CHECK POINT SOFTWARE TECHNOLOGIES LTD
Form 20-F
June 25, 2001

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SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 20-F

(Mark One)

( ) 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, 2000

OR

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

For the transition period from _____________ to __________

Commission file number 0-28584

CHECK POINT SOFTWARE TECHNOLOGIES LTD.

(Exact name of Registrant as Specified in Its Charter)

ISRAEL

(Jurisdiction of Incorporation or Organization)

3A Jabotinsky Street, Ramat-Gan 52520, Israel

(Address of Principal Executive Offices)

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

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

of NIS 0.01 nominal value

Ordinary shares (par value NIS 0.01) of registrant outstanding at December 31, 2000 -235,464,986 (end of reporting period).

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act: No

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

Yes X No

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

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PART I

ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISORS.

Not applicable.

ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE

Not applicable.

ITEM 3. KEY INFORMATION

The following selected consolidated statements of income data for the years ended December 31, 1998, 1999 and 2000, and the selected consolidated balance sheet data as of December 31, 1999 and 2000 have been derived from the Company's audited consolidated financial statements, set forth elsewhere in this Form 20-F. These financial statements have been prepared in accordance with Generally Accepted Accounting Principles in the United States ("US

GAAP"). The selected consolidated statement of income data for the years ended December 31, 1996 and 1997 and the selected consolidated balance sheet data as of December 31, 1996, 1997, and 1998, have been derived from audited consolidated financial statements not included in this Form 20-F and have also been prepared in accordance with US GAAP. The selected consolidated financial statements set forth below should be read in conjunction with and are qualified by reference to our consolidated financial statements and the related notes as well as "Item 5: Operating and Financial Review and Prospects" included elsewhere in this Annual Report on Form 20-F.

	YEAR ENDED DECEMBER 31,				
	1996 (*)	1997 (*)	1998 (*)	1999	200
	(IN THOUSANDS, EXCEPT SHARE DATA)				
CONSOLIDATED STATEMENT OF OPERATIONS DATA:					
Revenues................................	$34,580	$86,352	$141,941	$219,567	$425
Cost of revenues........................	2,884	6,839	13,623	22,423	35,
Gross profit............................	31,696	79,513	128,318	197,144	390,
Operating expenses:					
Research and development, net...........	3,803	7,105	10,629	18,923	30,
Sales and marketing.....................	10,275	26,611	39,966	68,229	110,
General and administrative..............	3,641	7,766	10,886	13,069	20,
Total operating expenses................	17,719	41,482	61,481	100,221	160,
Operating income........................	13,977	38,031	66,837	96,923	229,
Financial income, net...................	1,490	4,556	4,406	12,770	29,
Capital gain	--	--	2,581	192	
Income before taxes on income...........	15,467	42,587	73,824	109,885	258,
Taxes on income.........................	346	2,309	3,947	14,104	37,
	15,121	40,278	69,877	95,781	221,
Equity in losses of an affiliate.........	-	760	-	-	
Net Income..............................	$15,121	$39,518	$69,877	$95,781	$221,
Basic net earnings per share (1).........	$0.08	$0.19	$0.33	$0.43	$0.9
Shares used in computing basic net earnings per share (1)..................	190,476	203,622	212,610	222,930	232,61
Diluted net earnings per share (1).......	$0.07	$0.17	$0.30	$0.39	$0.8
Shares used in computing diluted net earnings per share (1)..................	215,958	228,312	232,170	246,456	262,51

	DECEMBER 31,				
	1996 (*)	1997 (*)	1998 (*)	1999	2
	(IN THOUSANDS)				
BALANCE SHEET DATA:					
Working capital	$56,603	$60,817	$80,872	$198,204	$313
Total Assets............................	66,572	124,964	212,235	394,346	777
Shareholder's equity	58,170	100,025	175,707	292,508	549

(1) See Note 2q of Notes to consolidated financial statements for an explanation of the determination of shares used in computing net earnings per share.

(*) Reported financial results reflect the acquisition of MetaInfo, Inc., which was accounted for as a pooling-of-interest transaction, and all prior period amounts have been restated.

RISK FACTORS

This Form 20-F contains forward-looking statements that involve risks and uncertainties. The statements contained in this Form 20-F that are not purely historical are forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), including, without limitation, statements regarding the Company's expectations, beliefs, intentions, goals, plans, investments or strategies regarding the future. Forward-looking statements also include statements in (i) Item 4 - Information on the Company regarding increased acceptance of Internet technologies, expansion of connectivity services, acceleration of the use of networks, increasing demands on enterprise security systems, the impact of the Company's OEM relationships on its sales goals, the contribution of the FireWall-1 and VPN-1 products to the Company's future revenue and the development of future products and (ii) "Item 5: Operating and Financial Review and Prospects" regarding future sources of revenue, ongoing relationships with current and future end-user customers and resellers, future costs and expenses, adequacy of capital resources and the Company's Year 2001 and Euro conversion readiness, exposure and expected expenditures. These statements involve risks and uncertainties and actual results could differ materially from such results discussed in these statements as a result of the risk factors set forth below in this Form 20-F. All forward-looking statements included in this document are based on information available to the Company on the date hereof, and the Company assumes no obligation to update any such forward-looking statements.

COMPETITION

The market for enterprise security products and services is intensely competitive and the Company expects competition to increase in the future. The Company's principal network security competitors include Cisco Systems and Nortel Networks. Other competitors include 3Com Corporation, Lucent Technologies, Microsoft Corp., Network Associates, NetScreen Technologies Inc., Nokia (the Company and Nokia jointly develop Firewall-1 and VPN-1

security appliances, however Nokia sells separately its own VPN solution which excludes a firewall), Novell Inc., SonicWALL Inc., Symantec Inc., WatchGuard Technologies Inc., and Secure Computing. The Company expects additional competition from other emerging and established companies. There can be no assurance that the Company's current and potential competitors, including its current OEM partners, will not develop network security products that may be more effective than the Company's current or future products or that the Company's technologies and products will not be rendered obsolete by such developments. In particular, the enterprise security market has historically been characterized by low financial entry barriers.

Many of the Company's current and potential competitors have longer operating histories, greater name recognition, access to larger customer bases and significantly greater financial, technical and marketing resources than the Company. As a result, they may be able to adapt more quickly to new or emerging technologies and changes in customer requirements or to devote greater resources to the promotion and sale of their products than the Company. In addition, certain of the Company's competitors may determine, for strategic reasons, to consolidate, to substantially lower the price of their enterprise security products or to bundle their products with other products, such as hardware products or other enterprise software products. The Company expects that there will be increasing consolidation in the enterprise security market and that there can be no assurance that such consolidation will not materially adversely impact the Company's competitive position. In addition, current and potential competitors have established or may establish financial or strategic relationships among themselves, with existing or potential customers, resellers or other third parties. Accordingly, it is possible that new competitors or alliances among competitors may emerge and rapidly acquire significant market share. There can be no assurance that the Company will be able to compete successfully against current and future competitors.

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Increased competition may result in price reductions, reduced gross margins and loss of market share, any of which would materially adversely affect the Company's business, operating results and financial condition.

In the future, vendors of operating system software or networking hardware may enhance their products to include functionality that is currently provided by the Company's VPN-1/FireWall-1 family of products. The widespread inclusion of the functionality of the Company's software as standard features of operating system software or networking hardware could render the VPN-1/FireWall-1 family of products obsolete and unmarketable, particularly if the quality of such functionality were comparable to that of the Company's products. Furthermore, even if the network security functionality provided as standard features by operating systems software or networking hardware is more limited than that of the Company's VPN-1/FireWall-1 software, there can be no assurance that a significant number of customers would not elect to accept more limited functionality in lieu of purchasing additional software. In the event of any of the foregoing, the Company's business, operating results and financial condition would be materially and adversely affected. See "Item 4 - Information on the Company."

RAPID TECHNOLOGICAL CHANGE

The enterprise security industry is characterized by rapid technological advances, changes in customer requirements, frequent new product introductions and enhancements and evolving industry standards in computer hardware and software technology. As a result, the Company must continually change and improve its products in response to changes in operating systems, application software, computer and communications hardware, networking software, programming tools and computer language technology. The introduction of products embodying new technologies and the emergence of new industry standards may render existing products obsolete or unmarketable. In particular, the market for Internet and intranet applications is relatively new and is rapidly evolving. The Company's future operating results will depend upon the Company's ability to enhance its current products and to develop and introduce new products on a timely basis that address the increasingly sophisticated needs of its resellers and that keep pace with technological developments, new competitive product offerings and emerging industry standards. There can be no assurance that the Company will be successful in developing and marketing new products or product enhancements that respond to technological change and evolving industry standards, that the Company will not experience difficulties that could delay or prevent the successful development, introduction and marketing of these products, or that any new products and product enhancements will adequately meet the requirements of the marketplace and achieve market acceptance. If the Company does not respond adequately to the need to develop and introduce new products or enhancements of existing products in a timely manner in response to changing market conditions or customer requirements, the Company's business, operating results and financial condition would be materially adversely affected. See "Item 4 - Information on the Company."

POTENTIAL FLUCTUATIONS IN FUTURE OPERATING RESULTS; POTENTIAL DECLINE IN MARGINS

The quarterly operating results of the Company can vary significantly due to several factors, any of which could have a material adverse effect on the Company's operating results, and there can be no assurance that the Company will continue to be profitable on a quarterly or annual basis. Historically, the Company has not been dependant on significant amounts of revenues being generated during the end of a quarter. This trend may change in the future and the Company could experience a dependency of significant amounts of revenues being generated during the end of a quarter thereby increasing the risk of revenues being realized in the following quarter. Other factors which can cause fluctuations in operating results include seasonal trends in customer purchasing, the volume and timing of orders and the ability to fulfill orders, the level of product and price competition, the Company's ability to develop new and enhanced products and control costs, the mix of products and goods sold, the mix of distribution channels through which products are sold, the Company's ability to integrate the technology and operations of acquired businesses with those of the Company, changes in customer capital spending budgets, fluctuations in foreign currency exchange rates and general economic factors.

The Company's sales to the Far East (including Japan), in millions, were $22, $36, and $70 in 1998, 1999 and 2000 respectively, representing 16% of revenues for the years 1998, 1999, and 2000. The economy in this region is still unstable, and therefore the Company cannot predict if similar levels of sales in the region are sustainable.

During the last quarter of 2000, in general, purchases of information technology products in the United States showed a significant slowdown. The Company cannot predict the length of this current negative economic climate

and indeed whether this slowdown will affect other parts of the world such as Asia and Europe.

The Company's revenues are subject to seasonal fluctuations related to the slowdown in spending activities in Europe for the quarter ending September 30 and the year-end purchasing cycles of many end-users of the Company's products. The Company believes that, in the absence of exceptional factors such as new product introductions, it will continue to encounter quarter-to-quarter seasonality that could result in proportionately lower sales in the quarters ending September 30 and March 31 relative to sales in the quarters ending June 30 and December 31, respectively.

The Company operates with virtually no backlog and, therefore, the timing and volume of orders within a given period and the ability to fulfill such orders determines the amount of revenues within a given period. The Company's sales are principally derived through indirect channels, which make revenues from such sales difficult to predict. Furthermore, the Company's expense levels are based, in part, on expectations as to future revenues. If revenue levels are below expectations, operating results are likely to be adversely affected. Net income may be disproportionately affected by a reduction in revenues due to the relatively small amount of the Company's expenses, which vary with its revenues. As a result, the Company believes that period-to-period comparisons of its results of operations are not necessarily meaningful and should not be relied upon as indications of future performance. Due to all of the foregoing factors, it is likely that in some future quarter the Company's operating results may be below the expectations of public market analysts and investors. In such event, the price of the Company's Ordinary Shares would likely be materially adversely affected. See "Item 5: Operating and Financial Review and Prospects."

The Company may experience a decline in operating margins as it expands its customer and technical support organization. The Company also expects that it will experience increasing competition and pricing pressure, which may result in lower operating margins. In 2001, the Company intends to continue to make significant investments in the further development and expansion of its sales and marketing organization, including the expansion of its field organization both in the United States and additional countries in Europe, Asia, and Latin America. In addition, the Company expects to further expand its research and development organization and make additional investments in its general and administrative infrastructure. As a result, the Company expects operating margins to decrease from historical levels. The amount and timing of these additional expenditures are likely to result in fluctuations in operating margins. See "Item 5: Operating and Financial Review and Prospects."

RISKS ASSOCIATED WITH EMERGING NETWORK SECURITY, INTERNET AND INTRANET MARKETS

The markets for the Company's products are rapidly evolving. There can be no assurance that the Internet or common public protocols will continue to be used to facilitate communications or that the market for enterprise security systems in general will continue to expand. Continued growth of this market will depend, in large part, upon the continued expansion of Internet usage and the number of organizations adopting or expanding intranets, upon the ability of their respective infrastructures to support an increasing

number of users and services, and upon the continued development of new and improved services for implementation across the Internet, and between the Internet and intranets. If the necessary infrastructure or complementary products and services are not developed in a timely manner and, consequently, the enterprise security, Internet and intranet markets fail to grow or grow more slowly than the Company currently anticipates, the Company's business, operating results and financial condition would be materially adversely affected. See "Item 4 - Information on the Company."

DEPENDENCE UPON LIMITED NUMBER OF KEY RESELLERS; PRODUCT CONCENTRATION; IMPACT OF NEW PRODUCT INTRODUCTIONS

The Company expects that it will continue to be dependent upon a limited number of resellers for a significant portion of its revenues. If anticipated orders from these resellers fail to materialize, the Company's business, operating results and financial condition will be materially adversely affected.

The Company has derived substantially all of its revenues from sales of its FireWall-1 product and VPN-1 product family and expects to continue to derive the vast majority of its revenues in the foreseeable future from sales of its FireWall-1 product and VPN-1 product family. During the first quarter of 2001, the Company announced the Check Point Next Generation release of VPN-1/FireWall-1, which will begin shipping in the third quarter of 2001. The Company's future financial performance will depend in significant part on the successful development, introduction, marketing and customer acceptance of new products and enhancements and new features for its existing product lines. If resellers delay ordering products or cancel orders for existing products in anticipation of new releases, the Company's business, operating results and financial condition would be materially adversely affected. See "Item 5: Operating and Financial Review and Prospects" and "Item 4 - Information on the Company."

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DEPENDENCE UPON KEY PERSONNEL

The Company's future performance depends, in significant part, upon the continued service of its key technical, sales and management personnel, including Gil Shwed, Marius Nacht and Jerry Ungerman. The loss of the services of one or more of the Company's key personnel could have a material adverse effect on the Company's business, operating results and financial condition. The Company's future success also depends on its continuing ability to attract and retain highly qualified technical, sales and managerial personnel. Competition for such personnel is intense, and there can be no assurance that the Company can retain its key technical, sales and managerial employees or that it can attract, motivate or retain other highly qualified technical, sales and managerial personnel in the future. If the Company cannot retain or is unable to hire such key personnel, the Company's business, operating results and financial condition would be materially adversely affected. See "Item 4 - Information on the Company."

PRINCIPAL OPERATIONS IN ISRAEL; INTERNATIONAL OPERATIONS

The Company is incorporated under the laws of, and its principal offices and research and development facilities are located in the State of

Israel. Although substantially all of the Company's sales currently are being made to resellers outside Israel, the Company is nonetheless directly influenced by the political, economic and military conditions affecting Israel, and any major hostilities involving Israel or the interruption or curtailment of trade between Israel and its present trading partners could have a material adverse effect on the Company's business, operating results and financial condition.

