarily meaningful and you should not rely upon them as indications of future performance. Our revenues declined in 2006 and we may not be able to achieve or sustain revenue growth in the future.

OUR QUARTERLY FINANCIAL PERFORMANCE VARIES SIGNIFICANTLY.

We have often recognized a substantial portion of our revenues in the last quarter of the year and in the last month, or even weeks or days, of a quarter. Our expense levels are substantially based on our expectations for future revenues and are therefore relatively fixed in the short term. If revenue levels fall below expectations, our quarterly results are likely to be disproportionately adversely affected because a proportionately smaller amount of our expenses varies with our revenues. Our operating results are generally not characterized by a seasonal pattern, except that our sales in Europe are generally lower in the summer months.

Due to the foregoing, our quarterly financial performance has in the past and may in the future vary significantly. Our revenues and operating results in any quarter may not be indicative of our future performance and it may be difficult for investors to evaluate our prospects. In some future quarter, our operating results may be below the expectations of public market analysts and investors. In such event, it is likely that the price of our ordinary shares would be materially and adversely affected.

WE DERIVE THE MAJORITY OF OUR REVENUES FROM TELECOMMUNICATIONS EXPENSE MANAGEMENT SOLUTIONS, THE MARKET FOR WHICH HAS DECLINED IN RECENT YEARS.

Until 2005, we derived substantially all of our revenues from our TABS.IT call accounting and billing products. In late 2004, we implemented a new strategy that has led to the development and introduction of our Application Suite. The Application Suite is built on the Microsoft.Net platform and establishes a framework for us to provide customized solutions that include customer care and billing in addition to our traditional telecommunications expense management , or TEM, solutions. The main functions of our TABS.IT and prior WinTrak families of products were incorporated into the Application Suite. In 2005, we expanded and enhanced the functionality of the Application Suite to include invoice management, which facilitates bill reconciliation and dispute management. In July 2006, we completed the acquisition of certain assets and liabilities of TelSoft Solutions, Inc., or TelSoft, a California-based provider of call accounting and TEM solutions. Despite all of the foregoing, our revenues from our TEM solutions declined each year from 1999 until 2003 and again in 2006 and revenues for these products may not grow in the future. If the market for our TEM solutions fails to grow in the future, our business, operating results and financial condition would be materially adversely affected. Our future financial performance will be dependent to a substantial degree on the successful introduction, marketing and customer acceptance of our invoice management products.

WE DEPEND ON BUSINESS TELEPHONE SYSTEM MANUFACTURERS, VENDORS AND DISTRIBUTORS FOR OUR SALES.

One of the primary distribution channels for our call accounting management products are private branch exchange, or PBX, original equipment manufacturers, or OEMs, and vendors who market our products to end-users in conjunction with their own products. We are highly dependent upon the active marketing and distribution efforts of our PBX OEMs. In 2004, 2005 and 2006, our three major OEMs, Siemens Gmbh, Philips Communications Systems B.V. and Ericsson, generated together 47.0%, 42.0% and 34.0%, respectively, of our consolidated revenues. The following percentage of sales were attributable to each of these OEMs in each of the 12 months ended December 31:

	2004	2005	2006
Siemens	38.0%	36.0%	29.0%
Philips	5.0%	4.0%	4.0%
Ericsson	4.0%	2.0%	1.0%

As these and other PBX vendors expand their product offerings to offer a wider range of newer technologies such as the Internet, Wireless Fidelity, or WiFi, and voice over Internet protocol, or VoIP, we have enhanced our Application Suite to accommodate these new services. In late 2004 and early 2005, we entered into partnership agreements with each of NEC Unified Solutions, Inc. and Avaya Inc. for the integration of our products with their own products and the marketing of our integrated product. Sales of call accounting solutions by PBX manufacturers and vendors have declined markedly in the recent past, and sales through this channel may not recover. Our success will be dependent to a substantial degree on the marketing and sales efforts of such third parties in marketing and integrating our products. These third parties may not give priority to the sale of our products as an enhancement to their products. Although most of the major business telephone switching systems manufacturers and vendors currently rely on third-party suppliers to provide call accounting and other telemanagement products, these manufacturers and vendors, including our current customers, may develop their own competing products or purchase competing products from others.

Because we sell our products through local master distributors in countries where we do not have a marketing subsidiary, we are highly dependent upon the active marketing and distribution efforts of our distributors. We also depend in large part upon our distributors for product maintenance and support. Our distributors may not continue to provide adequate maintenance and support to end-users or provide maintenance and support for new products, which might cause us to seek new or additional distributors or incur additional service and support costs. The distributors to whom we sell our products are generally not contractually required to make future purchases of our products and could, therefore, discontinue carrying our products at any time. None of our distributors or resellers is subject to any minimum purchase requirements under their agreements with us. We may not be able to continue our relationships with our OEM customers or, if such relationships are not maintained, we may not be able to attract and retain comparable PBX original equipment manufacturers. The loss of any of our major reseller or OEM relationships, either to competitive products offered by other companies or products developed by such resellers, would have a material adverse effect on our business, financial condition and results of operations. Our future performance will depend, in part, on our ability to attract additional PBX manufacturers and vendors that will be able to market and support our products effectively, especially in markets in which we have not previously distributed our products.

IN DECEMBER 2004, WE ACQUIRED CERTAIN ASSETS AND LIABILITIES OF TELEKNOWLEDGE GROUP LTD. AND ON JULY 31, 2006, WE ACQUIRED CERTAIN ASSETS AND LIABILITIES OF TELSOFT SOLUTIONS, INC. AND WE MAY NOT BE ABLE TO SUCCESSFULLY EXPLOIT THE ACQUIRED PRODUCTS.

In December 2004, we completed the acquisition of certain assets and liabilities of Teleknowledge Group Ltd., or Teleknowledge, a provider of carrier class billing and related solutions, and on July 31, 2006, we completed the acquisition of certain assets and liabilities of TelSoft, a California corporation, a provider of call accounting and TEM solutions. The acquisition of the Teleknowledge billing solution enables us to offer an end-to-end customer care and billing solution, including pre/post paid billing, web self-care, assets management, partner management, help desk and order management modules. These products offer a complementary solution to our own products. We believe that the acquisition of TelSoft's TEM and call accounting software will enable us to expand our TEM solutions and will assist us to strengthen our growing business in the United States. We may not be able to successfully integrate the operations of Teleknowledge and TelSoft into our business or successfully exploit the solutions that we acquired from them.

WE FACE RISKS ASSOCIATED WITH EXPANDING AND MAINTAINING OUR DISTRIBUTION NETWORK.

We sell our products through distributors, business telephone switching systems manufacturers and vendors, post, telephone and telegraph authorities, or PTTs and our direct sales force. Our ability to achieve revenue growth in the future will depend in large part on our success in establishing and maintaining relationships with business telephone switching systems manufacturers and vendors and PTTs, and establishing and maintaining relationships with distributors. Historically, we have at times experienced difficulty in establishing effective distribution relationships. We may not be able to successfully expand our distribution channels or any such expansion may not result in an increase in revenues. The failure to expand or maintain our distribution channels could have a material adverse effect on our business, operating results and financial condition.

WE ARE SUBJECT TO RISKS ASSOCIATED WITH INTERNATIONAL OPERATIONS.

We are based in Israel and generate a large percentage of our sales outside the United States. Our sales in the United States accounted for 53.0%, 52.0% and 51.1% of our total revenues for the years ended December 31, 2004, 2005 and 2006, respectively. We may not be able to maintain or increase international market demand for our products. To the extent that we cannot do so in a timely manner, our business, operating results and financial condition will be materially and adversely affected.

International operations are subject to inherent risks, including the following:

- the impact of possible recessionary environments in multiple foreign markets;
- costs of localizing products for foreign markets;
- longer receivables collection periods and greater difficulty in accounts receivable collection;
- unexpected changes in regulatory requirements;
- difficulties and costs of staffing and managing foreign operations;

- reduced protection for intellectual property rights in some countries;
- potentially adverse tax consequences; and
- political and economic instability.

Our distributors or resellers may not be able to sustain or increase revenues from international operations or the foregoing factors may have a material adverse effect on our future revenues and, as a result, on our business, operating results and financial condition.

We may be adversely affected by fluctuations in currency exchange rates. While our revenues are generally denominated in U.S. dollars and Euro, a significant portion of our expenses are incurred in NIS. We do not currently engage in any currency hedging transactions intended to reduce the effect of fluctuations in foreign currency exchange rates on our results of operations. If we were to determine that it was in our best interests to enter into any hedging transactions in the future, we may not be able to do so or such transactions, if entered into, may not materially reduce the effect of fluctuations in foreign currency exchange rates on our results of operations. In addition, if, for any reason, exchange or price controls or other restrictions on the conversion of foreign currencies into NIS were imposed, our business could be adversely affected. Currency fluctuations in the future may have a material adverse effect on revenues from international sales and, consequently, on our business, operating results and financial condition.

WE ARE SUBJECT TO RISKS RELATING TO PROPRIETARY RIGHTS AND RISKS OF INFRINGEMENT.