The Company intends to expand its international operations, which will require significant management attention and financial resources. In order to expand worldwide sales, the Company must establish additional marketing and sales operations, hire additional personnel and recruit additional resellers internationally. To the extent that the Company is unable to do so effectively, the Company's growth is likely to be limited and the Company's business, operating results and financial condition would be materially adversely affected. In addition, as the Company expands its international operations, a portion of revenues generated in international jurisdictions may be subject to taxation by such jurisdictions at rates higher than those to which the Company is subject in Israel. Most of the Company's worldwide sales are currently denominated in United States dollars. An increase in the value of the United States dollar relative to foreign currencies would make the Company's products more expensive and, therefore, potentially less competitive in those markets. Additional risks inherent in the Company's worldwide business activities generally include unexpected changes in regulatory requirements, tariffs and other trade barriers, costs of localizing products for foreign countries, lack of acceptance of localized products in foreign countries, longer accounts receivable payment cycles, difficulties in operations management, potentially adverse tax consequences, including restrictions on the repatriation of earnings, and the burdens of complying with a wide variety of foreign laws. There can be no assurance that such factors will not have a material adverse effect on the Company's future international sales and, consequently, the Company's business, operating results and financial condition. See "Item 4 - Information on the Company" and "Item 5: Operating and Financial Review and Prospects."

PRODUCT LIABILITY; RISK OF PRODUCT DEFECTS

The Company's sales agreements typically contain provisions designed to limit the Company's exposure to potential product liability or related claims. In selling its products, the Company relies primarily on "shrink wrap" licenses that are not signed by the end-user, and, for this and other reasons, such licenses may be unenforceable under the laws of certain jurisdictions. As a result, the limitation of the liability provisions contained in the Company's agreements may not be effective. The Company's products are used to manage network security, which may be critical to organizations, and, as a result, the sale and support of products by the Company may entail the risk of product liability and related claims. A product liability claim brought against the Company could have a material adverse effect upon the Company's business, operating results and financial condition. Software products as complex as those offered by the Company may contain undetected errors or failures when first introduced or when new versions are released. In particular, the personal computer hardware environment is characterized by a wide variety of non-standard configurations that make pre-release testing for programming or compatibility errors very difficult and time-consuming. Despite testing by the Company and by current and potential resellers, there can be no assurance that errors will not 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 resellers against the Company, any of which could have a material adverse effect upon the Company's business, operating results and financial condition.

See "Item 4 - Information on the Company."

DEPENDENCE ON PROPRIETARY TECHNOLOGY; RISKS OF INFRINGEMENT; TRADEMARK LITIGATION

The Company relies primarily on a combination of copyright and trademark laws, trade secrets, confidentiality procedures and contractual provisions to protect its proprietary rights as set forth below in the section entitled "Proprietary Rights and Trademark Litigation in "Item 4 - Information on the Company." In 1998, 1999 and 2000, the Company's sales to resellers in individual countries other than the United States, Japan, Great Britain and other countries in Europe, not including Israel, were less than 9% of total revenue. There can be no assurance that the Company's patent applications will be issued within the scope of the claims sought by the Company, if at all. Furthermore, there can be no assurance that any issued patent will not be challenged, and if such challenges are brought, that such patents will not be invalidated. In addition, there can be no assurance that others will not develop technologies that are similar or superior to the Company's technology or design around any patents issued to the Company. Despite the Company's efforts to protect its proprietary rights, unauthorized parties may copy aspects of the Company's products or obtain and use information that the Company regards as proprietary. Policing any of such unauthorized uses of the Company's products is difficult, and although the Company is unable to determine the extent to which piracy of its software products exists, software piracy can be expected to be a persistent problem. In addition, the laws of some foreign countries do not protect the Company's proprietary rights as fully as do the laws of the United States or Israel. To date, the Company has not conducted any material amount of business in such countries. There can be no assurance that the Company's efforts to protect its proprietary rights will be adequate or that the Company's competitors will not independently develop similar technology.

There can be no assurance that third parties will not claim infringement by the Company with respect to current or future products. The Company expects that software companies will increasingly be subject to infringement claims as the number of products and competitors in the Company's industry segment grows and the functionality of products in different industry segments overlaps. Responding to such claims, regardless of merit, could be time-consuming, result in costly litigation, cause product shipment delays or require the Company to enter into royalty or licensing agreements. Such royalty or licensing agreements, if required, may not be available on terms acceptable to the Company, which could have a material adverse effect upon the Company's business, operating results and financial condition.

GOVERNMENT REGULATION OF TECHNOLOGY EXPORTS

A number of governments have imposed controls, export license requirements and restrictions on the export of certain technology, and specifically encryption technology. As a result, the Company has not received and may not receive approval to sell certain of its encryption security products in certain markets. The Company conducts its research and development activities in Israel, and as a result is required to obtain export permission from the Israeli government before exporting certain encryption technologies. In addition, to the extent that its resellers operating from the United States

seek to sell the Company's software products outside the United States, or to the extent that the Company's products incorporate certain encryption technology developed in the United States, additional export controls are imposed by the United States.

APPROVED ENTERPRISE STATUS

The Company receives certain tax benefits in Israel, particularly as a result of the "Approved Enterprise" status of the Company's facilities and programs. To be eligible for tax benefits, the Company must meet certain conditions, relating principally to adherence to the investment program filed with the Investment Center of the Israeli Ministry of Industry and Trade and to periodic reporting obligations. The Company believes that it will be able to meet such conditions. Should the Company fail to meet such conditions in the future, however, it would be subject to corporate tax in Israel at the standard rate of 36%, and could be required to refund tax benefits already received. There can be no assurance that such grants and tax benefits will be continued in the future at their current levels or otherwise. The termination or reduction of certain programs and tax benefits (particularly benefits available to the Company as a result of the Approved Enterprise status of the Company's facilities and programs) or a requirement to refund tax benefits already received would have a material adverse effect on the Company's business, operating results and financial condition. See "Item 4 - Information on the Company" and the section entitled "Israeli Taxation, Foreign Exchange Regulation and Investment Programs" in "Item 10: Additional Information."

ANTI-TAKEOVER EFFECTS OF ISRAELI LAWS

Under the Israeli Companies Law, a merger is generally required to be approved by the shareholders and board of directors of each of the merging companies. Shares held by a party to the merger are not counted toward the required

approval. If the share capital of the company that will not be the surviving company is divided into different classes of shares, the approval of each class is also required. A merger may not be approved if the surviving company will not be able to satisfy its obligations. At the request of a creditor, a court may block a merger on this ground. In addition, a merger can be completed only after all approvals have been submitted to the Israeli Registrar of Companies and 70 days have passed from the time that a proposal for approval of the merger was filed with the Registrar.

The Israeli Companies Law provides that an acquisition of shares in a public company must be made by means of a tender offer, if as a result of the acquisition, the purchaser would become a 25% shareholder of the company. This rule does not apply if there is already another 25% shareholder of the company. Similarly, the Israeli Companies Law provides that an acquisition of shares in a public company must be made by means of a tender offer if, as a result of the acquisition, the purchaser would become a 45% shareholder of the company, unless someone else already holds a majority of the voting power of the company. These rules do not apply if the acquisition is made by way of a merger.

Regulations promulgated under the Israeli Companies Law provide that these tender offer requirements do not apply to companies whose shares are listed for trading outside of Israel if, according to the law in the country in which the shares are traded, including the rules and regulations of the stock exchange on which the shares are traded, either:

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

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

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

Finally, Israeli tax law treats specified acquisitions, including a stock-for-stock swap between an Israeli company and a foreign company, less favorably than does U.S. tax law. For example, Israeli tax law may subject a shareholder who exchanges his Ordinary shares for shares in a foreign corporation to immediate taxation.

PROVISIONS AFFECTING A POTENTIAL CHANGE OF CONTROL; POTENTIAL RIGHTS OF UNISSUED PREFERRED SHARES

The Company's Board of Directors has the authority to issue up to 5,000,000 Preferred Shares and to determine the price, rights (including voting rights), preferences, privileges and restrictions of such Preferred Shares, without any vote or actions by the Company's shareholders. The rights and preferences of such Preferred Shares could include a preference over the Ordinary shares on the distribution of the Company's assets upon a liquidation or sale of the Company, preferential dividends, redemption rights, and the right to elect one or more directors and other voting rights. The rights of the holders of the Ordinary shares will be subject to, and may be adversely affected by, the rights of the holders of any Preferred Shares that may be issued in the future. The Company has no current plans to issue Preferred Shares. The issuance of Preferred Shares, while providing desirable flexibility in connection with possible acquisitions and other corporate purposes, could have the effect of making it more difficult for a third party to acquire a majority of the outstanding voting shares of the Company. Furthermore, certain provisions of the Company's Articles of Association could delay or make more difficult a merger, tender offer or proxy contest involving the Company. These provisions stipulate that the Company cannot engage in a business combination with an interested shareholder (defined generally as the beneficial owner of 15% of the outstanding shares and its affiliates) for a period of three years following the date that such shareholder became an interested shareholder, unless certain conditions are met.

CONCENTRATION OF SHARE OWNERSHIP

As of May 31, 2001, the directors, executive officers and principal shareholders of the Company and their affiliates beneficially own approximately 29% of the outstanding Ordinary shares. As a result, these shareholders are able to exercise significant influence over all matters requiring shareholder approval, including the election of directors and approval of significant corporate transactions. Such concentration of ownership may have the effect of delaying or preventing a change in control of the Company. See "Item 7: Major Shareholders and Related Party Transactions."

The Company's Board of Directors and shareholders have adopted resolutions that provide that, subject to the provisions of Israeli law, the Company may indemnify its Office Holders (in general, directors and senior officers) for (a) any monetary obligation imposed upon them for the benefit of a third party by a judgment, including a settlement agreed to in writing by the Company, or an arbitration decision certified by the court, as a result of an act or omission of such person in his capacity as an Office Holder of the Company, and (b) reasonable litigation expenses, including legal

fees, incurred by such Office Holder or which he is obligated to pay by a court order, in a proceeding brought against him by or on behalf of the Company or by others, or in connection with a criminal proceeding in which he was acquitted, in each case relating to acts or omissions of such person in his capacity as an Office Holder of the Company.

EUROPEAN CURRENCY ISSUES

The Company is aware of the issues raised by the introduction of the Single European Currency ("Euro") on January 1, 1999 and during the transition period through January 1, 2002. The Company's internal systems that are affected by the initial introduction of the Euro have been made Euro capable without material system modification costs. Further internal systems changes will be made during the balance of the transition phase in preparation for the ultimate withdrawal of the legacy currencies in July 2002, and the costs of these changes are not expected to be material. The Company does not presently expect that introduction and use of the Euro will materially affect the Company's foreign exchange and hedging activities, or the Company's use of derivative instruments, or will result in any material increase in costs to the Company. While Check Point will continue to evaluate the impact of the Euro introduction over time, based on currently available information, management does not believe that the introduction of the Euro will have a material adverse impact on the Company's financial condition or overall trends in results of operations.

EXCHANGE CONTROLS AND OTHER LIMITATIONS AFFECTING SECURITY-HOLDERS

Until May 1998, Israel imposed restrictions on transactions in foreign currency. These restrictions affected the Company's operations in various ways, and also affected the right of non-residents of Israel to convert into foreign currency amounts they received in Israeli currency, such as the proceeds of a judgment enforced in Israel. Despite these restrictions, foreign investors who purchased shares with foreign currency were able to repatriate in foreign currency both dividends (after deduction of withholding tax) and the proceeds from the sale of the shares. In 1998, the Israeli currency control regulations were liberalized significantly, as a result of which Israeli residents generally may freely deal in foreign currency and non-residents of Israel generally may freely purchase and sell Israeli currency and assets. There are currently no Israeli currency control restrictions on remittances of dividends on the Ordinary shares or the proceeds from the sale of shares; however, legislation remains in effect pursuant to which currency controls can be imposed by administrative action at

any time.

Neither the Memorandum of Association nor the Articles of Association of the Company nor the laws of the State of Israel restrict in any way the ownership or voting of Ordinary shares by non-residents of Israel, except with respect to subjects of countries which are at a state of war with Israel.

ITEM 4. INFORMATION ON THE COMPANY

Check Point Software Technologies Ltd. (together with its subsidiaries the "Company" or "Check Point") develops, markets and supports Internet security solutions for enterprise networks, and service providers (Telcos, ISPs, ASPs and MSPs) including Virtual Private Networks (VPNs), firewalls, intranet and extranet security. The Company delivers solutions that enable secure, reliable and manageable business-to-business communications over any Internet Protocol ("IP") network--including the Internet, intranets and extranets. Check Point product offerings also include traffic control/quality of service (QoS) and IP address management. Check Point products are fully integrated as a part of the Company's Secure Virtual Network (SVN) architecture and provide centralized management, distributed deployment, and comprehensive policy administration. The capabilities of Check Point products can be extended with the Open Platform for Security (OPSEC), enabling integration with best of breed hardware, security applications and enterprise software applications.

INDUSTRY BACKGROUND

Information, and the ability to access and distribute it, is one of the main strategic assets in today's competitive business environment. This need to effectively use and communicate information as well as work more collaboratively has driven the extensive deployment of network-based communications systems. The resulting explosion in connectivity is in turn driving the need for technology to safeguard and manage the access to information available over these increasingly global networks.

Explosion of Connectivity

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The network computing market has undergone two major transitions over the past decade, the convergence of which has contributed to the recent dramatic increase in global connectivity. The first of these transitions was the migration of corporate computing environments from centralized mainframe systems to distributed client/server environments. The ability to access and share information through client/server technology has expanded the need for connectivity beyond workgroup LANs to enterprise-wide networks spanning multiple LANs and WANs. The second major transition has been the widespread adoption of the Internet for business-to-business communications. Internet-based business applications have rapidly expanded beyond e-mail to a broad range of business applications and services including electronic publishing, direct to customer transactions, product marketing, advertising and customer support. The emergence of eBusiness increases the challenges in enabling secure access to information and applications.

At the same time, the convergence of these two major transitions and the need for secure, managed communications, has led to the emergence of

virtual private networks, or VPNs, using the public Internet infrastructure and associated protocols and applications to share information and services both within the enterprise and with business partners and customers. As a result, businesses are able to share internal information and to run enterprise applications across geographically dispersed facilities as well as enable customers, suppliers and other business partners to inexpensively link into their enterprise information systems. As Internet protocols and infrastructure gain increasingly widespread acceptance for global communication, new wide-area connectivity services continue to emerge at a rapid rate, such as database access, transaction processing services, audio and telephone services and video teleconferencing services. This expansion of services and applications is further accelerating the use of networks as global communication systems.

The Need for Network Security

Although the explosion of connectivity and information exchange provides tremendous benefits, it also exposes an organization's sensitive information and mission critical applications to unauthorized access, both through connections to the public Internet and from within the enterprise. In addition, the transmission of data over the Internet also exposes the data to unauthorized interception. These risks create a critical need for enterprises to protect their information and information systems from unauthorized access and use.

Historical methods for securing information resources are no longer adequate to meet the security requirements of today's global networks. In the centralized mainframe environments that dominated the information systems landscape in previous years, organizations were able to secure a limited number of access points through physical barriers and controlled access to data through log-on procedures and password protection. However, in today's distributed network environments with multiple points of access and multiple network resources, it is impractical to individually secure every application and resource on the network. Therefore, an additional layer of security at the network level is needed to act as a "virtual" barrier to control access to the network and to regulate and protect the flow of data between network segments.

Traditional Approaches to Network Security

The increasing demands placed on enterprise security systems by the expansion of Internet services and global enterprise networking are quickly outpacing the capabilities of many traditional Internet firewall architectures. These demands include the need to define and transparently enforce an integrated, enterprise-wide security policy that can be managed centrally and implemented on a distributed basis. An effective network security solution also needs to be open and extensible to enable it to address the rapidly changing requirements of the Internet and intranets, including the addition of new security applications, such as authentication, encryption, URL filtering, anti-virus protection, and Java and ActiveX security services and functions.

THE CHECK POINT SOLUTION

With the introduction of the Secure Virtual Network (SVN) architecture, Check Point delivers a fundamentally new approach to Internet security deployment. With a single security framework, an organization can connect and secure all elements of the enterprise network: networks, applications, systems and users.