We are dependent upon our proprietary software technology and we rely primarily on a combination of copyright and trademark laws, trade secrets, confidentiality procedures and contractual provisions to protect our proprietary rights. We try to protect our software, documentation and other written materials under trade secret and copyright laws, which afford only limited protection. It is possible that others will develop technologies that are similar or superior to our technology. Unauthorized parties may attempt to copy aspects of our products or to obtain and use information that we regard as proprietary. It is difficult to police the unauthorized use of our products, and we expect software piracy to be a persistent problem, although we are unable to determine the extent to which piracy of our software products exists. In addition, the laws of some foreign countries do not protect our proprietary rights as fully as do the laws of the United States. Our means of protecting our proprietary rights in the United States or abroad may not be adequate or our competition may independently develop similar technology.

We are not aware that we are infringing upon any proprietary rights of third parties. However, it is possible, that third parties will claim infringement by us of their intellectual property rights. We believe that software product developers will increasingly be subject to infringement claims as the number of products and competitors in our industry segment grows and the functionality of products in different industry segments overlaps. It would be time consuming for us to defend any such claims, with or without merit, and any such claims could:

- result in costly litigation;
- divert management's attention and resources;
- cause product shipment delays; or
- require us to enter into royalty or licensing agreements. Such royalty or licensing agreements, if required, may not be available on terms acceptable to us, if at all.

If there is a successful claim of product infringement against us and we are not able to license the infringed or similar technology, our business, operating results and financial condition would be materially and adversely affected.

We rely upon certain software that we license from third parties, including software that we integrate with our internally developed software. These third-party software licenses may not continue to be available to us on commercially reasonable terms. If we lose or are unable to maintain any such software licenses, we could suffer shipment delays or reductions until equivalent software could be developed, identified, licensed and integrated, which would materially and adversely affect our business, operating results and financial condition.

WE MAY BE UNSUCCESSFUL IN OUR DEFENSE OF PENDING LITIGATION.

In April 2000, the tax authorities in Israel issued a demand for a tax payment for the 1997-1999 period in the amount of approximately NIS 6.0 million ($1.4 million). We have appealed to the Israeli District Court in respect of such tax demand and believe that certain defenses can be raised against the demand of the tax authorities. We have made a provision in our financial statements for this tax demand for the amount deemed probable.

If we are unsuccessful in these matters or if actual results are not consistent with our assumptions and judgments, we may be exposed to losses that could be material to our company.

OUR RESULTS MAY BE ADVERSELY AFFECTED BY COMPETITION.

The market for telemanagement products and invoice management solutions is fragmented and is intensely competitive. Competition in the industry is generally based on product performance, depth of product line, technical support and price. We compete both with international and local competitors (including providers of telecommunications services), many of whom have significantly greater financial, technical and marketing resources than us. We anticipate continuing competition in the telemanagement products and invoice management solution market and the entrance of new competitors into the market. Our existing and potential customers, including business telephone switching system manufacturers and vendors, may be able to develop telemanagement products and services that are as effective as, or more effective or easier to use than, those offered by us. Such existing and potential competitors may also enjoy substantial advantages over us in terms of research and development expertise, manufacturing efficiency, name recognition, sales and marketing expertise and distribution channels. We may not be able to compete successfully against current or future competitors and that competition may have a material adverse effect on our future revenues and, consequently, on our business, operating results and financial condition.

WE ARE SUBJECT TO RISKS ASSOCIATED WITH RAPID TECHNOLOGICAL CHANGE AND RISKS ASSOCIATED WITH NEW VERSIONS AND NEW PRODUCTS.

The information and telecommunication service providers market in which we compete is characterized by rapid technological change, introductions of new products, changes in customer demands and evolving industry standards. Our future success will depend upon our ability to keep pace with the technological developments and to timely address the increasingly sophisticated needs of our customers by supporting existing and new telecommunication technologies and services and by developing and introducing enhancements to our current and new products. We may not be successful in developing and marketing enhancements to our products that will respond to technological change, evolving industry standards or customer requirements, we may experience difficulties that could delay or prevent the successful development, introduction and sale of such enhancements or such enhancements may not adequately meet the requirements of the marketplace and achieve any significant degrees of market acceptance. If release dates of any new products or enhancements are delayed or, if when released, they fail to achieve market acceptance, our business, operating results and financial condition would be materially and adversely affected. In addition, the introduction or announcement of new product offerings or enhancements by us or our competitors may cause customers to defer or forgo purchases of current versions of our product, which could have a material adverse effect on our business, operating results and financial condition.

WE MAY NOT BE ABLE TO RETAIN OR ATTRACT KEY MANAGERIAL, TECHNICAL AND RESEARCH AND DEVELOPMENT PERSONNEL WE NEED TO SUCCEED.

Our success has largely depended and will depend in the future on our skilled professional and technical employees. The competition for these employees is intense. We may not be able to retain our present employees, or recruit additional qualified employees as we require them. The loss of any key member of our management team might significantly delay or prevent the achievement of our business or development objectives. Our ability to replace key members of our management team and hire additional skilled personnel in the future might be negatively impacted by the use of restrictive covenants in our industry and market. Any failure to attract and retain key managerial, technical and research and development personnel could have a material adverse affect on our ability to generate sales, deploy our products or successfully develop new products and enhancements.

THREE OF OUR SHAREHOLDERS ARE IN A POSITION TO CONTROL MATTERS REQUIRING A SHAREHOLDER VOTE.

Mr. Chaim Mer, our Chairman, and his wife, Dora Mer, our Israeli counsel, currently control the vote of approximately 35.05% of our outstanding ordinary shares, and Isaac Ben-Bassat, one of our directors, is the owner of 11.94% of our outstanding ordinary shares. As a result, such persons control and will continue to control the election of our entire Board of Directors other than our two outside directors and generally have the ability to direct our business and affairs.

WE ARE SUBJECT TO RISKS ARISING FROM PRODUCT DEFECTS AND POTENTIAL PRODUCT LIABILITY.

We provide free warranty and support for up to one year for end-users and up to 15 months for our OEM distributors. Our sales agreements typically contain provisions designed to limit our exposure to potential product liability or related claims. The limitation of liability provisions contained in our agreements may not be effective. Our products are used by businesses to reduce communication costs, recover charges payable by third parties, prevent abuse and misuse of telephone networks and converged BSS solutions for ITSPs, and as a result, the sale of products by us may entail the risk of product liability and related claims. A product liability claim brought against us could have a material adverse effect upon our business, operating results and financial condition. Products such as those offered by us may contain undetected errors or failures when first introduced or when new versions are released. Despite our testing and testing by current and potential customers, errors may be found in new products or releases after commencement of commercial shipments. The occurrence of these errors could result in adverse publicity, loss of or delay in market acceptance or claims by customers against us, any of which could have a material adverse effect upon our business, operating results and financial condition.

RISK FACTORS RELATED TO OUR ORDINARY SHARES

WE MAY IN THE FUTURE BE CLASSIFIED AS A PASSIVE FOREIGN INVESTMENT COMPANY, OR PFIC, WHICH WILL SUBJECT OUR U.S. INVESTORS TO ADVERSE TAX RULES.

Holders of our ordinary shares who are United States residents face income tax risks. There is a substantial risk that we may become a passive foreign investment company, commonly referred to as PFIC. Our treatment as a PFIC could result in a reduction in the after-tax return to the holders of our ordinary shares and would likely cause a reduction in the value of such shares. For U.S. Federal income tax purposes, we will be classified as a PFIC for any taxable year in which either (i) 75% or more of our gross income is passive income, or (ii) at least 50% of the average value of all of our assets for the taxable year produce or are held for the production of passive income. For this purpose, cash is considered to be an asset, which produces passive income. As a result of our relatively substantial cash position at the time, we believe that we were a PFIC in certain periods over the last few years under a literal application of the asset test described above, which looks solely to the market value of our assets. We do not believe that we were a PFIC in 2006. If we are classified in the future as a PFIC for U.S. federal income tax purposes, highly complex rules would apply to U.S. Holders owning ordinary shares. Accordingly, you are urged to consult your tax advisors regarding the application of such rules.

OUR SHARE PRICE HAS BEEN VOLATILE IN THE PAST AND MAY DECLINE IN THE FUTURE.

Our ordinary shares have experienced significant market price and volume fluctuations in the past and may experience significant market price and volume fluctuations in the future in response to factors such as the following, some of which are beyond our control:

- quarterly variations in our operating results;

- operating results that vary from the expectations of securities analysts and investors;
- changes in expectations as to our future financial performance, including financial estimates by investors;
- announcements of technological innovations or new products by us or our competitors;
- announcements by us or our competitors of significant contracts, acquisitions, strategic partnerships, joint ventures or capital commitments;
- announcements by third parties of significant claims or proceedings against us;
- changes in the status of our intellectual property rights;
- additions or departures of key personnel;
- future sales of our ordinary shares; and
- general stock market prices and volume fluctuations.

Domestic and international stock markets often experience extreme price and volume fluctuations. Market fluctuations, as well as general political and economic conditions, such as a recession or interest rate or currency rate fluctuations or political events or hostilities in or surrounding Israel, could adversely affect the market price of our ordinary shares.

In the past, securities class action litigation has often been brought against a company following periods of volatility in the market price of its securities. We may in the future be the target of similar litigation. Securities litigation could result in substantial costs and divert management's attention and resources.

WE DO NOT EXPECT TO DISTRIBUTE CASH DIVIDENDS.