Check Point's Stateful Inspection technology, the foundation of all

Check Point solutions, enables system administrators to define and transparently enforce an integrated, centrally managed, enterprise-wide network traffic policy that provides for secure and reliable communications. In addition, the Company's Open Platform for Security (OPSEC) framework provides a single platform that enables integration with multiple third-party security applications, computer hardware, internetworking hardware, appliances and enterprise applications from within Check Point's open, extensible management framework. The following are the key factors that differentiate Check Point's solution from historical network

security approaches:

Stateful Inspection technology. Check Point's VPN-1 and FireWall-1 product offerings are based upon Stateful Inspection technology that enables the screening of all communications attempting to pass through a gateway in a highly secure but efficient way. By being able to extract and maintain extensive "state information" from all relevant communications layers, the system can verify the data for full compliance with the security and traffic policy and make intelligent security and traffic prioritization decisions. By extracting and analyzing data in place without copying, VPN-1 and FireWall-1 cause virtually no performance degradation, enabling it to scale effectively as network bandwidth increase. In addition, Check Point's proprietary implementation of Stateful Inspection in a "virtual machine" design provides in-place upgradability and is designed to enable the Company's products to be easily ported to a wide range of platforms. In addition, because Check Point's products reside at network access points, which is the critical convergence point for network security and traffic management, the Company has a unique advantage by being able to apply this same architectural foundation to manage traffic flow and network performance, inspecting traffic only once for both critical network decisions. State information is extracted data maintained to provide context for future screening decisions.

Open Platform for Security Enterprise Connectivity ("OPSEC"). Check Point's Open Platform for Security, or OPSEC, allows users to integrate, manage, and deploy all aspects of network security through an open, extensible management framework. Today, more than 270 vendors have joined the OPSEC Alliance, embracing OPSEC as the industry's de-facto framework for securing the Internet. OPSEC partners develop specialized solutions that span the range of enterprise network security technologies - from high-performance internetworking, server and appliance platforms with embedded Check Point SVN software, to authentication, public key infrastructure, content security, intrusion detection, and other solutions. Additionally, through the OPSEC Check Point Certified Managed Service Provider (CCMSP) program, customers have the option to select a complete managed service offering from among a group of the world's leading MSPs participating in this program. The OPSEC framework is designed to allow end-users to choose system components that best meet their requirements, whether from the Company or various third-party vendors, and to rapidly exploit new developments in security technology.

Broad, Integrated Internet Security Solution. The VPN-1 and FireWall-1 product families extend across all major market segments, from small businesses to large enterprise networks. Most products support a broad range of platforms, including Sun Microsystems (Solaris), IPSO, Microsoft (Windows NT), Linux, Hewlett-Packard (HP-UX) and IBM Corporation (AIX). Both VPN-1 and

FireWall-1 also support all major networking technologies, including 10BaseT, 100BaseT, ATM, FDDI and Token Ring. Check Point's Internet security solutions provide a broad range of features and functionality including the following:

Integration of Third-Party Security Applications. Through OPSEC, end-users of VPN-1and FireWall-1 are able to integrate the product into various network management systems and add new features and functionality such as public key infrastructure, authentication, encryption, URL categorization, content security, anti-virus protection, intrusion detection, auditing and reporting controls and enterprise directory integration.

Implementation of the Virtual Private Networks. The VPN-1 architecture supports multiple authentication methods including digital certificates, password-based techniques, biometrics and authentication tokens. In addition, VPN-1 provides data encryption capabilities to shield communications over public networks from unauthorized monitoring or alteration, enabling companies to set up "virtual private networks" offering a level of privacy comparable to private communication lines. The VPN-1 product family supports multiple encryption and key management methods including IPSec, DES, IKE, AES, and 3DES. The Company extends the VPN to the mobile desktop users with its SecuRemote and SecureClient software. In addition, the multi-vendor interoperability offered by VPN-1 enables the deployment of secure and reliable intranet and extranet VPNs for business communications.

Extensive, Scaleable Application Support. VPN-1 and FireWall-1 support over 150 pre-defined applications, including database and enterprise applications such as Oracle SQL*Net, network management protocols such as SNMP, multimedia applications such as RealAudio, Microsoft's NetMeeting and Microsoft's NetShow, and Internet applications such as Secure HTTP. In addition, through the easy-to-use graphical user interface, system administrators can easily add support for new or custom applications by completing simple, on-line templates, or by writing simple macros using INSPECT, the Company's high-level scripting language.

Centralized Management. Check Point's products are capable of configuring and managing an enterprise-wide network policy at multiple enforcement points from a single, centralized administrative workstation, eliminating the need to configure each gateway and server independently. The system administrator can define a single

security policy for the enterprise that is then automatically distributed to each gateway. The Company's products contain extensive monitoring and reporting capabilities designed to improve the manageability of the system.

PRODUCTS

Check Point's product lines offer a broad range of policy-based solutions for securing and managing networks. The Company's Security product line includes its FireWall-1 family of products, its VPN-1 family of virtual

private networking solutions and some associated products. The Company's Traffic Control product line includes its FloodGate-1 bandwidth management solution. The Management product line includes Meta IP address management products.

The Company is currently shipping version 4.1 for all of its products.

FireWall-1

Check Point FireWall-1 is a comprehensive application suite that integrates access control, authentication, network address translation, content security, auditing and enterprise policy management. FireWall-1 is based on Check Point's patented Stateful Inspection technology to deliver high performance security, application support and scalability. The most widely used network security suite on the market today, FireWall-1 is ICSA and E3-certified. It is available on a variety of platforms including UNIX and Windows NT servers and several industry-leading third-party internetworking platforms.

The Company's FireWall-1 product contains the full flexibility of the FireWall-1 management and security capabilities, including a rule-based editor, object managers and authentication features. In addition to the single site functionality provided by FireWall-1 Internet Gateway, the FireWall-1 Enterprise products also enable centralized management of multiple gateways with distributed implementation, as well as remote management of the network security system. FireWall-1 Enterprise and Internet Gateway products consist of one Management Module and one firewall Module. Additional Inspection or firewall Modules for the support of multiple gateway environments are sold separately. All FireWall-1 products are compatible and FireWall-1 Internet Gateway products can be upgraded while retaining the same management and user interface capabilities.

VPN-1

The Company's VPN-1 product family is designed to meet the need of organizations to protect the privacy and integrity of network communications by establishing a confidential communications channel for virtual private networking. Multiple encryption schemes are supported, including emerging standards for interoperability between different vendors. Encryption, decryption and key management, including digital signatures and certificate authority, are all fully integrated with VPN-1's Management Module and rule base editor and log viewer. Included in the Company's VPN-1 product family is VPN-1 SecuRemote to extend the VPN to the desktop and laptop by providing end-to-end encryption support, and VPN-1 SecureClient incorporating all VPN-1 features plus a personal firewall.

FloodGate-1

FloodGate-1 is a policy-based bandwidth management solution that alleviates traffic congestion on oversubscribed Internet and Intranet links. The flagship product of the Company's Traffic Control product line, FloodGate-1 enables organizations to define and manage enterprise-wide policies that precisely control valuable bandwidth resources to optimize network performance and alleviate network congestion.

Meta IP

Meta IP is an automated solution for managing IP addressing and naming. Meta IP is designed to ensure control and reliability of address allocation and services while improving TCP/IP management efficiency. Meta IP's modular, replicated architecture enables multi-level fault-tolerance, cross-platform compatibility and distributed administration. Through its

User-to-Address Mapping(TM) (UAM) technology, Meta IP associates IP addresses with user login names, enabling comprehensive auditing and improved troubleshooting. The combination of UAM and FireWall-1 is the first and only solution to automatically enforce security policies by users in a dynamic addressing environment.

Provider-1

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Check Point Provider-1 pairs network security capabilities with powerful policy-based management capabilities developed specifically for Managed Service Providers (MSPs). Provider-1 enables MSPs to centrally create and manage the network security policies of multiple corporate customers on a single hardware server, while maintaining complete and secure isolation between individual customer databases. Provider-1 is designed to enable MSPs to significantly reduce the hardware and personnel costs associated with managed security services.

SofaWare

Check Point is a financial and strategic investor in SofaWare Technologies Ltd., a company established in 2000. Check Point has the right to acquire a controlling interest in SofaWare. SofaWare's goal is to provide the home and home office market with Internet security solutions, based on Check Point's Stateful Inspection technology. SofaWare's Safe@Home product protects the entire home network and enables consumers to easily manage and configure their security settings. Safe@Home also enables service providers to offer managed security solutions including content filtering and other value-added services to their subscribers.

TECHNOLOGY

The FireWall-1 Technology

Check Point's FireWall-1 technology provides a powerful, easy-to-use solution for the implementation of an integrated network security policy across an enterprise-wide network. The cornerstone of the FireWall-1 technology is the Company's patented Stateful Inspection technology, which enables the highly efficient, transparent screening of all communications attempting to pass through a network gateway, and its OPSEC architecture. OPSEC provides a single platform that manages various aspects of network security through an open, extensible management framework. Various third party security applications plug into the OPSEC framework through published application programming interfaces (APIs) such as CVP (Content Vectoring Protocol) which integrates virus scanning software and other content inspection programs, UFP (URL Filtering Protocol) which integrates URL list services and SAMP (Suspicious Activity Monitoring Protocol) which integrates suspicious activity monitoring programs, and through industry-standard protocols such as RADIUS, Manual IPSec, SKIP and SNMP. Once integrated into the OPSEC framework, all applications can be set up and managed from a central point, utilizing a single policy editor. In addition, the behavior of the inspect engine can be customized by end-users and third parties through programs written in the Company's INSPECT programming language.

FireWall-1 technology is implemented in both the Management Module and the Inspection or firewall Module. The Management Module defines the security

policy through a set of rules established by the system administrator that the Inspection and firewall Module enforces.

SALES AND MARKETING

The Company's sales and marketing strategy is designed to promote its products as strategic components of enterprise networks. The Company's marketing efforts are focused on promoting FireWall-1 and VPN-1 as the leading brand names in enterprise security. Sales efforts focus on expanding the installed base and increasing penetration levels of end-user customers worldwide by leveraging multiple channels of distribution: distributors, Value Added Resellers (VARs), Original Equipment Manufacture (OEMs), system integrators, and Managed Service Providers (MSPs).

The Company has OEM bundling relationships with server and workstation vendors such as Compaq and IBM; internetworking device manufacturers such as Nokia and Intrusion.com, and other suppliers of enterprise network products. The Company believes that strategic OEM relationships can significantly contribute to the achievement of its sales and marketing goals by integrating complementary technologies. Additionally, OEM partners provide primary support and training to their customers enabling Check Point to concentrate its support efforts on high-level technical assistance for these resellers. See the section "Risk Factors" in "Item 3: Key Information."

The Company also currently sells its products to end-user customers through numerous resellers and distributors worldwide. The Company expects that it will continue to be dependent upon a limited number of resellers for a significant portion of its revenues. If anticipated orders from these resellers fail to materialize, the Company's business, operating results and financial condition will be materially adversely affected. In 2000 and 1998, no reseller exceeded 10% of the Company's revenues. Approximately 12% of the Company's revenues were derived from a single reseller in 1999. See the section "Risk Factors" in "Item 3: Key Information." The Company's agreements with its OEM partners and resellers are

non-exclusive. These agreements generally provide for discounts based on minimum purchase commitments and/or expected or actual volumes purchased or resold by the reseller.

The Company has derived substantially all of its revenues and expects to continue to derive the majority of its revenues in the foreseeable future from sales of its FireWall-1 and VPN-1 products. See the section "Risk Factors" in "Item 3: Key Information."" Revenues from the sales to customers in the Americas, Europe and Japan were 57%, 26% and 7% in 1998, 53%, 29% and 11% in 1999, and 48%, 34%, and 9% in 2000 respectively, of total revenues.

To further expand the awareness of the Company's products, the Company has established informal marketing relationships with system integrators and vendors of complimentary products. System integrators with which the Company maintains informal cooperative relationships include Accenture, Computer Sciences Corporation, Electronic Data Systems, Integrated Network Services, Inc. and PriceWaterhouse Coopers. The Company's OPSEC Alliance program is focused on establishing integration and/or compatibility with complimentary products and developing marketing relationships with these companies to promote the solutions. The integration and compatibility of these products with the Company's products provides customers with a more complete enterprise

security solution, and provides the Company's channels with additional revenue opportunities. Companies that maintain a marketing relationship with the Company to promote their integrated products include Aladdin, Baltimore Technologies, Entrust, Hewlett-Packard, IBM, Network Associates, Novell, RSA Security, Symantec, Trend Micro and VeriSign, as well as many others. The Company also has informal marketing relationships with BackWeb, BMC Software, Microsoft, Netscape/AOL, Oracle and Progressive Networks to promote compatible products.

The Company conducts a number of marketing programs to support the sale and distribution of its products. These programs are designed to inform existing and potential OEM partners, resellers, and end-user customers about the capabilities and benefits of the Company's products.

CUSTOMER SERVICE AND SUPPORT

The Company operates a Worldwide Technical Services (WTS) organization, based in Dallas, Texas, with field locations throughout the world, which offers a wide range of professional services, technical support and training, enabling the Company to partner with resellers in implementing secure, reliable business communications solutions.

The Company's OEM partners and resellers generally provide the installation, training, maintenance and support for their customers, with Check Point providing the high-level technical backup support. Check Point also offers direct support agreements to end users who prefer to purchase directly from the manufacturer. As part of Check Point's direct market participation, the Company employs technical consultants and systems engineers who work closely with OEM partners, resellers and territory sales managers to assist with the pre-sales configuration, use and application support.

The Company operates a worldwide 24-hour by 7-day call center, based in Dallas, Texas. The Company supports resellers, partners, and sales personnel through standard systems and processes and are available via e-mail, the Internet, fax and telephone. The support structure includes "front line" call center engineers for resolving the majority of issues and questions during the first call. If necessary, bench testing using real-world configurations are performed by senior support engineers. Third level support is provided by the Escalation Group, an organization that resides with the Company's multiple research and development groups in Ramat Gan, Israel and Seattle, Washington, to provide an extremely close coupling between customer issues and usage and product development. The Escalation Group conducts code analysis and detailed troubleshooting and delivers updated code, as appropriate. Analysis of historical trouble tickets is conducted and tracked. This information is used in the development of features and enhancements in new product releases

To provide hands-on training, education and certification, Check Point has an in-house educational services group. The group develops courses and curricula for Check Point classes conducted directly by the Company or by an affiliate company. Such classes include both lecture-taught and computer-based training sessions on Check Point products, including installation, management and advanced implementations. The Company offers industry level certification programs including Check Point Certified Security Engineer (CCSE) and Check Point Certified Security Administrator (CCSA). Using a leveraged model, Check Point has trained hundreds of partners, and these partners have in turn established Authorized Training Centers. There are now over 222 Check Point Authorized Training Centers in 47 countries around the world.

The Company also has an established professional services organization with consultants in locations throughout the world. They offer a set of consulting services that includes on-site support for installation of its

products, and assistance in developing sound security business practices.

Prospective customers typically receive 30-day evaluation copies of the Company's software products. If the customer elects to purchase the Company's product, they place their order through their reseller, who in turn places the order to the Company. The Company issues an invoice to the reseller, and sends a software key to the reseller to provide to the customer which allows the evaluation copy to continue to function. The Company offers a variety of fee-based software services programs, including support of the Company's software products in accordance with specifications contained in the user's guide, and access to technical support personnel and product enhancements.

Customers are encouraged to purchase software subscription, which is a component of the services program that provides product updates and version upgrades for Check Point's products. In addition, once the software subscription has been purchased, customers can then purchase a variety of support programs. These software support programs can be sold and delivered by the Company's resellers and OEM partners or the customer can choose to purchase a Check Point software support program that is sold by the reseller but delivered by Check Point through its Worldwide Technical Services (WTS) organization directly to the customer.

PRODUCT DEVELOPMENT

The Company believes that its future success will depend upon its ability to enhance its existing products and develop and introduce new products that address the increasingly sophisticated needs of end-users. The Company works closely with its distribution channels and major resellers, who provide significant feedback for product development and innovation. See the section "Risk Factors" in "Item 3: Key Information."

The Company's new product development efforts are focused on enhancements to its current family of products and new products for network security and management. Although the Company expects to develop its new products internally, it may, based upon timing and cost considerations, acquire or license certain technologies or products from third parties.