We do not anticipate paying cash dividends in the foreseeable future. According to the Israeli Companies Law, a company may distribute dividends out of its profits (within the meaning of the Israeli Companies Law), so long as the company reasonably believes that such dividend distribution will not prevent the company from paying all its current and future debts. The declaration of dividends is subject to the discretion of our Board of Directors and will depend on various factors, including our operating results, financial condition, future prospects and any other factors deemed relevant by our board of directors. You should not rely on an investment in our company if you require dividend income from your investment in our company. The success of your investment will likely depend entirely upon any future appreciation of the market price of our ordinary shares, which is uncertain and unpredictable. There is no guarantee that our ordinary shares will appreciate in value or even maintain the price at which you purchased your ordinary shares.

COMPLIANCE WITH CORPORATE GOVERNANCE REGULATIONS COULD INCREASE THE COST OF OUR OPERATIONS.

As a result of changing laws, regulations and standards relating to accounting, corporate governance and public disclosure, the costs of being a public company in general have increased in recent years. The Sarbanes-Oxley Act of 2002 requires changes in some of our corporate governance and securities disclosure or compliance practices. We expect that the on-going implementation of these regulations will further increase our legal compliance costs and will make some activities more time consuming. We are presently evaluating and monitoring regulatory developments and cannot estimate the magnitude of additional costs we may incur as a result of such developments. In connection with our future implementation of Section 404 of the Sarbanes-Oxley Act of 2002, which governs internal controls and procedures for financial reporting, we have expended and will need to further expend significant management time and financial resources to comply with the applicable requirements. This and other proposed legislation may increase the fees of our professional advisors and our insurance premiums.

RISKS RELATING TO OPERATIONS IN ISRAEL

CONDUCTING BUSINESS IN ISRAEL ENTAILS SPECIAL RISKS.

We are incorporated under the laws of, and our principal executive offices and manufacturing and research and development facilities are located in, the State of Israel. As a result, the political, economic and military conditions affecting Israel directly influence us. Any major hostilities involving Israel, a full or partial mobilization of the reserve forces of the Israeli army, the interruption or curtailment of trade between Israel and its present trading partners, or a significant downturn in the economic or financial condition of Israel could have a material adverse effect on our business, financial condition and results of operations.

Since the establishment of the State of Israel in 1948, a number of armed conflicts have taken place between Israel and its Arab neighbors, and a state of hostility, varying from time to time in intensity and degree, has led to security and economic problems for Israel. Although Israel has entered into various agreements with Egypt, Jordan and the Palestinian Authority, there has been an increase in unrest and terrorist activity in Israel, which began in September 2000 and which has continued with varying levels of severity through 2006. In July 2006, an armed conflict began between Israel and Hezbollah forces in Lebanon, which involved rocket attacks on populated areas in the northern parts of Israel. On August 14, 2006, a cease-fire between Hezbollah and Israel took effect. This situation has had an adverse effect on Israel's economy, primarily in the geographical areas directly harmed by this conflict. Any future armed conflict, political instability or violence in the region may have a negative effect on our business condition, harm our results of operations and adversely affect our share price. No predictions can be made as to whether or when a final resolution of the area's problems will be achieved or the nature thereof and to what extent the situation will impact Israel's economic development or our operations.

Furthermore, there are a number of countries, primarily in the Middle East, as well as Malaysia and Indonesia, that restrict business with Israel or Israeli companies, and we are precluded from marketing our products to these countries. Restrictive laws or policies directed towards Israel or Israeli businesses may have an adverse impact on our operations, our financial results or the expansion of our business.

OUR RESULTS OF OPERATIONS MAY BE NEGATIVELY AFFECTED BY THE OBLIGATION OF OUR PERSONNEL TO PERFORM MILITARY SERVICE.

Many of our directors, officers and employees in Israel are obligated to perform annual reserve duty in the Israeli Defense Forces and may be called for active duty under emergency circumstances at any time. If a military conflict or war arises, these individuals 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 or a significant number of other employees due to military service. Any disruption in our operations could adversely affect our business.

OUR FINANCIAL RESULTS MAY BE ADVERSELY AFFECTED BY INFLATION AND CURRENCY FLUCTUATIONS.

Since we report our financial results in dollars, fluctuations in rates of exchange between the dollar and non-dollar currencies may affect our results of operations. A significant amount of our expenses are paid in NIS (primarily salaries) and are influenced by the timing of, and the extent to which, any increase in the rate of inflation in Israel over the rate of inflation in the United States is not offset by the devaluation of the NIS in relation to the dollar. Our dollar costs in Israel will increase if inflation in Israel exceeds the devaluation of the NIS against the dollar or if the timing of such devaluation lags behind inflation in Israel. Over time, the NIS has been devalued against the dollar, generally reflecting inflation rate differentials. We cannot predict any future trends in the rate of inflation in Israel or the rate of devaluation of the NIS against the dollar. If the dollar cost of our operations in Israel increases, our dollar measured results of operations will be adversely affected. Likewise, our operations could be adversely affected if we are unable to guard against currency fluctuations in the future.

13

THE GOVERNMENT PROGRAMS AND TAX BENEFITS WE CURRENTLY PARTICIPATE IN OR RECEIVE REQUIRE US TO MEET SEVERAL CONDITIONS AND MAY BE TERMINATED OR REDUCED IN THE FUTURE.

We have benefited from certain Israeli Government grants, programs and tax benefits. In late 2005 and early 2006 and 2007, we applied to the Office of the Chief Scientist of the Israeli Ministry of Industry, Trade and Labor for grants for our research and development projects. We received an approval for the 2005 and 2006 applications and our two 2007 applications are currently pending. The 2007 grant applications may not be approved by the Office of the Chief Scientist and we may not be able to obtain any such grants in the future. To remain eligible for these grants, programs and tax benefits, we must comply with certain conditions, including making specified investments in fixed assets from our own equity and paying royalties with respect to grants received. In addition, some of these programs restrict our ability to manufacture particular products and to transfer particular technology outside of Israel. If we do not meet these conditions in the future, the benefits we received could be canceled and we may have to refund payments previously received under these programs or pay increased taxes. The Government of Israel has reduced the benefits available under these programs in recent years and these programs and tax benefits may be discontinued or curtailed in the future.

SERVICE AND ENFORCEMENT OF LEGAL PROCESS ON US AND OUR DIRECTORS AND OFFICERS MAY BE DIFFICULT TO OBTAIN.

Service of process upon our directors and officers and the Israeli experts named herein, most of whom reside outside the United States, may be difficult to obtain within the United States. Furthermore, since substantially all of our assets, most of our directors and officers and the Israeli experts named herein are located outside the United States, any judgment obtained in the United States against us or these individuals or entities may not be collectible within the United States.

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 certain time limitations and other conditions, Israeli courts may enforce final judgments of United States courts for liquidated amounts in civil matters, including judgments based upon the civil liability provisions of those Acts.

PROVISIONS OF ISRAELI LAW MAY DELAY, PREVENT OR MAKE DIFFICULT OUR ACQUISITION BY A THIRD-PARTY, WHICH COULD PREVENT A CHANGE OF CONTROL AND THEREFORE DEPRESS THE PRICE OF OUR SHARES.

Provisions of Israeli corporate and tax law may have the effect of delaying, preventing or making more difficult a merger with, or other acquisition of, us. This could cause our ordinary shares to trade at prices below the price for which third parties might be willing to pay to gain control of us. Third parties who are otherwise willing to pay a premium over prevailing market prices to gain control of us may be unable or unwilling to do so because of these provisions of Israeli law.

THE RIGHTS AND RESPONSIBILITIES OF OUR SHAREHOLDERS ARE GOVERNED BY ISRAELI LAW AND DIFFER IN SOME RESPECTS FROM THE RIGHTS AND RESPONSIBILITIES OF SHAREHOLDERS UNDER U.S. LAW.

We are incorporated under Israeli law. The rights and responsibilities of holders of our ordinary shares are governed by our memorandum of association, articles of association and by Israeli law. These rights and responsibilities differ in some respects from the rights and responsibilities of shareholders in typical U.S. corporations. In particular, each shareholder of an Israeli company has a duty to act in good faith in exercising his or her rights and fulfilling his or her obligations toward the company and other shareholders and to refrain from abusing his power in the company, including, among other things, in voting at the general meeting of shareholders on certain matters. Israeli law provides that these duties are applicable in shareholder votes on, among other things, amendments to a company's articles of association, increases in a company's authorized share capital, mergers and interested party transactions requiring shareholder approval. In addition, a controlling shareholder of an Israeli company or a shareholder who knows that it possesses the power to determine the outcome of a shareholder vote or who has the power to appoint or prevent the appointment of a director or officer in the company has a duty of fairness toward the company. However, Israeli law does not define the substance of this duty of fairness. Because Israeli corporate law has undergone extensive revision in recent years, there is little case law available to assist in understanding the implications of these provisions that govern shareholder behavior.

AS A FOREIGN PRIVATE ISSUER WHOSE SHARES ARE LISTED ON THE NASDAQ CAPITAL

MARKET, WE MAY FOLLOW CERTAIN HOME COUNTRY CORPORATE GOVERNANCE PRACTICES INSTEAD OF CERTAIN NASDAQ REQUIREMENTS.