RESEARCH AND DEVELOPMENT

The Company's research and development activities involve the development of new products and modules in response to identified market demands and the support and enhancement of our existing products. We regard significant portions of our software products and systems as proprietary and rely on a combination of statutory and common law copyright, trademark and trade secret laws, customer licensing agreements, employee and third party nondisclosure agreements and other methods to protect our proprietary rights. The Company generally enters into confidentiality agreements with employees, consultants, customers and potential customers and limit access to, and distribution of its proprietary information. Some of the Company's products are co-developed with and co-owned by its technology and business partners.

Net research and development expenses for 1998, 1999 and 2000 were $10.6 million, $18.9 million and $30.3 million, respectively. At December 31, 2000, the Company had 311 employees dedicated to research and development activities, quality assurance and backline support. The Company is a member of

the International Computer Security Association (ICSA) and the Secure Wide Area Networking Task Force.

COMPETITION

See "Item 3, Key Information, Risk Factors"

PROPRIETARY RIGHTS AND TRADEMARK LITIGATION

The Company relies primarily on a combination of copyright and trademark laws, trade secrets, confidentiality procedures and contractual provisions to protect its proprietary rights. The Company seeks to protect its software, documentation and other written materials under trade secret and copyright laws, which afford only limited protection.

The Company has patents pending worldwide and holds two U.S. patents, No. 5,606,668 and No. 5,835,726. The Company also has corresponding patent applications to U.S. Patent No. 5,606,668 pending in Canada and Japan, as well as

under the European Patent Convention (designating Germany, France, United Kingdom, Italy, and Sweden as countries in which patent coverage may potentially be sought). The Company has also filed co-pending PCT national phase patent applications in Canada, Japan, Korea, Norway, and under the European Patent Convention (designating France, United Kingdom, Ireland, Sweden, Germany, Switzerland, and Finland) based on an earlier patent application filed in Israel currently pending. A patent issued from the European Patent Office becomes effective as though it were a national patent in each designated member nation once national fees are paid, and all other local requirements are met. The EPO opposition period of nine months from grant of the patent at the EPO can effect the enforcement of that patent nationally if an opposition is filed during that time. If the opposition is won, it can negate the patent altogether or result in the protection being offered by the patent being narrowed. There can be no assurance that the Company's applications, whether or not currently challenged by applicable governmental patent examiners, will be issued with the scope of the claims sought by the Company, if at all. Furthermore, there can be no assurance that others will not develop technologies that are similar or superior to the Company's technology or design around any patents issued to the Company. Despite the Company's efforts to protect its proprietary rights, unauthorized parties may copy aspects of the Company's products or obtain and use information that the Company regards as proprietary. Policing any of such unauthorized uses of the Company's products is difficult, and although the Company is unable to determine the extent to which piracy of its software products exists, software piracy can be expected to be a persistent problem. In addition, the laws of some foreign countries do not protect the Company's proprietary rights as fully as do the laws of the United States or Israel. To date, the Company has not conducted any material amount of business in such countries. There can be no assurance that the Company's efforts to protect its

proprietary rights will be adequate or that the Company's competitors will not independently develop similar technology.

There can be no assurance that third parties will not claim infringement by the Company with respect to current or future products, which are or will be subject to protection under intellectual property laws. The Company expects that software companies will increasingly be subject to infringement claims as the number of products and competitors in the Company's industry segment grows and the functionality of products in different industry segments overlaps. Responding to such claims, regardless of merit, could be time-consuming, result in costly litigation, cause product shipment delays or require the Company to enter into royalty or licensing agreements. Such royalty or licensing agreements, if required, may not be available on terms acceptable to the Company or at all, which could have a material adverse effect upon the Company's business, operating results and financial condition.

On July 5, 1996, Checkpoint Systems, Inc. ("CSI") a manufacturer of theft prevention devices for retail stores, filed an action alleging trademark infringement and unfair competition against the Company in the United States District Court for the District of New Jersey. CSI seeks to enjoin the Company from using the "Check Point" name in connection with the Company's products and services. The trial court dismissed CSI's claim for damages on summary judgment. The trial was conducted in November, 1999. The District Court issued its opinion in Check Point's favor on July 12,2000. CSI has filed its appellant's brief alleging that the District Court misapplied the governing law. On April 5th 2001, oral argument was presented to the Appellate court. The matter has been taken under advisement. The Company is unable to predict the outcome of this litigation. In the event that CSI is granted the full injunctive relief it is seeking and the Company is required to cease using the "Check Point" name in connection with its products and services, the Company may incur material expenses in launching a new name.

EMPLOYEES

As of March 31, 2001, the Company had 1137 employees, of whom 331 were engaged in research, development, quality assurance and backline support, 456 were engaged in marketing and sales, 223 were engaged in customer support and operations, and 127 were engaged in MIS, administration and finance. The Company believes that its relations with its employees are satisfactory.

The Company is subject to various Israeli labor laws and labor practices, and to administrative orders extending certain provisions of collective bargaining agreements between the Histadrut (Israel's General Federation of Labor) and the Coordinating Bureau of Economic Organizations (the Israeli federation of employers' organizations) to all private sector employees. For example, mandatory cost of living adjustments, which compensate Israeli employees for a portion of the increase in the Israeli consumer price index, are determined on a nationwide basis. Israeli law also requires the payment of severance benefits upon the termination, retirement or death of an employee. The Company meets this requirement by contributing on an ongoing basis towards "managers' insurance" funds that combine pension, insurance and, if applicable, severance pay benefits. In addition, Israeli employers and employees are required to pay specified percentages of wages to the National Insurance Institute, which is similar to the United States Social Security Administration. Other provisions of Israeli law or regulation govern matters such as the length of the workday, minimum wages, other terms of employment

and restrictions on discrimination.

ORGANIZATIONAL STRUCTURE

The Company is organized under the laws of the State of Israel, which wholly owns the subsidiaries specified below.

NAME OF SUBSIDIARY	COUNTRY OF INCORPORATIO
Check Point Software Technologies Inc. (*)	United States of America
Check Point Software Technologies (Canada) Inc.	Canada
Check Point Software Technologies (Australia) PTY, Ltd.	Australia
Check Point Software Technologies (Japan) Ltd.	Japan
Check Point Software Technologies (Singapore) PTE Ltd.	Singapore
Check Point Software Technologies SARL	France
Check Point Software Technologies (Netherlands) B.V.	Holland

Check Point Software Technologies (Netherlands) B.V. acts as a holding company and wholly owns the following principal operating subsidiaries specified below.

NAME OF SUBSIDIARY	COUNTRY OF INCORPORATIO
Check Point Software Technologies B.V.	Holland
Check Point Software Technologies (Italia) S.R.L.	Italy
Check Point Software Technologies (Switzerland) A.G.	Switzerland
Check Point Software Technologies Norway A.S.	Norway
Check Point Software Technologies (Spain) S.A.	Spain
Check Point Software Technologies Mexico S.A. de C.V.	Mexico

Check Point Software Technologies (Brazil) LTDA	Brazil
Check Point Software Technologies (UK) Ltd.	United Kingdom
Check Point Software Technologies GmbH	Germany
C.P.S.T. Sweden A.B.	Sweden

(*) Check Point Software Technologies Inc wholly owns MetaInfo Inc, incorporated in the United States of America

Israel Check Point Software Technologies Ltd. China is a representative office of Israel located in Beijing, China.

PLANTS, PROPERTY AND EQUIPMENT

The Company's headquarters and Research and Development facilities are located in Ramat-Gan, Israel, near Tel-Aviv, where the Company leases approximately 135,000 square feet of office space. These facilities are leased pursuant to leases that expire 2003, 2004, and 2006 including renewal options. The Company also leases approximately 40,465 square feet of office space for its marketing and field representatives at its United States sales and marketing headquarters in Redwood City, California, and approximately 31,275 square feet of office space for its support center in

Dallas. These facilities are leased pursuant to leases for periods of up to five years. In addition the Company leases office space in its US regional offices in Texas, Colorado, Michigan, Illinois, Massachusetts, Washington, Georgia, North Carolina, New York, Arizona, Florida, Pennsylvania, New Jersey, Virginia and Ontario. Other leased offices include Canada, England, France, Singapore, Germany, Japan, Holland, Italy, Australia, Sweden, Norway, Spain, Brazil and Mexico.

ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS

OVERVIEW

Check Point develops, markets, and supports policy-based enterprise security, traffic control and IP address management solutions that protect information assets and enhance the performance of enterprise networks. Check Point was founded in July 1993, introduced its first product, FireWall-1, in

April 1994 and began generating revenues in the third quarter of 1994. The Company's revenues totaled $141.9 million, $219.6 million and $425.3 million in the years 1998, 1999 and 2000, respectively, substantially all of which were derived from the sales of its FireWall-1 and VPN-1 product families including related software subscriptions, technical services and training programs.

Although the Company has experienced significant percentage growth in revenues and net income, the Company does not believe that such growth rates are sustainable. The Company believes that period-to-period comparisons of its financial results are not necessarily meaningful and should not be relied upon as an indication of future performance.

The Company accounts for software sales in accordance with Statement of Position (SOP) 97-2, "Software Revenue Recognition," as amended. SOP 97-2, generally requires revenues earned on software arrangements involving multiple elements to be allocated to each element based on the relative fair value of the element. The Company has adopted SOP 98-9, "Modification of SOP 97-2, Software Revenue Recognition with Respect to Certain Transactions", for all multiple element transactions entered into after January 1, 2000. SOP 98-9 requires that revenue be recognized under the "residual method" when vendor specific objective evidence ("VSOE") of fair value exists for all undelivered elements and VSOE does not exist for the delivered elements.

Revenue from license fees is recognized when persuasive evidence of an agreement exists, delivery of the product has occurred, the fee is fixed or determinable, and collectibility is probable. The Company maintains certain provisions for product returns and rebates in accordance with SFAS No. 48 "Revenue Recognition when Right of Return Exists". Such provisions amounted to $ 7.1 million and $ 10.1 million as of December 31, 1999 and 2000, respectively. The Company from time to time considers arrangements regarding certain customers with payment terms extending beyond customary payment terms not to be fixed or determinable. If the fee is not fixed or determinable, revenue is deferred and recognized when payments become due from the customer, providing that all other revenue recognition criteria have been met.

Software subscription, specified upgrades, support, consulting services and training program revenue included in multiple element arrangements is deferred and recognized on a straight-line basis over the term of the software subscription and support agreement. The VSOE of fair value of the undelivered elements (software subscription, specified upgrades, support, consulting services and training) is generally determined based on the price charged for the undelivered element when sold separately. Deferred revenues also include amounts received from customers for which services have not been provided.

The Company has derived substantially all of its revenues from sales of its FireWall-1 and VPN-1 families of software products including related software subscriptions, support, technical services and training programs. The Company expects to derive the vast majority of its revenues in the near future from sales of its FireWall-1 product suite and VPN-1 product family, and specifically the Internet Gateway and Enterprise product categories. If FireWall-1 or VPN-1 should fail to receive widespread market acceptance, or if end-users should subsequently adopt an alternative approach to enterprise security or VPNs, the Company's business, operating results and financial condition would be materially adversely affected.

No customer, distributor or reseller, exceeded 10% of the Company's revenues in either 1998 or 2000. During 1999 approximately 12% of the revenues were derived from a single distributor.

During each of the three years 1998, 1999 and 2000, the Company significantly increased the number of its distributors, resellers, system integrators and managed service providers on a worldwide basis.

The following table sets forth, for the periods indicated, the percentage of total consolidated revenues derived from sales into each of the regions identified in the table.

	YEAR ENDED DECEMBER 31,		
REGION	1998	1999	2000
Americas	57%	53%	48%
Great Britain	9%	9%	8%
Europe (excluding Great Britain)	17%	20%	26%
Japan	7%	11%	9%
Other - mostly Asia Pacific	10%	7%	9%

The Company may experience declining operating margins as it expands its customer and technical support organization. The Company also expects that it will experience increasing competition and pricing pressure, which would result in lower operating margins. In 2001, the Company intends to continue to make significant investments in the further development and expansion of its sales and marketing organization, including the expansion of its field organization both in the United States and additional countries in Europe, Asia, and Latin America. In addition, the Company expects to further expand its research and development organization and make additional investments in its general and administrative infrastructure. As a result, the Company expects operating margins to decrease from historical levels. The amount and timing of these additional expenditures are likely to result in fluctuations in operating margins.

Research and development costs, net of grants received, are charged to the statement of operations as incurred. SFAS No. 86 "Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed", requires capitalization of certain software development costs subsequent to the establishment of technological feasibility. Based on the Company's product development process, technological feasibility is established upon completion of a working model. Costs incurred by the Company between completion of the working models and the point at which the products are ready for general release have been insignificant. Therefore, all research and development costs have been expensed.

RESULTS OF OPERATIONS:

The following table presents, for the periods indicated, line items from the Company's statements of income (in thousands of US$).

	1998	1999	2000
Revenues	$141,941	$219,567	$425,283
Cost of revenues	13,623	22,423	35,265
Gross profit	128,318	197,144	390,018
Operating expenses:			
Research and development, net	10,629	18,923	30,309

	1998	1999	2000
Sales and marketing	39,966	68,229	110,003
General and administrative	10,886	13,069	20,409
Total operating expenses	61,481	100,221	160,721
Operating income	66,837	96,923	229,297
Financial income, net	4,406	12,770	29,147
Capital gain	2,581	192	---
Income before taxes on income	73,824	109,885	258,444
Taxes on income	3,947	14,104	37,231
Net income	$69,877	$95,781	$221,213

The following table presents, for the periods indicated, line items from the Company's statements of income as a percentage of the Company's revenues.

	1998	1999	2000
Revenues	100%	100%	100%
Cost of revenues	10	10	8

Gross profit	90	90	92
Operating expenses:			
Research and development, net	7	9	7
Sales and marketing	28	31	26
General and administrative	8	6	5
Total operating expenses	43	46	38
Operating income	47	44	54
Financial income, net	3	6	7
Capital gain	2	---	---
Income before taxes on income	52	50	61
Taxes on income	3	6	9
Net income	49%	44%	52%

Revenues. The Company's revenues are derived from the sale of software products and related software subscriptions, support contracts, consulting services and training. The Company's revenues were approximately $141.9 million, $219.6 million and $425.3 million in 1998, 1999 and 2000, respectively. These increases resulted primarily from the growth in the market for the Company's enterprise security products, expanded awareness of the Company's products, increased sales through OEMs and other resellers and the introduction of new versions of FireWall-1, VPN-1 and Provider-1. Revenues from sales to the Americas resellers were 57%, 53% and 48% of revenues in 1998, 1999 and 2000, respectively. However, the Company believes that since it sells its products to resellers and OEMs in the United States that have significant international reseller bases, a significant portion of its products are resold by these resellers and OEMs outside the United States.

Cost of Revenues. The Company's cost of revenues is comprised of the cost of freight, media, software production, manuals and packaging, the cost of post-sale customer support and royalties. Cost of revenues was $13.6 million, $22.4 million and $35.3 million for 1998, 1999 and 2000, respectively. Gross margins were 90%, 90% and 92% of the Company's revenues for 1998, 1999 and 2000, respectively.

Research and Development, Net. Research and development expenses consist primarily of salaries and other related expenses for research and development personnel, as well as the cost of facilities and depreciation of capital equipment. Net research and development expenses were $10.6 million, $18.9 million and $30.3 million in 1998, 1999 and 2000, respectively, representing 7%, 9% and 7% of revenues, respectively. The increases in absolute dollars were due to the addition of new

development personnel. The Company received non-royalty bearing grants of $450,000, $60,000 and $392,000 in 1998, 1999 and 2000, respectively. The Company anticipates that research and development expenditures will increase in the short term and may fluctuate as a percentage of revenues thereafter as the Company continues to expand its research and development organization.

Sales and Marketing. Sales and marketing expenses consist primarily of salaries, commissions, advertising, trade shows, travel and other related expenses. Sales and marketing expenses were $40.0 million, $68.2 million and $110.0 million in 1998, 1999 and 2000, respectively, representing 28%, 31% and 26% of revenues, respectively. The substantial increase in absolute dollars each year was due to the costs associated with the expansion of the Company's sales and marketing activities. Sales and marketing expenses decreased as a percentage of revenues in 2000 as compared with 1999, primarily due to a significant increase in revenues. The Company anticipates that its sales and marketing expenditures will increase in absolute dollars and may fluctuate as a percentage of revenues thereafter as the Company continues to expand its sales and marketing activities.