As a foreign private issuer whose shares are listed on the NASDAQ Capital Market, we are permitted to follow certain home country corporate governance practices instead of certain requirements of the NASDAQ Marketplace Rules, including the composition of our Board of Directors, director nomination procedure, compensation of officers, distribution of annual reports to shareholders and quorum at shareholders meetings. In addition, we may follow Israeli law instead of the NASDAQ Marketplace Rules that require that we obtain shareholder approval for certain dilutive events, such as for the establishment or amendment of certain equity based compensation plans, an issuance that will result in a change of control of our company, certain transactions other than a public offering involving issuances of a 20% or more interest in our company and certain acquisitions of the stock or assets of another company. Currently, we follow Israeli law and practice instead of the NASDAQ requirements with respect to the directors' nomination process.

ITEM 4. INFORMATION ON THE COMPANY

A. HISTORY AND DEVELOPMENT OF THE COMPANY

Our company was incorporated under the laws of the State of Israel in December 1995. We are a public limited liability company under the Israeli Companies Law 5739-1999 and operate under such law and associated legislation. Our registered offices and principal place of business are located at 22 Zarhin Street, Ra'anana 43662, Israel, and our telephone number is +972-9-762-1777. Our address on the Internet is www.mtsint.com. The information on our website is not incorporated by reference into this annual report.

We are a worldwide provider of solutions for telecommunications expense management, or TEM, used by enterprises, and business support systems, or BSS, used by information and telecommunication service providers, or ITSPs. Our TEM solutions assist enterprises and organizations to make smarter choices with their telecommunications spending at each stage of the service lifecycle, including allocation of cost, proactive budget control, fraud detection, processing of payments and spending forecasting. Our TEM solutions support our clients on an ongoing basis with both sophisticated software applications and a variety of managed services relationship models. Our converged BSS solutions for ITSPs have been successfully implemented worldwide by wireless providers, Voice over Internet Protocol, Internet Protocol Television, and content service providers. Our converged BSS solutions include applications for charging and invoicing customers, interconnect billing and partner revenue management using pre-pay and post-pay schemes. Our pre-configured BSS solutions have been designed to be implemented quickly and are competitively priced.

Call accounting systems afford businesses easy access to complete information on telephone usage, including the dialed number, calling extension, call duration, time of day, destination, trunk line usage, cost of each call and multi-carrier analysis. We started developing the TABS line of call accounting products for the DOS operating system and have upgraded and re-written our call accounting and management systems as the industry and technology advanced providing full compatibility to support the Windows operating systems and most versions of Windows NT. As our sales of TABS were worldwide, we needed to have a flexible and easily updated set of pricing tables to accommodate the different pricing schemes and modes used worldwide and with different carriers. As enterprises expanded and required information from their remote sites, so TABS has expanded to accommodate their needs by providing multi-site solutions and supporting most business telephone switching systems currently available for sale. The TABS solutions are capable of monitoring up to 100,000 extensions. The Application Suite provides for an unlimited number of extensions, subject to the capabilities of the customer's hardware, as well as an unlimited number of remote sites. The sites can be monitored from a browser at any point as the application is web based. Various modules were developed to service the needs of different vertical markets such as our Property Management System interface, or PMSi, module for the hotel industry and a solution for performing tie-line reconciliation for organizations and utilities having multiple PBXs. TRAK-View, our fault management system, provides an enterprise with early warning problem detection and prevention for multi-site and multi-vendor networks including PBXs. In 1998, we introduced IP.TRAK, a Web-based call accounting and management system that was built on the original model and principles of TABSweb. IP.TRAK was designed to harness the power of the Internet for the needs of information technology managers through its ability to access reports using a standard Internet browser. We added additional modules to IP TRAK that could collect the information from routers, firewalls and gateways. These additional modules provided tools for a comprehensive communications management system. We were able to collect additional data from files, file transfer protocol (FTP) servers, VoIP, and external buffers. We subsequently merged the functionality of PBX systems and IP networks to provide a unified management solution for multiple communication platforms from different vendors supporting voice, VoIP, video and data communications. The functionality of IP TRAK was subsequently superseded by the enhanced Application Suite.

We operate in five geographical areas. Our operations in Israel include research and development, sales, marketing and support. Our operations in the United States, Brazil, Europe and Asia include sales, marketing and customer service.

On April 24, 2000, we acquired all of the assets and assumed certain liabilities of IntegraTRAK Inc., a privately held Seattle-based company, engaged in the development and sale of packaged computer software for tracking telephone calls and costs.

In 2001, we developed our Web Access module that provides access and control to the communications usage database, under strict control and privacy, from anywhere on the web. During the second quarter of 2002, we added FaciliTRAK, which is a comprehensive software system that greatly simplifies the day-to-day task of maintaining and managing the physical layer details for any network. FaciliTRAK allows the user to record the equipment, cables, and pathways for the cable plant and define the connectivity and circuit routes. A user can utilize FaciliTRAK to plan and manage the moves and changes within his or her organization with the aid of the self-documenting service desk functions. The FaciliTRAK system is an essential tool for any enterprise that is thinking of implementing a disaster recovery program.

In December 2004, we completed the acquisition of certain assets and liabilities of Teleknowledge Group Ltd., or Teleknowledge, a provider of carrier class billing and related solutions. In connection with the acquisition, we paid an initial consideration of $2.374 million in cash and agreed to pay additional contingent consideration of up to $3.65 million over a period of three years based on post acquisition revenue performance. The acquisition of the Teleknowledge billing solution enables us to offer an end-to-end customer care and billing solution, including pre/post paid billing, Web self-care, assets management, partner management, help desk and order management modules.

During 2005, we conducted extensive research and development so that our products and solutions could operate in the high-end enterprise market. As a result, an advanced TEM module was developed, based on our Application Suite infrastructure. The modular and scalable architecture topology of our

Application Suite lends itself easily to an open platform where modules can be added and integrated seamlessly into the platform, thus allowing customers to buy such modules as they require.

In addition, in 2005 we strengthened our product offerings to the service provider and carrier market as a result of our release of a new billing solution module that we acquired from Teleknowledge and through significant investment in research and development in order to provide a complete end-to-end billing solution for the wholesale trade. As a result, we introduced an interconnect billing solution and our retail billing solution was expanded to accommodate legacy telephony that carriers can use to bill their subscribers. Also, new value-added services (such as video-on-demand (VOD), multimedia message service, short message service (SMS)) and content (such as news and games) were added to our billing solutions package. We believe that an advantage of our solutions is that they operate off a single data base. We also introduced a partner revenue management module to our billing solutions product, which complements our product line by enabling carriers to reconcile bills among one another.

During 2006, we enhanced our interconnect billing solution to include a sophisticated and user-friendly rate loader, that automatically loads the rates from the various Excel sheets that service providers receive and provides a composite picture of the rates.

In 2006, we also developed solutions for mobile phones based on a patent for which we have filed an international patent application (PCT application), which is currently pending, to track and account for calls made from a mobile phone. One of the solutions provides for reconciliation of calls made from a mobile phone independent of the service provider and is intended for enterprises to check and monitor calls made from mobile phones of their employees. Another solution, Wireless Leak Detector, is intended for service providers to ascertain that all calls made from a mobile phone have been accounted for and charged.

Another development in 2006 was the introduction of our Invoice Management as a stand-alone solution that allows for tracking of vendors, invoices, assets and contracts both for pricing and maintenance, with the ultimate objective of reconciling the invoices for payment or dispute. The solution can be purchased by an enterprise for their own accounting, or outsourced as an Application Service Provider (ASP).

On July 31, 2006, we completed the acquisition of certain assets and liabilities of TelSoft, a California corporation, a provider of call accounting and TEM solutions. The TelSoft products offer a complementary solution to our products. In connection with the acquisition, we paid an initial consideration of $1.1 million and agreed to pay additional contingent consideration based on post acquisition revenue performance during the 12 month period following the acquisition. We believe that the acquisition of TelSoft's TEM and call accounting software will enable us to expand our TEM solutions and will assist us to strengthen our growing business in the United States.

On February 6, 2006, our board of directors approved the sale of all of the shares of TABS Brazil Ltda., our wholly-owned subsidiary in Brazil, to certain Brazilian individuals for an aggregate of $334,850. The purchase price shall be paid in 60 installments, with the first installment, in the sum of $66,972, being due and payable on January 1, 2008, and the remaining balance in equal monthly installments of $5,581 each.

B. BUSINESS OVERVIEW

INDUSTRY BACKGROUND

Technological advances and worldwide deregulation and privatization in the telecommunications industry have resulted in the growth of alternative telecommunication services providers, such as cellular companies, competitive access providers, cable companies and data transmission companies. This growth, in conjunction with dramatic improvements in computing and communications technology, including the convergence of telephony systems and computers, or computer telephony integration, has fostered the rapid expansion of communication services and an increase in the volume of voice and data traffic by business organizations. The diversification of services and providers using varied pricing algorithms and the proliferation of domestic and international networks using varied equipment and technologies for different services and modes of transmission has placed new demands on telecommunication and information technology managers and has created the need for sophisticated and flexible telecommunication management solutions. This has created a demand for telemanagement solutions that are capable of supporting multiple sites, switching platforms, languages and currencies, as well as the generation of telecommunications usage information vital to an enterprise's operations.

Telemanagement solutions have evolved from the stand-alone PC-based telephone call accounting and billing systems of the mid-1980's to local area network or LAN-based systems offering call accounting, fraud detection and fault management solutions for users with complex voice and data networks. Today, the trend is moving more and more to web-based solutions, and to converged solutions where all expenses associated with the usage of a person or device are shown in one report or invoice.