General and Administrative. General and administrative expenses consist primarily of outside professional fees, salaries and other related expenses. General and administrative expenses were $10.9 million, $13.1 million and $20.4 million in 1998, 1999 and 2000, respectively, representing 8%, 6% and 5% of revenues, respectively. The increase in absolute dollars was primarily due to the addition of staff, and increased costs associated with the expansion of the Company's business. The decreases in general and administrative expenses as a percentage of revenues for all periods were attributable to the significant increases in revenues. The Company anticipates that general and administrative expenses will increase in absolute dollars and may fluctuate as a percentage of revenues as the Company expands its financial and administrative infrastructure, and continues to incur additional costs associated with being a public company.

QUARTERLY RESULTS OF OPERATIONS. The following table sets forth certain unaudited consolidated statements of income data for each of the quarters in 1999 and 2000, as well as the percentage of the Company's revenues represented by each item. The unaudited consolidated financial statements have been prepared on the same basis as the audited consolidated financial statements contained herein and include all adjustments (consisting only of normal recurring adjustments) that the Company considers necessary for a fair presentation of such information when read in conjunction with the Company's consolidated financial statements and Notes thereto appearing elsewhere in this annual report. The Company believes that quarter-to-quarter comparisons of its financial results are not necessarily meaningful and should not be relied upon as an indication of future performance.

Quarter ended, US$ in thousands, except per share data

	FISCAL YEAR 1999	FISCAL YEAR

	Q1	Q2	Q3	Q4	Q1	Q2	
Revenues	$43,772	$50,051	$57,799	$67,945	$78,166	$90,668	$1
Cost of revenues	4,711	5,092	6,053	6,567	7,644	8,006	
Gross profit	39,061	44,959	51,746	61,378	70,522	82,662	1
Operating expenses:							
Research and development, net	4,043	4,353	4,892	5,635	6,175	6,659	8
Sales and marketing	12,643	15,744	18,34	21,49	24,218	27,733	2
General and administrative	2,862	3,219	3,385	3,603	5,199	4,502	5
Total operating expenses	19,548	23,316	26,620	30,737	35,592	38,894	41
Operating income	19,513	21,643	25,126	30,641	34,930	43,768	64
Financial income, net	2,624	2,705	3,609	3,832	5,494	6,411	7
Capital gain	---	192	---	---	---	---	
Income before taxes on income	22,137	24,540	28,735	34,473	40,424	50,179	72
Taxes on income	2,434	3,008	4,010	4,652	5,545	6,508	10
Net income	$19,703	$21,532	$24,725	$29,821	$34,879	$43,671	$6
Basic net earnings per share	$0.09	$0.10	$0.11	$0.13	$0.15	$0.19	$
Shares used in computing basic net earnings per share	219,540	220,914	224,106	227,160	230,256	231,663	23
Diluted net earnings per share	$0.08	$0.09	$0.10	$0.12	$0.13	$0.17	
Shares used in computing diluted net earnings per share	241,830	243,354	248,526	256,704	262,941	263,637	26
AS A PERCENTAGE OF REVENUES							
Revenues	100%	100%	100%	100%	100%	100%	1
Cost of revenues	11	10	10	10	10	9	
Gross profit	89	90	90	90	90	91	
Operating expenses:							
Research and development, net	9	9	8	8	8	7	
Sales and marketing	29	31	32	32	31	31	
General and administrative	6	6	6	5	7	5	
Total operating expenses	44	46	46	45	46	43	
Operating income	45	44	44	45	44	48	
Financial income, net	6	5	6	6	7	7	
Income before taxes on income	51	49	50	51	51	55	
Taxes on income	6	6	7	7	7	7	
Net income	45%	43%	43%	44%	45%	48%	5

The Company's future revenues and operating results are uncertain and may fluctuate from quarter to quarter and from year to year due to a combination of factors, including the timing of new product releases and acceptance of new products, the demand for the Company's products, the volume and timing of orders and the ability to fulfill orders, the level of product and price competition, the expansion of the Company's sales and marketing organizations, the Company's ability to develop new and enhanced products and control costs, the Company's ability to attract and retain key technical, sales and managerial employees, the mix of distribution channels through which product is sold, the mix of products and services sold, the growth in the acceptance of and activity on, the Internet and World Wide Web, the growth of intranets, seasonal trends in customer purchasing, customer capital spending budgets, foreign currency exchange rates and general economic factors. The Company's revenue is subject to seasonal fluctuations related to the slowdown in spending activities in Europe for the quarter ending September 30 and the year-end purchasing cycles of many end-users of the Company's products. The Company believes that it will continue to encounter quarter-to-quarter seasonality that could result in proportionately lower sales in the quarters ending September 30 and March 31 relative to sales in the quarters ending June 30 and December 31, respectively.

The Company's expense levels are based, in part, on expectations as to future revenues. If revenue levels are below expectations, operating results are likely to be adversely affected. Net income may be disproportionately affected by a reduction in revenues due to the relatively small amount of the Company's expenses, which vary with its revenues. As a result, the Company believes that period-to-period comparisons of its results of operations are not necessarily meaningful and should not be relied upon as indications of future performance. Due to all of the foregoing factors, it is likely that in some future quarter the Company's operating results may be below the expectations of public market analysts and investors. In such event, the price of the Company's Ordinary Shares would likely be materially adversely affected.

LIQUIDITY AND CAPITAL RESOURCES

The Company has primarily financed its operations through cash generated from operations. Cash and cash equivalents and short term investments were $438.4 million, and long term investments were $219.3 million, totaling $657.7 million as of December 31, 2000, as compared with cash and cash equivalents and short term investments of $242.5 million and long term investments of $82.9 million totaling $325.4 million as of 1999. The Company generated net cash from operations of $70.3 million, $144.3 million and $315.7 million in 1998, 1999 and 2000. Net cash from operations for these periods consisted primarily of net income plus increases in deferred revenues, accrued expenses and other liabilities offset by increases in trade receivables, other receivables and prepaid expenses. The Company's capital investments amounted to approximately $6.1 million, in each of 1998 and 1999 and $9.1 million in 2000. Capital investments during 2000 were primarily for computer equipment and software for the Company's research and development and technical service organization efforts. As of December 31, 2000, the Company had no material commitments for capital expenditures. Net cash provided by financing activities was approximately $5.2 million, $15.7 million and $25.8 million in 1998, 1999 and 2000, respectively, primarily as a result of stock options exercised. Excess cash is invested in marketable securities and bank deposits of varying maturities, depending on projected cash needs for operations, capital purchases and other business purposes.

The Company believes that its existing sources of liquidity and cash flow will be adequate to fund its operations through at least the middle of 2002.

IMPACT OF INFLATION AND CURRENCY FLUCTUATIONS

The cost of the Company's operations in Israel, as expressed in dollars, is influenced by the extent to which any increase in the rate of inflation in Israel is not offset (or is offset on a lagging basis) by a devaluation of the NIS in relation to the dollar. The rate of inflation in Israel was zero in 2000 (compared to 1.3% in 1999 and 8.6% in 1998), while the NIS was revaluated upwards by 2.8% against the dollar (compared to 0.2% in 1999 and a devaluation of 17.6% in 1998). These decreases did not materially adversely affect the Company's results of operations in such periods, although there can be no assurance that there will not be a material adverse effect on the Company's business, operating results and financial condition in the future should this pattern recur. Most of the Company's revenues are denominated in United States dollars. In addition, a substantial portion of the Company's costs is incurred in dollars. Since the dollar is the primary currency in the economic environment in which the Company and its subsidiaries operate, the dollar is their functional and reporting currency, and, accordingly, monetary accounts maintained in currencies other than the dollar (principally cash and cash equivalents, short-term deposits, marketable securities, long-term investments and liabilities) 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 rate in effect at the date of the transaction. The effects of foreign currency remeasurement are reported in current operations. The Company's consolidated financial statements are also presented in United States dollars. Transactions and balances denominated in United States dollars are presented in the consolidated financial statements at their original amounts. Non-dollar transactions and balances have been translated into United States dollars in accordance with the principles set forth in SFAS No. 52 "Foreign Currency Translation". The Company has not engaged in any significant hedging activities

in the years up to and including 2000.

EFFECTIVE CORPORATE TAX RATE

The Company's effective tax rate was 5.3%, 12.8% and 14.4% in 1998, 1999 and 2000, respectively. These low tax rates were achieved due to the tax holiday prescribed by the Company's Approved Enterprise status of its production facilities in Israel.

The Company has been granted "Approved Enterprise" status by the Israeli government for four investment plans. The Approved Enterprise status allows for a tax holiday for a period of two to four years and a reduced corporate tax rate of 10%-20% for an additional six to eight years on the respective investment plans' proportionate share of taxable income. The tax benefits under these investment plans are scheduled to gradually expire from 2004 to 2008. See Note 8b of Notes to the consolidated financial statements. Almost all of the Company's Israeli income has been generated from its Approved Enterprises. To date, almost all of the Company's sales of products have been made from Israel. The Company's United States subsidiary, which commenced operations in July 1995, operated pursuant to a cost plus agreement with the Company through 1998 and has operated as a distributor since 1999. The Company's United States subsidiary incurred income taxes of $1 million, $2.5 million and $5.1 million in 1998, 1999 and 2000, respectively. See Note 8d of Notes to the consolidated financial statements. In addition, as the Company expands its international operations, a portion of revenues generated in foreign jurisdictions may be subject to taxation by such jurisdictions at

rates higher than those to which the Company is subject in Israel.

If the retained tax exempt income is distributed in a manner other than in the complete liquidation of the Company, it would be taxed at the corporate tax rate applicable to such profits as if the Company had not chosen the alternative tax benefits and an income tax liability would be incurred of approximately $80 million as of December 31, 2000.

EUROPEAN CURRENCY ISSUES

The Company is aware of the issues raised by the introduction of the Single European Currency ("Euro") on January 1, 1999 and during the transition period through January 1, 2002. The Company's internal systems that are affected by the initial introduction of the Euro have been made Euro capable without material system modification costs. Further internal systems changes will be made during the balance of the transition phase in preparation for the ultimate withdrawal of the legacy currencies in July 2002, and the costs of these changes are not expected to be material. The Company does not presently expect that introduction and use of the Euro will materially affect the Company's foreign exchange and hedging activities, or the Company's use of derivative instruments, or will result in any material increase in costs to the Company. While Check Point will continue to evaluate the impact of the Euro introduction over time, based on currently available information, management does not believe that the introduction of the Euro will have a material adverse impact on the Company's financial condition or overall trends in results of operations.

QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

Market risks relating to the Company's operations result primarily from weak economic conditions in the markets in which the Company sells its products and from changes in exchange rates and from changes in interest rates. Other than forward exchange currency contracts described below which are used for hedging cash flow in transactions which are not denominated in U.S. Dollars, the Company does not use derivative financial instruments in its investment portfolio.

FOREIGN CURRENCY RISK

Most of the Company's sales are denominated in US dollars. In addition, a substantial portion of the Company's costs are incurred in dollars. The Company's management believes that the dollar is the primary currency of the economic environment in which the Company and its subsidiaries operate, and thus the dollar is their functional and reporting currency. Accordingly, monetary accounts maintained in currencies other than the dollar (principally cash and cash equivalents, short-term deposits, marketable securities, long-term investments and liabilities) are remeasured into US dollars using the foreign exchange rate at the balance sheet date. Operational accounts and non-monetary balance sheet accounts are measured and recorded at the rate in effect at the date of the transaction. All transaction gains and losses of the remeasurement of monetary

balance sheet items are reflected in the statement of income as financial income or expenses, as appropriate.

The Company enters into foreign exchange forward contracts to minimize the short-term impact of foreign currency fluctuations on assets denominated in Japanese Yen. These contracts are highly inversely correlated to the hedge items and are designated as, and considered effective as, hedges of the underlying assets.

Gains and losses on the contracts are included in net financial income, and offset foreign exchange gains and losses from the revaluation of intercompany balances or other current assets and liabilities denominated in currencies other than the functional currency of the reporting entity.

Company's management is of the opinion that, due to the fact that the above transactions are carried out with well established institutions, liabilities owing to the Company will be fulfilled as of December 31, 2000. Total outstanding transactions to sell/purchase U.S. dollars in exchange for the Japanese yen, were in the amount of $ 6,669,000. The above transactions were for a period of 1.5 months. Gain and losses, which are included in the financial statements for the year ended December 31, 2000, were insignificant.

INTEREST RATE RISK

The Company's exposure to market risk for changes in interest rates relates primarily to the Company's investment in marketable securities. The Company's marketable securities comprise of Israeli Government debts and U.S. corporate debts. The fair value of the Company's long and short-term securities is based upon their market values as of December 31, 2000.

The table below presents principal amounts and related weighted average rates by date of the maturity for the Company's Marketable Securities.

(In thousands U.S. Dollars)

	MATURITY						TOTAL BOOK VALUE	FAIR VALUE AT 12/31/2000
	2001	2002	2003	2004	2005	2006		
INVESTMENT IN MARKETABLE SECURITIES								
U.S. dollar linked debt securities - Changing Interest								

Rate	15,694	6,312	11,486	1,144			34,636	35,529
Weighted Average Interest Rate*	5.90%	5.94%	6.77%	7.00%				
U.S. Corporate debts - Fixed Interest Rate	55,519	41,935	38,498	23,550	42,900	14,549	216,951	216,977
Weighted Average Interest Rate	7.77%	7.11%	6.54%	7.12%	7.20%	6.55%		
U.S. Corporate debts - Zero coupon		1,194					1,194	1,171

o Based upon the Libor as of December 31, 2000

ITEM 6. DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES

The directors and executive officers of the Company as at December 31, 2000 are as follows:

NAME	POSITION
Gil Shwed (1)............................	President, Chief Executive Officer and Chairman of the Board
Marius Nacht.............................	Senior Vice President, Director
Jerry Ungerman...........................	Executive Vice President
Eyal Desheh..............................	Chief Financial Officer
Shlomo Kramer............................	Founder, Director
Irwin Federman (1)(2)(3).................	Director
David Rubner.............................	Director
Ray Rothrock (1)(2)(3)...................	Director
Alex Vieux...............................	Director
Tal Shavit...............................	Director

(1) Member of Compensation Committee

(2) Member of Audit Committee

(3) Outside Director

Gil Shwed, a co-founder of the Company, has served as the Company's President and Chief Executive Officer and as a director of the Company since its inception in July 1993. In 2001, the position of President was transferred from Mr. Shwed to Mr. Ungerman. From June 1992 until June 1993, Mr. Shwed founded and served as a Software Manager for Heliogram, a software development company. From May 1991 until June 1992, Mr. Shwed served as a Consultant and Chief Developer at Graphics Arts, a division of Optrotech Ltd., an automated

optical imaging company. From February 1987 until February 1991, Mr. Shwed served in the Israel Defense Forces. Additionally, from February 1991 to July 1993, Mr. Shwed served as a Consultant for E&M Computing, a Sun Microsystems representative in Israel.

Marius Nacht, a co-founder of the Company, has served as the Company's Senior Vice President since January 1, 1999. Mr. Nacht served as the Company's Vice President of International Operations from September 1995 until December 1998, and from July 1993 to September 1995 Mr. Nacht served as a Vice-President of the Company. Mr. Nacht has served as a director of the Company since its inception in July 1993. In 2001, Mr. Nacht was appointed Vice President of the Board. Mr. Nacht received a Masters degree in Electrical Engineering and Communication Systems from Tel Aviv University, as well as a B.S. in Physics and Mathematics from Hebrew University of Jerusalem.

Jerry Ungerman is Executive Vice President of the Company and has global responsibility for sales, marketing, business development and technical services. He has served in this position since November of 1998. In 2001, Mr. Ungerman was appointed President of the Company. He began his career with IBM in 1967 and from July 1971 to October 1998, Mr. Ungerman held a number of senior management positions with Hitachi Data Systems Corp., a provider of computer networking and data storage solutions for computing environments. Mr. Ungerman holds a B.S.B. in business from the University of Minnesota and is on the board of Serena Software.