Call accounting products, a fundamental management tool, record, retrieve and process data received from a PBX or other telephone switching system, providing a telecommunications manager with information on telephone usage. This information enables managers to optimize an enterprise's telecommunications resources and reduce communication expenses, typically the second or third highest administrative expense of a business, through cost-tracking and management awareness.

As the trend continues toward enterprises utilizing one infrastructure for both voice and data services, more and more emphasis will be placed on finding efficient solutions to cope with the increasing demand on network resources and for reducing congestion. Enterprises have been required to buy additional communications resources to meet this demand immediately rather than optimizing their existing networks due to the time consuming nature of such projects. Information technology managers are constantly trying to justify the ever increasing expenses created by managing the enormous amount of data that is being transmitted through the Internet.

The abuse and misuse of telephone and data networks, either by employees making unauthorized telephone calls or by outside "hackers" who tap into an organization's long distance service has become a major problem for organizations resulting in great losses. Likewise, employees surfing the web for private use during working hours overloads the network, preventing critical tasks from getting through as well as reducing the overall productivity of the enterprise. These losses have led to the development of intelligent toll fraud detection systems that immediately alert or initiate preventive measures upon detecting a suspicious occurrence in network usage traffic.

Organizations with multiple PBXs and providers of maintenance services require systems that are capable of alerting telecommunications managers of impending or actual problems in a communications network. Financial and operational benefits of a fault management system can be immediate and significant, as down time of the system is reduced due to early problem detection and real information on remote site events. Maintenance costs are significantly lowered through better use of human resources and more efficient inventory management.

In addition, other executives and operational managers are now seeking telemanagement solutions which permit them to assess how efficiently employees are using their time, monitor customer service calls, analyze the effectiveness of marketing expenditures, utilize toll-free responses to determine demographics of callers through the use of caller identification information, know who is using the network and when they are using it, and obtain additional data that aid them in management of the business.

IP telephony and video conferencing are reaching technological maturity and are being adopted by an increasing number of organizations. Enterprises have begun to use the IP platform as a single common telecommunication infrastructure for all services. The convergence of voice, data and video has become commonplace, and there is a trend of data equipment manufacturers and PBX system manufacturers offering platforms that support all services. These developments as well as customer demands will require future management systems to be upgraded to support the convergence of voice, data and video and provide a unified management system that will provide information technology managers with knowledge about the usage of their resources, the ability to ensure the optimal use of these resources and centralized control over their networks.

With today's greater mobility, the need to keep track of moves and changes in an organization requires the use of tools to control, manage and document these changes more effectively. The useful life of a standard cabling structure should be 15 years. This means that existing cables should be able to support an average of three upgrades of communication equipment during its lifetime, plus an average of five changes to all outlets. It is virtually impossible to achieve this performance level without maintaining accurate records reflecting all details of cabling installations.

The continuing increase in use of cellular phones for business, during and outside working hours, has created the need to develop products that will enable an enterprise to generate a true and full record of all the calls made by its employees, including cellular calls and calls made by calling cards and other charge plans.

Telephony over the Internet, which provides voice communications using the Internet, is now becoming more prevalent. In conjunction with these services is "pre-paid", which allows a customer to buy a certain amount of time (expressed as a function of money) either from the web or through the purchase of a "scratch" card (which contains an account or personal identification number (PIN) and units of time) and debits the account with each usage.

18

Internet Protocol Television, or IPTV, digital television service delivered using the Internet Protocol over a network infrastructure, is also becoming more prevalent. For IPTV services, BSS are required to be able to offer and charge personalized rates, such as rate per content attributes, bundled package discounts and advice-of-charge according to subscriber's attributes before a service is consumed. In addition, since IPTV service providers rely heavily on revenues from direct advertising and charge the advertiser by exposures and per click, the BSS for IPTV must be able to identify such events and charge the advertiser accordingly.

PRODUCTS AND SERVICES

We offer a range of TEM solutions for enterprises and BSS solutions for ITSPs, based on our standard platforms which can be adjusted to specific customers' needs and requests, as well as fault management systems for networks and PBXs, and facilities management for cabling and equipment. Additionally, some of our products are geared for communications resellers and as such enable them to issue regular bills for the communications services rendered.

BACKGROUND HISTORY

We were the first company to offer a PC-based non-dedicated call accounting system when we introduced the first version of TABS in 1985. To date, over 70,000 TABS accounting systems have been sold to end-users located in over 80 countries. TABS supports worldwide charging methods (pulse and duration), call pricing tables and currencies and is available in different languages. Our PBX interface database includes default formats for the major PBX manufacturers and business phone systems, including those manufactured by Ericsson, Philips, Siemens, Lucent, Nortel, Alcatel, ECI/Tadiran, Harris, NEC, Avaya, Mitel, Damovo, LG and Panasonic, making TABS compatible with substantially all currently available PBX and business phone systems. Our flexible format allows some of the newer equipment such as VoIP PBXs and routers/gateways to be inputted to and reported on TABS. This includes the RADVision and Cisco gateways and gatekeepers.

CALL ACCOUNTING AND TELECOMMUNICATIONS EXPENSE MANAGEMENT SOLUTIONS FOR ENTERPRISES

TABS.IT

TABS.IT is a solution for small offices, medium sized businesses, and Fortune 500 enterprises that want to take full control over their communications network. Specific applications enable hotels, shared tenant environments, hospitals, universities and service bureaus to resell communications services to users employing simple, yet efficient mark-up formulas.

TABS.IT tracks the details of all voice communications usage (dialed numbers, call duration, destination, cost of each call, trunk line usage, etc.) and produces accurately priced individual customer bills. In addition, TABS.IT tracks the details of all data communications (IP address, name, number of bytes, bandwidth usage, nodes, etc.) and can produce a relative cost figure.

The powerful TABS.IT report generator provides a wide variety of usage reports that are easy to read and understand, yet provide all the information necessary to identify how communications network resources are being utilized. These reports can be generated either as a summary of the call data or complete with all the details necessary to make informed management decisions. Their structural flexibility allows the user to quickly zero in on the specific data of greatest interest. Historical reports may be maintained for an unlimited period of time and can become useful tools for assessing budget needs for the coming months or years.

Version 7 of TABS.IT is fully web-based allowing users to see their own call usage on-line from anywhere, and incorporates most of the features that were offered as separate modules in previous versions. This version is easily adapted to companies that have multiple sites, and would want to view the activity from a central site. The administrative functions can also be performed remotely using Internet Explorer. Full security and privacy is assured by use of various levels of password protection.

APPLICATION SUITE

The Application Suite is an integrated, customized solution to manage and control the entire communications network. The Application Suite implements and monitors real time performance and usage defined by the organization to maintain budget control, usage performance and system health, and utilized by service providers for converged pre and post paid billing. The system's flexible architecture enables organizations to effectively manage their entire billing process, adding on capabilities as their business grows, in accordance with customer's requests, special projects or market trends. Utilizing its web-based user centric capabilities, the platform provides its users, including administrators, employees, and customers, with a single easy-to-use interface self provisioning customer care, while guaranteeing corporate security via the different authentication levels.

The main functions of the TABS.IT and our prior WinTRAK family of products were incorporated into the Application Suite solution, which supersedes these solutions. In addition, budget control monitoring modules were added to the Application Suite solution to verify that the extensions, departments, cost centers operate within budget, and a credit limit may be assigned.

In 2005, we enhanced and expanded our Application Suite to include an invoice management module. This new module checks the rates billed by the service provider against the contracted rates and also reconciles an organization's telecommunications bills reflecting the usage reported by the service provider with the actual usage recorded by the Application Suite. Additionally, the new module checks that the services provider has charged only for communication equipment actually used by the organization, as opposed to equipment that is no longer serviceable or not under current service contracts. An organization's internal procedures for payment of bills can be entered into the Application Suite and it will track the bills and insure that there are no delays in payments, and in the case of discrepancies between the usage and bills, it will provide an analysis of the discrepancies.

BILLING SOLUTIONS

In today's growing telecommunication services world, operators and service providers must have full control and real-time monitoring capabilities of their expenses and revenues associated with the services provided. To achieve that, telecommunication BSS need to manage all aspects of their business, primarily in three main areas:

- Retail Billing - settlement with the end customer (business or residential) who purchases and consumes the services. Services may be consumed by either online or offline charging methods (supporting postpaid and prepaid scenarios).

- Partner Settlement - settlement of all value added services, or VAS, provided (such as content SMS/MMS, pay-by-mobile services and location-based advertising services). The settlement involves the support of advance business models, such as revenue sharing between the operator/service provider and VAS provider based on the end customer's consumption.

- Interconnect Settlement - settlement between the operator / service provider and other local or international carriers for the traffic which is transferred between them. The basic goal of an interconnect solution is to produce an invoice for the calls you have delivered for another operator and to validate the invoices received from other operators for the calls they have delivered for you. We believe that obtaining interconnect agreements is essential for new entrants that cannot deliver services without other networks to complete their calls.

To efficiently manage the foregoing business requirements, operational and economical wise, carriers and service providers require a convergent billing platform. This kind of platform should simplify the way in which an operator and service provider settles invoices with its customers and interconnects with value added partners.