Eyal Desheh, chief financial officer, joined the Company in May 2000. Prior to this appointment, he served as chief financial officer for Scitex Corporation Ltd., a world leader in digital imaging solutions for graphics communications, where he was responsible for all the major finance functions, investor relations, risk management, mergers and acquisitions and legal affairs. Before joining Scitex, he served in numerous finance and business development roles at Bezeq, The Israeli Telecommunications Corp. Ltd., Teva Pharmaceuticals Ltd., H.L. Financial Services Ltd. and Bank Hapoalim. Mr. Desheh holds a B.A. in Economics and an M.B.A in Finance both from Hebrew University of Jerusalem.

Shlomo Kramer, a co-founder of the Company, served as the Company's Executive Vice President from October 1996 until December 1998, and served as Vice President of Product and Business Development from October 1995 to October 1996. From July 1993 to October 1995, Mr. Kramer served as a Vice President of the Company. Mr. Kramer has served as a director of the Company since its inception in July 1993. Mr. Kramer received a Masters degree in Computer Science from Hebrew University of Jerusalem as well as a B.S. in Mathematics and Computer Science from Tel Aviv University.

Irwin Federman has served as a director of the Company since November 1995. Mr. Federman has been a General Partner of U.S. Venture Partners, a venture capital firm, since April 1990. From 1988 to 1990, he was a Managing Director of Dillon Read & Co., an investment banking firm, and a general partner in its venture capital affiliate, Concord Partners. Mr. Federman is a director of Centillium Communications, Inc., Komag Incorporated, MMC Networks,

Inc., NeoMagic Inc., Netro Corporation, Nuance Communications, Inc., QuickLogic, Inc., SanDisk Corp., and a number of private companies. Mr. Federman received a B.S. in Economics from Brooklyn College.

Ray Rothrock has served as a director of the Company since November 1995. Mr. Rothrock has been a member of Venrock Associates, a venture capital firm, since 1988 and a General Partner of Venrock Associates since 1995. Mr. Rothrock is also a director of USinternetworking, Fogdog Sports, Inc., and a number of private companies. Mr. Rothrock received a B.S. in engineering from Texas A&M University, an M.S. from the Massachusetts Institute of Technology and an M.B.A. from the Harvard Business School.

David Rubner has served as a director of the Company since June 1999. Mr. Rubner is chairman & chief executive officer of Rubner Technology Ventures Ltd. Prior to starting this company, David Rubner served as president and chief executive officer of ECI Telecommunications Ltd, Israel's largest high-tech company. Prior to this appointment, he held the positions of chief engineer, vice president of operations and executive vice president and general manager of the telecommunications division. Mr. Rubner holds a B.S. degree in engineering from Queen Mary College, University of London, and an M.S. degree from Carnegie Mellon University. Mr. Rubner is a member of the Presidium of the Electronics Industries Association and was a recipient of the Industry Prize in 1995.

Alex Serge Vieux has served as a director of the Company since September 1998. He is chief executive officer of DASAR Brothers, Inc., which he founded inE8">

Income tax reductions relating to exercise of stock options	$	279	$	467
Unrealized net gains from available-for-sale securities	$	75	$	50

Capital lease obligations	$ 30	$ 12

See accompanying notes to condensed consolidated financial statements

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RIMAGE CORPORATION AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

(1) Basis of Presentation and Nature of Business

Rimage Corporation (the Company) develops, manufactures and distributes high performance CD-Recordable (CD-R) and DVD-Recordable (DVD-R) publishing and duplication systems from its operations in the United States, Germany and Japan. The Company also distributes related consumables for use with its systems, consisting of media kits, ribbons, ink cartridges and blank CD-R and DVD-R media.

The accompanying condensed consolidated financial statements of Rimage Corporation are unaudited and have been prepared by the Company in accordance with accounting principles generally accepted in the United States of America for interim financial information, pursuant to the rules and regulations of the Securities and Exchange Commission. Pursuant to such rules and regulations, certain financial information and footnote disclosures normally included in the financial statements have been condensed or omitted. However, in the opinion of management, the financial statements include all adjustments, consisting of normal recurring accruals, necessary for a fair presentation of the financial position and results of operations and cash flows of the interim periods presented. Operating results for these interim periods are not necessarily indicative of results to be expected for the entire year, due to seasonal, operating and other factors. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2005.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of 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.

(2) Stock-Based Compensation

In December 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standard (SFAS) No. 123R, Share-Based Payment. SFAS 123R is a revision of FASB Statement No. 123, Accounting for Stock-Based Compensation, and supersedes Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, and amends SFAS 95, Statement of Cash Flows, and its related implementation guidance. SFAS 123R focuses primarily on accounting for transactions in which an entity obtains employee services through share-based payment transactions. SFAS 123R requires a public entity to measure the cost of

employee services received in exchange for the award of equity instruments based on the fair value of the award at the date of grant. The cost is to be recognized over the period during which an employee is required to provide services in exchange for the award. SFAS 123R also requires the benefits of tax deductions in excess of recognized compensation expense to be reported as a financing cash flow, rather than as an operating cash flow as prescribed under the prior accounting rules. This requirement reduces net operating cash flows and increases net financing cash flows in periods after adoption. Total cash flow remains unchanged from what would have been reported under prior accounting rules.

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RIMAGE CORPORATION AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

The Company implemented the provisions of SFAS 123R effective January 1, 2006 using the modified prospective method, and therefore has not restated prior periods results. Under this method, the Company recognizes compensation expense for all stock-based awards granted on or after January 1, 2006, and for previously granted awards not yet vested as of January 1, 2006. Under the provisions of SFAS 123R, the Company recognizes stock-based compensation net of an estimated forfeiture rate, resulting in the recognition of compensation cost for only those shares expected to vest. Prior to the adoption of SFAS 123R, the Company followed the intrinsic value method in accordance with APB 25 to account for the issuance of stock incentives to employees and directors. Accordingly, no compensation expense was recognized for share purchase rights granted in connection with the Company s Amended and Restated 1992 Stock Option Plan (the Stock Option Plan) or the Company s Employee Stock Purchase Plan (the Employee Stock Purchase Plan).

The Stock Option Plan, initially approved by shareholders in September 1992, and with the latest amendments approved by shareholders in May 2005, provides for the grant of incentive stock options, non-qualified stock options, restricted stock awards, deferred stock awards, stock appreciation rights and performance stock to certain key administrative, managerial and executive employees and the automatic periodic grants of stock options to non-employee directors. At September 30, 2006, a total of 211,621 shares were available for future grant under the plan. The exercise price of stock options granted under the Stock Option Plan is equal to the market value on the date of grant. Options issued to employees through March 31, 2006 generally become exercisable over a two-year period and terminate ten years from the date of grant. Options issued to employees after March 31, 2006 generally become exercisable over a four-year period and terminate ten years from the date of grant. Stock options granted to non-employee directors vest six months from the date of grant and terminate ten years from the date of grant. Performance shares granted to employees under the Stock Option Plan are issued contingent on the Company s achievement of revenue and operating income performance goals for the calendar year which follows two years after the grant date. Shares of the Company s common stock are issued to employees for the performance shares only if the Company achieves the performance goals during the applicable performance period. If the performance goals are not achieved at the end of the performance period, all performance shares will be canceled and the employees will receive no common stock for the canceled performance shares.

The Employee Stock Purchase Plan was approved by shareholders in May 2001. Under this plan, employees were entitled to purchase the Company s common stock at 85% of the lower of the market price of such shares on the first or last business day of each one-year period. The Employee Stock Purchase Plan was terminated effective July 1, 2006, and no additional shares will be issued under that plan. Shares originally authorized and reserved for issuance under the Employee Stock Purchase Plan and remaining unissued after its termination amounted to 165,126 shares. Such shares are no longer reserved for issuance under the Employee Stock Purchase Plan.

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Amounts recognized in the financial statements with respect to the Company s share-based payment arrangements are as follows:

	Three Months Ended September 30, 2006	Nine Months Ended September 30, 2006

	(in thousands)	
Total stock-based compensation cost	$ 637	$ 1,197
Amounts capitalized in inventory	(1)	(1)
Amounts recognized in income for amounts previously capitalized in inventory	1	
Amounts charged against income, before income tax benefit	637	1,196
Income tax benefit related to stock-based compensation included in net income	(212)	(328)
Net compensation expense included in net income	$ 425	$ 868
Impact on net income per share:		
Basic	$ 0.04	$ 0.09
Diluted	$ 0.04	$ 0.08

Total stock-based compensation cost of $1,197,000 for the nine months ended September 30, 2006 reflected in the preceding table consists of $1,170,000 and $5,000 of expense associated with stock options and performance shares, respectively, both issued under the Stock Option Plan (including $322,000 related to options granted prior to January 1, 2006), and $22,000 of expense associated with the Employee Stock Purchase Plan.

The fair value of each option award is estimated at the date of grant using the Black-Scholes option pricing model. No option awards were granted during the three months ended September 30, 2006. The following key assumptions were utilized in valuing option awards issued during the nine months ended September 30, 2006:

	Nine Months Ended September 30, 2006
Expected life of options in years	5.0 - 6.0
Risk-free interest rate	4.3 - 5.0%
Volatility	37.8 - 50.4%
Expected dividend yield	0.0%

In accordance with SFAS 123R, the Company reviews these assumptions at the time of each new option award and adjusts them as necessary to ensure proper option valuation. The expected life of each award was determined based on an analysis of historical exercise behavior. The risk-free

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interest rate is based on the yield of constant maturity U.S. treasury bonds with a remaining term equal to the expected life of the awards. The Company estimated the stock price volatility using historical weekly price observations over the expected life of the awards. The expected dividend yield is zero, as the Company has not paid or declared any cash dividends on its common stock, and does not currently have plans to pay dividends.

A summary of share option activity under the Stock Option Plan as of and for the nine months ended September 30, 2006 is presented in the table below (in thousands, except per share data):

	Shares	WAEP*	Weighted Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value**
Options outstanding at December 31, 2005	1,340	$ 10.67		
Granted	265	22.02		
Exercised	(231)	6.27		
Canceled	(5)	24.46		
Options outstanding at September 30, 2006	1,369	$ 13.56	6.30	$ 12,246
Options subject to exercise at September 30, 2006	1,025	$ 11.02	5.28	$ 11,737

**Weighted Average Exercise Price*

***Aggregate intrinsic value includes only those options with intrinsic value (options where the exercise price is below the market value).*

A summary of the status of the Company s nonvested option shares as of September 30, 2006 and changes during the nine months ended September 30, 2006 is presented in the table below (in thousands, except per share data):

	Number of Shares	Weighted Average Grant-Date Fair Value
Nonvested at December 31, 2005	206	$ 5.88
Granted	265	11.82
Vested	(121)	5.68
Cancelled	(4)	10.76
Nonvested at September 30, 2006	346	$ 10.44

As of September 30, 2006, there was $2,369,000 of total stock option compensation expense not yet recognized related to non-vested option awards, which is expected to be recognized over a weighted average period of 1.27 years.

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Other information pertaining to options is as follows:

Three Months Ended		Nine Months Ended	

	September 30, 2006	September 30, 2005	September 30, 2006	September 30, 2005
	(in thousands, except per share data)			
Number of options granted		18	265	314
Fair value of options granted	$	$ 224	$ 3,132	$ 1,978
Per share weighted average fair value of options granted	$	$ 12.44	$ 11.82	$ 6.31
Total fair value of stock options vested	$ 105	$ 162	$ 679	$ 891
Total intrinsic value of stock options exercised	$ 775	$ 817	$ 3,963	$ 2,734

Cash received from the exercise of stock options was $1,450,000 and $997,000 for the nine months ended September 30, 2006 and 2005, respectively. The income tax benefit realized from the exercise of stock options was $1,283,000 and $467,000 for the nine months ended September 30, 2006 and 2005, respectively.

Performance Shares:

During the three months ended September 30, 2006, the Company granted 16,967 performance shares to certain managerial and executive employees under the Stock Option Plan. The issuance of shares of the Company s common stock for the performance shares is contingent on the Company s achievement of revenue and operating income performance goals established for fiscal year 2008. If the performance goals are not achieved during the performance period, all performance shares will be canceled and the employees will receive no common stock for the canceled performance shares. An employee must also remain employed by the Company as of the end of the performance period to be eligible to receive common stock for the performance shares. During the period, 283 performance shares were canceled, leaving 16,684 outstanding performance shares as of September 30, 2006.

The valuation of the performance shares was based on the closing market price of the Company s common stock on the date of grant of $21.152, resulting in a total valuation of $359,000. Stock-based compensation expense charged against pre-tax income totaled $5,000 for the three and nine months ended September 30, 2006. Total stock-based compensation expense not yet recognized related to performance shares as of September 30, 2006 totaled $308,000, which is expected to be recognized over a weighted average period of 2.21 years, assuming the Company s achievement of the established performance goals for fiscal year 2008.

Results of operations for periods prior to 2006 have not been restated to reflect recognition of stock-based compensation expense. Had compensation costs for the Company s stock-based compensation been determined based on the fair value of the awards on the date of grant, consistent with the provisions of SFAS No. 123, the Company s net income and basic and diluted earnings per share for

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the three and nine months ended September 30, 2005 would have been adjusted to the proforma amounts stated in the following table (in thousands, except for per share data):

	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2005
Net income:		
As reported	$ 4,085	$ 9,064
Stock-based employee compensation, net of tax	(416)	(977)
Proforma	$ 3,669	$ 8,087

Basic net income per share:				
As reported	$	0.43	$	0.95
Stock-based employee compensation, net of tax		(0.05)		(0.10)
Proforma	$	0.38	$	0.85
Diluted net income per share:				
As reported	$	0.39	$	0.88
Stock-based employee compensation, net of tax		(0.03)		(0.08)
Proforma	$	0.36	$	0.80

(3) Marketable Securities

Marketable securities consist primarily of municipal securities, U.S. government agency securities and commercial paper with long-term credit ratings of AAA and short-term credit ratings of A-1. Marketable securities are classified as short-term or long-term in the balance sheet based on their effective maturity date. All marketable securities have maturities ranging from three to 36 months and are classified as available-for-sale. Available-for-sale securities are recorded at fair value and any unrealized holding gains and losses, net of the related tax effect, are excluded from earnings and are reported as a separate component of accumulated other comprehensive income (loss) until realized.

(4) Inventories

Inventories consisted of the following (in thousands):

		September 30, 2006		December 31, 2005
Finished goods and demonstration equipment	$	1,281	$	1,562
Work-in-process				290
Purchased parts and subassemblies		5,215		4,769
	$	6,496	$	6,621

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(5) Comprehensive Income

Comprehensive income consists of the Company s net income, foreign currency translation adjustments and unrealized holding gains (losses) from available for sale investments. The components of and changes in other comprehensive income (loss) are as follows (in

thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Net income	$ 4,441	$ 4,085	$ 9,459	$ 9,064
Other comprehensive income (loss):				
Net changes in:				
Foreign currency translation adjustments	37	(12)	184	(273)
Net unrealized gains on marketable securities	100	37	75	50
Total other comprehensive income	$ 4,578	$ 4,110	$ 9,718	$ 8,841

(6) Foreign Currency Contracts

The Company enters into forward foreign exchange contracts to hedge intercompany receivables denominated in Euros arising from sales to its subsidiary in Germany. Gains or losses on forward foreign exchange contracts are calculated at each period end and are recognized in net income in the period in which they arose. The fair value of forward foreign exchange contracts is recorded in other current assets or other current liabilities depending on whether the net amount is a gain or a loss.

As of September 30, 2006, the Company had seventeen outstanding foreign currency contracts totaling $3,573,000. These contracts mature in 2006 and early 2007 and bear rates ranging from 1.2516 to 1.29 U.S. Dollars per Euro. As of September 30, 2006, the fair value of foreign currency contracts is a net gain position of $21,000, recorded in other current assets.