Our IPTV solution meets market requirements and may be installed side-by-side with legacy systems and may provide an economic solution to new providers of virtual IPTV services. We believe that partnering with network vendors and system integrators is the most advantageous means to generate sales and to focus our resources on product marketing and software development.

OTHER MODULES

An add-on module, Tie Line Reconciliation, or TLR, provides for the accurate costing of calls in a private PBX network by calculating the actual cost of calls routed over private tie lines and assigning charges to the originating extension. The call is resolved into an accurate origination-destination configuration even though the call may pass many "nodes" along the way, with each potentially discharging an independent call record.

Another add-on module, Property Management System interface, or PMSi, provides an interface protocol and format for telecommunication management systems with hotel billing solutions (Front Office or PMS systems). Through the use of this interface, which can also connect to PBXs, the hotel system is able to control the opening and closing of guest extensions on check in or out.

Another add-on module is our Budget Manager, which allows an administrator to assign credit limits to extensions, departments, cost centers, or any other organizational hierarchy, and monitor whether these limits have been exceeded or the calls remain within their allocated budgets.

CUSTOMER SERVICE AND INSTALLATION

We provide customer support to end-user customers in the United States, Israel, Hong Kong, the Netherlands and Brazil on both a service contract and a per-incident basis. Our technical support engineers answer support calls directly and generally seek to provide same-day responses. We provide updated telephone rate tables to customers on a periodic basis under annual service contracts. The rate tables are obtained from third-party vendors who provide this data for all major long-distance service providers. Our distributors provide a full range of service and technical support functions for our products, including rate tables, to their respective end-user customers.

Our support staff installs our call accounting products at end-user locations, if required, from offices in Israel, the United States, Hong Kong, the Netherlands and Brazil. Our TEM products and BSS solutions are installed by our support staff at the and user locations or remotely from our offices in

Israel, the United States, Hong Kong, the Netherlands and Brazil. Customers who maintain their own technical staffs are generally able to install our call accounting products themselves. We charge our customers a fee for each installation performed by our employees. Our distributors are responsible for the installation and support of our products with respect to their end-user customers.

SALES AND MARKETING

We market our TEM products in over 80 countries worldwide through OEM distribution channels and our own direct sales force in the United States, Europe, Israel, Hong Kong and Brazil, and through a network of local distributors in these and various other countries in Europe, Asia, Africa and Latin America. We market our BSS solutions for ITSPs through next generation telecommunications network solutions suppliers and our own direct sales force. We employed 20 persons in sales and marketing and 29 persons in support as of December 31, 2006, as compared to 18 persons in sales and marketing and 30 persons in support as of December 31, 2005.

With the acquisition of IntegraTRAK in April 2000, our marketing efforts in North America were significantly increased. This also enabled us to acquire additional Fortune 500 companies as our customers. We also sell our products to business telephone switching systems manufacturers and vendors, distributors and PTTs. Since 1985, over 70,000 TABS call accounting products have been sold, many of which have been sold to large organizations. In addition, as customers move to consolidate the management of their multi-site telecommunications activities, we intend to capitalize on our initial successes with our customers and expand the use of our products by offering these organizations the added capabilities of expanding and monitoring on the web. By acquiring the FaciliTRAK software in March 2002, we gained access to a whole new realm of opportunities and we now are able to offer a complete solution to the high-end market sector. With the acquisition of TelSoft in July 2006, our marketing efforts in North America increased. The purchase of TelSoft has enabled us to increase our customer base.

MANAGED SERVICES

Our managed services solution is an outsourcing solution geared to multi-national companies that centrally manage their telecommunications usage and is offered as an added value service. This solution has been offered in the United States where our Seattle office acts as a service bureau.

SWITCHING SYSTEMS MANUFACTURERS AND VENDORS. We believe that the most efficient means of selling our telemanagement products is to enter into relationships with major business telephone system manufacturers and vendors who market our products on either an original equipment manufacturer, or OEM, basis, or supplemental sales basis at the time they sell their switching systems. We also utilize our distributors to market our products to local business telephone switching systems manufacturers and distributors. We intend to establish additional strategic relationships with business telephone switching systems manufacturers and vendors and PTTs. These manufacturers have begun to consider telemanagement capability as a competitive tool when selling their products and have begun to offer end-users a complete, integrated solution. Among the companies that sell our telemanagement products are Siemens, Philips, Ericsson, Lucent, Nortel, Alcatel, ECI/Tadiran, Harris, NEC, Avaya, Mitel, Cisco, Damovo, LG and Panasonic. We have also entered into an agreement with Airspan and another major global manufacturer with respect to our billing products. In addition, we work with gateway providers such as Cisco, Mera, ArelNet and

RADVision. The percentages of sales attributable to our three largest OEM customers, Siemens, Philips and Ericsson, in each of the three years ended December 31, 2006 are as follows:

	2004	2005	2006
Siemens	38.0%	36.0%	29.0%
Philips	5.0%	4.0%	4.0%
Ericsson	4.0%	2.0%	1.0%

DISTRIBUTORS. In general, in those countries where we do not have a marketing subsidiary, we distribute our products through a local distributor. Marketing, sales, training, product and client support are provided by our local distributors. A local distributor is typically a telecommunication products marketing organization with the capability to add value with installation, training, and support. Distributors are generally responsible for the localization of our products into their native language. The distributor also translates our standardized product marketing literature and technical documentation. Prior to becoming an authorized distributor, the distributor's employees must undergo sales and technical training. We are available for second-tier support for the distributor and for end-users. In coordination with the distributors, we also provide technical support for large and multinational accounts. We have distributors worldwide and intend to expand our network of distributors and resellers in selected markets.

PTTS. We also market our products to PTTs (post, telephone and telegraph authorities) who integrate our solutions with the telephone systems they sell or lease to their customers. Among the PTTs who sell our products are Telecom Italy, Cable and Wireless, Trinidad PTT and Hong Kong Telecom.

STRATEGIC RELATIONSHIPS. As part of our marketing strategy, we attempt to develop and establish new strategic relationships with manufacturers of voice and data communication systems and IP based equipment as means of entering new markets and channels. We are also continuing our relationship with RADVision, a recognized IP technology leader. Together with RADVision, we offer solutions consisting of RADVision's Gatekeeper and our advanced web-based call management solution. We also signed an agreement with Cisco, pursuant to which Cisco will certify the use of our VoIP solution in their CallManager call processing software, a key component of Cisco's AVVID (Architecture for Voice, Video and Integrated Data). Our software provides validated reports on call records, start time, duration, and origin and final destination. Additional features include the ability to allocate usage-sensitive call costing and, using an integrated fraud module, detect unauthorized or inappropriate system access.

OTHER MARKETING ACTIVITIES. We are conducting a wide range of marketing activities aimed at generating awareness and leads, including public relations, attendance at trade shows and exhibitions, user conferences, direct mail, response mail and seminars. We have joined alliances with strategic partners such as Avaya, Alcatel and Cisco. We regularly advertise our products in prominent trade publications, and we also participate in major regional and international technology and communications trade shows, forums, and fairs worldwide. These activities are intended both to generate leads and maintain the general public awareness of our products. We maintain our website, allowing for correspondence and queries from new potential customers as well as promoting support for our existing customer base.

COMPETITION

The market for telemanagement products and billing solutions is fragmented and is intensely competitive. Competition in the industry is generally based on product performance, depth of product line, technical support and price. We compete both with international and local competitors (including providers of telecommunications and billing services), many of whom have significantly greater financial, technical and marketing resources than we do. Our existing and potential customers, including business telephone switching system manufacturers and vendors, may be able to develop telemanagement and billing products and services that are as effective as, or more effective or easier to use than, those offered by us. Such existing and potential competitors may also enjoy substantial advantages over us in terms of research and development expertise, manufacturing efficiency, name recognition, sales and marketing expertise and distribution channels. Although we believe that the quality of our products is equal to or better than the product quality of our competitors with regard to performance and reliability, we have no quantitative data other than the evaluations of our present customers from which to assess our current ability to compete. There can be no assurance that we will be able to compete successfully against current or future competitors or that competition will not have a material adverse effect on our future revenues and, consequently, on our business, operating results and financial condition.

INTELLECTUAL PROPERTY RIGHTS

We rely upon a combination of security devices, copyrights, trademarks, patents, trade secret laws, confidentiality procedures and contractual restrictions to protect our rights in our products. In 2005, we filed an international patent application (PCT application), which is currently pending, relating to a mobile verification technique that verifies mobile phone usage against the bill received from the service provider. Our policy has been to pursue copyright protection for our software and related documentation and trademark registration of our product names. Some of our products have the added protection afforded by a hardware component which has embedded software that it is difficult to misappropriate. In addition, our key employees and independent contractors are required to sign non-disclosure and confidentiality agreements. All of the intellectual property rights with respect to our current products are held by Mer Telemanagement Solutions Ltd.

Our trademark rights include rights associated with the use of our trademarks and rights obtained by registration of our trademarks. We have obtained trademark registrations in Israel and the United States. The use and registration rights of our trademarks does not ensure that we have superior rights over other third parties that may have registered or used identical related marks on related goods or services. Trademark rights are territorial in nature; therefore we do not have rights in all jurisdictions.

We believe that, because of the rapid pace of technological change in the communication industry, the legal protections for our products are less significant factors in our success than the knowledge, ability and experience of our employees, the frequency of product enhancements and the timeliness and quality of support services provided by us.

C. ORGANIZATIONAL STRUCTURE

Our wholly owned subsidiaries in the United States, Hong Kong, the Netherlands and Brazil, MTS IntegraTRAK Inc., MTS TelSoft Inc., MTS Asia Ltd., JARAGA B.V. and TABS Brazil Ltda., respectively, act as marketing and customer service organizations in those countries. Our 50% owned affiliate in Spain, Jusan S.A., is engaged in the development, manufacture, assembly, sales, distribution and maintenance of vocal server and call billing applications.

D. PROPERTY, PLANTS AND EQUIPMENT

Our executive offices and research and development facilities are located at 22 Zarhin Street, Ra'anana, Israel, where we occupy approximately 16,300 square feet. The lease, which expires on June 15, 2010, has an annual rental charge of approximately $400,000. We have subleased approximately 4,400 square feet of this space until June 15, 2010 for an annual rental charge of approximately $100,000.

Our U.S. subsidiary occupies approximately 2,314 square feet of space in Kirkland, Washington. The lease, which will expire in October 2008, has an annual rental charge of approximately $51,000.

In addition, we have an office in New Jersey, where we occupy approximately 2,150 square feet of space. The lease, which will expire in July 31, 2007, has a remaining obligation of approximately $14,000.

We also have an office in Glendale, California, where we occupy approximately 2,340 square feet of space. The lease is on a month-to-month basis for a rental fee of $4,267 per month.

The combined total annual rental cost for our Hong Kong and Sao Paulo offices is approximately $43,000. The lease agreements for these premises will expire in October 2007 and August 2008, respectively.

ITEM 4A. UNRESOLVED STAFF COMMENTS

Not applicable.

ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS

A. OPERATING RESULTS

THE FOLLOWING DISCUSSION OF OUR RESULTS OF OPERATIONS SHOULD BE READ TOGETHER WITH OUR CONSOLIDATED FINANCIAL STATEMENTS AND THE RELATED NOTES, WHICH APPEAR ELSEWHERE IN THIS ANNUAL REPORT. THE FOLLOWING DISCUSSION CONTAINS FORWARD-LOOKING STATEMENTS THAT REFLECT OUR CURRENT PLANS, ESTIMATES AND BELIEFS AND INVOLVE RISKS AND UNCERTAINTIES. OUR ACTUAL RESULTS MAY DIFFER MATERIALLY FROM THOSE DISCUSSED IN THE FORWARD-LOOKING STATEMENTS. FACTORS THAT COULD CAUSE OR CONTRIBUTE TO SUCH DIFFERENCES INCLUDE THOSE DISCUSSED BELOW AND ELSEWHERE IN THIS ANNUAL REPORT.

BACKGROUND

We were incorporated under the laws of the State of Israel in December 1995, as a subsidiary of C.Mer Industries Ltd., an Israeli public company. Since our initial public offering in May 1997, our ordinary shares have been listed on the NASDAQ Stock Market. In June 1999, C.Mer Industries Ltd. distributed to its shareholders all of its remaining shares in our company as a dividend.

We have wholly-owned subsidiaries in the United States, Hong Kong, the Netherlands and Brazil, MTS IntegraTRAK Inc., MTS TelSoft Inc., MTS Asia Ltd., JARAGA B.V. and TABS Brazil Ltda., respectively, which act as marketing and customer service organizations in those countries. We also have a 50% owned affiliate in Spain, Jusan S.A., which is engaged in the development, manufacture, assembly, sales, distribution and maintenance of vocal server and call billing applications.

OVERVIEW

We are a worldwide provider of solutions for TEM used by enterprises and BSS used by ITSPs. Our TEM solutions assist enterprises and organizations to make smarter choices with their telecommunications spending at each stage of the service lifecycle, including allocation of cost, proactive budget control, fraud detection, processing of payments and spending forecasting. Our TEM solutions support our clients on an ongoing basis with both sophisticated software applications and a variety of managed services relationship models. Our converged BSS solutions for ITSPs have been successfully implemented worldwide by wireless providers, Voice over Internet Protocol, Internet Protocol Television, and content service providers. Our converged BSS solutions include applications for charging and invoicing customers, interconnect billing and partner revenue management using pre-pay and post-pay schemes. Our pre-configured BSS solutions have been designed to be implemented quickly and are competitively priced.

On July 31, 2006, we completed the acquisition of certain assets and liabilities of TelSoft, a California corporation, a provider of call accounting and TEM products. The TelSoft products offer a complementary solution to our products. In connection with the acquisition, we paid an initial consideration of $1.1 million and agreed to pay additional contingent consideration based on post acquisition revenue performance during the 12 month period following the acquisition. We believe that the acquisition of TelSoft's TEM and call accounting software will enable us to expand our TEM solutions and will assist us to strengthen our growing business in the United States.

GENERAL

Our consolidated financial statements appearing in this annual report are prepared in U.S. dollars and in accordance with generally accepted accounting principles in the United States, or U.S. GAAP. Transactions and balances originally denominated in dollars are presented at their original amounts. Transactions and balances in other currencies are remeasured into dollars in accordance with the principles set forth in Financial Accounting Standards Board Statement No. 52. The majority of our sales are made outside Israel in dollars. In addition, substantial portions of our costs are incurred in dollars. Since the dollar is the primary currency of the economic environment in which we and certain of our subsidiaries operate, the dollar is our functional and reporting currency and, accordingly, monetary accounts maintained in currencies other than the dollar are remeasured using the foreign exchange rate at the balance sheet date. Operational accounts and non-monetary balance sheet accounts are measured and recorded at the exchange rate in effect at the date of the transaction. The financial statements of certain subsidiaries and an affiliate whose functional currency is not the dollar, have been translated into dollars. All balance sheet accounts have been translated using the exchange rates in effect at the balance sheet date. Statement of operations amounts have been translated using the average exchange rate for the period. The resulting translation adjustments are reported as a component of shareholders' equity in accumulated other comprehensive income (loss).

DISCUSSION OF CRITICAL ACCOUNTING POLICIES AND ESTIMATIONS

The preparation of financial statements in conformity with generally accepted accounting principles requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates and the use of different assumptions would likely result in materially different results of operations.

Critical accounting policies are those that are both most important to the portrayal of a company's financial position and results of operations, and require management's most difficult, subjective or complex judgments. Although not all of our significant accounting policies require management to make difficult, subjective or complex judgments or estimates, the following policies and estimates are those that we deem most critical:

REVENUE RECOGNITION. We account for our revenue in accordance with the provisions of SOP No. 97-2, "Software Revenue Recognition," issued by the American Institute of Certified Public Accountants and as amended by SOP No. 98-9 and related interpretations. When an arrangement does not require significant production, modification or customization of software or does not contain services considered to be essential to the functionality of the software, revenue is recognized when the following four criteria are met:

- Persuasive evidence of an arrangement exists. We require evidence of an agreement with a customer specifying the terms and conditions of the products or services to be delivered typically in the form of a purchase order or the customer's signature on our proposal;

- Delivery has occurred. For software licenses, delivery takes place when the software is installed on site or remotely or is shipped via mail on a compact disc or server. For services, delivery takes place as the services are provided;

- The fee is fixed or determinable. Fees are fixed or determinable if they are not subject to a refund or cancellation and do not have payment terms that exceed our customary payment terms; and

- Collection is probable. We perform a credit review of all customers with significant transactions to determine whether a customer is credit worthy and collection is probable.

In general, revenue for transactions that do not involve software customization or services considered essential to the functionality of the software is recognized as follows: (i) software license fees for sales through OEMs are recognized upon receipt of license activity reports; (ii) all other software license fees are recognized upon delivery of the software; (iii) software maintenance and technical support are recognized ratably over the contract term; and (iv) consulting, training and other similar services are recognized as the services are performed.

We exercise judgment and use estimates in connection with the determination of the amount of product software license and services revenues to be recognized in each accounting period. If the fee due from the customer is not fixed or determinable, revenue is recognized as payments become due from the customer. If collection is not considered probable, revenue is recognized when the fee is collected. We record a provision to operating expenses for bad debts resulting from customers' inability to pay for the products or services they have received. These estimates are based on historical bad debt expense, analyses of credit memo data, and other known factors, such as bankruptcy. If the historical data we use to calculate these estimates do not accurately reflect future returns or bad debts, adjustments to these reserves may be required that would increase or decrease revenue or net income.

Many of our software arrangements involve multiple elements. Such elements typically include any or all of the following: software licenses, software maintenance, technical support and training services. For multiple-element arrangements that do not involve significant modification or customization of the software and do not involve services that are considered essential to the functionality of the software, we allocate value to each undelivered element based on vendor specific objective evidence, or VSOE, of the fair value of each undelivered element in the arrangement, in accordance with the "residual method" prescribed by SOP No. 98-9, "Modification of SOP No. 97-2, Software Revenue Recognition With Respect to Certain Transactions." The VSOE used by us to allocate the sales price to support services and maintenance is based on the renewal rate charged when these elements are sold separately. License revenues are recorded based on the residual method. Under the residual method, revenue is recognized for the delivered elements when (i) there is VSOE of the fair values of all the undelivered elements, and (ii) all revenue recognition criteria of SOP No. 97-2, as amended, as described above, are satisfied. Under the residual method any discount in the arrangement is allocated to the delivered element.