As of December 31, 2005, the Company had twenty three outstanding foreign currency contracts totaling $4,578,000, all maturing during 2006 at rates ranging from 1.1724 to 1.2155 U.S. Dollars per Euro. As of December 31, 2005, the fair value of foreign currency contracts was a net gain position of $25,000, recorded in other current assets.

(7) Recently Issued Accounting Standards

In June 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109. This interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes. This interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. It also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and

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transition. This Interpretation is effective for the Company beginning in fiscal year 2007. The Company is currently evaluating the impact of adopting this pronouncement on its consolidated financial statements and related disclosures.

In September 2006, the FASB issued Statement of Financial Accounting Standard (SFAS) No. 157, Fair Value Measurements. SFAS No. 157 establishes a single authoritative definition of fair value, sets out a framework for measuring fair value and requires additional disclosures about fair-value measurements. This Statement applies only to fair-value measurements that are already required or permitted by other accounting standards, except for measurements of share-based payments and measurements that are similar to, but not intended to be, fair value. This statement is expected to increase the consistency of fair value measurements, but imposes no requirements for additional fair-value measures in financial statements. The provisions under SFAS No. 157 are effective for the Company beginning

January 1, 2008, and are expected to be applied prospectively. The Company is currently evaluating the impact of adopting this pronouncement on its consolidated financial statements and related disclosures.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin (SAB) No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements. SAB 108 addresses how the effects of prior year uncorrected misstatements should be considered when quantifying misstatements in current year financial statements. SAB 108 requires registrants to quantify misstatements using both the balance sheet and income statement approaches and to evaluate whether either approach results in quantifying an error that is material in light of relevant quantitative and qualitative factors. When the effect of initial adoption is determined to be material, SAB 108 allows registrants to record that effect as a one-time cumulative-effect adjustment to beginning-of-year retained earnings. The requirements under the SAB are effective for the Company for its 2006 annual financial statements. The Company is currently evaluating the impact of adopting SAB 108 on its consolidated financial statements.

(8) Warranty Reserve

The warranty reserve rollforward, including provisions and claims, is as follows:

Nine Months Ended:	Beginning Balance	Warranty Provisions	Warranty Claims	Foreign Exchange Impact	Ending Balance
September 30, 2006	$ 317	551	(525)	8	$ 351
September 30, 2005	$ 187	699	(583)	(6)	$ 297

(9) Computation of Net Income Per Share of Common Stock

Basic net income per common share is determined by dividing net income by the weighted average number of shares of common stock outstanding. Diluted net income per common share includes the potentially dilutive effect of common shares issued in connection with outstanding stock options using the treasury stock method. Options to acquire 290,000 and 157,000 weighted average common shares have been excluded from the computation of diluted weighted average shares outstanding for the three

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and nine months ended September 30, 2006, respectively, as their effect is anti-dilutive. Similarly, options to acquire less than 1,000 and 4,000 weighted average common shares were excluded from the computation of diluted weighted average shares outstanding for the three and nine months ended September 30, 2005, respectively, as their effect was anti-dilutive. The following is a summary of the weighted average common shares outstanding and diluted potential common shares (in thousands, except for per share data):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Shares outstanding at end of period	9,881	9,580	9,881	9,580
Weighted average shares outstanding	9,854	9,553	9,783	9,507

Weighted average potential common shares	521	827	553	743
Total diluted weighted average shares outstanding	10,375	10,380	10,336	10,250
Net income	$ 4,441	$ 4,085	$ 9,459	$ 9,064
Basic net income per common share	$ 0.45	$ 0.43	$ 0.97	$ 0.95
Diluted net income per common share	$ 0.43	$ 0.39	$ 0.92	$ 0.88

(10) Contingencies

The Company is exposed to a number of asserted and unasserted claims encountered in the normal course of business. In the opinion of management, the resolution of these matters will not have a material adverse effect on the Company s financial position or results of operations.

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Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

The following table sets forth, for the periods indicated, selected items from the Company s consolidated statements of income.

	Percentage (%) of Revenues Three Months Ended September 30,		Percentage (%) Increase/(Decrease) Between Periods	Percentage (%) of Revenues Nine Months Ended September 30,		Percentage (%) Increase/(Decrease) Between Periods
	2006	**2005**	**2006 vs. 2005**	**2006**	**2005**	**2006 vs. 2005**
Revenues	**100**	100	(11)	**100**	100	2
Cost of revenues	**(51)**	(52)	(14)	**(54)**	(54)	2
Gross profit	**49**	48	(8)	**46**	46	3
Operating expenses:						
Research and development	**(6)**	(5)	4	**(7)**	(6)	14
Selling, general and admin	**(20)**	(21)	(15)	**(22)**	(21)	7
Operating income	**23**	22	(5)	**17**	19	(5)
Other income, net	**3**	1	105	**3**	1	123
Income before income taxes	**26**	23	1	**20**	20	3
Income tax expense	**(8)**	(8)	(11)	**(7)**	(7)	
Net income	**18**	15	9	**13**	13	4

Overview

Rimage develops, manufactures and distributes CD-Recordable (CD-R) and DVD-Recordable (DVD-R) publishing and duplication systems from its operations in the United States, Germany and Japan. These systems allow customers to benefit from cost savings by reducing their manual labor efforts in industries such as photography, medical, banking and government. Rimage anticipates increased future sales and marketing expenditures as a result of increased resources focused on developing these markets. As Rimage s sales within North America and Europe have averaged 94% of total sales over the past three years, the strength of the economies in each of these regions plays an important role in determining the success of Rimage.

Rimage earns revenues through the sale of equipment, consumables (ribbons, ink cartridges, media kits and Rimage-branded blank CD-R and DVD-R media), maintenance contracts, parts and repair services. Rimage s recurring revenues (consumables, maintenance contracts, parts and service) comprised approximately 46% and 37% of consolidated revenues during the nine months ended September 30, 2006 and 2005, respectively. Exclusive of a small amount of capital lease obligations, Rimage has no long-term debt and does not require significant capital investments as all fabrication of its products is outsourced to vendors.

Stock-Based Compensation

The Company implemented the provisions of Statement of Financial Accounting Standard (SFAS) No. 123R, Share-Based Payment effective January 1, 2006, using the modified prospective method, and therefore has not restated prior periods results. Prior to the adoption of SFAS 123R, the Company followed the intrinsic value method in accordance with Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees to account for the issuance

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Management s Discussion and Analysis of Financial Condition and Results of Operations (Continued)

of stock incentives to employees and directors. Accordingly, no compensation expense was recognized for equity compensation awards granted with no intrinsic value and the proforma disclosures required by SFAS 123 were presented in the notes to the Company s consolidated financial statements.

As a result of the adoption of SFAS 123R, the Company s income before taxes as reported in the Consolidated Statements of Income for the three and nine months ended September 30, 2006, was $0.6 million and $1.2 million lower, respectively, than under the previous accounting method for stock-based compensation. In addition, basic net income per share for the three and nine months ended September 30, 2006 was $.04 and $.09 lower, respectively, and diluted net income per share was $.04 and $.08 lower, respectively, than under the previous accounting method. SFAS 123R also requires that the benefits of tax deductions in excess of recognized compensation expense be reported as a component of cash flows from financing activities in the Consolidated Statements of Cash Flows. This change increased cash flows provided by financing activities by $1.0 million and reduced cash flows provided by operating activities by the same amount during the nine months ended September 30, 2006. Compensation cost not yet recognized as of September 30, 2006 related to nonvested awards totaled $2.4 million, which is expected to be recognized over a weighted average period of 1.27 years.

Results of Operations

Revenues. Revenues decreased 11% to $24.8 million and increased 2% to $72.7 million for the three and nine months ended September 30, 2006, respectively, from $28.0 million and $71.1 million for the respective prior-year periods. Revenues for the both the quarterly and year-to-date periods were impacted by a decrease in the volume of sales of Producer product line equipment of $4.3 million and $5.1 million, respectively. Driving the decline in Producer product line sales was the shipment in the prior year s third quarter of a $6.0 million Producer equipment order related to the Company s product rollout into the U.S. retail market. The volume of recurring revenues, consisting of sales of media kits, blank CD-R and DVD-R media, printer ribbons, ink cartridges, parts and maintenance contracts, increased $1.5 million and $6.9 million for the three and nine months ended September 30, 2006, respectively, offsetting the year-to-date decline in Producer product equipment sales. The strong growth in recurring revenues was primarily due to the continued expansion of the Company s worldwide installed base of CD-R and DVD-R publishing systems, and the Company s increased emphasis on promoting this portion of its business. Sales of desktop product line equipment decreased $0.3 million and $0.2 million in the third quarter and year-to-date periods in 2006, respectively, impacted by a stronger volume of sales in the prior year periods of the Rimage 360i desktop product, released in April 2005.

International sales decreased 9% for the third quarter and increased 4% for the year-to-date period compared to the same prior year periods. The third quarter reduction in international sales was impacted primarily by lower sales in Latin America, due to stronger than normal sales in the

prior year s third quarter. International sales comprised 29% and 33% of total sales for the three and nine months ended September 30, 2006, respectively, compared with 28% and 33% for the same periods in the prior year. The European market continued to generate the majority of international sales. Sales in Asian markets continue to increase, reflecting increased sales efforts in this region

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Management s Discussion and Analysis of Financial Condition and Results of Operations (Continued)

with the establishment of a subsidiary operation in Japan in 2005. Currency fluctuations affecting the Company s European and Japanese operations increased reported consolidated revenues for the three months ended September 30, 2006 by 1%, and decreased reported consolidated revenues for the nine months ended September 30, 2006 by less than 1%.

As of and for the nine months ended September 30, 2006, foreign revenues from unaffiliated customers generated by the Company s German and Japanese operations and the operating income and net identifiable assets of such operations were $20.9 million, $0.3 million and $7.5 million, respectively. These amounts related primarily to the Company s German operations, as the establishment of subsidiary operations in Japan occurred in June 2005. Comparable amounts for the Company s German and Japanese operations as of and for the nine months ended September 30, 2005 were revenues of $19.3 million, operating income of $0.6 million and net identifiable assets of $6.9 million. The growth in revenues and assets is due to increasing penetration in foreign markets of sales of CD-R and DVD-R products.

The Company is estimating that fourth quarter 2006 consolidated revenues will range between $23 million and $25 million.

Gross profit. Gross profit as a percentage of revenues was 49% and 46% for the three and nine months ended September 30, 2006, respectively, compared to 48% and 46% for the respective prior year periods. The volume and concentration of Producer product line equipment sales, which generally carry higher margins than desktop product line equipment or recurring revenues, decreased during the three and nine months ended September 30, 2006, due primarily to the impact of the large shipment of Producer product line equipment into the U.S. retail market during the third quarter of 2005. Producer product line equipment sales comprised 46% and 44% of total sales for the three and nine months ended September 30, 2006, compared to 56% and 52% in the same prior year periods. The volume and concentration of recurring revenues, which generally carry lower margins than equipment sales, increased during the current year periods, comprising 45% and 46% of total revenues for the three and nine months ended September 30, 2006, compared to 35% and 37% in the same prior year periods. In spite of the described changes in product mix, the third quarter gross margin improved by one percentage point relative to the same prior year period as a result of the benefit of reduced manufacturing overhead costs and improved service related margins. Additionally, equipment revenues in the current year s third quarter were more concentrated in higher margin transactions, some of which were impacted by higher average selling prices for some Producer equipment configurations. The third quarter change in revenue mix and higher average selling prices for Producer product line equipment also favorably impacted gross profit as a percentage of revenues for the year-to-date period. Offsetting this benefit was the impact of increased manufacturing and service labor and overhead costs for the year-to-date period stemming from increased investments in these areas to support an expected continued growth in total sales. Stock-based compensation expense included in cost of revenue for the three and nine months ended September 30, 2006 had a minimal impact on gross profit as a percentage of revenues, and amounted to $25,000 and $57,000, respectively.

Future gross profit margins will continue to be affected by many factors, including product mix, the timing of new product introductions, changes in material costs, manufacturing volume, the rate of

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Management s Discussion and Analysis of Financial Condition and Results of Operations (Continued)

growth of service related revenues relative to associated service support costs, foreign currency exchange rate fluctuations and levels of sales returns.

Operating expenses. Research and development expenses totaled $1.5 million and $4.8 million for the three and nine months ended September 30, 2006, respectively, representing approximately 6% and 7% of revenues, respectively. Expenses for the same prior year periods totaled $1.4 million and $4.2 million, representing 5% and 6% of revenues, respectively. The 4% and 14% respective increases in expenses for the three and nine months ended September 30, 2006 were primarily due to continued development of new products and enhancements to existing products. Research and development expenses for the three and nine months ended September 30, 2006 were minimally impacted by stock-based compensation expense of $41,000 and $122,000, respectively.

Rimage anticipates continued expenditures in research and development in 2006 to support new product development initiatives and to improve existing products.

Selling, general and administrative expenses for the three and nine months ended September 30, 2006 were 20% and 22% of revenues at $5.0 million and $16.1 million, respectively, compared to expenses in the same prior year periods at 21% of revenues, or $5.9 million and $15.1 million, respectively.

The net changes in selling, general and administrative expenses for the three and nine months ended September 30, 2006 reflect sales and marketing expenses decreasing $0.5 million and $0.7 million, respectively, and general and administrative expenses declining $0.4 million in the third quarter and increasing $1.7 million in the year-to-date period, respectively. The decline in sales and marketing expenses is primarily the result of reduced costs for advertising and promotional activities due to implementation of programs in the prior year s second quarter to support the launch of the Rimage 360i desktop product, and a reduction in cooperative marketing program costs resulting from the Company s transition to an alternative program format with its distributors. The decrease in general and administrative expenses in the quarterly period resulted from $1.1 million of consulting expenses incurred in the prior year s third quarter for the initiation of a strategic analysis of the Company s operations. The strategic analysis continued into and was completed during the first quarter 2006, and $1.2 million of expenses incurred in the first quarter are reflected in year-to-date expenses. Partially offsetting the impact of the reduction in consulting expenses during the three months ended September 30, 2006, and contributing to the growth in year-to-date expenses were $0.3 million and $0.8 million of expenses incurred during the respective periods to support the implementation of a new enterprise resource planning system. Also contributing to the growth in general and administrative expenses for both current year periods were stock-based compensation expenses. Such expenses increased aggregate selling, general and administrative expenses by $0.6 million and $1.0 million for the three and nine months ended September 30, 2006, respectively.

Other income, net. The Company recognized net interest income on cash investments of $0.7 million and $2.0 million for the three and nine months ended September 30, 2006, compared to $0.4 million and $1.0 million for the same prior year periods. The increase in the quarterly and year-to-date periods was due to a $13 million increase in both periods in average cash equivalent and marketable securities balances and an increase in effective yields.

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Management s Discussion and Analysis of Financial Condition and Results of Operations (Continued)

Income taxes. The provision for income taxes represents federal, state and foreign income taxes on income. Income tax expense for the three and nine months ended September 30, 2006 amounted to $2.1 million and $5.2 million, or 31.8% and 35.5% of income before taxes, respectively. Income tax expense for the three and nine months ended September 30, 2005 was $2.3 million and $5.2 million, or 36.3% and 36.5% of income before taxes, respectively. The decrease in the effective tax rates for the three and nine months ended September 30, 2006 primarily reflects the benefit of increased tax-exempt interest income, including the impact of out-of-period tax adjustments for such interest income approximating $0.2 million, and reductions in the tax contingency reserve for the elimination of exposure items included in prior years tax reserves. The Company anticipates its effective tax rate will range between 36% and 37% for the full year 2006.

Net income / net income per share. Resulting net income for the three and nine months ended September 30, 2006 was $4.4 million, or 18% of revenues, and $9.5 million, or 13% of revenues, respectively. Comparable amounts for the three and nine months ended September 30, 2005 were net income of $4.1 million, or 15% of revenues, and $9.1 million, or 13% of revenues, respectively. Related net income per diluted share amounts for the three and nine months ended September 30, 2006 were $0.43 and $0.92, respectively, compared to $0.39 and $0.88 per diluted share for the respective prior year periods. The Company expects fourth quarter 2006 net income to range from $0.23 to $0.28 per diluted share.