Revenues from billing products which involve significant customization of our software to customer specific specifications are recognized in accordance with SOP No. 81-1, "Accounting for Performance of Construction-Type and Certain Production-Type Contracts," using contract accounting on a percentage of completion method, over the period from signing of the license through to customer acceptance in accordance with the "input method." The amount of revenue recognized is based on the total license fees under the license agreement and the percentage to completion achieved. The percentage to completion is measured by monitoring progress using records of actual costs incurred to date in the project compared with the total estimated project requirements. Estimates of total project requirements are based on prior experience of customization, delivery and acceptance of the same or similar technology and are reviewed and updated regularly by management.

Where arrangements recognized according to SOP No. 81-1 involve maintenance and support services, revenues are recognized according to Emerging Issues Task Force, or EITF, Issue No. 00-21, "Revenues Arrangements with Multiply Deliveries," or EITF 00-21. According to EITF 00-21, a multiple-element arrangement (an arrangement that involves the delivery or performance of multiple products, services and/or rights to use assets) is separated into more than one unit of accounting, if the functionality of the delivered element is not dependent on the undelivered element, there is VSOE of fair value of the undelivered element and delivery of the delivered element represents the culmination of the earnings process for this element. We have established VSOE for maintenance and support services based on the renewal rate that will be charged when these elements are sold separately and therefore the arrangement consideration is allocated to maintenance and support services based on their relative VSOE.

After delivery, if uncertainty exists about customer acceptance of the software, license revenue is not recognized until acceptance. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are first determined, in the amount of the estimated loss on the entire contract. As of December 31, 2006, no such estimated losses were identified.

Estimated gross profit or loss from long-term contracts may change due to changes in estimates resulting from differences between actual performance and original forecasts. Such changes in estimated gross profit are recorded in results of operations when they are reasonably determinable by management, on a cumulative catch-up basis.

We believe that the use of the percentage of completion method is appropriate as we have the ability to make reasonably dependable estimates of the extent of progress towards completion, contract revenues and contract costs. In addition, contracts executed include provisions that clearly specify the enforceable rights regarding services to be provided and received by the parties to the contracts, the consideration to be exchanged and the manner and terms of settlement. In all cases we expect to perform our contractual obligations and our licensees are expected to satisfy their obligations under the contract.

ALLOWANCES FOR DOUBTFUL ACCOUNTS. We perform ongoing credit evaluations of our customers' financial condition and we require collateral as deemed necessary. We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make payments. In judging the adequacy of the allowance for doubtful accounts, we consider multiple factors including the aging of our receivables, historical bad debt experience and the general economic environment. Management applies considerable judgment in assessing the realization of receivables, including assessing the probability of collection and the current credit worthiness of each customer. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required.

INCOME TAXES. Estimates and judgments are required in the calculation of certain tax liabilities and in the determination of the recoverability of certain of the deferred tax assets, which arise from net operating losses tax carryforwards and temporary differences between the tax and financial statement recognition of revenue and expense. Statement of Financial Accounting Standards, or SFAS, No. 109, "Accounting for Income Taxes," also requires that the deferred tax assets be reduced by a valuation allowance, if based on the weight of available evidence, it is more likely than not that some portion or all of the recorded deferred tax assets will not be realized in future periods.

In evaluating our ability to recover our deferred tax assets, in full or in part, we consider all available positive and negative evidence including our past operating results, the existence of cumulative losses in the most recent fiscal years and our forecast of future taxable income on a jurisdiction by jurisdiction basis. In determining future taxable income, we are responsible for assumptions utilized, including the amount of Israeli and international pre-tax operating income, the reversal of temporary differences and the implementation of feasible and prudent tax planning strategies. These assumptions require significant judgment about the forecasts of future taxable income and are consistent with the plans and estimates we use to manage the underlying businesses.

Based on estimates of future taxable profits and losses in certain foreign tax jurisdictions, we determined that a valuation allowance of $2.9 million was required for tax loss carryforwards and other temporary differences as of December 31, 2006. If these estimates prove inaccurate, a change in the valuation allowance could be required in the future.

CONTINGENCIES. We are involved in legal proceedings and other claims from time to time. We are required to assess the likelihood of any adverse judgments or outcomes to these matters, as well as potential ranges of probable losses. A determination of the amount of reserves required, if any, for any contingencies are made after careful analysis of each individual claim. The required reserves may change due to future developments in each matter or changes in approach, such as a change in the settlement strategy in dealing with any contingencies, which may result in higher net loss. If actual results are not consistent with our assumptions and judgments, we may be exposed to gains or losses that could be material. See "Item 8A. Financial Information - Consolidated Statements and Other Financial Information - Legal Proceedings."

IMPAIRMENT OF LONG-LIVED ASSETS. We review our long-lived assets and certain identifiable intangible assets for impairment whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Factors that could indicate an impairment include significant underperformance of the asset as compared to historical or projected future operating results, significant changes in the actual or intended use of the asset, or significant negative industry or economic trends. When we determine that the carrying value of an asset may not be recoverable, the related estimated future undiscounted cash flows expected to result from the use and eventual disposition of the asset are compared to the carrying value of the asset. If the sum of the estimated undiscounted future cash flows is less than the carrying amount, we record an impairment charge based on the difference between the carrying value of the asset and its fair value, which we estimate based on discounted expected future cash flows. In determining whether an asset is impaired, we must make assumptions regarding recoverability of costs, estimated future cash flows from the asset, intended use of the asset and other related factors. If these estimates or their related assumptions change, we may be required to record impairment charges for these assets. As of December 31, 2006, no impairment losses have been identified.

GOODWILL. We have recorded goodwill as a result of acquisitions. Goodwill is not amortized, but rather is subject to an annual impairment test. Statement of Financial Accounting Standard, or SFAS, No. 142 requires goodwill to be tested for impairment at least annually or between annual tests if certain events or indicators of impairment occur. The impairment test consists of a comparison of the fair value of goodwill with its carrying amount. If the carrying amount of goodwill exceeds its fair value, an impairment loss is recognized in an amount equal to that excess. Goodwill is tested for impairment at the reporting unit level by a comparison of the fair value of a reporting unit with its carrying amount. We have elected to perform our analysis of goodwill at the end of the third quarter of the year. During 2004, 2005 and 2006, no impairment losses were identified.

28

RESULTS OF OPERATIONS

The following table presents certain financial data expressed as a percentage of total revenues for the periods indicated:

	Year Ended December 31,		
	2004	2005	2006
Revenues			
Product sales	75.1%	66.0%	71.7%
Services	24.9	34.0	28.3
Total revenues	100.0%	100.0%	100.0%
Cost of revenues			

Product sales	25.6	25.7	25.1
Services	4.3	7.2	6.9
Total cost of revenues	29.9	32.9	32.0
Gross profit	70.1	67.1	68.0
Selling and marketing	66.9	41.5	29.4
Research and development, net	25.1	38.0	34.7
General and administrative	22.3	24.5	25.3
Operating loss	(44.2)	(36.9)	(21.4)
Financial income (expenses), net	0.8	0.5	(0.5)
Loss before taxes on income	(43.4)	(36.4)	(21.9)
Taxes on income	2.8	0.1	1.1
Net loss before equity in earnings of affiliate	(46.2)	(36.5)	(23.0)
Equity in earnings of affiliate	2.4	0.0	1.5
Net loss	(43.8)%	(36.5)	(21.5)

YEARS ENDED DECEMBER 31, 2006 AND 2005

REVENUES FROM PRODUCTS AND SERVICES. Revenues consist primarily of software license fees sales, hardware sales and revenues from services, including service bureau, maintenance, training, professional services and support. Revenues decreased by 9.3% to $10.48 million for the year ended December 31, 2006 from $11.56 million for the year ended December 31, 2005. Revenues from our wholly-owned U.S. subsidiary, MTS IntegraTRAK, decreased by 11.4% to $5.35 million, or 51.1% of our total revenues, for the year ended December 31, 2006 from $6.04 million, or 52.3% of our total revenues, for the year ended December 31, 2005. The decrease in revenues in 2006 is primarily attributable to a longer sales cycle for our solutions during the year ended December 31, 2006 compared with the year ended December 31, 2005. We anticipate that our revenues will slightly increase in 2007.

COST OF REVENUES FROM PRODUCTS AND SERVICES. Cost of revenues consists primarily of (i) production costs (including hardware, media, packaging, freight and documentation); (ii) certain royalties and licenses payable to third parties (including the Office of the Chief Scientist of the Ministry of Industry, Trade and Labor of the State of Israel), (iii) professional services costs; and (iv) warranty and support costs for up to one year for end-users and up to 15 months for our OEM distributors. Cost of revenues decreased by 11.8% to $3.34 million for the year ended December 31, 2006 from $3.80 million for the year ended December 31, 2005. The decrease in cost of revenues is consistent with the decrease in revenues and principally a result of a reduction in the number of employees in professional services and technical support departments.

RESEARCH AND DEVELOPMENT, NET. Research and development expenses, net consist primarily of salaries of employees engaged in on-going research and development activities, outsourcing subcontractor development and other related costs, net of grants that were approved by the Office of the Chief Scientist of the Ministry of Industry, Trade and Labor of the State of Israel. Research and development, net expenses decreased by 17.3% to $3.63 million for the year ended December 31, 20