Liquidity and Capital Resources

The Company expects it will be able to maintain current operations, including anticipated capital expenditure requirements, through its internally generated funds and, if required, from Rimage s existing credit agreement. This credit agreement allows for advances under an unsecured

revolving loan up to a maximum advance of $10 million. At September 30, 2006, no amounts were outstanding under the credit agreement.

At September 30, 2006, the Company had working capital of $61.3 million, a decrease of $12.7 million from working capital reported at December 31, 2005. The decline was primarily impacted by the purchase of $25.1 million of non-current marketable securities and capital expenditures of $2.5 million, partially offset by year-to-date net income of $9.5 million and proceeds from employee stock plans of $1.8 million. The Company intends on utilizing its current assets primarily for its continued organic growth. To help strengthen the Company s ability to manage anticipated future growth, the Company expects to invest approximately $4 million in 2006 and early 2007 for the implementation of an enterprise resource planning system in its U.S. and German operations. Additionally, the Company may use its available cash for potential future strategic initiatives or alliances.

Net cash provided by operating activities totaled $8.2 million for the nine months ended September 30, 2006, compared to $9.2 million in the same prior year period. The $1.0 million decrease in cash generated from operations was primarily impacted by a $1.8 million increase in net income adjusted for non-cash items, offset by a $1.8 million larger use of cash from changes in operating assets and liabilities and the impact of a $1.0 million non-cash reduction in operating cash flows associated with excess tax benefits recognized as an addition to the APIC (additional paid-in capital) pool

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Management s Discussion and Analysis of Financial Condition and Results of Operations (Continued)

under SFAS 123R. SFAS 123R requires such amounts to be reported as an addition to financing activities and a reduction in operating activities in the Statements of Cash Flows. Primarily contributing to the change in operating assets and liabilities compared to the prior year s year-to-date period was a $4.5 million variation in the change in accounts payable, accrued compensation and accrued expenses, partially offset by a $2.4 million smaller increase in accounts receivable. The change in accounts payable, accrued compensation and accrued expenses resulted from a $2.7 million reduction in these accounts in the current year s period, compared to a $1.8 million increase in the prior year s period. The current period reductions in the accounts payable and accrued expense accounts were impacted by the payment of $1.8 million of consulting fees accrued at December 31, 2005, and the timing of payroll and vendor payments. Additionally, accounts payable at September 30, 2005 included an accrual for $1.1 million of consulting fees incurred in the third quarter 2005. The smaller increase in accounts receivable in the current year s period was impacted by a $3.2 million reduction in revenue in the third quarter 2006 relative to the prior year s third quarter.

Investing activities resulted in a small net use of cash of $0.03 million for the nine months ended September 30, 2006, and provided a net increase in cash of $6.1 million for the same prior year period. The decrease in cash from investing activities relative to the prior year s period was the result of a $5.0 million increase in purchases of marketable securities, net of related maturities of marketable securities, and a $1.3 million increase in capital expenditures. Capital expenditures for the nine months ended September 30, 2006 totaled $2.5 million, and consisted primarily of costs capitalized as part of the implementation of an enterprise resource planning system and purchases of furniture and leasehold improvements for a new leased facility for the Company s operations in Germany. Costs capitalized during the year-to-date period for the enterprise resource planning system amounted to $1.6 million, and consisted of system software, hardware and software development costs required to be capitalized under Statement of Position 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use.

Net cash provided by financing activities totaled $2.8 million and $1.3 million for the nine months ended September 30, 2006 and 2005, respectively. Financing activities in each period included proceeds from stock option exercises and purchases under the Company s Employee Stock Purchase Plan of $1.8 million and $1.3 million, respectively. Additionally, the current year period includes $1.0 million associated with excess tax benefits recognized as an addition to the APIC pool, which as discussed above, are required to be reported as an addition to financing activities in the Statements of Cash Flows under the provisions of SFAS 123R.

Critical Accounting Policies.

Management utilizes its technical knowledge, cumulative business experience, judgment and other factors in the selection and application of the Company s accounting policies. The accounting policies described below are considered by management to be the most critical to the presentation of the consolidated financial statements because they require the most difficult, subjective and complex judgments. Given the implementation effective January 1, 2006 of SFAS 123R, Share-Based Payment, in the second quarter 2006 the Company added a new critical accounting policy for its accounting for stock-based compensation, discussed below. Management made no changes to the Company s critical accounting policies during the third quarter 2006.

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Management s Discussion and Analysis of Financial Condition and Results of Operations (Continued)

In applying the critical accounting policies described below, management reassesses its estimates each reporting period based on available information. Changes in such estimates did not have a significant impact on earnings for the three and nine months ended September 30, 2006.

Revenue Recognition. Revenue for product sales (including hardware and consumables), which do not include any requirement for installation or training, is recognized on shipment, at which point the following criteria of SAB Topic 13(A)(1) have been satisfied:

- Persuasive evidence of an arrangement exists. Orders are received for all sales and sales invoices are mailed on shipment.
- Delivery has occurred. Product has been transferred to the customer or the customer s designated delivery agent, at which time title and risk of loss transfers.
- The vendor s price is fixed or determinable. All sales prices are fixed at the time of the sale (shipment).
- Collectibility is probable. All sales are made on the basis that collection is expected in line with the Company s standard payment terms, which are consistent with industry practice in the geographies in which the Company markets its products.

A standard product sale by the Company does not require a commitment on the Company s part to provide installation, set-up or training. When such services are requested, value-added resellers generally arrange and perform the service directly with the customer, with no financial interest or obligation on the part of the Company. In the limited situations in which the Company does provide installation or training services for customers, the Company charges separately for the service based upon its published list prices, and recognizes the associated service revenue upon the successful completion of the service.

The Company records a reserve for sales returns from its customers. The amount of the reserve is based upon historical trends, timing of new product introductions and other factors. A return policy is in place with the Company s distributors to restrict the volume of returned products, and the Company reviews the distributor s inventory to insure compliance with the return policy.

Revenue for maintenance agreements is recognized on a straight-line basis over the life of the contracts (commencing once the period covered by standard warranty expires).

Emerging Issues Task Force (EITF) Issue No. 00-21, Revenue Arrangements with Multiple Deliverables provides revenue recognition guidance for arrangements with multiple deliverables, and the criteria to determine if items in a multiple deliverable agreement should be accounted for separately. The elements of the Company s sales transactions are clearly and separately stated and sufficient evidence of their fair value exists to separately account for the elements.

Allowance For Doubtful Accounts And Sales Returns. The Company records a reserve for accounts receivable that are potentially uncollectible. The reserve is established based on a specific assessment of accounts with known collection exposure, based upon a review of the age of the receivable, the customer s payment history, the customer s financial condition and industry and general economic conditions, as well as a general assessment of collection exposure in the remaining receivable population based upon bad debt history. Actual bad debt exposure could differ

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Management s Discussion and Analysis of Financial Condition and Results of Operations (Continued)

significantly from management s estimates if economic conditions worsened for the Company s customers. As described above under Revenue Recognition, the Company also records a reserve for sales returns from its customers. The amount of the reserve is based upon historical trends, timing of new product introductions and other factors.

Inventory Reserves. The Company records reserves for inventory shrinkage and for potentially excess, obsolete and slow moving inventory. The amounts of these reserves are based upon historical loss trends, inventory levels, expected product lives and forecasted sales demand. Results could be materially different if demand for the Company s products decreased because of economic or competitive conditions, or if products became obsolete because of technical advancements in the industry or by the Company.

Deferred Tax Assets. The Company recognizes deferred tax assets for the expected future tax impact of temporary differences between book and taxable income. A valuation allowance and income tax charge are recorded when, in management s judgment, realization of a specific deferred tax asset is uncertain. Income tax expense could be materially different from actual results because of changes in management s expectations regarding future taxable income, the relationship between book and taxable income and tax planning strategies employed by the Company.

Warranty Reserves. The Company s non-consumable products are warranted to the end-user to ensure end-user confidence in design, workmanship and overall quality. Warranty lengths vary by product type, ranging from periods of six to twelve months. Warranty covers parts, labor and other associated expenses. The Company performs the majority of warranty work, while authorized distributors and dealers also perform some warranty work. The Company records a liability for warranty claims at the time of sale. The amount of the liability is based on an analysis of historical claims experience, which includes labor, parts and freight costs and consideration of the proportion of parts that can be re-used. Also considered are the anticipated impact of product improvements, releases of new products and other factors. Claims experience could be materially different from actual results because of the introduction of new, more complex products; a change in the Company s warranty policy in response to industry trends, competition or other external forces; or manufacturing changes that could impact product quality.

Stock-Based Compensation. The Company implemented the fair value recognition provisions of SFAS No. 123R effective January 1, 2006 using the modified prospective method. Under this method, the Company recognizes compensation expense for all stock-based awards granted on or after January 1, 2006, and for previously granted awards not yet vested as of January 1, 2006.

The Company utilizes a Black-Scholes option pricing model to estimate the fair value of each award on the date of grant. The Black-Scholes model requires the input of certain assumptions that involve management judgment. Key assumptions that affect the calculation of fair value include the expected life of stock-based awards and the Company s stock price volatility. Additionally, the Company is required to estimate the expected forfeiture rate of unvested awards and recognize expense for only those shares expected to vest. The assumptions used in calculating the fair value of stock-based awards and the forfeiture rate of such awards reflect management s best estimates. However, circumstances may change and additional data may become available over time, which could result in changes to these assumptions that materially impact the fair value determination of

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Management s Discussion and Analysis of Financial Condition and Results of Operations (Continued)

future awards or their estimated rate of forfeiture. If factors change and the Company uses different assumptions in the application of SFAS 123R in future periods, the compensation expense recorded under SFAS 123R may differ significantly from the expense recorded in the current period. See Note 2 under the Notes to Condensed Consolidated Financial Statements in this Form 10Q for additional information on stock-based compensation.

Recently Issued Accounting Standards

In June 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109. This interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes. This interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. It also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. This Interpretation is effective for the Company beginning in fiscal year 2007. The Company is currently evaluating the impact of adopting this pronouncement on its consolidated financial statements and related disclosures.

In September 2006, the FASB issued Statement of Financial Accounting Standard (SFAS) No. 157, Fair Value Measurements. SFAS No. 157 establishes a single authoritative definition of fair value, sets out a framework for measuring fair value and requires additional disclosures about fair-value measurements. This Statement applies only to fair-value measurements that are already required or permitted by other accounting standards, except for measurements of share-based payments and measurements that are similar to, but not intended to be, fair value. This

statement is expected to increase the consistency of fair value measurements, but imposes no requirements for additional fair-value measures in financial statements. The provisions under SFAS No. 157 are effective for the Company beginning January 1, 2008, and are expected to be applied prospectively. The Company is currently evaluating the impact of adopting this pronouncement on its consolidated financial statements and related disclosures.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin (SAB) No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements. SAB 108 addresses how the effects of prior year uncorrected misstatements should be considered when quantifying misstatements in current year financial statements. SAB 108 requires registrants to quantify misstatements using both the balance sheet and income statement approaches and to evaluate whether either approach results in quantifying an error that is material in light of relevant quantitative and qualitative factors. When the effect of initial adoption is determined to be material, SAB 108 allows registrants to record that effect as a one-time cumulative-effect adjustment to beginning-of-year retained earnings. The requirements under the SAB are effective for the Company for its 2006 annual financial statements. The Company is currently evaluating the impact of adopting SAB 108 on its consolidated financial statements.

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Management s Discussion and Analysis of Financial Condition and Results of Operations (Continued)

Cautionary Note Regarding Forward-Looking Statements

This report contains forward-looking statements that involve risks and uncertainties. For this purpose, any statements contained in this report that are not statements of historical fact may be deemed to be forward-looking statements. Without limiting the foregoing, words such as may, will, expect, believe, anticipate, estimate or continue or comparable terminology are intended to identify forward-looking statements statements by their nature involve substantial risks and uncertainties. The Company s actual results could differ significantly from those discussed in the forward-looking statements.

Factors that could cause or contribute to such differences include, but are not limited to, the following, as well as other factors not now identified: the Company s ability to keep pace with changes in technology in the computer and storage media industries as well as technology changes in the retail, medical, banking, government and office markets; increasing competition and the ability of the Company s products to successfully compete with products of competitors and newly developed media storage products; the ability of the Company s newly developed products to gain acceptance and compete against products in their markets, the significance of the Company s international operations and the risks associated with international operations including currency fluctuations, local economic health and management of these operations over long distances; the Company s ability to protect its intellectual property and to defend claims of others relating to its intellectual property; the Company s dependence upon the selling efforts of the Company s key channel partners; the Company s ability to maintain adequate inventory of products; the Company s reliance on single source suppliers; the ability of the Company s products to operate effectively with the computer products developed and to be developed by other manufacturers; the negative effect upon the Company s business from manufacturing or design defects; the effect of U.S. and international regulation, including the costs of implementing and complying with new regulations enacted in various countries requiring the reduction of hazardous substances in electrical and electronic equipment, including the European Union Waste Electrical and Electronic Equipment Directive and Restriction of Hazardous Substances Directive; fluctuations in the Company s operating results; the Company s dependence upon its key personnel; the volatility of the price of the Company s common stock; provisions governing the Company relating to a change of control, compliance with corporate governance and securities disclosures rules and other risks, including those set forth in the Company s reports filed with the Securities and Exchange Commission, including Item 1A of Part I of the Company s Annual Report on Form 10-K for the year ended December 31, 2005. These forward-looking statements are made as of the date of this report and the Company assumes no obligation to update such forward-looking statements, or to update the reasons why actual results could differ materially from those anticipated in such forward-looking statements.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

The Company is exposed to market risk from foreign exchange rate fluctuations of the European Euro and Japanese Yen to the U.S. dollar as the financial position and operating results of the Company s German and Japanese subsidiaries, Rimage Europe and Rimage Japan, respectively, are translated into U.S. dollars for consolidation. Resulting translation adjustments are recorded as a separate component of stockholders equity.

The Company enters into forward exchange contracts principally to hedge inter-company receivables denominated in Euros arising from sales to its subsidiary in Germany. Gains or losses on forward exchange contracts are calculated at each period end and are recognized in net income in the period in which they arose. The Company records the fair value of its open forward foreign exchange contracts in other current assets or

other current liabilities depending on whether the net amount is a gain or a loss. The Company does not utilize financial instruments for trading or other speculative purposes.

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Item 4. Controls and Procedures

(a) Evaluation of Disclosure Controls and Procedures

The Company s Chief Executive Officer, Bernard P. Aldrich, and the Company s Chief Financial Officer, Robert M. Wolf, have evaluated the Company s disclosure controls and procedures as of the end of the period covered by this report. Based upon such evaluation, they have concluded that these disclosure controls and procedures are effective.

(b) Changes in Internal Control Over Financial Reporting

There have been no changes in internal controls over financial reporting that occurred during the fiscal quarter covered by this report that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting**.**

PART II OTHER INFORMATION

Item 1. Legal Proceedings

Not Applicable.

Item 1A. Risk Factors

Not Applicable.

Item 2. Changes in Securities and Use of Proceeds

Not Applicable.

Item 3. Defaults Upon Senior Securities

Not Applicable.

Item 4. Submission of Matters to a Vote of Security Holders

Not Applicable.

Item 5. Other Information

Not Applicable

Item 6. Exhibits

(a) The following exhibits are included herein:

31.1 Certificate of Chief Executive Officer pursuant to Rules 13a-14 and 15d-14 of the Exchange Act.

31.2 Certificate of Chief Financial Officer pursuant to Rules 13a-14 and 15d-14 of the Exchange Act.

32 Certifications pursuant to 18 U.S.C. §1350.

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SIGNATURES

In accordance with the Exchange Act, the registrant has duly caused this report to be signed on its behalf by the undersigned thereto duly authorized.

RIMAGE CORPORATION
Registrant

Date: November 7, 2006	By: /s/ Bernard P. Aldrich
	Bernard P. Aldrich Director, Chief Executive Officer, and President (Principal Executive Officer)
Date: November 7, 2006	By: /s/ Robert M. Wolf
	Robert M. Wolf Chief Financial Officer (Principal Financial Officer) (Principal Accounting Officer)